ARIZONA COURT OF APPEALS

DIVISION ONE

ARIZONA PUBLIC SERVICE COMPANY, Appellant, v. ARIZONA CORPORATION COMMISSION, Appellee.	Court of Appeals Division One No. 1 CA-CC 21-0002 Arizona Corporation Commission No. E-01345A-19-0236
SIERRA CLUB and RESIDENTIAL UTILITY CONSUMER OFFICE, Intervenors.	

APPELLANT ARIZONA PUBLIC SERVICE COMPANY'S OPENING BRIEF

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INTRODUCTION

This appeal raises important questions of Arizona and federal law regarding the Arizona Corporation Commission's approach to setting rates for electricity provided by public service corporations ("PSCs"). While Arizona's Constitution empowers the Commission to set rates for utility services, it must do so lawfully and in a "just and reasonable" manner. In its November 9, 2021 decision (Decision 78317) setting electric rates for Arizona Public Service Company ("APS"), however, the Commission flouted these obligations, precluding APS from collecting reasonable rates that yield a constitutionally sufficient return on its investments.

Key aspects of Decision 78317 represent unlawful, and arbitrary and capricious, departures from the Commission's prior approach to ratemaking, threatening the certainty of the regulatory framework on which PSCs rely. Indeed, independent financial-market experts have concluded that the Commission's new approach has transformed Arizona into "'the single most value destructive regulatory environment'" for public utilities in the country. APPV13-012. If allowed to stand, the decision will drive up the cost of capital and debt for all Arizona PSCs; chill PSC investments critical to

statewide economic growth; increase utility prices for every citizen and business in Arizona; and threaten the future reliability of the State's electric grid, natural gas and water delivery, and other utility services. To correct the Commission's errors and restore a stable regulatory environment for Arizona PSCs, this Court should reverse several aspects of Decision 78317.

First, the Commission unlawfully disallowed APS's recovery of a significant investment in air pollution controls for the Four Corners Power Plant, which were necessary to keep the plant in operation. Seven years ago, the Commission approved APS's plan to expand its interest in Four Corners. The Commission recognized explicitly that APS would need to install EPA-required emission controls to operate the plant, it acknowledged the necessary costs involved, and it found the plan prudent. In reliance on those decisions, APS and Four Corners' other co-owners contracted with a third party to install the emission controls (known as Selective Catalytic Reduction equipment or "SCRs"). APS's proportionate share of these costs was $365.9 million.

The public reaped substantial benefits—Four Corners has remained in service, preserving the reliability of Arizona's electrical grid while California

suffered rolling blackouts. Yet years after approving the acquisition, in Decision 78317, the Commission changed course, finding $215.5 million of the environmental costs imprudent, even though there was no evidence APS could have reliably and affordably met its electric service obligations without the power generation the SCRS made possible.

Instead of such evidence, the Commission's decision was driven by and expressly premised on impermissible considerations of hindsight. The Commission seized on APS's January 2020 decision to exit coal and retire Four Corners early as purported evidence that APS never should have invested in Four Corners. The Commission also relied on recent changes in energy prices occurring long after APS's investment was completed and the SCRs were fully operational. But the Commission's own prudency regulations prohibit such retroactive considerations, and there is no evidence that APS's eventual exit from coal production was foreseeable when it made the investment in Four Corners.

To justify its decision, the Commission also contrived a novel, never-before-announced prudence standard that added a new procedural duty obligating APS to prove that it continually reconsidered its investment

throughout the course of the project. That standard contradicts the Commission's longstanding approach to prudence, which focuses on the circumstances at the outset of the investment and presumes, as Commission regulations require, that an investment was prudent absent clear and convincing evidence otherwise. By retroactively changing its standard long after APS completed its investment, the Commission upset APS's reasonable investment-backed expectations and violated constitutional requirements related to retroactivity and fair warning. It also acted arbitrarily and capriciously in violation of administrative law and constitutional standards and contradicted the Commission's own regulation. Without the flawed new standard, the $215.5 disallowance cannot stand.

Second, the Commission further exceeded its authority by setting an unreasonably low return on APS's investments. The Arizona Constitution guarantees PSCs "a fair return on the fair value of [their] properties." *ACC v. Ariz. Water Co.*, 85 Ariz. 198, 203 (1959). And the U.S. Constitution guarantees a return "commensurate with returns on investments in other enterprises having corresponding risks." *Fed. Power Comm'n v. Hope Nat. Gas Co.*, 320 U.S. 591, 603 (1944).

Here, the Commission set a return on equity that is one of the lowest in the Nation for investor-owned utilities. The Commission first calculated an unjustifiably low return of 8.9% using out-of-date risk premium information that arbitrarily and capriciously skewed that number downwards. The Commission then reduced that rate by 20 basis points—from 8.9% to 8.7%—to punish APS for alleged "deficiencies" in "customer service performance," APPV5-022. That penalty violated the constitutional requirement that the Commission set rates based on the marketwide return for comparable investments, and grossly exceeded the Commission's penalty authority.

The Commission also denied APS a fair return on its "fair value increment"—the amount by which the value of APS's assets exceeds their original cost. This Court has recognized that a fair return on the fair value increment is required to comply with the Arizona Constitution's "fair value" standard. The Commission disagreed, however. Reasoning that no return was required—but a *de minimis* return might stave off a lawsuit—it set a return of 0.15%, tantamount to no return at all. That result violates the constitutional "fair value" standard. It is also arbitrary and capricious because it rests on an erroneous view of the Commission's obligations, and the 0.15% return lacks any economic justification or record support.

The Commission's disregard for constitutional and regulatory standards and the basic requirements of reasoned decisionmaking discourages the capital investments needed to keep the lights on. Left unchecked, the Commission's approach will jeopardize the reliability—and drive up the price—of critical utility systems, including electricity, gas and water, to the detriment of Arizona's citizens who have long benefited from the state's strong economic growth. To hold the Commission to its legal obligations and protect Arizona PSCs' investment-backed expectations, these key flaws in Decision 78317 should be reversed.

STATEMENT OF THE CASE AND FACTS

I. Arizona Law Entitles APS To Collect Rates Sufficient To Recover Its Prudent Investments Plus A Reasonable Rate Of Return

As Arizona's largest and longest-serving energy provider, APS provides reliable and affordable electricity for 2.7 million Arizonans. To meet its responsibility as a PSC to reliably satisfy consumer demand, APS has invested billions of dollars in infrastructure.

Although APS's "assets are employed in the public interest to provide consumers of the State with electric power," APS is "owned and operated by private investors." *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989). As

a result, while the rates Arizonans pay APS are fixed by the Commission rather than the market, Ariz. Const. art. 15, § 3, APS "is entitled to realize a fair and reasonable profit," *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 149 (1956). The Arizona Constitution directs the Commission to prescribe "just and reasonable" rates based on the "fair value" of PSCs' investments, Ariz. Const. art. 15, §§ 3, 12, 14. And as the U.S. Supreme Court recognized in *Hope*, the U.S. Constitution guarantees a public utility's "equity owner[s]" a return that is both (1) "commensurate with returns on investments in other enterprises having corresponding risks"; and (2) "sufficient to assure confidence in [its] financial integrity." 320 U.S. at 603.

The Commission's regulations implement these requirements by allowing PSCs to recover their investments, plus a reasonable rate of return, through rates paid by customers. A.A.C. R14-2-103(A)(1), (3)(h). These investments are recoverable as part of the "'[o]riginal cost rate base'" if they are "prudently invested" and the property is "used or useful." A.A.C. R14-2-103(A)(3)(h). The Commission treats the original cost rate base as a component of the "fair value" of APS's investments—as the Arizona Constitution requires, *Simms*, 80 Ariz. at 155—and applies separate rates of return to the debt and equity portions of that rate base. APPV5-028-029. To the extent

the fair value of APS's investments exceeds their original cost, APS is also entitled to a return on the excess—called the "fair value increment." APPV5-023-024.

By Commission regulation, "[a]ll investments shall be presumed to have been prudently made." A.A.C. R14-2-103(A)(3)(*l*). That presumption "may be set aside only by clear and convincing evidence that such investments were imprudent"—*i.e.*, "dishonest or obviously wasteful"—"when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made." *Id.*

The regulations thus measure prudence based on circumstances "at the time [the] investments were made," and place the burden on the party challenging prudence to come forth with "clear and convincing evidence" that the investments were "dishonest or obviously wasteful." A.A.C. R14-2-103(A)(3)(*l*). For decades, the Commission followed that standard by assessing prudence on a total-project basis. That is, once a company prudently commits to an investment, the Commission has not second-guessed the decision to complete the project, nor required PSCs to continually reexamine the project's prudence along the way. APPV10-081-091.

II. The Commission Approves APS's Investment In The Four Corners Power Plant, Which Includes The Necessary Installation Of SCR Emission Controls

At issue here is APS's investment in Four Corners, a five-unit, coal-fired power plant within the Navajo Nation that services Arizona and New Mexico. APPV11-023. Four Corners is "jointly owned by APS and four other entities" that provide electricity in Arizona and New Mexico. APPV9-043.

In 2010, APS sought the Commission's authorization to acquire an additional interest in Units 4 and 5 of Four Corners as part of a larger plan that entailed shutting down Units 1-3 and installing SCRs on Units 4-5. APPV11-034. APS explained that installation of SCRs at Four Corners by 2018 was required under federal law, namely EPA's Regional Haze regulations, *id.*, which required Four Corners to reduce its emissions through the "Best Available Retrofit Technology" ("BART"), APPV11-028 & n.12.

