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ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

2 COMMISSIONERS

3 MIKE GLEASON, Chairman
4 WILLIAM A. MUNDELL
5 JEFF HATCH-MILLER
6 KRISTIN K. MAYES
7 GARY PIERCE

8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA PUBLIC SERVICE COMPANY
10 FOR A HEARING TO DETERMINE THE
11 FAIR VALUE OF THE UTILITY PROPERTY
12 OF THE COMPANY FOR RATEMAKING
13 PURPOSES, TO FIX A JUST AND
14 REASONABLE RATE OF RETURN
15 THEREON, TO APPROVE RATE
16 SCHEDULES DESIGNED TO DEVELOP
17 SUCH RETURN

DOCKET NO. E-01345A-08-0172

Arizona Corporation Commission

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18 **POST-HEARING REPLY BRIEF**
19 **OF ARIZONA PUBLIC SERVICE COMPANY**

20 **(OCTOBER 8, 2008)**

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1 materialize when a relatively inexpensive means of significantly reducing the risk of
2 those ramifications exists?

3 **I. VIRTUALLY EVERY PARTY NOW AGREES THAT THE**
4 **COMMISSION HAS THE AUTHORITY TO GRANT INTERIM**
5 **RELIEF IN THIS INSTANCE.**

6 Except for RUCO, every single party to this docket now concedes that there is
7 no legal barrier to granting APS's request for interim rate relief under the
8 circumstances of this case. After discussing most of the same authorities cited by
9 APS regarding Commission authority to grant interim rate relief, Staff concedes that:

10 The plenary and exclusive Constitutional authority of the Commission
11 over rates would seem to necessarily encompass the ability to act to
12 prevent an emergency from occurring just as much as it encompasses
13 the ability to act to alleviate an emergency that is in the process of
14 occurring or has occurred.

15 Staff Brief at 8. Staff also acknowledges that the recent upheaval in the financial
16 community heightens the concerns about APS's precarious financial condition and
17 provides further support for a finding by the Commission that an "impending
18 emergency" warranting interim rate relief may exist in this instance:

19 [G]iven the gravity of the recent financial crisis, the Commission
20 certainly has the discretion to find that these circumstances create the
21 prospect of an impending emergency such that the granting of some
22 interim relief would [be] appropriate.

23 *Id.* at 2. As Staff explains further, "these circumstances [*i.e.*, the upheaval in the
24 financial markets] combined with the Company's unique situation could create the
25 type of urgency that could be used as the basis for some interim relief in this case."

26 *Id.* at 9. Indeed, whether termed an "emergency," an "impending emergency,"
"exigent circumstances," "urgent circumstances," "imminent threat of emergency," or
"impending crisis" – all of which terms are used by Staff – Staff correctly observes
that the Commission's authority to grant interim rate relief is broad enough to

1 encompass the facts giving rise to APS's current financial crisis if such facts are
2 accepted by the Commission. *Id.* at 7-11.

3 Thus, Staff joins APS, AECC, Arizona Investment Council ("AIC"), and
4 Mesquite Group – every other party in this proceeding except RUCO – in
5 acknowledging that the Commission has the authority under the circumstances in this
6 case to grant the interim rate relief requested by APS. Indeed, although Staff appears
7 to suggest that the existence of a current "actual emergency" has not been
8 demonstrated in this case, Staff correctly acknowledges that both the case law and the
9 1971 Attorney General opinion do not require the Commission to find the existence of
10 a current actual emergency in order to grant interim rate relief. *See id.* at 8 ("In other
11 words, the Commission should not have to step back and wait for an actual
12 emergency to occur prior to taking some action.").

13 RUCO alone continues to argue that the Commission's authority to grant
14 interim rate relief must be "narrowly construed" and that the definition of
15 "emergency" must be rigidly applied. RUCO's Post-Hearing Brief ("RUCO Brief")
16 at 4-5. The applicable legal authorities, however, say exactly the opposite. In fact,
17 RUCO's position not only misstates the law, but also fails to recognize the broad
18 scope of the Commission's authority to grant rate relief, whether on an interim or
19 permanent basis. For example, the Attorney General has stated that "the
20 Commission's powers are not limited to those expressly granted by the Constitution;
21 the Commission may exercise all powers necessary or essential in the performance of
22 its duties." *Op. Att'y Gen. 71-17* at 2-3. With specific reference to interim rate relief,
23 the Attorney General cited with approval cases from other jurisdictions holding that
24 the public utility commission "carries with it the incidental and implied power to
25 grant interim rate relief, if the facts warrant such summary relief," and further stated
26 that the "only valid generalization" on the issue of the Commission's authority to

1 grant interim rate relief is that the request for such relief must be “timely” made. *Id.*
2 at 7, 13. Similarly, Arizona courts have stated expressly that “[i]nterim rates are not
3 limited to emergency situations,” *Pueblo Del Sol Water Co. v. Ariz. Corp. Comm’n.*,
4 160 Ariz. 285, 287, 772 P.2d 1138, 1140 (App. 1988), and that the inability to obtain
5 permanent rate relief within a reasonable time is by itself grounds for interim relief,
6 *Ariz. Corp. Comm’n. v. Mountain States Tel. & Tel. Co.*, 71 Ariz. 404, 228 P.2d 749
7 (1951). Even the Commission’s own expression of its authority undermines RUCO’s
8 position: “We agree with Staff that our authority to determine emergencies is not
9 limited to specific, narrowly tailored facts, and that our ratemaking authority is
10 sufficiently broad to enable us to grant relief tailored to many different situations.”
11 Decision No. 68685 (May 5, 2006) at 23.

12 The infirmity of RUCO’s argument concerning the Commission’s authority to
13 grant interim rate relief is underscored by RUCO’s incorrect insistence that such relief
14 must be sparingly applied because it is somehow inconsistent with the requirement
15 that rates approved by the Commission ultimately be grounded in a finding of fair
16 value. *See* RUCO Brief at 5. This “fair value” argument ignores the nature and
17 purpose of an interim rate. As the Attorney General has stated, “the Corporation
18 Commission need not establish the fair value of the property of a public service
19 corporation prior to establishing interim rates.” *Op. Att’y Gen. 71-17* at 10. This is
20 so because interim rates will eventually become a part of a permanent rate increase or
21 be refunded to ratepayers with interest following a fair value determination made after
22 full examination of all relevant data in the permanent rate case. Indeed, the Attorney
23 General opined that it would be “ill-advised” for the Commission to make any fair
24 value determination at the time of granting an interim rate increase. *See id.* at 11.
25 And in any event, as explained in both APS’s Initial Post-Hearing Brief (“APS Brief”)
26 as well as Staff’s Brief, the nature of the Company’s request is such that a temporary

1 finding of fair value can easily be made on the evidence in the record. *See* APS Brief
2 at 12-13. Thus, there simply is no merit to the narrow position advanced by RUCO
3 regarding the circumstances under which the Commission may grant interim rate
4 relief.

5 There can be no real dispute, therefore, that the Commission has the authority
6 to grant interim rate relief in this instance irrespective of whether the Commission
7 finds that the circumstances give rise to an emergency, an impending emergency,
8 exigent circumstances, or some other characterization of the financial crisis that faces
9 APS and threatens to impose financing obstacles and huge additional financing costs
10 on APS and its customers. As the Attorney General stated more than 35 years ago:

11 [T]he Commission's broad and exclusive legislative power to choose
12 the modes by which it establishes rates . . . should be construed broadly
13 enough to permit the Commission to avail itself of concepts and
14 procedures which are devised from time to time to permit effective
utility regulation and to keep pace with constantly changing economic
and social concerns.

