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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR AN ORDER APPROVING MODIFICATIONS IN INVESTMENT FUND CONTRIBUTION LIMITS AND ALLOWING ADDITIONAL TRUST FUND INVESTMENT FLEXIBILITY	DOCKET NO. E-01345A-10-____ E-01345A-10-0067

APPLICATION

Arizona Public Service Company ("APS" or "Company") hereby requests an Order from the Arizona Corporation Commission ("Commission") authorizing:

1. removal of the $75 million funding contribution cap for each of the fixed-income Palo Verde Nuclear Generating Station ("PV") decommissioning trust funds managed by Delaware Investment Advisors ("DIA") and NISA Investment Advisors ("NISA");

2. removal of the $200 million funding contribution cap for the equity trust fund managed by Mellon Capital Management ("MCM"); and

3. discretion to move funds between the above forms of equity and fixed-income investments subject to the overall 60/40 equity/fixed-income allocation strategy established in Decision No. 60098 (March 19, 1997).

Such Order is requested for several reasons. First, the Company estimates it will reach the authorized contribution limits for both fixed-income funds by the third quarter of 2010. Second, removing the contribution funding levels, as well as increasing the flexibility in transferring funds between managers will allow the Company a greater ability to manage fund risk under often rapidly changing market conditions. Finally, APS believes that retention of the overall 60/40 equity/fixed-income allocation strategy adequately provides the

Company with guidelines to appropriately manage fund contributions and protects the independence of the funds.

I. INTRODUCTION

APS is a public service corporation within the meaning of Article 15 of the Arizona Constitution and is thus subject to regulation by the Commission. APS is a 29.1% part owner of PV. Other owners of PV include Salt River Project, Southern California Edison, El Paso Electric Company, Public Service Company of New Mexico, Southern California Public Power Authority, and the Los Angeles Department of Water and Power. PV is licensed to operate by the Nuclear Regulatory Commission ("NRC") pursuant to 42 U.S.C. § 2011, *et seq.* Like all nuclear power plants, PV will eventually need to be decommissioned – an expensive and time consuming process. Regulatory agencies throughout the country, including the Commission, have required that the cost of this eventual decommissioning be recovered from electric customers during the operating life of the facility.

Amounts collected from ratepayers during the life of a nuclear generating plant can either be administratively segregated by the utility collecting into a so-called "internal" decommissioning fund, or placed into a separate external fund (usually a trust). Both the NRC and most state regulators prefer the external funding option, both because of the increased security of the funding for its intended purpose and because of significant income tax benefits available to external funds meeting certain Internal Revenue Service ("IRS") qualifications, hence the term "qualified fund."

APS was first directed by the Commission to establish an external "qualified" nuclear decommissioning trust in Decision No. 55931 (April 1, 1988). That Order also established the Commission's control over certain parameters of that trust, including approval of the trustee, the various fund managers, and the categories of and limits to permissible classes of investments for the trust. To enable the trust's qualification under the Internal Revenue Code and IRS regulations, which in turn affords the trust favorable tax treatment (thus permitting the fund to grow at a significantly lower cost to ratepayers),[1] the Commission also had to specifically apportion the total amount of APS's annual contribution (that was reflected in APS retail rates) to each of the three PV Units.

The first (fixed-income) fund manager, RCM Capital Management ("RCM"), was approved in Decision No. 56384 (March 9, 1989). When RCM reached its original $50 million dollar limit, the Commission authorized first an equity fund manager (MCM) and later a second fixed-income manager (DIA). *See* Decision Nos. 58675 (June 22, 1994) and 60098. The present trustee for all three of the investment fund managers, The Bank of New York Mellon ("BNY Mellon"), was approved in Decision No. 70553 (October 23, 2008).

Decision No. 64393 (January 31, 2002) increased the equity funding limit from $150 million to $200 million and increased both fixed-income fund contribution limits from $50 million to $75 million.[2] These caps were consistent with the over-all "60/40" equity/fixed-income contribution limit also established by Decision No. 60098.

II. FUND INFORMATION

Currently, APS invests PV Decommissioning funds with three separate managers, MCM, DIA and NISA. The following provides a brief description of the fund managers:

- MCM is the equity fund in which the Company invests. It is a passive equity index fund. MCM holds companies within the S&P 500; however, it excludes electric utilities that own a nuclear power plant.

- DIA is one of two fixed-income managers. Their portfolio includes U.S. Treasury and other government securities, corporate bonds, asset-backed securities, and municipal bonds. The benchmark for DIA is the Barclays Capital Aggregate Bond Index.

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[1] IRC § 468A provides that contributions to a qualified nuclear decommissioning trust are deductible in the year made to the extent these amounts are actually collected from ratepayers as part of cost-of-service. Furthermore, the income earned by the trust is taxed at a reduced rate.

