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**REBUTTAL TESTIMONY OF TODD A. SHIPMAN**  
**On Behalf of Arizona Public Service Company**  
**Docket No. E-01345A-19-0236**

November 6, 2020

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**Attachments**

Todd Shipman’s Curriculum Vitae .....Attachment TAS-01RB

Rating Scales .....Attachment TAS-02RB

1                                   **REBUTTAL TESTIMONY OF TODD A. SHIPMAN**  
2                                   **ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY**  
3                                   **(Docket No. E-01345A-19-0236)**

3    I.     INTRODUCTION

4    **Q.    PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS.**

5    A.    My name is Todd A. Shipman. I am an Executive Advisor to Concentric Energy  
6          Advisors, Inc. (Concentric), which has its headquarters at 293 Boston Post Road  
7          West, Suite 500, Marlborough, Massachusetts 01752.

8    **Q.    ON WHOSE BEHALF ARE YOU SUBMITTING THIS TESTIMONY?**

9    A.    I am testifying on behalf of Arizona Public Service Company (APS or Company).

10   **Q.    PLEASE SUMMARIZE YOUR EDUCATION AND BUSINESS**  
11       **EXPERIENCE.**

12   A.    I graduated from Texas Christian University with a Bachelor of Business  
13          Administration (B.B.A.) degree with a major in economics and from Texas Tech  
14          University School of Law with a Juris Doctor (J.D.) degree. I was awarded the  
15          Chartered Financial Analyst (C.F.A.) designation in 1989. I have 35 years of  
16          experience in the financial and utility industries. I began in the financial industry  
17          as an analyst with a research firm that specialized in analyzing and reporting the  
18          investment implications of the actions and behavior of utility regulators.  
19          Subscribers to the research included investment bankers and analysts at major Wall  
20          Street firms, large institutional investors such as insurance companies and mutual  
21          funds, utilities, and regulators.

22                                   I then joined an independent power producer. My primary responsibility was in  
23          regulatory affairs. I coordinated and managed its interventions in state regulatory  
24          proceedings. I also assisted in its development efforts, analyzing avoided-cost rates  
25          and regulatory policies toward non-utility power production, and in its investor  
26          relations.

27  
28

1 I spent the last 21 years of that stage of my career at S&P Global Ratings (S&P), a  
2 major ratings agency that has been in business over 150 years and issues more than  
3 one million ratings on over \$46 trillion of debt across all global capital markets. I  
4 performed credit surveillance of utilities, pipelines, midstream energy, and  
5 diversified energy companies. In the final ten years at S&P, I was the Sector  
6 Specialist on the North American utilities team. In that role, I was the lead analyst  
7 on the team charged with ensuring ratings quality, assisting in the training and  
8 development of new analysts, and creating the criteria used to establish utility  
9 credit ratings. I also led outreach efforts to investors and the regulatory community  
10 and performed a lead analytical role in the development and application of global  
11 ratings criteria for hybrid capital securities.

12 **Q. PLEASE DESCRIBE THE RESPONSIBILITIES OF YOUR CURRENT**  
13 **POSITION.**

14 A. After retiring from S&P, I became a management consultant specializing in  
15 advising utilities and other entities on credit and ratings issues, balance sheet  
16 management, and capital markets strategies. I also continued to teach advanced  
17 undergraduate finance courses at Boston University's Questrom School of  
18 Business for a while as an adjunct faculty member. I joined Concentric in August  
19 2018 as an Executive Advisor. My curriculum vitae appears as Attachment TAS-  
20 01RB.

21 **Q. HAVE YOU PREVIOUSLY TESTIFIED ON CREDIT RATING ISSUES?**

22 A. Yes. As an expert on credit ratings, I have participated in proceedings before the  
23 Federal Energy Regulatory Commission, the Hawaii Public Utilities Commission,  
24 the Wisconsin Public Service Commission, the California Public Utilities  
25 Commission, the New York Public Service Commission, the Virginia State  
26 Corporation Commission, the Mississippi Public Service Commission, the New  
27  
28

1 Mexico Public Regulation Commission, the Texas Public Utility Commission, and  
2 the Arizona Corporation Commission.

3 **Q. HAVE YOU FILED DIRECT TESTIMONY IN THIS PROCEEDING?**

4 A. No.

5 **Q. ARE YOU SPONSORING ANY ATTACHMENTS THAT ACCOMPANY**  
6 **YOUR TESTIMONY?**

7 A. Yes. Attachment TAS-01RB is my curriculum vitae. Attachment TAS-02RB  
8 contains the ratings scales of the two major rating agencies.

9 **Q. WHAT IS THE PURPOSE OF YOUR PREPARED REBUTTAL**  
10 **TESTIMONY IN THIS PROCEEDING?**

11 A. I address the negative effect on the Company's credit quality of the intervenor and  
12 Staff recommendations. In addition, I respond to specific recommendations in the  
13 prepared direct testimony filed by:

- 14 • Christopher C. Walters on behalf of Federal Executive Agencies (FEA), and
- 15 • Richard Gayer, Intervenor

17 **Q. PLEASE SUMMARIZE YOUR PREPARED REBUTTAL TESTIMONY.**

18 A. My prepared rebuttal testimony consists of the following:

- 19 • An overview and explanation of credit ratings
- 20 • The role credit ratings play in the capital markets and in turn how capital  
21 markets play a role in credit ratings
- 22 • The effect that credit ratings have on utilities and customers
- 23 • The benefits that customers have already experienced from past  
24 improvements to APS's credit ratings
- 25 • The risk of a downgrade of APS's credit ratings
- 26 • The risk of a downgrade of APS's credit ratings
- 27 • The risk of a downgrade of APS's credit ratings
- 28 • The risk of a downgrade of APS's credit ratings

- The effect of a utility’s regulatory environment on its ratings
- The backdrop of this case amid a negative credit rating environment due to capital market and macroeconomic fallout from the COVID-19 crisis, and
- The importance of this and future decisions on APS, its ratings and its customers

II. CREDIT RATINGS AND CAPITAL MARKETS

A. *Determining a Credit Rating*

**Q. WHAT IS A CREDIT RATING, AND HOW DOES IT DIFFER FROM OTHER MEASURES OF THE FINANCIAL CONDITION OF A UTILITY?**

A. A credit rating summarizes credit risk, which is primarily the ability and willingness of an issuer to fulfill its financial obligations in full and on time. Ratings first address the relative probability that an issuer or a specific debt issuance will experience default, i.e., the failure to pay either the required periodic payment or the principal when it matures under the terms of the security. As a secondary matter, some ratings incorporate the concept of recovery into the analysis. Recovery looks at the prospect of being made whole in the event of a default.

Credit ratings have a longer-term focus than other common financial benchmarks such as earnings-per-share, rate of return, and the market prices of a company’s securities at a particular point in time. Ratings are an objective, independent opinion offered by firms that have no financial stake in the outcome of its analysis. The combination of the long-term and independent nature of credit ratings offer utility regulators a useful guide to help navigate through the many decisions they must make in the course of balancing the various stakeholder interests that come before them.

1 **Q. IS A CREDIT RATING AN ACCURATE MEASURE OF AN ISSUER'S**  
2 **RISK AND FINANCIAL INTEGRITY?**

3 A. Yes. The historical default experience of issuers validates the usefulness of credit  
4 ratings as a measure of risk. From 1994 through 2019, Moody's Investor Service  
5 (Moody's) calculated that the five-year average, volume-weighted corporate bond  
6 default rate increases as you descend the ratings scale, from a low of 0.4% for the  
7 "Aaa" category to 39.55% for the combined "Caa-C" categories. For the  
8 investment-grade categories, the rate never gets to 1% and leaps to almost 4%,  
9 nearly four times as high, in the first speculative-grade category.<sup>1</sup>

10 **Q. HOW DOES A CREDIT RATING AGENCY ESTABLISH A CREDIT**  
11 **RATING?**

12 A. Ratings are established by a committee that specializes in the industry or industries  
13 of the rated entity. Ratings conform to common standards of credit risk by  
14 employing ratings criteria that are consistently applied. The analysis centers on two  
15 main areas. The quantitative side of the analysis examines financial ratios and other  
16 metrics to analyze the financial risk of the issuer. The qualitative side is the  
17 assessment of business risk, which is built up from the broad macro risks at the  
18 country and industry level. The issuer's more specific risk within its business and  
19 economic environment is then determined. For a utility, the major business risks  
20 are regulatory risk, operating risk and cash-flow diversity.

