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**MEMORANDUM**

TO: Docket Control

FROM: Steven M. Olea
Director
Utilities Division

DATE: December 4, 2012

RE: **APS COMMENTS ON STAFF REPORT** – ARIZONA PUBLIC SERVICE COMPANY – APPLICATION FOR AN ORDER OR ORDERS AUTHORIZING IT TO ISSUE, INCUR AND AMMEND EVIDENCES OF LONG-TERM INDEBTEDNESS AND OTHER LONG-TERM SECURITIES, TO MANAGE INTEREST RATE RISK, TO EXECUTE NEW SECURITY INSTRUMENTS TO SECURE ANY SUCH INDEBTEDNESS OR OTHER LONG-TERM SECURITIES AND FOR DECLARATORY ORDER CONCERNING VARIABLE INTEREST ENTITIES – DOCKET NO. E-01345A-11-0423

On November 2, 2012, Commission Staff filed its Staff Report in the above captioned docket. On November 8, 2012, APS filed comments on the Staff Report.

Staff has reviewed APS' comments, and hereby submits its Response.

SMO:JAC:kdh/BAS:MAS

Originator: John A. Cassidy

Attachment: Original and sixteen copies

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AZ CORP COMMISSION
DOCKET CONTROL

Service List for: ARIZONA PUBLIC SERVICE COMPANY
Docket No. E-01345A-11-0423

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**Introduction**

On November 22, 2011, Arizona Public Service Company ("APS") filed an application with the Arizona Corporation Commission ("Commission") requesting authorization for various financing transactions. On November 2, 2012, Staff filed its Staff Report in the matter, requesting that comments be filed on or before November 9, 2012. On November 8, 2012, APS filed Comments to the Staff Report. Staff has reviewed the Comments filed by APS, and responds as follows.

**Staff's Response to APS Comments on Staff Report ("Comments")**

In general, APS appears to support the substantive recommendations made by Staff in this Docket. However, there are certain Staff recommendations to which APS takes exception and, as a consequence, has requested clarification/modification in the ordering language to be used in the final Order.

**Clarification/Modification to Staff Recommendation 1(a) – 40 percent common equity test**

*Staff Recommendation*

1. Increasing APS' authorized long-term debt threshold to $5.1 billion subject to the following conditions:
   (a) common equity represents at least 40 percent of total capital (common equity, preferred stock, long-term debt and short-term debt);
   (b) debt service coverage ratio ("DSC") is equal to or greater than 2.0;
   (c) variable interest debt should not exceed $750 million; and
   (d) APS not having entered into any agreement/contract for any financial derivative security or similar instrument other than those authorized by the Commission, and establishing that violation of this condition shall result in immediate expiration of this general authorization to issue long-term indebtedness (this provision is not intended to place any restriction on hedging activities pertaining to energy procurement).

In its Comments, APS points out that Staff has modified, without explanation, the 40 percent common equity test referred to in recommendation 1(a) above. Specifically, APS states that "short-term debt was excluded from the definition of 'total capital'" in Decision No. 65976 (dated April 4, 2003), and reaffirmed in the 2007 Order (Decision No. 69947, dated October 30, 2007). In the present Docket, APS correctly notes that Staff has included short-term debt as a component of total capitalization for purposes of calculating the 40 percent equity test. APS characterizes the change from prior Commission decisions as being "subtl[e] but substantive." APS asks that short-term debt be excluded from the definition of total capital for purposes of the 40 percent equity test unless Staff can "identify a reason for changing a proven and well-vetted calculation of this test."

First, Staff would note that the position it is taking in the current APS financing docket in regard to this issue is consistent with the position originally advocated by Staff in the prior APS

financing docket.[1] In the prior Staff Report (dated May 18, 2007), total capital, for purposes of the 40 percent equity test, was defined as "common equity, preferred stock, long-term debt *and short-term debt*" (emphasis added) (see Staff Report, Docket No. E-01345A-06-0779, at page 6). In Comments filed by APS to the Staff Report in that docket,[2] the Company suggested that short-term debt be excluded from total capital in keeping with the methodology used in Decision No. 65796.[3] While Staff subsequently dropped its objection to the exclusion of short-term debt from total capital as suggested by APS,[4] this concession was made as a part of negotiations. Nevertheless, Staff still considers the inclusion of short-term debt in its definition of "total capital" for purposes of the 40 percent equity test to be appropriate for the following reasons:

