DIRECT TESTIMONY OF CHRIS R. BAUER

On Behalf of Arizona Public Service Company

Docket No. E-01345A-25-0105

June 13, 2025

Table of Contents

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I. INTRODUCTION

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

A. My name is Chris R. Bauer. I am the Vice President and Treasurer for Arizona Public Service Company (APS or Company), a subsidiary of Pinnacle West Capital Corporation (Pinnacle West), and my business address is 400 N. 5th Street, Phoenix, Arizona 85004.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL AND EDUCATIONAL BACKGROUND.

A. I received a Bachelor of Arts degree in Accounting from Flagler College and a Master of Business Administration degree from the University of North Florida. I joined APS in November 2024 as the Vice President and Treasurer. Prior to APS, I was the Director of Corporate Finance and Assistant Treasurer for Duke Energy Corporation (Duke Energy), where I oversaw all external financing activities for the company and its subsidiaries. In addition, I was responsible for maintaining relationships with Duke Energy's commercial banks, the fixed income investor community, and the credit rating agencies.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE ARIZONA CORPORATION COMMISSION (COMMISSION)?

A. No. However, I have provided testimony before the North Carolina Utilities Commission, the Public Service Commission of South Carolina, the Kentucky Public Service Commission, and the Public Utilities Commission of Ohio.

Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS PROCEEDING?

A. My testimony will address APS's financial objectives, capital structure, and cost of capital, and how these concepts form the foundation of APS's ability to provide cost-effective, safe, and reliable service to customers. I will also discuss the current credit ratings and forecasted capital needs of APS. Throughout my testimony, I will emphasize the importance of a financially stable utility to power opportunity for the customers APS serves. I also discuss the importance of a formula rate in providing a better experience for customers. Given the nature of APS's service territory, a formula rate supports stable cash flows amidst a backdrop of significant customer growth and the required infrastructure investment necessary to support and serve existing and new customers.

In support of these topics, I sponsor Standard Filing Requirements (SFR) D-1 through D-4, which disclose the Company's actual capital structure, the weighted average cost of long-term debt, and APS's proposed return on equity (ROE) and the return on fair value rate base increment (FVRB increment) for this rate proceeding. The proposed ROE and return on FVRB increment are based upon market studies conducted by APS witness James M. Coyne.

II. SUMMARY

Q. PLEASE SUMMARIZE YOUR DIRECT TESTIMONY.

A. As described further in my testimony, I discuss APS's forecasted capital needs, which are accelerating rapidly given the unprecedented load growth within the Company's service territory. Throughout my testimony, I address the importance to customers of APS's continued ability to meet its operational and financial objectives while maintaining the Company's existing credit quality. In support of this, I include descriptions of how credit rating agencies, lenders, and equity investors assess a utility company's risk profile and credit quality. Providing safe and reliable service requires consistent access to capital through all economic conditions. Given that current economic conditions reflect a persistent level of elevated volatility, restrictive Federal Reserve policy, and capital market uncertainty regarding tariffs and trade policy, APS's financial stability remains paramount. I will discuss how APS's current investment grade credit ratings and investor confidence in a financially stable utility company have a direct impact on how much customers pay for electric service. This stability includes a capital structure that supports the Company's credit ratings and the establishment of a fair and reasonable ROE that is in line with APS's utility company peers and the ability to consistently earn the allowed ROE.

Achieving APS's operational goals requires support for the evolving ways its customers use energy. This is especially relevant given the rising capital requirements necessary to accommodate a diverse and growing economy broadly across APS's service territory. The Company continues to see an exceptional number of new customers relocate to Arizona, on the order of approximately 2% per year, as well as new businesses establishing themselves in APS's service territory — in particular, high load factor customers that require large amounts of energy around-the-clock. As such, the Company must continue to make substantial investments in expanding its generation resources and investing in the grid to modernize and harden the system to accommodate both APS's continued load growth and changing customer energy usage trends.

Finally, I explain the concept of regulatory lag, which is the significant delay between the time that the Company invests in the system or incurs an expense and when those costs are recovered in rates. Given the new, dynamic environment APS's service territory is experiencing, I discuss how structural regulatory lag is exacerbated during periods of elevated capital investment. Regulatory lag is even more impactful to APS during periods of high inflation and rising interest rates. The implementation of a formula rate for APS has the dual benefit of improved timeliness of investment recovery for the Company's capital providers while also providing the opportunity to pass on cost savings to customers.

III. IMPORTANCE OF A FINANCIALLY STABLE UTILITY FOR CUSTOMERS

Q. WHAT IS MEANT BY A FINANCIALLY STABLE UTILITY?

A. A financially stable utility is one that can attract the necessary capital on terms favorable to its customers under a broad range of economic conditions. This requires strong investment-grade credit ratings and the ability to consistently earn an equity return comparable to industry peers as adjusted for applicable risk.

Q. IS IT IN CUSTOMERS' BEST INTEREST TO HAVE A FINANCIALLY STABLE UTILITY?

A. Yes. Customers expect safe, reliable and affordable electricity to be available on demand. For APS to meet the expectations of its customers, the Company must have access to external sources of financing from debt (bondholders and bank lenders) and equity (shareholders) capital on demand and through all market conditions. A balance of both debt and equity capital is necessary to fund utility investments on behalf of customers under ordinary circumstances and becomes even more critical under the business circumstances APS is confronted with today. The Company is planning for an acceleration of capital investments which are necessary to keep pace with strong growth, respond to the evolving needs of customers, and address the multitude of challenges confronting reliable service. As such, to serve customers cost-effectively through increased infrastructure investments, particularly during persistent volatile economic conditions, maintaining financial stability is more important for customers than ever.

Q. PLEASE DESCRIBE CURRENT CAPITAL MARKET VOLATILITY.

A. Volatility in the price of financial securities within capital markets has been significant. As Mr. Coyne describes in his Direct Testimony, capital markets are influenced by the state of the economy, interest rates and interest rate outlook, inflation, and trade policy. Both interest rates and inflation have remained elevated, Gross Domestic Product growth has slowed, and international trade policy has entered a period of high uncertainty as tariffs and trade alliances have been revisited. When combined, these factors create macroeconomic risk that can result in swings in the cost and availability of capital. Given that APS competes in capital markets with other utilities for access to both debt and equity capital, achieving a high level of financial stability enables the Company to effectively compete and access lower-cost sources of capital on terms favorable to customers across a range of economic conditions.

IV. CAPITAL REQUIREMENTS

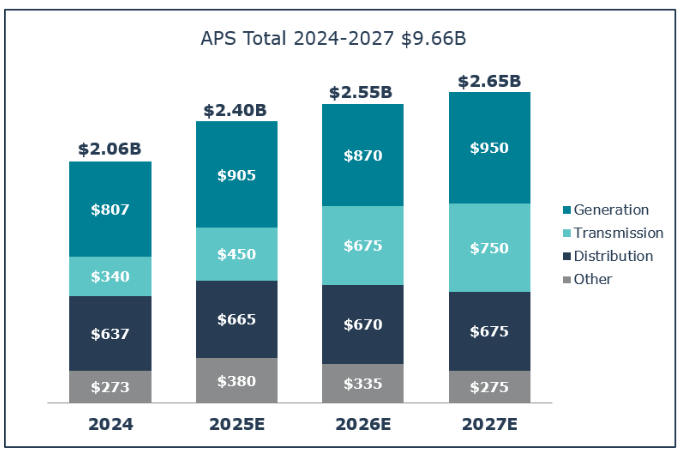
Q. PLEASE DESCRIBE APS'S NEAR-TERM CAPITAL EXPENDITURE REQUIREMENTS.