In an April 24, 2012 decision (Decision 73130), the Commission approved the "proposed transaction"—expressly including the installation of SCR emissions controls—concluding that the proposal "would provide 'unique value' to [APS's] customers, both from an environmental and rate impact standpoint." APPV11-036-047; *see also* APPV11-028 (defining "proposed transaction" to include "add[ing] pollution control equipment to

Units 4 and 5"). The Commission rejected the Sierra Club's arguments that APS should reduce its reliance on coal generation, and instead emphasized the need to "maintai[n] a diverse energy supply portfolio that balances coal, gas, and nuclear generation to complement the growing role of renewable resources and energy efficiency needed to meet APS'[s] customers' energy needs." APPV11-045-046. The Commission explained that APS had "consider[ed] the financial risks of its coal generation exposure in its analyses and even considering those risks, the evidence showed that the proposed transaction resulted in a 'clear and significant discount'" to consumers. APPV11-046.

On December 30, 2013, APS closed the acquisition and sought the Commission's leave to reflect the acquisition costs in its rates. APPV11-073. APS again disclosed that the project would require installation of SCRs at a then-estimated cost of $365.6 million. APPV11-064; *see also* APPV11-066-067 (indicating that this estimate was presented to the Commission).

On December 12, 2014, in Decision 74876, the Commission found the acquisition prudent and allowed APS to recover the costs of expanding its ownership interest in Four Corners Units 4-5 through rates, plus a commensurate return on that investment. APPV11-088. The Commission

reasoned that the project—which it acknowledged was expressly premised on the "installation of … SCRs—would "help ensure the continued provision of reliable and reasonably priced electricity for APS's customers." APPV11-076, -088. It emphasized that Commission staff—who found a "99.4 percent chance" that the acquisition (factoring in the expected costs of SCRs) would have "positive net present value," APPV11-081—had "vigorously tested the validity of APS's analytical approach and the data and models APS used" to justify the project, APPV11-083. The Commission also recognized that the project would "greatly suppor[t]" the Navajo Nation by preserving jobs at the power plant and the adjacent coal mine. APPV11-074, -083.

III. APS Installs SCRs And Seeks To Recover The Cost Of Installation

In August 2015, APS entered into a consent decree with the EPA, agreeing to install SCRs on Units 4-5 by 2018 in satisfaction of environmental laws. APPV2-015. Later that month, APS executed an SCR construction agreement with its vendor and co-owners, *id.*, cementing its legal commitment to fund the SCRs installation. APS thereafter completed installation, and the Unit 4 and 5 SCRs entered service in April 2018 and December 2017, respectively. *Id.*

In April 2018, APS sought approval from the Commission—now constituted with new members—to include in its rates $383.1 million for the SCRs, reflecting $365.9 million in installation costs plus deferred operating expenses. APPV2-017. Following a lengthy hearing, the Commission's Administrative Law Judge ("ALJ") issued a Recommended Opinion and Order ("ROO") in November 2018 recommending a finding—based on testimony from the Commission staff's witness—"that the SCR project was completed in a cost-efficient, reasonable and prudent manner and that the fair value rate base associated with APS's ownership interest is $383.096 million." APPV11-113.

The Commission never acted on the 2018 ROO, however. Instead, it directed APS to commence the present rate case, which addresses a range of issues, including the SCRs. APPV1-023, -067. APS commenced the case in October 2019, and again sought recovery of $383.1 million for the SCR project, plus $32.8 million in additional deferred operating expenses, for a total of $415.9 million. APPV2-017-019.

IV. Responding To New Developments, APS Announces A New Commitment To Exit Coal Generation By 2031

While this case was pending, APS announced a historic new Clean Energy Commitment in January 2020. APPV1-054. Among other things, APS committed to exiting coal generation, and retiring Four Corners, by 2031—seven years earlier than originally planned. *Id*. The commitment reflected APS's response to growing demand for sustainable energy sources from customers, business organizations, and non-governmental organizations. APPV13-042.

Opponents of coal-fired generation seized on the announcement as a basis to challenge cost-recovery for the SCRs. *See, e.g.*, APPV9-088. No party, however, presented any evidence that the 2020 decision to exit coal-fired generation in 2031 was foreseeable when APS decided to install the SCRs, or indeed at any time before installation was complete. Nor did any party identify any alternative resource portfolio by which APS could have reliably met its service commitments at a lower cost without installing SCRs—much less one that APS should have anticipated when it made the SCR investment. The Commission's staff supported allowing APS to include the SCRs in its rate base. APPV2-031.

V. Nearly Seven Years After Approving APS's Four Corners Investment, The Commission Backtracks

On November 9, 2021, the Commission issued Decision 78317. Relying extensively on hindsight—particularly APS's 2020 decision to retire Four Corners in 2031—the Commission reversed course, disallowed APS from recovering most of its SCR investment, and slashed APS's rate of return on its investments, significantly reducing APS's rates from the level APS sought.

A. From the outset, several Commissioners made clear that they viewed this case as an opportunity to "achieve a rate decrease" for APS's customers. APPV9-045; *see also* APPV9-092 (discussing objective of "reduc[ing] the authorized rates"). The Commission thus cycled through a series of results-driven, rate-reducing proposals that offered various theories for disallowing or postponing recovery of different portions of the cost of installing SCRs. *See* APPV9-110-113; APPV10-008-017; APPV10-043-049; APPV10-050-051; APPV10-052-063; APPV10-064-071. The Commission settled on a decision to disallow $215.5 million in SCR costs—nearly 60% of the $365.9 million APS requested for SCR installation. APPV2-042. But the Commission did not identify any particular expenditures that it found

imprudent. Instead, the amount of the disallowance was expressly calculated "based on the early (2031) retirement of the SCRs," *id.* n.189, even though that retirement decision was not made until years after the investment was completed.

The linchpin of the Commission's decision was what it called "planning imprudence"—a novel standard the Commission had never before applied or purported to adopt. APPV2-042. Rather than evaluate the objective prudence of the decision to invest on a total-project basis, as it had done for decades, the Commission held for the first time that "each investment made along the way"—*i.e.*, each additional expenditure on an ongoing project—"is subject to a prudency determination" based on the separate circumstances at each step. APPV2-038. And rather than presuming prudence absent clear and convincing evidence of "dishones[t]" or "obvious[ly] wasteful[l]" expenditures, as required by its regulation, the Commission shifted the burden, creating and imposing on APS (and all PSCs) a new procedural "duty to monitor the economics of its investments" even after the investment is initiated and until the project investment ceases. *Id*. Because APS purportedly failed to conduct *additional* economic analyses during the SCR project but *after* the Commission had approved it in 2014, the

Commission deemed $215.5 million of the project imprudent and disallowed that part of the investment. APPV2-039 (emphasis added).

B. The Commission compounded its error by setting a historically low rate of return on the equity and fair value increment portions of APS's investments.

Return on equity: The Commission determined that APS's original cost rate base (i.e., its invested capital) totalled $8,607,103,000, including $4,705,503,000 in equity and $3,901,600,000 in debt, and allowed a return of 8.7% on equity and 4.1% on debt. APPV4-078, APPV5-028, -022, APPV2-050. To determine return on equity, the parties submitted competing calculations of the "[c]ost of [e]quity"—the return that "investors could earn by investing in other enterprises of comparable risk"—which is the relevant standard under *Hope*. APPV4-079, APPV5-022. APS's expert calculated 10%; the Commission's staff calculated 9.4%. APPV4-080. A group of federal executive agencies ("FEA") calculated 9.3%. *Id*. Arizona's Residential Utility Consumer Office ("RUCO"), which represents ratepayers before the Commission, calculated 8.9%. APPV5-015. Another ratepayer group—Arizonans for Electric Choice & Competition ("AECC")—used 9.75% in its analyses. APPV4-080. APS offered to accept the mean of these calculations

(9.47%). *Id*. But the Commission accepted RUCO's obvious low-ball calculation of 8.9%, APPV5-022, without any response to APS's criticisms that it reflected decades-old data that was inconsistent with contemporary returns, APPV5-009.

The Commission then applied a "20-basis point [(0.2%)] reduction" based on alleged "deficiencies in APS's customer service performance." APPV5-022. Chairwoman Márquez Peterson explained that the reduction was intended as a "penalty, in essence," APPV10-041, but the Commission gave APS no prior notice that it was considering such a penalty. The resulting 8.7% rate of return is one of the lowest in the Nation among investor-owned utilities, notwithstanding heightened risks faced by APS, including from owning and operating a nuclear power plant. *See* APPV10-093.

<u>Return on fair value increment</u>: The Commission also calculated a fair value increment of $3,418,936,000, meaning the fair value of APS's assets exceeded their original costs by $3,418,936,000. APPV4-078. As the Commission's staff recognized, the Commission has "consistently" allowed a return on the fair value increment based on the expected return on a risk-free investment. APPV5-027. APS's witness thus testified that APS was

entitled to a return equal to the risk-free rate of 1.28%. APPV5-023. APS offered to compromise between 0.6% and 0.8%. *Id.*; APPV9-104.

The Commission instead limited APS's return on this fair value increment to just 0.15%, APPV5-028. Bucking the Arizona Constitution's requirement that PSCs receive "a fair return on the fair value of [their] properties"—not just on the "original cost" of their investments, *Ariz. Water Co.*, 85 Ariz. at 203—the Commission held that "there is no justification" or "legal mandate" for "authorizing a positive return" on the fair value increment, APPV5-028. Thinking it might avoid a "lawsuit predicated on the Commission's denying" a positive return, the Commission nonetheless allowed a nominal return of 0.15%, but offered no justification for choosing that amount. *Id*.[1]

STATEMENT OF THE ISSUES

Whether the Commission acted unlawfully, arbitrarily and capriciously, and without substantial evidence when it:

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[1] APS timely applied for rehearing on November 24, 2021. The 20-day deadline for the Commission to rule on the application expired on December 14, 2021. APS timely filed a notice of appeal on December 17, 2021. This Court has jurisdiction pursuant to A.R.S. § 40-254.01(A).

