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Arizona Regulation: Drawing a Line in the Sand? Not with this Commission — Continuing Our Deep Dive in the Desert with Commissioner Myers and Commissioner Thompson

Key Message: We are updating our thoughts on Arizona's regulatory climate following a client event we hosted for Commissioner Nick Myers and Commissioner Kevin Thompson as a result of heightened utility investor interest in Arizona on the back of the recent Open Meeting addressing the TEP case as well as multiple other rate proceedings occurring over the next several months. Investors were keen to listen to the Commissioners' return to share their viewpoints on ratemaking, setting rates of return, and how best to reduce the frequency of rate cases needing to be filed while also addressing regulatory lag, among other topics. In our view, these two commissioners have gone a long distance in a short amount of time to properly bridge and balance ratepayer and institutional investor interests, which, in our view, were improperly skewed in the past. Below, we highlight some of the key items that we discussed with the commissioners while contrasting their messaging from the last time we spoke, where applicable.

For a continued deep dive into AZ regulation with Commissioner Myers and Commissioner Thompson, please see our prior call's recap note [HERE](#) as well as our initial introduction to Commissioner Thompson at our January NARUC Roundtable event at Guggenheim (link [HERE](#)).

So how are the commissioners thinking broadly about ROEs and regulatory certainty/consistency? As another rate case cycle ramps up in AZ, the topic of ROE certainty came up on a general level, with the key question being an important, albeit conceptual one: should ROEs for utilities across the state be the same, or should they vary depending on the business and financial risk profile of each company (as is broadly the case across the country)? The commissioners' viewpoints were that ROEs do not have to move in unison for every utility, noting that, as with any business, there's an argument to be made that companies with riskier or more sophisticated operations naturally warrant a higher rate of return vs. peers in order to account for the additional complexity and potential risks they are taking on (e.g., in the utility space, we note that this usually applies to more advanced forms of power generation like nuclear, etc.). Nothing the commissioners said on this front came as a surprise, in our view, and instead echoed the approaches of most utility regulators we have spoken with from across the country in jurisdictions that appear to be balanced from a regulatory construct standpoint.

Overall, the commissioners' views on ROE remained consistent from our last call with them, particularly those of Commissioner Myers, who we noted had said that he preferred a data-driven approach, which would allow the commission to start by **comparing the ROEs of other companies with similar risk profiles and operations across the nation** and then adjusting the figure up or down from there in relation to a matrix of some sort, including inputs such as customer service scores relative to other utilities, and so on. On that call, Commissioner Thompson was generally in agreement, although he did not share the matrix view but did seem to agree that looking at ROEs in the broader context of what is occurring nationally is reasonable.

What happened with TEP's ROE, why was there a focus on FVI, and what does this mean for utility ROEs going forward in AZ? Commissioner Myers discussed the 11th and 12th amendments he proposed on the record, which ultimately resulted in the utility agreeing to forego receiving a Fair Value Increment return in favor of being provided with a roughly equivalent simple ROE instead. **His intention seemed to be both simplifying/better clarifying the components that make up a utility's rate of return** as well as to bring AZ into the fold with other states, which also provides the added benefit of allowing

easier comparisons of authorized return levels across states (since the FVI is an Arizona-only construct). **We note that some investors appeared unaware that despite the higher headline ROE, TEP's authorized net income actually ended up being slightly lower with the 9.55% ROE vs. what it would have been had the ALJ's recommendation of a 9.40% ROE + 20bps FVI been adopted.** Due to AZ legal precedent, the utility had to consent to dropping the FVI and adopting Commissioner Myers' proposal instead, a decision it made in real time during the Open Meeting and a gamble that seems to have paid off as investor sentiment towards the higher headline ROE has been unanimously positive, based on our interactions, with little to no focus on the lower resulting earnings power.

In our view, dropping the FVI component in favor of higher plain ROEs going forward is a clear example of these commissioners successfully implementing the type of regulatory changes they talked about wanting to make earlier this year, particularly in TEP's case, as both sides seemed to have won, with investors pleased with the "higher" ROE, while ratepayers received a reduction to what their bills otherwise would have been due to the slightly reduced revenue requirement, which resulted from adopting the lower return level afforded by the 9.55% ROE vs. the ALJ's ROO (9.4% ROE + 0.2% FVI). **In summary, the final result also aligns with the commissioners' reiterated goal of encouraging investors to see Arizona as an increasingly "...safe place for you to park your money... and ensuring that Arizona continues to be something on your radar as a positive and not a negative," as Commissioner Thompson put it.**

Is reducing rate case frequency and regulatory lag still a primary focus?... Yes, the commissioners reiterated their interest in and commitment to **exploring options that could reduce the number of rate cases currently being filed in AZ.** Doing so would almost certainly result in saving both time and money for taxpayers, ratepayers, and shareholders while also substantially reducing the ACC Staff's current workload and freeing them up to pursue other projects such as furthering the commissioners' work on evaluating the potential move to forward-looking or hybrid test years in place of the current standard of historic test years plus the incorporation of post-test year plant (PTYP). We note that, **consistent with their prior comments in our previous meetings,** the commissioners remained primarily focused on forward-looking test years, or even hybrid test years; however, **when we asked about non-water utilities potentially implementing similar mechanisms to the System Improvement Benefits (SIB) programs those utilities employ,** each commissioner said they were not necessarily opposed to the idea and would even be open to considering any similar proposals in other cases.

