APS

A subsidiary of Pinnacle West Capital Corporation

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AZ CORP COMMISSION
DOCKET CONTROL

Donald G. Robinson
President & Chief Operating Officer

Tel. (602) 250-3392
Fax: (602) 250-2367
Donald.Robinson@aps.com

Mail Station 9040
P.O. Box 53999
Phoenix, AZ 85072-3999

March 18, 2009

Arizona Corporation Commission
DOCKETED

MAR 18 2009

DOCKETED BY

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007-2996

Re: Compliance Filing of Arizona Public Service Company Regarding Cost Management Efforts, Docket No. E-01345A-08-0172 (Interim Rate Proceeding)

Dear Sir or Madam:

In Decision No. 70667 (December 24, 2008), the Commission directed Arizona Public Service Company ("APS" or "Company") to examine its operations and expenses and employ "easily identifiable short term measures" to improve its financial condition. That decision indicated that APS should target additional cost reductions to operations and expenses of at least $20 million. The specific reductions to be included in this effort were left to APS's discretion, but the decision directed APS to consider such items as (1) reducing lobbying expenses, (2) reducing advertising expenses, (3) paring back management compensation for 2009, (4) imposing a temporary hiring freeze for all non-essential personnel, (5) examining payroll overhead, and (6) implementing a freeze on any increases in its dividend in 2009.

APS has identified and is in the process of implementing a minimum of $25.9 million of specific cost reductions to operations and other costs for 2009, which are described below and summarized on the attached Table 1. These cost reductions are in addition to the substantial cost management savings that have previously been discussed with the Commission. (*See* October 14, 2008 and November 26, 2008 letters, both of which are attached.) Further, APS is committing to several of the specific actions identified in Decision No. 70667, including a dividend freeze and a hiring freeze for non-essential personnel for the remainder of 2009.

In identifying and pursuing these additional cost reductions, APS has sought to carefully balance the benefit of attaining short-term improvements in the financial condition of the Company with the risk of resultant long-term adverse consequences to our customers and the Company—certainly a challenge that many businesses are faced with in today's economy. The actions APS is taking with respect to each such specific cost reduction area identified in the decision is discussed below, followed by a discussion of other cost management actions APS is implementing, concluding with an update on the overall cost management efforts of the Company.

I. Specific Areas Referenced in Decision No. 70667

Lobbying Expenses. APS's 2009 lobbying budget, for both state and federal lobbying, has been reduced by $500,000. This represents nearly a 20% reduction to the total budget, even though current state and federal legislative activity is higher, more complex and more important than at any time in recent memory. Much of this savings will be achieved from the cancellation or non-renewal of outside services agreements.

Advertising Expenses. APS currently receives specific funding for customer outreach and program marketing relating to RES and DSM activities from surcharges, which will remain at current Commission-approved levels. However, APS has reduced its remaining non-funded advertising budget by approximately 30% or $1,000,000. This non-funded advertising budget had supplemented RES and DSM advertising programs, largely in the area of developing and producing new advertisements and messages focused on renewable energy, energy efficiency and safety. Nevertheless, APS believed it appropriate to make these reductions. The remaining APS advertising budget will continue to emphasize renewable energy, energy efficiency, customer programs and safety.

Management and Other Compensation. APS had incorporated a higher base salary amount in its 2009 budget. This was not a cost of living adjustment, but instead reflected APS's long-standing practice of granting annual merit increases based on both individual performance and labor market trends. The Company determined, however, to freeze all officer and senior managers salaries at levels established in late 2007, and to freeze all other management salaries at 2008 levels.[1] In addition, merit increases for non-union[2] frontline employees were significantly reduced or eliminated. The APS share of total savings resulting from this action was $7.5 million. APS also has frozen contractor wage increases for 2009. APS estimates its share of those savings to be an additional $1.8 million.

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1 An employee who receives a promotion, however, could move into a higher grade.

2 APS's current collective bargaining agreements contractually specify how annual union base pay increases are to be implemented and could not be modified.

Temporary Hiring Freeze. APS requires CEO approval to fill any new position or any vacant position with an outside hire, and such approval will be provided for only the most critical positions.

Payroll Overhead. The Company has modified its medical plan program to reduce the medical costs absorbed by APS, primarily by increasing co-pays and limiting the scope of certain benefits. Total APS savings from this change will be approximately $1.2 million.

Dividend Freeze. APS will not increase its dividend in 2009.