15 Op. Att'y Gen. 71-17 at 3 (internal quotation marks and citation omitted). This
16 statement (which is echoed in case law discussing the Commission's authority to
17 grant interim rates) stands for the proposition that interim rate relief is always
18 available to the Commission where, as here, financial difficulties and effective
19 ratemaking dictate that it be implemented. In the permanent rate case, the
20 Commission can and should deal with the circumstances that for the last five years
21 have kept APS on the precipice of a "junk" credit rating. In the meantime, the law is
22 clear that the Commission has the authority to use interim rates "to avert an
23 impending crisis" such as that now facing APS. Staff Brief at 8.

1 **II. THE TOTALITY OF THE EVIDENCE DEMONSTRATES A**
2 **SUBSTANTIAL RISK THAT APS WILL BE DOWNGRADED TO**
3 **JUNK STATUS ABSENT INTERIM RELIEF.**

4 Except for RUCO and possibly Staff, every party to this proceeding agrees that
5 APS currently faces a substantial risk of being downgraded to junk credit status, and
6 that, because Arizona's energy future is not worth such a gamble, the Commission
7 should grant the Company interim relief in order to prevent such an event from
8 occurring. Staff, while conceding that the evidence in the record supports a finding
9 that APS may indeed face an impending crisis that justifies interim rate relief (*see,*
10 *e.g.*, Staff Brief at 9, 11), also appears to posit, like RUCO, that the Commission
11 could nonetheless deny the Company's request because APS has not proven to a
12 **certainty** that it will be downgraded if interim rates are not granted. *See, e.g.*, Staff
13 Brief at 9; RUCO Brief at 2. It would, of course, be virtually impossible for the
14 Company to prove to an absolute certainty that **any** future event will occur absent
15 interim relief. But the evidence is clear that the Company and this Commission can
16 take certain, proactive measures to substantially reduce the risk of a downgrade
17 occurring before irreversible harm is done and the opportunity to prevent that harm
18 has slipped away.

18 While acknowledging that APS faces a risk of downgrade, Staff and RUCO
19 nonetheless argue that the risk is not as great as the Company suggests for what
20 amount to essentially three reasons: (1) APS relies too heavily on its downward
21 trending FFO/Debt financial metrics (which fall to 15.8 percent in 2009 absent
22 interim relief), and, as Staff interprets agency reports, an FFO/Debt ratio of 18 percent
23 is no longer the applicable threshold into junk grade for APS in any case, *see* Staff
24 Brief at 18-23; RUCO Brief at 7; (2) published reports from the rating agencies are
25 the only reliable evidence in the record regarding the likelihood of downgrade, and –
26 in Staff's consultants' lay interpretations – those reports do not expressly state that

1 APS is at risk of a downgrade absent interim relief, *see* Staff Brief at 23-29; RUCO
2 Brief at 7-8; and (3) future economic and regulatory conditions **might** somehow
3 improve such that APS could resolve its financial difficulties by alternatives other
4 than interim rates, *see* Staff Brief at 31-36. But each of these arguments is unavailing,
5 based on flawed analyses and an insistence that the Commission disregard the entirety
6 of the evidence in the record and focus exclusively instead on Staff's and RUCO's
7 own interpretations of published credit ratings agency material.

8 **A. The Evidence Is Clear That APS Must Be Able to Maintain an**
9 **FFO/Debt Ratio of Above 18 Percent in Order to Maintain Its**
10 **Current BBB- Credit Rating.**

11 Both Staff and RUCO acknowledge that the end goal for APS should **not** be
12 for the Company to teeter on the brink of junk status, as it currently does, but rather
13 for APS to secure a credit rating that is as far from non-investment grade as possible.
14 *See* Parcell Testimony at 979:17-980:7; Ahearn Testimony at 1063:22-1064:16. Staff
15 also acknowledges that even the slightest "blip" in conditions outside of the
16 Company's control could cause APS's financial metrics to fall below investment
17 grade levels. *See* Staff Brief at 18, 27. Nevertheless, relying solely on their own
18 interpretations of published credit rating agency decisions and pure speculation as to
19 how rating agencies are likely to react to various hypothetical conditions, Staff and
20 RUCO assert that APS focuses too strongly on its declining FFO/Debt ratio in
21 assessing the risk of downgrade, and suggest that it is at best unclear as to whether the
22 downward trend of that key credit metric below the 18 percent level will result in a
23 downgrade to junk status. *See, e.g.,* Staff Brief at 22, 27; RUCO Brief at 507.

24 As an initial matter, even if Staff and RUCO are correct and the published
25 materials themselves are unclear as to whether or not an 18 percent threshold for
26 BBB- credit status applies (which they are not), it is illogical to suggest that the

1 Commission should resolve any such lack of clarity **against** interim relief by
2 assuming that a downgrade will **not** occur, when the acknowledged goal is ultimately
3 to restore APS's financial health and raise its current credit position to levels above
4 the Company's current BBB- ("one notch above junk") credit grade. Indeed, it makes
5 little sense to resolve **any** uncertainties in this case in a manner that risks further
6 damaging APS's financial strength such that the Company will not be able to make
7 the investments necessary to support Arizona's energy future. *See* Post Testimony,
8 710:10-711:5.

9 That policy matter aside, the evidence in the record – both documentary and
10 otherwise – makes plain that Staff and RUCO are simply wrong, and that APS must
11 be able to achieve and sustain an FFO/Debt ratio of at least 18 percent in order to
12 maintain its current BBB- credit rating. As discussed in Mr. Brandt's Rebuttal
13 Testimony, APS has never disputed that ratings agencies use a number of quantitative
14 and qualitative factors to determine the appropriate credit rating for a particular
15 utility. *See* Brandt Rebuttal Testimony (APS Exhibit 2) at 22. Nevertheless, as the
16 agencies' written reports make abundantly clear, the FFO/Debt financial metric is a
17 key (if not **the** key) financial risk indicator that the credit rating agencies use to assess
18 a company's cash flow, which itself is critical to the ratings determination. *See* S&P
19 2008 Corporate Ratings Criterion, contained in Staff Exhibit 1 (Smith Direct
20 Testimony, Attachment RCS-3) at 24 ("Cash flow analysis is usually the single most
21 critical aspect of credit rating decisions.") and 43 (of the financial metrics used to
22 analyze cash flow adequacy, "Funds from Operations (FFO/Total Debt) is the most
23 frequently used credit measure in industrial ratings"). Neither Staff nor RUCO has
24 ever attempted to address, let alone dispute, these documented statements, which
25 come directly from the rating agencies.

1 Moreover, as the very documents on which Staff and RUCO rely make clear, it
2 is precisely **because** of APS's relatively weak qualitative factors that the Company
3 must maintain higher financial metrics to remain investment grade, a point with which
4 Mr. Parcell agreed on cross-examination. *See* Parcell Testimony at 923:8-16. In its
5 most recent credit opinion, for example, Moody's focused its discussion of APS's
6 financial metrics **exclusively** on the Company's FFO/Debt ratio, and expressly stated
7 that "[i]n general, Moody's would look for APS to have financial metrics that are
8 somewhat stronger than comparably rated utility operating companies that operate in
9 regulatory environments that have historically been more supportive of credit
10 quality." Parcell Direct Testimony (Staff Exhibit 2), Attachment 6, at 4.

