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November 26, 2008

Arizona Corporation Commission
DOCKETED

Commissioner Kristin K. Mayes
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Re: ***Request for Information Regarding Efforts by APS to Cut Costs; Docket No. E-01345A-08-0172***

Dear Commissioner Mayes:

In your letter of November 19, 2008, you asked for information regarding the efforts of Arizona Public Service Company ("APS" or "Company") to reduce its costs. Before responding to this request, it is important to keep in mind that the fundamental issue facing APS is that our prices do not reflect our cost of service either on a current or prospective basis. Neither the present financial crisis facing APS and its customers nor the long-term, substantial earnings shortfall that has been borne by APS shareholders are the result of a decline in productivity, reduced operational efficiency, poor reliability or lackluster customer service.

APS presently has only its third request for a base rate increase since 1991 pending before the Arizona Corporation Commission ("Commission"). That request, as you correctly note, is for \$278.2 million annually, of which the Company has sought to implement \$115 million (or just over 40% of the total) on an interim basis subject to refund. Even if this current base rate increase is granted in full, APS base rates will have only increased by a compounded rate of 1.2% per year since 1991, which is well below the overall rate of inflation (3.3%) present in the general economy during this same period. In fact, the cost of electricity for APS customers as a percentage of personal income has declined 22% since 1990. Thus, the Company believes that it has provided outstanding value for our customers. The Company has for years consistently requested that the Commission set rates that will recover on a timely basis only the reasonable cost of meeting the essential energy needs of customers in our service area. We regard such compensatory rates as both an economic necessity to allow APS to continue to provide reliable electricity service to the public and fully consistent with the requirements of both the Arizona and United States Constitutions.

That said, APS continuously strives to control its costs. The most recent announcements of over $500 million in additional capital spending cuts or deferrals (bringing the total to date to approximately $720 million) and $50 million in O&M reductions clearly demonstrate APS's rigorous and continuing cost management culture, a business culture that has been in effect for many years at APS. The bottom line results of this way of doing business include some remarkable statistics:

- Despite having a relatively low density service territory (a little over 20 customers per square mile compared to nearly 300 customers per square mile for TEP and SRP), APS has nearly 1000 fewer employees now compared to 20 years ago, and its customer-to-employee ratio has improved from 98 to 227 during than same period, providing an increase of 130% in efficiency per employee.

- APS fossil fuel generating plants continue to operate at the highest levels of capacity factor and availability in the industry.

- Nuclear plant performance reached industry highs during the 1997-2001 period, and thanks to the ongoing Performance Improvement Plan, is returning to that level of performance with an anticipated annual capacity factor (including refueling outages) of approximately 84% for 2008. We also expect the NRC to remove Palo Verde from Column 4 oversight sometime next year.

- The Company's introduction of computer-aided standardized designs and the use of pre-fabricated components have reduced the manpower needed to build a new substation from 6-7 workers to 3-4 workers, while at the same time reducing construction time from 2-3 months to 3-4 weeks.

- The frequency of distribution-related APS customer outages has declined 67% from 1996 through 2007. The average duration of outages has declined 16 minutes (over 15%). APS expects in 2008 to break last year's reliability record for the lowest frequency of customer outages (clear weather SAIFI), and expects to improve over last year's performance on the duration of customer outages (SAIDI).

- Despite the decrease in the workforce, APS employees have twice won the highest award in the electrical industry for inventiveness and technical innovation. No other U.S. utility has received this award more than once during this same period.

- Overall non-production O&M levels (which provide an accurate comparison between electric utilities owning various levels of generation)[1] for APS fall well below our peers, both regionally and nationally. *See* Figure 1, below.

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[1] Moreover, the Commission has already audited the Company's fuel costs and power production functions and found them to be reasonable.