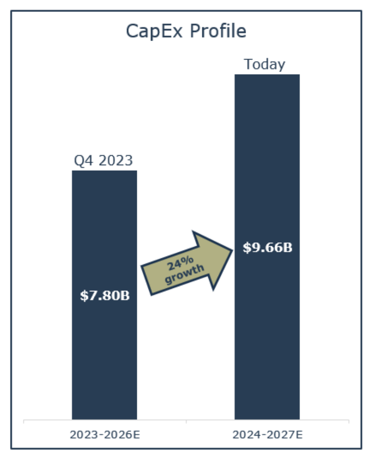
A. APS faces substantial capital needs over the next several years to strengthen existing infrastructure and to support the anticipated customer growth described in APS witness Jacob Tetlow's Direct Testimony. This includes efforts to refurbish, replace, and upgrade aging grid infrastructure to withstand prolonged summer heat; to modernize the grid to mitigate wildfire risks in order to protect the communities APS serves; and to construct or acquire needed generation and transmission resources to support large-scale growth within the Company's service territory.

Included among the resources APS is constructing over the next few years to meet these needs are the Sundance and Redhawk gas plant expansions, Ironwood solar generation facility, and Agave Battery Energy Storage System (BESS) project. At the same time, APS continues to invest in the long-term life of its existing fleet of generation resources, including, most importantly, the Palo Verde Generating Station to ensure this critical resource continues to reliably generate electricity year-round.

To fund necessary infrastructure improvements, modifications, and new construction, APS's investment needs are rapidly expanding across the entire business. As seen below in Figure 1, APS's capital requirements for the 2025-2027 period are projected to include approximately $7.6 billion in capital expenditures, as of the date of my testimony.[1] Expanded to a four-year view that includes the Company's historical 12-month period ended December 31, 2024 (Test Year), Figure 1 shows a 24% growth in the Company's required capital plan over the prior four-year period. Analysis in Mr. Coyne's Direct Testimony shows that APS's required rate of capital growth, as a percentage of net utility plant, is approximately 1.5 times higher than the proxy group median growth rate and higher than all but two proxy group utilities.

Figure 1: Planned Capital Expenditure Growth Through 2027





Q. WHY IS IT IMPORTANT FOR APS TO ENSURE FINANCIAL STABILITY GIVEN ONGOING CAPITAL REQUIREMENTS?

A. Structurally, APS operates with negative free cash flow, which is common for capital-intensive and growing utilities. This means ongoing capital needs to support increasing customer demand cannot be generated solely from operating cash flows (i.e., funds received from customers, net of annual operating expenses) but must

[1] APS 2024 Form 10-K at 78.

be supplemented with additional debt and equity capital from sources external to the Company. In other words, APS recovers costs in a delayed fashion and must redeploy capital to continue investing in the system to ensure reliable service. Lenders to the Company provide long-term debt with terms up to 30 years in duration. In order to loan money to APS for long periods of time, these investors need confidence that APS will be financially stable for the foreseeable future with the ability to make periodic interest payments and repay the principal in full upon maturity. Likewise, equity investors will provide necessary capital only when they believe the earned return on their investment adequately compensates them for the risk they assume. This financing confidence comes from a utility's financial stability. Specifically, this requires:

- The ability to maintain stable, and even improve, levels of financial and regulatory risk;
- A growing cash flow in line with the Company's additional investments to help pay back interest to debt-providers and dividends to equity holders (akin to interest payments), while also maintaining liquidity in a dynamic business environment;
- A strong expectation that the Company will have reasonable opportunity to recover prudent costs and authorized returns; and
- Sustaining a balanced capital structure with a competitive ROE that fairly compensates investors for the risks of providing equity capital to APS.

To achieve the level of capital investment necessary to keep pace with growth and respond to customers' evolving needs, while at the same time proactively addressing the operational risks and challenges facing its business, APS must acquire external capital on favorable terms. This is only achievable by maintaining financial stability. Doing so helps to ensure affordable rates for customers during this period of sustained high capital investment coupled with substantial financial market volatility.

V. CREDIT QUALITY AND CREDIT RATINGS

Q. WHY IS CREDIT QUALITY IMPORTANT TO APS AND ITS CUSTOMERS?

A. Credit quality (or credit-worthiness) is a term used to describe a company's overall financial health and its ability to repay all financial obligations in full and on time. By maintaining a strong credit rating on its corporate debt, utility companies are able to access necessary capital resources more cost-effectively and on better terms for customers across a range of economic conditions. Given APS's substantially increased investment needs, achieving strong credit quality will allow APS to access the necessary capital at favorable rates for customers. Maintaining APS's investment-grade credit ratings ensures APS is able to secure lower cost debt and equity financing of the infrastructure needed to serve customers, which in turn contributes to lower customer rates for service.

Q. HOW ARE CREDIT RATINGS DETERMINED FOR APS?

A. An assessment of APS's creditworthiness is performed by Moody's Investor Services (Moody's), S&P Global Ratings (S&P and Fitch Ratings (Fitch). The credit rating agencies consider both qualitative and quantitative factors when assessing the appropriate credit rating for an issuer of public debt securities.

Qualitative aspects include, but are not limited to, the history and overall supportiveness of Arizona's regulatory climate, APS's track record for delivering on its commitments, corporate governance, operating performance, and the diversity of its customer base. Each of these elements are key factors in the assessment of the business risk profile of a utility. Companies with stronger credit quality are those that operate in a more stable and predictable regulatory environment where the utility can recover prudently incurred costs and earn a fair return. Diversification of customer business types also contributes to a stronger credit profile as this helps a utility mitigate risks to cash flows from variations in economic cycles, commodity price movements, or a singular large customer.

Quantitative measures are primarily based on operating cash flow and focus on APS's ability to meet its fixed obligations (interest expense in particular) based on rates approved by the Commission (funds from operations) and the level at which APS maintains debt balances. The percentage of debt-to-total capital is another example of a quantitative measure — whereby, a lower percentage of debt relative to a utility company's overall total capital is indicative of stronger credit quality, because the utility company has greater ability to manage its debt obligations across a range of financial conditions.

Q. WHAT IS THE ROLE OF REGULATION IN THE DETERMINATION OF A UTILITY COMPANY'S CREDIT QUALITY?

A. Credit rating agencies regard consistency and predictability of regulation as one of the most important factors in assessing a utility company's financial stability and, hence, the quality of its credit. Capital providers want to be confident that the Company operates in a stable and supportive regulatory environment that will allow the Company to recover prudently incurred costs and earn a reasonable return on investments necessary to meet the demand, reliability, and service requirements of its customers and service territory. Important considerations include the allowed rate of return, adequate operating cash flows, the timely recovery of capital investments, the stability of earnings, and the strength of capital structure. Positive consideration is also given for utilities operating in states where the regulatory process is streamlined and the time lag in capital investment recovery is minimized through cost recovery mechanisms, such as adjustors and trackers. As discussed further in my testimony, the Company is proposing a formula rate with an annual adjustment that serves to achieve many of these objectives.

Q. HOW IS APS'S CREDIT CURRENTLY RATED BY THE CREDIT RATING AGENCIES?

A. As of the date of this testimony, Moody's, S&P, and Fitch rated APS's outlook "Stable" as shown in Figure 2 below.

Figure 2. APS's Issuer Credit Ratings

	Issuer Ratings	Outlook
APS		
Moody's	Baa1	Stable
S&P	BBB+	Stable
Fitch	BBB+	Stable

Obligations carrying a credit rating in the "A" category are considered strong, investment-grade securities subject to low credit risk for the investor. "A" rated debt is presumed to be susceptible to changes in circumstances and economic conditions; however, the debt issuer's capacity to meet its financial obligations is considered strong. By contrast, ratings in the "BBB" category (or "Baa" family, for Moody's) are considered adequate and have less assurance of access to the capital markets in challenging market conditions. "AA" and "Aa" ratings for S&P/Fitch and Moody's, respectively, are stronger than single letter "A" ratings.

