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 STN-50-530 Palo Verde Nuclear Station, Unit 3, Arizona Publi 05000530

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 CONWAY, W.F.      Arizona Public Service Co. (formerly Arizona Nuclear Power      R  
 RECIP. NAME      RECIPIENT AFFILIATION  
 TAYLOR, J.M.      Ofc of the Executive Director for Operations      I

SUBJECT: Forwards Pinnacle West response to State of AZ Corp      D  
 Commission filing w/SEC, filed on 900521.

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WILLIAM F. CONWAY  
EXECUTIVE VICE PRESIDENT  
NUCLEAR

268-00052-WFC/JNB *sent*  
June 1, 1990

Mr. James M. Taylor  
Executive Director for Operations  
U. S. Nuclear Regulatory Commission  
One White Flint North  
11555 Rockville Pike  
Rockville, MD 20852

*① Mont Virginia MW*  
*② Jerry Crutchfield*  
*③ S. Bogert*  
*④ J. L. ...*  
*→ S. Peterson*

Dear Mr. Taylor:

Subject: Palo Verde Nuclear Generating Station (PVNGS)  
Pinnacle West Response to Arizona Corporation Commission Filing  
re Pinnacle West with U.S. Securities and Exchange Commission  
File: 90-056-026; 90-001-028.6

In my May 14, 1990, letter to you, I sent a copy of a complaint filed by the Arizona Corporation Commission with the U. S. Securities and Exchange Commission seeking to revoke the exemption from the Public Utilities Holding Company Act held by APS's Corporate parent, Pinnacle West Capital Corporation. As I noted, that complaint was based, in part, on incomplete extracts from NRC documents, especially the recent Diagnostic Evaluation Report.

Enclosed is a copy of the response to the complaint filed on May 21, 1990, by Pinnacle West. The section addressing misstatements based on NRC documents appears at pp. 12-15.

We will advise you of any future developments which may be of interest to the NRC.

Sincerely,

*WFC*

WFC/JNB/sg

enc.

cc: J. Martin  
D. Crutchfield  
Document Control Desk

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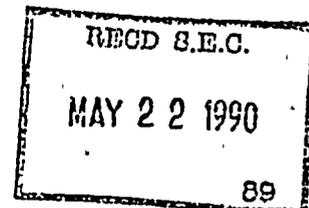
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New York, New York  
May 21, 1990



Mr. Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

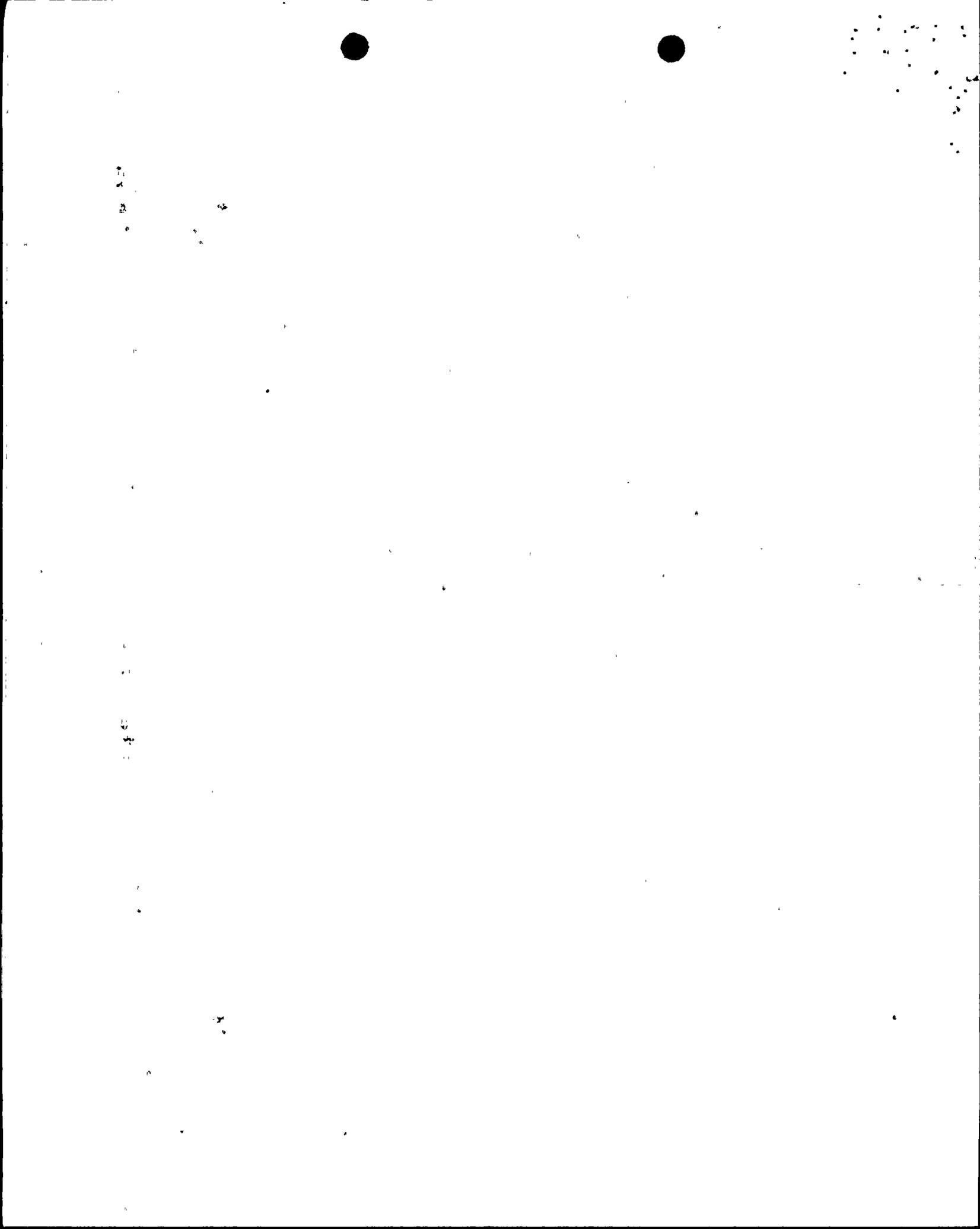
Re: Pinnacle West Capital Corporation-  
Response to Complaint Filed by  
Arizona Corporation Commission  
File No. 69-306

Gentlemen:

I. INTRODUCTION

We are acting as counsel to Pinnacle West Capital Corporation ("Pinnacle West"), a holding company exempt under Section 3(a)(1) of the Public Utility Holding Company Act of 1935 (the "'35 Act") pursuant to annual filings with the Securities and Exchange Commission (the "SEC") in accordance with Rule 2.1/

1. In April 1985, the shareholders of Arizona Public Service Company ("APS") approved the formation of Pinnacle West, then known as AZP Group, Inc. Since 1985, Pinnacle West has made annual filings with the SEC on Form U-3A-2 claiming an exemption from registration pursuant to the provisions of Section 3(a)(1) of the '35 Act. Pinnacle West's principal subsidiaries, in addition to APS, are Malapai Resources Company ("Malapai"), El Dorado Investment Company ("El Dorado") and SunCor Development Company ("SunCor"). Malapai is engaged in the business of producing and selling uranium concentrates for use in nuclear power plants; El Dorado is engaged in the business of making equity investments in other companies; and SunCor is engaged primarily in the business
- (footnote continued)



