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MEMORANDUM

ORIGINAL

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TO: THE COMMISSION

 THRU: Ernest Johnson *EJ*
 Director
 Utilities Division

 FROM: Robert Gray *MR for BG*
 Senior Economist
 Utilities Division

DATE: October 14, 2005

 RE: STAFF RESPONSE TO COMMISSIONER MAYES' SEPTEMBER 21, 2005
 AND OCTOBER 11, 2005 LETTERS RELATED TO THE UNS GAS PGA
 SURCHARGE PROPOSED IN DOCKET NO. G-04204A-05-0596
AZ CORP COMMISSION
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The following discussion is Staff's response to Commissioner Mayes' September 21, 2005 and October 11, 2005 letters related to the UNS Gas, Inc., (UNS) purchased gas adjustor (PGA) surcharge filing contained in Docket No. G-04204A-05-0596.

Responses to Questions In Commissioner Mayes' September 21, 2005 Letter

1. Applicability of Florida Power and Light Approach – Staff believes that a primary difficulty in applying Florida Power and Light's (FP&L) approach to having a two tiered fuel adjustor is the different physical characteristics of the FP&L' and UNS' service territories. Unlike FP&L's service territory where there is a minimal range of elevation (the highest elevation in Florida is 345 feet) and therefore usage is likely to be relatively homogeneous across the entire service territory, UNS' service territory has significant variations in elevation and weather and therefore some parts of UNS' service territory have significantly higher natural gas usage levels than others. For example, Flagstaff is at an elevation of 7,000 feet while Lake Havasu City is at an elevation of 575 feet. In such a situation a surcharge structure patterned after FP&L's approach would result in cross-subsidization with high elevation, high use areas bearing a disproportionate percentage of the costs to be recovered through the PGA surcharge. Staff believes that the significant variations in elevation, weather, and consumption across UNS' service territory make FP&L's approach highly problematic for UNS to apply.
2. Prohibition on UNS Conducting Disconnections from December through March – Staff recognizes the need to ensure the health and safety of UNS customers during the coming winter heating season and is generally supportive of the concept of a disconnection

moratorium. Staff believes that further discussion on the nature of such a moratorium would be useful and necessary (please refer to Commission rule R14-2-311.A.5.C).

3. Implementation of Reasonable Payment Program – Staff supports efforts which will help customers pay their bills to the extent they can and encourages programs and other efforts which further this goal. It is not clear to Staff what specific program, beyond current program offerings such as levelized billing, would be offered as a reasonable payment program.

Responses to Questions In Commissioner Mayes' October 11, 2005 Letter

1. Merits and Demerits of Option Nine Contained in Staff's September 12, 2005 Staff Memo – First, it should be noted that Option Nine contained in the Staff memo was not specifically designed to recover the same amount of money as Staff's proposed surcharge level (Option Four) and would recover approximately \$6 million less than the Staff proposed surcharge in the first 12 months. However, Option Nine could be restructured to recover a similar amount of revenue as the Staff proposal. Revision to Option Nine to have a \$0.16 per therm surcharge in winter months (November – April) and a \$0.47 per therm surcharge in summer months (May through October) would provide an approximately equivalent amount of revenue as the Staff proposal.

The primary merit of Option Nine or some similar variant is that on a system-wide basis recovery of costs is balanced out more evenly across the year, providing relief for customers that have much higher use in the winter months. For example, under Staff's proposal the surcharge would recover \$27.9 million in the first twelve months, with \$20.3 million recovered in winter months and \$7.3 million recovered in summer months. Under the revised Option Nine scenario discussed above (\$0.16 per therm in winter months and \$0.47 per therm in summer months), the split between summer and winter changes to \$14.0 million being recovered in winter months and \$13.8 million being recovered in summer months.

The primary difficulty with Option Nine or some similar variant is that a shifting of cost recovery to the summer months will inequitably impact customers who have significant summer consumption, resulting in interclass and possibly some intraclass cross-subsidization. While most (but not all) residential customers have much lower summer consumption, at least some commercial, industrial, and irrigation customers have similar or even possibly in certain cases higher average monthly usage in the summer than in the winter. For such customers Option Nine or some similar variant would result in enormous bill increases in the summer months compared to options which pursue cost recovery on a more even per therm basis across the year. The table below shows the percentage of total consumption each month in 2004 by customer class.

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| | JAN | FEB | MAR | APR | MAY | JUN | JUL | AUG | SEP | OCT | NOV | DEC |
|-----------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Percent Residential | 67.7% | 66.8% | 66.9% | 63.2% | 58.8% | 53.2% | 51.3% | 50.4% | 51.3% | 55.5% | 63.5% | 67.0% |
| Percent Commercial | 24.5% | 23.9% | 24.3% | 29.0% | 29.6% | 36.1% | 38.3% | 38.9% | 37.9% | 34.9% | 27.5% | 24.7% |
| Percent Industrial | 1.3% | 2.5% | 1.7% | 1.2% | 5.1% | 5.3% | 5.4% | 4.7% | 5.1% | 3.3% | 2.4% | 1.6% |
| Percent Irrigation | 0.0% | 0.0% | 0.0% | 0.1% | 0.2% | 0.3% | 0.5% | 0.9% | 0.6% | 0.5% | 0.1% | 0.0% |
| Percent Municipality | 6.6% | 6.8% | 7.1% | 6.6% | 6.3% | 5.1% | 4.4% | 5.2% | 5.1% | 5.8% | 6.6% | 6.7% |
| Total Non-residential | 32.3% | 33.2% | 33.1% | 36.8% | 41.2% | 46.8% | 48.7% | 49.6% | 48.7% | 44.5% | 36.5% | 33.0% |

