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September 9, 2009

Arizona Corporation Commission
DOCKETED

SEP - 9 2009

DOCKETED BY

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

Re: Chairman Kristen K. Mayes' September 1, 2009 letter regarding declining natural gas prices and possible acceleration of refund of the over-collections in Arizona Public Service Company's . . . Power Supply and Purchased Gas adjustor account, Docket No. E-01345A-08-0172; Commissioner Gary Pierce's August 31, 2009 letter regarding declining natural gas prices, Docket No. E-01345A-08-0172.

Dear Chairman Mayes and Commissioner Pierce:

This letter responds to various inquiries posed to the parties to the Arizona Public Service Company ("APS" or "Company") rate case in Chairman Mayes' letter of September 1, 2009 and Commissioner Pierce's correspondence of August 31, 2009. Each of those letters primarily asks questions related to whether the current over-collected balance in APS's Power Supply Adjustor ("PSA") should be refunded to customers prior to the proposed January 1, 2010 effective date for new rates. The Chairman also asks that APS state "whether it would be in the public interest to delay the implementation of the base rate increase portion of the proposed APS rate increase for several months," and if not, why not.

APS strongly believes that public policy supports approving the Settlement Agreement as proposed. Consider:

- Coordinating the PSA reset with the implementation of new rates would result in a **less than one percent rate increase** for the average residential customer, providing a smooth transition for needed rate relief.

- Implementing the PSA reset today will not significantly reduce customer bills, which on average will decline considerably in the coming months in any event due to lower usage and winter rates.

- Delaying the rate increase until May would compound the impact of the normal transition to higher summer energy bills.

- Timing the PSA reset with the onset of new rates in January sends more correct price signals to customers, whose current rates do not reflect the costs required to serve.

- Delaying the rate increase would materially alter the balance struck in the Settlement Agreement and jeopardize its other provisions, including APS's equity infusion, renewable energy, and energy efficiency commitments.

The following elaborates on these points and responds to the remaining inquiries posed in your respective letters.

I. Customer interests are best served by timing the PSA reset so that its early implementation corresponds with the proposed rate increase.

The Company recognizes the Commission's discretion concerning when the PSA surplus balance should be credited to customers. Nevertheless, we continue to believe that the public interest is best served by timing the PSA reset to coincide with the effective date of new rates, notwithstanding the current economic recession. The hottest summer months have now passed. With the onset of the cooler season and lower winter rates, customers will see reduced energy bills regardless of a PSA reset. Indeed, the average residential customer bill is more than $73.50 per month less in the winter compared to what it is during the summer. Under the terms of the Agreement, if the fuel balance is used to offset the proposed base rate increase, the average residential bill will actually decrease again by another small amount in January. Residential customers will thus not see any rise in their electric bills from the base rate increase until May, when the normal transition to higher summer rates occurs. And even then, the net annual rate increase resulting from the proposed Settlement Agreement would be less than one percent – a smooth transition for needed rate relief.

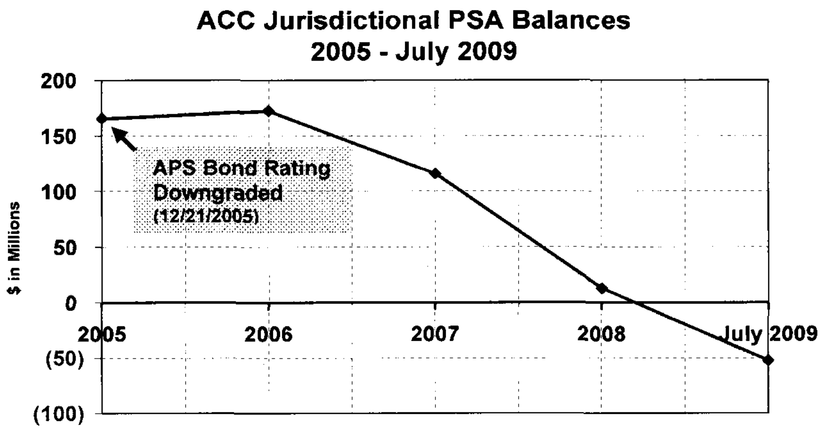
Although resetting the PSA today would reduce the average winter bill slightly (adding a marginal savings of about $1.75 per month[1] to the current $73.50 reduction), doing so will cause it to go up again in January, just a few short months from now, creating rate instability for customers. This is precisely what the parties to the settlement thought best to avoid. In contrast, timing the reset – which is paid back to customers with interest – to coincide in time with new rates would enable the Commission to use the benefit of lower-than-expected fuel costs to almost entirely offset the needed rate increase, giving customers more stability in their electric bills that will help them plan their household budget in these tight economic times. That, APS believes, is a better benefit than saving less than two dollars per month on average for the next few months.

