APS ORIGINAL

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ARIZONA PUBLIC SERVICE

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April 29, 2010

Docket Control
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

RE: Arizona Public Service Company 2008 Amended Rate Case
Plan to Maintain Credit Ratings and Improve Financial Metrics
E-01345A-08-0172, Decision No. 71448

Pursuant to Arizona Public Service Company's ("APS") Settlement Agreement approved in Decision No. 71448, APS was ordered to submit the following:

> Section 1.16(d): "a plan to be prepared by APS to maintain investment grade financial ratios and improve APS' financial metrics."
>
> Section 8.4: "prepare and submit to the [Arizona Corporation] Commission and Signatories within 120 days of approval of the Agreement, a plan detailing steps it intends to take to maintain and improve its financial ratings with the credit rating agencies."
>
> Section 13.2(g): "submit a plan to the Commission to maintain investment grade financial ratios and to improve financial metrics."

In fulfillment of each of these provisions, APS has prepared and hereby submits the following plan to maintain the Company's credit ratings and improve financial metrics.

If you have any questions regarding this information, please contact Zachary Fryer at (602) 250-4167.

Sincerely,

Susan Casady

Susan Casady

SC/sl
Attachment
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Brian Bozzo
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Parties of Record

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Arizona Public Service Company

Plan to Maintain Credit Ratings and Improve Financial Metrics

Compliance Filing, Decision No. 71448,
Docket No. E-01345A-08-0172

April 29, 2010

APS

Arizona Public Service Company
Plan to Maintain Credit Ratings and Improve Financial Metrics

Executive Summary

Arizona Public Service Company's ("APS" or "Company") current credit ratings are "BBB-" from Standard & Poor's ("S&P"), "Baa2" from Moody's Investors Service ("Moody's"), and "BBB" from Fitch Ratings ("Fitch"), all of which currently classify those ratings as "stable." The Company's ultimate credit rating objective is to improve or maintain its ratings to at least the mid-BBB level or its equivalent, if not better, at all three of the ratings agencies. Doing so would permit APS to borrow at more favorable interest rates and enhance its ability to reliably access the capital markets, while also providing greater protection from a non-investment grade rating – outcomes that benefit customers and APS alike. Such an improvement, however, will take time because the ratings agencies ultimately look for stability and predictability in credit quality – characteristics that can take several years to demonstrate.

A change to APS's credit rating can be accomplished by improving the Company's financial metrics, improving the underlying risk profile (what S&P calls "business position"), or a combination of both. APS's Plan to Maintain Credit Ratings and Improve Financial Metrics ("Plan") focuses on enhancing the Company's financial metrics (such as ROE and FFO/Debt) wherever practicable, and advocating that the ratings agencies recognize the improvements in our underlying risk profile.

The most critical qualitative factor that all the ratings agencies consider when rating investor-owned utilities is the extent to which the regulatory environment provides timely and full cost recovery. The Arizona Corporation Commission's ("Commission") approval of the Company's recent Settlement Agreement ("Agreement") provided a platform that improved APS's earned returns on equity and financial performance and established a rate case filing schedule with process improvements, and was thus viewed by the ratings agencies as a positive development in APS's regulatory environment. Other regulatory decisions, such as the Commission's approval of APS's AZ Sun program and the Federal Energy Regulatory Commission's ("FERC") approval of transmission formula rates for APS, also provide positive support for this aspect of the ratings agencies' analysis.

Against this important backdrop, this Plan outlines APS's key strategies to maintain its credit ratings and improve its financial metrics: managing the capital structure, primarily through well-planned debt and equity issuances; taking measures to reduce negative effects of imputed debt; effectively managing costs across the Company; and advocating for recognition of a positive qualitative change in the Company's risk profile. Each is discussed in greater detail herein.

Arizona Public Service Company
Plan to Maintain Credit Ratings and Improve Financial Metrics

Introduction

Section 8.4 of APS's Agreement, approved in Decision No. 71448 (December 30, 2009), requires APS to "prepare and submit to the [Arizona Corporation] Commission and Signatories within 120 days of approval of the Agreement, a plan detailing steps it intends to take to maintain and improve its financial ratings with the credit rating agencies." Section 13.2(g) similarly requires APS to "submit a plan to the Commission to maintain investment grade financial ratios and to improve [the Company's] financial metrics." In fulfillment of these provisions, APS has prepared and hereby submits the following Plan.