Mr. Jonathan G. Katz

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May 21, 1990

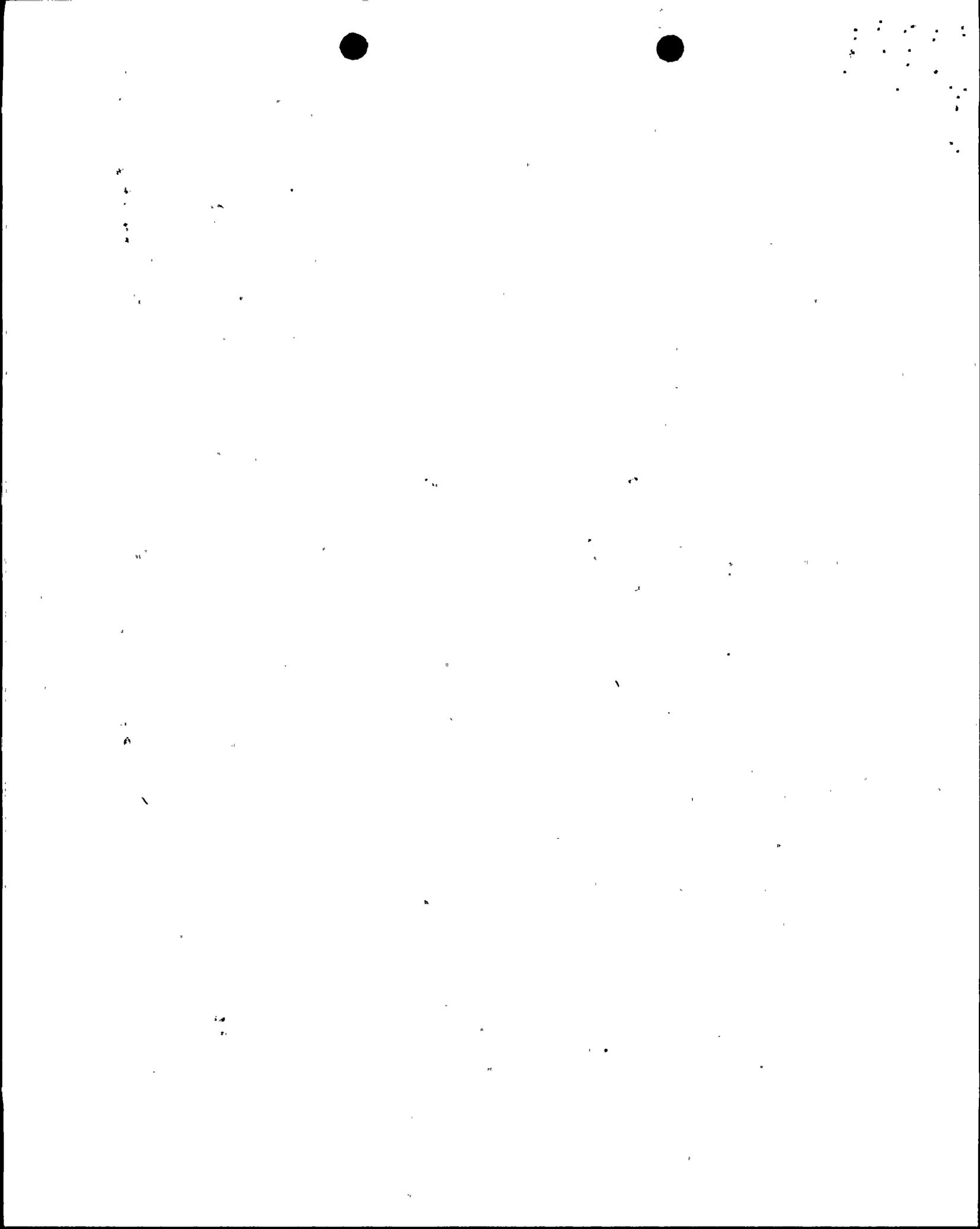
This letter is submitted by the undersigned on behalf of Pinnacle West in response to the submission to the SEC on May 1, 1990, by the Arizona Corporation Commission (the "ACC"), of a Complaint, Petition for Revocation or Modification of Pinnacle West Capital Corporation's Exemption, Request for Hearing and Petition to Intervene (the "Complaint"), pursuant to which, among other things, the ACC has requested the SEC to revoke or modify Pinnacle West's exemption from the '35 Act.

For the reasons summarized below and set forth in greater detail herein, Pinnacle West believes that the public interest and the interest of investors and consumers would best be served by the SEC refusing to take any of the actions requested by the ACC in the Complaint and promptly notifying Pinnacle West and the ACC of such decision.

Pinnacle West's diversification-related financial difficulties are now largely behind it. These difficulties were primarily attributable to the acquisition of MeraBank, A Federal

of owning, holding, and developing real property in the State of Arizona.

2. According to Mr. Timothy M. Hogan, Chief Counsel of the ACC, the Complaint was principally prepared by him with the assistance of Ms. Janice M. Alward, an ACC staff attorney, and Mr. Scott F. Hempling, an attorney previously with the Environmental Action Foundation in Washington, D.C., who is now in private practice. The decision to submit the Complaint to the Commission was made by a 2-1 vote of the ACC, concluding a politically-charged public meeting at which the matter was decided upon after very brief testimony presented that same day. Public notice of such meeting was given only 24 hours in advance, and, at the meeting itself, the ACC refused Pinnacle West's request for additional time to evaluate the Complaint and to correct the misstatements contained therein.
3. In requesting that the SEC revoke or modify Pinnacle West's exemption, the ACC proffered four reasons why such highly unusual relief was necessary: (1) diversification-induced financial pressures on APS have worsened its "strapped" cash position by constraining its access to external debt and equity financing; (2) the interaction between APS' problems at the Palo Verde Nuclear Generating Station ("Palo Verde") and Pinnacle West's financial problems has left APS in a dangerously weakened financial state; (3) Pinnacle West's diversification efforts have jeopardized the effectiveness of ACC regulation; and (4) the Pinnacle West holding company system fails to meet the criteria for an exemption under Section 3(a)(1).



Mr. Jonathan G. Katz

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May 21, 1990

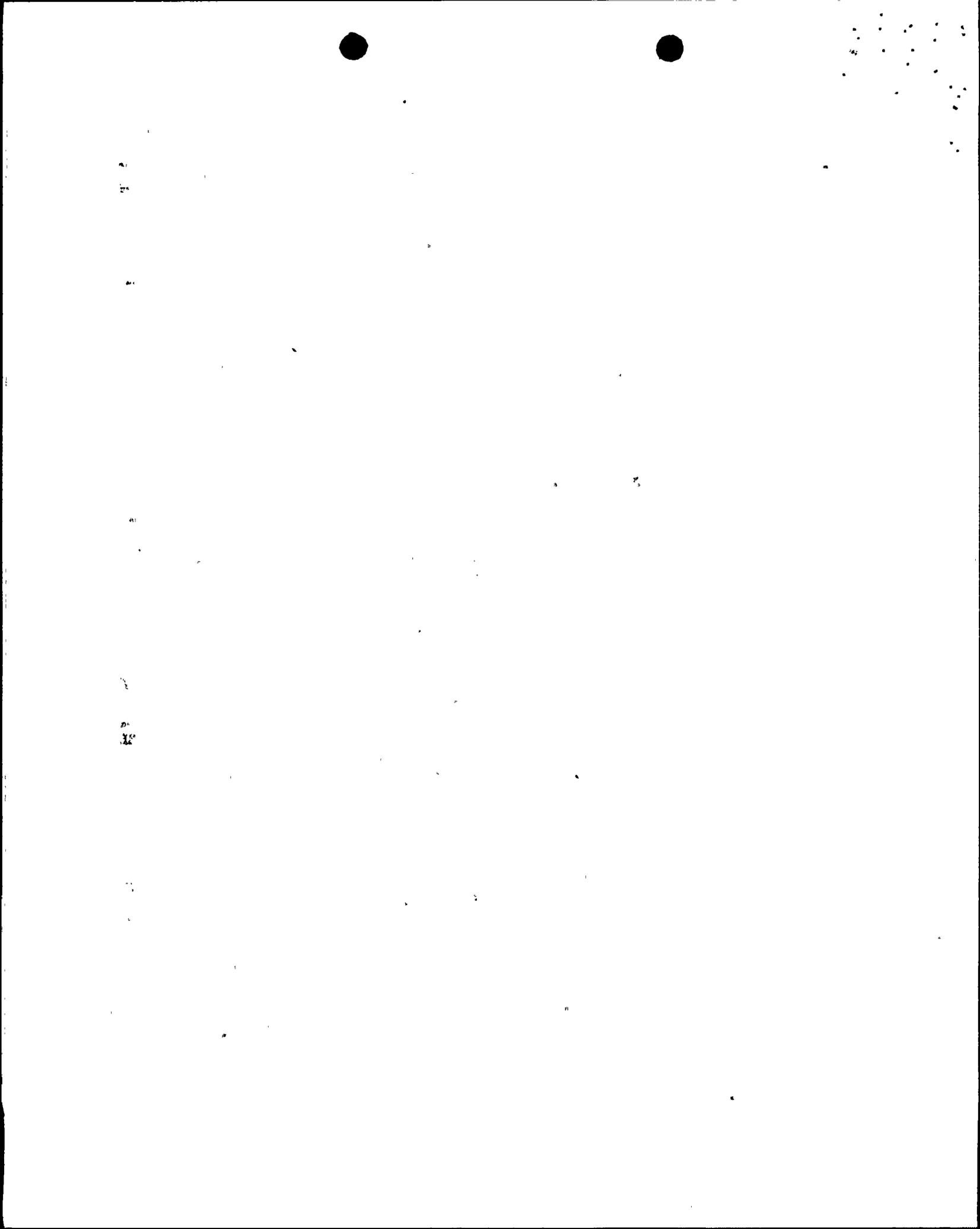
Savings Bank ("MeraBank"), which, as discussed in more detail below, has since been disposed of. Under the leadership of its new President, Chief Executive Officer and Chairman of the Board, Richard Snell, Pinnacle West is implementing a well-conceived program for its financial recovery which is aimed at maximizing shareholder values, and APS remains committed to providing quality utility service in Arizona. Thus, there is no compelling reason at this time for the SEC to take any of the actions suggested in the Complaint as these actions would have the effect of hindering new management in its efforts in this regard. Moreover, Pinnacle West's present corporate strategy is not to further diversify, and, by virtue of contractual restrictions contained in its various loan agreements, Pinnacle West would be severely restricted in so doing.