S&P and Fitch may both also modify their ratings with the use of a plus or minus sign to further indicate the relative standing within a major rating category. Moody's similarly uses the numbers "1", "2", and "3" to indicate relative standing within a rating category, with a "1" and "3" analogous to a "+" and "-". For example, a "BBB+" with S&P and Fitch, is equivalent to a "Baa1" with Moody's.

Q. ARE IMPROVEMENTS IN APS'S CREDIT RATING STILL NEEDED?

A. Yes. While recent constructive developments and outcomes across the Company's regulatory proceedings have stopped the Company's credit ratings from falling further, the Company's current credit rating is still lower than where it had historically been maintained. Prior to 2021, the Company held an "A2" rating with Moody's (equivalent to a solid single "A" with S&P and Fitch and two notches above APS's current credit rating with Moody's) and "A-" with both S&P and Fitch (one notch above APS's current credit rating with each).[2] Through continued constructive engagement with the Commission, rate reforms to reduce regulatory lag, and a competitive return for investor-supplied capital, maintaining, and even strengthening the Company's credit quality are achievable. While APS's current credit ratings are near the industry average, as a single jurisdictional utility with higher levels of growth, stronger credit metrics would provide some additional headroom to allow the Company to make the necessary investments needed while not putting the current ratings at risk.

Q. WHAT STRENGTHS AND WEAKNESSES HAVE THE CREDIT RATING AGENCIES IDENTIFIED WITH RESPECT TO APS?

A. The rating agencies have identified challenges the Company faces in maintaining and improving upon its current credit ratings. In their most recent credit opinion of APS dated March 2025, Moody's highlighted the fact that APS's Cash from Operations pre-Working Capital to Debt ("Funds from Operations to Debt" or "FFO to Debt") have been "pressured because of an increasing capital expenditure program necessitating additional leverage while experiencing slow cash flow

[2] *See* APS's 2021 Form 10-K, filed Feb. 25, 2022 at 79, *available at*:https://www.sec.gov/Archives/edgar/data/7286/000076462222000014/pnw-20211231.htm.

growth".[3] Moody's noted specifically that, although APS benefits from several cost recovery mechanisms, the historical Test Year pressures on the Company's cash flow over the last several years is particularly challenging as the Company faces significant investments to continue providing reliable service. Moody's goes on to emphasize that the last two rate cases have taken more than 12 months to complete, further exacerbating regulatory lag and reducing the cash flows needed to support strong credit quality in the face of significant infrastructure spending needs.[4]

Q. WHAT EFFECTS DO CAPITAL STRUCTURE AND ROE HAVE ON CREDIT QUALITY?

A. Capital structure and ROE are important components of credit quality. When higher percentages of equity are authorized to fund business investment, that typically translates into higher credit quality and lower borrowing costs. In addition, the allowed ROE is a key component in the generation of earnings and cash flows, and in turn, retained earnings are a tool used to support incremental investment. An adequate ROE helps ensure equity investors receive fair compensation for their investment while reducing the risk for APS debt investors through stable cash flows.

This is particularly important during periods of increased market volatility present across the economy today and helps reduce customer costs associated with the capital needed to finance infrastructure spending to ensure a reliable grid. Conversely, a weak capital structure and an inadequate allowed ROE produces lower earnings and cash flows, lowers credit quality, and will limit financial flexibility, especially during periods of economic volatility.

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[3] *See* Moody's Credit Opinion for Arizona Public Service Co., March 25, 2025 at 1.
[4] *See* Moody's Credit Opinion for Arizona Public Service Co., March 25, 2025 at 1-3.

Q. WHAT IS APS'S PROPOSED CAPITAL STRUCTURE?

A. APS's proposed capital structure is 52.35% equity and 47.65% debt, which reflects the Company's actual Test Year capital structure. Using the actual Company capital structure for rate-making follows established Commission precedent for APS. The Company's proposed capital structure introduces an appropriate amount of risk due to leverage while minimizing the weighted average cost of capital to customers. Approval of the proposed capital structure will help APS maintain its current credit quality.

Q. IS THE PROPOSED CAPITAL STRUCTURE IN LINE WITH UTILITY PEERS?

A. Yes. The proxy group discussed in Mr. Coyne's Direct Testimony has an equity ratio over 52%, with the upper bound of the proxy group range having a nearly 60% equity ratio. APS's Test Year equity ratio is well within this range, although it is below the approved equity layers in three utility rate cases approved in Arizona in 2024 (*see* Figure 3):

Figure 3. Equity Layers Approved in Arizona Rate Cases in 2024

Tucson Electric Power[5]	54.32%
Arizona Water Company[6]	58.03%
UniSource Energy Service[7]	53.72%
EPCOR[8]	57.69%

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[5] *In re Application of Tucson Electric Power Co. for the Establishment of Just and Reasonable Rates and Charges*, Docket No. E-01933A-22-0107, Decision No. 79065 (Aug. 25, 2023) at 31.

[6] *In re Application of Ariz. Water Co. for a Determination of the Fair Value of its Util. Plant and Property,* Docket No. W-01445A-22-0286, Decision No. 79428 (Jul. 18, 2024) at 52.

[7] *In re Application of UNS Electric, Inc. for the Establishment of Just and Reasonable Rates and Charges*, Docket No. E-04204A-22-0251, Decision No. 79277 (Jan. 30, 2024) at 47.

[8] *In re Application of EPCOR Water Ariz., Inc., San Tan Water and Wastewater Districts, for a Determination of the Fair Value of its Water and Wastewater Util. Plant and Property*, Docket No. WS-01303A-20-0025, Decision No. 78546 (Apr. 28, 2022) at 28.

Q. DOES APS'S CAPITAL STRUCTURE HAVE AN ADEQUATE EQUITY COMPONENT TO ENABLE APS TO ACHIEVE THE COMPANY'S FINANCIAL OBJECTIVES?

A. Yes. APS's equity layer, as requested in this case, enables it to maintain current credit ratings, financial strength, and flexibility. This level of equity enables the Company to tolerate different business cycles while also providing more confidence to the Company's lenders and bondholders. Like many utilities, APS is in a period of growing capital investment necessary to provide cost-effective, safe, and reliable service to its customers in a time of rising costs and higher load growth. The magnitude of APS's capital requirements dictates the need for a sufficient equity component of the Company's capital structure to support strong credit ratings and ensure access to capital at reasonable terms.

My testimony addresses the financial benefits of APS's proposed formula rate below. As part of the Company's proposal, APS's capital structure and ROE would remain fixed during annual formula updates and would be reevaluated during the next general rate case proceeding. This would provide sufficient visibility to equity investors on the amount of equity required and the level of authorized return over a multi-year period, while also creating rate stability for customers by minimizing the number of variables during annual formula rate updates.

Q. WHAT IS APS'S AVERAGE COST OF LONG-TERM DEBT?

A. APS's weighted average cost of long-term debt as of the end of the Test Year was 4.26% (*see* SFR Schedule D-2) and was used to compute the Company's requested weighted average cost of capital of 7.63% (*see* SFR Schedule D-1). The Company will update the average cost of long-term debt throughout the proceeding.