II. Other Cost Savings Identified by APS

In addition to the areas described above, APS has identified cost savings in other areas:

Fossil Generation O&M. APS will reduce fossil plant O&M by reducing or deferring work on various maintenance items in 2009, including deferring certain maintenance work at the Four Corners, West Phoenix, Cholla, and Redhawk power plants. APS share of these savings will be approximately $4.1 million.

Other O&M Reductions. APS will also reduce or postpone various activities in legal, customer service, information services, delivery, finance and facilities. For example, APS will further consolidate and streamline its call center functions, reduce the level of internal mail service at various Company locations, and reduce insurance limits. APS savings from these reductions will be approximately $4.0 million.

Supply Chain Cost Reductions. APS is implementing a new supply chain management sourcing effort that will reduce the price paid for wood, steel and concrete poles and towers. Estimated annual savings are approximately $1.5 million.

Freight and Delivery Cost Reductions. APS is implementing a new company-wide initiative to reduce freight costs and optimizing material delivery costs that will result in an annual savings of approximately $1.3 million.

Renegotiated Call Center Contract. APS has renegotiated a contract for APS Call Center contract labor resulting in annual savings of approximately $500,000.

Lowering Technology Services Support. Technology services support related to responsiveness and availability for APS departments will be reduced. APS savings will be approximately $1 million.

Reduction of Short Term Interest Expense. APS will reduce working capital in an amount that would result in an annual reduction of short term interest expense by at least $1.5 million.

APS believes that the estimates of cost savings identified above are conservative. These cost savings do not reflect any estimate of potential vacancy savings in 2009 from the more restrictive hiring freeze. Neither does it include additional interest, depreciation, and property tax savings from reduced capital expenditures. In that regard, and in addition to those cost reductions previous announced, APS recently eliminated another $72 million from its 2009-2011 capital budget.

III. APS's Overall Cost Management Efforts

APS has approached these additional cost reductions similarly to the cost reductions announced last year—with a critical and often difficult balancing of short-term and long-term impacts to our customers, employees and operations. The challenges facing both our industry and our state are significant, further complicating this balancing process. APS remains committed to maintaining reliability and customer service, while efficiently and proactively planning for the future in these most uncertain of times. For example, the Resource Plan Report submitted to the Commission earlier this year is a key element of the Company's long-term planning.

High-quality customer service, reliability, prudent long-term planning, resource diversity, operational excellence—all the things that go into sustainability—require APS to be financially strong so that it can attract and retain the resources, both capital and human, necessary to fulfill its obligations to the public and its over one million Arizona customers. As APS has indicated in its pending rate case, long-term improvement in the financial health of the Company cannot be achieved solely through more aggressive cost management, but must be complemented with prices that truly reflect APS's prudent and reasonable cost of providing service. At the same time, APS recognizes that it has the responsibility to actively and effectively manage those costs without compromising service and reliability and without sacrificing long-term efficiencies for short-term benefit.

IV. Conclusion

The Company is committed to cost management in both good times and bad. But the current economic circumstances for APS and its customers make those efforts doubly important. APS does not intend to stop its cost containment efforts with just the actions identified above but will rather continue to build on them throughout this year and into future years. In all such efforts, the focus will remain on APS's core values of safety, reliability, customer service, and value for customers.

Sincerely,

Donald G. Robinson

cc: Chairman Mayes
Commissioner Pierce
Commissioner Newman
Commissioner Kennedy
Commissioner Stump
Michael Kearns
Ernest Johnson
Terri Ford
Barbara Keene
Janice Alward
Brian Bozzo
Parties of Record

Table 1: Summary of Cost Reductions

Area	Action Being Taken	Cost Savings
Lobbying Expenses	Reducing expenditures, including reduced consulting arrangements	$500,000
Advertising	Reducing expenditures primarily related to design and production	$1,000,000
Management and Employee Compensation	Freezing base compensation for all management employees and many non-union frontline employees	$7,500,000
Contractor Wage Freeze	Freezing wage or salary increases for contractors	$1,800,000
Reduced Payroll Overhead	Modifying medical plan to require higher co-pays and limit certain benefits coverage	$1,200,000
Fossil Plant	Deferring or reducing various maintenance items for 2009	$4,100,000
Legal, Customer Service, Information Services, Delivery, Finance and Facilities	Deferring or eliminating various activities and support functions in each of these areas, such as consolidating and streamlining call center functions, reducing internal mail service, and modifying insurance coverages	$4,000,000
Supply Chain Management	Reducing cost of acquiring wood, steel, and concrete poles	$1,500,000
Freight Delivery	Reducing and optimizing freight and delivery costs	$1,300,000
Call Center	Reduce contract labor costs	$500,000
Technology Services	Reduce level of technology support for various business units	$1,000,000
Short-Term Interest	Reduce level of required working capital resulting in interest savings	$1,500,000
Total		***$25,900,000***