21 Business risk and financial risk can be viewed as complementary sides of the total  
22 risk of an entity, so that more of one risk must be offset by less of the other risk to  
23 arrive at a given rating. Because utilities are closely regulated and constrained on  
24 how much financial metrics vary over time, it is often the qualitative analysis that  
25 drives ratings outcomes. In investment-grade categories, which almost all U.S.  
26

27 \_\_\_\_\_  
28 <sup>1</sup> See Exhibit 54 in Moody's Investor Service, *Annual Default Study: Defaults will edge higher in 2020*, Jan. 30, 2020.

1 utilities occupy, qualitative factors are weighted more than financial factors in the  
2 credit analysis.

3 **Q. HOW IS BUSINESS RISK MEASURED?**

4 A. The business risk profile for a utility is focused primarily on regulatory risk. Other  
5 risk areas include operating risk, diversification, industry risk, and country risk.  
6 They are relevant and can sometimes exert influence on the final result, but in the  
7 U.S., they are rarely distinguishing factors in the analysis. Because regulatory risk  
8 is so important and encompassing, I devote an entire section to the topic (*see*  
9 Section III *infra*).

10 **Q. WHAT IS THE MOST DETERMINATIVE FACTOR WHEN ASSESSING**  
11 **A UTILITY'S BUSINESS RISK?**

12 A. The analysis of a utility's business risk, as with any other corporate issuer, revolves  
13 around the concept of volatility, especially regarding cash flow. Although rating  
14 agencies review and analyze many aspects of a utility's regulatory construct, it all  
15 comes down to two things: the ability to earn a compensatory rate of return on its  
16 investment, which is tied to financial risk, and the stability of those financial  
17 results, which is business risk in a nutshell. Another way to summarize a utility's  
18 business risk is to concentrate on regulatory lag. Regulatory lag (the delay between  
19 the incurrence of costs and the recovery of those costs in rates) consumes a great  
20 deal of rating agency attention in the analysis of business risk. To combat  
21 regulatory lag, they look for the degree that adjustment mechanisms and other cost  
22 adjustors are employed by a regulator to assist the timely recovery of costs in rates.

23 **Q. CAN YOU PROVIDE AN EXAMPLE THAT SHOWS HOW RATING**  
24 **AGENCIES VALUE THE USE OF ADJUSTMENT MECHANISMS AND**  
25 **ADJUSTORS?**

26 A. Yes. For example, in Moody's methodology, the concept appears in the area they  
27 call "Ability to Recover Costs and Earn Returns," which alone accounts for a full  
28



1 25% of its regulated utility rating scorecard.<sup>2</sup> As they state, “The criteria we  
2 consider include provisions and cost recovery mechanisms for operating costs,  
3 mechanisms that allow actual operating and/or capital expenditures to be trued-up  
4 periodically into rates without having to file a rate case (this may include formula  
5 rates, rider and trackers, or the ability to periodically adjust rates for construction  
6 work in progress) as well as the process and timeframe of general tariff/base rate  
7 cases – those that are fully reviewed by the regulator, generally in a public format  
8 that includes testimony of the utility and other stakeholders and interest groups.”<sup>3</sup>  
9 Moody’s also includes an extensive discussion of APS’s various cost recovery  
10 mechanisms in its credit analysis.<sup>4</sup>

11 **Q. HOW IS FINANCIAL RISK MEASURED?**

12 A. It is mostly a matter of calculating credit metrics for the issuer on both a historical  
13 and forecasted basis. The forecasted metrics are more impactful to the analysis,  
14 especially if they are expected to differ from the actual metrics recorded by the  
15 issuer. There are essentially two types of metrics. Leverage metrics assess the  
16 relative burden of debt and other fixed-income obligations compared to the  
17 financial responsibility being carried by shareholders. Coverage metrics gauge the  
18 issuer’s ability to service its fixed-income obligations, much like a mortgage  
19 company looks at a homeowner’s income compared to the house payment. Credit  
20 analysis by a rating agency is more sophisticated than that, however, and a credit  
21 analyst will affect numerous adjustments to accurately capture the issuer’s  
22 financial capabilities and debt burden.

23 Notably, operating cash flow is emphasized in credit metrics more than the  
24 earnings measures used in equity analysis. This difference was most recently  
25 exhibited when assessing the effect of tax reform on utilities. For most corporate  
26

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27 <sup>2</sup> Moody’s, *Rating Methodology*, pp. 12-15.

28 <sup>3</sup> *Id.* at 12.

<sup>4</sup> Moody’s, *Arizona Public Service Company*, Jan. 27, 2020, p. 4.

1 issuers and for shareholders, tax reform was beneficial. For utilities and their  
2 creditors, though, it was not favorable because of its negative cash-flow impact.

3  
4 Finally, financial risk also comprises two other vital components – liquidity and  
5 financial policy – that are not part of the metric analysis. The latter is especially  
6 relevant to a utility’s regulator, as it takes a broader and longer-term view of an  
7 issuer’s financial condition and the prospect for changes to it. The regulator’s  
8 regard for and support of a utility’s balance sheet and the consistency of its support  
9 can be a factor in this part of the financial analysis.

10 **Q. WHY IS A GOOD UNDERSTANDING OF CREDIT RATINGS AND THE**  
11 **METHODOLOGIES AND PROCEDURES USED TO ESTABLISH**  
12 **RATINGS IMPORTANT FOR THE PURPOSES OF THIS PROCEEDING?**

13 A. The proper use of credit ratings as a measure of risk and financial integrity requires  
14 an in-depth understanding of the ratings process and analytical approach to ratings.  
15 A lack of understanding can lead to erroneous and unsupported conclusions about  
16 financial risk.

17 **Q. DO YOU HAVE ANY CONCERNS ABOUT FEA WITNESS MR.**  
18 **WALTERS’S USE OF CREDIT RATING ANALYSIS<sup>5</sup> TO MEASURE**  
19 **APS’S FINANCIAL INTEGRITY DEFICIENT? IF SO, PLEASE**  
20 **EXPLAIN.**

21 A. Yes. Mr. Walters omits or misconstrues many parts of the S&P methodology. For  
22 example, he cites obsolete criteria and fails to consult the relevant criteria and fails  
23 to address the business risk side of the methodology that I explained above, which  
24 is an integral part of any credit analysis. Because of these failures, he does not  
25 calculate the core financial metric accurately.

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<sup>5</sup> Direct Testimony and Exhibits of Christopher C. Walters on behalf of Federal Executive  
Agencies, (Oct. 2, 2020), *Section IV.J. Financial Integrity*, pp. 53-56.

1 **Q. HOW DOES THE ABSENCE OF ANY DISCUSSION OF BUSINESS RISK**  
2 **AFFECT MR. WALTERS’S ANALYSIS?**

3 A. Attempting to reach a conclusion on the effect of his return recommendations based  
4 on a credit analysis that only considers credit metrics misses more than half of the  
5 credit quality equation. As I explained above, business risk is weighted more in a  
6 ratings analysis than financial risk. Mr. Walters, along with FEA witness Michael  
7 Gorman, are advocating a 70% reduction in the requested revenue deficiency<sup>6</sup>  
8 based on a return on equity that is below the national average.<sup>7</sup> Such a result would  
9 draw the attention of the rating agencies. It could potentially affect S&P’s  
10 assessment of the APS business risk profile.<sup>8</sup>

11 **Q. WHAT ARE YOUR CONCERNS ABOUT MR. WALTERS’ INCOMPLETE**  
12 **CREDIT ANALYSIS?**

13 A. Because he used outdated criteria and omitted using relevant criteria, he uses a  
14 metric that does not appear in the S&P criteria<sup>9</sup> and doesn’t correctly calculate the  
15 relevant core credit metric of funds from operations (FFO)-to-debt.<sup>10</sup> Mr. Walters  
16 derives an FFO-to-debt for APS of 27%, which is far above the latest figure of  
17 22.5% reported by S&P<sup>11</sup> and the S&P projection of 18-20%.<sup>12</sup> The wide gap  
18 between his calculation and S&P’s is a solid indication that his number is wrong.  
19 This renders his analysis unsuitable as a means to opine on the Company’s financial  
20 integrity.