Q. WHAT ROLE DO EQUITY INVESTORS PLAY IN FINANCING INFRASTRUCTURE NEEDS?

A. Equity investors provide significant amounts of financial resources, for which a reasonable economic return is required. APS compensates equity investors for the risk of their investment in Pinnacle West by targeting fair and adequate returns, a stable dividend, and earnings growth — these are all necessary to preserve access to equity capital. Returns to equity investors are realized only after all operating expenses and fixed payment obligations of the business have been paid. Because equity investors are the last to receive earnings and cash flows, their investment involves significantly more risk. For this reason, equity investors require a higher return for their investment than interest rates to lenders. As determined and supported in Mr. Coyne's Direct Testimony, the Company's proposal in this proceeding of a 10.7% ROE and 1.00% return on FVRB increment supports the overall requirement for a reasonable return commensurate with current investment risks.

Q. DOES CAPITAL INVESTMENT GROWTH MEAN BOTH EQUITY AND DEBT FUNDING WILL NEED TO EXPAND?

A. Yes. As year-over-year grid, generation, and infrastructure investment increases, preserving APS's balanced capital structure means that APS will require increases to both equity and debt capitalization. For example, in 2024, Pinnacle West obtained $800 million in new equity investment and needs an additional $700 to $900 million in new common equity between 2025 and 2027.[9] In APS's recently approved financing order, the limit on APS's authorized long-term debt was also increased from $8.0 billion to $9.5 billion to accommodate increasing financing

[9] *See* Pinnacle West 2024 Year End Earnings Investor Deck at slide 12, *available at:* https://s22.q4cdn.com/464697698/files/doc_financials/2024/q4/Q4_2024_Earnings_Final.pdf.

needs over this same period.[10] To secure this necessary financing to fund infrastructure supporting customer growth, it will be critical for the Company to preserve its existing relationships with established financing partners and to expand and diversify its sources of capital. Within the context of APS's growing capital needs, financial stability means that incumbent investment partners are assured that APS can maintain cash flows, credit metrics, and a balanced capital structure so as to not increase the risks of their investment with the Company. New investors of both debt and equity will similarly need to see that financial metrics and regulatory outcomes support recovery of their investment along with required, risk-weighted equity or debt returns.

VI. BENEFITS OF A FORMULA RATE

Q. PLEASE DESCRIBE THE CONCEPT OF REGULATORY LAG IN A JURISDICTION USING A HISTORICAL TEST YEAR.

A. As regulated public-service entities, investor-owned utilities like APS are authorized to seek a return of and a return on prudent investments and the opportunity to recover expenses needed to provide safe and reliable electric service to customers. However, the duration of formal processes for regulatory filings, public review and comment, and approval of customer rates based on a historical test year framework can substantially delay the timeframe in which these costs are recovered through rates charged to customers. Some prudent costs are never able to be recovered altogether. As APS experiences rising costs, capital expansion, and fluctuating interest rates, among other changes, by the time new rates are in effect, the Company's current cost of service is often significantly out of alignment with the costs used for rates based on historical test years.

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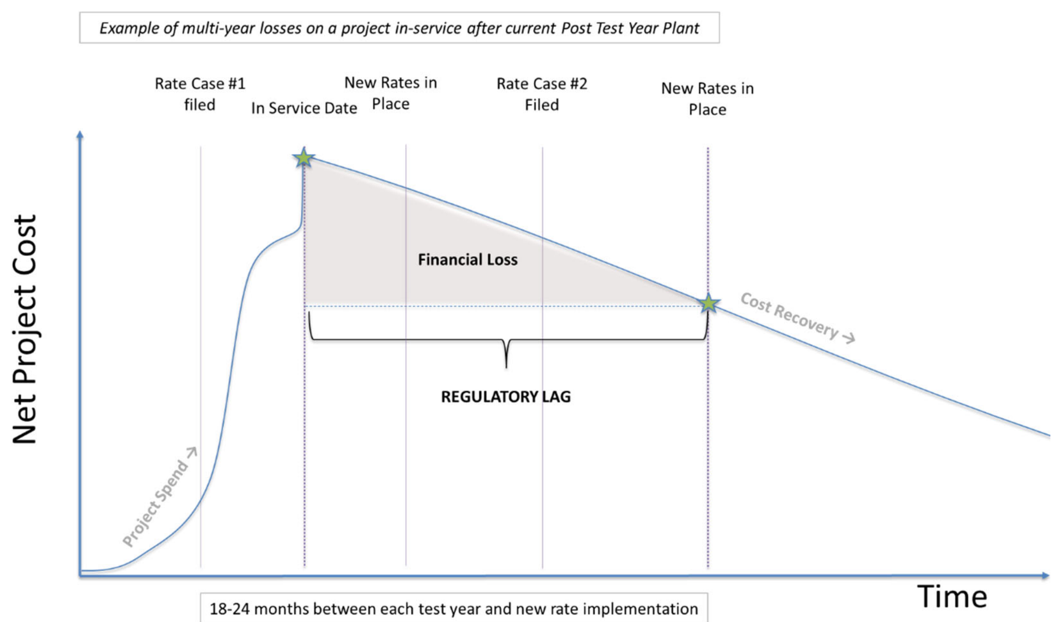
[10] *In re Application of Ariz. Pub. Serv. Co. for an Order Authorizing it to Issue, Incur, and Amend Evidences of Long-Term Indebtedness,* Docket No. E-01345A-24-0089*,* Decision No. 79643 (Dec. 17, 2024) at 21.

The concept of regulatory lag describes the time between when a utility incurs additional costs, or makes incremental investments, and when rates to recover those costs are approved and implemented. This impact is felt across the business including, but not limited to, increased vendor service costs, higher labor rates, material cost inflation, changes in fuel prices, and additional cost for wildfire risk mitigation. As seen in the capital project example below in Figure 4, regulatory lag is a ratemaking inefficiency that results in recurring financial losses to a utility on costs that are prudent and would customarily be allowable within the ratemaking framework.

Figure 4. Regulatory Lag for a Capital Project Placed In-service Immediately Following the Post Test Year Period



Q. WHY IS REGULATORY LAG HARMFUL TO THE FINANCIAL STABILITY OF A UTILITY?

A. Regulatory lag impairs a utility's opportunity to earn its authorized ROE. SFR Schedule A-2 provides a historical perspective on the impacts of regulatory lag, whereby, APS has earned approximately 200 basis points below its authorized ROE. For example, despite new rates effective in early 2024 and higher sales due to warmer than average weather, APS still earned well below its authorized ROE as a result of the embedded gap between today's costs and the 2021-2022 historical test year that forms the basis of current rates for APS service. While organic revenue growth from new customer additions can help to partially offset the net impact of regulatory lag, the cost of new grid investment to support these customers is often at a higher price than the depreciated rate base reflected in customer rates. The result is that, even with customer growth, a utility's revenue deficiency from regulatory lag tends to increase each year due to increasing plant in-service and the rising cost of business.