[2] APS refers to these limits as "contribution limits" because in each instance, the Company is permitted to place additional monies into the fund until it reaches the prescribed limit. Thereafter, APS cannot contribute additional amounts, but the fund can continue to accumulate earnings in excess of the "cap."

- NISA is the second fixed-income manager. NISA has both qualified and non-qualified trust components. The qualified trust portfolio includes the same characteristics of that in DIA. The non-qualified trust portfolio includes municipal bonds.[3] The benchmark for NISA is the Barclays Capital Municipal Bond Index.

As of January 31, 2010, the total amount of contributions was $240.1 million, with $142.6 million in the two fixed-income funds ($73.7 million for DIA and $68.9 million for NISA) and $97.5 million related to the MCM equity fund.[4] As can be seen from the above figures, both the DIA and the NISA fixed-income funds are close to reaching their contribution limits, and in fact both will reach their limits in the third quarter of 2010. Although the equity fund contributions appear to be somewhat below the $200 million limit today, APS is requesting to remove the contribution cap in effort to be consistent with the proposed treatment of the fixed-income funds.

III. REMOVAL OF THE CONTRIBUTION CAPS

Presently, APS is subjected to fund contribution caps for both the equity and fixed-income trust funds, while also being governed to the 60/40 equity/fixed-income contribution limit. APS is becoming exceedingly close to reaching the caps for both fixed-income funds. However, instead of simply requesting an increase in the fund contribution caps, which would only allow the Company to stay out for a year or two prior to filing yet another application, APS is requesting the caps be eliminated. In its place the Company would be permitted to

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[3] APS maintains a non-qualified trust portfolio because NRC regulations required the Company to establish a decommissioning trust mechanism when the first Palo Verde Unit came on line in 1986, which was prior to Decision No. 55931. Without such a Commission order, the IRS would not recognize pre-1988 fund contributions as "qualified."

[4] As of January 31, 2010, the aggregate market value of all three decommissioning funds was $413.7 million. Of this, some $276.5 million was in the two fixed-income funds ($117.7 million for DIA and $158.8 million for NISA), and the MCM equity fund was valued at $137.2 million. The average annual after-tax (including only taxes on realized gains) return on the equity fund from its original authorization by the Commission in 1994 for the Unit 1&3 Qualified Trust, Unit 1&3 Non-Qualified Trust, Unit 2 Qualified Trust, and the Unit 2 Non-Qualified Trust has been 7.3%, 7.4%, 6.5%, and 6.2%, respectively. Since 1989, the fixed income fund(s) for the Unit 1&3 Qualified Trust, Unit 1&3 Non-Qualified Trust, Unit 2 Qualified Trust, and the Unit 2 Non-Qualified Trust have had an annual return of 6.1%, 6.5%, 5.3%, and 5.3%, respectively.

contribute to any of the three funds so long as contributions remained in accordance with 60/40 equity/fixed-income allocation strategy set forth in Decision No. 60098.

The 60/40 equity/fixed-income allocation strategy was originally established by the Commission for the Company after reviewing decommissioning funding practices of similarly situated electric utilities, as well as funding practices used by APS and others for pension and other long-term investments. The strategy provides the Commission with ample governance over the Company's decommissioning investments, while giving the Company adequate flexibility to maximize contributions to a specific fund depending on market conditions.

APS has the ultimate legal responsibility to decommission PV and is vitally interested in ensuring that adequate funding levels are achieved by the time the plant is to be decommissioned. Therefore, APS believes that the specific fund contribution caps create restrictions that are counter-productive to the goal of achieving sufficient funding. Allowing the Company to manage the funds with the governance of the 60/40 equity/fixed-income ratio will afford the opportunity to diversify funds depending on market conditions.

IV. CONCLUSION

APS has reached the point where it will reach the maximum contribution amounts by the third quarter of 2010 for both the fixed-income funds. Removing the caps from both the equity and fixed-income funds, and instead afford APS the opportunity to have the flexibility to contribute to different funds under different market conditions while still maintaining the 60/40 equity/fixed-income allocation of contribution limits will be beneficial for both the Commission and the Company. Therefore, APS requests that the Commission determine that:

1. contribution caps on the two fixed-income and the one equity fund are no longer necessary and should be removed; and

2. the 60/40 equity/fixed-income allocation of contributions limit should be retained until further order of the Commission.

RESPECTFULLY SUBMITTED this 24th day of February, 2010.

PINNACLE WEST CAPITAL CORPORATION
LAW DEPARTMENT

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ORIGINAL and thirteen (13) copies of the foregoing filed this 24th day of February 2010, with:

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