NEW APPLICATION

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BEFORE THE ARIZONA CORPORATION COMMISSION

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G-04204A-06-0013

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR.

DOCKET NO. G-04204A-06-_____

APPLICATION TO REVIEW AND REVISE PURCHASED GAS ADJUSTOR

UNS Gas, Inc. ("UNSG" or the "Company") hereby respectfully requests that the Arizona Corporation Commission ("Commission") review and revise UNSG's Purchased Gas Adjustor ("PGA") in accordance with the recommendations set forth below. In support, UNSG states as follows:

I. INTRODUCTION.

The PGA no longer allows UNSG, "to react to market fluctuations expediently in the regulatory environment in order to avoid severe impact on the Company's earnings and rate shock to the customers." (Citizens Utilities Co., Decision No. 58664 at 64, June 16, 1994). The current volatile natural gas market has exposed weaknesses in the PGA mechanism that cause significant delays in the recovery of gas costs incurred by UNSG. This severely impacts the customer's ability to make informed consumption decisions that reflect actual costs. This also severely impacts the Company's cash flows, which ultimately could have a negative effect on its earnings. Moreover, as bank balances are increased and surcharges imposed, it is inevitable that the Company's customers will see significant increases in their bills.

In order to avoid unintended negative consequences of the PGA, the existing mechanism must be modified to meet the specific circumstances in UNSG's service territory and the unprecedented price volatility in today's natural gas markets. The deficiencies existing in the current PGA mechanism include: (1) inappropriate price signals; (2) the potential for large bank balances to accumulate recovery of which causes price fluctuation and rate shock; (3) below market interest allowed to be earned on the bank balance; (4) an inappropriately narrow bandwidth; and (5) potentially adverse impact on UNSG's ability to devote capital to other necessary investments to serve its customers. Contributing to these problems is the volatile nature of the natural gas market. The current PGA mechanism was not designed to adequately cope with such volatility. Thus, it should be revised to correct these deficiencies.

Although UNSG intends to file a rate case in mid-2006, the shortcomings of the existing PGA should be addressed well before then. Accordingly, UNSG requests that the Commission adopt the following revisions:

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1. **Bandwidth.** Given the recent volatility in natural gas prices, UNSG does not believe that a bandwidth cap should be imposed on the PGA mechanism. However, in order to moderate volatility of customer bills, the current bandwidth cap of $.10 per therm could initially be increased to $.25 per therm as an alternative and then eliminated.

2. **Increase Interest.** The interest earned on the PGA bank balance should reflect UNSG's actual incremental cost of debt. UNSG can obtain new debt at LIBOR plus 1.5%. Thus, the interest on the PGA bank balance should be at least LIBOR plus 1.5%.

3. **Regulatory Asset.** When the actual PGA bank balance is greater than two times the Commission-approved threshold level, as has occurred under the existing PGA mechanism, it is clear that continuing to report the asset as "short-term" on the Company's balance sheet (meaning that it will be settled in its entirety within one year) is no longer appropriate. Instead, it should more correctly be considered as a

long-term asset (similar to materials, supplies, plant and equipment) requiring UNSG to commit longer-term investment capital, thereby justifying a carrying cost at a rate equal to UNSG's authorized weighted average cost of capital. Currently, that rate is 9.05%.

4. **Symmetrical threshold.** In order to be fair both the ratepayers and shareholders, symmetry should prevail, with the same threshold level applying to both under-collected and over-collected bank balances. UNSG recommends that the new threshold level for under-collected bank balances established in Decision No. 68325 ($6,240,000) also be adopted as the threshold level for over-collected bank balance.

5. **Capital Structure.** If the PGA mechanism results in UNSG accumulating significant PGA bank balances, additional long-term debt financing will likely be required. This additional debt will impact the Company's capital structure and weighted cost of capital, thus altering the determination of revenue requirements in future rate cases. Because the current PGA mechanism provides for the accrual of carrying charges on the monthly balance (notwithstanding the inadequacy of the current interest accrual rate as previously described), the PGA bank balance would not be includible in rate base for ratemaking, even though <u>all</u> long-term debt issues are normally reflected in capital structure. As a result, the computed overall rate of return to be applied to rate base would be artificially diminished, as would be the computed overall revenue requirement. UNSG respectfully requests that the Commission specifically find that any additional long-term debt issued solely to support the PGA bank balance be excluded from the determination of the cost of capital in future UNSG rate case proceedings. This is similar to the exclusion of short-term debt balances from capital structure when they support construction work in progress, which is not included in rate base.

6. **Surcharges.** The above modifications should reduce the need for surcharges. However, when surcharges are required, the Commission should approve a

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surcharge large enough or a recovery period short enough, to eliminate the bank balance in a reasonable time period.

II. UNSG's CURRENT PROBLEMS.

A. Problems Facing UNSG.

The current structure of the PGA, combined with recent changes in the natural gas market, puts UNSG in an untenable position. Because UNSG currently receives only a fraction of its gas distribution revenues through a fixed monthly customer charge, the Company is dependent on continued gas sales and system throughput in order to earn a margin reflective of its authorized rate of return and to maintain its financial health. However, under the current PGA structure, higher gas sales at rates below full cost exacerbate the gas cost under-recovery problem, thus resulting in higher PGA bank balances which must be financed with additional debt. Given contractual limits imposed on UNSG with respect to the amount of debt it may incur, higher gas sales expose the Company to additional liquidity risk. So while higher gas sales result in higher revenues for UNSG, these higher sales also serve to deplete the credit line available to UNSG.

In light of UNSG's limited borrowing capacity, its continuing exposure to gas price volatility, and a continuing need for capital to fund growth-related plant additions, UniSource Energy Corporation made an additional $10 million equity investment in UNSG in December 2005. This equity investment was made despite the fact that the prospect of UNSG earning its authorized rate of return anytime soon, without rate relief, is doubtful. While this equity investment has served to postpone new borrowings by UNSG, the Company forecasts that significant additional borrowings will be required in 2006 and 2007 if gas prices remain high and the current PGA structure remains unchanged.

The current PGA mechanism is problematic in several respects. First and foremost, UNSG must carry a large and ever-mounting PGA bank balance. Second, funding for other needed projects is constrained because of the resources required to support the PGA bank balance. Third, the PGA bandwidth is too narrow and, therefore, no longer reflects the volatility of the cost of gas purchased by and transported to UNSG. Fourth, because interest earned on the PGA bank balance

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is well below UNSG's incremental cost of borrowing, UNSG loses money on every dollar in the PGA account. These problems, which are described in greater detail below, can be remedied by adopting the six recommendations described above.

1. Adverse effects of large PGA bank balances.

The most significant problem is the relative magnitude of the PGA bank balance that UNSG must carry. A history of the PGA bank balance since UNSG purchased the assets from Citizens in August 2003 is shown on Attachment A. The PGA bank balance is currently $10.6 million at the end of November and is projected to be $18.6 million at the end of February 2006. The large PGA bank balance continues to increase. By January 2007, UNSG projects the PGA bank balance will reach over $25 million. At that point, it is estimated that each customer's share of the PGA bank balance will be $180 (bank balance/number of customers.) The projected level of the monthly PGA bank balances over the next three years is shown on Attachment B. All projections for Attachment B are based on forward prices as of December 22, 2005.

A revised version of Attachment B, containing updated projections, is attached as Attachment B-1. The projections for Attachment B-1 are based forward prices as of January 6, 2006. As a comparison of these two exhibits demonstrates, a change of only two weeks can have a significant impact on projections. This only underscores the high volatility of the current natural gas market. The PGA must be re-designed to accommodate this dramatically high volatility.

Historically, the Commission intended the PGA mechanism to allow local gas distribution companies such as UNSG to recover their gas costs, while providing rate stability and certainty to customers. Under the current PGA methodology and surcharge procedure, the PGA bank balance may not be recovered for many years. Such a structural deficit is bad for consumers, who will eventually have to pay for these incurred costs. And it is bad for UNSG, who is forced to bear the large financial burden of the bank balance. That translates to substantially increased business and financial risks, thereby raising UNSG's cost for all sources of new capital, which will be directly reflected in the Company's revenue requirement.