22 \_\_\_\_\_  
23 <sup>6</sup> Direct Testimony of Michael P. Gorman, p. 2.

24 <sup>7</sup> Walters, Direct at 4.

25 <sup>8</sup> See the outlook statement in the latest S&P credit report, where the downside ratings  
26 scenario envisions “... unfavorable regulatory outcomes such that it is inadequate to  
27 achieve its targeted revenue growth...” S&P, *Arizona Public Service Co.*, May 8, 2020.

28 <sup>9</sup> He calls it the adjusted total debt ratio which S&P does not employ anywhere in its  
criteria. Walters, *Direct* at 55.

<sup>10</sup> FFO-to-debt is defined in S&P, *Criteria | Corporates | General: Corporate  
Methodology: Ratios and Adjustments*, April 1, 2019. Mr. Walter’s calculation appears in  
Attachment CCW-18DR, p.1.

<sup>11</sup> S&P, *Arizona Public Service Co.*, May 8, 2020, p. 6.

<sup>12</sup> *Id.* at 5.

1 **Q. DO YOU HAVE ANY FUTHER COMMENTS ON ANY INTERVENORS’**  
2 **TESTIMONY?**

3 A. Yes. I briefly respond to Mr. Gayer’s comments later in my testimony. Other than  
4 that, I do not reference every Staff and intervenors’ testimony. My failure to  
5 address statements or recommendations should not be taken as an endorsement of  
6 such statements and recommendations.

7 B. *Credit Ratings in the Capital Markets*

8 **Q. WHAT ROLE DO THE RATING AGENCIES PLAY IN THE CAPITAL**  
9 **MARKETS?**

10 A. Credit rating agencies provide an assessment of the creditworthiness of a company  
11 or a financial instrument to facilitate access to fixed income capital markets at the  
12 most efficient cost. The agencies publish analyses of the issuers and issuances to  
13 explain the ratings to the capital markets. Ratings are expressed in a series of letters,  
14 numbers and/or symbols to summarize the relative creditworthiness of the entity  
15 or issue. The ratings scales of the two major rating agencies on which my testimony  
16 focuses, S&P and Moody’s, appear in Attachment TAS-02RB. Ratings in the  
17 BBB/Baa category and above are considered “investment-grade” by market  
18 participants. Ratings below BBB-/Baa3 are known as “speculative-grade,” or  
19 colloquially “junk,” ratings. Because some investors are precluded from holding  
20 speculative-grade issues, the difference between investment-grade and speculative-  
21 grade ratings is stark and is recognized as such by rating agencies and market  
22 participants.

23 **Q. WHICH PARTICIPANTS IN THE CAPITAL MARKETS CONSULT**  
24 **CREDIT RATINGS?**

25 A. Investors use them to assist their investment decisions: which companies to invest  
26 in and the price (yield) that they will charge to lend to or invest equity in a  
27 company. Ratings are helpful because they are based on a consistent approach to  
28

1 assessing risk across time, industries and types of issuers. Because rating agencies  
2 are independent and objective but also have unique access to confidential  
3 information from issuers, ratings are also an effective solution to the familiar  
4 problem identified by economists as asymmetric information. Ratings therefore  
5 lubricate the function of raising capital. Beyond raising capital, ratings enhance the  
6 liquidity of the secondary market for securities by providing consistent and up-to-  
7 date credit assessments of issuers that buyers and sellers can use to assist their  
8 trading decisions.

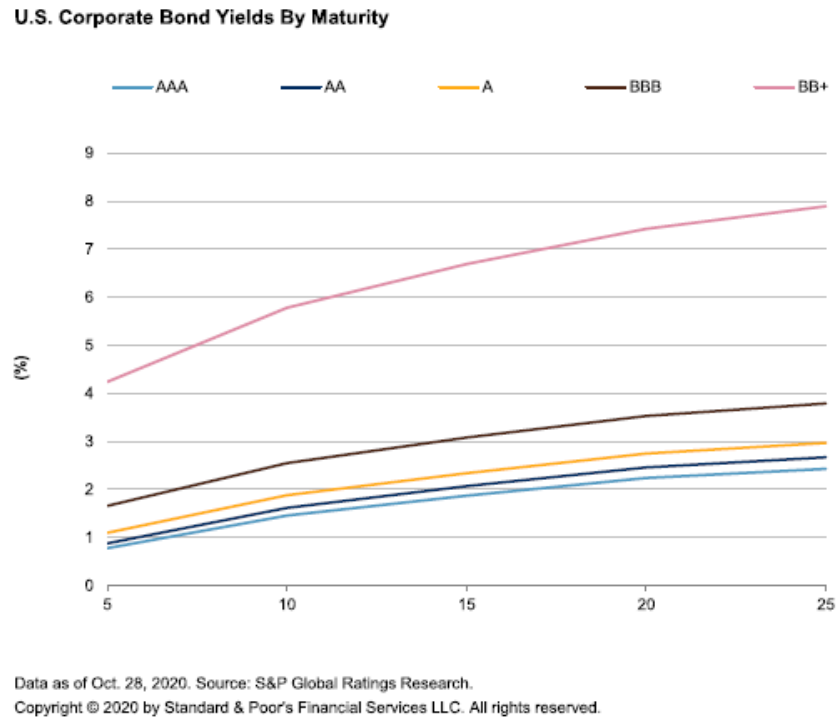
9 **Q. IF RATINGS ARE DESIGNED TO MEET THE NEEDS OF INVESTMENT**  
10 **PROFESSIONALS AND FINANCIAL INTERMEDIARIES LIKE**  
11 **BANKERS, WHY SHOULD THE ACC CONSIDER THE EFFECTS OF ITS**  
12 **ACTIONS ON APS'S CREDIT RATINGS?**

13 A. Credit ratings have a direct effect on utility customers and the bills they pay.

14 **Q. HOW DO CREDIT RATINGS AFFECT UTILITY CUSTOMERS AND THE**  
15 **BILLS THEY PAY?**

16 A. Ratings affect a utility's cost of capital, a major component of the cost of service,  
17 by influencing investor perceptions of a utility's risk. That is evident on the cost of  
18 debt, where we see a correlation between bond yields and ratings:

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Source: S&P, Ratings Direct, *Credit Trends: U.S. Corporate Bond Yields as of October 28, 2020, October 29, 2020*

It does not end with bondholders and other fixed-income investors. Equity investors, i.e., shareholders, look to ratings to guide their investment decisions, too. Many of the investor calls and interactions I experienced at S&P were with equity analysts and private equity investors as well as fixed-income professionals. Since the equity side of the balance sheet also uses ratings for guidance, especially when they are upgraded or downgraded, the cost of equity is another area where ratings are consequential.

Ratings also affect a utility's access to capital, especially during times of financial system stress. Stable and ideally improving ratings are essential to attracting capital at a reasonable cost. Maintaining strong ratings, not just adequate ratings, is vital to utilities because of the essential and quasi-public nature of the service they provide. Ready access to the capital they need in all market conditions is necessary

1 to achieve the level of reliability and support for the local economy that they must  
2 offer at all times.

3 A by-product of the nature and design of the ratings system is that regulators ought  
4 to take as much interest in credit ratings as any investment banker or analyst. The  
5 combination of the long-term and independent nature of credit ratings make them  
6 an ideal touchstone for utility regulators to use to help navigate through the many  
7 decisions they must make in the course of balancing the various stakeholder  
8 interests that come before them.