(1) disallowed APS's recovery, through rates, of $215.5 million of its capital investment in SCRs for Units 4 and 5 of the Four Corners Power Plant; and

(2) established a return of: (a) 8.7% on the equity portion of APS's rate base; and (b) 0.15% on the fair value increment of APS's rate base.

ARGUMENT

I. Standard of Review

A.R.S. § 40-254.01 requires courts to set aside "any order of the commission involving [PSCs] and relating to rate making" upon a "clear and satisfactory showing that the order is unlawful or unreasonable," *id.* § 40-254.01(A), (E), including because it was "arbitrary" or "unsupported by substantial evidence," *Litchfield Park Serv. Co. v. ACC*, 178 Ariz. 431, 434 (App. 1994). Courts review "issues of constitutional and statutory compliance … de novo" without "'defer[ring] to the Commission's interpretation of its own ratemaking authority.'" *Sun City Home Owners Ass'n v. ACC*, 252 Ariz. 1, 5 ¶ 18 (Ariz. 2021). Further, A.R.S. § 12-910(F) provides that in proceedings brought by "the regulated party, the court shall decide all questions of law" and "all questions of fact without deference to any previous determination that may have been made on the question by the agency."

II. The Decision To Deny Full Cost Recovery For The SCRs Is Arbitrary And Capricious, Unlawful, And Unsupported By Substantial Evidence

The Commission first abused its discretion by disallowing $215.5 million of APS's investment in the Four Corners SCRs. APPV2-042. The SCRs were an integral part of APS's plan to acquire a greater interest in Four Corners Units 4-5 and bring them into compliance with EPA emissions requirements for continued operation. *Id.* The Commission approved that plan (expressly including the SCR installation) and deemed the acquisition prudent knowing full well the SCR costs necessarily entailed. Having reaped the public benefit of APS's substantial SCR investment in reliance on that approval, however, the Commission now seeks to deny APS compensation for nearly 60% of what it spent to install SCRs. That denial is expressly driven by APS's 2020 decision to retire Four Corners early, a decision made years *after* APS completed its investment in SCRs—indeed, after the SCRs were operational. But the Commission's own regulations prohibit it from judging APS's investment decisions in hindsight.

The Commission thus hides behind a novel "planning imprudence" standard that challenges APS's *process* for reassessing its investment decisions rather than the objective merits of those decisions at the time they were

made. APPV2-042. But that new standard unlawfully departs from both the Commission's longstanding approach to prudence and its regulations defining that term. And the Commission's further efforts to insulate its decision through purported findings about low-gas-price projections and intentional manipulation lack record support and cannot justify the decision. This Court should therefore reverse the Commission's unlawful SCR disallowance and direct the Commission to allow recovery of APS's full SCR costs.

A. The Decision Is Expressly Premised On Impermissible Hindsight

The Commission's regulations are clear that the prudence of a PSC's investments must be judged without the benefit of hindsight. A PSC's investments are "presumed to have been prudently made" absent "clear and convincing evidence" to the contrary. A.A.C. R14-2-103(A)(3)(l). That evidence must show that the investments were imprudent "in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, *at the time such investments were made*." *Id.* (emphases added). And under "general principle of administrative law," "'an agency must follow its own rules and regulations'"—"'to do otherwise is unlawful.'" *McKesson Corp. v. Ariz. Health Care Cost Containment Sys.*, 230

Ariz. 440, 443 ¶ 9 (App. 2012) (quoting *Clay v. Ariz. Interscholastic Ass'n*, 161 Ariz. 474, 476 (1989)).

Here, the Commission failed to follow its regulations because its SCR disallowance was expressly predicated on hindsight. Construction on Units 4-5 was completed by April 2018 and December 2017, respectively, and the decision to proceed with construction was made much earlier. APPV1-086-087. Yet the Commission's disallowance decision repeatedly relied on developments that postdated the installation of the SCRs entirely, and additional information that postdated APS's investment decisions. Whichever of these times is considered "the time [APS's] investments were made," A.A.C. R14-2-103(A)(3)(l), the Commission's extensive reliance on hindsight is unlawful.

1. Before APS announced its decision to retire Four Corners early, the Commission never questioned the prudence of the SCR investment. To the contrary, in 2014, the Commission found APS's Four Corners acquisition "prudent," while recognizing that it necessarily encompassed "installation of … SCRs." APPV11-076, -090. The Commission thoroughly evaluated and rejected alternative generation resources, finding each more costly than continuing to operate Four Corners even with the addition of SCRs. APPV11-

081-084. The Commission concluded that the acquisition would "help ensure the continued provision of reliable and reasonably priced electricity for APS's customers." APPV11-090.

In reaching that conclusion, moreover, the Commission was fully aware of the estimated cost of the SCRs: APS disclosed that the project would require installation of SCRs at an estimated cost of $365.6 million, *see supra* at 19—nearly identical to the amount ($365.9 million) that APS now seeks in installation costs, APPV2-017. If these future, necessary SCR investments had been imprudent, the acquisition of APS's additional interest in Units 4-5 could not have been approved, because those units could not be operated past 2018 without SCRs. Yet the Commission unambiguously approved the transaction as a whole, and in doing so necessarily determined that the overall plan was prudent.

The principal change between 2014 and now (other than election of new Commissioners) was APS's 2020 decision to retire Four Corners early. By the Commission's own telling, "the disallowance of $215.5 million is based on the early (2031) retirement of the SCRs." APPV2-042 n.189. But that decision was not made until January 2020—long after the decision to

make the SCRs investment had been completed and the SCRs were fully operational. APPV1-054, APPV2-015-016. The Commission acknowledges that "[u]ntil APS made its Clean Energy Commitment" in 2020, "all indications were that the SCRs would provide … service" from "April 2018 to July 2038." APPV2-041.

The Commission cites no evidence that before the SCRs were completed, APS should have known it would retire Four Corners early. Nor does it cite evidence that APS should have anticipated the developments—including growing demand for renewable energy sources from customers, business organizations, and non-governmental organizations—that drove APS's decision to exit coal generation. *See supra* at 22. The Commission's reliance on Four Corners's early retirement is thus pure, impermissible hindsight.

2. The Commission's analysis is also replete with other references to information and circumstances that post-date the completion of the SCR project in April 2018. In particular, the Commission compared *2019* solar PPA and natural gas prices, *current* prices for wind resources and battery storage, and allegedly *current* (*but now entirely inaccurate*) *projections* of "low" natural gas prices to the *current* cost of energy from Four Corners. APPV2-

040. But none of this evidence shows what prices APS should have predicted years earlier when it decided to install SCRs. And, of course, gas prices are inherently volatile, as evidenced by current prices that vastly exceed the purportedly "low" prices that the Commission "expected" to continue through 2029.[2]

The Commission also considered longer-term changes in renewable energy prices, stating, for example, that "[s]olar PPA prices declined by more than 80% between 2009 and 2019," and photovoltaic prices "decreased by 70% between 2010 and 2019." APPV2-040. But any price decline *before* the December 2013 Four Corners acquisition was already considered in the Commission's 2014 decision (Decision 74876) finding the acquisition prudent. And any decline *after* the SCR investment decision is impermissible hindsight. A ten-year range of price changes thus says nothing about the information available when APS made the relevant decision.

[2] For example, the Commission projected SoCal Border Hub prices to remain under $3/MMBtu, APPV2-040, but as of the week of this filing, they are $6.26/MMBtu. APPV13-061. The Energy Information Administration reported the expected average price for the second quarter of 2022 as $5.85/MMBtu. APPV13-059.

3. Compounding the Commission's error is the Commission's failure to identify "the time such investments were made"—as required by its own prudence regulation. A.A.C. R14-2-103(A)(3)(l). While the SCRs were *completed* by 2018, APS had to decide years earlier whether to invest in SCRs.

By December 2013, APS had invested hundreds of millions of dollars in the Four Corners acqusition, with the Commission's approval, expressly including SCR installation. APPV11-073. Abandoning Four Corners a few years after the acquisition—as would have been required without SCRs—would have squandered APS's investment, leaving APS's ratepayers with nothing to show for their contributions to the acquisition. Doing so would have been wasteful and inefficent, especially when there was no evidence that APS or its customers would have saved any money as a result.

No party has offered evidence of how APS could have reliably met its electricity generation obligations while abandoning Four Corners. Indeed, the Sierra Club—the SCR project's principal opponent—concedes that it "did not present a reliability analysis demonstrating that Four Corners could have been replaced with a specific alternative portfolio." APPV10-097. With no identifiable alternative to Four Corners, APS thus had no choice by 2013

but to decide to install SCRs. Moreover, the "community impacts of retiring the plant are significant" and would have had to be "carefully considered even before such evaluations could be made." APPV9-043.

APS was also legally committed to funding SCR installation. "Four Corners is jointly owned by APS and four other entities, and together the owners have a coal contract that runs through 2031." APPV9-043. And in August 2015, APS executed a SCRs construction agreement with its contractor and the other Four Corners co-owners, agreeing to fund SCR installation. APPV2-015-016. Between those two contracts, it was "not an option for APS to retire the plant without the agreement of the other owners," each of whom had their own right to generation from Four Corners and relied on that generation to supply their customers. APPV9-043. Given the long lead time and expenditures required to add generation capacity, APPV9-102, moreover, there is no evidence that APS could have met its generation commitments had it chosen in 2015 or later to retire Four Corners by 2018.

By August 2015 at the latest, therefore, APS's full SCR investment was *fait accompli*. That is less than two years after the Four Corners acquisition, and less that a year after the Commission found that acqusition prudent,

endorsing its staff's finding that the acquisition had a "99.4 percent chance" of yielding "positive net present value," APPV11-081, -083.

The Commission's hindsight analysis takes no account of that timing. Discussion of *present-day* energy prices and *ten-year* trends—let alone APS's 2020 decision to exit coal generation in 2031—says nothing about what APS "kn[ew]" or "should have … known" in 2015. It certainly does not show that price expectations so dramatically changed between December 2013 and August 2015 that APS should have concluded that its only cost-effective option was to abandon its investment in Four Corners and somehow immediately secure replacement energy generation capacity.