2. New Option Reflecting a "Shoulder Period" recovery plan similar to that shown in footnote one in Commissioner Mayes' October 11, 2005 letter – the table shown on Attachment-1 reflects a possible structure for such a recovery plan. The rates shown in the footnote would collect approximately \$24.9 million in the first twelve months, \$3 million less than the Staff proposal. To recover the same amount of revenue as Staff's proposal (Option Four) the rates could be structured to charge \$0.15 per therm in November through February, \$0.25 per therm in March, \$0.30 per therm in April, \$0.35 per therm in May, \$0.40 per therm in June, \$0.50 per therm in July and August, \$0.40 per therm in September and \$0.30 per therm in October. Generally speaking this rate structure would reflect similar merits and difficulties to the Option Nine rate structure discussed in the previous question. An additional merit is that its gradual movement might help customers adjust to a much higher summer rate in comparison to Option Nine. A possible difficulty would be that with rates changing so often, customers might have difficulty understanding what their rates would be in future months.

3. Discussion of Adjustment to PGA Bank Balance Trigger Filing Required by December 31, 2005 – Staff has been in discussions with the Company regarding this requirement and is hopeful that this item can be brought before the Commission for consideration at the November 8-9, 2005 open meeting.

4. RUCO Assertion regarding recovery of actual accrued balances – Staff is cognizant of the issues related to some level of reliance on projections in setting PGA surcharge levels. One factor in the recent movement in looking more at projections of the PGA bank balance and related data is that the Commissioners have asked in recent PGA surcharge proceedings what the bank balance is projected to be in the future, leading to discussions and consideration of projected information. Further, to some extent such information is relatively reliable, as, for example, UNS has approximately half of its natural gas supplies for the upcoming winter locked in at known, fixed prices. Additionally, Staff tends to approach such price and bank balance projections in a relatively conservative manner, recognizing that they are only projections. The alternative to relying only on actual accrued balances is that any higher costs and balance increases which occur in a given winter heating season are not likely to be substantively addressed by a PGA surcharge until the next year's heating season. For example, if UNS saw their PGA bank balance move well above the trigger level in December, such data would be filed with the Commission near the end of February in the Company's monthly PGA report. UNS then would likely file for a PGA surcharge in early March, followed by possible Commission action in late March or April at the earliest. Thus a

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new PGA surcharge under such a scenario would likely not be in place until the April or May billing cycle at the earliest, largely bypassing the current winter heating season when the high prices and bank balance is accumulated.

Attachments 2 & 3 have supporting information. Attachment-2 shows a revenue comparison over the twelve month period from November 2005 through October 2006 under the Staff proposal, Option Nine, and the option contained in footnote one of Commissioner Mayes October 11, 2005 letter. Attachment-3 provides the customer bill impact and other information contained in the September 12, 2005 Staff memo for the twelve options and for the option contained in footnote one of Commissioner Mayes October 11, 2005 letter.

Comparable Information for Scenario Contained in Footnote One in Commissioner Mayes' October 11, 2005 Letter

End of Month PGA Bank Balance

Note: This uses the same cost projection information as the scenarios contained in the September 12, 2005 Staff memo

| <u>Jun-05</u> | <u>Jul-05</u> | <u>Aug-05</u> | <u>Sep-05</u> | <u>Oct-05</u> | <u>Nov-05</u> | <u>Dec-05</u> | <u>Jan-06</u> | <u>Feb-06</u> | <u>Mar-06</u> |
|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| \$3,805,459 | \$3,794,935 | \$4,090,525 | \$5,035,919 | \$7,096,043 | \$9,697,738 | \$13,107,228 | \$16,050,821 | \$15,625,148 | \$13,320,362 |
| <u>Apr-06</u> | <u>May-06</u> | <u>Jun-06</u> | <u>Jul-06</u> | <u>Aug-06</u> | <u>Sep-06</u> | <u>Oct-06</u> | <u>Nov-06</u> | <u>Dec-06</u> | <u>Jan-07</u> |
| \$10,600,066 | \$8,370,956 | \$7,376,873 | \$7,125,939 | \$7,292,671 | \$7,569,791 | \$9,012,372 | \$10,690,381 | \$12,763,584 | \$12,150,146 |