9 **Q. CAN YOU DEMONSTRATE THE BENEFITS THAT BETTER CREDIT**  
10 **RATINGS BRING TO CUSTOMERS?**

11 A. Yes. The history of APS's ratings offers the parties a vivid, real-life example of  
12 how attention to credit quality is in the customers' best interests. A full  
13 understanding of where the Company has been from a credit quality standpoint can  
14 help us evaluate whether to support further actions to maintain ratings.

15 **Q. WHAT HAS BEEN THE COMPANY'S RECENT EXPERIENCE WITH ITS**  
16 **CREDIT RATINGS?**

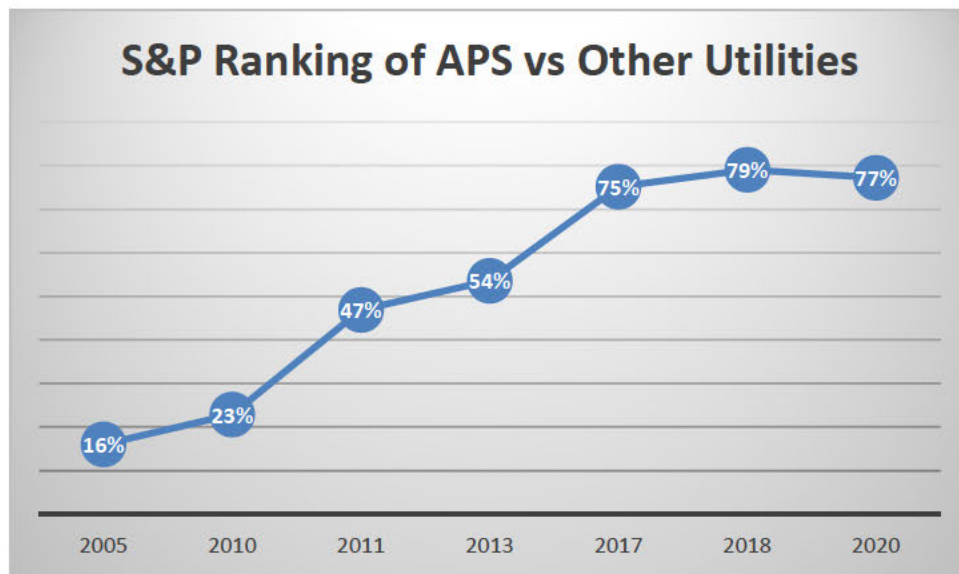
17 A. Consistently upward. To show the credit quality improvement clearly, I chose to  
18 concentrate on the history of one agency's ratings.<sup>13</sup> S&P's ratings on APS have  
19 climbed from "BBB-," on the cusp of a speculative-grade (or "junk") rating, into  
20 the "A" category ("A-") in the last decade. The work that went into the ratings  
21 upgrades goes back even further when S&P first downgraded APS to "BBB-" at  
22 the end of 2005. To summarize, S&P's concerns about the Company's regulatory  
23 risk and operating risk led to the "BBB-" rating, and by focusing on reducing both  
24 kinds of risk, in conjunction with some progress in financial performance, APS has  
25 restored its credit quality to a level not seen since the 1980s. The business and  
26 financial risk containment that S&P identified throughout this period was  
27

28 <sup>13</sup> Moody's ratings on APS have also improved over the timeframe I analyzed.

1 accompanied by recognition of improvement in APS's management and  
2 governance, as well as improved timeliness of cost recovery due to shortened  
3 timeframes to complete rate cases as well as new adjustment mechanisms.

4 **Q. HOW DO WE KNOW THAT THE RATINGS UPGRADES ARE TIED TO**  
5 **THE COMPANY'S PERFORMANCE AND NOT JUST PART OF A**  
6 **LARGER TREND?**

7 A. One reason I tracked the S&P ratings is that it publishes rankings of the utilities  
8 that it rates. The chart below is a dramatic illustration of APS's improving credit  
9 quality, moving from near the bottom of its peers to near the top. The figures in the  
10 chart represent the position on APS in the S&P ranking list in which it appeared  
11 that year, expressed as a percentile. The rankings make clear that APS earned the  
12 upgrades by distinguishing itself among industry participants by effective risk  
13 management.



22 Source: S&P, North American Electric, Gas and Water Regulated Utilities – Strongest to Weakest



1 **Q. CAN YOU SHOW THAT APS'S CUSTOMERS WERE BENEFICIARIES**  
2 **OF THE RECORD OF RATINGS IMPROVEMENTS?**

3 A. Yes. I performed an analysis of the interest expense savings that will directly  
4 benefit APS's customers as a consequence of the rating improvements. I estimate  
5 that the pre-tax interest savings of APS long-term debt issuances since the S&P  
6 upgrades began in 2011 will total about \$1.9 billion over the lifetime of the debt.  
7 The direct customer benefit will continue to accumulate as the years unfold.

8  
9 The lower interest cost for long-term debt is only the beginning of the benefit to  
10 customers. My analysis does not include:

- 11 • savings from interest on short-term debt and variable-rate debt, which are  
12 more difficult to accurately identify;
- 13  
14 • the savings from other types of capital, such as common equity, that also  
15 benefit from the lower risk profile that the rating improvements were based  
16 upon;
- 17 • the interest savings that resulted from the Company's ability to redeem high-  
18 cost debt early to take advantage of the lower cost of issuing replacement  
19 debt at lower rates; and
- 20  
21 • the "qualitative" benefits that better ratings can generate for the Company  
22 and its customers. Better access to capital on reasonable terms in all types  
23 of economic and capital market conditions, especially in financial crises and  
24 other periods of market stress, has already been mentioned. Stronger credit  
25 ratings also facilitate and lower the cost of transactions with third parties,  
26 from simple, day-to-day trade with suppliers that shows up on O&M  
27 expense to the cost of purchased power and long-term agreements with  
28 generators that lean on the Company's balance sheet. These, too, are more

1                   difficult to quantify, but I believe that qualitative benefits are as important  
2                   in delivering reliable, clean and efficient power to customers as the more  
3                   tangible quantitative benefits.

4   **Q.    ARE THESE BENEFITS AT RISK?**

5   A.    Yes. The outcome of this and future proceedings will determine whether customers  
6           will continue to realize the benefits of the Company’s advantageous ratings.  
7           Moody’s this year invoked a negative outlook out of concerns centered on financial  
8           metrics.<sup>14</sup> Fitch Ratings (Fitch), another major agency that provides credit ratings  
9           on the Company, has carried a negative outlook on the Company since 2019.<sup>15</sup>

10   **Q.   SIMILAR TO HOW THE CUSTOMER BENEFITS DESCRIBED ABOVE**  
11           **HAVE BEEN HARNESSSED FROM IMPROVED CREDIT RATINGS,**  
12           **DOWNGRADES CAN HURT CUSTOMERS IN A NUMBER OF WAYS**  
13           **OVER A LONG PERIOD OF TIME. WHAT ARE THE AGENCIES**  
14           **CONCERNED ABOUT?**

15   A.    I pick up the primary reason as concerns over financial metrics. That is what S&P  
16           cited in its revocation of the positive outlook in 2018 and what Moody’s and Fitch  
17           outline in their negative outlooks. In describing their negative outlooks, both of  
18           Moody’s and Fitch cite heightened regulatory risk, and specifically this  
19           proceeding, as a key driver for their prospective ratings decisions on the Company  
20           and tie potential negative ratings actions to the outcome. Because of the direct  
21           relationship between credit ratings and rate case outcomes, adopting the APS  
22           capital structure, return on common equity and cash-flow capabilities in its rates  
23           should be given consideration in reaching a decision in this proceeding.

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27           <sup>14</sup> Moody’s, *Rating Action: Moody’s affirms ratings of Arizona Public Service and*  
*Pinnacle West, revises outlooks to negative*, Jan. 22, 2020.

28           <sup>15</sup> Fitch Ratings, *Rating Action Commentary, Fitch Affirms Pinnacle West Capital &*  
*Arizona Public Service’s IDRs at ‘A-’: Outlooks to Negative*, June 26, 2019.