Credit Ratings Objectives

APS's ultimate credit rating-related objective is to maintain mid-BBB level or better credit ratings that will enable the Company to finance needed investments at reasonable costs and avoid undue exposure to a potential for downgrade to non-investment grade levels. Given the financial commitments and rate case filing restrictions to which APS is bound, and the current macroeconomic environment, APS believes that an improvement to its current credit ratings is likely to take several years of sustained performance.[1] APS will work to improve its financial metrics and the qualitative factors within its control (which, as discussed below, are important elements within the ratings process), both of which could improve credit quality and better position the Company to achieve its ratings objectives.

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1 Moody's, for example, has indicated that "APS's rating is not likely to be revised upward in the near-to-medium term. Longer term, an upgrade could be possible if there is an increase in supportive regulatory treatment resulting in material, timely rate increases, or if there are material reductions in costs or leverage such that Moody's could anticipate key financial ratios improving significantly from their current levels." Moody's Investors Service, Credit Opinion: Arizona Public Service Company (February 25, 2009).

The Agreement contains several provisions that APS intends to use as vehicles to facilitate eventual promotion to higher credit ratings. Of course, the rating agencies are independent arbiters of credit ratings and APS cannot control their analysis of all the underlying factors. For at least the period between now and December 31, 2014 (the "Settlement Term"), APS's objective is to maintain its current credit ratings at stable levels, improve the underlying financial metrics supporting those ratings, and build on the foundation to improved credit ratings paved by the Agreement.

Ratings Process

Credit rating agencies describe the ratings process as an art as much as a science. This process includes a quantitative assessment of a utility's key financial metrics and other factors, as well as a qualitative assessment of the utility's business position, including its regulatory environment. The evaluation of various key financial metrics such as Funds from Operations ("FFO") interest coverage, FFO/Debt, and Debt/Total Capital is a cornerstone of the quantitative aspect of the rating agencies' credit assessment. However, other factors such as accounting and financial governance policies and practices, cash flow adequacy, liquidity availability and access to capital are also critical quantitative factors.

Just as important as the *quantitative* analysis, however, is a *qualitative* assessment of various criteria that are core to credit quality and directly impact the predictability and sustainability of financial performance. Within the utility industry, these core areas include regulation and the utility's regulatory environment, markets, diversification, operations and management. Although specific ratings assessment approaches and relative weightings of credit factors may differ among the ratings agencies (along with the transparency of the analytical approaches), the concept, context and product are the same – rating agencies undertake an analysis of key quantitative and qualitative factors driving credit quality and from this analysis they develop and assign ratings to an issuer.

Settlement Term Action Plan

To address the key quantitative and qualitative factors of this evaluation, APS intends to focus primarily on three objectives that address its ratings challenges.

First, the Company expects to earn a Return on Equity ("ROE") around 9% between now and the Company's next rate case, and work to earn closer to its authorized 11% ROE thereafter. Actually earning a ROE at these levels should provide APS with sufficient cash flow to result in a FFO/Debt ratio that supports the Company's present credit ratings. In addition to supporting FFO/Debt, improving the Company's ROE also encourages equity investment, which is necessary to finance capital projects and maintain a balanced capital structure, and is also critical given APS's equity funding commitments. Although rates charged and revenues received from customers are critical factors in earning a reasonable ROE, that metric can also be strengthened by reducing expenses. APS's Plan combines both to achieve its ROE objective.

Second, APS will manage its FFO/Debt ratio and capital structure to comply with the terms of Sections 8.2 and 8.3 of the Agreement, which require the Company to "use its best efforts to maintain investment grade financial ratios and a balanced capital structure that optimizes benefits to ratepayers" and "to strive to achieve a capital structure with no more than 52% debt/total capital, as calculated by the credit rating agencies, by December 12, 2012." Pinnacle West's recent equity issuance of $253 million (described in further detail herein) is an early step in this direction. The strategy to accomplish this objective also includes addressing negative effects of imputed debt.