11 Nor is it the case, as Staff and RUCO seem to suggest, that S&P, in the face of
12 deteriorating financial markets and increasing rating agency accountability, has
13 somehow **lowered** its standards to now allow APS to maintain an FFO/Debt ratio of
14 below 18 percent without threat of a downgrade to junk. Both S&P's published
15 ratings criteria and express representations to APS from S&P analysts prove exactly
16 the opposite.

17 Prior to November 30, 2007, the published S&P ratings criteria that applied to
18 utilities categorized the industry members into various enumerated "Business
19 Profiles" in order "to better reflect the business risk among companies in this sector."
20 *See* APS Exhibit 14 at 2. Under that analysis, a utility perceived as being a greater
21 business risk (which would have been assigned a higher business risk profile) would
22 have to demonstrate the ability to achieve higher financial credit metrics to remain
23 within its designated investment grade ratings range. *See id.*; Parcell Testimony at
24 923:8-16. Under those guidelines, APS was categorized in Business Profile 6 (of 10),
25 which required the Company to maintain an FFO/Debt ratio of 18 to 28 percent to
26 remain in the BBB credit range. *See* APS Exhibit 14 at 4.

1 On November 30, 2007, S&P published its intent to begin portraying utilities in
2 the general S&P corporate ratings matrix rather than calling that sector out under
3 separate published criteria. *See* RUCO Exhibit 3 (“RUCO-3”) at 2. Although S&P
4 moved the utility industry into the general corporate matrix, it made it very clear that
5 such movement did **not** change the ratings methodology that S&P had historically
6 applied to utilities. Indeed, the article describing the shift stated the exact opposite:
7 **“The utilities rating methodology remains unchanged, and the use of the**
8 **corporate risk matrix has not resulted in any changes to ratings or outlooks.”**
9 *See id.* (emphasis added). This statement is not limited to the factors considered when
10 determining a company’s Business Risk Profile, as Staff suggests, *see* Staff Brief at
11 21, but specifically applies to the entire “rating methodology” used to assess a utility’s
12 credit rating (of which business risk is only one part) – a point underscored by the
13 discussion about that methodology that continues throughout the remainder of the
14 article.

15 Under the Corporate Ratings Matrix, utilities are still assessed, as they were in
16 the past, using a methodology that employs both a Business Risk Profile and a
17 Financial Risk Profile. *See* RUCO-3 at 2; Parcell Testimony at 924:13-20. The only
18 substantive difference resulting from the shift into the corporate matrix was a
19 technical one: rather than assigning numbers (such as “Business Profile 6”) to a
20 particular utility and comparing them only to other utilities, the new matrix classifies
21 Business Risk Profiles by name (“Excellent,” “Strong,” “Satisfactory,” “Weak,” and
22 “Vulnerable”) and compares them to all companies rated within the Corporate Ratings
23 Matrix. *See* RUCO-3 at 2. Given the nature of the utility business, regulated utilities
24 virtually always fall in the upper range (“Excellent” or “Strong”) of Business Risk
25 Profiles. *See id.* APS, consistent with its Business Risk Profile in the bottom half of
26 utilities under the previously published ratings guidelines (6 of 10), is rated a

1 misleadingly-named “Strong” under the corporate matrix – the lowest of the two
2 profiles generally applied to utilities. *See* Parcell Testimony at 924:21-925:7.

3 S&P then determines the Financial Risk Profile applicable to a particular utility
4 (“Minimal,” “Strong,” “Intermediate,” “Aggressive,” or “Highly Leveraged”) “using,
5 in part, the indicative ratio ranges” published in Table 2 of the November 30, 2007
6 report, in combination with various qualitative and quantitative factors. RUCO-3 at
7 2-3. In other words, just as it had under the previous utility-specific ratings criteria,
8 S&P evaluates the financial metrics appropriate for a utility in light of its perceived
9 business risk and classifies that utility, using the ranges published in Table 2, into a
10 “Financial Risk Profile.” *See* RUCO-3 at 2; Parcell Testimony at 945:16-946:25.
11 That is not to say, however, that a utility that achieves an FFO/Debt ratio anywhere
12 within the 10 to 30 percent range will necessarily be classified as merely
13 “Aggressive” (as opposed to “Highly Leveraged”) or that S&P somehow
14 predetermines a company to be an “Aggressive” financial risk and thereafter applies a
15 broad 10 to 30 percent FFO/Debt range for the purposes of ratings determinations, as
16 Staff wrongly suggests. *See* Staff Brief at 21. To the contrary, S&P expressly
17 explained that, under the corporate ratings matrix, as under the previous utility-
18 specific rating methodology, **“a utility that . . . falls along the lower end of its
19 business risk designation would have to demonstrate an ability to achieve
20 financial metrics along the more stringent end of the ratio ranges to reach a
21 given rating.”** RUCO-3 at 3 (emphasis added).

22 Moreover, as Staff’s consultant Mr. Parcell concedes, there is significant
23 overlap in the financial metrics that apply to the Financial Risk Profiles displayed in
24 Table 2. For example, a utility with an FFO/Debt ratio within the 10 to 15 percent
25 range, depending on other factors, could be classified as either “Highly Leveraged” or
26 “Aggressive.” *See* RUCO-3 at 3. Put another way, a utility perceived as having a

1 strong regulatory and operational environment might be deemed “Aggressive” even
2 though its FFO/Debt ratio is only 10 percent, while a Company with an FFO/Debt
3 ratio of 14 percent could be classified as “Highly Leveraged” because it is viewed as
4 existing within a challenging regulatory or operational environment. The difference is
5 a critical one. If deemed “Highly Leveraged,” the ratings result for a “Strong”
6 company is a downgrade not just to **BB+** (the notch below **BBB-** and the first step
7 into junk grade) but **BB-** – **three notches below investment-grade credit standing.**
8 *See* RUCO-3 at 2 (Table 1). As Mr. Parcell concedes, the Corporate Ratings Matrix
9 does not itself expressly indicate what financial metrics would result in a rating of **BB**
10 or **BB+** (still non-investment grade) for a Company perceived as being a greater
11 business risk. *See* Parcell Testimony at 931:8-11; 931:23-932:1. In other words,
12 Table 2 does not state what threshold would cause that critical drop to the first level of
13 junk for APS, though one can reasonably assume it is well above the 15 percent
14 threshold that might result in a downgrade to not just one, but **three** notches into non-
15 investment grade.

16 In addition, as Staff notes, S&P makes quite clear that the ratings matrix is only
17 a guide and that, depending on the applicable factors, “[m]ost outcomes will fall
18 within one notch on either side of the indicated rating.” RUCO-3 at 3. But for APS,
19 for which the combination of a “Strong” Business Risk Profile and “Aggressive”
20 Financial Risk Profile suggests a rating of **BBB-**, the difference between that rating
21 and “the notch below” into junk grade is a critical one – both for the Company and for
22 its customers. As Mr. Parcell agreed at the hearing, it is thus important that the
23 financial metrics that APS maintains are sufficiently high to ensure that it is not
24 assigned a rating a “notch below” the indicated range. *See* Parcell Testimony at
25 949:2-11. In other words, if the aim is to prevent a downgrade to junk, the more
26

1 cautious approach is to reach for higher metrics within the indicated range, not lower
2 ones.