4. The *amount* of the Commission's disallowance also reflects impermissible hindsight. Because the Commission never specified *when* the investment was made or *when* it supposedly became imprudent, it never made any finding linking its $215.5 million disallowance to the amount APS invested after that unknown date, or comparing that amount to the cost of any hypothetical course of conduct. Instead, the amount disallowed had nothing to do with the timing of the investment. It was expresly "based on the early (2031) retirement of the SCRs." APPV2-042 n.189. Because the Commission failed to identify what portion—if any—of APS's investment

occurred after the investment purportedly became imprudent, the disallowance cannot stand.

B. The Commission Applied An Invalid And Improperly Adopted New Prudence Standard

To justify its hindsight-based decision, the Commission devised an unlawful new prudence standard with no precedent in any Commission decision or regulation. Rather than assess the economics of the overall project, based on circumstances at the time the PSC committed to the project, the Commission's new "planning imprudence" standard takes a piecemeal approach to prudence and focuses on whether the PSC conducted an ongoing reassessment, not on the objective prudence of the investment itself. APPV2-042. The Commission announced its newfound "belie[f]" that "each investment made along the way" requires a separate "prudency determination." APPV2-038. Without prior warning, the Commission then imposed a retroactive "duty" on APS to "monitor the economics of its investments" as part of the prudence inquiry, and held that APS's purported failure to perform "additional economic analyses" throughout the course of the SCR project itself violated that duty and was sufficient grounds for disallowing the investment. APPV2-038-039. The Commission reached this

result without any showing that, had APS performed the retroactively required analyses, the information reasonably available at the time would have revealed an economically viable alternative solution that would have ensured reliable energy production to the Arizona public at lower cost.

The Commission's new approach exceeds its authority for three principal reasons: It constitutes an unlawful retroactive change in the Commission's longstanding approach to prudence; the Commission failed to acknowledge and justify this change; and the new standard is directly at odds with the regulation through which the Commission carries out its constitutional duty to set "just and reasonable rates." Ariz. Const. art. 15, §§ 3, 12.

1. The New Prudence Standard Is Unlawfully Retroactive

The Commission's novel approach to assessing planning imprudence runs afoul of the Commission's longstanding practice of evaluating prudence on a total investment basis. *See* APPV10-081-091. For example, in Decision 55931, the Commission *rejected* an argument that APS "should have stopped construction" on a power plant based on a "retrospective regression analysis" purporting to show that continuing the project was no longer prudent. APPV11-013. The Commission held that it need not even "repeat" or

"summarize" substantive "criticisms" of the analysis because the analysis was simply "not sufficient" to establish imprudence given the rule that investments be judged "'at the time such investments were made.'" *Id.*

Similarly, in Decision 77850, the Commission held that past expenditures on an ongoing pipe replacement program were prudently incurred—even though the Commission later discontinued the program as unnecessary—because the PSC had "compl[ied] with the terms and conditions of the Commission-approved ... program." APPV12-015. Notwithstanding the lack of evidence of any "immediate public health and safety concern" supporting the program, the Commission treated its original decision to approve the project as sufficient to support continued recovery up to the point where the Commission ordered the program discontinued. APPV12-020; *see also* APPV10-081-091 (listing additional examples).

Here, by contrast, rather than assessing the prudence of the total investment "at the time such investments were made," as required under A.A.C. R14-2-103(A)(3)(*l*), the Commission found that APS should have reassessed each expenditure throughout project development for the SCRs until the project was completed. The decision thus imposes a hitherto-unrecognized "duty" on APS "to monitor the economics of its investments" at the

risk of disallowance. APPV2-038. That duty has no precedent in the Commission's prior prudency decisions and was imposed retroactively without advance notice to APS. The Decision does not even attempt to identify any way APS could have prophesied in advance that the Commission would require it to reassess an investment decision that the Commission itself had already approved, let alone be faced with disallowance if it failed to conduct continual reassessments of prudency to the subsequent satisfaction of the Commission.

By imposing this new approach years after APS completed its investment in reliance on the Commission's prior approach, the Commission violated the constitutional limits on retroactive rulemaking and APS's right to fair notice of its duties as a regulated entity.

Under Arizona law, a law may not "'attac[h] new legal consequences to events completed before its enactment'" or "disturb vested substantive rights by retroactively changing the law that applies to completed events." *San Carlos Apache Tribe v. Superior Court ex rel. Cty. of Maricopa*, 193 Ariz. 195, 205 ¶ 15 (1999) (en banc). Laws that "retroactively alter vested substantive rights" thus "violate the due process clause" of the Arizona Constitution. *Id.* at 205-06 ¶ 16. The same is true in the regulatory context. *See George v. ACC*,

83 Ariz. 387, 390-91 (1958). "Retroactive regulations are just as obnoxious as retroactive laws" because "the whole spirit of our government is opposed thereto, and unless the legislative authority expressly declares regulations may be retroactive, it is beyond the power of a commission or subordinate body to give them that effect." *Taylor v. McSwain*, 54 Ariz. 295, 312-13 (1939).

With respect to adjudicative decisions, Arizona courts apply a three-factor test to determine whether an adjudication should be given "prospective application only": "(1) [w]hether the decision establishes a new legal principle by either overruling clear and reliable precedent or deciding an issue whose resolution was not clearly foreshadowed; (2) [w]hether retroactive application will further or retard operation of the rule, considering its prior history, purpose and effect; and (3) [w]hether retroactive application will produce substantial inequitable results." *Mark Lighting Fixture Co. v. Gen. Elec. Supply Co.*, 155 Ariz. 27, 30 (1987) (en banc).

All three factors weigh against applying a new prudency standard retroactively here.

First, the Commission's novel "planning imprudence" standard is a "new legal principle" that is contrary to the Commission's longstanding "precedent" and was never "foreshadowed"—clearly or otherwise—by any

past Commission decision. *Mark Lighting*, 155 Ariz. at 30. A new rule is not foreseeable when no prior decisions "even broache[d] the subject," *Hawkins v. Allstate Ins. Co.*, 152 Ariz. 490, 504 (1987). Here, the Commission never signaled its "planning imprudence" standard prior to this case. APS had no indication when the Commission approved its acquisition of an additional interest in Units 4-5 that the Commission would later second-guess an essential premise of that acquisition.

Second, "retroactive application will … retard"—not "further"—"operation of the rule." *Mark Lighting*, 155 Ariz. at 30. A rule purportedly meant to encourage prudent planning is effective only if regulated entities know of the duty in advance. Applying the rule retroactively deprived APS of the opportunity to conduct the type of ongoing reassessments the Commission now says are required.

Third, retroactive application would have "inequitable results." *Mark Lighting*, 155 Ariz. at 30. This factor "focuses on the injustice or hardship that would result from retroactive application of the new rule." *Fain Land & Cattle Co. v. Hassell*, 163 Ariz. 587, 597 (1990) (en banc). As in *Fain Land*, allowing the Commission to apply its novel prudence standard retroactively would "inflict great hardship" on "innocent people," and "disrupt the economy of

the state," *id.*, by destroying APS's reasonable investment-backed expectations and threatening APS's and other PSCs' ability to access capital on reasonable terms for future capital projects needed for the Arizona economy. APPV10-024; -031-036.

Inequities also arise when a new rule subjects a party to additional claims in "'cases [it] previously believed had been finalized.'" *Wiley v. Indus. Comm'n*, 174 Ariz. 94, 104 (1993) (en banc). Here, the Commission's traditional approach and prior decisions gave APS ample reason to believe that the Commission had already confirmed the need for the SCRs investment by finding the acquisition of an additional interest in Units 4-5 to be prudent and beneficial while recognizing that the SCRs were essential to achieve the benefits of continued operation of those units. And the Commission's regulations and prior approach to prudence determinations more generally gave APS every reason to anticipate that even if the prudence of the SCRs investment had not already been determined, it would be assessed on a total investment basis without applying an unknown duty to conduct an expenditure-by-expenditure reassessment on an ongoing basis.

Independent of the constitutional limitations on retroactive rulemaking, moreover, the due process clause of the U.S. Constitution requires at a

minimum that an agency give regulated entities "fair warning of the conduct it prohibits or requires." *Gates & Fox Co. v. OSHRC*, 790 F.2d 154, 156 (D.C. Cir. 1986). "In the absence of notice—for example, where the regulation is not sufficiently clear to warn a party about what is expected of it—an agency may not deprive a party of property," as the Commission has done here by disallowing recovery of a substantial portion of APS's investment. *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1328-29 (D.C. Cir. 1995), *as corrected* (June 19, 1995). This fair-notice requirement—which "has now been thoroughly 'incorporated into administrative law'"—"'compels clarity' in the statements and regulations setting forth the actions with which the agency expects the public to comply." *Id.* at 1329. By imposing a new duty with no precedent in prior agency decisions and no basis in the Commission's regulations, the Commission thus violated APS's right to due process.

2. The Commission's Decision Is Arbitrary And Capricious Because The Commission Failed To Acknowledge And Justify Its Change In Approach

The change in standards is also arbitrary and capricious because the Commission failed to acknowledge that it was changing its approach, failed to justify that change, and failed to consider APS's reasonable investment-

backed reliance on the prior approach. Arizona courts judge the reasonableness of agency actions by the same generally accepted principles of administrative law applied by federal courts under the federal Administrative Procedures Act. *See, e.g.*, *Compassionate Care Dispensary, Inc. v. Ariz. Dep't of Health Servs.*, 244 Ariz. 205, 213 ¶ 25 (App. 2018) (applying *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)). Under those well-established principles, "the requirement that an agency provide reasoned explanation for its action … ordinarily demand[s] that it display awareness that it *is* changing position." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009). "An agency may not … depart from a prior policy *sub silentio*," and it "must show that there are good reasons for the new policy." *Id.* "A full and rational explanation becomes 'especially important' when … an agency elects to 'shift its policy' or 'depart from its typical manner of' administering a program." *Sw. Airlines Co. v. FERC*, 926 F.3d 851, 856 (D.C. Cir. 2019) (alterations omitted).