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The PGA bank balance imposes a large financial burden on UNSG. Using the same gas price forecast that was used to estimate the PGA bank balances in Attachment B, UNSG estimates that it will have to borrow an additional $42 million through 2008. The total line of credit available to UNSG is $30 million. As UNS Electric will also have borrowing needs resulting from customer growth in its service area, an amount less than $30 million will likely be available to UNSG after 2006.

Additionally, under the terms of a long-term note issuance in 2003, as well as under the current credit facility, UNSG must have an interest coverage ratio of at least 2.50X in order to incur additional debt. A minimum interest coverage ratio of at least 2.25X is required in the current credit facility also in order to maintain compliance with that agreement. As of September 30, 2005, the interest coverage ratio for UNS Gas was 3.39X. (See Attachment C for a copy of the calculation provided to lenders for the period ending September 30, 2005.)

Using the borrowing rate of 6.03%[1], UNSG could have borrowed an additional $39 million based on the Company's interest coverage ratio as of September 30, 2005. (See Attachment D for this calculation.) However, short-term interest rates will likely increase in 2006 if the Federal Reserve continues to tighten its monetary policy. At the same time, earnings available to cover interest payments at UNSG are expected to decline as the Company enters its fourth year of a rate moratorium while its cost of service continues to increase due to growth in the number of customers and inflation. As a consequence, UNSG estimates that using weather-normalized sales, the Company's borrowing capacity will be limited to approximately $20 – 25 million through 2007. This compares to forecast borrowing of $42 million by 2008. Should sales be lower than expected due to mild weather or customer conservation, UNSG's borrowing capacity would be limited even further.

Continuation of the existing PGA mechanism in the current volatile gas market exposes UNSG to significant financial risk. If UNSG is forced to acquire additional capital in excess of its

[1] This is the rate applicable to UNSG under the credit facility as of December 28, 2005, which is based on a 3-month LIBOR rate of 4.53% plus a credit spread of 1.50%.

borrowing capacity to finance the PGA bank balance, the Company will be left with few remaining options. Those options would consist of (1) asking UniSource Energy Corporation for additional equity capital with no reasonable prospect during the next 18 months of earning a compensatory return on that capital, (2) liquidating UNSG's forward gas positions that have a positive mark-to-market value, or (3) seeking waivers or amendments to existing loan agreements. However, there can be no assurance that lenders would be amenable to any waiver or amendment to the loan documents, and even if they were, such concessions would likely come at a significant price to UNSG.

2. *Adverse impact on other capital projects.*

In addition to these direct adverse effects, the expected financing of PGA bank balances would cause an additional problem. By consuming a large and ever-increasing share of UNSG's financial resources, the PGA bank balance is diverting limited financial resources from other important projects. Upgrading the UNSG distribution system to meet operational and safety needs requires substantial and recurring capital investment. Moreover, portions of UNSG's service territory are experiencing strong growth. Such growth benefits a utility, but also requires additional plant investment. While some of this investment for growth can be funded through Contributions-In-Aid-of-Construction ("CIAC") and Advances-In-Aid-of-Construction ("AIAC") from developers, the Commission is aware of the dangers of excessive reliance on CIAC and AIAC.

In addition to sharply limiting UNSG's ability to fund needed capital projects, the large PGA bank balances have a similar effect on UNSG's sister company, UNS Electric, Inc. ("UNS Electric"). Portions of UNS Electric's service territory are also experiencing significant growth. Like UNSG, UNS Electric needs access to capital to fund capital projects. But as a result of the deficiencies in the current PGA mechanism, UNSG is consuming a larger and growing portion of the $40 million joint credit facility.[2] UNS Electric is left with the funds that remain, limiting its ability to meet its capital needs as they arise.

[2] Under this credit facility, each subsidiary is limited to $30 million.

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3. ***Inadequate Bandwidth.***

The purpose of the PGA is to allow UNSG to recover its gas costs in a reasonably timely fashion while smoothing out price fluctuations for customers. The primary means to smooth out prices is the 12 month rolling average feature of the PGA Rate. As an additional protection, the Commission added a "band" which further limits movement of the PGA Rate. The band was intended to come into play only in "extraordinary" circumstances, and not on a routine basis.[3]

Contrary to the original intent of the band, it has come into play much more frequently than anticipated. The band has precluded the PGA Rate from accurately reflecting the current 12-month weighted average cost of gas in **five** of the last **12** months, and is expected to limit the PGA Rate in EVERY month for the next 12 months, thereby causing the PGA bank balance to grow significantly.

Because it has come into effect so often, the band limit no longer acts as a price smoothing device. Instead, the band has completely severed the link between the cost of gas and the allowed recovery level such that no meaningful price signals are sent to customers. In other words, the band no longer just limits price volatility, it limits the PGA from reflecting fundamentally higher prices of gas. This causes the PGA to act like an "out-of-control credit card," piling up debt faster than customers can pay it off.

To eliminate undue financial risk for the Company and its customers, and to send the proper price signals, the PGA band limit should be eliminated. This will allow the rolling average of the PGA to accurately reflect the true, long-term cost of gas while still using the 12 month rolling average to smooth out price fluctuations. A band is not a necessary component of a PGA, but if the Commission believes that a band is necessary, UNSG would accept having a band as a temporary additional protection for customers. The band must be set at an appropriate level. When the band is too narrow, it does not protect customers. Rather, it harms them by removing needed price signals causing them to run up a huge debt, because they do not know the true, underlying cost of gas they are consuming. It also harms UNSG, who must bear the burden of the

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[3] *See infra* at 14-15.

bank balances until it is paid off. The current constrictive band should be eliminated, or in the alternative, temporarily increased and then eliminated.

4. Inadequate Interest.

UNSG's financial situation is further aggravated by the inadequate level of interest allowed on the PGA bank balance. Under the revolving credit facility, UNSG pays interest at a rate of LIBOR plus a credit spread of 1.5%.[4] Thus, when the PGA does not cover the cost of gas, UNSG borrows money at this rate to pay for the gas it buys for its customers. UNSG is only allowed to recover a lower interest rate on the PGA bank balance – the three month non-financial commercial paper rate. Currently, LIBOR plus 1.5% is 6.03% while the three month non-financial commercial paper rate is 4.43%. For every dollar borrowed to fund the PGA bank balance, UNSG loses money as a result of the spread between interest paid and interest earned, even if the bank balance is ultimately paid off.

Ordinarily, a business expects to earn a profit on goods or commodities that it purchases and then sells to its customers. When operating as intended, a PGA provides the utility with no profit on the gas it purchases for its customers. The utility at best only recover its gas costs, dollar-for-dollar. The only profit that a utility is allowed is a reasonable opportunity to earn a fair rate of return on prudently-invested capital. UNSG understands and accepts this tenant of cost-based utility regulation. However, the PGA no longer operates as it was originally intended, with customers now paying for gas at prices that do not fully reflect costs. UNSG potentially loses money on each sale because costs not currently recovered are deferred to a tracking account upon which interest is accrued at a low rate. Therefore, UNSG respectfully requests that the interest rate on the PGA bank balance should be increased to at least LIBOR plus 1.5%.

B. Impact of Unique Characteristics of UNSG on these Problems.

The unique characteristics of UNSG and its service territory magnify the structural flaws in the current PGA. The current PGA was designed on a "generic" basis – it applies to all Arizona

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[4] "LIBOR" stands for "London Inter-Bank Offering Rate," and is a commonly used benchmark interest rate.

Local Distribution Companies ("LDCs") subject to the Commission's jurisdiction.[5] The PGA was not designed specifically for UNSG or its service territory.

For example, UNSG is a unique size. It is much smaller than Southwest Gas. Southwest Gas has more Arizona customers, and it has additional customers in Nevada and California. UNSG's smaller size gives it less ability to withstand the financial stress of high PGA bank balances. UNSG is larger than the other two natural gas[6] LDCs in Arizona. Those two LDCs (Duncan Rural and Graham County Utilities) are cooperatives, and as such, have access to special low cost lenders (such as RUS and CFC), and special income tax benefits. UNSG does not have these special advantages. UNSG's service territory is also unique. UNSG's Northern Arizona service territory is the coldest in Arizona. Its customers have the greatest need for heat and they have the highest usage. The increased usage occurs predominantly just as prices are at their highest. Under the current PGA, these factors produce bank balances which, in proportion to the utility's size, are high.