Secondly, the ACC provides no basis for its allegation that its ability to regulate APS, or protect APS ratepayers, has been impeded by Pinnacle West's past diversification activities, or that the ACC will be so impeded in the future. One point is quite clear, however. The ACC has a legal responsibility to authorize just and reasonable rates for APS and its customers in the rate case that APS filed with the ACC over five (5) months ago. A procedural order setting hearing dates in the case has not yet been issued. It is this rate case, the outcome of which is within the control of the ACC not Pinnacle West, that will largely determine APS' future financial condition.

Significantly, Pinnacle West's prospects could also be affected by the fact that it has received multiple offers, including one just last Thursday, from PacifiCorp, a highly-diversified, Oregon-based utility with public utility operations in seven (7) states, to acquire Pinnacle West or APS. To further complicate matters, the day after PacifiCorp's latest offer, Pinnacle West received a proposal from Salt River Project Agricultural Improvement and Power District ("SRP"), another major provider of electric power in Arizona, to acquire certain of APS' assets for a purchase price of up to \$500 million. In responding to the Complaint, we urge that the SEC not act in a manner that could or would affect the ability of Pinnacle West's Board of Directors to protect the interests of its shareholders in matters of this nature.

Fourthly, the ACC's allegation that Pinnacle West no longer meets the objective criteria for an "intrastate" exemption is entirely without merit.

And, finally, the Complaint materially misstates facts concerning Palo Verde, quotes Nuclear Regulatory Commission ("NRC") documents out of context, and fails to recognize the pervasive nature and effectiveness of NRC regulation of Palo Verde. The ACC's allegations in this respect are representative of the many instances in which the Complaint contains material misstate-



Mr. Jonathan G. Katz

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May 21, 1990

ments of fact, presenting the SEC with an incomplete and distorted view of the current business, financial condition and prospects of Pinnacle West and APS.

## II. DISCUSSION

### A. Pinnacle West is Implementing a Program for Financial Recovery and its Financial Condition Has Stabilized

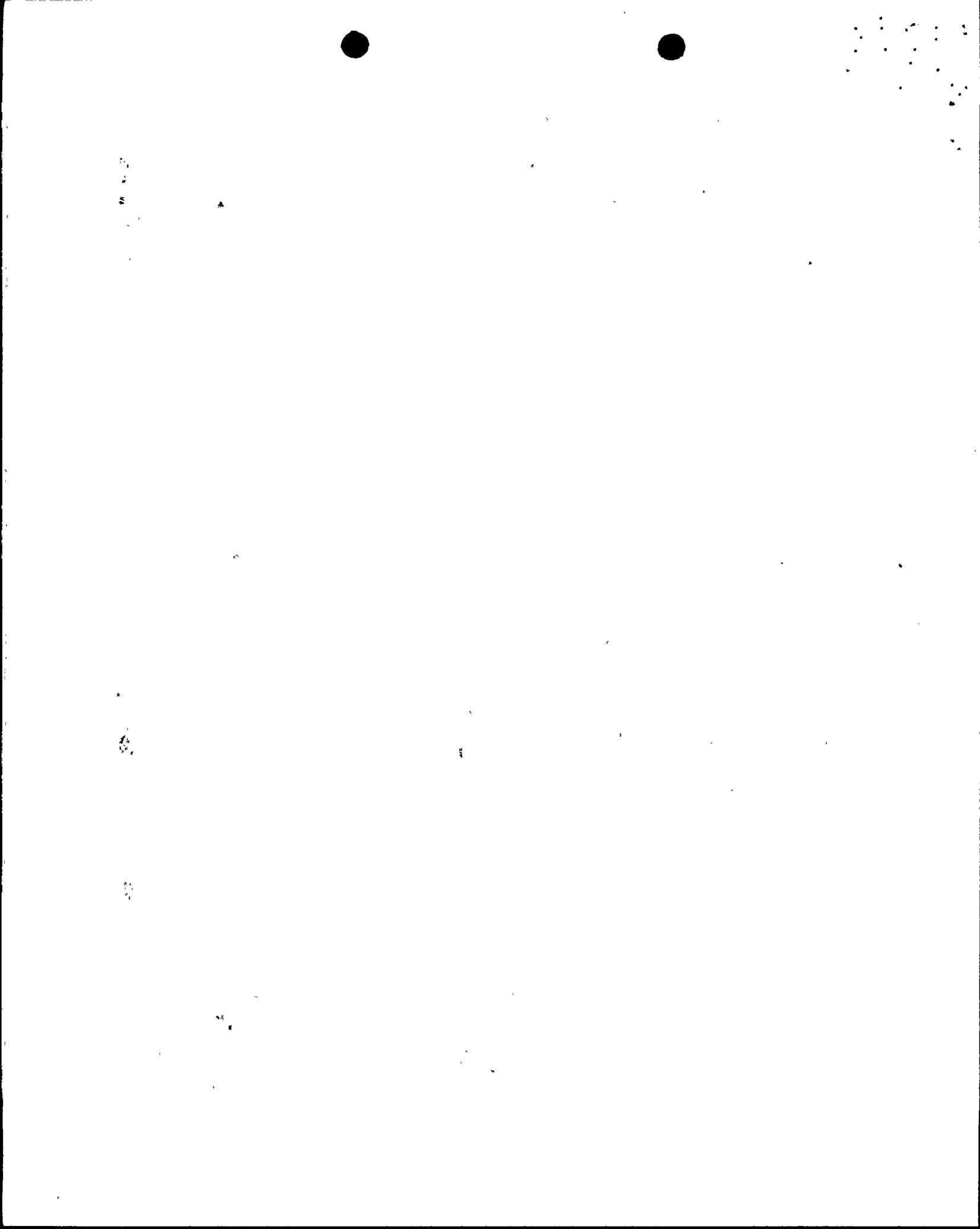
#### The MeraBank Settlement

Pinnacle West acquired MeraBank in December 1986. MeraBank recorded earnings for 1986 and 1987 of approximately \$37.4 million and \$25.1 million, respectively. However, due to the widespread deterioration of the real estate market in the Southwest, MeraBank recorded significant losses in 1988 and 1989. Pinnacle West suspended its quarterly dividends to shareholders in the fourth quarter of 1989, and, on January 31, 1990, MeraBank was placed in receivership by the Office of Thrift Supervision, United States Department of Treasury ("OTS").