So then why was TEP's System Reliability Benefit mechanism not approved, would it not have accomplished the commissioners' goals above? Beginning with the recommended denial in the ROO, the ALJ opposed TEP's SRB on the basis that she thought it was insufficiently designed, including taking the position that it was too broad in scope and that it constituted, **in her view,** single-issue ratemaking that was solely focused on reducing regulatory lag incurred by the utility. **However, the commissioners seemed most focused on there simply not having been enough time for parties to properly conduct due diligence on the proposal given its late reintroduction into the docket by TEP as part of its Rejoinder Testimony, which was filed shortly before the hearing began.** We understand that investors would be inclined to read into the ALJ's ROO as potentially setting future precedent; however, in our view, **TEP's relatively late filing for inclusion as well as the circumstances of the denial of its proposal were very situational.** We also note that while the ALJ's recommendation may be consistent with past precedent in recent years, so was her inclusion of a Fair Value Increment when establishing an appropriate ROE, something that Commissioner Myers actively changed with agreement from the utility in the case as well. In other words, we absolutely expect the commissioners to be **driven by their own views** on how utility regulation **should be done,** rather than simply following recommendations grounded in current precedents and policies that they fundamentally disagree with.

Guggenheim viewpoint: What could all this mean for APS? In short, we don't see any clear readthrough here from either the denial of TEP's late-filed SRB proposal nor do we see anything to clearly infer from the commissioners' high-level lack of outright rejection of the idea of using adjustment mechanisms to advance their stated goals of less frequent rate cases. Ultimately, as we stated above, **TEP's SRB proposal was very situational, making it unfortunately not comparable to APS' proposal, we believe, and while the commissioners seemed to us to continue to prefer that fewer rate cases (which are costly and time-consuming for all parties involved) be required going forward, they also appeared agnostic to how that gets achieved. As a result, we couldn't get a strong**

sense one way or another on any readthrough or applicability to APS' proposal in its case.

That said, while we see the potential for approval as a better than zero probability, we currently view APS getting an SRB mechanism approved as more of a long shot for now and continue to believe that moving to a forward-looking test year remains these commissioners' preferred option.

Anything to infer regarding APS' updated pension expense request? Unfortunately, the same lack of a clear readthrough also extended to the topic of pension expense when we asked on the matter as the **commissioners instead shifted the discussion towards more generally moving away from historic test years as the ultimate solution to addressing relevant known and measurable expenses that fall after the end of a test year under the current construct**; however, this, of course, would not be something that happens in the near term and would not help APS/PNW with obtaining approval for the updated pension expense ask in its current rate case, which was filed as part of the company's Rebuttal Testimony.

Smaller utilities seem able to reach settlements while large utilities in the state have not been... could we see more settlements for larger utilities going forward? The commissioners were quick to note that commission staffing levels have been driving this dichotomy as smaller utilities' cases are usually simpler and require less time/effort to review and negotiate compared with those of the state's larger utilities (i.e., politics with larger players as well as more resource constraints make settlements with larger utilities more challenging than for their smaller peers). Without a significant increase in staffing levels or a reduction in the number of rate cases being filed, it seems unlikely that settlements will become a more common sight in AZ for now for a company the size of APS, though we could see partial settlements of certain items, in our view.

Finally, Commissioner Thompson echoed his previous viewpoint that “The best place for policymaking is in the legislature.” — The commissioner pointed to the broad push for EVs adoption, making it quite clear that, in his view, a topic of this scope warranted a policy discussion, which should take place at the legislature as the state determines whether it wants to move to an all-electric transportation system and of course who would be expected to fund that transition.

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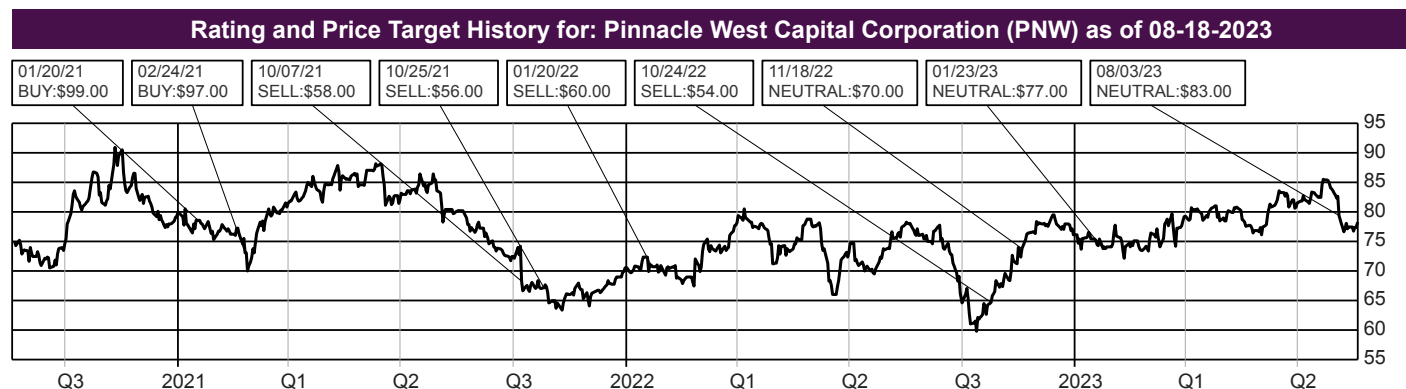
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