Copies of the foregoing emailed or mailed
This 18th day of March 2009 to:

Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
ejohnson@cc.state.az.us

Maureen Scott
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
mscott@azcc.gov

Janet Wagner
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
jwagner@azcc.gov

Terri Ford
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
tford@azcc.gov

Barbara Keene
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
bKeene@cc.state.az.us

Daniel Pozefsky
Chief Counsel
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
dpozefsky@azruco.com

William A. Rigsby
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
brigsby@azruco.gov

Tina Gamble
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
egamble@azruco.gov

C. Webb Crockett
Fennemore Craig
3003 North Central, Suite 2600
Phoenix, AZ 85012-2913
wcrocket@fclaw.com

Kevin Higgins
Energy Strategies, LLC
215 South State Street, Suite 200
Salt Lake City, UT 84111
khiggins@energystrat.com

Michael L. Kurtz
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
mkurtz@BKLlawfirm.com

Kurt J. Boehm
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
kboehm@BKLlawfirm.com

The Kroger Company
Dennis George
Attn: Corporate Energy Manager (G09)
1014 Vine Street
Cincinnati, OH 45202
dgeorge@kroger.com

Stephen J. Baron
J. Kennedy & Associates
570 Colonial Park Drive
Suite 305
Roswell, GA 30075
sbaron@jkenn.com

Theodore Roberts
Sempra Energy Law Department
101 Ash Street, H Q 13D
San Diego, CA 92101-3017
TRoberts@sempra.com

Lawrence V. Robertson, Jr.
2247 E. Frontage Road
Tubac, AZ 85646
tubaclawyer@aol.com

Michael A. Curtis
501 East Thomas Road
Phoenix, AZ 85012
mcurtis401@aol.com

William P. Sullivan
501 East Thomas Road
Phoenix, AZ 85012
wsullivan@cgsuslaw.com

Larry K. Udall
501 East Thomas Road
Phoenix, AZ 85012
ludall@cgsuslaw.com

Michael Grant
Gallagher & Kennedy, P.A.
2575 East Camelback Road
Phoenix, AZ 85016
MMG@gknet.com

Gary Yaquinto
Arizona Investment Council
2100 North Central, Suite 210
Phoenix, AZ 85004
gyaquinto@arizonaic.org

David Berry
Western Resource Advocates
P.O. Box 1064
Scottsdale, AZ 85252-1064
azbluhill@aol.com

Tim Hogan
Arizona Center for Law in the Public Interest
202 East McDowell Road
Suite 153
Phoenix, AZ 85004
thogan@aclpi.org

Jeff Schlegel
SWEEP Arizona Representative
1167 W. Samalayuca Dr.
Tucson, AZ 85704-3224
schlegelj@aol.com

Jay I. Moyes
MOYES, SELLERS, & SIMS
1850 North Central Avenue, Suite 1100
Phoenix, AZ 85004
jimoyes@lawms.com

Karen Nally
MOYES, SELLERS, & SIMS
1850 North Central Avenue, Suite 1100
Phoenix, AZ 85004
kenally@lawms.com

Jeffrey J. Woner
K.R. Saline & Assoc., PLC
160 N. Pasadena, Suite 101
Mesa, AZ 85201
jjw@krsaline.com

Scott Canty
General Counsel the Hopi Tribe
P.O. Box 123
Kykotsmovi, AZ 86039
Scanty0856@aol.com

Cynthia Zwick
1940 E. Luke Ave
Phoenix, AZ 85016
czwick@azcaa.org

Nicholas J. Enoch
349 North 4th Ave
Phoenix, AZ 85003
nick@lubinandenoch.com

Karen S. White, Esq
Air Force Utility Litigation &
Negotiation Team
AFLOA/JACL-ULT
139 Barnes Drive
Tyndall AFB, FL 32403
karen.white@tyndall.af.mil

Amanda Ormond
Interwest Energy Alliance
7650 S. McClintock
Suite 103-282
Tempe, AZ 85284
asormond@msn.com

Douglas V. Fant
Law Offices of Douglas V. Fant
3655 W. Anthem Dr.
Suite A-109 PMB 411
Anthem, AZ 85086
dfantlaw@earthlink.net

Barbara Wyllie-Pecora
27458 N. 129th Drive
Peoria, AZ 85383
bwylliepecora@yahoo.com

Carlo Dal Monte
Catalyst Paper Corporation
65 Front Street, Suite 201
Nanaimo, BC V9R 5H9
Carlo.dalmonte@catalystpaper.com