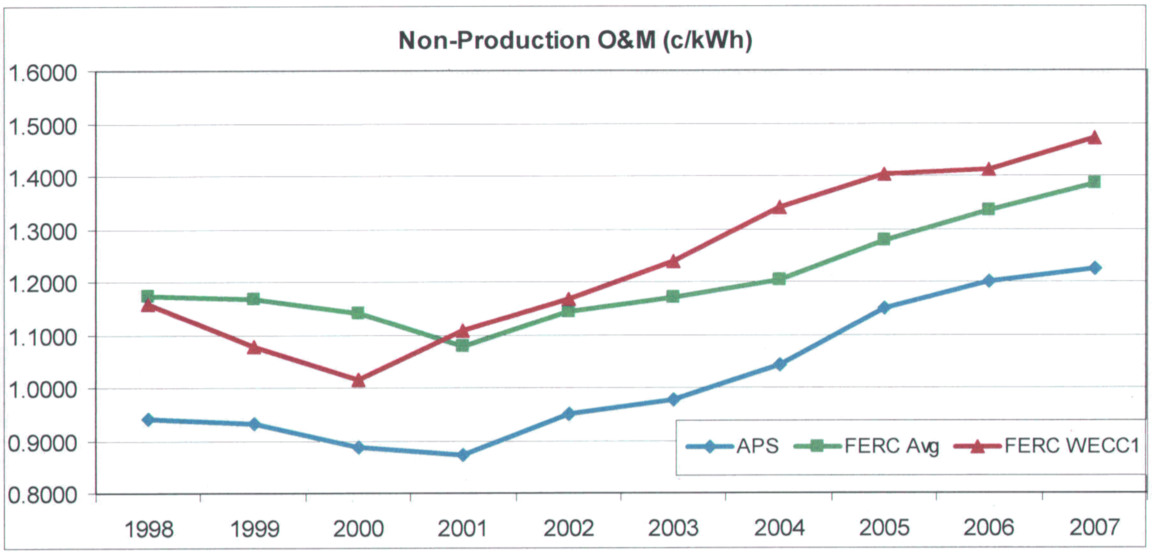

Figure 1: APS Non-Production O&M Comparison (FERC Form 1 Data)

You have asked whether APS considered several specific actions such as a blanket hiring "freeze," wage and salary freezes, and minimizing pay increases. Although the Company has considered many potential options for managing costs, to implement the measures cited in your letter would be harmful to both our short- and long-term operational performance, and would be counter to our customers' best interests. In fact, APS does not know of any comparable utility companies that have halted the hiring of necessary personnel, instituted blanket wage and salary freezes, or declined to pay employees appropriate compensation. Even in those "unregulated" companies characterized by failed business models and ineffective risk management (such as AIG or Lehman Brothers), these types of actions accompany a massive if not total reduction in services or reductions in output or both. Unlike these businesses, APS cannot pursue such value-destroying policies and practices, and due to its legal obligation to serve, APS cannot simply cut back on core services or output.

In a detailed letter from Jack Davis to the Commission dated August 1, 2006, Mr. Davis provided an exhaustive discussion of APS efforts to manage its costs over the years. These efforts have continued. Mr. Davis specifically indicated in that letter that the creation of new job positions at APS could only take place with his authorization as President of APS. Since Don Brandt has become President of the Company, he has maintained this policy. However, a complete cessation of all hiring would run counter to the best interests of the Company and its customers. The electric industry's workforce is rapidly aging, and there is an acute shortage of qualified utility employees nationwide. For this reason alone, APS must retain the ability to attract and retain such employees when the opportunity presents itself. Moreover, we must maintain critical positions at all times, and the training of the next generation of employees to the highest standards must continue.

The provisions of the collective bargaining agreements covering many APS employees render the limitation, let alone the elimination, of pay increases an impossibility. Although not subject to the same contractual agreements, but for the same reasons I discussed with regard to the concept of a hiring "freeze," APS must remain competitive in the compensation it pays for both management and non-management personnel. To do less would sacrifice competency, professionalism and long-term efficiencies for minimal and, perhaps, illusory short-term gains. APS compensation levels are reasonable and comparable to peer companies, particularly given the demand for qualified utility personnel that we are seeing in our industry today.