As a condition to its acquisition of MeraBank, Pinnacle West signed a stipulation with Federal regulators (the "Stipulation") stating that, as long as it controlled MeraBank, Pinnacle West would cause the regulatory capital of MeraBank to be maintained at the level required by certain Federal regulations and, as necessary, Pinnacle West would infuse additional equity capital into MeraBank to meet such requirements. Although the enforceability of the Stipulation was a matter of dispute between Pinnacle West and such regulators, Pinnacle West's potential financial exposure thereunder contributed significantly to Pinnacle West's financial difficulties in 1989, including the steep decline in the market value of its common stock and its inability to refinance or repay maturing debt.

On December 6, 1989, after months of negotiation, Pinnacle West entered into an agreement with the OTS whereby Pinnacle West would be released from its purported "keep-well" obligations under the Stipulation if Pinnacle West delivered to MeraBank, on or before March 31, 1990, a \$300 million cash payment and a \$150 million promissory note, each with interest payable from December 6, 1989 (the "MeraBank Settlement"). The financial markets reacted very favorably to the MeraBank Settlement. The closing price of Pinnacle West's common stock on the New York Stock Exchange on December 7, 1989, was \$10.25, compared to a closing price on the previous day of \$5.375.

On March 22, 1990, Pinnacle West made the agreed upon cash payment to MeraBank of approximately \$310.5 million, obtained from the proceeds of the sale of Senior Secured Debentures, and delivered to the Resolution Trust Corporation, as



receiver for MeraBank, a promissory note in the principal amount of \$155 million. Thereupon, Pinnacle West was released from its purported obligation to infuse capital into MeraBank under the Stipulation or any other source of such an alleged obligation.

As a result of the MeraBank Settlement, the uncertainty regarding Pinnacle West's financial exposure under the Stipulation was eliminated, thereby stabilizing Pinnacle West's financial condition. In addition to causing a dramatic increase in the market value of Pinnacle West's common stock, the MeraBank Settlement permitted Pinnacle West to restructure substantially all of its debt because, prior to the MeraBank Settlement, Pinnacle West's lenders were unwilling to restructure their loans in the face of Pinnacle West's unknown financial exposure under the Stipulation. In short, the MeraBank Settlement resolved Pinnacle West's most immediate financial problem and put it on the road to financial recovery.

#### The Restructuring of Pinnacle West's Debt

Immediately after Pinnacle West obtained the MeraBank Settlement, Pinnacle West began negotiating with over 40 of its lenders to restructure substantially all of its debt so that Pinnacle West would have additional time to meet its repayment obligations and to implement its program for financial recovery. On January 31, 1990, less than two months after the MeraBank Settlement, Pinnacle West and these lenders completed a restructuring of approximately \$676 million in principal amount of Pinnacle West's long-term debt. Pursuant to the restructuring, Pinnacle West was able to extend the principal maturities of its debt for two years, subject to a mandatory \$65 million principal prepayment on or before June 30, 1990. Since the date of the MeraBank Settlement, Pinnacle West has already repaid approximately \$40 million of its debt, and it expects to repay another \$35 million by the end of June 1990.

The restructuring of Pinnacle West's debt, accomplished in a remarkably short period of time, required the unanimous approval of affected lenders. This restructuring, made possible by the MeraBank Settlement, further strengthened Pinnacle West's financial condition.

As a condition to the restructuring of its debt, Pinnacle West granted substantially all of its lenders and the holders of the Senior Secured Debentures a security interest in the outstanding common stock of APS pursuant to a Pledge Agreement, dated as of January 31, 1990 (the "Pledge Agreement").<sup>4/</sup>

4. In conjunction with the negotiation of the Pledge Agreement and related documents, questions arose as to the status of  
(footnote continued)



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On March 31, 1990, the APS common stock secured approximately \$956 million in principal amount of Pinnacle West's outstanding debt.

In addition to having successfully restructured its debt, by the end of this month, Pinnacle West expects to have in place a \$100 million liquidity facility with a major commercial bank, thus providing Pinnacle West with an additional source of funds.

#### Pinnacle West's Contractual Restrictions

In the Complaint, the ACC focuses heavily on Pinnacle West's unsuccessful diversification efforts and asks the SEC to require Pinnacle West to divest itself of its remaining non-utility subsidiaries and to prohibit further investments by Pinnacle West in new non-utility businesses. As the ACC is aware, however, and as Pinnacle West has disclosed in numerous SEC filings, the terms and conditions of the various agreements under which Pinnacle West completed its debt restructuring and made the capital infusion into MeraBank severely restrict Pinnacle West from investing in new non-utility businesses, as well as from making additional investments in its current non-utility businesses. Moreover, while any such debt is outstanding (the latest maturity date falls in the year 2001), Pinnacle West is (a) prohibited from issuing new debt except under very limited circumstances, (b) required to repay debt with any available excess cash (including cash obtained from the sale of certain subsidiaries or substantially all of their assets), and (c) severely restricted in its ability to pay cash dividends.

Any new investments by Pinnacle West in its existing subsidiaries (excluding APS) are generally restricted to \$15 million in the aggregate until Pinnacle West's lenders are fully repaid. Any other new investments by Pinnacle West are generally restricted to \$20 million in the aggregate until the lenders are fully repaid and may not be made until Pinnacle West is able to meet the dividend test referred to below.

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the various lenders under the '35 Act given the pledge. As a result, the subject was completely addressed in a "no action" letter issued earlier this year by the Staff of the SEC. The "no action" letter, in effect, clarified that prior to an Event of Default (as defined in the Pledge Agreement) giving the lenders the right to vote the pledged stock of APS, the lenders would not be deemed to be a "holding company" as defined in Section 2(a)(7) of the '35 Act. See Pinnacle West Capital Corporation (available April 23, 1990).



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Pinnacle West may not incur additional debt, except generally (and with certain restrictions) for (a) borrowings to reduce, refinance, or prepay existing debt, (b) extensions or replacements of existing reimbursement obligations, guarantees, or letters of credit, and (c) borrowings under the liquidity facility.

Pinnacle West's ability to pay cash dividends or to make other corporate distributions is dependent upon the satisfaction of a specified interest coverage ratio. This dividend test effectively prohibits Pinnacle West from paying cash dividends for the foreseeable future. The amount of permitted dividends or other corporate distributions may not exceed fifty percent (50%) of Pinnacle West's net income calculated from and after April 1, 1990. Any excess cash available to Pinnacle West must be applied to the repayment of existing debt.

Finally, in the event of a sale of all or substantially all of the assets or shares of common stock of Malapai, SunCor, or El Dorado, the net cash proceeds must be applied by Pinnacle West to reduce its outstanding debt.

If the ACC honestly believes that Pinnacle West's business activities must be severely restricted to protect the public interest and the interest of investors and consumers, one need look no further than Pinnacle West's loan agreements to confirm that such restrictions are currently in place and will be so for at least the next several years.

#### Sale of Non-Utility Assets

In addition to obtaining the MeraBank Settlement and restructuring substantially all of its debt, Pinnacle West has taken other steps to improve its financial condition. On April 4, 1990, SunCor completed the sale of certain of its properties for \$70 million. SunCor immediately applied \$29.5 million of the proceeds of such sales to the repayment of its debt. On April 26, 1990, Pinnacle West entered into an agreement in principle to sell Malapai to a U.S. affiliate of Electricite' de France. In accordance with Pinnacle West's financing agreements, the net cash proceeds from the sale of Malapai, as well as from the sale of all or substantially all of the assets or shares of common stock of SunCor or El Dorado, must be used to reduce Pinnacle West's outstanding debt.

As demonstrated above, Pinnacle West is implementing a program for financial recovery and its financial condition has stabilized. The public interest and the interest of investors and consumers would best be served by Pinnacle West continuing its progress in this regard.