Q. WHAT MACROECONOMIC CONDITIONS HAVE EXACERBATED REGULATORY LAG FOR APS?

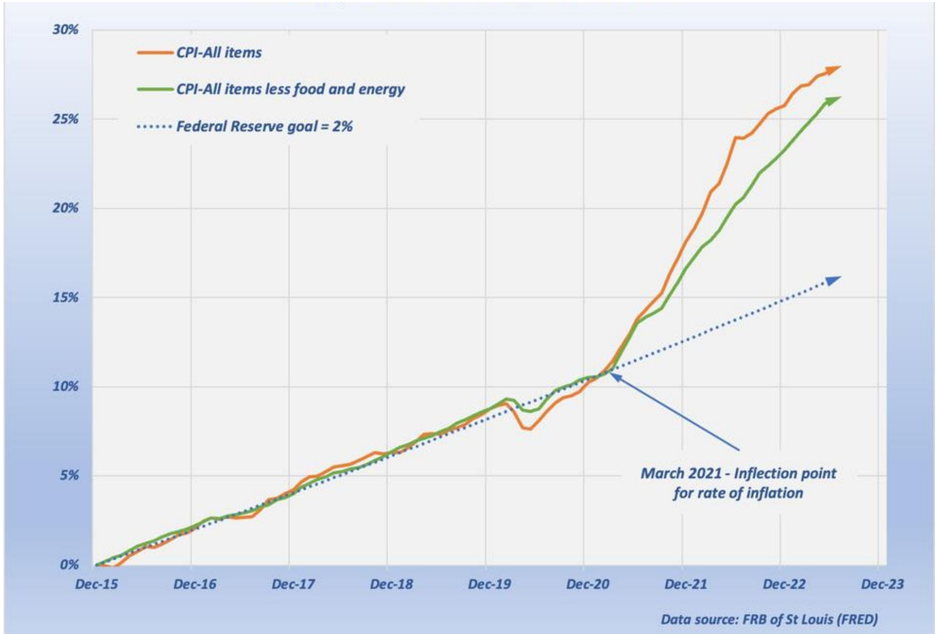
A. Over the past four years, the Federal Reserve has implemented a more restrictive policy stance by raising short-term interest rates to combat persistent inflation. During this time, the economy has slowly recovered from the COVID-19 pandemic, and as the United States Treasury yield curve has begun to normalize, the 10-year United States Treasury rate has risen steadily, leading to higher borrowing costs for APS. In January 2022, the 10-year United States Treasury average rate was 1.76%; in January 2023, the average rate was 3.55%; in January 2024, the average rate was 4.04%; and in January 2025, the average rate was 4.63%. This substantial increase in interest rates is reflected in the Company's Test Year cost of debt rising from 3.85% in the prior rate case to 4.26% today, and the Company has been paying these higher interest rates to lenders but only recovering at a rate of 3.85%. Even beyond the Test Year, in 2025, APS will need to refinance an existing 10-year note with a stated coupon of 3.15% and will price a new security with the same tenor at an expected rate of approximately 6.00%. Not only do higher interest rates impact borrowing cost, but they are a direct input into the

Company's pension expense, which has also risen substantially since the test year in the 2022 rate case, as I discuss later in my testimony.

Q. **ARE THERE OTHER MACROECONOMIC FACTORS THAT ARE DISLOCATING COSTS FROM CURRENT RATES AND CAUSING REGULATORY LAG?**

A. The CPI in the greater Phoenix area from 2022 to 2025 shows stabilizing levels of inflation in the near term, but the past three years of substantially higher levels of inflation are not currently reflected in the cost of service being recovered by APS customers. These rates were all set using operating expenses from a test year ending on June 30, 2022. Since then, and as demonstrated in Figure 5 below, prices for goods and services necessary to provide APS customers with reliable service have still risen at historically very high levels of inflation — none of which is reflected in current rates for service. This dramatic under collection creates not only lower earned returns each year but also a reduction in cash flows needed to service debt and fund critical operating expenses. This results in a permanent loss to the utility until rates can catch up to reflect the current cost of service. For example, the average unit price for multiple distribution transformer types sampled by APS increased 51.1% between the test year used in the Company's 2022 rate case and the current 2024 Test Year. Over the same timeframe, the level of investment to support growth and reliability needs resulted in an average 26.6% increase in the volume required for each transformer type.

Figure 5. CPI Compared to Federal Reserve 2% Goal[11]



For these reasons, ratemaking frameworks with longer periods of regulatory lag tend to be viewed unfavorably by credit rating agencies, investors, and lenders due to the uncertainty created by the length of time to recover those costs. On the other hand, more efficient ratemaking processes, like formula rates, are viewed favorably because their structure materially reduces regulatory lag without sacrificing safeguards to ensure utilities are incurring costs and expenses prudently and in the best interest of customers.

Q. WHY IS APS PROPOSING A FORMULA RATE?

A. A formula rate will provide a better customer experience through smaller, more gradual rate changes while serving as a more efficient ratemaking tool that meaningfully decreases regulatory lag by matching the actual cost of service to customer rates. It benefits both customers and APS by using a streamlined methodology that is established through a formal process where both stakeholders

[11] John S. Tobey, *U.S. Inflation Cycle's Damage Is Worsening*, Forbes Media LLC (Sep. 3, 2023), https://www.forbes.com/sites/johntobey/2023/09/03/us-inflation-cycles-damage-is-worsening/.

and regulators provide feedback. For example, if a utility is underearning as compared to the authorized ROE, it is allowed to seek a rate adjustment to recover prudently incurred costs. Alternatively, if a utility exceeds its authorized return due to higher revenues (e.g., because of favorable weather or reductions to interest rates), it will adjust the formula rate to reflect the reduced revenue requirement. This creates an efficient and symmetrical process to more closely align current cost of service with current customer rates.

Throughout 2023 and 2024, the Commission, utilities, and stakeholders explored methods to reduce regulatory lag through alternative ratemaking structures such as future test years, hybrid test years, and formula rates. In December 2024, the Commission approved a policy statement allowing utilities to include formula rate proposals in subsequent rate case proceedings.[12]

Q. HOW DOES A FORMULA RATE IMPROVE FINANCIAL STABILITY AND BENEFIT CUSTOMERS?

A. A formula rate brings several significant benefits to both customers and APS: for customers, a formula rate provides rate gradualism on bills — through annual adjustments — in lieu of much larger and less predictable rate adjustments following a lengthy multi-year general rate case. A formula rate structure also offers protections for customers in years that APS exceeds the allowed ROE due to circumstances such as higher revenues from more favorable sales growth by providing a mechanism to adjust customer rates on a more timely basis. As discussed in APS witness Jessica E. Hobbick's Direct Testimony, the Company is proposing various customer protections, including an earnings test and other provisions, which are outlined in the Formula Rate Adjustment Mechanism Plan of Administration. For APS, a formula rate would mitigate the existing structural

[12] *See* Decision No. 79647.

regulatory lag, reduce regulatory risk, provide meaningful consistency in cash flows, and significantly reduce the time-consuming cycle of frequent rate cases. As proposed in APS's formula rate proposal, the length of regulatory lag would be reduced to an annual rate evaluation period, better matching rates to actual costs, as opposed to the several years of lag during fully litigated rate cases.

Q. HOW WOULD INVESTORS AND CREDIT RATING AGENCIES VIEW THE ADOPTION OF A FORMULA RATE?

A. The adoption of a formula rate would be viewed favorably by investors and the credit rating agencies by providing APS a reasonable opportunity to earn the allowed ROE and stabilizing cash flows. Moody's assessment of business risk would likely be more favorable if a change in Arizona's regulatory environment "leads to meaningfully greater revenue predictability and more timely recovery of prudently incurred costs and investments."[13] A formula rate for APS would undoubtedly foster these conditions.

In addition, some equity investors have already begun to evaluate APS based on an assumption that the Company will operate with a formula rate in the coming years and purchasing stock on that basis. To the extent that market expectations around a formula rate become reality, greater positive impacts on APS's overall financial performance and ability to access capital on terms favorable to customers will very likely arise.

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[13] See Moody's Credit Opinion for Arizona Public Service Co, March 25, 2025 at 2.

VII. <u>FINANCIAL COMPONENTS WITHIN THE PROPOSED FORMULA RATE DESIGN</u>

Q. WOULD THE PROPOSED FORMULA RATE IMPACT THE COMPANY'S CAPITAL STRUCTURE?

A. No. As discussed in Ms. Hobbick's Direct Testimony, the proposed formula rate would use the Commission-approved capital structure, ROE, and Fair Value Increment adopted in the Company's most recent rate case. As discussed previously, this structure provides greater stability and certainty to both customers and capital providers with respect to annual rate adjustments.