3 Thus, while Table 2 suggests that a utility with an FFO/Debt ratio of 15 or 16
4 percent might be deemed to be an “Aggressive” financial risk (which, for a utility
5 with a “Strong” Business Risk Profile would result in a rating of BBB- [or perhaps a
6 notch **below** that rating]), it is not at all the case that APS’s financial metrics are now
7 allowed to drop to such levels without threat of downgrade to junk status. To the
8 contrary, just as under the previous utility-specific 10 point system, APS’s Business
9 Risk Position remains such that it must demonstrate the ability to achieve higher
10 financial metrics in order to remain BBB- and that an FFO/Debt ratio of 18 percent or
11 higher therefore still applies. And, it makes no sense to conclude that, in the midst of
12 a nationwide financial crisis (which Mr. Parcell noted has been taking place for over a
13 year, *see* Parcell Testimony at 905:3-12) and under heightened federal scrutiny and
14 legal accountability for its ratings actions, pursuant to the Credit Rating Agency
15 Reform Act of 2006, 15 U.S.C. § 78o-7, S&P reconstructed its assessment guidelines
16 to now allow greater financial leeway to companies like APS. This plain
17 interpretation is supported not only by the documents themselves, but by the
18 testimonies of Donald Brandt and Kevin Higgins – individuals with noteworthy
19 experience interacting with credit rating agencies and monitoring the careful interplay
20 between the financial markets and the utility sector. *See* Brandt Testimony at 344:8-
21 16; Higgins Testimony at 250:15-20. Given the substantial experience of these
22 witnesses, this interpretation should be given greater evidentiary weight than the
23 reading of the S&P guidelines offered by Staff’s witnesses Smith and Parcell.

24 In this case, however, the Commission has the benefit not only of what S&P
25 has said in the published documents about how all utilities are rated generally, but
26 also of specific evidence regarding what S&P and Moody’s have directly told APS

1 about the metrics that the Company must maintain in order to sustain its current BBB-
2 credit rating. As Mr. Brandt testified, both S&P and Moody's have told three APS
3 executives [including Mr. Brandt, Mr. James Hatfield (the Company's Senior Vice
4 President and Chief Financial Officer), and Ms. Barbara Gomez (APS's Vice
5 President and Treasurer)] that APS must maintain an FFO/Debt ratio of at least 18 to
6 20 percent to maintain its current BBB- credit rating because of what these agencies
7 perceive to be Arizona's challenging regulatory environment. *See* Brandt Rebuttal
8 Testimony (APS Exhibit 2) at 26-27; Brandt Testimony at 91:5-13, 386:16-23. The
9 totality of the evidence is thus compelling that S&P still regards APS as having a
10 business risk that would classify it in what was once referred to as a "Business Profile
11 6," and that an FFO/Debt ratio threshold of at least 18 percent still applies to the
12 Company's already precarious BBB- credit rating.

13 **B. The Record Is Replete with Plain and Compelling Evidence, Both**
14 **Documentary and Otherwise, Indicating That APS Faces a**
15 **Substantial Risk of Downgrade Prior to the Resolution of the**
16 **Permanent Rate Case If Interim Relief Is Denied.**

16 As discussed above, the evidence overwhelmingly supports the Company's
17 assertion that it must maintain an FFO/Debt ratio of at least 18 percent to remain
18 within investment grade. And it is undisputed that the Company's FFO/Debt ratio
19 will fall far below that threshold – to 15.8 percent – in 2009 without interim relief.
20 *See* APS Exhibit 6. Although Staff argues that a downgrade is less likely to occur
21 because APS's 2008 FFO/Debt ratio is roughly 21 percent, *see* Staff Brief at 22, the
22 metric of that single year alone will not save the Company from a downgrade in light
23 of the facts that: (a) the increase in funds underlying that 2008 FFO/Debt ratio was the
24 result of a one-time tax benefit (which will be backed out by credit rating agencies
25 when calculating the Company's financial metrics for the purposes of a ratings
26 determination, resulting in an FFO/Debt ratio of 17.6 percent for 2009, already below

1 investment grade levels); and (b) ratings agencies analyze cash flow based on future
2 trends, not current year conditions, and the future trend for the Company's FFO/Debt
3 ratio shows metrics in the 15 percent range. See Brandt Testimony at 81:6-17,
4 173:14-174:1, 204:3-11. Staff's attempt to undermine Mr. Brandt's testimony in this
5 regard by asserting that there is an "absence of official statements" regarding the
6 importance of future trends to the ratings process is patently incorrect. See Staff Brief
7 at 22. As noted in the very documents on which Staff's own witnesses rely, "cash
8 flow analysis focuses on understanding and **forecasting** how cash is generated and
9 spent by a business. It incorporates identifying a company's cash flows, **determining**
10 **trends and sustainability**, distinguishing operating from investing and financing
11 flows, **and understanding potential sources of distortion and future volatility.**"
12 Smith Direct Testimony, Attachment RCS-3 at 40 (emphasis added). Contrary to
13 Staff's suggestion, it is thus quite clear that the future trend for a Company's financial
14 metrics – not a single-year history distorted by one-time cash benefits– is critical to
15 the ratings assessment. See Staff Brief at 22-23.

16 And there is little doubt that a trend showing that this important credit metric
17 will fall to a range of 15 to 16 percent in 2009 and 2010 places APS at significant risk
18 of downgrade now, as the credit rating agencies have themselves indicated. Indeed,
19 S&P has directly informed APS not only that it must maintain an FFO/Debt ratio in
20 the upper end of the range applicable to utilities (at least 18 to 20 percent), *see, e.g.*,
21 Brandt Rebuttal Testimony (APS Exhibit 2) at 26-27, 91:5-13; 386:16-23, it has also
22 expressly informed the Company that it will be reevaluating APS's credit rating in its
23 ratings committee after the Commission rules on the Company's interim request. *See,*
24 *e.g.*, Brandt Rebuttal Testimony (APS Exhibit 2) at 26-27; Brandt Testimony at
25 143:5-10; 203:14-22.

1 While Staff and RUCO would have the Commission disregard this clear and
2 admissible evidence because it is not in writing, it would be wholly irresponsible to
3 do so. Not only are the strict rules of evidence more relaxed in Commission
4 proceedings (for which the Commission has determined as a policy matter that it
5 would like the benefit of **all** relevant evidence, not just what might be deemed
6 admissible under strict legal standards [*see* A.A.C. R14-3-109(K)]), the conversations
7 between APS management and the credit rating agencies that Staff and RUCO
8 challenge are the very kind of conversations that the agencies themselves rely on
9 when making their ratings decisions. As S&P describes in its 2008 Corporate Ratings
10 Criteria, its ratings process specifically and intentionally includes meetings with “the
11 rated entity’s management team to review, in detail, key factors that could affect the
12 rating.” *See* Staff Exhibit 1, Attachment RCS-3, at 7 of 107. Such meetings are far
13 from unusual – they are a routine and key component of the agency’s assessment
14 process. *See id.* To disregard evidence regarding these meetings for lack of a written
15 document would be to dismiss evidence that S&P itself relies on in making its
16 assessment – a clearly inappropriate action when attempting to assess the risk of a
17 credit ratings downgrade by that very same agency.