B. The Financial Condition of Pinnacle West and APS is Dependent Primarily on the ACC

As previously discussed, Pinnacle West's diversification-related financial difficulties, stemming primarily from MeraBank, are largely a thing of the past. However, the financial condition of Pinnacle West and APS will continue to be adversely affected by the failure of the ACC to grant APS the opportunity to earn a just and reasonable return on its public utility properties, including its prudent investment in all three Palo Verde units.<sup>5/</sup> Palo Verde Unit 3 commenced commercial operation on January 8, 1988. As of March 31, 1990, APS' investment in Palo Verde Unit 3 was approximately \$1.2 billion. APS' investment in Palo Verde Unit 3, as well as its investment in Unit 4 of the Cholla Plant ("Cholla 4") (totalling \$242 million as of March 31, 1990), are not currently reflected in APS' retail rates. On January 11, 1990, APS filed an application with the ACC for a permanent increase in annual retail rates. The filing, which was revised on May 11, 1990, seeks a permanent increase in annual retail rates of approximately \$259 million, to be phased in in three annual installments commencing January 1, 1991. The proposed rate increase seeks to recover the costs of Palo Verde Unit 3 and Cholla 4, as well as costs incident to the increase in retail customers since the prior test year of 1986, and the increase in APS' cost of service since that test year. Hearings on the rate application have not yet been scheduled. APS' and Pinnacle West's financial condition will be adversely affected so long as APS is unable to include these assets in rate base and have the opportunity to earn a just and reasonable return thereon. Pinnacle West believes, therefore, that the prospects for its continued financial recovery, and the financial condition of APS, depend in large measure on the ACC.<sup>6/</sup>

5. An ACC-mandated audit of the costs of Palo Verde, which was completed in March 1989, identified approximately \$60 million of costs for the entire Palo Verde project that were unreasonably incurred, of which APS' share is approximately \$18 million. This represents only about one percent (1%) of APS' total investment in Palo Verde. The audit also identified approximately \$300 million of cost savings attributable to performance. APS' share of such savings is approximately \$85 million. The ACC has not established a procedural framework to consider formally the results of the audit or the reasonableness of the costs of Palo Verde.
  6. Independent rating agencies apparently agree with that conclusion. On March 28, 1990, Moody's Investors Service raised the securities ratings of Pinnacle West and lowered those of the preferred stock of APS, stating that factors related to Palo Verde "continue to dominate the uncertain-
- (footnote continued)



C. The ACC Must Not be Permitted to  
Abdicate its Legal Duties

The ACC's allegation that it is unable properly to carry out its legal duties to authorize just and reasonable rates for APS and its customers because in so doing it fears triggering a Pinnacle West default under its financing agreements, and a consequential loss of control over APS, is without foundation and entirely specious. Only a confiscatory rate order by the ACC would raise doubts about APS' ability to make prudent dividend payments to its shareholders, including Pinnacle West, thereby raising the possibility that Pinnacle West could not service its debt. If the ACC carries out its legal responsibility to authorize just and reasonable rates for APS and its customers, the ACC need not, and, indeed, should not worry about the possibility of Pinnacle West defaulting under its financing agreements.

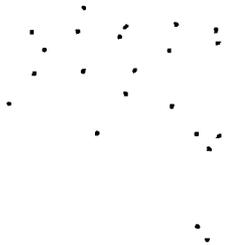
Pinnacle West believes that APS is entitled to the rate relief it has requested in the rate case that has been pending before the ACC for more than five (5) months. However, irrespective of the merits of that case, it is clear that such issues properly reside at the ACC, not at the SEC. The '35 Act is not a

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ties facing Arizona Public Service and will be the key determinants in any future rating adjustments." Moreover, in February of this year, Duff & Phelps Inc. lowered the ratings on APS' first mortgage bonds, preferred stock, commercial paper and certain secured lease obligation bonds serviced by APS lease payments because:

"[APS] has heavy dependence upon regulation for the restoration of its financial health...Regulation in Arizona has been increasingly difficult; the Chairman of the Arizona Corporation Commission (ACC) is running for re-election in 1990... Adequacy of rate treatment has become increasingly uncertain."

Similarly, on May 11, 1990, Fitch Investors Service, Inc. ("Fitch") lowered its securities ratings on APS' first mortgage bonds, preferred stock, and certain collateralized pollution control revenue bonds, citing the fact that "[t]he regulatory climate in Arizona...is extremely politicized against APS and its parent." Fitch also noted that "[t]he Arizona Corporation Commission recently voted to request the SEC to revoke the parent's exempt holding company status and require divestiture of all non-utility operations."



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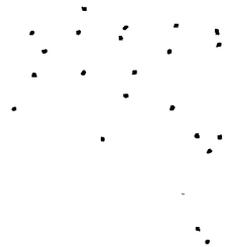
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ratemaking statute;<sup>7/</sup> Congress never intended that the '35 Act should be used as a vehicle for a state public service commission to abdicate its legal responsibility to establish just and reasonable rates for utilities subject to its jurisdiction.

Moreover, the ACC's allegations that it cannot effectively regulate the business of APS are not supported by the facts.<sup>8/</sup> APS is currently restricted in the amount of common stock dividends it can pay to Pinnacle West. Specifically, pursuant to an agreement among APS, Pinnacle West, the Pinnacle West Shareholders' Association, Inc., the Residential Utility Consumer Office, and the ACC (the "ACC Settlement Agreement"),<sup>9/</sup> APS may not, without prior ACC approval, directly or indirectly transfer any funds to Pinnacle West except for, among other things, regular quarterly dividends to Pinnacle West at the level paid out on July 13, 1989. The ACC alleges that, because Pinnacle West mounted a legal challenge to the ACC's jurisdiction to restrict the payment of dividends by APS to Pinnacle West, the ACC is essentially powerless to impose whatever limits on such dividends it believes are necessary to protect APS and its customers. Despite the legal challenge, APS and Pinnacle West have been and continue to be subject to the limitations of the ACC Settlement Agreement. Clearly, the existence of the dividend restrictions in the ACC Settlement Agreement, when coupled with the covenants in certain of Pinnacle West's financing agreements and Pinnacle West's present corporate strategy not to further diversify, render without merit the ACC's allegations that renewed diversification remains a plausible threat.

7. Ohio Power Co. v. FERC, 880 F.2d 1400, 1407 (D.C. Cir. 1989), cert. granted sub nom. Arcadia, Ohio v. Ohio Power Co., 110 S. Ct. 1522 (1990).
8. The ACC is a constitutionally created agency pursuant to Article 15 of the Arizona Constitution ("Article 15"). Its three (3) members are popularly elected for six (6) year terms. Article 15, Section 1. The ACC has long been regarded in Arizona as a "fourth branch of government." State v. Tucson Gas, Electric Light & Power Company, 15 Ariz. 294, 306, 138 P. 781, 785-86 (1914). The ACC's constitutional status and the regulatory powers bestowed therein make it uniquely capable of fully protecting APS ratepayers by regulating APS directly.
9. The ACC Settlement Agreement was reached on August 15, 1989, and was amended effective March 1, 1990, to remain in effect until the earlier of September 30, 1991, or the issuance by the ACC of a final rate order in the rate case filed by APS on January 11, 1990.



D. In Evaluating the Complaint, the SEC Should Consider How its Actions Could Impact the PacifiCorp and SRP Offers

As is widely known, Pinnacle West has received multiple offers from PacifiCorp, the most recent being only last Thursday, indicating its desire to acquire Pinnacle West or APS. In addition, after the close of the market last Friday, Pinnacle West received a proposal from SRP to purchase certain of APS' distribution and transmission facilities for up to \$500 million. Against this backdrop of shifting, fast-moving developments, we urge that the SEC not act in a manner that could or would affect the ability of Pinnacle West's Board of Directors to protect the interests of its shareholders.<sup>10</sup>

The latest of PacifiCorp's overtures offered cash consideration of \$21 for each share of Pinnacle West common stock. Pinnacle West's Board of Directors has not yet responded to this proposal. This most recent offer, however, in our view, readily illustrates two of the points we urge the SEC to consider in connection with its deliberations as to how best to respond to the Complaint: First, PacifiCorp's attempts to acquire Pinnacle West have had a significant and immediate impact on the interests of investors. The closing price of Pinnacle West's common stock on the New York Stock Exchange was \$12.75 on May 16, 1990, the day prior to the announcement of PacifiCorp's latest offer, and was \$16.375 on the day of such offer. Secondly, it illustrates PacifiCorp's judgment that the recovery plan initiated by Pinnacle West's new management is having its intended effect.