Third, APS will continue to highlight to credit rating agencies the positive developments in Arizona's regulatory environment, which is the qualitative consideration that S&P deems to be "the most important factor in [its] analysis of a U.S. regulated, investor-owned utility's business risk."[2] In particular, APS intends to build on the momentum gained by the settlement and work with Commission Staff and interested parties on the process improvements discussed in the Agreement that credit rating agencies will view as additional enhancements to Arizona regulation.

To achieve these objectives, APS intends to:

1. **Maintain a Balanced Capital Structure and Infuse Equity as Appropriate.**

APS's capital programs and investment must be financed with an appropriate balance of debt and equity, and both are needed to maintain and strengthen APS's capital structure. APS cannot rely solely on debt to finance its significant capital spending program without damage to its financial metrics, but neither can or should it rely too heavily on equity capital, which is more expensive than debt and increases the Company's overall cost of capital and thus cost to customers.

For these reasons, the Agreement authorized Pinnacle West to infuse $700 million of equity into APS through December 31, 2014, and APS agreed to complete infusions of at least that amount by that date. *See* Agreement at § 8.1. APS completed the first tranche of this commitment through Pinnacle West's issuance of 6,900,000 shares of common stock in April 2010, which resulted in net proceeds to Pinnacle West of approximately $253 million. APS anticipates using these capital contributions to repay short-term indebtedness, to finance capital expenditures, and for other general corporate purposes. As a general matter, and subject to market conditions, the Company expects to issue or obtain new debt and

[2] *See "Assessing U.S. Utility Regulatory Environments,"* Global Credit Portal, Ratings Direct (March 11, 2010).

equity financing as needed to fund its requirements while maintaining a balanced capital structure throughout the Settlement Term.

2. Mitigate Negative Impacts of Credit Rating Agency Debt Imputation.

When calculating a company's debt levels and interest obligations for credit ratings purposes, credit rating agencies impute as debt certain obligations under long-term Purchased Power Agreements ("PPAs"), operating leases, or other contractual arrangements. Because of this practice, any utility that procures resources through PPAs or is a party to long-term operating lease agreements will be deemed effectively to have more debt on its balance sheet than it would without such contracts. Of particular concern is the level of subjectivity, variables, and assumptions at play in the rating agencies' calculation of the debt imputation amounts. These values are less certain and identifiable than balance sheet amounts representative of a debt and equity finance mix. APS, which has a significant portfolio of both renewable and conventional PPAs, is particularly vulnerable to the impact of debt imputation.

Critical to managing and mitigating that impact is investment in utility-owned resources, financed with an appropriate mix of debt and equity – the very type of investment recently approved for APS with AZ Sun for utility-scale renewable generation. The Agreement not only gives APS the key tools needed to make those investments, but requires APS to use those tools to reduce its imputed debt levels. Under Section 15 of the Agreement, APS must acquire significant amounts of renewable energy, such that renewable resources will be approximately 10% of APS's retail sales by 2015. This obligation requires significant financial commitments that – if procured solely through PPAs – could harm the Company's financial metrics and run contrary to APS's commitment to "strive to maintain a 52% debt/total capital ratio as calculated by the credit rating agencies by December 31, 2012," which the Agreement also requires. *See* Agreement at § 8.3.

A similar option that APS may pursue is to purchase already constructed generation resources to replace PPA resources, assuming favorable pricing. Purchasing such resources, financed with an appropriate mix of debt and equity, would also eliminate the imputed debt impact associated with a PPA. Any such acquisition of a non-renewable generation plant could require a waiver by the Commission from the restrictions of APS's self-build moratorium, in effect until January 1, 2015.

Finally, APS is evaluating its leasehold interests, looking at several viable alternatives that will further mitigate negative impacts of imputed debt on the Company's balance sheet.