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III. TRENDS IN NATURAL GAS MARKETS AND THEIR IMPACT ON THE PGA.

A. Recent History Has Shown Dramatic and Fundamental Changes in the Natural Gas Market.

1. Tight Match Between Supply and Demand.

The natural gas market is currently characterized by a tight match between supply and demand. As Staff recently noted, there is a "fundamentally tight supply-demand balance in natural gas markets."[7] For example, the import of liquefied natural gas has not increased as expected due to competing overseas demand for natural gas. Moreover, recent hurricanes have reduced domestic natural gas production in the Gulf Coast area magnifying the tight balance in the short-term. This has occurred at the same time that demand for natural gas has increased due to the large increase in gas generation, specifically in Arizona and the Southwest. This tight supply and

[5] *See infra* at 14-16.
[6] There are also two small propane LDCs.
[7] "Causes and Anticipated Impacts of Rising Natural Gas Prices," at slide 7, Bob Gray, Arizona Corporation Commission, September 8, 2005.

demand balance predates those hurricanes. As the American Gas Association explained long before the hurricanes hit, under no scenario "does the natural gas market return to the conditions that prevailed in most of the 1980s and 1990s – surplus supply and relatively low, stable prices."[8] In short, this trend is not going to go away for the foreseeable future.

2. *Declining domestic production.*

Production from existing well-fields in North America peaked a few years ago, and has subsequently been in decline. This is true even though record numbers of wells are in operation. Few opportunities exist to find additional natural gas in North America, except for certain offshore areas which are largely "off-limits" to drilling.

3. *Expensive new sources.*

There are no new, inexpensive sources of gas in North America. New sources, such as LNG, have longer lead times, come with geo-political risk, and are much more costly than historical resources. As the United States Energy Information Administration recently noted, "More rapid growth in worldwide demand for natural gas… reduces the availability of LNG supplies to the United States and raises worldwide natural gas prices, making LNG less economical in U.S. energy markets.[9]

4. *Increased demand.*

While domestic supply drops, demand continues to rise. A major factor driving increased demand is the prevalence of gas-fired electrical generation. Almost all new electric generation (base load and peaking) constructed in the United States in the last decade has utilized natural gas. Economic and population growth are additional factors driving increased demand, as well as growing foreign demand.

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[8] "Natural Gas Outlook to 2020", Executive Summary at 1, American Gas Association, February 2005.

[9] United States Energy Information Administration, "Annual Energy Outlook 2006 with Projections to 2030 (Early Release) – Overview", www.eia.doe.gov/aeo, (December 2005); *see also* Federal Energy Regulatory Commission, "Winter 2005-2006 Natural Gas Market Update", (December 15, 2005)(noting that LNG imports remained below expectations, due to "many reasons", including higher overseas demand)

5. *Transportation issues.*

In addition to these national trends, Arizona-specific factors can also have an impact on customers. Arizona lacks any natural gas storage facilities. In addition, Arizona has limited options for pipelines to transport gas, especially in central and southern Arizona. Moreover, the major pipeline operator in Arizona is in the process of substantially raising its rates.

B. Effects of these Trends.

Declining domestic production, more expensive new sources, and increased worldwide demand has resulted in higher overall natural gas prices. As this Commission has acknowledged "the world of $3 gas is over."[10] This tight match between supply and demand leads to increased prices and also large price swings from the market's increased volatility. This is easily observed as may be seen from the relative price movements for the January Nymex Natural gas contract shown on Attachment E. In just over two weeks, from the end of November to the middle of December, the January Nymex contract price increased over $3.50 per mmBtu which equates to $0.35 per therm.

C. Implications for the PGA.

Increasing prices and increasing volatility have implications that should be considered in reviewing the PGA. First, higher long-term prices signal that the Commission should not assume that lower prices will eventually take care of the bank balance. Second, greater price volatility implies that the bandwidth should be eliminated, or at least appropriately increased, or the PGA, without additional surcharges, will never fully recover gas costs, leaving the bank balances rising ever higher. Third, the Commission should recognize the difference between these two factors – increased prices and increased volatility. A properly structured PGA, in combination with actions like hedging and promotion of levelized billing, can partially shield customers from volatility. But no PGA can, over the long term, shield customers from increased gas prices. Sooner or later, the bill will come due. Thus, a properly structured PGA should be able to adjust to accurately reflect higher (or lower) prices, while providing some protection from price volatility.

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[10] Open Meeting Transcript, October 18, 2005, at page 36, line 11.

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IV. HISTORY OF THE PGA.

In order to understand the genesis of the current difficulties facing UNSG regarding the PGA, it is useful to review the history of the PGA. As the Commission is aware, UNSG acquired its gas properties from Citizens. These properties had a long-established PGA. But this company-specific PGA was eliminated in favor of a standard PGA mechanism in the late 1990s. Recent decisions regarding the PGA have not adequately addressed or resolved the underlying flaws in the operation of the PGA.

A. Citizens' Original PGA.

The Citizens Northern Arizona PGA "for a number of years" consisted of a "12 month rolling average PGA rate, with no band."[11] While it was in place, this PGA was generally effective in stabilizing customer rates and enabling the Company to recover its gas supply costs in a reasonable time period. Thus, the Commission found that this PGA should be retained, explaining:

> The record indicates that all parties have concurred that the gas cost component is a very substantial expense of the Company. As such, the PGA mechanism permits the Company to react to market fluctuations expediently in the regulatory environment in order to avoid severe impact on the Company's earnings and rate shock to the customers. Elimination of the PGA clause would require the Company to file rate cases on a more frequent basis which could substantially prolong and burden the regulatory process and hinder the Company's ability of responding to volatile market conditions.[12]

In the last Citizens' Northern Arizona rate case[13] prior to the acquisition by UniSource Energy, the Commission modified the Citizens PGA by instituting a threshold amount (then called a "triggering mechanism") of $ 2,500,000.[14] Like the current threshold, Commission review was required if this threshold was exceeded. This was the only structural change to the Citizens PGA, which otherwise continued as before.

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[11] "Staff Report on the Rolling Average PGA Mechanism", December 2, 2001, Docket No. G-00000C-98-0568 at 4.
[12] Citizens Utilities Co., Decision No. 58664 at 64, June 16, 1994.
[13] Docket No. E-1032-95-473. This case only applied to Citizen's Northern Arizona Gas Division.
[14] Citizens Utilities Company, Northern Arizona Gas Division, Decision No. 59875 at 4, October 29, 1996.

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B. The Generic PGA Docket.

1. 1998 Staff Report.

Before 1998, other utilities had a fixed PGA rate that only adjusted when the Commission specifically approved an adjustment. This procedure is similar to the current one for surcharges. Typically, when the bank balance became "significantly under or over-collected" utilities would file for an adjustment to their PGA rate.[15] This resulted in the PGA rate "lag[ing] behind the market", and thus caused "sharp" changes when adjustments were finally made.[16]

Because of these problems, Staff recommended that this traditional PGA methodology be modified in several respects. Staff recommended that the Commission adopt a banded 12-month rolling average weighted cost of gas.[17] This is similar to the Citizens Northern Arizona 12-month rolling average PGA.[18] The only difference was the addition of a "band" that limited fluctuations in the PGA Rate.

Staff explained that the bands could be set at various levels. Staff noted that banding "has the effect of smoothing large swings in the PGA rate."[19] Staff warned that if "the banding is set too tight, the bank balance would have a strong tendency to build up sizable over or under collections and the price signal to the customer would be largely muted."[20] Staff proposed the following standard for setting the band: "The banding of the PGA rate needs to be set so that in most cases the changing PGA rate will accurately track the 12-month rolling average."[21] The banding should be set so that it will apply only in "extreme circumstances."[22] Staff recommended a $.07 per therm band.[23]

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[15] "Staff Report on Purchased Gas Adjustor Mechanisms", October 19, 1998, Docket No. G-00000C-98-0568 at 3.)
[16] *Id.* at 10.
[17] 12-month weighted average cost of gas less cost of gas in basic service rates.
[18] *Id.* at 19.
[19] *Id.* at 13.
[20] *Id.*
[21] *Id.*
[22] *Id.* at 14
[23] The $.07 per therm was for natural gas. For propane customers, the price band was $.12 per therm. *Id.* at 24.