SRP's offer of last Friday to purchase certain of APS' assets for up to \$500 million obviously only further complicates matters.

E. The ACC's Allegation that Pinnacle West No Longer Meets the Objective Criteria for an Exemption Under Section 3(a)(1) is Entirely Without Merit

The ACC's allegation that Pinnacle West no longer meets the objective criteria for an "intrastate" exemption under Sec-

10. Indeed, we respectfully submit that it would be appropriate for the SEC to consider at this juncture the possible effects, were it to institute a Rule 6 proceeding or to take any or all of the other actions sought by the ACC, on the protection of the interests of Pinnacle West's shareholders in dealing with PacifiCorp's unsolicited offers or that of SRP (as well as any competing overtures, should others materialize). We suggest that the SEC's procedures -- involving potential delays in response time and possible premature public exposure of delicate deliberations -- could, in this context, adversely affect the very shareholder interests that the SEC would be seeking to protect.

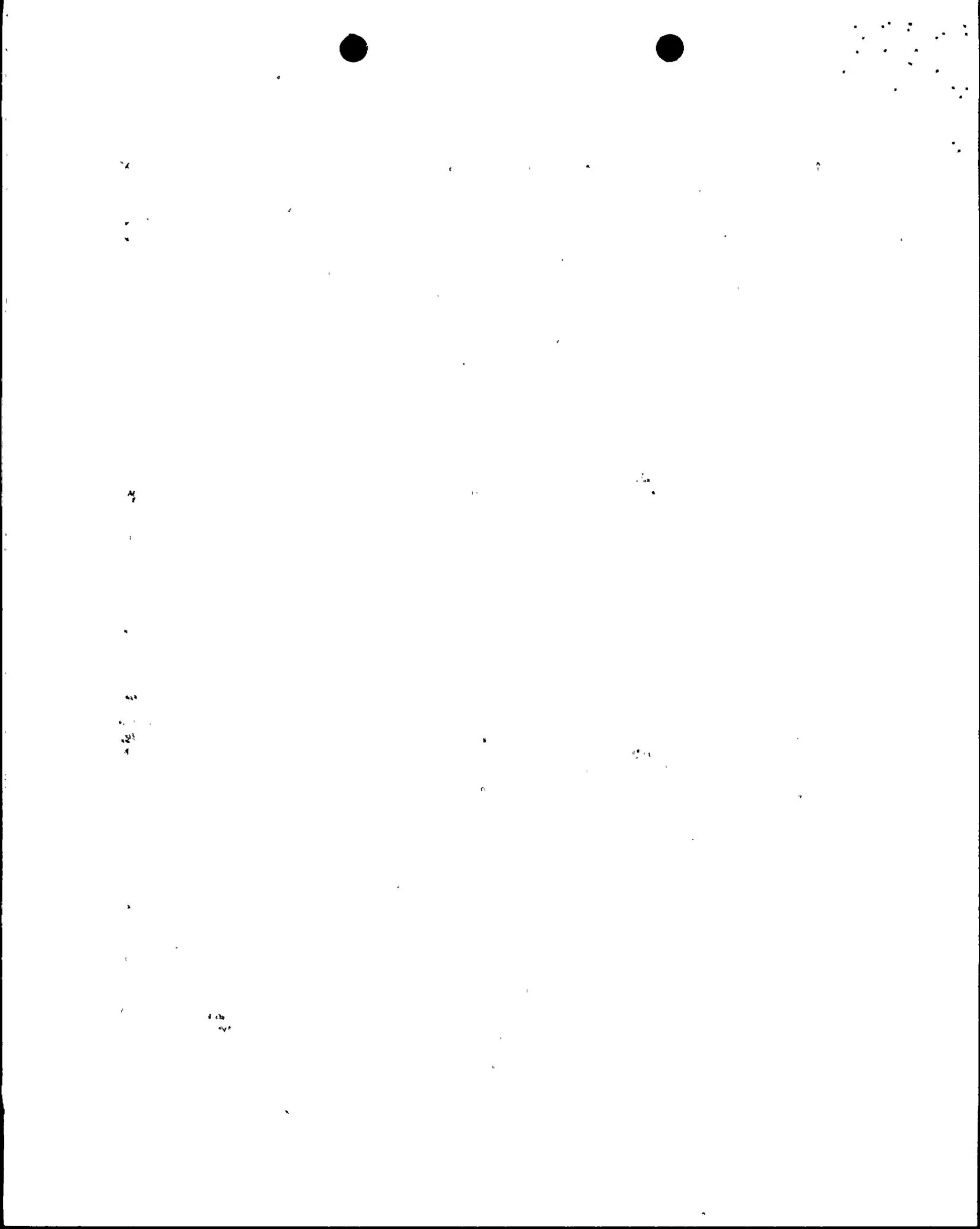


tion 3(a)(1) is entirely without merit.<sup>11/</sup> Pinnacle West is organized in Arizona, as is APS, its only public utility subsidiary, and each is predominantly intrastate in character and carries on its business substantially in Arizona. The ACC suggests that the fact that Pinnacle West raises capital in interstate commerce disqualifies it for exemption under Section 3(a)(1). For the SEC to give any credence to this assertion would be to render the standards of Section 3(a)(1) entirely without meaning.

F. The Complaint Misstates Facts Concerning Palo Verde, Quotes NRC Documents Out of Context, and Fails to Recognize the Pervasive Nature of NRC Regulation

The NRC, under the Atomic Energy Act of 1954 ("AEA"), has jurisdiction over APS and Palo Verde with respect to nuclear safety issues, including jurisdiction over questions relating to financial qualifications and corporate control of the operator of a nuclear power plant. In exercising its jurisdiction, the NRC has continually evaluated APS' and Palo Verde's performance, as documented in numerous inspection reports, in Systematic Assessments of Licensee Performance ("SALPs"), and very recently in a lengthy diagnostic evaluation report of Palo Verde operations ("DER").<sup>12/</sup> The Complaint singled out a few pages of the DER to paint a picture about Pinnacle West, APS and Palo Verde that is

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11. Rule 2 provides, in relevant part, that "[a]ny holding company, and every subsidiary company thereof as such, shall, upon the filing of an exemption statement on Form U-3A-2 and subject to the filing of such exemption statement on or before March 1 of each year thereafter, and subject to the provisions of [Rule 6], be exempt from all the provisions of the ['35 Act] and rules thereunder, except section 9(a)(2) of the ['35 Act], if --
- (1) such holding company, and every subsidiary company thereof which is a public-utility company from which such holding company derives, directly or indirectly, any material part of its income are predominantly intrastate in character and carry on their business substantially in a single State in which such holding company and every such subsidiary company thereof are organized..."
12. A SALP is "an integrated NRC staff effort to collect available observations and data on a periodic basis and to evaluate a licensee's performance based on this information. The program is supplemental to normal regulatory processes used to ensure compliance with NRC rules and regulations." NRC SALP Report, Docket Nos. 50-528/89-48, 50-529/89-48, 50-530/89-48 at 1 (Nov. 22, 1989) ("1989 Palo Verde SALP Report").



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neither an accurate representation of the NRC's regulatory assessment nor an accurate representation of the DER.

Perhaps the best evidence of the NRC's current views concerning the overall performance of Palo Verde may be drawn from the most recent NRC SALP report for Palo Verde:

Overall, the SALP Board found the performance of licensed activities at Palo Verde to be satisfactory and directed toward safe facility operation...[M]ost indications are that improved performance can continue in the future, assuming that senior management successfully implements the various corrective action programs and initiatives laid out during this SALP period.<sup>13/</sup>

The Complaint also misstates the current facts concerning operations at Palo Verde; in particular, those relating to the likelihood of the NRC issuing an order to shut Palo Verde down. Although Palo Verde experienced operational problems in 1989 and early this year, these matters are being addressed to the NRC's satisfaction. In June 1989, the NRC gave its approval to restart Palo Verde Unit 2; approval followed to restart Unit 3 in December 1989. APS expects to request NRC approval to restart Unit 1 in the near future.