3. **Focus on Cost Management.**

An important component of maintaining a reasonable earned ROE between rate cases is disciplined cost management – having processes in place engineered to set budget and cost projections at appropriate levels and keep actual costs within those projected ranges. Maintaining an earned ROE closer to the authorized return, through a combination of the rate relief provided by the Commission and cost management, will support APS's financial metrics. During the Settlement Term, a cost management focus also is critical for APS to meet the Agreement's expense reduction requirement (whereby APS committed to reduce expenses by an average $30 million per year, for a total reduction of $150 million for the Settlement Term, *see* Section 7.1). Consistent with Section 7.3 of Agreement, APS will submit an annual report detailing the specific reductions made each year to meet the Agreement's expense reduction requirements. Pursuant to the Agreement, the first such report will be filed on April 29, 2011.

Some current examples of APS's cost management efforts include:

- APS held its operating budget for 2010 flat compared to 2009 budgeted levels, notwithstanding cost increases for materials and supplies, technology cost increases, maintenance cost increases, and increased maintenance levels required to maintain aging equipment. Doing so required virtually every area of the Company to reprioritize, rebalance, and reassess risk so that APS could hold flat its anticipated spend without jeopardizing the safety of employees or the reliability of service to customers. The same intense focus on cost management was also an important piece of our capital expenditure plan review for 2010.
- APS is restructuring its supply chain organization, transforming the processes by which goods and services are procured to become more efficient and cost-effective. This undertaking is significant. Supply chain management is one of the most important strategic aspects of any capital intensive business. Decisions must be made about how to coordinate the production of goods and services, how and where to store inventory, from whom to buy materials and under what terms, and how to distribute those materials in the most cost-effective, timely manner. Among other things, the supply chain initiative now underway will significantly reduce procurement costs by standardizing the Company's procurement practices and allowing APS to be more strategic about the payment and other contract terms used with vendors, thus obtaining the best value for the Company and its customers.
- APS has adopted and is now implementing a new operations model for its fossil plants that incorporates all aspects of how the Fossil Generation business unit operates. A critical component of the model is a movement to a one-fleet mindset, looking at all of the

Company's plants as one generation fleet that operates consistently and towards common goals. Fossil Generation is also making changes to implement best utility practices with respect to both staffing and processes. The model will drive the fleet towards improved consistency, economies of scale, implementation of best practices, resource and knowledge sharing, and cost management opportunities.

- APS is also implementing a power plant operations strategy to reduce environmental compliance cost exposure in the long-term and certain operational and maintenance ("O&M") expenses in the short run. For example, the Company is looking at various options to address the environmental matters at the Four Corners Power Plant and resolve ownership issues at Units 4 and 5 that may arise given Southern California Edison's indication that California legislation may prohibit it from investing any significant amount in those units going forward. While several complicating variables have yet to be resolved, APS hopes to achieve a result that, with the Commission's approval, will reduce APS's cost exposure under increasingly stringent federal EPA requirements and maintain an important baseload resource to support the Company's increasing acquisition of renewable resources.
- APS has launched an initiative in its Energy Delivery business unit to improve work processes, gain greater consistency in the execution of that work, and enhance the business unit's overall operational efficiency and performance. The Company's use of more modern technology, standardized work methods, and more streamlined processes will enhance its ability to plan, schedule, organize, execute

and monitor the work needed to manage the assets and equipment required to serve customers and reduce costs.

4. Pursue Rate-Related Strategies for Timely Cost Recovery.

As the foregoing describes, APS is focused on analyzing its operations and taking important steps to effectively and efficiently manage costs, finance with the right combination of debt and equity, and mitigate negative ratings impacts of imputed debt. But the sum total of these efforts does not eliminate the Company's need for appropriate rate relief. APS has a significant capital expenditure program devoted, among other things, to building infrastructure needed throughout the state, addressing environmental issues at its generation plants, and otherwise fostering an environmentally-friendly, sustainable, and efficient Arizona energy future. In combination with the other facets of this Plan, adequate and timely cost recovery is critical for APS to improve its ROE and other financial metrics.