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2. ***First PGA Order.***

The Commission considered and approved these Staff recommendations.[24] The First PGA Order specifically approved a "banded 12-month rolling average mechanism."[25] The Commission explicitly recognized "price stability as one of the goals of the natural gas procurement process."[26] The Commission stated that utilities "should be permitted an opportunity to recover the gas costs associated with" prudent contracts.[27] The Commission recognized that the new PGA mechanism was not fixed in stone, but rather that it needed periodic reviews. Thus, the Commission ordered Staff to review the new PGA mechanism and file recommendations within 24 months.[28]

3. ***Second PGA Order.***

Staff completed the assigned review and filed a staff report detailing its findings.[29] Staff commented on the band limit, noting that "where there are extreme swings in the price of natural gas, the PGA rate is likely to hit the band. In such cases an LDC may find that its PGA bank balance becomes highly over or under collected...."[30] Staff explained that the bands were "arbitrarily set" and are subject to adjustment in the future. Staff recommended that the band for natural gas be increased to $.10 per therm.[31] Staff also noted that "there are a number of other interest rates which could be applied to the PGA bank balance", although it did not recommend a change in the interest rate.[32]

The Commission considered and approved the recommendations in this Staff report.[33] The Commission increased the band for gas to $.10 per therm.[34] The Commission also clarified how

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[24] Purchased Gas Adjustor Mechanisms, Decision No. 61225, October 30, 1998 ("*First PGA Order*"). At that time, the price for natural gas was much lower than the current costs and volatility was much less then recent experience.
[25] *Id.* at 2.
[26] *Id.*
[27] *Id.*
[28] *Id.* at 3.
[29] "Staff Report on the Rolling Average PGA Mechanism", September 6, 2000, Docket No. G-00000C-98-0568.
[30] *Id.* at 2.
[31] Staff recommended that the band for propane be modified to $.16 per therm.
[32] *Id.* at 4.
[33] Rolling Average Purchased Gas Adjustor Mechanism, Decision No. 62994, November 3, 2000 (Second PGA Order).
[34] *Id.* at 2.

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interest should be applied to the PGA bank balance, and it ordered Staff to file a further report on the PGA mechanism by December 2001.[35]

4. *Third PGA Order.*

The Commission later ordered Staff to conduct workshops concerning prudence reviews.[36] Recently, Staff initiated such a prudence review of UNSG.[37] Thus, the prudence of UNSG's gas purchases is not at issue in this docket.

5. *December 2001 Staff Report.*

As required by the Second PGA Order, Staff filed a report in December 2001.[38] Staff recommended that interest on the PGA bank balance reflect income tax effects.[39] Staff also clarified which Federal Reserve publication should be used to determine the interest rate for the PGA bank balance.[40] That interest rate is the "three month nonfinancial commercial paper rate,"[41] even though this is typically below the cost of borrowing. Staff noted that "several other interest rate options have been discussed" but recommended that the current interest rate be retained.[42] Staff's rationale was that there was no "compelling reason" to recommend a different rate, and there "may even be some benefit in having the interest rate be less than the utility's cost of borrowing in that the utility would be given an incentive to not let the bank balance become overly large without taking action to address it."[43]

C. The Surcharge Holiday.

As of May 2001, Citizen's PGA bank balance was nearly $39 million.[44] The Commission therefore approved a variable surcharge to attempt to recover the uncollected balance over a period

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[35] *Id.*.
[36] Review of Natural Gas Procurement Activities, Decision No. 63848, June 28, 2001(Third PGA Order.)
[37] *See* Docket No. G-04204A-05-0831.
[38] "Staff Report on the Rolling Average PGA Mechanism", December 3, 2001, Docket No. G-00000C-98-0568.
[39] *Id.* at 2.
[40] *Id.* at 3.
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] Citizens Utilities Co., Decision No. 65384 at Finding of Fact No. 3, November 13, 2002. The balances were $36,906,303 for the Northern Arizona Gas Division and $2,072,018 for the Santa Cruz Gas Division. Thus, the total for both divisions was $38,978,321.

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of twenty-four months, or when the bank balance was fully collected, whichever occurred first.[45] This surcharge was not fixed. Instead, under the surcharge, a customer's total per therm cost of gas (base cost + PGA Rate + PGA surcharge) was fixed, and the surcharge was determined by subtracting the base cost and PGA rate from this total fixed cost.[46] The surcharge changed in an "equal and opposite manner" relative to changes in the PGA rate.[47]

By August 2002, the Citizen's PGA bank balance was over $11 million.[48] While reduced, this amount was still high. However, the Commission decided to impose a "surcharge holiday", which eliminated the surcharge for January and February 2003 and halved it for December 2002 and March 2003.[49] The surcharge holiday was motivated by a desire to limit the pain of high utility bills by providing "significant rate relief."[50]

Staff projected that under the surcharge holiday, Citizen's under-collected bank balance would be fully recovered by September 2003, which was the end of the recovery period approved in Decision No. 64054.[51] Unfortunately, this did not occur. Instead, by October 2003, the under-collected balance was projected to be more than $7 million.[52] This was due to two factors. First, the introduction of a surcharge holiday prevented the surcharge from fully reducing the under-collected bank balance. Second, the structure of the surcharge was ineffective. Because the surcharge varied inversely to the PGA rate, when prices increased, the surcharge decreased, delaying recovery and compounding the problem.

These two factors resulted in a large bank balance and yet more surcharges. The utility was forced to carry this large balance and the customers ultimately had to foot the bill. This situation benefited no one.

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45 *Id.* at Finding of Fact No. 2 (citing Decision No. 64504, September 27, 2001).

46 *Id.* at Finding of Fact No. 4.

47 *Id.*

48 *Id.* at Finding of Fact No. 14. The balances were $10,511,382 for the Northern Arizona Gas Division and $615,147 for the Santa Cruz Gas Division. Thus, the total for both divisions was $11,126,529.

49 *Id.* at Finding of Fact 15-16 and Conclusion of Law No. 3.

50 *Id.*

51 *Id.*

52 UNS Gas, Inc., Decision No. 66341 at Finding of Fact No. 6, September 30, 2003.

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D. UNSG Acquires Citizens' Gas Operations.

In late 2002, UniSource Energy agreed to acquire Citizen's gas utility assets in Arizona. UniSource Energy formed a new subsidiary – UNSG – to own and operate these assets. The Commission approved this transaction and granted a Certificate of Convenience and Necessity to UNSG. (Citizens Communication Co., Decision No. 66028, July 3, 2003)("Citizens' Sale Order").

The Citizens' Sale Order included a settlement of the pending Citizens gas rate case. The Commission directed that the existing Citizens bank balance and PGA mechanism remain unaffected by the transaction.[53] The Commission approved a base cost of gas of $.40 per therm.[54] This compares to current market prices in the $1.00 per therm range. The Commission also approved a temporary increase in bandwidth to $.15 per therm for one year.[55]

E. The Circuit Breaker.

The Commission recognized that the Citizens fluctuating surcharge "led to a high level of uncertainty regarding recovery of the undercollected PGA bank balance."[56] The Commission therefore abandoned the fluctuating surcharge and adopted a fixed surcharge.[57] This fixed surcharge was $ 0.1155 per therm.[58] The Commission did not provide for a specific termination date, explaining that it "is appropriate for UNSG to continue the PGA surcharge until the PGA bank balance reaches zero."[59]

In this order, the Commission also adopted a "circuit breaker". Under the circuit breaker, the surcharge would not apply to a residential customer whose usage in a month exceeded 140% of

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[53] However, because the existing Citizens operating gas divisions (Northern Arizona and Santa Cruz) were being combined into the entity that has become UNSG, the PGA bank for the two properties were also combined, as were the base costs of gas, the PGA rates, and the gas cost surcharges. *Id.* at 17.