1 In turn, APS must press forward with meeting the operational challenges cited by  
2 the rating agencies, which predominantly require execution on the Company’s  
3 clean energy plans. S&P noted several aspects of this operational challenge in its  
4 latest credit report: the “risk of distributed generation, the company’s limited  
5 regulatory diversity, the higher operating risks of nuclear generation, and potential  
6 environmental risks associated with the company’s coal-fired generation.”<sup>16</sup> They  
7 note that the base-load sources remain around 40% of the generation capacity. With  
8 the Company’s announced goal of being completely carbon-free in its generation  
9 by 2050 and the interim goal of ending all coal-fired generation by 2031, it has set  
10 for itself an ambitious operating challenge. It will produce more benefits for its  
11 customers and Arizona and align with the growing ESG-mindedness<sup>17</sup> of the credit  
12 rating agencies, but it will also stress its financial position. Further progress on both  
13 sides of the credit analysis will be necessary to preserve ratings in the face of this  
14 negative sentiment.

15 C. *Capital Market’s Effect on Credit Ratings*

16 **Q. YOU EXPLAINED HOW RATINGS PLAY A ROLE IN THE CAPITAL**  
17 **MARKETS. DO THE CAPITAL MARKETS PLAY A ROLE IN CREDIT**  
18 **RATINGS?**

19 A. Yes. It is a two-way street. An issuer’s ability to access capital is an important  
20 element in credit analysis, especially for utilities. As Moody’s states in its utilities  
21 methodology, “Liquidity and access to financing are of particular importance in  
22 this sector. .... Utilities are among the largest debt issuers in the corporate universe  
23 and typically require consistent access to the capital markets to assure adequate  
24 sources of funding and to maintain financial flexibility.”<sup>18</sup>

25 \_\_\_\_\_  
26 <sup>16</sup> S&P, *Arizona Public Service Co.*, May 8, 2020, p. 4.

27 <sup>17</sup> ESG is shorthand for “Environmental, Social, and Governance,” a group of risks that  
the agencies increasingly look to evaluate as vital to understanding an issuer’s overall risk  
profile.

28 <sup>18</sup> Moody’s, *Rating Methodology: Regulated Electric and Gas Utilities*, Nov. 4, 2019, p.  
25.

1 **Q. WHAT IS NECESSARY IN THE REGULATORY PROCESS TO GIVE**  
2 **DEBTHOLDERS AND RATING AGENCIES CONFIDENCE THAT A**  
3 **UTILITY WILL BE ABLE TO ACCESS CAPITAL ON REASONABLE**  
4 **TERMS FOR THE BENEFIT OF CUSTOMERS?**

5 A. First and foremost, investors look for a regulatory jurisdiction that features a fair  
6 and transparent ratemaking process that they can evaluate for its capacity to allow  
7 a utility a reasonable opportunity to earn its cost of capital. I covered this in more  
8 depth in my discussion of business risk above and in more depth in the next section.  
9 This aspect of regulation supports access to debt capital, which is an obvious  
10 concern to the rating agencies, but when followed it also underpins good access to  
11 equity capital that is equally important to assessing utility credit quality.

12 **Q. WHY DO RATING AGENCIES CARE AS MUCH ABOUT THE**  
13 **TREATMENT OF SHAREHOLDERS AS THEY DO OF DEBTHOLDERS?**

14 A. Weak or costly access to equity capital can lower ratings because it provokes  
15 greater reliance on debt to fund capital expenditures. In other words, more leverage.  
16 Additionally, credit metrics will suffer as low returns constrain cash flow and  
17 earnings.

18 **Q. HAVE YOU OBSERVED ANY RECOMMENDATIONS IN THIS**  
19 **PROCEEDING THAT YOU THINK WOULD HARM CREDIT QUALITY**  
20 **IN THIS WAY?**

21 A. Yes. The casual and arbitrary recommendation of Intervenor Richard Gayer<sup>19</sup> to  
22 eliminate or cut the APS common dividend would, if acted upon, alarm investors  
23 and rating agencies. I believe an unnecessary dividend reduction would cause a  
24 negative ratings reaction because it would make investors question the  
25 dependability of the regulatory environment in Arizona. In accordance with good  
26 corporate governance and risk management principles, dividend policy and  
27

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28 <sup>19</sup> Intervenor Richard Gayer's Prepared Direct Testimony (Sept. 22, 2020) , p. 2.

1 decisions on the timing and level of dividends are best left with the body that is  
2 legally and sensibly charged with overseeing them, the issuer's Board of Directors.

3 **Q. WHY DO YOU CHARACTERIZE THE RECOMMENDATION AS**  
4 **ARBITRARY?**

5 A. Witness Gayer does not substantiate his recommendation with any analysis. It  
6 appears to be based on his mistaken belief that the requested rate increase is directly  
7 connected to the level of dividends that are paid by APS. Being unfamiliar with  
8 finance fundamentals, Mr. Gayer seems to think that a temporary suspension of the  
9 regular APS common dividend would save customers money.

10 **Q. WHAT IS THE FUNDAMENTAL PROBLEM WITH MR. GAYER'S**  
11 **POSITION?**

12 A. In his testimony he states:

13 ...APS does not need a rate increase at this time, especially when  
14 thousands of its customers are suffering from the impact of  
15 COVID-19 on their health and, more importantly in this context,  
16 their ability to pay APS' high bills. .... The \$184 Million increase  
17 sought by APS amounts to about half of its anticipated dividends to  
be paid to PNW's shareholders of its common stock in 2021. APS  
customers should not be required to fund PNW's dividends.<sup>20</sup>

18 Mr. Gayer is wrong in assuming that APS customers fund the common dividend.  
19 Shareholders pay the dividend out of shareholder funds.

20 **Q. CAN YOU SHOW THAT COMMON DIVIDENDS ARE PAID WITH**  
21 **SHAREHOLDER FUNDS?**

22 A. Yes. The stock price of a publicly-traded company will be reduced by the amount  
23 of the dividend on the date a shareholder is no longer entitled to participate in a  
24 dividend payment.<sup>21</sup> Denying the requested rate increase on any basis other than

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25 <sup>20</sup> Gayer at 6.

26 <sup>21</sup> That date is called the ex-dividend date. As explained on a basic financial website that  
27 is easily accessible to anyone with internet access, "Stock market specialists will mark  
28 down the price of a stock on its ex-dividend date by the amount of the dividend. For  
example, if a stock trades at \$50 per share and pays out a \$0.25 quarterly dividend, the

1 sound regulatory and financial principles and “paying” for the denial by disrupting  
2 the orderly payment of regular dividends though an arbitrary mandate would not  
3 benefit customers. It would harm them by prompting an adverse reaction from  
4 investors and rating agencies.

5 **Q. WHY WOULD INVESTORS REACT NEGATIVELY TO A DISRUPTION**  
6 **IN THE DIVIDEND?**

7 A. The arbitrary nature of the action alone would lead them to assign more regulatory  
8 risk to APS than they do now. Rating agencies value stability and transparency in  
9 the regulatory arena.<sup>22</sup> Investor reaction would be tied to a finance concept known  
10 as the signaling effect. As explained in an academic textbook, “When a firm  
11 increases its dividend, it sends a positive signal to investors that management  
12 expects to be able to afford higher dividends for the foreseeable future. Conversely,  
13 when managers cut the dividend, it may signal that they have given up hope that  
14 earnings will rebound in the near term and so need to reduce the dividend to save  
15 cash.”<sup>23</sup> In other words, investors and rating agencies would view a regulator’s  
16 decision to try to force a utility to cut its dividend as a signal that regulatory risk  
17 was worsening to the detriment of future earnings and cash flow stability. Lower  
18 ratings would result, in my opinion, and customers would thereby pay for that  
19 intrusion into APS’s dividend policy through a long-term increase in the cost of  
20 capital.