Timing the PSA reset with the implementation of new rates also sends correct price signals to customers, encouraging them to reduce their usage and invest in energy efficiency and similar

[1] This number reflects the PSA balance as of July 2009.

measures to keep their bills down. The prices that customers pay today for electricity do not accurately reflect the overall costs incurred to serve them. To the extent practicable, base rates should send customers market price signals that will shape their usage patterns and better reflect the costs to serve. Delaying the PSA reset until the proposed rate increase is effective, at which time energy prices will be somewhat more aligned with the cost of producing and delivering that energy, will send the right price signals to customers – an important policy consideration.

The fact that the PSA is currently running a credit balance is neither unanticipated nor inconsistent with the structure of the APS fuel adjustor, which was always intended to be, and by its terms is, symmetrical in operation. Prior to the reforms to the PSA ordered by the Commission in the Company's last rate case, continual and significant under-collections impaired APS's financial health, ultimately causing APS's credit rating to be downgraded to its current BBB- status. Past under-collections reached variance levels of upwards of $160 million and $170 million in some years, far exceeding the current $52 million over-collection. The following table shows how the PSA balance has changed over time:



The changes to the PSA authorized by the Commission in Decision No. 69663 resolved many of the cash flow problems caused by the volatile fuel costs experienced by the Company, and the new PSA has been recognized by credit rating agencies as important to the Company's financial health.

Yet even the current PSA, which uses a forward-looking estimate of fuel and purchased power costs to set the adjustor rate, adjusts that balance to reflect actual costs just once each year (on February 1). Although there is a "Transition Component" mechanism in the PSA that allows the Commission to approve a mid-year change to the PSA rate, that device is reserved for "cases where variances between the anticipated recovery [or refund] of fuel and purchased power costs for the PSA Year . . . become so large as to warrant recovery, should the Commission deem such an adjustment to be appropriate." *See* PSA Plan of Administration at 2. If the Commission views a $52 million variance (the current over-collection) as "so large as to warrant recovery," it is empowered to use this mechanism in order to reset rates mid-year. We believe that a mid-year adjustment should be the exception rather than the rule.

In sum, we believe customer and policy interests are best served by aligning the PSA reset with the effective date of new rates. The parties to the Agreement, including residential and commercial customer advocates and Commission Staff, fully considered this issue and agreed that the proposed timing is consistent with the public interest. That said, the Company understands that this is a policy decision for the Commission and respects the Commission's discretion to determine whether or not the adjustment to the PSA is more appropriately made now. If the Commission determines it should be done now, APS will file an application to effect that decision.

II. Delaying the implementation of the base rate increase portion of the proposed rate increase for several months is not in the public interest and would be a material change to the Agreement.

Chairman Mayes next asks the parties to indicate whether it is in the public interest to delay the proposed base rate increase "for several months" in order to allow customers "a reprieve from higher bills." APS believes that the answer to this question is an emphatic "no."