[54] *Id.*

[55] *Id.* at 17.

[56] UNS Gas, Inc., Decision No. 66341 at Finding of Fact 8, September 30, 2003.

[57] *Id.*

[58] *Id.* at Finding of Fact No. 6.

[59] *Id.* at Finding of Fact No. 18.

the average residential customer usage for that month.[60] The circuit breaker was in effect during December, January, February and March.[61]

However, a few months later, the Commission modified this order.[62] The Commission ordered that the surcharge terminate after the October 2004 billing cycle, even if the under-collected bank balance was not recovered.[63] The Commission also lowered the trigger for the circuit breaker to only 125% of average monthly usage.[64] In its Decision, the Commission also ordered Staff to conduct a study evaluating any "potential unintended consequences of the circuit-breaker mechanism."[65]

Staff filed the study as ordered.[66] This report noted numerous potential problems with circuit breaker mechanisms:

- Customer confusion (a circuit breaker on top of a surcharge on top of a PGA on top of the base cost of gas)
- Additional billing costs (from reprogramming billing systems)
- Forced levelized billing (by deferring costs to summer months, even when the customer did not choose levelized billing)
- False expectations of savings (the customers run up a credit card bill without knowing it)
- Generational inequities (by deferring costs, new customers must pay for costs they did not cause)
- Inequities between customer classes (classes not subject to circuit breaker subsidize those that are subject to it)

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[60] *Id.* at Finding of Fact No. 18.

[61] *Id.*

[62] UNS Gas, Inc., Decision No. 66861, March 23, 2004.

[63] *Id.* at Finding of Fact No. 7.A.

[64] *Id.*

[65] *Id.* at Finding of Fact No. 8.

[66] "Staff Report on Circuit-Breaker Mechanisms: Possible Unintended Consequences, Potential Inequities, and Impacts on Energy Conservation", filed June 9, 2004, Docket No. E-01032C-00-0751 et al.

- Inequities within class (because circuit breaker only protects high usage customers, low usage customers perversely end up paying more than their fair share)
- Reduced conservation (because the circuit breaker in essence creates a declining block rate structure, i.e. those who use more pay less per unit)[67]

Although Staff discussed these issues as "potential" problems, these issues demonstrate the substantial practical and theoretical problems created by circuit-breakers.

F. Recent Actions.

1. The three cent surcharge.

The previous UNSG surcharge expired after the October 2004 billing cycle. Because of the limits imposed by the Commission, this surcharge was not effective in reducing the PGA bank balance. By the end of 2004, UNSG's under-collected bank balance was approximately $9.29 million.[68] Thus, in January 2005, UNSG requested a new surcharge of $.06 per therm.[69] Staff recommended a surcharge of $.05 per therm, noting that the bank balance would not be fully recovered unless the surcharge was at least as high as $.05.[70] But the Commission, citing "pricing concerns of consumers," approved only a $.03 per therm surcharge.[71] The Commission also directed that the surcharge not apply to low-income customers receiving service under the CARES tariff.[72]

Two Commissioners dissented. They did so because they believed the decision was unfair to both customers and UNSG.[73] They explained that the decision "is unfair to UNSG because it prevents the Company from timely recovering unavoidable costs that the Commission has mandated."[74] And the decision was unfair to ratepayers because "the longer it takes to eliminate the balance, the more interest the customers will ultimately have to pay, the larger the next

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[67] *Id.*
[68] UNS Gas, Inc., Decision No. 67730 at 2, March 31, 2005.
[69] *Id.* at 1.
[70] *Id.* at 4.
[71] *Id.* at 4.
[72] *Id.*
[73] UNS Gas, Inc., Decision No. 67730, Dissenting Opinion, dated April 11, 2005.
[74] *Id.*

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surcharge will have to be and the more services will be endangered. If gas prices should increase, the impact on consumers will be even greater, and could result in severe rate shock."[75]

2. *The current surcharge.*

Unfortunately, natural gas prices increased rapidly. Moreover, gas transportation prices also increased, as the El Paso Natural Gas Company ("EPNG") filed for a substantial rate increase. Following its normal practice, the Federal Energy Regulatory Commission ordered that EPNG's proposed rates go into effect while the case is processed.[76] As the Commission recently told FERC, the "customers are already facing unprecedented rate increases resulting from record high natural gas commodity prices", which, when combined with increased transportation costs create "the potential for rate shock."[77]

UNSG projected that its PGA bank balance would reach $25 million in January 2005 and $45 million in January 2007.[78] The Commission acknowledged increases in both prices and price volatility, noting "natural gas market conditions have shown significant volatility since UNSG's filing on August 17, 2005" and "the upcoming winter should see some of the highest sustained natural gas prices since wellhead prices were deregulated in the 1980s."[79]

Under these circumstances, UNSG requested a $.27 per therm surcharge.[80] Staff proposed a $.19 per therm surcharge that would increase to $.25 per therm in January 2006.[81] But the Commission, noting that the "greatest increase in the surcharge coincides with the height of the winter heating season", adopted the following surcharges:

November 2005 – February 2006	$.15 per therm
March – April 2006	$.25 per therm

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[75] *Id.*

[76] El Paso Natural Gas Co., 112 FERC ¶ 61,150 at ¶ 92 (July 29, 2005)(ordering that the proposed rates become effective on January 1, 2006); El Paso Natural Gas Co., Letter Order, Docket No. RP05-422 (December 12, 2005)(approving stipulated delay in effective date for certain charges until April 1, 2006).

[77] "Initial Comments of the Arizona Corporation Commission Regarding Technical Conference Issues", El Paso Natural Gas Co., Docket No. RP05-422 (November 18, 2005).

[78] UNS Gas, Inc., Decision No. 68241 at 2, October 25, 2005.

[79] *Id.* at 3.

[80] *Id.* at 1

[81] *Id.* at 4-5.

May – June 2006	$.30 per therm
July – September 2006	$.35 per therm
October – November 2006	$.25 per therm
December 2006 – February 2007	$.20 per therm
March – April 2007	$.25 per therm[82]

The Commission also adopted a number of customer protections. The exemption for CARES customers was continued. In addition, the Commission imposed a moratorium on disconnections from December 1, 2005 to March 30, 2006 (except for operational safety concerns).[83] The Commission also directed UNSG to implement a deferred payment plan for certain "individuals who are struggling to pay their bills."[84] Further, the Commission directed UNSG to conduct a "highly visible" public relations campaign, including promoting budget billing and the CARES program.[85]

3. *Increased threshold.*

The Commission recently increased the threshold level in the PGA. A bank balance level rising above the threshold requires UNSG to file for a surcharge (or explain why no surcharge is needed). The Commission noted that UNSG's then existing threshold was based on the threshold originally established for Citizens. Noting an increased volume of sales, as well as "high and more volatile natural gas prices", the Commission increased the threshold to $6,240,000.[86] But this increase only applied to under-collected bank balances, not over-collected bank balances.[87] The Commission did acknowledge the "general interest in having the cost causer pay for gas costs."[88]

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[82] *Id.* At 8.
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] UNS Gas, Inc., Decision No. 68325 at 3, December 9, 2005.
[87] *Id.* at 5.
[88] *Id.* at 4

G. Lessons from History.

1. Overview.

A long-standing regulatory tool in Arizona, the PGA was intended to limit price volatility, yet afford affected utilities a reasonable opportunity to recover costs in a timely manner. It is a price-smoothing device, not a credit card. Yet, as currently designed, the main effect of the PGA is not to smooth out price fluctuations, but to defer recovery of a substantial part of the cost of gas for extended periods of time. This creates enormous bank balances. Customers must eventually pay off these balances. In the meantime, UNSG is forced to bear the financial burden of these balances. Its recovery of these balances is delayed and it does not recover all of its carrying costs.