Q. WHY IS THE COMPANY INCLUDING PROJECTED PLANT IN SERVICE IN THE FORMULA?

A. One central tenet in implementing a formula rate is to eliminate regulatory lag by more closely matching costs incurred by the Company to when they can be recovered through rates. Post-Test Year plant (PTYP) is an example of a utility ratemaking tool that decreases regulatory lag by including certain capital expenditures in rates associated with assets placed into service after the test year concluded, but prior to the Commission's final rate order. Ms. Hobbick discusses the Company's detailed formula rate proposal in her Direct Testimony, including the addition of projected plant, which overall achieves much greater efficiency of regulatory cost recovery as compared to the current historical test year model (even with PTYP). This is consistent with current practice under APS's existing Federal Energy Regulatory Commission (FERC) Formula for transmission investments that have been in place since 2008. Absent the inclusion of projected plant, even with a formula rate, a prudent investment placed into service in the first month after a Test Year may still have more than a year and a half delay before its revenue requirement is reflected in customer rates.[14] In the meantime, the Company would incur property taxes, insurance costs, and depreciation expenses, among others, that would be permanently lost from rate recovery.

Q. WHAT DOES AN ROE BAND ACCOMPLISH WITH RESPECT TO CUSTOMER RATES?

A. As discussed in the Commission's policy statement regarding formula rates,[15] an effective formula rate should include an earnings test with a "dead band" of plus or minus 20 basis points of a utility's authorized ROE. The dead band is intended to help minimize the frequency of rate adjustments to customers by providing a range of earned return outcomes where no rate adjustment would be necessary. If the earnings test for a given historical test year reflects an actual earned ROE within plus or minus 20 basis points of the authorized return, no adjustment to customer rates will be made. As noted in Ms. Hobbick's Direct Testimony, only when the actual earned ROE is less than or greater than the dead band range would a compensating adjustment occur. As an example, utilizing the proposed ROE of 10.7%, no annual formula adjustment would occur, subject to any changes related to the true-up, if the earned ROE fell between 10.5-10.9%.

With respect to customer rates, the ROE dead band helps to accomplish the rate gradualism I discussed earlier in my testimony by helping to limit the amount of change customers may see in any given year on their bills. It does this transparently and efficiently through an approved formula and can result in years of rate stability when the utility-earned ROE stays within the dead band. By contrast, in years

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[14] Assumes that with a calendar year test year, an asset in service January of Year 1 would not be included in rates until September of Year 2, per the Company's Formula Rate Adjustment Mechanism timeline.

[15] *See* Decision No. 79647, Attachment A at 1.

where the earned ROE exceeds the deadband, customers could see a reduction in rates for APS service.

Q. HOW DOES ANNUALLY UPDATING THE COST OF DEBT AFFECT CUSTOMERS?

A. Consistent with APS's FERC formula rate, updating the cost of debt annually allows rates to recover prudently incurred borrowing costs. If interest rates decline, a formula allows APS to update customer rates to reflect additional savings as the Company adds or refinances debt below the existing embedded cost of debt. As interest rates rise, adjusting the cost of debt through an annual formula reset provides the opportunity to recover actual borrow cost experienced. The reduced uncertainty helps to protect customer savings over the long term by preserving cash flows in line with the Company's existing credit quality.

Q. WHY IS IT NECESSARY TO KEEP THE POWER SUPPLY ADJUSTMENT (PSA) AND SYSTEM RELIABILITY BENEFIT (SRB) ADJUSTMENT MECHANISMS INTACT WITH A FORMULA RATE?

A. In her Direct Testimony, Ms. Hobbick discusses APS's proposal to eliminate the company's LFCR adjustor after the first formula rate filing as part of the proposal to adopt a new formula rate, in line with the Commission's December 2024 policy statement.[16] However, other rate adjustment mechanisms — specifically the Power PSA and the SRB — should remain in partnership with the formula rate, to preserve a financially stable rate structure.

The PSA is a mechanism to pass operating fuel, chemical, and purchased power costs directly to customers. The PSA allows utilities to track any net customer cost savings or cost increases in real-time through the combination of a forward component and a true-up of accrued costs on customer bills. Mechanisms similar

[16] *See* Decision No. 79647 at Attachment A.

to the PSA have been put in place across the United States to protect utilities from bankruptcy or to avoid windfall earnings because of highly volatile electricity market and commodity prices. For instance, according to the United States Energy Information Administration, in a string of cold winter weather in 2022, natural gas spot prices in the West climbed to 10 times higher than those at the Henry Hub, the national benchmark price.[17] The PSA is a fundamentally important tool to protect APS's liquidity in an environment where electric power service can be safely and reliably provided to customers 24 hours a day, 365 days a year. All companies within the proxy group from Mr. Coyne's analysis have a fuel and purchased power adjustment mechanism. Absent the PSA, energy price swings could threaten the Company's overall financial stability in a very short period of time.

Similarly, the SRB is an important cost recovery mechanism for new utility-owned generation assets. The SRB process allows for all stakeholders to review these large, singular capital investments prior to approval and inclusion into the Company's rate base. In today's environment where the scale of new customer demand and retiring generation resources exceeds anything APS has experienced in its recent history,[18] the Company proposes to retain the flexibility of the SRB mechanism not only to preserve the stakeholder process, but to allow for offsetting benefits associated with tax credits to be timed concurrent with the costs and minimize customer impacts. In Decision No. 79293 (March 5, 2024), [19] the Commission approved the SRB for recovery of prudent generation assets being placed in service with a 100-basis point discount applied to the weighted average

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[17] *See* https://www.eia.gov/todayinenergy/detail.php?id=55139.

[18] APS 2023 Integrated Resource Plan, Executive Summary at 5.

[19] *In re Application of Ariz. Pub. Serv. Co. for a Hr'g to Determine the Fair Value of the Util. Prop. of the Co. for Ratemaking Purposes*, Docket No. E-01345A-22-0144, Decision No. 79293 (Mar. 5, 2024) (Decision No. 79293).

cost of capital associated with such investments. These financial benefits to customers are provided within the SRB and should be maintained on a going forward basis while costs are recovered through that mechanism.

VIII. RETIREMENT PLAN EXPENSES

Q. PLEASE EXPLAIN THE COMPANY'S NORMALIZE EMPLOYEE BENEFITS PRO FORMA ADJUSTMENT.

A. The Normalize Employee Benefits pro forma adjustment reflects changes in the cost of pension benefits, medical benefits, and life insurance offered under the Company's retirement plans. This pro forma normalizes these changes by calculating the difference between expense included in the Test Year and future known and measurable expense as determined by APS's third party actuarial consultants, which results in a net increase in Test Year expenses of $20.9 million.

As described in more detail below, this normalization pro forma adjustment also addresses the cost impacts associated with the expiration of a long-term credit dated back to 2014 that has been fully returned to customers (i.e., fully amortized and no longer exists). This adjustment results in an increase in Test Year expense of $18.7 million.

The pro forma adjustment to normalize Test Year pension and other post-employment benefits (OPEB) expense is described in more detail by APS witness Elizabeth A. Blankenship.

Q. WHY IS THE NORMALIZATION OF PENSION AND OPEB BASED ON KNOWN AND MEASURABLE ACTUARIAL CHANGES APPROPRIATE?

A. When utilizing a historical test year to determine expenses incurred to serve APS customers, normalization is appropriate to reflect actual costs during the period rates will be in effect. This approach reflects the matching principle of actual utility costs and the recovery of those costs in rates for service. These costs are known and measurable because they are based entirely on actuarial calculations for calendar year 2025 as of December 31, 2024, including spot interest rates at that time, and market returns earned over the prior calendar year.