Your letter also refers to the potential reduction or elimination of "management bonuses." The term "bonus" is actually not descriptive of the Company's incentive program. A "bonus" implies gratuitous additional compensation in excess of what the market requires to attract and retain employees at all levels. In that sense, APS pays no "bonuses." APS, like most utilities and many non-utility businesses, does have a component of each employee's compensation that falls under the heading of "at risk." "At risk" means that the level of this element of compensation depends upon performance – both individually and collectively. Thus, we and others refer to such compensation as "incentive" pay because it provides a direct and measurable incentive to achieve or surpass critical performance measures affecting the Company's operations. APS's outside compensation expert testified, without refutation by any other party, in the previous general rate case about the critical importance of the "at risk" component of overall employee compensation. Without this element, the Company could not compete for qualified executives, managers, and non-management employees with other companies using such compensation factors. The Commission recognized in the last APS rate case that these critical performance measures redounded in very large part to our customers' benefit, and thus cash incentive compensation should properly be included in APS's cost of service.

Allow me now to address some of the specific information you have requested:

1. Both the federal affairs and the public affairs groups are at Pinnacle West, and costs are allocated to APS and other affiliates. Lobbying-related expenditures for 2008 will total approximately $2.4 million, from a total federal and public affairs budget of $3.8 million. As you are no doubt aware, the Commission determined in the Company's last general rate case to effectively split these costs "50/50" between customers and shareholders. However, lobbying efforts have saved APS customers far more in the form of favorable legislation and administrative relief than even the full cost of such efforts. APS has previously provided significant detail on specific lobbying efforts that benefited customers in a November 26, 2007 letter to you from Meghan Grabel. In 2008, these efforts have focused on federal matters such as the extension of tax credits for renewable generation and state matters such as protecting our customers' interests in the Western Climate Initiative and working to try to minimize adverse impacts of state budget cuts on APS, its customers and the regulatory process in Arizona.

2. All employee incentive program compensation expended in 2008 has already been paid out. The APS expense was $6.7 million for officers and other senior management employees.

3. The Company's advertising budget anticipates that approximately $2.7 million of costs will be charged to the applicable regulatory accounts during 2008. This amount covers messaging solely around energy efficiency, conservation, renewables (other than that directly funded through the RES), and the "green choice" rate program. In addition, the DSM programs approved by the Commission have a marketing component, which includes approximately $1.2 million for advertising. Advertising related to the RES is separately budgeted and approved by the Commission as part of the overall category of RES marketing and outreach. For 2008, this RES-related marketing and outreach budget was $2.5 million. There is also some APS advertising related to safety messages. This safety-related advertising budget is about $200,000 for 2008. Finally, there is roughly $5000 of APS signage connected to charitable and civic events. That small amount is recorded "below-the-line" and paid for by APS shareholders. APS has no sports sponsorship costs for 2008.

4. The cost management efforts of APS have resulted in the reduction of some 550 positions. Of these, 375 positions were full-time employees, including 26 management positions, and 175 were contract employees.

5. The APS dividend to Pinnacle West for 2008 is $170 million. The dividend that APS has paid has not changed in well over a decade not withstanding equity infusions from Pinnacle West of over $700 million. Since 1996, this represents at least a 27% decline in the real (inflation adjusted) APS dividend to Pinnacle West and over a 50% decline in the dividend as a percentage of Pinnacle West's equity investment in APS.

APS understands the regulatory compact it has with the Commission. In the recent past, the Commission has examined the Company's operations and service quality in general rate cases, including the current proceeding in which Commission Staff alone has served some 25 sets of Data Requests (nearly 600 questions, often with numerous subparts) upon APS. The Commission has retained consultants to conduct specialized audits of fuel and power procurement and management, power plant operations, and hedging. Commission Staff itself has similarly reviewed APS's management of its financing costs. Neither Staff nor its consultants determined that APS managed these activities in an imprudent manner.

The capital and O&M cost savings announced during the second and third quarter conference calls focused primarily on 2009 and beyond. However, as APS has discussed in the Company's general rate case testimony, APS implemented some $14 million in O&M savings in 2008, including reductions in lobbying, advertising and communications costs. These cost savings also reflected reduced medical expenses resulting from changes to employee health care plans and reprioritizing, deferring or improving the efficiency of a variety of operations and maintenance work. Also, the initially-announced $200 million in capital expenditure reductions included work planned in 2008 as well as subsequent years.