While an agency need not demonstrate that its new policy is better than the old one, it must at least "acknowledge [those] precedents" and then either "distinguish them" or explain its "rejection of their approach." *Tenn. Gas Pipeline Co. v. FERC*, 867 F.2d 688, 692 (D.C. Cir. 1989). The agency must

also "take account of legitimate reliance on [its] prior interpretation[s]" and policies. *Smiley v. Citibank (S.D.), N. A.*, 517 U.S. 735, 742 (1996). Failure to do so is "'arbitrary, capricious,'" or "'an abuse of discretion.'" *Id.* (quoting 5 U.S.C. § 706(2)(A)). And arbitrary decision-making is incompatible with the Commission's duty to set "just and reasonable" rates. Ariz. Const. art. 15, §§ 3, 12.

Here, the Commission has neither acknowledged its change of practice, attempted to justify it, nor considered APS's reliance interests. Those failures alone render its decision arbitrary and unlawful. But those failures are aggravated here by the fact that the Commission has chosen to apply its new approach retroactively in a manner that divests APS of its reasonable investment-backed expectations. While an "agency need not always provide a more detailed justification" for a change of position "than what would suffice for a new policy created on a blank slate," "[s]ometimes it must—when, for example, … its prior policy has engendered serious reliance interests that must be taken into account." *Fox*, 556 U.S. at 515. Indeed, it "would be arbitrary or capricious to ignore such matters. In such cases it is not that further justification is demanded by the mere fact of policy change; but that a

reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy." *Id*. at 515-16.

The Commission's unacknowledged change in standards also puts its decision at odds with the Commission's allowance of full cost recovery of the same investment to Tucson Electric Power Company ("TEP"), a co-owner of Four Corners Units 4-5. The Sierra Club challenged TEP's investment in Four Corners, requesting "that the Commission disallow recovery of test year capital costs" at the Plant "until the Company has presented rigorous analyses justifying the continued operation of those plants." APPV12-023. But the Commission rejected this argument, reasoning that Sierra Club "ha[d] not presented any factual or legal basis to support a finding that TEP's investment in … Four Corners was imprudent *at the time it was made*." APPV12-024 (emphasis added). The Commission thus allowed TEP full recovery for its capital costs, which necessarily included the SCRs investment that TEP made jointly with APS. *See* APPV13-010 (showing TEP's share of capital costs for installing SCR technology on Units 4-5). Rather than place the burden on TEP to conduct and present to the Commission "rigorous analyses justifying the continued operation of those plants," as it did with

APS, the Commission followed its regulation by judging TEP's investment "at the time it was made." APPV12-023-024.

The Commission's inconsistent treatment of APS and TEP is arbitrary and capricious. As federal courts have recognized in construing the parallel federal prohibition against arbitrary agency decisionmaking, "'disparate treatment'" of "similarly situated entities" is unlawful, *Lilliputian Sys., Inc. v. PHMSA*, 741 F.3d 1309, 1313 (D.C. Cir. 2014), because government "is at its most arbitrary when it treats similarly situated people differently," *Etelson v. OPM*, 684 F.2d 918, 926 (D.C. Cir. 1982). An agency seeking to draw distinctions between similarly situated entities therefore must give a "reason for its differing treatment[.]" *Id*. at 927. But the Commission failed to "articulat[e] an adequate explanation" for its disparate treatment. *Int'l Fabricare Inst. v. EPA*, 972 F.2d 384, 389 (D.C. Cir. 1992). The Commission's failure to justify its departure from past decisions even as to the *same* investment is textbook arbitrary decisionmaking.

3. The Commission's New "Planning Imprudence" Standard Violates The Commission's Own Regulations

The Commission's novel prudence standard also directly contravenes the Commission's own regulation defining prudence. The new standard

thus violates the well-established "general principle of administrative law" that "'an agency must follow its own rules and regulations.'" *McKesson*, 230 Ariz. at 443 ¶ 9.

The Commission's regulations define a regulated entity's "[o]riginal cost rate base"—investment costs that the entity may recover through its rates—based on the "depreciated original cost, prudently invested," of its "used or useful" property. A.A.C. R14-2-103(A)(3)(h). To count towards the rate base, therefore, an investment must be both "prudently invested" and "used or useful." *Id.* The regulations define "[p]rudently invested" to include all "[i]nvestments which under ordinary circumstances would be deemed reasonable and not dishonest or obviously wasteful." A.A.C. R14-2-103(A)(3)(*l*). The definition further provides that "[a]ll investments shall be presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that such investments were imprudent, when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made." *Id.*

The Commission's novel "planning imprudence" standard, APPV2-042, cannot be squared with this regulation, for at least two reasons.

First, the regulation defines the relevant standard in terms of the prudence of the "investment," not the prudence of the planning process leading to (or post-dating) the decision to invest. The regulation states that all "[*i*]*nvestments* which under ordinary circumstances would be deemed reasonable and not dishonest or obviously wasteful" are prudent, and that "[a]ll *investments* shall be presumed to have been prudently made," absent "clear and convincing evidence that such *investments* were imprudent[.]" A.A.C. R14-2-103(A)(3)(*l*) (emphases added). The rule thus makes clear that the prudence inquiry is focused solely on the objective question of whether the "investment" itself was prudent, given the known or reasonably ascertainable conditions when the PSC became obligated to make the investment. The rule says nothing about the prudence of the evaluation or planning mechanism by which the PSC decided to make the investment or about whether or how frequently the PSC must reexamine the wisdom of the investment after it commenced. A mere absence of continual reassessments in no sense establishes that the investment was "dishonest or obviously wasteful," so it cannot satisfy the regulation's definition of imprudence. *Id*.

By nonetheless shifting focus to the planning process, the Commission impermissibly substituted a procedural duty (to conduct ongoing prudence

reassessments) for the substantive standard imposed by the rule. But the regulation is clear that a regulated entity's failure to "exercise … reasonable judgment" during the planning process does *not*, standing alone, establish the imprudence of the investment. A.A.C. R14-2-103(A)(3)(*l*). To the contrary, if the regulated entity fails to apprise itself of "all relevant conditions" that it "should have … known" in the "exercise of reasonable judgment," the consequence is merely that the Commission may take those conditions into account in assessing the objective prudence of the "investment." *Id.* The consequence is *not* that the investment is automatically deemed imprudent without regard to whether it would have been justified "in the light of all relevant conditions." *Id.* If that were the consequence, the provision's reference to conditions that "should have been known" would serve no purpose and be "rendered superfluous"—in violation of basic rules of interpretation, *State v. Deddens,* 112 Ariz. 425, 429 (1975) (en banc)—since the failure to "exercise reasonable judgment" alone would establish imprudence and obviate the need for further inquiry.

Second, by imposing on APS a "duty to monitor the economics of its investments," APPV2-038, the Commission violated the presumption of prudence and the allocation of the burden of proof mandated by the regulation.

Under the regulation, "[a]ll investments shall be presumed to have been prudently made." A.A.C. R14-2-103(A)(3)(*l*). The regulation thus places the burden on those challenging an investment to produce "clear and convincing evidence" that the investment was objectively imprudent. *Id.* The Commission's novel "duty to monitor," by contrast, impermissibly overturns the presumption and shifts the burden of proof, requiring APS to establish that it has continually reexamined and reconfirmed the economic justification for the investment throughout the project.

The Commission has thus claimed the right to make a finding of imprudence despite the absence of any evidence (let alone clear and convincing evidence) that the investment was imprudent at the relevant point in time. As a result, the Commission never attempted to explain or cite evidence that the most cost-effective approach to providing reliable service to APS's customers would have been to cancel the SCRs project, shut down Four Corners by 2018, and make the other (unexplained) investments necessary to replace the resulting massive loss of generation capacity. Sierra Club admits that no such evidence was presented. *See supra* at 35.

To the contrary, the record reflects that Four Corners is "an invaluable resource when it comes to reliability," APPV9-079, and its unplanned retirement would have "caus[ed] a resource-constrained market to be even more resource-constrained," "potentially leading to rolling blackouts in Arizona," APPV9-041. "[D]uring the heat storm" in summer 2020, Four Corners Units 4-5 "operated at virtually full capacity," and as a result, "APS, unlike some other utilities in the West, was able to keep the lights on for [its] customers." APPV9-079.

This evidence is undisputed. The Commission expressly acknowledged that "the SCRs were used and useful," including "most notably during the heat storm in August 2020," APPV2-042, when neighboring states suffered rolling blackouts that Arizona avoided—thanks to Four Corners, APPV9-036-037. The Commission thus did not dispute APS's evidence that the SCRs have been "crucial to reliability of service during the summer months." APPV2-042. Only by disregarding the presumption of prudence and shifting the burden of proof to APS—in contravention of its own regulation—could the Commission overcome the utter lack of evidence that the SCR investment was imprudent. The disallowance is therefore unlawful.

C. The Commission's Additional Findings Lack Record Support

To the extent the Commission attempts to justify its hindsight analysis through additional findings, those findings lack evidentiary support.

First, the Commission alleges that in deciding to install SCRs, APS failed to "include a low-gas-cost forecast." APPV2-039. But the Commission's December 2014 decision approving the Four Corners Acquisition (Decision 74876) expressly accounted for the possibility of declining natural gas prices. APS addressed this possibility in its 2014 integrated resource plan, which considered both a "Gas Dominates Scenario" that "assume[d] limited regulations on hydraulic fracturing and sustained low natural gas prices," and an "Economic Contraction Scenario" that assumed "no additional shale gas regulation, which leads to low gas prices." APPV11-058, -060. The Commission's statement that the 2014 plan "did not include a low-gas-cost forecast," APPV2-039, is thus incorrect.

