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IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR APPROVAL OF ADJUSTMENT TO PURCHASED GAS ADJUSTOR SURCHARGE.	DOCKET NO. G-04204A-05-0596 **RESPONSE TO COMMISSIONER MAYES' OCTOBER 11, 2005 LETTER**

UNS Gas, Inc. ("UNS Gas" or "Company"), through undersigned counsel, hereby responds to Commissioner Mayes' letter of October 11, 2005 (the "Letter") filed in connection with UNS Gas' surcharge adjustment request. UNS Gas responds to the Letter as follows:

I. THE ISSUES RAISED IN THE LETTER.

The Letter requests that UNS Gas and Commission Staff analyze additional options for collecting the surcharge balance. The Letter tasks UNS Gas with (1) presenting the merits and demerits of (a) "Option 9" as offered in the Commission Staff's report dated September 12, 2005 (the "Staff Report"); and (b) a "modified shoulder recovery plan," and (2) responding to RUCO's October 6, 2005 letter that proposes that the Commission limit any PGA surcharge to recover actually accrued balances, rather than setting the surcharge to meet projected bank balances.

II. ANALYSIS OF SURCHARGE OPTIONS.

Option 9 from the Staff Report and the "modified shoulder plan" suggested in the Letter have similar features -- lowering the winter surcharge when gas usage is at its peak and then increasing the surcharge in the summer when usage drops. The difference is the degree to which the surcharge increases in the shoulder months to compensate for the lower winter rate. Option 9 increases the surcharge from $0.15 per therm to $0.30 per therm in May while the modified plan spreads the increase out over several months.

Both options have the benefit of reducing the impact of an increased surcharge on customers in the winter months. At the same time, both options have a number of adverse impacts. Both options have the effect of reducing conservation by setting an artificially low winter price. Both fail to adequately address the accumulating undercollected bank balance, and in fact, both cause the balance to peak at a higher level. Both will cause UNS Gas to borrow additional funds to purchase gas to cover this increased supply cost and recovery mismatch. Both involve cost shifting or subsidization between customer classes. These general problems are illustrated by the following discussion of Option 9 and the modified shoulder option.

A. Option 9.

The Staff Report included a list of 12 options the Commission may consider in addressing UNS Gas' Application for an increase in the Company's Purchased Gas Adjustment ("PGA") surcharge. Option 9 on the list states:

> \$0.15 in winter, \$0.30 in summer (Oct, May – Sept.) - \$0.15 per therm from November 2005 through April 2006 and \$0.30 per therm May 2006 through October 2006.

As indicated above, Staff's Option 9 would implement a lower winter surcharge when usage is greatest and a significant surcharge increase in the summer months when consumption is down.

In providing the various options, Commission Staff was careful to note that many of scenarios or options are "provided to illustrate a range of possible PGA surcharge levels, but in some cases do not appear to address the projected undercollected PGA bank balance on an ongoing basis to the extent [sic] which seems to be necessary." *See* Staff Report at 3. That is the very problem with Option 9 – it does not address the undercollected PGA bank balance and instead causes the undercollected balance to increase.

Given that approximately 75% of UNS' gas usage occurs in November through April, Option 9 is equivalent to a flat annual surcharge of approximately \$0.18 – a surcharge that is significantly less than the \$0.25 surcharge requested by UNS Gas to cover gas price increases. *See* UNS Gas' Exceptions to the Recommended Order dated September 22, 2005. Using current October 2005 price projections, Option 9 results in a bank balance of \$29 million dollars in March

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2006, and a balance of $47 million dollars in March 2007.

The winter/summer surcharge structure of Option 9 could be modified to prevent increased undercollection. For example, using UNS Gas' proposed first-year surcharge of $0.25 as a base, a graduated surcharge that lowers the winter surcharge by just $0.05 to $0.20 per therm requires a $0.20 increase to $0.40 per therm in the summer months to remain revenue neutral.