18 Not only was such evidence properly admitted in this case, it is compelling.
19 Witnesses for each and every party noted the effect of S&P’s statements on their
20 assessments of whether or not APS was at risk of a downgrade, particularly given the
21 current difficulties in the nation’s financial markets. *See* Higgins Testimony at 279:3-
22 11; Ahearn Testimony at 1064:25-1065:2; Cicchetti Testimony at 840:21-841:7;
23 Parcell Testimony at 897:12-898:10; 908:18-24. Staff’s own witness, Mr. Parcell,
24 expressly stated that – given Mr. Brandt’s statements, he was unable to testify that
25 APS was **not** currently at a substantial risk of a credit ratings downgrade. *See* Parcell
26 Testimony at 897:24-898:10. Given both the magnitude of these statements and the

1 fact that there is simply no reason to doubt the integrity of Mr. Brandt, who testified
2 several times under oath that these statements were made, this evidence should clearly
3 be considered by the Commission in making its determination in this matter. *See*
4 Brandt Testimony at 150:4:10; 203:2-22.

5 Nor is it correct, as Staff and RUCO seem to suggest, that the published rating
6 agency reports themselves undermine the Company's position that it is more than
7 likely to be downgraded to non-investment grade absent rate relief. To the contrary,
8 as described in APS's Initial Brief, each and every one of the credit rating agencies
9 has publicly predicated its current "stable" outlooks of the Company's ratings on the
10 prospect of interim relief. *See* APS Brief at 18. Moody's, for example, noted that
11 **"the stable outlook assumes that APS will be reasonably successful in managing**
12 **its regulatory relationships with an objective of achieving more timely recovery**
13 **and an opportunity to earn a fair return."** Staff Exhibit 2, Attachment 6 at 3. The
14 same article also describes the "most important drivers of the rating and outlook," first
15 and foremost of which is the Company's "historically challenging regulatory
16 environment, which Moody's ranks as below average for U.S. regulatory jurisdictions
17 in terms of supportiveness and predictability and stability of regulated cash flows."
18 *Id.* at 3 (also describing APS's regulatory environment as one where "there has tended
19 to be below average assurance of timely recovery of costs and the ability to earn a
20 reasonable return on investment"). Even so, as Moody's notes, the "stable" outlook
21 **"contemplates recent ACC decisions and regulatory activities that appear**
22 **intended to reduce regulatory lag and provide more timely recovery of costs,"**
23 **and specifically includes as one such activity** (described under the heading
24 **"Reduced Regulatory Lag for Certain Items") the potential for interim rate relief in**
25 **this matter**, importantly noting that "the ACC has granted interim increases in the
26 recent past" and that "Moody's views mechanisms designed to reduce the time

1 required to recover a utility's costs, such as the requested interim base rate increase, a
2 positive for credit quality." *Id.* at 3. Clearly, it is reasonable to conclude from these
3 statements that a key driver of Moody's "stable" outlook and current rating for APS is
4 the Company's interim request and the expectation that it may be granted.

5 Similarly, in a recent published discussion, S&P also made plain that the
6 Company's interim request was both known to and considered by that agency in
7 affirming the "stable" outlook assigned to APS. *See* Parcell Direct Testimony (Staff
8 Exhibit 2, Attachment 9 at 5. In fact, after specifically noting that "APS's
9 consolidated financial performance will continue to be challenged by regulatory lag,
10 which could be moderated by APS's interim rate request," S&P expressly forewarned
11 that APS's "[r]atings could be lowered to speculative grade if the company is not
12 able to overcome the challenge of ensuring timely recovery of its prudently
13 incurred costs," and that, given such challenges, S&P sees "little potential for
14 positive movement in the rating or outlook." *Id.* at 5. This written warning, in
15 combination with S&P's expressed intent to reassess APS's ratings in a ratings
16 committee meeting after a decision in this interim matter is announced, presents
17 compelling evidence that APS faces a substantial risk of downgrade by S&P upon the
18 conclusion of this matter if interim relief is not permitted.

19 Neither can the Commission take comfort in the fact that the Company's
20 outlook is "stable" rather than "negative" or "under review" as evidence that APS is
21 not currently at substantial risk of a downgrade. As discussed in APS's Brief, the
22 Company was downgraded by S&P on December 21, 2005 to its current BBB- credit
23 grade notwithstanding the fact that – **just five days earlier** – S&P had published a
24 lengthy and detailed article discussing the Company's strengths and weaknesses in
25 which APS's then "stable" outlook was affirmed. *See* APS Exhibit 15. Like today,
26 APS had a general rate case pending at the time. *See id.*

1 Staff attempts to sidestep this important evidence by suggesting that, because
2 the stakes of downgrading APS are higher now than they were then (with the current
3 threat being a plunge into non-investment grade, “which would have much greater
4 and more devastating consequences for the Company in terms of access to capital and
5 the cost associated with that capital,” Staff Brief at 29), they “just don’t think [S&P]
6 would take a drastic step” without giving APS “more of a warning and chang[ing] the
7 outlook of the Company first before downgrading it to junk status.” Staff Brief at 28-
8 29 (quoting, in part, Smith Testimony at 640:16-641:6). This argument, however, is
9 based entirely on the speculation of Staff’s witnesses and ignores the documented
10 actions taken by the very same ratings agency in the recent past. Moreover, Staff’s
11 argument disregards the fact that **S&P has already given a warning to the**
12 **investment community in its published material**, in which it has repeatedly
13 cautioned that – notwithstanding all of the favorable actions that the Commission has
14 recently taken for APS (to which S&P refers) – **“ratings could be lowered to**
15 **speculative grade if the company is not able to overcome the challenge of**
16 **ensuring timely recovery of its prudently incurred costs.”** Given the dire
17 consequences that Staff candidly admits will result from a downgrade, it would be far
18 more prudent to proceed in this matter assuming that history will repeat itself and that
19 APS could be downgraded while the rate case is pending without any change in
20 outlook, rather than sitting back and hoping – because of those consequences – that it
21 will not. *See also* AIC Opening Brief at 6.

22 In a final effort to suggest that the harm that will befall APS and its customers
23 upon a downgrade is not “imminent,” Staff and RUCO argue that only S&P currently
24 has APS on the precipice of junk and that Moody’s and Fitch currently rate APS two
25 steps above non-investment grade. *See* Staff Brief at 29; RUCO Brief at 6. From this
26 they opine – again, with no evidentiary support other than the speculation of Staff’s

1 consultant Mr. Parcell (who himself admits that “he doesn’t know” whether “S&P
2 cares what Moody’s does”) that S&P is unlikely to downgrade APS to two levels
3 below Moody’s and Fitch and that Moody’s and Fitch are unlikely to downgrade the
4 Company to junk even if S&P does so. *See* Parcell Testimony at 901:13-21. Apart
5 from being based on admitted speculation, this argument ignores the plain testimony
6 of Staff’s own witness that a downgrade to junk by just **one** rating agency will
7 nonetheless result in an increase in APS’s cost of debt and diminish its ability to
8 access the capital markets, particularly in this troubling financial time. *See* Parcell
9 Testimony at 901:25-902:13; 960:4-9 (“I think it goes without saying there would be
10 negative implications of S&P downgrading APS to non-investment grade even if the
11 other two agencies had two notches above non-investment grade”). In addition,
12 Mr. Brandt, who has more than 25 years of experience working in a financial capacity
13 for regulated utilities and interacting with credit rating agencies, also specifically
14 testified that “as a practical matter, if any one of the three major credit rating agencies
15 downgrades APS [to junk], the Company’s debt will be regarded as junk by the
16 market.” Brandt Rebuttal Testimony (APS Exhibit 2) at 27. Thus, the evidence
17 shows that, as a practical matter, it will make little difference if Moody’s and Fitch
18 rate APS near-junk once S&P downgrades the Company – the harm will have already
19 occurred, which consequences will take years to reverse. *See* Brandt Testimony at
20 502:21-503:10.