The Complaint also mischaracterizes the DER and its contents. It incorrectly refers to the DER as an "NRC Deficiency Letter," thus implying that the areas presenting opportunities for improvement may be violations of NRC requirements. This is not true.<sup>14/</sup> The DER does not support any conclusion that Pinnacle West's financial difficulties have impaired operations at Palo Verde:

[T]he [Palo Verde Diagnostic Evaluation] team found no evidence to suggest that financial difficulties at Pinnacle West or APS appropriation levels had jeopardized safety systems or

13. Letter from J.B. Martin (NRC Region V Administrator) to W.F. Conway (Executive Vice President, Nuclear, Arizona Nuclear Power Project) at 1 (Nov. 22, 1989) (transmitting the 1989 Palo Verde SALP Report for the period Nov. 1, 1988 through Oct. 31, 1989).
14. In fact, a DER is an evaluation conducted "for the purpose of gaining expert insight into significant aspects of plant operations, plant performance, safety, and compliance with NRC regulations." NRC Manual Chapter 0520, "NRC Diagnostic Evaluation Program," at 4041 (March 3, 1988).



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safe operation of the units. Interviews and documents revealed that the resources (money, people, equipment, materials and facilities) provided to Palo Verde by APS were generally adequate to meet needs...Senior management at both the site and corporate offices indicated a strong commitment of resources to operate the plant safely and reliably.<sup>15/</sup>

In sum, the DER does not support the ACC's allegations that Pinnacle West's financial difficulties have impaired the ability of APS to operate Palo Verde in a reliable and safe manner.

The SEC should also be mindful of the NRC's pervasive regulatory jurisdiction over nuclear safety issues under the AEA and the Energy Reorganization Act of 1974.<sup>16/</sup> As the foregoing discussion clearly indicates, the NRC has been closely monitoring operations at Palo Verde to assure that any performance problems which may have previously existed at Palo Verde either have already been resolved, or are in the process of being resolved, to the NRC's satisfaction. Moreover, the DER made clear that Pinnacle West's financial condition has not had an adverse effect on the operations of Palo Verde. As a matter of comity and administrative regulatory efficiency, the SEC should, therefore, defer to the NRC's expertise with respect to those allegations of the ACC concerning Palo Verde.<sup>17/</sup>

15. Palo Verde DER at 25.

16. 42 U.S.C. §§ 2011 et seq.; 42 U.S.C. §§ 5801 et seq. See Pacific Gas & Electric Co. v. State Energy Resources Conservation and Development Commission, 461 U.S. 190, 212 (1983) (NRC has "exclusive authority" over nuclear power plant construction and operation); Siegel v. ACC, 400 F.2d 778, 783 (D.C. Cir. 1968) (AEA is "virtually unique in the degree to which broad responsibility is reposed in the administering agency, free of close prescription in its charter as to how it shall proceed in achieving the statutory objective").

17. The AEA is "hallmarked by the amount of discretion granted the Commission in working to achieve the statute's ends," Public Service Co. of New Hampshire v. NRC, 582 F.2d 77, 82 (1st Cir. 1978), cert. denied, 439 U.S. 1046, and the NRC's interpretation of what is properly within its jurisdictional scope is entitled to great deference; Power Reactor Development Co. v. International Union of Electrical, Radio and Machine Workers, 367 U.S. 396, 408 (1961), Nader v. NRC, 513 F.2d 1045, 1055-56 (D.C. Cir. 1975), and "will not be over-  
(footnote continued)

G. The Complaint Contains Other  
Material Misstatements of Fact

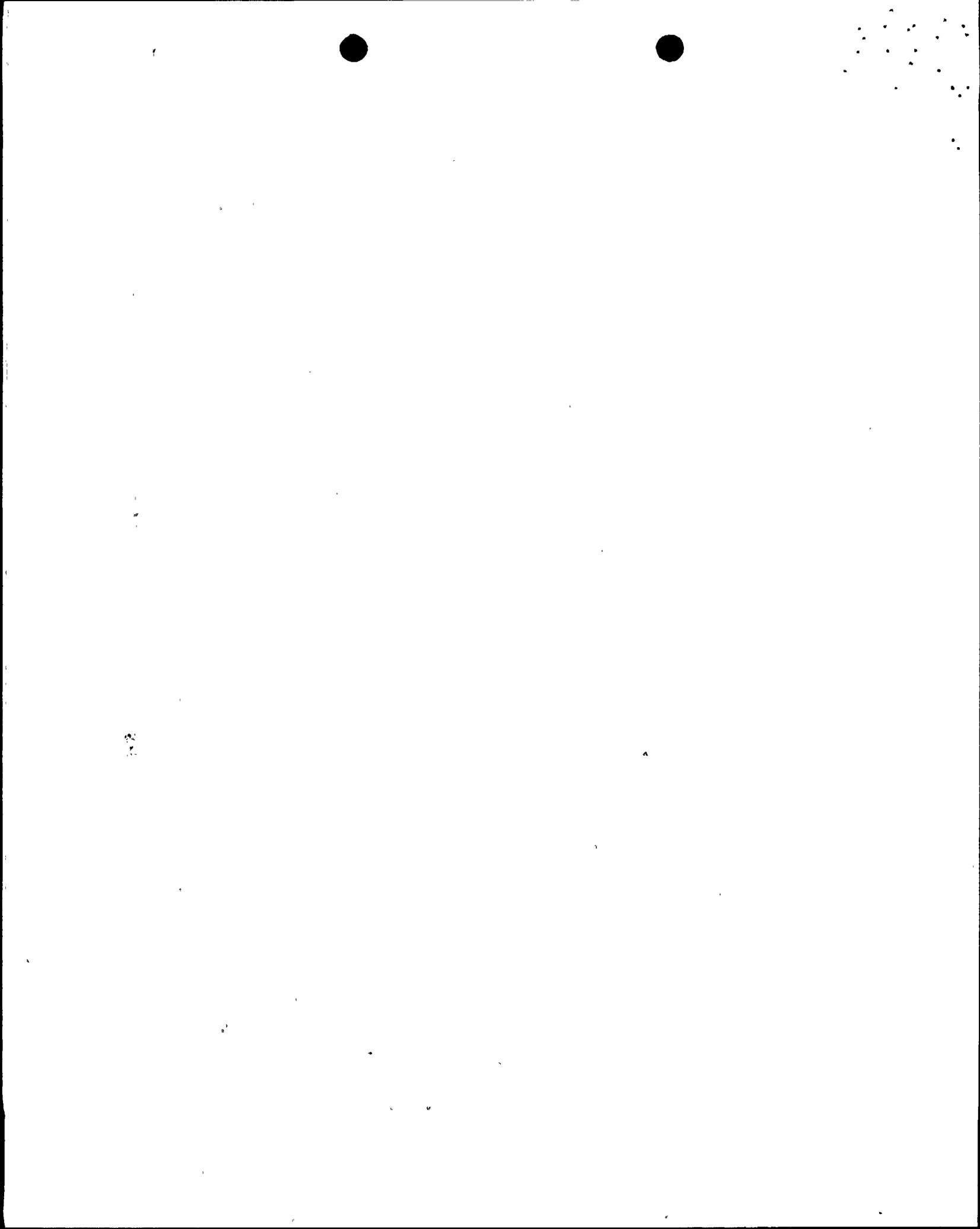
The Complaint contains a number of material misstatements of fact, the result of which is that the ACC has presented the SEC with an incomplete and distorted picture of the current business, financial condition and prospects of Pinnacle West and APS. Several of these misstatements were pointed out to the ACC by Pinnacle West in the ACC's public meeting of May 1. However, the ACC refused Pinnacle West's request that the misstatements be corrected before filing the Complaint with the SEC. These misstatements will be addressed in turn.<sup>18/</sup>

1. In several places in the Complaint, the ACC materially misstates existing limitations on Pinnacle West's ability to raise capital, suggesting that these alleged limitations severely weaken APS by leaving it with no prospect of gaining access through Pinnacle West to the capital markets. On page 30, the ACC alleges that "[u]nder [Pinnacle West's] long-term financing agreements, Pinnacle West's creditors could block [sales of Pinnacle West common stock]," and that "Pinnacle West's creditors could block any stock dilution." On page 34, the ACC alleges that "[Pinnacle West's] long-term financing agreements...restrict Pinnacle West's access to equity markets..." that