Further, this treatment of pension and OPEB expense adjustments, determined by third party actuarial consultants, is consistent with numerous prior rate case decisions.[20] In APS's most recent rate case, the Commission authorized normalization of OPEB costs based on the full 2022 calendar year.[21]

Q. WHY DO PENSION AND OPEB EXPENSES VARY FROM YEAR TO YEAR?

A. Accounting rules require that pension and OPEB obligations and assets be measured, or valued, each year. These measurements are required to reflect changes in the plan population, promised benefits, and asset performance since the prior measurement date, as well as market conditions at the time of the measurement, including the current interest rate environment and expected return on plan assets. These annual valuations are also subject to financial market forces that are outside the Company's control. Financial market changes are calculated based on the obligation and trust assets valued as of the measurement date

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[20] *See In re the Application of Ariz. Pub. Serv. Co. for a Hr'g to Determine the Fair Value of the Util. Prop. of the Co. for Ratemaking Purposes*, Docket No. E-01345A-08-0172, Decision No. 71448 (Dec. 30, 2009); *In re the Application of Ariz. Pub. Serv. Co. for a Hr'g to Determine the Fair Value of the Util. Prop. of the Co. for Ratemaking Purposes,* Docket No. E-01345A-11-0224, Decision No. 73183 (May 24, 2012); *In re the Application of Ariz. Pub. Serv. Co. for a Hr'g to Determine the Fair Value of the Util. Prop. of the Co. for Ratemaking Purposes*, Docket No. E-01345A-16-0036, Decision No. 76295 (Aug. 18, 2017); and *In re Application of Ariz. Pub. Serv. Co. for a Hr'g to Determine the Fair Value of the Util. Prop. of the Co. for Ratemaking Purposes*, Docket No. E-01345A-19-0236, Decision No. 78317 (Nov. 9, 2021).

[21] Decision No. 79293 at 107, lines 5-7.

considering the latest market conditions, population, and actuarial assumptions. Uncertainty around future medical costs and demographic experience, including life spans, length of careers, and other similar factors, also contribute to variability in pension and OPEB expense.

Q. DOES APS MITIGATE THIS VARIABILITY IN PENSION AND OPEB EXPENSE AND COST INCREASES EXPERIENCED BY CUSTOMERS?

A. Yes. One way the Company achieves a lower risk and lower volatility investment portfolio for its pension and OPEB plans is by managing interest rate risk through a liability-hedging strategy. APS has designed the investment portfolios of the pension and OPEB plans to generally match the changes in plan obligations — for example, if interest rates increase, therefore reducing plan obligation, then plan assets decrease. Similarly, if interest rates decrease, therefore increasing plan obligation, then plan assets increase. In this way, the impact of swings in interest rates on the funded status of the plan is lessened.

Additionally, the Company has limited its investments in return-seeking assets (such as stocks and real estate, for example) as these assets tend to be more volatile. This focus on a more stable overall funding status allows APS to better manage the volatility of its pension and OPEB expense.

Q. APART FROM TYPICAL ACTUARIAL ADJUSTMENTS TO TEST YEAR PENSION AND OPEB EXPENSES, WHY ARE OTHER ADJUSTMENTS NEEDED TO THESE TEST YEAR EXPENSES AS COMPARED TO 2025 ACTUAL COSTS?

A. When a change is made to the underlying benefits provided by a specific benefit plan, the future obligations of that plan also change, impacting expenses across future years. Accounting rules require that any costs and credits related to these plan amendments be recognized through amortization over a fixed period. When this fixed period expires, expenses will change based on the expiration of the amortization. In these situations, the impact of that change is entirely known and measurable because it is based on plan benefit changes of a specified value that have an impact over a fixed amortization period into the future.

In 2014, the Company changed its medical benefits for eligible pension plan participants, resulting in an overall savings of $388.6 million through a reduction to the plan's long-term future obligations — a tremendous benefit to customers. APS amortized these savings over a 10-year period beginning in 2015 and has been reducing the Company's annual revenue requirement each year since that time. Because this $388.6 million is now fully amortized, the change in pension and OPEB expense between the Test Year and 2025 includes the removal of this annual credit that had been previously offsetting these costs. The expiration of the credit accounts for $18.7 million of the requested adjustment in expenses for the Test Year reflected in the normalization pro forma.

Q. DID APS MAKE ANY CHANGES TO MINIMIZE THE INCREASE IN PENSION AND OPEB COSTS?

A. Yes. The 2025 OPEB cost also reflects the impact of a change in the Company's actuarial assumptions regarding indexing benefits for eligible retirees. This change resulted in a one-time decrease to future OPEB obligations of approximately $42.4 million. This reduction in plan obligation benefits customers by decreasing 2025 OPEB expense by approximately $3.2 million, which is reflected in the normalization pro forma to reduce customer costs for the Test Year.

Q. HOW WOULD THE AVAILABILITY OF A FORMULA RATE MECHANISM IMPACT THIS PENSION AND OPEB NORMALIZATION ADJUSTMENT IN THE YEARS AFTER NEW RATES TAKE EFFECT?

A. The Company is proposing to adjust Test Year pension and OPEB expense to normalize these costs to reflect a typical-year level for ratemaking purposes. This is based on a consistently applied normalization method accepted by the Commission in numerous prior cases. This is very similar to the way weather is normalized in a test year – which is to ensure rates are designed to recover costs that can be expected or are typically experienced. In this case, the Company has also proposed a formula rate, which means that rates in this case will be designed to reflect normalized Test Year levels, but each subsequent year, the formula will evaluate actual costs and actual revenues against the authorized ROE. If the Company earns more than the level authorized, based on the normalized levels established in this proceeding, those surplus revenues will provide a benefit to customers in the annual application of the formula rate reset.

IX. OTHER FINANCIAL MATTERS

Q. PLEASE DESCRIBE THE WILDFIRE OPERATIONS AND MAINTENANCE (O&M) EXPENSE DEFERRAL REQUESTS APS HAS MADE.

A. APS has a pending deferral application related to its growing wildfire risk mitigation spending, specifically with respect to O&M expenses such as insurance premiums. With wildfire risks increasing to extraordinary levels and for reasons well beyond APS's control, the deferral supports increasing efforts to limit public safety risks and ensure grid reliability through APS's Comprehensive Fire Mitigation Plan (CFMP).[22] Mr. Tetlow's Direct Testimony describes the

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[22] *See In re Application of Ariz. Pub. Serv. Co. for Accounting Deferral for Recovery of Non-Capital and O&M Fire Mitigation Expenses, Docket E-01345A-24-0186, APS's Wildfire Deferral Application (Aug. 14, 2024) at 2.*

Company's wildfire mitigation efforts in detail. Of critical importance for APS's financial stability, in particular cash flows necessary to support critical operations, this deferral preserves an opportunity to recover the increasing costs associated with insurance premiums between general rate case proceedings, which saw an increase of 640% in 2025 alone due to the rising wildfire risk across the Western United States.[23] As a going forward matter, adoption of APS's formula rate proposal in this case will obviate the need for future accounting deferrals related to wildfire O&M expenses. For now, however, and in alignment with Staff's Recommended Order issued on May 28, 2025, Ms. Blankenship's Direct Testimony describes the request to seek recovery of the accumulation of these specific fire mitigation related O&M costs incurred after the Company's Test Year and which would otherwise be lost if not sought and recovered in this case.

Q. DID APS ALSO REQUEST A DEFERRAL OF SIGNIFICANTLY INCREASING COSTS ASSOCIATED WITH THE CESSATION OF COAL-FIRED GENERATION AT CHOLLA POWER PLANT (CHOLLA)?