PINNACLE WEST
CAPITAL CORPORATION
LAW DEPARTMENT

Thomas L. Mumaw
Senior Attorney
(602) 250-2052
Direct Line

October 14, 2008

Hon. Lyn Farmer
Chief Administrative Law Judge
Hearing Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

Re: Docket No. E-01345A-08-0172 (APS Interim Rate Request)
APS Late-Filed Exhibit 23

Dear Judge Farmer:

As stated in my letter to you dated September 26, 2008, this is the second part of Arizona Public Service Company's ("APS" or "Company") response to the outstanding requests for certain information in the above proceeding. Per your instructions, this letter and its attachments have been designated as APS Exhibit 23.

Attachment 1 to this letter provides a more detailed breakdown of reduction in the anticipated capital expenditures ("CAPX") for the years 2009-2011. It does so by first beginning with the CAPX forecast presented in Exhibit DEB-3, which is an attachment to Donald E. Brandt's Direct Testimony in the pending general rate case, but with 2011 added using the same assumptions that had been used for the years 2009 and 2010 in Exhibit DEB-3.[1] The net changes to the CAPX forecast as of October 2008 are set forth separately. As you can see, anticipated CAPX reductions in distribution, transmission and general plant actually exceed $500 million[2] APS has provided the CAPX forecast changes in the same format and to the same level of granularity as in Exhibit DEB-3 for ease of

[1] The rate case testimony attachment had not addressed 2011 because it was 2010 that formed the basis for the Company's proposed attrition adjustment. However, to start everyone off on the same page with an "apples to apples" comparison; APS added what would have been the 2011 forecast using the same assumptions as for 2009 and 2010 in DEB-3.

[2] As the Commission is aware, Palo Verde is operating under a separate Performance Improvement Plan and is not included in the general Company efficiency/cost reduction program that will produce the reduction in future CAPX. Therefore, and although Palo Verde CAPX may change for reasons unrelated to the more general CAPX reduction program, it is held constant at DEB-3 levels for purposes of this analysis.

APS • APS Energy Services • SunCor • El Dorado

Law Department, 400 North Fifth Street, Mail Station 8695, Phoenix, AZ 85004-3992
Phone: (602) 250-2052 · Facsimile (602) 250-3393
E-mail: Thomas.Mumaw@pinnaclewest.com

comparison. This means, for example, that while the major transmission projects that will be delayed are specifically identified to the extent they were in the prior CAPX forecast, smaller projects (and even larger projects that were not included in the earlier 2008 DEB-3 forecast) are shown collectively at line 22. Please also note that these represent preliminary estimates that may change materially, either up or down, depending on future events and more specifically, depending on the needs of our customers.

Although not specifically requested, APS believes there was some confusion during the recent hearing over the CAPX forecast submitted in August of 2007 and that subsequent CAPX forecast attached to Mr. Brandt's general rate case testimony. *See* Brandt Testimony at 602:7 – 603:10. A great deal, if not all, of the differences between the two forecasts is a result of the differing vintages of the forecasts. Although provided in August of 2007, what was then requested was a breakdown of the capital items identified back in late 2006 as Exhibit 27 in the Company's last general rate case. As can be seen on Attachment 2, the actual vintage of the forecast that resulted in both Exhibit 27 and the August 2007 filing was August of 2006 – some 21 or 22 months earlier than the forecast used for DEB-3 (rather than the six or seven months referenced at the time of the hearing) and well prior to the Company's announcement of $200 million CAPX reductions in late 2007 and early 2008 (which, of course, have recently been significantly expanded). Attachment 2 provides a reconciliation between the two vintages of CAPX forecast. APS would add that although the actual time between the two forecasts is considerably longer than what may have been thought during the recent interim rate hearing, even if there had been "only" a six month difference, it is still very possible that a CAPX forecast could materially change in such a relatively short period of time.

APS believes this letter has been responsive to the issues discussed above and would request admission of the letter and its attachments as APS Exhibit 23 in accordance with the procedure outlined by your honor on September 19.