APS submitted the plan to the Commission, and the Commission expressly addressed it in Decision 74876. *See* APPV11-081. Sierra Club also directly challenged APS's "natural gas price assumptions." APPV11-078. But Decision 74876 found that challenge "not … convincing" and declared the Units 4-5 acquisition prudent, based on what was known at the time.

APPV11-076, -081-083, -087, -089. The speculative prospect of low gas prices—which has proven utterly unrealistic, *see supra* at 34 n.2—thus provides no basis to revisit the prudence of APS's investments.

Second, the Commission accuses APS of "intentionally manipulat[ing] its analysis of resources need[ed]" to meet its generation obligations. APPV2-039. That accusation—first raised long after the close of the record, via amendment, Tovar No. 1—lacks record support and has no bearing on the prudence of the SCR investment. No party in the case made any such allegation, nor did any party submit any evidence to support such an allegation. And the Commission itself failed to identify evidence establishing that APS acted with anything other than complete good faith.

Instead, the Commission cites decisions from 2015 and 2018 finding that APS overestimated population growth in forecasting energy demand. APPV2-039 n.188 (citing Decision 75608 and 76632). But APS's forecasts were not inaccurate, much less intentionally so. The Commission cites no record basis for finding that APS's load forecasts were unreasonable given the information available to APS at the relevant time and its obligation to ensure the reliability of its system in the face of inherently unpredictable future energy needs. Nor does the Commission even *purport* to find—let alone

cite evidence—that any alleged overestimate was intentional or made in bad faith. No evidence whatsoever even remotely suggests that APS intentionally or unintentionally withheld information from the Commission or the public regarding its forecasting methodologies, resource planning, or investment decisions.

Regardless, the Commission does not even attempt to suggest that any purported inaccuracy in APS's load forecasts was sufficiently substantial to bring into question the need for Four Corners' capacity to meet peak loads. To the contrary, APS turned out to be *correct* that SCRs were needed to meet peak demand, as illustrated during the 2020 heat storm. *See supra* at 54. Merely reciting the words "intentional manipulation" is no substitute for actually demonstrating—under whatever load forecasts the record may support—that Four Corners was unnecessary to reliability given APS's generation obligations. Because the Commission made—and the record supports—no such finding, the Commission's disallowance of $215.5 million in SCR costs should be reversed.

III. The Unreasonably Low Return On APS's Investments Is Arbitrary And Capricious, Unlawful, And Unsupported By Substantial Evidence

The Commission further abused its discretion and exceeded its authority in setting the returns on APS's investments.

Pursuant to Article 15, § 14 of the Arizona Constitution, APS is "entitled to a fair return on the fair value of its properties." *Ariz. Water*, 85 Ariz. at 203. And under the Takings Clause of the U.S. Constitution's Fifth Amendment, APS is entitled to a return "commensurate with returns on investments in other enterprises having corresponding risks." *Hope*, 320 U.S. at 603.

The Commission implements these twin requirements by setting a separate rate of return on: (1) the "original cost" of the assets included in APS's rate base; and (2) the "fair value increment" of those assets—*i.e.*, the amount by which the fair value of the assets exceeds (or falls below) their original cost. A.A.C. R14-2-103(A)(3)(h); APPV5-026. The Commission further divides the "original cost" into the portions attributable to equity and debt. APPV4-079. The Commission thus calculates separate returns on equity, debt, and the fair value increment, and uses a weighted average to set APS's overall return. APPV5-028.

Here, the Commission set returns of 8.7% on equity, 4.1% on debt, and 0.15% on fair value increment. APPV5-028. The Commission thus calculated a weighted average return of 4.77%, as shown here (*id.*):

	$ Amount	% Amount	Cost Rate	Composite Cost
Common Equity	4,705,503	39.13%	8.70%	3.40%
Long-Term Debt	3,901,600	32.44%	4.10%	1.33%
FVI	3,418,936	28.43%	0.15%	0.04%
			FVROR:	**4.77%**

Two of the three component returns, however—on equity and on fair value increment—were unreasonably low and improperly established. Both should be vacated and remanded to the Commission.

A. The 8.7% Return On Equity Reflects Multiple Errors

The Commission calculated an 8.7% return on equity in two steps. First, applying the federal constitutional standard established in *Hope*, the Commission determined that the "[c]ost of [e]quity"—the return that "investors could earn by investing in other enterprises of comparable risk"—was 8.9%. APPV4-079, APPV5-022. The Commission then applied a "20-basis point [(0.2%)] reduction" based on alleged "deficiencies in APS's customer service performance." APPV5-022. Both steps were flawed, and the end result—one of the lowest equity returns in the Nation among electric utilities—falls well below the baseline set by the U.S. Constitution.

1. The Commission's Starting Point—An 8.9% Cost Of Equity—Was Based On Faulty Quantitative Analyses

The Commission based its 8.9% cost of equity on the faulty analyses of John Cassidy, a witness for RUCO, which represents ratepayers before the Commission. APPV5-015, -022. Like witnesses for Commission Staff, APS, and FEA, Cassidy submitted the results of a variety of commonly-used quantitative analyses to estimate the cost of equity for other utilities. APPV9-018-030. These analyses included a discounted cash flow ("DCF") analysis, a capital asset pricing model ("CAPM") analysis, and a comparable earnings analysis. *Id.* Like Cassidy, all four witnesses that submitted quantitative analyses in support of a requested cost of equity performed a CAPM analysis. APPV4-081 (APS); APPV5-013 (FEA); APPV5-015 (RUCO); APPV5-019 (Staff). But Cassidy's approach to and reliance on his CAPM analysis stands in marked contrast to the analyses provided by all other participants.

Whereas APS's witness used forward-looking data for her CAPM analysis, APPV5-008-009; APPV9-060, Cassidy relied on fully historical data dating back to 1978. APPV9-023-027. But under the U.S. Constitution, return on equity must be commensurate with the return on equivalent investments "generally being made *at the same time*." *Bluefield Waterworks & Improvement*

Co. v. Pub. Serv. Comm'n, 262 U.S. 679, 692 (1923) (emphasis added). "It is impossible to ascertain what will amount to a fair return upon properties devoted to public service, without giving consideration to the cost of labor, supplies, etc., at the time the investigation is made"—that is, contemporaneous data. *State of Mo. ex rel. Sw. Bell Tel. Co. v. Pub. Serv. Comm'n of Mo.*, 262 U.S. 276, 287-88 (1923).

Cassidy's use of aged data skewed his results downward. To establish the risk premium used as an input to his CAPM calculations, Cassidy used data that spans 1978 to 2019. *See* APPV9-027; APPV9-032. But the average risk premium from the first half of that period (1978-1998) is 5.54%. *Id.* By contrast, the average for the latter half (1999-2019) is 9.25%. *Id.* Cassidy's use of such out-dated, pre-1999 data to force down the average—without any plausible justification for doing so—was unreasonable, and the Commission's acceptance of that approach was therefore arbitrary and capricious and unlawful. Indeed, "[i]t is well settled that [a] rate maker may not rely on out-of-date information when more recent actual experience, which shows a substantial disparity between the earlier forecasts and the rate of return actually earned, is available." *Potomac Elec. Power Co. v. Pub. Serv.*

Comm'n, 380 A.2d 126, 134 (D.C. Ct. App. 1977), *aff'd en banc*, 402 A.2d 14 (1979) (citing *W. Ohio Gas Co. v. Pub. Utils. Comm'n*, 294 U.S. 79, 82 (1935)).

The results of Cassidy's stale and wholly backward-looking CAPM analysis are wildly out of line with the results of his other models. His CAPM analysis yields a midpoint value of 7.75%, APPV5-015—1% lower than his DCF analysis (8.63%) and 2% lower than his comparable earnings analysis (9.75%). *Id.* Faced with a similar discrepancy in their own calculations, the Commission's Staff chose to omit their outlier, backward-looking CAPM analysis from their estimate of the cost of equity. APPV5-021. Cassidy, by contrast, included his skewed CAPM analysis in his analysis, driving down his proposed cost of equity. APPV9-027. Because it reduced APS's return on equity based on this flawed analysis, the Commission's decision is unlawful, unsupported by substantial evidence, and an abuse of discretion.

2. The Commission Exceeded Its Constitutional And Statutory Authority When It Reduced APS's ROE By 0.2% As A Penalty For Alleged Customer Service Issues

The Commission separately exceeded its authority when it reduced APS's return on equity by 20 basis points—from 8.9% to 8.7%—as a penalty based on criticisms of APS's customer service. Under clearly established precedent, including the Commission's own decisions, the question before

the Commission in setting the return on equity was a narrow one: Its task was to determine the "returns that investors could earn by investing in other enterprises of comparable risk"—*i.e.*, the cost to APS of obtaining equity, at arm's length, in the marketplace. APPV5-022. Once the Commission answered that question by calculating a cost of equity of 8.9%, *id.*, its task was at an end, and it had no authority to further reduce APS's return as a penalty. Instead, to penalize APS for purported customer service issues, the Commission would have had to act within the limits of its express constitutional and statutory penalty authority, which it far exceeded here.

a. *Hope* and *Bluefield* are clear that the Fifth Amendment's Takings Clause guarantees public utilities "a return … equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties." *Bluefield*, 262 U.S. at 692-93. "[T]he return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." *Hope*, 320 U.S. at 603.