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25  
26 stock will be marked down to open at \$49.75 per share.” Zack’s, *How Does the Stock*  
27 *Price Change When a Dividend Is Paid?* Feb. 19, 2019, found at  
<https://finance.zacks.com/stock-price-change-dividend-paid-3571.html>.

27 <sup>22</sup> See my discussion of the effect of regulatory risk on ratings below.

28 <sup>23</sup> Berk and DeMarzo *Corporate Finance: The Core, Fourth Edition*, Pearson Education,  
2017, Chapter 17, Section 6, “Signaling with Payout Policy.”

1 **III. THE EFFECT OF REGULATORY ENVIRONMENT ON CREDIT RATINGS**

2 **A. *The Importance of a Utility’s Regulatory Environment***

3 **Q. WHY IS REGULATORY RISK A CRUCIAL INPUT IN THE CREDIT**  
4 **ANALYSIS OF A UTILITY?**

5 A. Regulatory risk for a utility is analogous to the competitive environment of an  
6 unregulated corporate issuer. The influence of a company’s competitive position  
7 on its credit quality will vary depending on the nature of its industry and the  
8 competitive dynamics of its business model. Some industries have products or  
9 services that can differentiate the firm from competitors. Others sell a product or  
10 service that is nearly identical, a so-called commodity business. Some firms are  
11 capital-intensive, in that they must invest heavily in order to produce the product  
12 they sell. Utilities share some of those attributes in varying degrees, but the  
13 characteristic that defines the credit profile of a utility is regulation. Its importance  
14 can be seen in S&P’s breakdown of the weight in the business risk analysis given  
15 to what is generically called competitive advantage in the table below and for  
16 utilities is called regulatory advantage:<sup>24</sup>

17 Table 12

18 **Competitive Position Group Profiles (CPGPs) And Category Weightings**

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Component	--(%)--					
	Services and product focus	Product focus/scale driven	Capital or asset focus	Commodity focus/cost driven	Commodity focus/scale driven	National industries and utilities
1. Competitive advantage	45	35	30	15	10	60
2. Scale, scope, and diversity	30	50	30	35	55	20
3. Operating efficiency	25	15	40	50	35	20
Total	100	100	100	100	100	100
Weighted-average assessment*	1.0-5.0	1.0-5.0	1.0-5.0	1.0-5.0	1.0-5.0	1.0-5.0

25 \*1 (strong), 2 (strong/adequate), 3 (adequate), 4 (adequate/weak), 5 (weak).

25 25

26 \_\_\_\_\_  
27 <sup>24</sup> S&P, *Key Credit Factors for The Regulated Utilities Industry*, Dec. 4, 2019, paragraph 20.

28 <sup>25</sup> S&P, *Criteria | Corporates | General: Corporate Methodology*, Apr. 30, 2020, Table 12, p. 22.

1 Even areas that do not explicitly touch on regulatory behavior, like scale and  
2 operating efficiency, are subsumed in the central question of utility regulation: cost  
3 recovery, including full recovery of its cost of capital through a reasonable  
4 authorized return on equity. Thus, in Moody's utility methodology, regulatory risk  
5 constitutes fully 80% of business risk.<sup>26</sup> It is nominally 60% for S&P, as seen  
6 above, but in my experience the impact is much greater and effectively approaches  
7 the Moody's weighting.

8 **Q. DOES THAT FULLY CAPTURE THE INFLUENCE OF REGULATION**  
9 **ON A UTILITY'S CREDIT PROFILE?**

10 A. No. We know that regulators have a profound impact on financial results. That  
11 means regulators act on both sides of the credit rating equation. The details of  
12 establishing rates and the level and timing of cost recovery has a direct effect on a  
13 utility's ability to earn its authorized return on equity (ROE) and produce enough  
14 earnings and cash flow to support its ratings. A fair rate of return, including a  
15 capital structure that offers more risk protection to bondholders and other creditors,  
16 are features of a credit-supportive regulatory environment. Completing the circle,  
17 the same regulatory actions that affect a utility's ability to earn a competitive ROE  
18 also have a compounding effect on business risk, thereby magnifying the ratings  
19 impact of regulatory decisions and behavior that fall outside expectations or norms.

20 B. *Evaluating a Utility Regulatory Environment*

21 **Q. WHAT'S THE FIRST STEP IN ASSESSING REGULATORY RISK FOR A**  
22 **RATINGS ANALYST?**

23 A. Both S&P and Moody's begin with the basic regulatory framework, including (1)  
24 the legal foundation for utility regulation, (2) the ratemaking policies and  
25 procedures that determine how well the utility is afforded the opportunity to earn a  
26 reasonable return with a reasonable cash component, and (3) the history of

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27 <sup>26</sup> Moody's, *Rating Methodology, Regulated Electric and Gas Utilities*, Nov. 4, 2019, p.  
28 4.



1 regulatory behavior by the governing bodies applying those laws, policies and  
2 procedures.

3 **Q. AFTER THE BROAD FRAMEWORK IS ANALYZED, HOW IS**  
4 **REGULATORY RISK DETERMINED?**

5 A. S&P and Moody's next examine the mechanics of regulation, particularly the rate-  
6 setting process. Rate cases take up much of the analysis, but the totality of a utility's  
7 tariff schedule is assessed to capture the effect on business risk of revenues  
8 generated outside base rates. Creditors, and therefore rating agencies, attribute less  
9 risk to tariff provisions, such as adjustor and adjustor mechanisms, that operate  
10 outside the rate case cycle and adjust rates frequently to match revenues with  
11 expenses. A flexible tariff regime minimizes regulatory lag. That kind of rate  
12 flexibility is almost universal across the utility industry and helps to stabilize  
13 earnings and cash flows. It embodies good risk management, which lowers risk to  
14 the benefit of the utility and its customers.

15 **Q. WHAT OTHER FORCES ENTER INTO THE ASSESSMENT OF**  
16 **REGULATORY RISK?**

17 A. The nature and pace of the process of recognizing an incurred cost as recoverable  
18 through rates is always going to be the paramount consideration for determining  
19 regulatory risk. That said, the supplemental factor of the political aspect of utility  
20 regulation is brought into the analysis to discern the broader risk of the potential  
21 for abrupt changes to the prevailing regulatory approach. This factor is implied in  
22 the Moody's methodology, where it appears under the initial framework step.<sup>27</sup>  
23 S&P highlights political risk by carving it out as a separate item in its criteria,  
24 dubbed "Regulatory independence and insulation."<sup>28</sup> The analytical approach to  
25 political considerations was further explained in a subsequent commentary:  
26 "Bondholders should recognize that utility regulation harbors political as well as

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27 <sup>27</sup> *Id.* at 7.

28 <sup>28</sup> S&P, *Key Credit Factors*, Dec. 4, 2019, paragraph 27.

1 economic risks. Therefore, how politics could influence regulation helps [S&P]  
2 evaluate a regulatory environment. .... The primary factor in this part of our  
3 analysis is the regulators' (and, when relevant, the judicial body that reviews the  
4 regulators' decisions) political independence.”<sup>29</sup>

5 Overlaying all the analysis of regulatory risk is the rating agency's view of the  
6 utility's ability to manage regulatory risk. This is again less explicit in the Moody's  
7 methodology, but S&P delineates the distinction between the regulatory  
8 environment and the individual utility's regulatory risk in its criteria.<sup>30</sup>

9 **Q. ARE THE MECHANICS AND POLITICS OF REGULATION THE ONLY**  
10 **CONSIDERATIONS THAT GO INTO DETERMINING REGULATORY**  
11 **RISK?**

12 **A.** No. Investors and therefore rating agencies also value consistency and transparency  
13 in regulation. Rating agencies rate many types and tenors of fixed income  
14 securities, but the quintessential instrument that drives the analysis is a long-term  
15 bond. They regard debtholders who extend credit over long periods as their primary  
16 audience and strive to rate long-term debt as accurately as possible over the longest  
17 timeframe as possible. Utilities fund capital expenditures with long-dated  
18 maturities to match the life of the assets, and utility investors value ratings that are  
19 forward-looking and stable. Regulatory frameworks and institutional behavior that  
20 allow rating agencies to confidently project future cash flows and debt leverage  
21 will inevitably be accorded a better business risk profile. Predictability facilitates  
22 the ability to accurately assess risk over the debt's term and improves the ability of  
23 the company to manage its business activities and capital program for the long-  
24 term benefit of customers.