First, delaying the rate increase will not be necessary in order to shield customers from paying materially higher energy bills. As previously discussed, if the Commission agrees with the settling parties that the PSA reset should offset the needed rate increase, customer bills are expected to increase by less than one percent. Customers are not likely to see any noticeable difference between what they were paying on December 31, 2009 and what they will pay on January 1, 2010, if new rates take effect in January as proposed. On the other hand, delaying the effective date by "a few months" means that the rate increase will take effect around May of next year – precisely the time of year when customer bills naturally rise in any event with the return of hot weather and higher summer rates. A rate increase in May would compound the seasonal bill impact customers already face. As a matter of policy, customers are less impacted when rates are increased in the winter or shoulder periods, when naturally lower electric bills ease the transition to the new rate.

Second, this issue should not be characterized in terms of providing a "reprieve" to customers from paying rates that come closer to covering (though still do not fully cover) APS's cost of service. No party to the Agreement disputed the fact that APS's existing rates are insufficient and that accordingly an increase is necessary. Put differently, customers have not been required to pay the true cost of electricity for years. The Agreement, if approved, will not change this. Under the terms of the Agreement, APS has committed to a revenue level that is expected to produce only a 9.4% return on equity ("ROE") in 2010 – 1.6% below the proposed cost of equity. Even if rates take effect in January as proposed, APS will still have a revenue deficiency of $80 million in 2010 (a shortfall that takes into account the Company's commitment to reduce expenses by $30 million per year). Delaying the increase until May 1, 2010 would cause that expected ROE to fall by a full percent – to 8.4% – and would increase the revenue deficiency in 2010 by another $50 million. This result would only compound the $554 million cumulative earnings shortfall that APS has suffered since 2003.

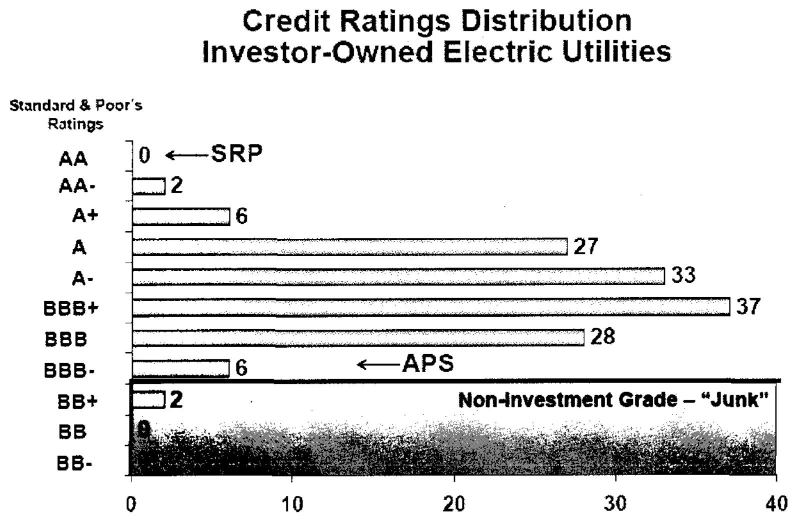
APS's Funds from Operations ("FFO") to Debt ratio would also fall to 17.2% in 2010, below the 18% threshold for investment grade, **in the very first year of the settlement period.** This trend would continue until APS's next rate case, challenging the Company's ability to issue equity under reasonable terms during the intervening years. And there is little doubt that Pinnacle West will be unable to issue equity at all until APS receives a rate increase. Investors are encouraged by the terms of the settlement, but are waiting to see whether it is adopted by the Commission before agreeing to put their money in the Company.

Thus, although delaying the rate increase until May will have a small short-term benefit to customers, it will significantly and adversely affect the Company. Simply put, the economic package provided in the Agreement is the minimum APS needs to be in a financial position to issue equity and to fulfill the commitments it has made in furtherance of Arizona's energy policy. Delaying the increase to May would accordingly be a very material change to the Agreement from our point of view.