Aside from the undercollection problem of Option 9, there is the problem of cost shifting between customer classes. For example, commercial and industrial customers' gas consumption is typically flatter over the year with smaller differences between winter and summer usage. With residential customers, however, there is marked increase in gas consumption in the winter months. Using the same 20/40 cent surcharge structure described above, a customer that has flat consumption of 50 therms per month will pay an average surcharge of $0.30 per therm on 600 therms of annual gas consumption. At the same time, however, a customer that uses 80 therms per month in the winter and 20 therms per month in the summer will pay an average surcharge of $0.24 per therm on the same 600 therm annual consumption.

Finally, UNS Gas' financial planning estimates indicate that adopting Option 9's $0.15 per therm winter surcharge would cause the Company to have to borrow approximately $20 million dollars in the fourth quarter of 2005 to cover its spot market and forward contract gas purchases. This borrowing will financially overextend the Company and force it to incur significant debt service costs which must ultimately be paid by UNS Gas' customers.

B. Modified Shoulder Plan.

Building on the basic structure of Option 9, the Letter questions whether a PGA surcharge could be designed with a more even distribution over the entire year than the 15/30 increase presented in Option 9. The Letter suggests the following surcharge design:

> $0.15 per therm November through February; $0.25 per therm in March and April; $0.30 per therm in May and June; $0.35 per therm in July through September; $0.25 per therm in October and November; $0.20 per therm in December 2007 through February; and $0.25 per therm in March and April of 2007

See Letter at 1, fn. 1. Analyzing the graduated surcharge design outlined in the Letter or similar graduated rate designs, the Company determined that there is little improvement in bank balance impacts over Option 9. The graduated designs still grow the bank balance by delaying the recovery of gas costs paid by the Company to supply its customers. For example, using October 2005 price projections, the graduated plan proposed in the Letter results in an undercollected bank balance of $25 million in March 2006 and a balance of $28 million in January 2007.

To prevent undercollection while employing a graduated surcharge requires a significant surcharge increase in the shoulder and summer months. Again, using UNS Gas' proposed $0.25 surcharge, the table below illustrates the surcharge rates required to remain revenue neutral for the first 12 months.

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November 05	$0.15
Dec. 05 – Feb. 06	$0.20
Mar. 06 – Apr. 06	$0.25
May 06 – Sept. 06	$0.40
Oct. 06	$0.25

In sum, by artificially lowering the surcharge in the winter and then increasing the surcharge in the non-winter months, whether the compensating increase occurs at a trigger date or is graduated over several months, the result is the same – the undercollected bank balance increases due to the decrease in recovery of the gas costs until after the high usage winter period. Further, providing a below market surcharge in the winter months results in decreased conservation and cost shifting among customers classes. Finally, failing to provide UNS Gas with a surcharge that covers its procurement costs will result in the Company having to borrow to cover its purchases and cause it to incur significant debt service costs.

III. RUCO ASSERTION.

RUCO's proposal that the Commission alter the PGA surcharge to only recover actually incurred balances rather than setting the surcharge to meet projected accumulated balances overlooks the reality of the natural gas market. Because of the volatility of the market, limiting UNS Gas to seeking surcharge adjustments only for accumulated balances places the Company in the position of regularly exceeding its bank balance threshold and having to file serial applications for a surcharge increase. RUCO's proposal would similarly force the Commission to address serial surcharge adjustment applications with the possibility of having multiple applications pending at a single time. The end result of the serial filings and adjustments being repeated surcharge increases on customer bills.

RUCO's proposal is also contrary to Commission Staff and working group recommendations that Arizona local distribution companies seek PGA surcharge adjustments that anticipate market changes to avoid regular PGA surcharge adjustments. *See* Staff Report on Purchased Gas Adjustor Mechanisms, October 19, 1998 adopted as part of Decision No. 61225. Indeed, without the proposed surcharge increase, UNS Gas will be building a significant undercollected balance while its customers are not receiving accurate price signals to utilize conservation and other measures to address the price increase. As a result, customers will be building an even greater bank balance that must be collected at a later date through even higher surcharges.

In short, RUCO's proposal is not in the public interest and should be rejected.

Respectfully submitted this 7th day of October 2005

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