21 Moreover, both Mr. Brandt and Mr. Parcell testified that a downgrade from one
22 rating agency could precipitate a downgrade by one or more of the other rating
23 agencies, as it has in the past. *See* Parcell Testimony at 960:10-13; Brandt Rebuttal
24 Testimony (APS Exhibit 2) at 27. Indeed, Fitch and Moody’s each downgraded APS
25 to its current credit ratings within one and four months, respectively, of S&P’s
26 downgrade in December of 2005, all of which downgrades occurred while APS’s

1 general rate case was still pending. *See* Parcell Testimony at 960:24-962:1. Although
2 Mr. Parcell suggested that Moody's would unlikely do so again today, his opinion
3 rests wholly on his mere speculation about whether or not Moody's "pride" is too
4 great to "look like they were copying S&P." *Id.* at 960:13-20. Suffice it to say that
5 increased accountability stemming from the Credit Rating Agency Reform Act of
6 2006 is likely to make all rating agencies much more quick to downgrade a company
7 if the financial data or the actions of other rating agencies indicate that a downgrade is
8 warranted.

9 In sum, and in the face of a mountain of evidence raising a clear risk that APS
10 will be downgraded absent interim relief, Staff and RUCO ask the Commission to rely
11 purely on Staff witnesses' own selective reading of published documents and their
12 speculation about what the rating agencies may or may not do, to the exclusion of
13 other significant evidence in the record demonstrating that APS faces a substantial
14 threat that will have devastating impacts to APS, its customers, and the State. There
15 is no question that the Commission has taken several proactive steps over the past
16 several years to address some of APS's financial problems and that those steps have
17 been noticed and applauded by the rating agencies, as Staff and RUCO have both
18 noted. *See, e.g.,* Staff Brief at 4-5; 16; 25; RUCO Brief at 7. The fact remains,
19 however, that the Company's financial metrics continue to be progressively depressed
20 by circumstances that have not yet been addressed by the Commission – most
21 importantly, an inability to timely recover massive capital expenditures – and this
22 fact remains a key concern of the ratings agencies. *See* Brandt Testimony at 516:22-
23 517:14.

24 Staff and RUCO attempt to dismiss the importance of this concern,
25 notwithstanding numerous documented references in credit agency reports that
26 establish just how critical it is to the maintenance of APS's current credit ratings. If,

1 as both Staff and RUCO's witnesses expressed, it is important to our State's energy
2 future that APS be elevated above its current "one step away from junk" grade and
3 into higher credit metrics, it is critical that the Commission not turn a blind eye to the
4 clear concern held by rating agencies over the Company's ability to timely recover its
5 capital costs. To do so unnecessarily risks a plunge into non-investment grade – a
6 position that will exponentially increase APS's difficulty in ultimately reaching any
7 credit rating that will allow the Company to achieve the more secure level of financial
8 health that all parties believe is appropriate for a utility like APS.

9 **C. The Commission Should Not Deny Interim Relief Based on the**
10 **Mere Hope That Conditions Outside of APS's Control Might**
11 **Improve and That Other "Alternatives" to Interim Relief May**
12 **Emerge.**

13 Finally, Staff suggests that the Commission should view with "skepticism" the
14 Company's claim that there are no alternatives available to deal with the Company's
15 financial crisis apart from interim relief, apparently suggesting that the Commission
16 might deny interim relief for APS because other alternative options exist that would
17 make interim relief unnecessary. *See* Staff Brief at 31. In support of that contention,
18 it cites to three potential alternatives the Commission might rely on: a potential
19 equity infusion in 2009, additional debt financing, and further capital expenditure
20 reductions (beyond the \$700 million total cost reduction already undertaken or in the
21 process of being undertaken by the Company over the past year). *See id.* at 32-36.
22 But, as Staff admits, the availability of at least the first two of these alternatives rests
23 entirely on the mere hope that conditions in financial markets will improve and that
24 "the outcome of the current financial crisis on Wall Street" will favorably resolve
25 prior to the resolution of the general rate case. *Id.* at 31. As Staff acknowledges, "the
26 current Wall Street crisis has cast a pall of uncertainty over this case, [and] Staff
predicts that it is too early to predict the outcome of that event." *Id.* at 36. Given

1 those uncertainties, it makes little sense to rely on the mere possibility that things
2 might get better and that these alternatives might become viable as a reason to deny
3 APS otherwise appropriate interim relief.

4 With respect to the potential for an equity infusion, there is no dispute that
5 Pinnacle West cannot issue equity in 2008, and that, in the current financial market
6 (which continues to deteriorate) and under Pinnacle West's current stock conditions, it
7 seems unlikely that it will be able to do so in the foreseeable future. *See id.* at 31-32.
8 While an equity issuance could provide a source of needed capital that would, if made
9 for sound business reasons, relieve the pressure on the Company's credit metrics to
10 some degree in 2009 **if conditions improved**, it makes no sense to rely on the
11 hypothetical chance that such will be the case instead of using a certain and
12 controllable means of improving APS's financial condition, such as interim relief.
13 Moreover, any attempt to issue equity for the sole purpose of improving the
14 Company's FFO/Debt ratio would be both inappropriate from a business perspective
15 (*see* Brandt Testimony at 522:11-525:17), and viewed with a critical eye by the rating
16 agencies themselves if attempted solely to avert a financial crisis. As S&P has
17 explained, "[i]n theory, equity issuance is another source of capital; in practice, this
18 source cannot be relied upon in a crisis scenario. The public equity markets are
19 extremely fickle. Selling new common stock generally is feasible only if the
20 company is seen as having at least decent prospects and the overall stock market is
21 favorable." *See* Staff Exhibit 1, Attachment RCS-3 at 51.

22 As to potential debt issuances, not only will such issuances have the effect of
23 significantly **lowering** APS's FFO/Debt ratio to even more dismal levels and thus
24 **increasing** its risk of downgrade, there is little doubt that APS will struggle in today's
25 market to even secure debt financing, despite the fact that it has been authorized by
26 this Commission to do so. APS has already been prevented from accessing the

1 commercial paper markets twice in the past two years under less volatile market
2 conditions than exist today, *see* Brandt Affidavit (APS Exhibit 1) at 13, and Staff
3 itself acknowledges that “the ultimate impact of this crisis upon the Company’s ability
4 to obtain debt financing is not known at this time.” Staff Brief at 11. Thus, this
5 second proffered alternative is subject to conditions that are entirely outside of the
6 Company’s control and cannot be reasonably relied upon. Moreover, to the extent
7 Staff suggests that APS can use its existing \$900 million bank revolving credit facility
8 to finance its capital needs while the rate case is pending, *see* Staff Brief at 11, it is
9 incorrect. As Mr. Brandt expressly testified – testimony that was neither questioned
10 nor disputed – the Company “cannot meet all of its spending needs for the next
11 several years with existing credit revolving agreements.” Brandt Rebuttal at 21.