APS understands the need to maintain customer service to the greatest extent possible. Certainly, this means balancing the level of service provided with the costs associated with such service levels. However, APS does not want short-term considerations to undermine an established record of improving customer service and satisfaction. Neither should cost-cutting be asked to come at the expense of environmental stewardship, our communities or the implementation of technological innovations such as advanced metering infrastructure. Each of these elements has an important call on the Company's responsibility as Arizona's largest electric utility.

While we understand that price increases are unpopular, including those driven by fuel costs outside the control of APS and this Commission, APS has received high ratings in customer satisfaction. Over the last several years, APS has ranked among the highest investor owned utilities in the Western United States in J.D. Power studies of customer satisfaction. Certainly, a major commitment to customer-friendly technology has enhanced customer satisfaction, such as installing over 150,000 "smart" meters, designing a state of the art website (ranked the 6th best in North America by E-Source), and demonstrating its overall dedication to the best in information technology (ranked 1st by the technology trade publication *Information Week*). APS employees work hard to support our communities, including thousands of volunteer hours donated to a wide array of causes and activities. APS's general efforts have benefited economic development in at least 40 separate Arizona communities or regions, promoted educational opportunities for Arizona students, and provided support to environmental and other important community projects. Also, in 2008, the Better Business Bureau awarded APS the Business Ethics Award.

Environmental stewardship informs many of the actions undertaken by APS. Beginning with its becoming the first utility to join the Coalition for Environmentally Responsible Economies in 1994 to its 2006 Climate Protection Award by the EPA, APS has become a recognized leader in the field of environmental and economic sustainability. Indeed, APS can claim status as the only Arizona company and only one of two U.S. utilities to rank among the world's 100 Most Sustainable Corporations. It enjoys a AAA rating from Innovest as being at the top of its industry in economic innovation, as well as concern for the environment and the community. APS continues to demonstrate its long-standing concern for the environment by providing its customers with the option of purchasing energy generated from renewable sources of electricity and by conserving electricity through energy efficiency and demand response.

With this Commission's support and policies, APS has become a leader in renewable resources particularly after the Commission's enactment of the Renewable Energy Standard ("RES"). With advent of the RES, however, APS has increased its renewable portfolio over thirty-fold since just 2005. With Solana and similar facilities and assuming the Company has the financial capability, APS has a goal of producing nearly half of its incremental needs in the years ahead through renewable resources. APS customers can contribute directly through both participation in distributed renewable energy projects and by subscribing to one of the Company's "green" power pricing options.

Again with Commission support, APS has instituted a number of cost-effective demand side management and energy efficiency programs. Just through 2007, these will result in 1.7 million MWH in lifetime energy savings. Notwithstanding the adverse impacts to the Company's financial performance from implementing effective energy efficiency programs, APS has increased its 2008 spending on energy efficiency by some 20% over 2007 levels, and for the second straight year, the EPA and the Department of Energy named APS an Energy Star Partner. Assuming continued regulatory support, APS hopes to increase its commitment to at least $25 million per year beginning in 2009. Recently, APS submitted for Commission approval a demand response program for general service customers. If approved, this will become the first of such programs, as APS anticipates providing an ever-increasing share of its additional capacity and energy needs through customer-based programs for demand reduction and energy efficiency.

We hope that the information contained in this letter responds to your requests and also helps the Commission view our present circumstances in an appropriate context. Challenging times often call for difficult decisions. When dealing with a vital service such as electricity, we need to avoid marginal solutions that may result in compromising important long-term values such as efficiency, reliability, safety, the environment and service to our communities. We take all of these factors into consideration each and every day in all of our business decisions, never losing sight of the long-term objectives we must pursue. APS looks forward to working with the Commission to providing the best possible service to our over one million customers.

Sincerely,

Thomas L. Mumaw

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