This clearly was not the Commission's intent in establishing the PGA. The First PGA Order, and the other orders in the generic PGA docket, attempted to establish a fair mechanism for utilities to recover their gas costs while limiting customers' exposure to price volatility. The current PGA does not fulfill this laudable purpose because of structural flaws described above. These flaws include a too-narrow band limiting the change in monthly PGA rates, inadequate rates for accruing interest on PGA bank balances, and surcharges that when approved do not provide for the full and timely recovery of bank balances. Fortunately, these flaws can be remedied, and the purpose of the PGA can be fulfilled.

2. Bandwidth.

The first flaw is the band. As Staff explained if "the banding is set too tight, the bank balance would have a strong tendency to build up sizable over or under collections and the price signal to the customer would be largely muted."[89] This is exactly what happened. Staff's standard for evaluating the band is that in "most cases … the changing PGA rate will accurately track the 12-month rolling average" with the banding coming into play only in "extreme circumstances."[90] The Commission approved all of Staff recommendations in its First PGA Order, thus endorsing this standard.

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[89] "Staff Report on Purchased Gas Adjustor Mechanisms" at 13-14, October 19, 1998, Docket No. G-00000C-98-0568.

[90] *Id.*

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Under these standards, recent history has shown that the banding is clearly too narrow. The banding prevented the PGA Rate from accurately reflecting long-term trends in the cost of gas, resulting in large bank balances on numerous occasions. The band limit has been in effect for **five** of the last twelve months and is projected to be in effect for every one of the next 12 months. The band limit has acted, not just in extreme circumstances, but in routine circumstances.

The original Citizens PGA, which had no band, successfully achieved the purpose of a PGA. The 12-month rolling average served to smooth out price fluctuations, while still allowing the utility to recover its costs. Under the current PGA, the rolling 12 month average was intended to remain the primary protection for customers. The band was simply an experimental additional safeguard, to protect against extreme circumstances. The band is not needed, and it should be eliminated. But if it is retained, it must be set at an appropriate level. A $.25 per therm band, while still quite restrictive, would start to move the band back towards its original and proper purpose.

The current band is not set in stone. The band was experimental, and Staff agrees it was "arbitrarily set."[91] The Commission increased the band in the Second PGA Order and, temporarily, in the Citizens' Sale Order. Had the Commission not done so, the current situation would be even worse. These actions were appropriate, and the Commission should act again to eliminate the band or to set the band at an appropriate level.

3. Interest.

The PGA mechanism was not intended to create large bank balances; thus, the use of a **90-day** interest rate. When bank balances did exceed the threshold, it was anticipated that surcharges would be approved that would promptly reduce the bank balances. Large bank balances did occur and adequate surcharges were not implemented. In recent times, it has taken more than two years for some gas costs to be recovered through the PGA. In such circumstances, an adequate interest rate for use in computing carrying charges on the bank balance, reflecting the significant unrecovered costs as well as the duration between cost incurrence and cost recovery, is critical.

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[91] "Staff Report on Rolling Average PGA Mechanism at 2", September 6, 2000, Docket No. G-00000C-98-0568.

Unfortunately, the current interest rate is flawed, because it is not tailored to UNSG, and because it does not reflect UNSG's actual costs. The current rate – like the rest of the PGA – was set on a "generic" basis, rather than being tailored to each utility. Each utility is different, and the PGA for each utility should reflect these differences. The current interest rate is flawed because it does not take into account UNSG's actual cost of new debt. Moreover, the current interest rate (the three month non-financial commercial paper rate) is well below the actual interest rate that UNSG must pay to borrow the funds needed to buy the gas required by its customers.

In the most recent staff report on PGA interest, Staff offered two justifications for the current interest rate. First, Staff suggests that there is no "compelling reason" to change the rate.[92] Staff cites no authority for this standard. Even if it was valid, circumstances have changed since then. In an era of inadequate surcharges and high bank balances, adequate interest is of critical importance.

Staff's second argument was that an interest rate below the cost of borrowing might give utilities an "incentive" to take action before bank balances become too large. Under the PGA, bank balances are reduced by surcharges. But UNSG cannot unilaterally impose a surcharge. Instead, UNSG must request that the Commission approve a surcharge. UNSG has diligently filed for such surcharges, as mandated by the PGA. But in practice, the surcharges which were approved were not adequate to reduce the bank balance. In hindsight, this incentive no longer makes sense. No one anticipated that so many surcharges would be needed, or that the surcharges would not be large enough to reduce the bank balances. No one anticipated that UNSG would be forced to carry such large balances. But these things came to pass, and they must be addressed.

4. Surcharges.

When the current PGA was designed, surcharges were expected to be a rare occurrence. The fact that they have become common is a sign that the PGA is flawed. By increasing the allowed interest rate and bandwidth (or eliminating the band altogether), the Commission can reduce the need for surcharges.

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[92] "Staff Report on the Rolling Average PGA Mechanism", December 3, 2001, Docket No. G-00000C-98-0568.

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But when surcharges are needed, experience shows that they should be applied. Unrecovered costs will not by themselves disappear, and customers need to have prices that send the proper signals so that they can make prudent decisions on the extent and manner of their energy usage. In the past, the Commission often approved surcharges smaller than needed. Experience has shown that this just causes more problems later.[93] When a surcharge is needed, the Commission should approve a surcharge large enough to effectively reduce the bank balance in a timely manner.

Out of these same concerns, the Commission has experimented with devices to limit surcharges. The Commission approved the surcharge holiday and the circuit breaker-mechanism. These experiments, while well-intentioned, failed. Further, these experiments did not effectively target customers that needed help the most. For example, any family using large amounts of gas to heat a large house would have been protected under both experiments.

In sum, the PGA should be modified to make surcharges less common. And when they are needed, the full necessary surcharge should be approved.

V. <u>REGULATORY AND LEGAL PRINCIPLES FOR PGAS.</u>

A. Regulatory Principles.

A well-designed PGA should be designed in light of the basic principles of utility regulation. The current PGA mechanism does not comply with these fundamental principles, and it should thus be altered. These basic regulatory principles, and their application to the current PGA, are more fully-described below.

1. Fairness.

Perhaps the most fundamental regulatory principle is that any regulatory mechanism should be fair to both the customer and the utility. The current PGA is fair to neither. It allows customers (collectively) to consume energy without fully knowing the true cost of their usage decisions. In between, the utility is footing the bill for the customer. This bill will come due sooner or later. At

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[93] Further, the long lag between the Company incurring gas costs and it fully recovering these costs creates the potential for generational inequities. For example, a new customer would have to pay for the high bank balance that was caused by earlier customers obtaining below-cost gas.

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that point, customers will likely experience rate shock and be understandably upset. As was recently noted, "this is a credit card that the users have taken out. They have to pay that money sooner or later."[94]

The current PGA is also unfair to UNSG. As shown above, the financial burden of carrying bank balances is heavy and growing heavier by the day. Further, the interest rate on the bank balance is too low, and thus UNSG loses money on each dollar added to the bank balance. Moreover, the bank balance uses limited financial resources, thereby diminishing UNSG's and UNS Electric's ability to fund important capital investments.

2. *Cost Recovery.*

Another bedrock principle is that a utility is entitled to recover its prudently incurred costs, plus a reasonable profit. This Commission, and its counterparts in other states, have been guided by this principle for more than 90 years. The Commission recognized the importance of cost recovery in the First PGA Order and in UNSG's most recent surcharge order.[95] As Commissioner Mayes recently said, a utility should be allowed "to recover its reasonable costs."[96]

The current PGA violates this core principle in two ways. First, UNSG is not recovering all of the costs it incurs in connection with the gas it purchases for and delivers to its customers. Because the current PGA is flawed, a large amount of these costs are placed into the bank balance. Under the current PGA and current surcharge, the bank balance may not return to zero for a substantial period of time, if ever. In other words, unless something changes, UNSG may not recover some of the cost of the gas that its customers use for a substantial period of time. There can be no clearer sign that the current PGA is broken and must be fixed.

Second, UNSG is does not fully recover the interest costs it incurs in funding the bank balance. As described above, the allowed interest rate on the bank balance is well below the interest rate UNSG must actually pay to get money to buy the gas that its customers consume.

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[94] October 18, 2005 Open Meeting Tr. at 107:20-21.
[95] See First PGA Order at 2; Decision No. 68325 at 4.
[96] October 18, 2005 Open Meeting Tr. at 180:4-5.