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27 <sup>29</sup> S&P, *Assessing U.S. Investor-Owned Utility Regulatory Environments*, May 18, 2015,  
28 p. 7.

<sup>30</sup> S&P, *Key Credit Factors*, para. 29-30.

1 Rating agencies therefore place inordinate emphasis on concepts that can be  
2 grouped into two important analytical factors when evaluating regulatory risk:  
3 certainty and timeliness. Certainty is paramount because of the long-term nature of  
4 their analysis, as noted immediately above, and because ratings are forward-  
5 looking. Greater confidence in the future actions and behavior of a utility's  
6 regulators will lead to better ratings due to the stability and accuracy of the  
7 analyst's forecasts that a rating committee reviews. Timeliness is the second  
8 concept that rating agencies pay substantial attention to. For the most part,  
9 timeliness refers to the recognition of costs in rates. As noted earlier, regulatory lag  
10 is tracked closely by the agencies due to its effect on cash flow. The importance of  
11 tariff adjustment clauses cannot be overstated. It also is reflected in the regard that  
12 agencies have for how the ratemaking process is managed. S&P summed it up in  
13 its criteria: "We base our assessment of the regulatory framework's relative credit  
14 supportiveness on our view of how regulatory stability, efficiency of tariff setting  
15 procedures, financial stability, and regulatory independence protect a utility's credit  
16 quality and its ability to recover its costs and earn a timely return. Our view of these  
17 four pillars is the foundation of a utility's regulatory support."<sup>31</sup>

18 C. *Improving the Regulatory Environment*

19 **Q. GIVEN THE IMPORTANCE OF REGULATION AND THE RATING**  
20 **AGENCIES' ANALYTICAL APPROACH TO GAUGING REGULATORY**  
21 **RISK, WHAT DO YOU SEE AS THE IMPLICATIONS FOR APS, THE**  
22 **ACC, AND CUSTOMERS FROM THE OUTCOME OF THIS**  
23 **PROCEEDING?**

24 A. I see several implications for the parties in this case from a fuller understanding of  
25 credit ratings, their importance to customers and rating agency analysis of utility  
26 credit quality. I see some of the most impactful pieces as:

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28 <sup>31</sup> *Id.* at para. 22.

- 1 • ROE and capital structure;
- 2
- 3 • Determination of prudence and recovery of Four Corners Selective
- 4 Catalytics Reduction investment and the Ocotillo Modernization Project,
- 5 and their respective deferrals; and
- 6 • Prevent an increase in regulatory lag by authorizing more timely recovery
- 7 of APS's future clean energy investments.

8 **Q. HOW WOULD SUPPORT FOR A CLEAN ENERGY ADJUSTOR BY THE**  
9 **STAKEHOLDERS INVOLVED IN THE REGULATORY OVERSIGHT OF**  
10 **APS IMPROVE THE COMPANY'S REGULATORY RISK?**

11 A. The eventual adoption of a clean energy adjustor would extend the benefits that  
12 customers are already experiencing from the risk reduction effects of Arizona's use  
13 of adjustor mechanisms. Adjustors are prominently cited by S&P<sup>32</sup> and Moody's<sup>33</sup>  
14 as a credit strength. By working off the solid base of progressive ratemaking that  
15 has been established over the years, acknowledgement of the magnitude of the  
16 clean energy transformation, and a regulatory response to help effectuate the  
17 transformation would be a natural advancement of the existing framework. I  
18 believe the proposed adjustor would reinforce the long-term positive direction of  
19 the entire Arizona regulatory climate in the minds of investors and rating agencies.

20 **Q. DO YOU THINK ATTITUDES ABOUT REGULATORY RISK IN**  
21 **ARIZONA ARE SUPPRESSING APS'S CREDIT RATINGS?**

22 A. Yes. Arizona has a relatively low standing with S&P and in the investment  
23 community with regard to regulatory risk.<sup>34</sup> APS's business risk is nevertheless  
24

25 <sup>32</sup> S&P, *Arizona Public Service Co.*, May 8, 2020, p. 4.

26 <sup>33</sup> Moody's, *Arizona Public Service Company*, Jan. 27, 2020, p. 3.

27 <sup>34</sup> Due to its two-pronged approach to regulatory risk, S&P assesses regulatory  
28 jurisdictions as part of the credit analysis of utilities. Arizona is in the second-lowest  
category among the five that S&P uses to rank North American jurisdictions. S&P, *U.S.  
and Canadian Utility Regulatory Updates and Insights: June 2020*, June 8, 2020. Arizona

1 assessed as low (i.e. credit-positive) by Moody’s (solid “A” scores across the board  
2 on regulatory factors)<sup>35</sup> and S&P (an “Excellent” business risk profile, the highest  
3 attainable among six categories). Both agencies have misgivings about the  
4 Company’s business risk, however. Moody’s is focused on regulatory risk, noting  
5 that a rating downgrade could result “if the Arizona regulatory environment  
6 becomes less credit supportive or predictable, such as through an adverse rate case  
7 ruling or cost recovery disallowances...”<sup>36</sup> Given its view that the Arizona  
8 regulatory environment could restrict credit quality, S&P similarly cautions about  
9 “unfavorable regulatory outcomes” in its downside outlook scenario.<sup>37</sup>

10 I believe an APS with authorized timely recovery of clean energy investments, in  
11 addition to its existing adjustors, would improve investor and rating agency  
12 perceptions of regulatory risk. All those stakeholders, and especially customers,  
13 have benefitted from the advancements in ratemaking procedures and mechanisms  
14 through dramatically higher credit ratings. Taking the next step would preserve the  
15 gains from the transformation of APS from near junk-bond status to among the best  
16 integrated electric utilities in the U.S.

17 **IV. CREDIT RATING ENVIRONMENT AND CONCLUSIONS**

18 **Q. WHAT IS THE CURRENT STATE OF THE CREDIT RATING**  
19 **ENVIRONMENT FOR UTILITIES?**

20 **A.** This case is unfolding against a backdrop of economic stress from the sudden onset  
21 of the COVID-19 pandemic and the continuing effect of tax reform on the financial  
22 position of U.S. utilities. While the crisis has a different character than the last  
23 major disruption in 2008-2009, in some ways it harbors greater risk because of the  
24

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25 is in roughly the lower third of the most widely accepted ranking among investors,  
26 published by a separate arm of S&P. S&P Global Market Intelligence, *RRA Regulatory*  
27 *Focus, State Regulatory Evaluations*, May 19, 2020.

28 <sup>35</sup> Moody’s, *Arizona Public Service Company*, p. 7.

<sup>36</sup> *Id.* at 2.

<sup>37</sup> S&P, *Arizona Public Service Co.*, May 8, 2020, p.3

1           unprecedented nature of the cause and sheer unpredictability of the coronavirus  
2           spread and the world’s reaction to the threat.

3           **Q.   HAS   THE   MACROECONOMIC   AND   CAPITAL   MARKET**  
4           **ENVIRONMENT   HAD   AN   EFFECT   ON   THE   RATING   AGENCIES’**  
5           **OUTLOOK   ON   THE   UTILITY   SECTOR?**

6           A.   Yes. S&P had returned the utilities industry to a stable outlook for 2020 after being  
7           more negative in past years, but they revised the industry outlook back to negative  
8           in April after their forecast of the economic effect of the coronavirus outbreak  
9           showed a deep, worldwide recession.<sup>38</sup> Numerous utilities with credit metrics at  
10          the edge of downgrade triggers combined with pre-existing environmental  
11          pressures and COVID-19 to tip the outlook downward. In their view, COVID-19  
12          concerns center on utilities with large commercial and industrial customer bases  
13          and those with significant commodity exposure in non-utility portions of their  
14          portfolios.<sup>39</sup> S&P pointed to capital spending cuts to mitigate the risk of widespread  
15          credit deterioration in a severe recession, with dividend cuts the next line of  
16          defense.<sup>40</sup> S&P analysts have also stressed the need for effective regulatory  
17          responses<sup>41</sup> and utility responses<sup>42</sup> to COVID-19 pressures on credit quality.