- Unlike equity capital, debt capital (whether short-term or long-term) represents a fixed cost obligation for which an organization is responsible (i.e., periodic interest and principle payments). As such, not recognizing any debt component for which APS is responsible fails to capture the appropriate level of financial risk;
- Inclusion of short-term debt as a component of "total capital" when making the equity test calculation is particularly appropriate when authorizing an increase to a debt threshold for an extended period of time (i.e., 2013-2016); and
- Pursuant to ARS 40-302(D), APS is allowed to issue short-term debt up to 7 percent of total capitalization which represents significant financial risk that should be recognized in any long-term general authorization to issue debt. A simplified method for recognizing the financial risk presented by short-term debt is to recognize short-term debt indirectly by increasing the equity ratio. A 42.8 percent equity to total capital ratio that excludes short-term debt is equivalent to a 40 percent equity to total capital ratio that includes 7 percent short-term debt [(100% + 7%) x 40% = 42.8%]. Accordingly, increasing the required equity to total capital ratio to 42.8 percent would effectively recognize the financial risk presented by the maximum level of short-term debt while avoiding the complications of including short-term debt in the calculation, and a somewhat lower equity ratio (e.g., 42.0 percent) would recognize that the maximum level of short-term debt is not typically outstanding.

In light of the above, Staff recommends that the ordering language of Staff Recommendation 1(a) be changed to read as follows:

*1(a)* *Common equity represents at least 42.0 percent of total capital (common equity, preferred stock and long-term debt).*

Alternatively, Staff recommends retaining the ordering language in Staff recommendation 1(a), without modification. However, if the Commission finds that it is preferable not to specify a particular equity to total capital ratio, Staff recommends that the Commission direct APS to maintain a healthy capital structure and, in the event that the Company's equity to total capital *(common equity, preferred stock and long-term debt)* ratio falls

[1] Docket No. E-01345A-06-0779.
[2] Comments of Arizona Public Service Company on Staff Report (dated May 29, 2007).
[3] *Ibid.* (p. 3, lines 19-23).
[4] Direct Testimony of Gordon L. Fox, (Docket No. E-01345A-06-0779), pp. 3-4, lines 23-3.

below 42.0 percent, to file notice of such occurrence with the Commission Docket Control Center within 30 days. Upon receiving such notification, the Commission may then take whatever action, if any, it deems appropriate.

**Clarification/Modification to Staff Recommendation 1(b) – DSC test of 2.0**

In Staff recommendation 1(b) above, APS asserts that Staff has similarly included, without explanation, principal amounts previously excluded from the calculation of the DSC test of 2.0 agreed to by Staff and approved in the 2007 Order. APS states that for entities utilizing sinking fund financing (i.e. amortizing debt) inclusion of such amounts would be of little consequence. However, as an investor-owned electric utility APS uses so-called "bullet maturity" financing, and argues that inclusion of such principal amounts in the DSC test calculation would make it difficult if not impossible for the Company to meet the DSC test, "thus eviscerating the authorization of additional long-term debt recommended by Staff."

In response, Staff acknowledges that it has included principal amounts in the DSC test calculation (see Staff Report, p. 13, footnote 19). Staff further acknowledges that it has no objection to debt principal amounts being excluded from the DSC test calculation. Staff considers a DSC test of 2.0 exclusive of principal amounts in the denominator to be a sufficient parameter by which to verify APS' financial integrity for purposes of issuing long-term debt.

**Clarification/Modification to Staff Recommendation 1(d) – Ordering language**

In regard to Staff recommendation 1(d) above, APS has two concerns. First, APS states that the language used is somewhat vague, and asks that any final order be clear and specific as to whether the interest rate management instruments referenced in Staff recommendation 15 (forward-starting swaps based on LIBOR or U.S. Treasuries and U.S. Treasury rate-locks) are, in fact, included in the authorization provided in 1(d). Staff has no objection to the Company's request that the ordering language relating to this issue be made more specific.