12 The only other alternative Staff offers is that APS further cut its capital
13 spending. As APS has shown, it has already undertaken two specific capital
14 expenditure reduction programs over the past year: it reduced spending by \$200
15 million in 2007 and is now undertaking to cut capital costs by another \$500 million
16 for 2009 to 2011. *See* Brandt Testimony at 115:23-116:10. The impact of the first
17 round of cutbacks was included in the projections underlying the Company’s interim
18 filing. And, as shown on APS Exhibit 22, the second round of reductions is estimated
19 to improve APS’s FFO/Debt ratio by **at most** only 0.6 to 1.0 percent in 2009, enough
20 to bring the Company’s FFO/Debt ratio that year to 18 percent **if combined with a**
21 **grant of interim relief**. Staff is correct that, if interim relief is denied in this case, the
22 Company may have no choice but to delay or discontinue additional capital projects,
23 but doing so risks sacrificing the reliability of APS’s system and the Company’s
24 ability to continue to implement the customer-beneficial programming (such as AMI
25 and similar technology) that expressed Commission policy clearly supports. *See*
26 Brandt Rebuttal Testimony (APS Exhibit 2) at 19. Moreover, the second \$500

1 million reduction has already taken into consideration the impact of a slowing
2 economy and slower growth (which Staff suggests should allow further spending
3 cutbacks), so there is little room for further reductions that will not have a significant
4 impact on how APS generates and delivers energy and how it will continue to do so
5 going forward.

6 If the Commission's goal is to strengthen APS financially so that it can
7 implement a sustainable energy future for Arizona, the Company must be allowed the
8 financial strength to continue its infrastructure and programming investments. It
9 should not be forced to cut capital costs for a third time so that it can continue to
10 subsidize the price of electricity to customers, for whom the current price is below its
11 cost to APS. *See* Brandt Affidavit (APS Exhibit 1) at 5-6; Brandt Rebuttal Testimony
12 (APS Exhibit 2) at 13; Brandt Testimony at 525:18-527:15. Relying on this as an
13 "alternative" is simply contrary to the long-term best interests of both customers and
14 the State.

15 **III. THE COMPANY'S REQUESTED \$115 MILLION OF INTERIM RATE**
16 **RELIEF IS THE MOST PRUDENT COURSE OF ACTION BY THIS**
17 **COMMISSION UNDER THE CIRCUMSTANCES PRESENTED.**

18 The Commission has been presented with four alternative levels of interim rate
19 relief in this proceeding. The Company has requested an annual increase of \$115
20 million, or approximately 4.3 percent, based on the same adjusted 2007 Test Year
21 sales utilized to determine the revenue requirement in the pending general rate case.
22 Staff, although maintaining that no interim relief is necessary, offered an alternative
23 of an increase of \$65.2 million, or 2.4 percent. Intervenor AECC concluded, as have
24 APS and Intervenor AIC and Mesquite Group, that interim rate relief for APS was
25 necessary, but unlike those other three parties, AECC believed that only \$43.2 million
26 of relief should be granted (1.62 percent), and not until January 1, 2009. And of
course, there is zero relief – the position advocated by RUCO, and which also

1 represents Staff's primary recommendation. Of these options, the Company's
2 requested increase of \$115 million will best serve to protect APS customers from the
3 far greater costs of a further credit downgrade for APS, the potential of limited access
4 to credit for Arizona's largest utility at a time of critical need for new investment, and
5 the potential additional rate impact of a final decision in the general rate case,
6 hopefully late next year.

7 In its Brief, Staff argues that the Commission should not base the amount of
8 interim rate relief on an attempt to hit a specific FFO/Debt ratio. Indeed, Staff states:
9 "... using FFO/Debt ratios as the basis for setting interim rates will deteriorate into
10 this sort of 'roll the dice' sort of analysis" Staff Brief at 36. APS agrees.

11 It was never APS's intent to base the amount of its interim rate request on
12 merely achieving a minimal level of FFO/Debt. APS determined the amount of such
13 request, \$115 million, to achieve significant improvement in all its financial metrics,
14 including FFO/Debt – improvements it believed necessary to greatly reduce what is a
15 clear risk of a downgrade to "junk." At the same time, APS believed that this level of
16 interim relief would send the appropriate positive signal to the capital markets that the
17 Commission took APS's deteriorating financial condition seriously and was moving
18 in a manner to address that deterioration just as it had when the Commission granted
19 interim rate relief in 2006. Finally, the Company's requested level of interim relief
20 would provide a means of smoothing out or phasing in the eventual impacts of a final
21 order in the permanent rate proceeding while not increasing customer rates above the
22 levels in place as recently as July of this year.

23 But all this being said, one simply cannot ignore the impact these various
24 proposed levels of interim rate relief will have on this critical financial metric of
25 FFO/Debt. After all, the goal here is to prevent a credit downgrade of APS to "junk,"
26 or at least reduce that potential to the extent possible, and not to conduct a mini-
general rate case with the attendant focus on test periods, rate base, and the other
attributes of general ratemaking. The results of the Staff and AECC levels of interim

1 relief show FFO/Debt ratios buried deep in the “junk” range, especially if equity
2 market conditions do not significantly improve in 2009 – something we all hope for
3 but something upon which the Commission would be unwise to count on to justify
4 only minimal interim rate relief. For example, APS’s 2009 FFO/Debt ratio is forecast
5 at 15.8 percent without interim relief and would improve only slightly to 16.4 percent
6 and 16.7 percent, respectively, under the AECC and Staff levels of interim relief. *See*
7 APS Exhibits 6 and 9; Brandt Testimony at 83:16-84:8. As bluntly put by Mr.
8 Brandt, these results produce a “substantially greater risk” of a downgrade
9 irrespective of what this Commission does or does not do in the general rate case. *See*
10 Brandt Testimony at 503:17-22, 589:10-590:2.¹

11 Thus, Staff is essentially asking the Commission to do precisely what it warned
12 against – turning the grant of interim relief into a “roll of the dice” proposition, but
13 one with a “substantially greater risk” of losing. APS realizes this is no mere game of
14 chance that faces the Commission, but the analogy is perhaps helpful, for the stakes
15 for APS customers are exceedingly high,² and there are no prizes for coming in
16 second. We either succeed in preventing APS from further deterioration into “junk”
17 status or we fail.

18 If the Commission is more comfortable with conceptualizing the extent of
19 interim rate relief in terms of the incremental investment that APS has added since the
20 findings in Decision No. 69663, the grant of \$115 million is still easily justified. Staff
21 labels the increase in APS rate base through the end of 2007 as relatively “non-

22 ¹ AECC’s proposed increase of \$43.2 million was premised on a \$400 million equity infusion from
23 Pinnacle West by November 2008 and was designed to yield an FFO/Debt ratio of 18.25 percent.
24 Without the equity infusion (which all parties now agree cannot happen in the near future), a \$43.2
25 million interim rate increase leaves APS well below the 18 percent FFO/Debt ratio that it requires.
26 Although AECC concedes this to be the case, AECC inexplicably clings to its \$43.2 million interim
rate increase recommendation.