18                   Moody’s has retained its stable outlook on the industry but increasingly highlighted  
19                   the downside risks in a series of published comments that reveals its growing  
20                   unease with that outlook. After initially envisioning credit resilience despite  
21                   coronavirus disruptions<sup>43</sup> and dismissing greater leverage for liquidity purposes as  
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23                   <sup>38</sup> S&P, *COVID-19: The Outlook for North American Regulated Utilities Turns Negative*,  
24                   April 2, 2020.

25                   <sup>39</sup> *Ibid.*, p. 7.

26                   <sup>40</sup> *Ibid.*, p. 8.

27                   <sup>41</sup> S&P, *Regulatory Responses to COVID-19 Are Key to Utilities’ Credit Prospects*, May  
28                   20, 2020.

29                   <sup>42</sup> S&P, *North American Regulated Utilities Face Tough Financial Policy Tradeoff to*  
30                   *Avoid Ratings Pressure Amid the COVID-19 Pandemic*, May 11, 2020.

31                   <sup>43</sup> Moody’s, *Sector Comment: Utilities demonstrate credit resilience in the face of*  
32                   *coronavirus disruptions*, Mar. 18, 2020.

1 merely temporary,<sup>44</sup> they proceeded to explain that, while they do not expect to see  
2 widespread reduction in utility dividends, slowed dividend growth may be  
3 necessary if the disruption becomes a prolonged downturn.<sup>45</sup> Then, after expressing  
4 confidence that regulatory support would protect utility credit quality or even be a  
5 credit positive,<sup>46</sup> they realized that the economic devastation from COVID-19  
6 would depress consumer tolerance for rate increases<sup>47</sup> and authorized returns<sup>48</sup> and  
7 conceded that outcomes will vary among jurisdictions.<sup>49</sup>

8 **Q. WHAT ARE YOUR CONCLUSIONS ABOUT THE POTENTIAL**  
9 **OUTCOME IN THIS PROCEEDING?**

10 A. The ACC is faced with important decisions for APS in this case that could have  
11 far-reaching consequences for its credit ratings and the regulatory environment for  
12 all Arizona utilities. The record of ratings upgrades that the Company was able to  
13 achieve with the Commission's support in the decade following its 2005 descent  
14 to the edge of investment-grade ratings has stalled. We are now experiencing an  
15 unprecedented type of economic crisis that has stressed the economic, political and  
16 social fabric of the nation. At the same time, APS has embarked on bold and  
17 innovative programs to accelerate its transformation to a clean, sustainable energy  
18 provider with an increased focus on its customers' needs in the areas of demand  
19 management and electric vehicles. That transformation amid the challenging  
20 economic and market conditions prompted a negative outlook by both Moody's  
21 and the aforementioned Fitch report.<sup>50</sup> The answer to those investor concerns is in

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22 <sup>44</sup> Moody's, *Sector Comment: FAQ on credit implications of the coronavirus outbreak*,  
23 Mar. 26, 2020.

24 <sup>45</sup> Moody's, *Sector Comment: Dividends a major source of cash if coronavirus downturn*  
*is prolonged*, Apr. 6, 2020.

25 <sup>46</sup> Moody's, *Sector Comment: Coronavirus outbreak delays rate cases, but regulatory*  
*support remains intact*, Apr. 6, 2020.

26 <sup>47</sup> Moody's, *Sector Comment: Coronavirus-fueled rise in unemployment will limit*  
*consumer tolerance for rate hikes*, Apr. 17, 2020.

27 <sup>48</sup> Moody's, *Sector Comment: Continued decline in ROEs to heighten pressure on*  
*financial metrics*, Apr. 17, 2020.

28 <sup>49</sup> *Ibid.*, p. 6.

<sup>50</sup> Moody's, *Rating Action*, Jan. 22, 2020.

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the short run to authorize the requested revenue requirement to promote ratings stability and investors' views of the Arizona regulatory environment. Adding a clean energy adjustor mechanism in the future would lower regulatory risk for APS, with all the customer benefits that go with it.

V. CONCLUSION

**Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

A. Yes.



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## TODD A. SHIPMAN, CFA

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### Experience

#### **Utility Credit Consultancy LLC**

**Boston, MA**

Principal

May 2018 - Present

Founded a consulting firm to provide utilities with expert witness services and advice on capital market strategies. Specialize in capital markets issues, credit rating advisory, and hybrid securities.

#### **Boston University**

**Boston, MA**

Lecturer

January 2017 – June 2020

Adjunct faculty member in the Questrom School of Business, Department of Finance. Taught advanced undergraduate finance courses covering capital markets, monetary and economic policy, and corporate finance.

#### **S&P Global Ratings**

**New York, NY and Boston, MA**

Senior Director

April 2014 - May 2018

Director

April 2000 - April 2014

Associate Director

March 1997 - April 2000

Sector Specialist on the Global Infrastructure Ratings North American Utilities team. Performed credit surveillance of utilities, pipelines, midstream energy, and diversified energy companies. Chaired most team rating committees. Wrote credit reports and commentaries and led outreach efforts to investors and the regulatory community, including speeches and training seminars. Lead analytical role developing global rating criteria for utilities, master limited partnerships, and hybrid capital securities.

#### **Electric Utility Research Inc (defunct), San Francisco, CA**

Senior Vice President

May 1996 - March 1997

Edited and contributed to an investor newsletter covering the electric utility industry

#### **Sithe Energies Inc.**

**New York, NY**

Manager, Regulatory Affairs

November 1993 - May 1996

Managed state regulatory matters for a major independent power company. Coordinated interventions in regulatory proceedings. Assisted in identifying development opportunities. Participated in investor relations activities.

#### **Regulatory Research Associates**

**Jersey City, NJ**

Vice President

October 1993 - November 1993

Senior Analyst

August 1989 - October 1993

Analyst

August 1985 - August 1989

Analyzed and reported on actions by state regulators affecting the financial status of electric, gas, and telephone utilities for a firm that provided research to the Wall St. community. Contributed to the firm's sell-side research.

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### Education

J.D., Texas Tech University School of Law, Lubbock, TX May 1984

B.B.A., Texas Christian University, Fort Worth, TX May 1981

### Professional Affiliations & Other Activities

Executive Advisor, Concentric Energy Advisors, Marlborough MA

Chartered Financial Analyst

Wall Street Utility Group

Fixed Income Analysts Society Inc

Society of Utility and Regulatory Financial Analysts

### Other Activities

Board of Directors, The Good Shepherd School, Charlestown, MA

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**MOODY'S  
INVESTOR  
SERVICE**

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**S&P GLOBAL  
RATINGS**

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<b>Aaa</b>	<b>AAA</b>
<b>Aa1</b>	<b>AA+</b>
<b>Aa2</b>	<b>AA</b>
<b>Aa3</b>	<b>AA-</b>
<b>A1</b>	<b>A+</b>
<b>A2</b>	<b>A</b>
<b>A3</b>	<b>A-</b>
<b>Baa1</b>	<b>BBB+</b>
<b>Baa2</b>	<b>BBB</b>
<b>Baa3</b>	<b>BBB-</b>
<b>Ba1</b>	<b>BB+</b>
<b>Ba2</b>	<b>BB</b>
<b>Ba3</b>	<b>BB-</b>
<b>B1</b>	<b>B+</b>
<b>B2</b>	<b>B</b>
<b>B3</b>	<b>B-</b>
<b>Caa1</b>	<b>CCC+</b>
<b>Caa2</b>	<b>CCC</b>
<b>Caa3</b>	<b>CCC-</b>
<b>Ca</b>	<b>CC</b>
<b>C</b>	<b>C</b>
<b>D</b>	<b>D</b>