Bill Impact of PGA Surcharge Each Month

| <u>Jan-05</u> | <u>Jun-05</u> | <u>Jul-05</u> | <u>Aug-05</u> | <u>Sep-05</u> | <u>Oct-05</u> | <u>Nov-05</u> | <u>Dec-05</u> | <u>Jan-06</u> | <u>Feb-06</u> | |
|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| \$3.14 | \$0.60 | \$0.44 | \$0.42 | \$0.45 | \$0.61 | \$7.25 | \$13.13 | \$15.71 | \$13.18 | |
| <u>Mar-06</u> | <u>Apr-06</u> | <u>May-06</u> | <u>Jun-06</u> | <u>Jul-06</u> | <u>Aug-06</u> | <u>Sep-06</u> | <u>Oct-06</u> | <u>Nov-06</u> | <u>Dec-06</u> | <u>Jan-07</u> |
| \$18.95 | \$15.91 | \$11.06 | \$6.02 | \$5.19 | \$4.88 | \$5.25 | \$5.09 | \$12.08 | \$17.50 | \$20.94 |

Total Residential Customer Bill

| <u>Jan-05</u> | <u>Jun-05</u> | <u>Jul-05</u> | <u>Aug-05</u> | <u>Sep-05</u> | <u>Oct-05</u> | <u>Nov-05</u> | <u>Dec-05</u> | <u>Jan-06</u> | <u>Feb-06</u> | |
|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| \$101.58 | \$26.76 | \$21.59 | \$20.71 | \$21.78 | \$27.08 | \$60.85 | \$105.12 | \$124.23 | \$108.83 | |
| <u>Mar-06</u> | <u>Apr-06</u> | <u>May-06</u> | <u>Jun-06</u> | <u>Jul-06</u> | <u>Aug-06</u> | <u>Sep-06</u> | <u>Oct-06</u> | <u>Nov-06</u> | <u>Dec-06</u> | <u>Jan-07</u> |
| \$103.57 | \$88.47 | \$56.50 | \$34.18 | \$27.80 | \$26.56 | \$28.09 | \$33.59 | \$70.51 | \$118.10 | \$139.93 |

PGA Surcharge in Effect Each Month Under
per therm

| <u>Jan-05</u> | <u>Jun-05</u> | <u>Jul-05</u> | <u>Aug-05</u> | <u>Sep-05</u> | <u>Oct-05</u> | <u>Nov-05</u> | <u>Dec-05</u> | <u>Jan-06</u> | <u>Feb-06</u> | |
|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| \$0.03 | \$0.03 | \$0.03 | \$0.03 | \$0.03 | \$0.03 | \$0.15 | \$0.15 | \$0.15 | \$0.15 | |
| <u>Mar-06</u> | <u>Apr-06</u> | <u>May-06</u> | <u>Jun-06</u> | <u>Jul-06</u> | <u>Aug-06</u> | <u>Sep-06</u> | <u>Oct-06</u> | <u>Nov-06</u> | <u>Dec-06</u> | <u>Jan-07</u> |
| \$0.25 | \$0.25 | \$0.30 | \$0.30 | \$0.35 | \$0.35 | \$0.35 | \$0.25 | \$0.25 | \$0.20 | \$0.20 |

Average Residential Customer Bill Absent any PGA Surcharge

| | <u>Jan-05</u> | <u>Jun-05</u> | <u>Jul-05</u> | <u>Aug-05</u> | <u>Sep-05</u> | <u>Oct-05</u> | <u>Nov-05</u> | <u>Dec-05</u> | <u>Jan-06</u> | <u>Feb-06</u> | |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Avg. Res. Cons. Therms | 105 | 20 | 15 | 14 | 15 | 20 | 48 | 88 | 105 | 88 | |
| Customer Charge | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | |
| Tariffed Rate | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | |
| Monthly PGA rate | \$0.1729 | \$0.2537 | \$0.2546 | \$0.2535 | \$0.2541 | \$0.2560 | \$0.2639 | \$0.2709 | \$0.2692 | \$0.3081 | |
| Estimated Monthly Bill Absent PGA Surcharge | \$98.44 | \$26.16 | \$21.15 | \$20.29 | \$21.33 | \$26.46 | \$53.60 | \$92.00 | \$108.52 | \$95.65 | |
| | <u>Mar-06</u> | <u>Apr-06</u> | <u>May-06</u> | <u>Jun-06</u> | <u>Jul-06</u> | <u>Aug-06</u> | <u>Sep-06</u> | <u>Oct-06</u> | <u>Nov-06</u> | <u>Dec-06</u> | <u>Jan-07</u> |
| Avg. Res. Cons. Therms | 76 | 64 | 37 | 20 | 15 | 14 | 15 | 20 | 48 | 88 | 105 |
| Customer Charge | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 | \$7.00 |
| Tariffed Rate | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 | \$0.7004 |
| Monthly PGA rate | \$0.3233 | \$0.3301 | \$0.3427 | \$0.3535 | \$0.3535 | \$0.3535 | \$0.3541 | \$0.3560 | \$0.3639 | \$0.3692 | \$0.3692 |
| Estimated Monthly Bill Absent PGA Surcharge | \$84.61 | \$72.56 | \$45.45 | \$28.16 | \$22.62 | \$21.68 | \$22.83 | \$28.50 | \$58.43 | \$100.60 | \$118.99 |