Sincerely,

Thomas L. Mumaw

Thomas L. Mumaw

Attorney for Arizona Public Service Company

TLM/Attachments

Original and 13 copies of the foregoing filed this 14th day of October 2008 with:

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, AZ 85007

and

Copies of the foregoing emailed or mailed this 14th day of October 2008 to:

Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
ejohnson@cc.state.az.us

Maureen Scott
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
mscott@azcc.gov

Janet Wagner
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
jwagner@azcc.gov

Terri Ford
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
tford@azcc.gov

Barbara Keene
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
bKeene@cc.state.az.us

Daniel Pozefsky
Chief Counsel
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
dpozefsky@azruco.com

William A. Rigsby
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
brigsby@azruco.gov

Tina Gamble
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
egamble@azruco.gov

C. Webb Crockett
Fennemore Craig
3003 North Central, Suite 2600
Phoenix, AZ 85012-2913
wcrockett@fclaw.com

Kevin Higgins
Energy Strategies, LLC
215 South State Street, Suite 200
Salt Lake City, UT 84111
khiggins@energystrat.com

Michael L. Kurtz
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
mkurtz@BKLlawfirm.com

Kurt J. Boehm
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
kboehm@BKLlawfirm.com

The Kroger Company
Dennis George
Attn: Corporate Energy Manager (G09)
1014 Vine Street
Cincinnati, OH 45202
dgeorge@kroger.com

Stephen J. Baron
J. Kennedy & Associates
570 Colonial Park Drive
Suite 305
Roswell, GA 30075
sbaron@jkenn.com

Theodore Roberts
Sempra Energy Law Department
101 Ash Street, H Q 13D
San Diego, CA 92101-3017
TRoberts@sempra.com

Lawrence V. Robertson, Jr.
2247 E. Frontage Road
Tubac, AZ 85646
tubaclawyer@aol.com

Michael A. Curtis
501 East Thomas Road
Phoenix, AZ 85012
mcurtis401@aol.com

William P. Sullivan
501 East Thomas Road
Phoenix, AZ 85012
wsullivan@cgsuslaw.com

Larry K. Udall
501 East Thomas Road
Phoenix, AZ 85012
ludall@cgsuslaw.com

Michael Grant
Gallagher & Kennedy, P.A.
2575 East Camelback Road
Phoenix, AZ 85016
MMG@gknet.com

Gary Yaquinto
Arizona Investment Council
2100 North Central, Suite 210
Phoenix, AZ 85004
gyaquinto@arizonaic.org

David Berry
Western Resource Advocates
P.O. Box 1064
Scottsdale, AZ 85252-1064
azbluhill@aol.com

Tim Hogan
Arizona Center for Law in the Public Interest
202 East McDowell Road
Suite 153
Phoenix, AZ 85004
thogan@aclpi.org

Jeff Schlegel
SWEEP Arizona Representative
1167 W. Samalayuca Dr.
Tucson, AZ 85704-3224
schlegelj@aol.com

Jay I. Moyes
MOYES, SELLERS, & SIMS
1850 North Central Avenue, Suite 1100
Phoenix, AZ 85004
jimoyes@lawms.com

Karen Nally
MOYES, SELLERS, & SIMS
1850 North Central Avenue, Suite 1100
Phoenix, AZ 85004
kenally@lawms.com

Jeffrey J. Woner
K.R. Saline & Assoc., PLC
160 N. Pasadena, Suite 101
Mesa, AZ 85201
jjw@krsaline.com

Scott Canty
General Counsel the Hopi Tribe
P.O. Box 123
Kykotsmovi, AZ 86039
Scanty0856@aol.com

Cynthia Zwick
1940 E. Luke Ave
Phoenix, AZ 85016
czwick@azcaa.org

Attachment 1

Arizona Public Service Company
Cost Efficiency Program Impact on Construction Expenditures Projection 2009 - 2011
$Millions

line		2009	2010	2011	3 - yr Total
1	**2008 Rate Case Forecast per note below**	**1,085**	**993**	**964**	**3,042**
	Changes as a result of the Cost Efficiency Program:				
	Production				
	Nuclear (APS Share)				
2	Nuclear Fuel	-	-	-	-
3	Reactor Vessel Head, Units 1, 2, 3	-	-	-	-
4	Evap Pond & Reservoir Liner Replacement	-	-	-	-
5	Cooling Tower Replacement, Unit 1	-	-	-	-
6	Rapid Refueling Package	-	-	-	-
7	Other Nuclear Power Plant Improvements - Includes regulatory, safety, reliability, or efficiency projects not listed above	-	-	-	-
8	**Total Nuclear**	-	-	-	-
	Fossil (APS Share)				
9	Cholla Environmental- Includes Baghouse, Scrubber, and other Environmental projects	(24)	(47)	18	(53)
10	Four Corners Environmental - Includes NOX abatement, particulate control, and other Environmental projects	1	-	19	20
11	Navajo Environmental - Includes NOX abatement and other Environmental projects	1	-	-	1
12	Other Coal Plant projects - Includes regulatory, safety, reliability, and efficiency projects at coal plants	(9)	(24)	(8)	(41)
13	Environmental Projects at Gas Plants	(2)	1	3	2
14	Long-Term Service Agreement Costs at Redhawk, West Phoenix	(29)	25	(1)	(5)
15	Other Plant projects - Includes capital costs for regulatory, safety, reliability, and efficiency projects at gas plants, and Childs/Irving Decommissioning	(3)	(14)	7	(10)
16	**Total Fossil**	**(65)**	**(59)**	**38**	**(86)**
17	**Total Production**	**(65)**	**(59)**	**38**	**(86)**