The Commission acknowledged here that *Hope* and *Bluefield* are the "seminal U.S. Supreme Court cases" that "establis[h] … the authorized return on equity ('ROE') for a public utility." APPV4-079. The Commission

has repeatedly recognized, moreover, that under these cases, "'the return determined by the Commission *must be equal* to an investment with similar risks made at generally the same time.'" APPV11-050-051 (emphasis added); APPV11-017 (same). Return on equity is thus fundamentally an *economic* inquiry that "is normally determined by two methods—the 'investor method', that is, an analysis of how investors form reasonable expectations of the earning-dividend and growth expectation of utility stocks or the 'opportunity cost comparative earnings method', that is, what capital would earn in other enterprises of corresponding risks and hazards." *Sun City Water Co. v. ACC*, 26 Ariz. App. 304, 309 (1976), *vacated on other grounds by* 113 Ariz. 464 (1976) (en banc).

Here, the Commission conducted the required economic inquiry and arrived at a rate of 8.9%, not 8.7%. Cassidy "calculated a COE [(cost of equity)] … of 8.90%" based on indicators of the "cost of capital" for "a proxy group of 12 publicly traded electric utility companies." APPV5-014-015. The Commission agreed, accepting Cassidy's "calculated COE of 8.90%" before applying a 20-basis-point reduction. *Id.* To be sure, Cassidy's analysis was flawed. *See supra* at 60-62. But once the Commission accepted that testimony, *Hope* and *Bluefield* required a rate no lower than 8.9%—"equal" to the

return the Commission calculated for comparable investments. *Bluefield*, 262 U.S. at 692; APPV11-050-051; APPV11-017.

b. Rather than following *Hope* and *Bluefield*, however, the Commission reduced APS's return to 8.7% based on purported "deficiencies in APS's customer service performance." APPV5-022. Because that reduction both operated and was expressly intended as a penalty, and was an express departure from returns for comparable investments, it exceeded the Commission's ratemaking authority.

From the start, RUCO proposed the reduction as a penalty, not an economic factor in calculating the cost of equity. Cassidy did not testify in support of the reduction as part of his cost of equity calculation. Instead, a separate RUCO witness testified that reducing APS's return based on allegedly poor customer service would "'send a strong message to APS and to all other utilities.'" APPV5-016 (alteration omitted). Chairwoman Márquez Peterson likewise described the reduction as a "penalty, in essence." APPV10-041.

Neither RUCO nor the Commission offered any economic analysis in support of imposing a reduction, nor any explanation whatsoever for setting the reduction at 20 basis points. Neither decision was remotely rooted in

"the earning-dividend and growth expectation of utility stocks" (the "investor method") or "what capital would earn in other enterprises of corresponding risks and hazards" (the "opportunity cost comparative earnings method"). *Sun City*, 26 Ariz. App. at 309. And neither RUCO nor the Commission made any attempt to link APS's customer service to the "returns on investments in other enterprises having corresponding risks." *Hope*, 320 U.S. at 603.

The reduction thus plainly was intended as a penalty, and the Commission has never attempted to justify it under the relevant constitutional standard for return on equity. To the contrary, the 8.7% rate is *necessarily* not "equal" to the return available on comparable investments, *Bluefield*, 262 U.S. at 692; APPV11-050-051; APPV11-017, because the Commission itself determined that rate to be 8.9% (and the remaining evidence in the record supports a higher return). Reducing the return to 8.7% thus exceeds the Commission's ratemaking authority.

c. Consistent with these principles, courts in multiple states have recognized that imposing customer-service-related penalties is not a valid exercise of ratemaking authority. The Florida Supreme Court, for example,

squarely rejected as impermissible the approach followed by the Commission here, holding that the Florida Railroad and Public Utilities Commission "had no authority to deny an increase in rates which it found to be just, by the means of inflicting a penalty because of poor or inadequate service, and exceeded its jurisdiction when it inflicted such penalty in a rate-making proceeding." *Fla. Tel. Corp. v. Carter*, 70 So. 2d 508, 510 (Fla. 1954) (en banc).

The Kentucky Supreme Court has similarly recognized that "granting the Commission the authority, in a rate case, to penalize the utility for poor service would be an improper extension of the statutory procedure." *S. Cent. Bell Tel. Co. v. Util. Regul. Comm'n*, 637 S.W.2d 649, 653 (Ky. 1982). The court explained that the "rate making process is to provide for the utility a reasonable profit on its operations so that its owners may achieve a return on their investment. Such matters are purely those of a financial nature." *Id.*; *accord Elyria Tel. Co. v. Pub. Utils. Comm'n*, 110 N.E.2d 59, 63 (Ohio 1953) ("Upon the record in this case, the commission erred in suspending the increased rates until such time as the services and facilities have been improved.").

The Utah Supreme Court has likewise recognized that ratemaking must be based on "economic factors" alone. *Stewart v. Utah Pub. Serv. Comm'n*, 885 P.2d 759, 770 (Utah 1994) ("In both rate-of-return and rate-base

cases, the issue is what economic factors the Commission may consider in determining what rates should be charged ratepayers for the benefit of shareholders[.]”). The same conclusion is warranted under Arizona law: Penalties for non-economic considerations like customer service have nothing to do with the constitutional ratemaking considerations and are not a valid exercise of the Commission’s ratemaking authority.

d. The reduction is also unlawful because it exceeds the Commission’s penalty authority. Article 15, Section 16 of the Arizona Constitution provides that “[i]f any [PSC] shall violate any of the rules, regulations, orders, or decisions of the corporation commission, such corporation shall forfeit and pay to the state not … more than five thousand dollars for each such violation, to be recovered before any court of competent jurisdiction.” A.R.S. § 40-424(A) likewise provides that “[i]f any corporation or person fails to observe or comply with any order, rule, or requirement of the commission or any commissioner, the corporation or person shall be in contempt of the commission and shall, after notice and hearing before the commission, be fined by the commission in an amount not … more than five thousand dollars, which shall be recovered as penalties.”

Under these provisions, the Commission may impose penalties only for a violation of the Commission's "rules, regulations, orders, or decisions," Ariz. Const. art. 15, § 16, or any other "requirement of the commission," A.R.S. § 40-424(A). Penalties may be imposed only "after notice and hearing before the commission." *Id.* And penalties are limited to $5,000 per violation. *Id.*; Ariz. Const. art. 15, § 16.

The Commission flouted each of these limitations. It found APS's customer outreach "ineffective," found an "error" with the "Rate Comparison Tool" provided to customers, and found "poor customer satisfaction." APPV6-028. But it found no *violation* of any rule, regulation, order, decision, or other requirement. Nor did the Commission give APS notice of any alleged violation at any time in the form of an order to show cause, contempt hearing, or otherwise. And the 20-basis-point reduction—amounting to a multi-million-dollar reduction in APS' revenue every year (APPV5-028)—far exceeds the $5,000 penalty limitation. The reduction thus exceeds the Commission's penalty authority under both the Arizona Constitution and Arizona statutory law.

The Arizona Supreme Court has been careful to guard the line between the Commission's ratemaking authority and other sources of authority. In

Johnson Utilities, L.L.C. v. ACC, for example, the Court held that the Commission's "ratemaking power d[id] not authorize [an] Order appointing an interim manager" to oversee a utility's operations, although the Commission could appoint an interim manager "pursuant to its permissive power under article 15, section 3." 249 Ariz. 215, 228 ¶¶ 56-57 (2020). The difference was critical because "the constitution places important limits on the Commission's permissive authority" that do not apply to ratemaking. *Id.* at 228 ¶ 58. Here too, the Commission's authority to impose penalties is limited by the Arizona Constitution and by statute. The Commission cannot avoid those limits by recasting penalties as an exercise of ratemaking authority.

3. An 8.7% Return Violates The Capital Attraction Standard Of *Hope* And *Bluefield*

The Commission's flawed two-step process yielded a flawed outcome. The resulting 8.7% return on equity falls short of the constitutional requirements of *Hope* and *Bluefield* in two ways.

First, the result is not "commensurate with returns on investments in other enterprises having corresponding risks." *Hope*, 320 U.S. at 603. Of the 93 investor-owned utilities in the United States, the median return on equity is 9.58%, and only four have state-established returns less than 8.8%.

APPV10-093. APS's 8.7% return is thus one of the very lowest in the Nation. Yet the Commission never acknowledged this fact or attempted to justify it through any discussion of the risks facing APS.

An ROE near the bottom in the United States is particularly inappropriate because APS owns and operates a nuclear facility and thus faces greater risks than other utilities. APS is a 29.1% owner of the Palo Verde Nuclear Plant and is the operator of that plant. APPV1-053 n.35. Nuclear generation is widely regarded as having increased business risks as compared to non-nuclear generation providers and distribution only entities. *See* APPV9-011-012; APPV10-035; *In re Baltimore Gas & Elec. Co.*, 277 P.U.R.4th 365 (Md. P.S.C. 2009) (noting business rating agencies find nuclear power "risky at best"); *In re United Illuminating Co.*, 2002 WL 31720159 (Conn. D.P.U.C. 2002) ("Generation is more risky than distribution business and nuclear adds to that risk."). None of the four U.S. investor-owned utilities with lower returns on equity than APS owns or operates any nuclear generation, making APS's return the lowest nationwide among owners of nuclear generation. The Commission's failure to justify this aberration makes its 8.7% return constitutionally deficient and, at a minimum, arbitrary and capri-

cious. *Cf. State Farm*, 463 U.S. at 43 (agency action is "arbitrary and capricious if the agency … entirely failed to consider an important aspect of the problem.").

Second, the *Hope* and *Bluefield* standard is meant to ensure, among other things, that a utility's return on equity is "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Hope*, 320 U.S. at 603. But the Commission's 8.7% return falls short of this requirement, as indicated by the response of financial analysts and ratings agencies.

Even before the Commission issued the decision—as the Commission considered a recommended order that would have allowed APS a 9.16% return on equity, APPV8-042-044—"[r]ating agencies, including Fitch and Moody's" called that recommendation "draconian." APPV10-020. When the Commission nonetheless proceeded to consider a proposed amendment to reduced APS's return on equity to 8.7%, *see* APPV9-106, APS advised the Commission that "several ratings indices ha[d] warned APS that they w[ould] downgrade the company's credit rating" if the recommended decision was adopted with the amendments that the Commission was considering. APPV10-020; *see also* APPV10-022-023; APPV10-033.