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turned if reasonably related to the language and purposes of the statute." Public Service Co. of New Hampshire v. NRC, 582 F.2d at 82. In this regard, "the...[AEA] gives the NRC complete discretion to decide what financial qualifications are appropriate" for its licensees (see Coalition for the Environment v. NRC, 795 F.2d 168, 174 (D.C. Cir. 1986); Public Service Co. of New Hampshire v. NRC, 582 F.2d at 93). When appropriate, the NRC has used this authority to impose license conditions requiring greater financial assurances from licensees when the operator is experiencing financial difficulties. Public Service Co. of New Hampshire (Seabrook 1 & 2). CLI-88-10, 28 NRC 573 (1988). The NRC also has the authority to approve direct or indirect transfers of control over NRC licenses or NRC licensees, such as APS. See 42 U.S.C. § 2234 (1988). See also 10 C.F.R. §§ 50.80, 50.81 (NRC license transfer and creditor regulations); Arizona Public Service Co., et al. (Palo Verde Nuclear Generating Station, Unit 1), CLI-85-17, 22 NRC 875 (1985) (statutory prohibition on license transfers without NRC consent applies to direct or indirect transfers of control over NRC licensees).

18. All subsequent page numbers refer to those in the Complaint.



"Pinnacle West is hindered in its ability to raise more money for APS, at least through the sale of new stock," and that "any [Pinnacle West stock issuance] can be vetoed by [Pinnacle West's] creditors."

In fact, Pinnacle West is not prohibited from issuing new common stock under such financing agreements. Although such agreements place limitations on Pinnacle West's ability to infuse capital into other Pinnacle West subsidiaries, Pinnacle West obtained from its lenders the right to infuse an unlimited amount of capital into APS, subject to the maintenance of certain specified financial ratios.

2. On page 29, the ACC alleges that "[a]s for equity, APS is completely dependent on Pinnacle West..."; and on page 34, the ACC alleges that "APS, of course, cannot issue its own equity..."

Again, such allegations are simply untrue. There is nothing contained in the Pledge Agreement or any other Pinnacle West financing agreement that restricts APS' ability to issue equity in the form of preferred stock to finance its ongoing operations.

3. On pages 8-9, in describing the effects of the pledge by Pinnacle West of the stock of APS under the Pledge Agreement, the ACC alleges that Pinnacle West's "creditors might be 'holding companies' subject to regulation" under the '35 Act both by reason of "taking a security interest in APS' stock" and "by virtue of [the creditors'] rights under Pinnacle West's financing agreements to restrict certain activities of Pinnacle West or APS..." In support of this argument, the ACC alleges on page 30, that "Pinnacle West's creditors...have the power to block any vote by the Pinnacle West Board which, in the creditors' sole judgment, will reduce the value of Pinnacle West's common stock." The ACC alleges on pages 40-41 that, as a consequence, "major decisions affecting APS, such as whether Pinnacle West can issue new stock to finance APS' needs, now are under the control of non-Arizona entities."

Pinnacle West's creditors do not have the power to block votes of Pinnacle West's Board of Directors on matters which may reduce the value of Pinnacle West's common stock. The Pledge Agreement provides that, until Pinnacle West and the collateral agent under the Pledge Agreement (the "Collateral Agent") receive notice of the occurrence and continuation of an Event of Default (as defined in the Pledge Agreement), Pinnacle West is



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entitled to exercise or refrain from exercising any and all voting and all other consensual rights pertaining to the pledged stock. As to matters other than the election of directors, Pinnacle West has agreed not to exercise or refrain from exercising any such rights if, in the Collateral Agent's judgment, such action would have a material adverse effect on the value of the pledged stock. Such a provision, which is designed to ensure against a material impairment of the lenders' collateral, is common in commercial lending transactions.<sup>19</sup>

4. The ACC alleges on page 11, that the existence of the "keep-well" arrangements regarding MeraBank "was not even disclosed until MeraBank's financial problems became the subject of formal action by federal regulatory agencies [in June 1989]."

On the contrary, the existence of the "keep-well" agreement was disclosed in publicly-filed documents in 1987, shortly after the acquisition of MeraBank.<sup>20</sup>

H. The Existence of the Complaint, when Coupled with the Lack of a Negative Response to it by the SEC, Is Likely to Have an Adverse Effect on Pinnacle West and its Shareholders and Consumers

A prompt response by the SEC refusing to take any of the actions requested in the Complaint would be very much in the public interest and the interest of investors and consumers. Simply the existence of the Complaint, when coupled with the lack of such a negative response by the SEC, is likely to have an adverse effect on Pinnacle West and its shareholders and consumers. For example, SunCor's ability to sell or enter into

19. Cf. Narragansett Capital Corporation (available May 4, 1978).

20. For example, the Form 10-K of Pinnacle West for the fiscal year ended December 31, 1986, contained the following:

"The Company has stipulated to the [Federal Savings and Loan Insurance Corporation] that, as long as it controls MeraBank, the Company will cause the regulatory capital of MeraBank to be maintained at the level required by applicable regulations and, as necessary, will infuse sufficient additional equity capital to effect compliance with such requirement. Regulatory amendments effective January 1, 1987, are expected to increase the minimum regulatory net worth required of MeraBank..."



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joint ventures to dispose of or otherwise to maximize the value of its real estate assets is likely to be hindered by the uncertainty surrounding the Complaint and the SEC's response to it. Moreover, even the theoretical possibility of a forced divestiture by Pinnacle West of its non-utility assets could prevent Pinnacle West from realizing the fair value of such assets, thereby reducing the amount of debt that Pinnacle West would be able to repay with the proceeds of any such sale. This is especially significant in view of the fact that the book value of Pinnacle West's non-utility assets represents approximately one-half of the total outstanding principal amount of its debt. As a result, it is in the public interest and in the interest of investors and consumers for the SEC to dispose of the Complaint in as expeditious a manner as possible.

### III. CONCLUSION

Pinnacle West believes that the ACC's allegations in the Complaint are based, in part, on material misstatements of fact, are legally without substance, or, given the successful implementation to date by Pinnacle West of its program to maximize shareholder values, are based upon Pinnacle West's past problems rather than its current business, financial condition and prospects. Nevertheless, the fact remains that the key to Pinnacle West's and APS' long-term financial condition lies in the legal duty of the ACC to provide APS with an opportunity to earn a just and reasonable return on its prudent investments, a factor noted by, among others, the leading independent rating agencies.<sup>21/</sup>

It is also important to stress again the progress that Pinnacle West has made to date. Pinnacle West has a new President, Chief Executive Officer and Chairman of the Board. MeraBank operations have been discontinued pursuant to the MeraBank Settlement, and any obligation Pinnacle West may have had to infuse equity capital into MeraBank has been terminated. Pinnacle West has restructured substantially all of its debt, has repaid approximately \$40 million to date and expects to repay another \$35 million on or before June 30, 1990. SunCor has recently completed the sale of certain properties for \$70 million, and Pinnacle West has an agreement in principle to sell Malapai. Such positive steps toward financial recovery clearly demonstrate that the SEC should best evaluate the merits of Pinnacle West's continued exemption by focusing on its current business, financial condition and prospects and not on its past problems, which largely have been resolved.

For the foregoing reasons, Pinnacle West hereby respectfully requests that the SEC refuse to take any of the actions requested by the ACC in the Complaint and promptly notify

21. See supra note 6.



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Pinnacle West and the ACC of such decision. If the SEC were to take any action sought by the ACC (which would undoubtedly be quite time-consuming and expensive for all parties involved), it would hinder the efforts of Pinnacle West's new management in implementing its program for financial recovery, as well as distract the ACC from the performance of its legal duties. As such, SEC action of this nature would clearly not be in the public interest or in the interest of investors or consumers.

If you have any questions, or if Pinnacle West or the undersigned may be of any further assistance, please feel free to contact the undersigned at (212) 603-2240.

Very truly yours,

REID & PRIEST,  
Counsel for Pinnacle West Capital  
Corporation

By /s/ Richard M. Farmer  
Richard M. Farmer

cc: William C. Weeden