In that regard, APS will:

- File a rate case on June 1, 2011, using a 2010 test year as permitted by Section 2.2 of the Agreement. Among other things, this rate filing will present the required information in a format that more transparently aligns the Company's revenue needs and its cost drivers.
- Work with the Settling Parties and Commission Staff to process the case within 12 months of a sufficiency filing, as contemplated by the Agreement. *See* Agreement at § 2.3. The 12 month turnaround provision is important to reducing the negative financial impact of regulatory lag and has been heralded by ratings analysts. APS will facilitate this processing time, both by filing the required 120 day notice of its intent to file, informally discussing issues relating to the rate filing with the parties well before that required notification, and

coordinating the logistics that will enable the parties to meet and confer about the anticipated rate filing, as the Agreement requires. *See* Agreement at § 2.4.

- Actively participate in the Commission's decoupling workshops and pursue a decoupling mechanism that supports the Company's ability to meet the aggressive energy efficiency levels set in the Commission's recent rulemaking without impairing APS's financial performance. S&P recently noted that, properly structured, decoupling "supports creditworthiness because it can lessen volatility in revenues and cash flow." Assurance of recovery of APS's fixed costs through decoupling will send a positive signal to the rating agencies that Arizona's regulatory environment is one that will support the Company's financial health while furthering important policy goals.
- Continue using FERC formula rates to recover costs for additional transmission investments, and pursue timely approval of the Company's Transmission Cost Adjustor applications each year.

5. Support the Capital Markets' Evolving Perception of Arizona's Regulatory Environment and Other Qualitative Factors.

Ratings agencies appropriately recognized the Agreement as a major milestone demarking what they believe to be an increasingly supportive regulatory environment. All three ratings agencies have described the Commission's approval of the Agreement as an indication of improving credit quality. S&P noted that "recent rate activity is evidence that the company's management of regulatory risk has improved" and that "interim rates and recovery of certain post-test year costs have mitigated some risk in APS's latest case."[3] Moody's similarly affirmed APS's current rating after the Agreement was approved to reflect its view of APS's "continued financial and operating performance as well as recent decisions and recommendations of the Arizona Corporation Commission (ACC) and the ACC Staff respectively, which in our opinion appear to be somewhat more supportive than had historically been the case . . . . We believe the potential for rate settlements has increased, which could also potentially reduce regulatory lag."[4] Fitch also described the Agreement's approval as "supportive of APS's current credit ratings and a constructive development for APS fixed income investors."[5]

As a means of further improving this key qualitative aspect of the utility credit quality, APS plans to work with the Commission and other parties to capitalize on the momentum gained during the settlement. To that end, APS intends to:

- Pursue ratemaking mechanisms and processes that will allow APS to implement important state and federal policy objectives and move Arizona further into the evolving energy future without degradation to the Company's financial metrics;
- Work with the Commission and other interested parties to reach constructive agreements to settle future cases, if practicable, in order to conserve Commission resources and mutually promote shared goals.

Although credit ratings agencies deem "regulatory environment" to be the most important qualitative factor governing their assessment of investor-owned

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[3] Standard & Poor's, RatingsDirect, Arizona Public Service Company at 2 (December 22, 2009).

[4] Moody's Investors Service, Rating Action: Arizona Public Service Company (February 23, 2009).

[5] Fitch Ratings, Corporates, Global Power U.S. & Canada Credit Update: Arizona Public Service Company (December 30, 2009).

utility risk profiles, others are also considered, including market position, operational performance, and company management (looking at such things as a commitment to credit quality, operating efficiency and cost control). Many of the steps outlined in this Plan address these other qualitative considerations, as to which APS will continue to advocate its strong performance.

Conclusion

The Agreement was an important step in the right direction towards stabilizing the Company's credit quality. Going forward, the Company will focus on maintaining a balanced capital structure and issuing equity and debt as appropriate; managing costs; and implementing strategies that mitigate negative impacts of imputed debt. Capitalizing on and furthering the momentum achieved during the settlement, APS also will work with the Commission and stakeholders as it pursues a decoupling mechanism and other forms of rate relief that are both timely and adequate to give APS a reasonable opportunity to earn its authorized rate of return. Collectively, these and other future efforts should improve APS's financial health and credit quality.