Despite these warnings, the Commission adopted the 8.7% amendment. APPV13-012. The result from rating agencies was swift and unambiguous. On October 7, 2021, Guggenheim downgraded Pinnacle West Capital Corp. ("Pinnacle West"), APS's corporate parent, from "buy" to "sell," and its analyst referred to the Commission as "'the single most value destructive regulatory environment in the country'" for investor-owned utilities. *Id.* Then on October 12, 2021, Fitch Ratings ("Fitch") downgraded ratings of both Pinnacle West and APS by one notch and continued to maintain a negative outlook for both. In doing so, Fitch characterized the 8.7% return on equity as "punitive." APPV13-013-020.

The downgrades continued after the Commission adopted its final decision. On November 9, 2021, S&P Global downgraded both Pinnacle West and APS, and continued to maintain a negative outlook for both, citing the Commission's decision as a precipitating factor. APPV13-027-029. And on November 17, 2021, Moody's also downgraded Pinnacle West. *See* APPV13-033-034.

These responses, including particularly the ratings downgrades by Fitch and S&P Global, make clear that APS is unable to "maintain its credit"

as required by *Hope*. 320 U.S. at 603. The 8.7% return on equity is thus contrary to law and must be vacated.

B. A 0.15% Return On Fair Value Increment Is Insufficient And Unjustified

The Commission further erred in setting a 0.15% return on the "fair value increment" of APS's assets. APPV5-028. That value is arbitrary, devoid of record support, and unlawful. The Commission should have instead adopted a return between 0.6% to 0.8%, consistent with the Commission's prior practice, from which it unreasonably departed.

The Commission has historically calculated return on fair value increment based on the expected return on a risk-free investment. *See, e.g.*, APPV11-020; APPV11-093. As the Commission explained as recently as February 2022, "the Commission has used a real risk-free rate of return, which involves the removal of the rate of inflation from the nominal risk-free rate." APPV12-027. Here, as the Commission's staff recognized below, the parties all "'agree that the Commission has consistently used the risk-free rate of return as the basis for calculating the return on [fair value increment] to properly satisfy AZ law.'" APPV5-027 (emphasis omitted).

The Commission's historical practice makes sound economic sense because it compensates the utility owner for the opportunity cost of not selling existing assets. When a public utility uses its assets to serve the public, it forgoes the opportunity to sell those assets for their fair value and earn a market rate of return by reinvesting the proceeds. A reasonable investor would thus expect a return not only on the assets' original cost, but on their full fair value. APPV9-014. To the extent the fair value exceeds the original cost, the return on fair value increment thus compensates investors for the return they would earn from reinvesting the excess. And the risk-free rate is the lowest plausible estimate of that return because it reflects the lowest return that an investor could expect from a conservative investment such as 30-year U.S. treasury bonds. APPV9-014-015.

Here, APS's witness calculated a real risk-free rate of 1.28% after correcting certain mathematical errors identified by the Commission's staff.

APPV5-023; APPV9-055-056. APS nonetheless offered to accept a compromise return between 0.6% and 0.8%, APPV5-023.[3]

In instead setting a return of just 0.15%, the Commission broke with its historical practice. That rate has nothing to do with the risk-free rate, which the Commission did not even calculate. Instead, the Commission arbitrarily chose a return of 0.15%, but offered no justification for choosing that amount. APPV5-028. That rate cannot withstand scrutiny, for several reasons.

First, the 0.15% is "arbitrary" in the most basic sense of the word. *Litchfield*, 178 Ariz. at 434. "An agency acts arbitrarily and capriciously when it does not examine 'the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made.'" *Compassionate Care*, 244 Ariz. at 213 ¶ 25 (quoting *State Farm*, 463 U.S. at 43); *accord Saguaro Healing LLC v. State*, 249 Ariz. 362, 368 ¶ 35 (2020) (similar). But here, the Commission cited no relevant data in support of a 0.15% return, and offered no explanation whatsoever for

[3] The Commission's historical practice has been to cut the risk-free rate in half, *see* APPV12-027. There is "no basis whatsoever for" this approach, APPV9-014, but this Court need not address that issue here in light of APS's compromise offer.

choosing that number over any other. No participant to this proceeding provided evidence supporting such a value. And Commissioner Olson's Amendment No. 1, which first established this return, provided no articulated reason for selecting this figure. Rather, like the 0.20% reduction in APS's return on equity discussed *supra* at 63-70, the 0.15% return on fair value increment has no basis in any analysis or economic theory. It is therefore arbitrary and capricious.

Second, a 0.15% return is also contrary to the requirement of the Arizona Constitution that rates be set based on the fair value of the utility's assets. Article 15, § 14 of the Arizona Constitution requires the Commission, in setting a PSC's rates, to "ascertain the fair value of the [PSC's] property." The Arizona Supreme Court has interpreted this requirement to mean that a PSC is entitled to "a fair return on the fair value of its properties"—not just on the "original cost" of its investments, *Ariz. Water*, 85 Ariz. at 203.

This Court reached the same conclusion in *Chaparral City Water Co. v. ACC*, 2007 WL 9710985 (Ariz. Ct. App. Feb. 13, 2007). The Court of Appeals vacated a Commission decision that "engage[d] in a superfluous mathematical exercise," *id.* at ¶ 17, through which it effectively set a utility's "revenue requirements and rates, … based not on the fair value of its

property, but on its [original cost]," *id.* at ¶ 14. This, the Court held, "does not comport with the Arizona Constitution," *id.*, and "is inconsistent with Arizona law," *id.* at ¶ 17.

An FVI return of 0.15% is similarly contrary to the Arizona Constitution and law because it results in no meaningful difference between the return on the fair value of the utility assets and what would be the return if based on original cost alone. Indeed, an FVI return of 0.15% is so negligible as to be tantamount to an FVI return of zero, and thus renders effectively meaningless the Arizona State Constitution requirement that returns be set based on fair value and not original cost.

The Commission dismissed *Chaparral City* because it "does not create legal precedent and generally cannot be cited as precedent under Arizona Supreme Court Rule 111(c)." APPV5-027. The Commission thus concluded that "there is no justification" or "legal mandate" for "authorizing a positive return" on the fair value increment at all. APPV5-028. But independent of any precedential effect, *Chaparral City* is binding on the parties to that case, including the Commission. *Cochise Sanitary Servs., Inc. v. ACC*, 2 Ariz. App. 559, 561 (1966). And independent of *Chaparral City*, the Commission's obligation to award a return on fair value—rather than original cost basis—is

clear from the Arizona Constitution and the Arizona Supreme Court's decision in *Arizona Water*.

Third, even setting aside how low the 0.15% is, the decision is arbitrary and capricious because it was inextricably intertwined with the Commission's erroneous conclusion that it had no legal obligation to award a return on the fair value increment. Having concluded—incorrectly—that it had no "legal mandate" to "authoriz[e] a positive return," APPV5-028, the Commission simply selected a *de minimis* rate to avoid a "lawsuit predicated on the Commission's denying" a positive return. *Id*. Had the Commission understood its legal duty, it would have ordered a greater return.

The Commission's legal error renders its decision arbitrary and capricious. "An agency decision is 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law,' … if the agency applies an incorrect legal standard." *Gen. Land Off. v. U.S. Dep't of Interior*, 947 F.3d 309, 320 (5th Cir. 2020). Just as a lower court decision based on "'an erroneous view of the law'" is "'necessarily'" an abuse of discretion, *James, Cooke & Hobson, Inc. v. Lake Havasu Plumbing & Fire Prot.*, 177 Ariz. 316, 319 n.4 (App. 1993), an agency "order may not stand if"—as here—"the agency has misconceived the law," *SEC v. Chenery Corp.*, 318 U.S. 80, 94 (1943).

Fourth, the Commission failed to acknowledge that it was departing from longstanding practice. The *parties* each recognized that "'the Commission has consistently used the risk-free rate of return as the basis for calculating the return on'" fair value increment. APPV5-027. But the Commission erroneously insisted that "it has not consistently authorized a positive return" on the fair value increment. APPV5-026.

The Commission cited just one decision—in the 14 years since it began using the risk-free rate, *see* APPV11-020—in which it denied a positive return on fair value increment based on the risk-free rate. *See* APPV12-011. Since then, however, the Commission has continued to use the risk-free rate, even after the decision in APS. APPV12-027. The Commission also cited two decisions in which it speculated that it was not *required* to award a positive return. But in each of those decisions, the Commission ultimately *did* set a return on fair value increment based on the risk-free rate. *See* APPV12-017; APPV9-073-074. These decisions thus confirm that with only one other aberration in more than a decade, the Commission has been remarkably consistent in using the risk-free rate.

The Commission's failure to "display awareness that it is changing position" renders its decision arbitrary and capricious, *Fox*, 556 U.S. at 515 (emphasis omitted). The mere fact that the Commission may have departed from its prior practice a single time three years ago—before returning to that practice in later cases—is not an excuse to arbitrarily change its methodology from case to case. As explained *supra* at 49, government "is at its most arbitrary when it treats similarly situated people differently," *Etelson*, 684 F.2d at 926. Because the Commission has provided no justification for treating APS more harshly than other utilities, the 0.15% rate must be vacated. *Id*. at 927.

CONCLUSION

This Court should reverse the Commission's $215.5 million SCR disallowance, vacate the 8.7% return on equity and 0.15% return on fair value increment, and remand to the Commission with instructions to allow APS's full SCR costs, eliminate the 0.2% penalty reduction on the return on equity, and reconsider APS's return on equity and fair value increment consistent with the law and evidence.

RESPECTFULLY SUBMITTED this 27th day of April, 2022.

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