A. Yes. In the case of Cholla, the deferral request is consistent with prior Commission orders and supports appropriate recovery of operating expenses and the remaining unrecovered net book value as Cholla ceased coal-fired operations in early 2025.[24] Specifically, the Cholla application requests the deferral of 1) "all non-fuel costs associated with APS's ownership, operation, and maintenance of the remaining [electric generation units]", and 2) Cholla decommissioning costs, including environmental remediation, Coal Combustion Residual (CCR) management facilities and CCR corrective actions.[25] With respect to these costs, CCR-related

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[23] *Id.* at 3-4.

[24] *See In re Application of Ariz. Pub. Serv. Co. for Accounting and Deferral Order Associated with Unrecovered Book Value and Closure Costs of Cholla Power Plant,* Docket E-01345A-24-0185, APS's Cholla Deferral Application (Aug. 14, 2024) at 6.

[25] *Id.* at 5-6.

expenses necessary to comply with recently changed federal environmental regulations promulgated in May of 2024 are the most significant driver of expenses that will not be captured in current rates for service. In fact, absent these changes in federal environmental regulations, only a relatively small amount of unrecovered net book value remains for Cholla, such that current rates would substantially recover such costs prior to the projected rate effective date in this proceeding. As described in Mr. Tetlow's Direct Testimony, these cost increases are both extraordinary and wholly outside of APS's control, given that they result from recent changes to federal environmental regulations governing CCR management and remediation.

Ms. Blankenship's Direct Testimony discusses the accounting mechanisms by which costs will be collected in rates for service as a result of this rate case. In addition, APS requests that the deferral for costs and expenses arising from the cessation of operations at Cholla, in particular CCR management and remediation costs, be continued after new rates take effect as a result of this rate case.

Q. WHY IS THE DEFERRAL FOR CHOLLA CLOSURE COSTS IMPORTANT FOR MAINTAINING THE FINANCIAL STABILITY OF APS?

A. In the case of costs arising from the cessation of coal-fired generation at Cholla, the Company is effectively providing financing for prudent costs it has incurred in the public's interest until costs can be recovered from customers later. Cost deferrals provide critical financial support for APS when extraordinary changes to necessary expenditures occur before they can be established in recovery mechanisms. Deferrals typically seek to keep customer bills lower through a gradual recovery over a multi-year timeframe. In the near term, Company credit metrics face pressure as necessary spend constrains operating cash flows, and the

Company must seek additional financing from debt and equity markets until revenue recovery can catch up. Nonetheless, because the deferral mechanism provides an opportunity to recover these costs at a later date, the deferrals support financial stability by ensuring these costs are not automatically lost to regulatory lag. In addition, because of the significant increase in CCR-related costs — most of which will be incurred in large amounts annually over the next approximately five years — the deferral of these costs provides a mechanism to amortize these expenses over a longer period of time. In this respect, maintaining the deferral for these significantly increasing costs on a going forward basis — after rates associated with this case take effect — will reduce customer costs associated with the closure of Cholla.

Q. IS THE COMPANY PROPOSING ANY CHANGES TO THE TREATMENT OF INVESTMENT TAX CREDITS RELATED TO ITS ARIZONA SUN BESS?

A. Yes. Section 13102(f)(5) of the Inflation Reduction Act provides utilities an election out of the tax normalization requirements for Investment Tax Credits (ITC) for its energy storage property that has a maximum capacity of at least 500 kWh. Unless such an election is made, Internal Revenue Service (IRS) normalization continues to be required for the ITC from battery systems.

The Company made an election out of the tax normalization requirements for ITC related to its Arizona Sun BESS, as part of its 2023 tax return filing.[26] By making this election, the Company has increased flexibility in how these ITC benefits can be provided to customers.

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[26] The Arizona Sun BESS is a collection of battery storage — totaling approximately 200 MW — at nine APS solar facilities. The project was included in the Company's PTYP request in its last rate case.

In this filing, the Company is proposing to provide customer relief by accelerating the ITC benefits from the Arizona Sun BESS. Specifically, the Company is proposing to amortize through its cost of service the remaining unamortized net ITC balance as of the new rate enactment date over a period of three years. Accelerating this amortization will offset the cost of electricity for current customers in this rate case, who currently rely on the Arizona Sun BESS facility to provide grid reliability, reducing the current revenue requirement by $19.8 million.

This proposed methodology has been reflected in the Company's rate request, with the first year of this expected amortization being reflected as a cost-of-service adjustment in the Company's Normalize Income Tax Expense/Interest Synchronization.

Q. HAS THE COMPANY PLACED IN SERVICE ANY OTHER BATTERY INVESTMENTS THAT AN ELECTION OUT OF THE IRS TAX NORMALIZATION REQUIREMENTS COULD HAVE BEEN MADE?

A. As of the end of the December 31, 2024 Test Year, no. However, the Company has included the investment costs of the Agave BESS, which is expected to be operational by December 31, 2025, as part of the Company's PTYP request. The Company intends to make an election out of the IRS tax normalization requirements for the Agave BESS on its tax return for the year the plant is placed in service.

Q. HAS THE COMPANY INCLUDED ANY ESTIMATED ITC BENEFITS RELATED TO THE AGAVE BESS IN ITS RATE REQUEST? IF YES, WHAT METHODOLOGY HAS THE COMPANY APPLIED?

A. Yes. The Company has included estimated ITC benefits related to its Agave BESS in its PTYP Income Statement Pro Forma.

Because the Company intends to elect out of the IRS tax normalization requirements for this investment, the Company is proposing to follow a similar treatment to what it has proposed for the Arizona Sun BESS ITC and provide customers with the net benefits of the Agave BESS ITC over a five year cost-of-service amortization period.

This proposed methodology has been reflected in the Company's rate request, with the first year of this expected amortization being reflected as a cost-of-service adjustment in the Company's PTYP Income Statement Pro Forma.

Q. WHY IS THE COMPANY PROPOSING A DIFFERENT AMORTIZATION PERIOD FOR ITS AGAVE BESS ITC THAN IT IS PROPOSING FOR THE ARIZONA SUN BESS ITC?

A. The Company believes that an amortization period that aligns with the tax depreciable life (as opposed to the book depreciable life) of the battery storage investment, (i.e., five years), is supportable for its Agave BESS ITC. By year six, the Company will have fully depreciated the asset for tax purposes. The result of adopting APS's proposed amortization period is that tax savings flow back to customers more quickly, offsetting the cost of electricity for customers. However, because the Arizona Sun BESS has been in service since 2023, the Company believes that a shorter amortization period for providing benefits back to customers is warranted for this asset.

Q. HAS THE COMPANY RECOGNIZED ANY TAX BENEFITS RELATED TO NUCLEAR POWER PRODUCTION TAX CREDITS?

A. No. The Nuclear Power Production Tax Credit (Nuclear PTC) was passed into law as part of the Inflation Reduction Act of 2022.[27] APS is currently awaiting guidance from the United States Treasury Department related to the definition of "gross

[27] *See* https://www.congress.gov/bill/117th-congress/house-bill/5376.

receipts from nuclear sales" for purposes of the credit phase-out that is part of the Nuclear PTC calculation. Without such guidance, APS is uncertain as to the amount of benefit the Nuclear PTC may provide as a full credit phase-out remains a possibility. APS continues to monitor activity by the United States Treasury to determine how best to leverage the Nuclear PTC for the benefit of customers. Ms. Hobbick discusses various mechanisms in her Direct Testimony that could be used to return tax credits to customers between rate cases.

X. <u>CONCLUSION</u>

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.