Note: This forecast is included in the Direct Testimony of Donald E. Brandt (Docket No. E-01345A-08-0172) as Attachment DEB-3. The forecast provided here differs from that provided in Attachment DEB-3 only in terms of years shown. Attachment DEB-3 shows the Company's forecast for 2008-2010 as of June 2008, consistent with the Company's asking in that case. The projections shown here are for years 2009-2011, to give the background necessary to show the impact of the recent Cost Efficiency Program (which will be seen in that timeframe) on the Company's overall forecast at the time of the rate case.

Arizona Public Service Company
Cost Efficiency Program Impact on Construction Expenditures Projection 2009 - 2011
$Millions

line		2009	2010	2011	3 - yr Total
	Transmission & Distribution				
	Transmission				
	Selected Major Transmission Projects				
18	Palo Verde - TS5 - TS9 TS5 to be located northwest of White Tanks; TS9 to be located near existing Raceway substation	(47)	(30)	(86)	(163)
19	TS5 - TS1 - Palm Valley TS1 to be located southwest of 195th Av & Deer Valley	(10)	(3)	4	(9)
20	TS9 - Pinnacle Peak 500kV	46	(18)	-	28
21	Palo Verde - North Gila 500kV	(30)	(37)	22	(45)
22	All Other Transmission Infrastructure Additions & Upgrades - includes Line & Substation additions & upgrades for 69kV and above voltage not listed above	(28)	(104)	(115)	(247)
23	Transmission Reliability Projects - includes Breaker, Capacitor, and Reactor projects, and other major reliability projects	7	(3)	-	4
24	Transmission relocations & emergency projects	-	-	-	-
25	**Total Transmission**	**(62)**	**(195)**	**(175)**	**(432)**
	Distribution				
26	Distribution Infrastructure projects - includes line & substations additions & upgrades	(29)	(39)	(28)	(96)
27	Distribution Reliability Projects - includes projects for substation, overhead, and underground equipment	-	2	(4)	(2)
28	Other Distribution Projects - Safety, Relocation / Conversion, Emergency, and other projects	13	15	10	38
29	**Subtotal, Distribution excluding Customer Construction**	**(16)**	**(22)**	**(22)**	**(60)**
	New Customer Construction (excl Schedule 3 CIAC)				
30	Meters (primarily AMI project)	19	28	20	67
31	Transformers	(6)	(14)	(23)	(43)
32	Service & Line Extensions	(19)	(32)	(91)	(142)
33	Street Light / Dusk-to-Dawn	1	1	-	2
34	**Total New Customer Construction excl Schedule 3 CIAC**	**(5)**	**(17)**	**(94)**	**(116)**
35	**Total Distribution excluding Schedule 3 CIAC**	**(21)**	**(39)**	**(116)**	**(176)**
36	**Total Transmission & Distribution**	**(83)**	**(234)**	**(291)**	**(608)**

$Millions

line	General Plant	2009	2010	2011	3 - yr Total
37	Customer Service information systems	6	7	7	20
38	Distribution operations & work-management systems	23	9	8	40
39	All Other Info Sys Projects - includes infrastructure additions, equipment replacement, and all other Generation, T&D, and Shared Services systems & telecom	3	1	12	16
40	Deer Valley Operations Hub	(63)	(14)	86	9
41	Facilities - includes new service centers, upgrades of existing facilities, and replacements of mechanical equipment, plumbing, etc. at APS facilities.	(44)	(45)	(27)	(116)
42	Other General Plant	2	-	4	6
43	**Total General Plant**	**(73)**	**(42)**	**90**	**(25)**
44	**Total Change excluding Schedule 3 CIAC**	**(221)**	**(335)**	**(163)**	**(719)**
45	Schedule 3 CIAC	30	50	116	196
46	**Total Change including Schedule 3 CIAC**	**(191)**	**(285)**	**(47)**	**(523)**
47	**Construction Expenditure Projection as of October 2008**	**894**	**708**	**917**	**2,519**