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3. ***Responsibility.***

Responsibility is also a core regulatory principle. Here, there is no plan for paying off the bank balance and the bank balance is beyond reasonable control by UNSG. A responsible PGA should be structured so that the bank balance does not spiral out of control and there is a reasonable plan to pay off the bank balance in a timely manner.

4. ***Financially healthy utilities.***

Another appropriate principle is that regulation should be designed to allow utilities to be financially healthy. This principle is important for many reasons. Financially healthy utilities are able to withstand operational and economic problems that occur. The public can have confidence in the ability of financially healthy utilities to meet their public service obligations. And financially healthy utilities contribute to the economic success of the state.

As shown above, the current PGA inflicts financial strain on UNSG. It weakens important financial ratios. It consumes financial resources, to the detriment of other needs. It makes acquiring new debt or equity financing more difficult, driving up the cost of debt and the cost of equity because UNSG is more risky. The PGA should be revised so that it does not impact the financial health of UNSG to such a degree.

5. ***Price signals.***

Commodities should be priced at appropriate levels. This includes reflecting the economic cost of the commodity, as well as the value of other social goals, such as conservation of scarce resources. Appropriate pricing sends price signals to consumers about the value of the commodity they are consuming. The Commission recognizes the importance of sending appropriate price signals. For example, aware of the value of water in this desert, the Commission adopted "inverted block" three tiered rate designs to encourage conservation.

The current PGA sends inappropriate price signals because it does not accurately reflect the average gas cost to customers. A substantial portion of these costs are instead diverted to the bank balance, where they accumulate unseen by the customer. The customer is not being given the correct information (through prices) about the economic value of the commodity they are buying.

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This prevents the customer from making informed choices. Such choices can be short-term (e.g. turning down the thermometer) or long-term (e.g. selecting more efficient appliances or adding insulation).

During the October 18, 2005 Open Meeting, several Commissioners expressed some skepticism about whether price signals work for natural gas.[97] Based on these concerns, UNSG would like to provide additional information on this topic. FERC's Chairman Kelliher recently emphasized the importance of timely prices signals, stating:

> Effective conservation must start with early consumer awareness of the high level of gas prices. Under most circumstances, the consumer receives a price signal after consumption, when the consumer receives a bill from the gas utility. If they consumer understands ahead of time that gas prices will be high this winter, they are more likely to conserve.[98]

6. Minimize Changes in Prices.

Many customers value predictable utility bills. Thus, regulatory commissions often attempt to minimize changes in the prices customers pay. The 12-month rolling average feature of the PGA serves this purpose. Indeed, as shown above, the rolling average was intended as the primary mechanism to limit price changes. If needed, a band can be a secondary mechanism to limit price changes. But if a band is used, it must be set at an appropriate level.

Further, the PGA is not the only means of limiting price changes. UNSG's hedging policy is based on price stability.[99] As Mr. David Hutchens recently told the Commission "what we do then ... is to smooth or mitigate drastic price increases ... We don't do it betting on the market."[100] UNSG attempts to "smooth out the bumps" rather than trying to beat the market.[101] Moreover, customers that place importance on predictability can enroll in levelized billing. An appropriate mix of a rolling average, a band (if needed), hedging, and the option of levelized billing can limit price changes without undermining price signals.

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[97] *See* October 18, 2005 Open Meeting Tr. at 73-85.

[98] Federal Energy Regulatory Commission, "High Natural Gas Prices: The Basics", Edition 1, December 8, 2005.

[99] Hutchins, Oct 18, 2005 Open Meeting Tr. at 47-68.

[100] *Id.* at 48:2-4.

[101] *Id.* at 64.

7. *Recognize Uniqueness.*

A PGA should fit the utility and its customers. The current PGA was designed on a generic, "one size fits all" basis. It should be modified to take account of the unique characteristics of UNSG and its customers.

8. *Symmetry.*

A requirement that applies to both a utility and its customers should be symmetrical. This demonstrates that the requirement was designed in a fair and even handed manner. The PGA threshold applies to both under-collected amounts (owed by customers) and over-collected amounts (owed by the utility). As Staff's gas expert, Mr. Bob Gray, explained, "in fairness" the PGA threshold should be symmetrical.[102]

B. Legal Principles.

1. *Under the Arizona Constitution, UNSG should be permitted to recover its operating expenses.*

In reviewing the PGA, the Commission should be concerned with protecting consumers. *See State v. Tucson Gas, Electric Light & Power Co.*, 15 Ariz. 294, 308, 138 P. 781, 786 (1914). But this is not – and cannot be – a one way street. The Commission has a duty to set "just and reasonable rates." Ariz. Const. Art. XV § 3. Such rates must be "fair to **both** consumers and public service corporations." *Phelps Dodge Corp. v. Arizona Elec. Power Co-op.*, 207 Ariz. 95, 106 ¶ 30, 83 P.3d 573, 584 (App. 2004)(emphasis added). In other words, rates must be "as fair as possible to all whose interests are involved." *Arizona Community Action Assoc. v. Arizona Corp. Comm'n*, 123 Ariz. 228, 231, 599 P.2d 184, 187 (1979)(quoting *Salt River Valley Canal Co. v. Nelssen*, 10 Ariz. 9, 14, 85 P. 117, 119 (1906)).

Fairness is determined by the traditional standard that a "public utility subject to regulation and the fixing of rates is entitled to realize a fair and reasonable profit from its operation in the service of the public." *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 149, 294 P.2d 378, 381 (1956). In order to earn a fair profit, a utility must cover its operating expenses and, in

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[102] *Id.* at 71:7-10.

addition, "is entitled to a fair rate of return on the fair value of its property, no more and no less." *Litchfield Park Service Co. v. Arizona Corp. Comm'n,* 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994)(quotation marks omitted) *see also Cogent Public Service, Inc. v. Arizona Corp. Comm'n*, 142 Ariz. 52, 57, 688 P.2d 698, 703 (App. 1984). Therefore, the Commission "must permit a utility to realize a fair and reasonable rate of return on the owners' capital investment in the utility." *Turner Ranches Water and Sanitation Co. v. Arizona Corp. Comm'n,* 195 Ariz. 574, 577 ¶ 6, 991 P.2d 804, 807 (App. 1999).

Of course, the utility cannot earn a fair profit – or any profit at all – until its operating expenses are covered. For this reason, rates must cover the company's "overall operating costs" and provide a reasonable rate of return. *Consolidated Water Utilities, Ltd. v. Arizona Corp. Comm'n,* 178 Ariz. 478, 482, 875 P.2d 137, 141 (App. 1993)(quoting *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 612, 615 (App. 1978)). Therefore, the Commission must set rates to allow for the "recovery of all reasonable expenses, plus a return on investment." *Tucson Electric Power Co. v. Arizona Corp. Comm'n.*, 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982).

The current PGA fails this test. There is no dispute that gas costs are high. The Commission itself ruled that "the upcoming winter could see some of the highest sustained natural gas prices since wellhead price were deregulated in the 1980s." (*UNS Gas, Inc.*, Decision No. 68241 at 3, October 25, 2005). The only question is whether the PGA will be modified to recognize UNSG's right to recover its operating costs.

2. Under the United States Constitution, the Commission should allow UNSG to recover its costs.

Federal law has long recognized that rate-setting commissions must "navigat[e] the straits between gouging utility customers and confiscating utility property." *Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 481 (2001). The United States Constitution forbids state governments from setting rates that are so low they are confiscatory. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989). Under the Constitution, it is "not theory but the impact of the rate order which

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counts. If the total effect of the rate order cannot be said to be unreasonable" it is constitutional. *Id.*, 488 U.S. at 310 (quoting *FPC v. Hope Natural Gas*, 320 U.S. 591 (1944)). A rate decision is confiscatory unless it allows "not only for operating expenses but also for the capital costs of the business." *Hope,* 320 U.S. at 603. Such capital costs include debt service and a return on equity. *Id.* The return on equity must "be commensurate with returns on investments in other enterprises having corresponding risks." *Id.* The return on equity must also be high enough to "assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Id.*

The current PGA fails all of these tests. It does not even allow UNSG to recover its operating expenses. Further, the excessive bank balance imperils UNSG's financial integrity. This is not a case like *Duquesne* where the unrecovered expense reduced revenues by less than one percent. Here, the financial impact can be significant and must be remedied.