Second, APS requests that the language in (d) requiring "immediate expiration of this general authorization to issue long-term indebtedness" be modified. Specifically, in the event APS were to issue a "derivative" other than the types identified in Staff Recommendation 15, APS urges that this language be modified to instead make such issuance *grounds* for summary revocation by the Commission. APS argues that creating *automatic* penalties for the occurrence of future events is seldom a good idea, especially when the consequences are so severe. APS further points out that it has no control over what the accounting community may at some future point in time label as a "derivative" when it had not previously been so described, and the Company would at least like to have the opportunity to explain the situation to the Commission before such drastic action was taken. Staff concurs with APS in this regard, and has no objection to a modification to the ordering language as proposed by APS.

In light of the above, Staff recommends that the following changes be made to the ordering language of Staff Recommendation 1(d):

*1(d)* *APS not having entered into any agreement/contract for any financial derivative security or similar instrument other than those authorized by the Commission in Staff recommendation (15) below, and establishing that the issuance by APS of a derivative security other than the types identified in (15) be grounds for summary revocation by the Commission of the general authorization to issue long-term indebtedness granted in this proceeding (this provision is not intended to place any restriction on hedging activities pertaining to energy procurement).*

**Clarification/Modification to Staff Recommendation 2 – Palo Verde sale/leaseback Decisions**

*Staff Recommendation*

2. That the authorizations to incur long-term debt and short-term debt obligations provided in this proceeding replace all existing authorizations and that all existing authorizations expire upon the effective date of the authorizations provided in this proceeding.

As in the 2007 Order, APS requests that Decision Nos. 55120 (dated July 24, 1986) and 55320 (dated December 5, 1986) dealing with the Palo Verde sale/leaseback be expressly exempted from the replacement of "all existing authorizations" language contained in Staff recommendation 2 above. APS asserts that these two Palo Verde sale/leaseback Decisions have always stood on their own, distinct from general financing authorizations of the type at issue herein and contain numerous provisions critical to the continued validity of these transactions. Staff concurs with the Company, and has no objection to APS' request that these Decisions relating to the Palo Verde sale/leaseback be exempt from the "all existing authorizations" language in recommendation 2 above, and that the ordering language conform to that used in the 2007 Order (see Decision No. 69947, page 18, lines 10-12).

APS presumes, correctly, that Staff recommendation 2 serves only to supplant the relevant long-term and short-term debt authorizations from the 2007 Order and not to revoke that Decision in its entirety. The sentence preceding Staff's recommendations, "Staff recommends adoption of an Order that includes language similar to that of Decision No. 69947 modified to reflect the following:" (see Staff Report, page 13) was written so as to convey this intent.

**Clarification/Modification to Staff Recommendation 5 – Inclusion of the term, "reprice"**

*Staff Recommendation*

5. Authorization for APS to redeem, refinance, refund, renew, reissue, roll-over, repay, and re-borrow from time to time the long-term debt and short-term debt in (1) and (3) above.

APS correctly points out that Staff failed to include the term "reprice" from the authorizations included in Staff recommendation 5 above. Staff has no objection to the inclusion of this term among the authorizations provided, but recommends the spelling of the word as used in the Company's application, "re-price."

**Clarification/Modification to Staff Recommendation 6 – Expiration of debt authorizations**

*Staff Recommendation*

6. That the short-term and long-term debt levels authorized in this proceeding expire on December 31, 2016.

In the Comments relating to Staff Recommendation 6 above, APS' primary concern appears to be that the ordering language contained therein fails to adequately make it clear that any debt properly issued by APS prior to Staff's stipulated December 31, 2016, expiration date would remain valid in accordance with its terms. While APS strongly urges that language similar to that adopted in the 2007 Order (see Decision No, 69947, page 18, lines 13-20) be used with regard to all authorizations approved of in this proceeding, the Company nevertheless is critical of the ordering language contained in the 2007 Order. APS asserts that the failure to include long-term debt within the scope of the 2007 Order's language is what "has brought us to the current situation of having to get the matter decided by year's end." APS advocates that the authorizations granted in this proceeding should remain in effect until further order of the Commission *if and only if* the Company files an application to continue or expand such authorizations prior to January 1, 2016. Otherwise, such authorizations would expire after December 31, 2016, as per Staff recommendation 6.