Attachment 2

APS Construction Expenditure Projections
2005 Rate Case Forecast vs 2008 Rate Case Forecast
$Millions

line		2005 Rate Case Forecast [A]				2008 Rate Case Forecast [B]				Change				Notes
		(1) 2008	(2) 2009	(3) 2010	(4) 3-yr Total	(5) 2008	(6) 2009	(7) 2010	(8) 3-yr Total	(5)-(1) 2008	(6)-(2) 2009	(7)-(3) 2010	(8)-(4) 3-yr Total	
1	Nuclear Fuel (APS Share)	41	59	55	155	93	117	110	320	52	58	55	165	C
2	Nuclear Plant Improvements (APS Share)	42	39	21	102	55	78	79	212	13	39	58	110	D
3	Fossil Plant Improvements (APS Share)	179	191	138	508	231	190	181	602	52	(1)	43	94	E
4	Transmission	222	283	182	687	208	317	288	813	(14)	34	106	126	F
5	Distribution, excluding Schedule 3 CIAC	307	317	326	950	299	248	260	807	(8)	(69)	(66)	(143)	G
6	General Plant - Information Systems, Facilities, Other	133	134	123	390	162	194	154	510	29	60	31	120	H
7	Total APS excluding Schedule 3 CIAC	924	1,023	845	2,792	1,048	1,144	1,072	3,264	124	121	227	472	
8	Schedule 3 CIAC	-	-	-	-	(25)	(59)	(79)	(163)	(25)	(59)	(79)	(163)	
9	**Total APS**	**924**	**1,023**	**845**	**2,792**	**1,023**	**1,085**	**993**	**3,101**	**99**	**62**	**148**	**309**	

A The forecast provided in the 2005 Rate Case (Docket Nos. E-01345A-05-0816, E-01345A-05-0826 and E-01345A-05-0827) as Exhibit 27 was based upon August 26, 2006 projections. This forecast information was subsequently provided in the Financing Hearing (Docket No. E-01345A-06-0779), as Exhibit 4.

B The forecast provided in the 2008 Rate Case (Docket No. E-01345A-08-0172) as Attachment DEB-3 to Donald E. Brandt General Rate Case Testimony, was based on June 2008 projections.

C Changes principally due to increases in the cost of nuclear fuel.

D Changes principally due to changes in timing & scope of various plant improvement projects

E Changes principally due to changes in timing & scope of various plant improvement projects and increases to material prices

F Changes principally due to changes in timing & scope of various transmission projects and increases to material prices and right-of-way costs

G Changes principally due to recognized slower customer growth and efficiency initiative reductions, partially offset by changes in timing & scope of various distribution projects and increases in material prices

H Changes principally due to the addition of the Deer Valley Operations hub and changes in timing & scope of various facilities and information systems projects

PINNACLE WEST
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DOCKET CONTROL

Thomas L. Mumaw
Senior Attorney
(602) 250-2052
Direct Line

November 26, 2008

RECEIVED
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AZ CORP COMM
Director Utilities

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.

Law Department, 400 North Fifth Street, Mail Station 8695, Phoenix, AZ 85004-3992
Phone: (602) 250-2052 · Facsimile (602) 250-3393
E-mail: Thomas.Mumaw@pinnaclewest.com

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.

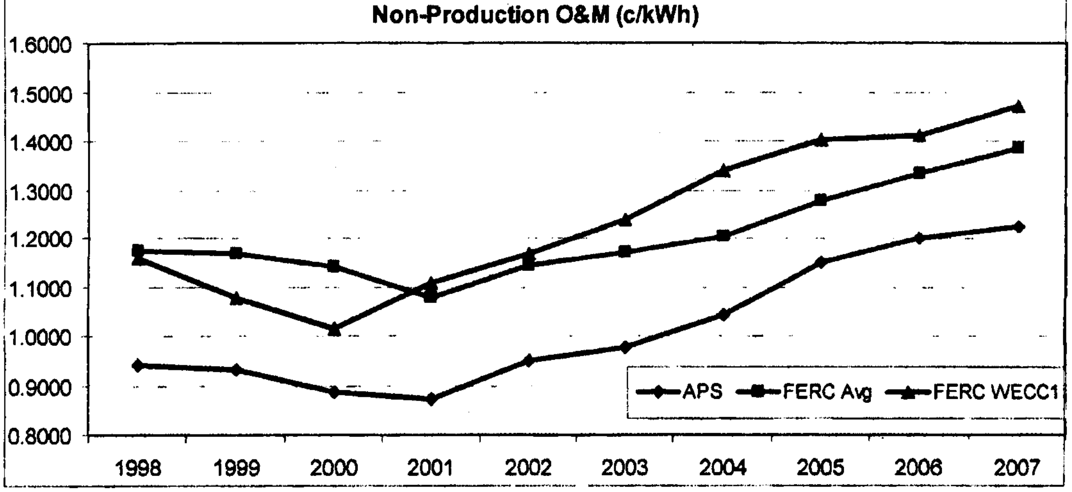

Figure 1: APS Non-Production O&M Comparison (FERC Form 1 Data)