² The added financing costs stemming from a downgrade could cause as much as an annual rate
increase of another 5.5 percent, and unlike the interim increase (which would effectively be
subtracted from the future rate increase), this 5.5 percent would be **in addition to** whatever other
future APS rate increases may be required. *See* Brandt Testimony at 513:13-514:5 (citing therein to
Brandt General Rate Case Testimony at 45).

1 controversial." *See, e.g.,* Smith Testimony at 619:3-14, 677:18-25. APS would
2 certainly agree with that sentiment. But if the additional plant is "non-controversial"
3 and the annual depreciation accruals at Commission-approved depreciation rates
4 through 2007 used to offset that additional plant in Mr. Smith's analysis are "non-
5 controversial," APS fails to understand how the same annual depreciation expense, as
6 calculated on the "non-controversial" plant at the same depreciation rates, can
7 somehow be believed to be **overly** controversial. Similarly, property taxes are what
8 they are. The former is determined by this Commission and the latter by the various
9 state and local property tax authorities in accordance with a strict statutory formula.
10 Adding just depreciation to Staff's "non-controversial" rate base figure would
11 increase the annual interim relief to \$95.8 million and with property taxes, to \$107.7
12 million. *See* APS Exhibit 10; *see also* Rumolo Rebuttal Testimony (APS Exhibit 19)
at 4 and Attachment DJR_RB-1, page 1.

13 If you then add to the "non-controversial" 2007 rate base just three plant
14 additions that, based on prior Commission decisions and the treatment of such plant
15 additions in other jurisdictions, are likely to be also "non-controversial," the interim
16 increase that can be justified **exceeds** that requested by APS. *See* Rumolo Rebuttal
17 Testimony (APS Exhibit 19) at 5. These three items are: the new steam generator for
18 Palo Verde Unit 3 (placed into service in January 2008); the two new combustion
19 turbine units at the Yucca site in Yuma (placed into service in June 2008); and
20 environmental upgrades to the Cholla plant (placed into service in March and May
2008).

21 The replacements of the steam generators at Palo Verde Units 1 and 2 were
22 placed into APS's rate base in Decision Nos. 67744 (April 7, 2005) and 69663 (June
23 28, 2007) without controversy in either case despite the fact that the replacements
24 occurred even further outside the test period than is here the case. This new steam
25 generator and the associated increase in Palo Verde generating capacity have been
26 serving APS customers for nearly a year now, providing them additional energy and

1 favorably impacting fuel costs recoverable through the PSA. Clearly such an
2 investment is very likely to be “non-controversial.”

3 The two Yucca generators were specifically authorized by this Commission in
4 Decision No. 69400 (March 30, 2007). As such, they are very analogous to the
5 Sundance Units that the Commission included in the Company’s rate base (without
6 opposition) in Decision No. 69663, even though acquired by APS after the then test
7 period. And unlike Sundance, the new Yucca units were found necessary to serve a
8 load pocket that was becoming exceedingly constrained. These two units provided
9 much needed capacity to APS customers this past summer and to the extent they can
10 be operated more cheaply than other APS units or incremental purchases, they have
11 lowered the costs to APS customers through the PSA.

12 APS can point to no Commission decision that directly addresses
13 environmental improvements, but as testified to by Mr. Rumolo, such investments
14 generally receive favorable regulatory treatment. *See* Rumolo Testimony at 1033:24-
15 1034:7. They are obviously not revenue-producing investments, but yet they are
16 already providing Arizona citizens with environmental benefits. Neither are they
17 associated with customer growth or likely to produce any cost savings. Thus, in
18 addition to the public policy reasons supporting favorable regulatory treatment of
19 environmental upgrades, there are no offsetting factors that could even potentially
20 reduce the ongoing carrying costs of these sorts of investment.

21 In suggesting this means of determining the level of interim rate relief to be
22 afforded APS, the Company is not asking that the Commission “prejudge” general
23 rate case issues any more than is Staff in its alternative recommendation. Neither
24 Staff nor APS asks this Commission to somehow “predict” the outcome of the general
25 rate case. That is why interim rates are subject to refund. What APS is attempting to
26 do is to provide the Commission with an alternative basis for granting what it believes
is a prudent level of interim rates. But whether the Commission uses financial metrics

1 or some calculation of incremental rate base to guide its decision, APS urges the
2 Commission to keep its eye on the objective of interim relief rather than the means of
3 its determination. That objective is best served by granting APS its requested \$115
4 million in interim rate relief.

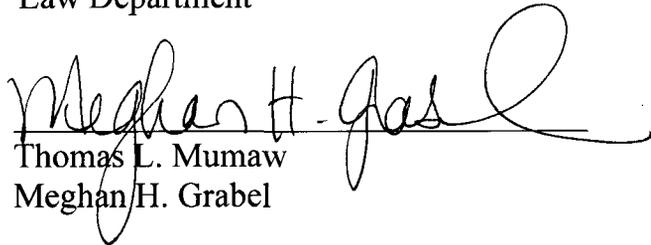
5 CONCLUSION

6 All parties to this docket agree that this case is riddled with uncertainties,
7 particularly in light of recent events on Wall Street. Only one party (RUCO) suggests
8 that, under current conditions, there is no legal basis to grant APS its requested relief.
9 Four of the six parties recommend granting APS interim relief, three of which would
10 award APS the full amount requested. Witnesses for each and every party concede
11 that there is at least some risk that APS will be downgraded prior to the resolution of
12 the general rate case, and that the ramifications of such an event will be severe. On
13 the other hand, interim relief (which would be fully refundable with interest at the
14 close of the general rate proceedings) provides relatively inexpensive insurance
15 against such consequences.

16 The parties also agree that, to continue to serve Arizona reliably and implement
17 the Company's and Commission's vision of a sustainable and independent energy
18 future for our State, APS must be financially healthy and should be as far from junk
19 status as possible. Given that goal, and as indicated earlier, the real issue for this
20 Commission to resolve is thus the following: when a risk, however it is quantified,
21 undoubtedly and undisputedly exists, and the ramifications of ignoring that risk are
22 extreme, why take the chance when a relatively inexpensive means of preventing that
23 risk from materializing exists? APS believes, and hopes the Commission agrees, that
24 Arizona's energy future and the fate of APS customers are not worth that gamble.

1 RESPECTFULLY SUBMITTED this 8th day of October 2008.

2 PINNACLE WEST CAPITAL CORP.
3 Law Department

4 
5 Thomas L. Mumaw
6 Meghan H. Grabel

7 Attorneys for Arizona Public Service Company

8
9 ORIGINAL AND 13 COPIES OF THE FOREGOING
10 filed this 8th day of October 2008 with:

11 Docket Control
12 Arizona Corporation Commission
13 1200 West Washington
14 PHOENIX, AZ 85007

15 AND copies of the foregoing emailed or mailed
16 this 8th day of October 2008 to:

17 All Parties of Record

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26

Copies of the foregoing emailed or mailed
This 8th day of October 2008 to:

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