III. SRP's situation is significantly different.

In contrast to APS, SRP has the financial capability and flexibility to fashion the amount and timing of its intended rate increases. SRP and APS are two starkly different entities. SRP is a municipal corporation that benefits from tax-free financing, does not pay income taxes, does not pay property taxes (making lower "in lieu of" payments instead), and that has the ability to benefit from preference power and similar legislative advantages not available to APS to lower its cost of service. Not regulated by the Commission, SRP also has the discretion to raise rates using a streamlined process without independent external review and to base those rates on forward-looking costs. In fact, unlike that proposed for APS, SRP's currently contemplated rate increase appears to be based on fiscal year 2011 projections, not just on its historical, actual costs. Although not directly related to its governmental status, SRP also serves a distinctly more compact service area and benefits from higher customer density. As a result of these and other differences between APS and SRP, **SRP has a credit rating of "AA" – higher than any investor-owned utility in the country.**

By contrast, as the following makes plain, APS vies with a just handful of other utilities to be the **third worst** rated investor-owned utility in America.



As a BBB- rated utility, APS simply cannot weather delays in rate relief as well as its AA rated counterpart. Just one step from junk bond status, APS faced challenges in accessing the capital markets in the recent periods of economic distress. When capital became available, the cost of that capital was significantly higher than it would have been had APS been rated AA like SRP, rather than BBB-.

Finally, notwithstanding these relative advantages, SRP reportedly does not intend to delay its full rate increase until mid-next year. SRP plans to raise rates in November by roughly 2.1%, offsetting that increase with a partial decrease in its fuel rates – similar to the Agreement's proposal for APS in this case. Although SRP may delay the balance of its planned rate increase until next year, it also intends to maintain its fuel rates at levels that are not fully adjusted for the lower cost of natural gas. It appears that SRP will retain the surplus in the interim and partially offset a later base rate increase with a second fuel rate decrease.

Put in perspective, this means that, even with SRP's recent change in timing, both APS and SRP will raise rates in the next year. SRP will likely raise them once in November and then once again – perhaps a higher increase – about six months later. If the Commission adopts the terms of the APS Settlement Agreement, APS will receive just one base rate increase in January, offset by PSA reductions. The Company will not be permitted to increase base rates again for another two and a half years. Delaying the rate increase is simply not necessary for APS customers to benefit from the Agreement.

IV. Differences in the bill impact of lower-than-expected fuel costs on APS compared to SRP.

Finally, Commissioner Pierce asks APS to indicate: (1) whether it is true that the amount of energy APS receives from natural gas is approximately three times greater than SRP; and (2) why, if

APS receives a larger percentage of its energy from natural gas, the bill impact associated with the declining natural gas costs is not greater for APS customers than for SRP customers.

With respect to the first question, the *Arizona Republic* article correctly noted that natural gas currently comprises about 32% of APS's overall fuel and purchased power resources (assuming all purchases to be from gas resources). APS is uncertain whether the 11% number quoted for SRP reflects the same assumptions. For example, if purchased power were included as natural gas in SRP's portfolio, we believe that percentage may have been larger in 2009. As to the second question, if the PSA reset occurs on January 1, 2010 as the Agreement proposes, rates for the average APS residential customer would go down by about $4.71. According to the *Arizona Republic*, SRP originally intended to similarly reduce its summer fuel rates such that the typical SRP home bill would decrease by about $5.26 in November.

Although it is difficult to precisely isolate the cause of the 55 cent difference, APS believes that it likely results from differences between the manner in which each utility measures its "average residential customer" (SRP's typical customer consumes more kilowatt hours than the average APS residential customer, which would mean the bill impact for a fuel rate reduction would be bigger), differences in each company's hedging practices, and differences in the amount of the over-collection (the more you have to refund, the bigger the refund).

APS welcomes further discussion of any of these items during the hearings.

Sincerely,

Meghan H. Grabel

Meghan H. Grabel

cc: Commissioner Paul Newman
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