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

Thomas L. Mumaw

cc: Mike Gleason, Chairman
William A. Mundell
Jeff Hatch-Miller
Gary Pierce
Ernest Johnson
Janice Alward
Lyn A. Farmer
Brian McNeil
Rebecca Wilder
Parties of Record
Docket Control

Copies of the foregoing emailed or mailed
This 26th day of November 2008 to:

Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
ejohnson@cc.state.az.us

Maureen Scott
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
mscott@azcc.gov

Janet Wagner
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
jwagner@azcc.gov

Terri Ford
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
tford@azcc.gov

Barbara Keene
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
bKeene@cc.state.az.us

Daniel Pozefsky
Chief Counsel
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
dpozefsky@azruco.com

William A. Rigsby
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
brigsby@azruco.gov

Tina Gamble
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
egamble@azruco.gov

C. Webb Crockett
Fennemore Craig
3003 North Central, Suite 2600
Phoenix, AZ 85012-2913
wcrocket@fclaw.com

Kevin Higgins
Energy Strategies, LLC
215 South State Street, Suite 200
Salt Lake City, UT 84111
khiggins@energystrat.com

Michael L. Kurtz
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
mkurtz@BKLlawfirm.com

Kurt J. Boehm
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
kboehm@BKLlawfirm.com

The Kroger Company
Dennis George
Attn: Corporate Energy Manager (G09)
1014 Vine Street
Cincinnati, OH 45202
dgeorge@kroger.com

Stephen J. Baron
J. Kennedy & Associates
570 Colonial Park Drive
Suite 305
Roswell, GA 30075
sbaron@jkenn.com

Theodore Roberts
Sempra Energy Law Department
101 Ash Street, H Q 13D
San Diego, CA 92101-3017
TRoberts@sempra.com

Lawrence V. Robertson, Jr.
2247 E. Frontage Road
Tubac, AZ 85646
tubaclawyer@aol.com

Michael A. Curtis
501 East Thomas Road
Phoenix, AZ 85012
mcurtis401@aol.com

William P. Sullivan
501 East Thomas Road
Phoenix, AZ 85012
wsullivan@cgsuslaw.com

Larry K. Udall
501 East Thomas Road
Phoenix, AZ 85012
ludall@cgsuslaw.com

Michael Grant
Gallagher & Kennedy, P.A.
2575 East Camelback Road
Phoenix, AZ 85016
MMG@gknet.com

Gary Yaquinto
Arizona Investment Council
2100 North Central, Suite 210
Phoenix, AZ 85004
gyaquinto@arizonaic.org

David Berry
Western Resource Advocates
P.O. Box 1064
Scottsdale, AZ 85252-1064
azbluhill@aol.com

Tim Hogan
Arizona Center for Law in the Public Interest
202 East McDowell Road
Suite 153
Phoenix, AZ 85004
thogan@aclpi.org

Jeff Schlegel
SWEEP Arizona Representative
1167 W. Samalayuca Dr.
Tucson, AZ 85704-3224
schlegelj@aol.com

Jay I. Moyes
MOYES, SELLERS, & SIMS
1850 North Central Avenue, Suite 1100
Phoenix, AZ 85004
jimoyes@lawms.com

Karen Nally
MOYES, SELLERS, & SIMS
1850 North Central Avenue, Suite 1100
Phoenix, AZ 85004
kenally@lawms.com

Jeffrey J. Woner
K.R. Saline & Assoc., PLC
160 N. Pasadena, Suite 101
Mesa, AZ 85201
jjw@krsaline.com

Scott Canty
General Counsel the Hopi Tribe
P.O. Box 123
Kykotsmovi, AZ 86039
Scanty0856@aol.com

Cynthia Zwick
1940 E. Luke Ave
Phoenix, AZ 85016
czwick@azcaa.org

Nicholas J. Enoch
349 North 4th Ave
Phoenix, AZ 85003
nick@lubinandenoch.com

Karen S. White, Esq
Air Force Utility Litigation &
Negotiation Team
AFLOA/JACL-ULT
139 Barnes Drive
Tyndall AFB, FL 32403
karen.white@tyndall.com