Staff appreciates APS' concerns regarding this issue, but still believes there should be an expiration of this financing approval. Accordingly, Staff recommends that Staff Recommendation 6 be changed to read as follows:

6. *That the short-term and long-term debt levels authorized in this proceeding remain valid until otherwise further ordered by the Commission, but expire no later than December 31, 2017.*

This expiration date would not have any effect on any debt properly issued by APS prior to December 31, 2017.

**Clarification/Modification to Staff Recommendation 14 – "Speculative purposes"**

*Staff Recommendation*

14. Find that any authorization granted APS to engage in financial derivative securities or similar contracts to manage interest rate risk and/or exposure should specifically exclude use of such authorization for speculative purposes.

APS can accept Staff recommendation 14 for purposes of this proceeding, but in the Comments points out that what is or is not "speculative" is, like beauty, somewhat in the eye of the beholder. Rather than make suggestions as to how best to define the word "speculative," APS instead goes on to say that both the Application and the Staff Report identify the business purpose behind the Company's proposals in this regard, and that APS has no intent to deviate from such purpose. In light of the Company's statement, Staff is confident that APS has a proper understanding of what meaning was intended by the expression "speculative purposes" as used in Staff recommendation 14.

**Clarification/Modification to Staff Recommendation 16 – Amortization of gains/losses**

*Staff Recommendation*

16. Deny APS' request to amortize gains or losses associated with pre-issuance interest rate hedging transactions over the life of the new debt issuance to which they relate.

Staff recommendation 16 above serves to deny APS' request to establish the ratemaking treatment of gains and losses associated with pre-issuance interest rate hedging transactions. In its Comments, APS correctly points out that under Generally Accepted Accounting Principles ("GAAP") such gains and losses are to be amortized over the life of any new debt issuance to which they relate, and that APS plans to conform to GAAP in this regard for financial reporting purposes. While APS acknowledges that Staff has declined to endorse a particular ratemaking treatment of the gains and losses associated with pre-issuance interest rate hedging transactions, the Company agrees that the ratemaking treatment of any gains or losses can be addressed in its next rate case. In this regard, Staff and APS are in agreement.

**Clarification/Modification to Staff Recommendation 17 – Palo Verde sale/leaseback Decisions**

*Staff Recommendation*

17. Order that the authorizations to incur short-term and long-term debt obligations in this case shall replace all existing authorizations for the incurrence of short-term and long-term debt provided for in Decision No. 69947, that those authorizations expire upon the effective date of an Order in this case, and that all existing obligations incurred under lawful authorizations shall remain valid.

See Staff's response to APS' Comments on Staff Recommendation 2.

**Clarification/Modification to Staff Recommendation 18 – Compliance filing requirement**

*Staff Recommendation*

18. That on each occasion when APS enters into a new long-term debt agreement that APS file with the Commission's Docket Control Center within 90 days of the completion of the transaction a description of the transaction and a demonstration that the rates and terms were consistent with those generally available to comparable entities at the time and provide the Utility Division Compliance Section a copy of the relevant agreements.

APS points out that, in the 2007 Order, the compliance filing requirement was limited to long-term debt issuances greater than $5 million, with no compliance filing being necessary for long-term debt issuances having a principal value less than $5 million. Because APS enters into all manner of relatively small equipment leasing and other business arrangements that may have characteristics of long-term debt, the Company asserts that it would be administratively burdensome to comply with the required compliance filings for such small transactions as per Staff recommendation 18 above. Staff agrees with this assessment. Accordingly, Staff recommends that Staff Recommendation 18 be changed to read as follows:

*18. That on each occasion when APS enters into a new long-term debt agreement that APS file with Docket Control, within 90 days of the completion of the transaction, as a compliance item in this docket a description of the transaction and a demonstration that the rates and terms are consistent with those generally available to comparable entities at the time and provide the Utility Division Director a copy of the relevant agreements. No such filing need be made for any such new long-term debt agreement that has a principal value of less than $5 million within a calendar year for (a) any individual agreement or transaction or (b) the aggregate of similar agreements or transactions with a single entity.*

This concludes Staff's Response to APS' Comments.