Other cases support this conclusion. An example is *State ex rel. Montana Power Co. v. Department of Public Service Regulation*, 548 P.2d 136, 141 (Mont. 1975). There, Montana Power requested a temporary rate increase to cover increased gas costs. The Montana Commission allowed only a portion of the request, apparently reasoning that the utility should break certain contracts with Canadian suppliers. On appeal, the Montana Supreme Court sympathized with the difficulty of the Commission's job during "a period of extreme inflation", but noted that the Commission's actions "cannot go beyond its statutory or constitutional powers." *Id.* The court ruled that Commission's order was confiscatory "in violation of the constitutional prohibition against taking property without due process of law."[103]

Another case finding a constitutional violation in a failure to allow gas costs is *United States Gas Corp. v. Mississippi Public Service Corp.*, 127 So.2d 404, 443 (Miss. 1961). There, the utility objected that the Mississippi Commission had not allowed it to recover the cost of gas purchased from a subsidiary. The court agreed, ruling that the utility had a "statutory and constitutional right" to the recovery the "cost of gas" because this was "an operating expense." *Id.*

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[103] *Id.*

The court strongly suggested that the Mississippi Commission approve a gas cost adjustment clause to remedy this problem. *Id.*[104]

VI. RECOMMENDED REVISIONS TO THE PGA.

For these reasons, UNSG recommends that the Commission make the following revisions to the PGA:

1. **Bandwidth.** The band should be eliminated, or in the alternative temporarily, increased to $.25 per therm and then eliminated.

2. **Increase Interest.** The interest earned on the PGA bank balance should reflect UNSG's actual cost of new debt, which is LIBOR plus 1.5%.

3. **Regulatory Asset.** When the bank balance is greater than two times the threshold level, UNSG should earn its weighted average cost of capital as determined in its most recent rate case. Currently, this is 9.05%.

4. **Symmetrical threshold.** The new threshold level for under-collected bank balances established in Decision No. 68325 ($ 6,240,000) should also be adopted as the threshold level for over-collected bank balances.

5. **Capital Structure.** The Commission should declare that it will not include debt related to the bank balance in UNSG's capital structure for the purpose of calculating UNSG's weighted average cost of capital.

6. **Surcharges.** When surcharges are needed, the Commission should approve a surcharge large enough to eliminate the PGA bank balance within a reasonable period.

These revisions will be consistent with the regulatory and legal principles described above. These revisions will remedy the problems described above by (1) sending appropriate price

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[104] Although it has unique facts, the Second Circuit's decision in *Consolidated Edison Co. of New York v. Pataki*, 292 F.3d 338, 355 (2nd Cir. 2001), also supports full recovery of costs incurred under an adjustor mechanism. In that case, Con Ed had a fuel adjustment clause approved in a rate case settlement with the New York Public Service Commission. The New York Legislature passed a law forbidding the recovery of certain costs under the clause related to an outage of a nuclear power plant. The court ruled that this was unconstitutional, relying on the Bill of Attainder clause. *Id.* While this theory is somewhat novel, it demonstrates that disallowing cost recovery under an established adjustor violates constitutional norms.

signals; (2) preventing large PGA bank balances from accumulating in the future; (3) protecting UNSG's financial health; (4) protecting UNSG's capacity to fund needed capital projects; (5) allowing the PGA to accurately reflect the average cost of gas; and (6) allowing the existing PGA bank balance to be recovered. Under these revisions, the PGA will still provide substantial "smoothing" of the prices paid by customers. These revisions are consistent with the goals established by Staff and the Commission during the generic PGA docket. These revisions will correct the flaws in the current PGA, thus allowing it to fulfill twin purposes of lost recovery and price smoothing.

A proposed order adopting these revisions is attached as Attachment F.

WHEREFORE, UNSG prays that the Commission commence an expedited review of the PGA as applied to UNSG, and following that review, that the Commission enter an order adopting the revisions described above.

RESPECTFULLY SUBMITTED this 10th day of January 2006.

ROSHKA DEWULF & PATTEN, PLC

By ______________________

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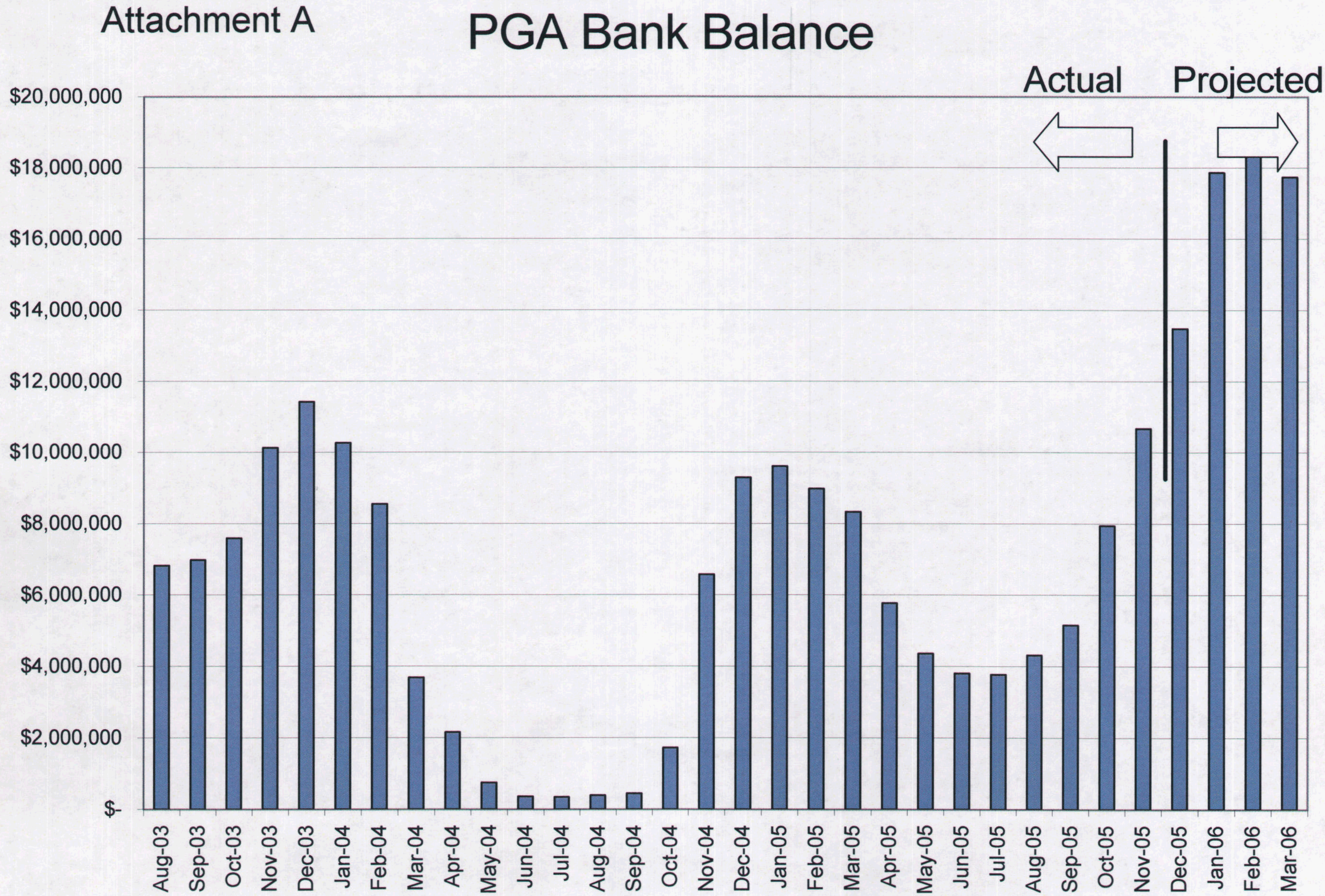
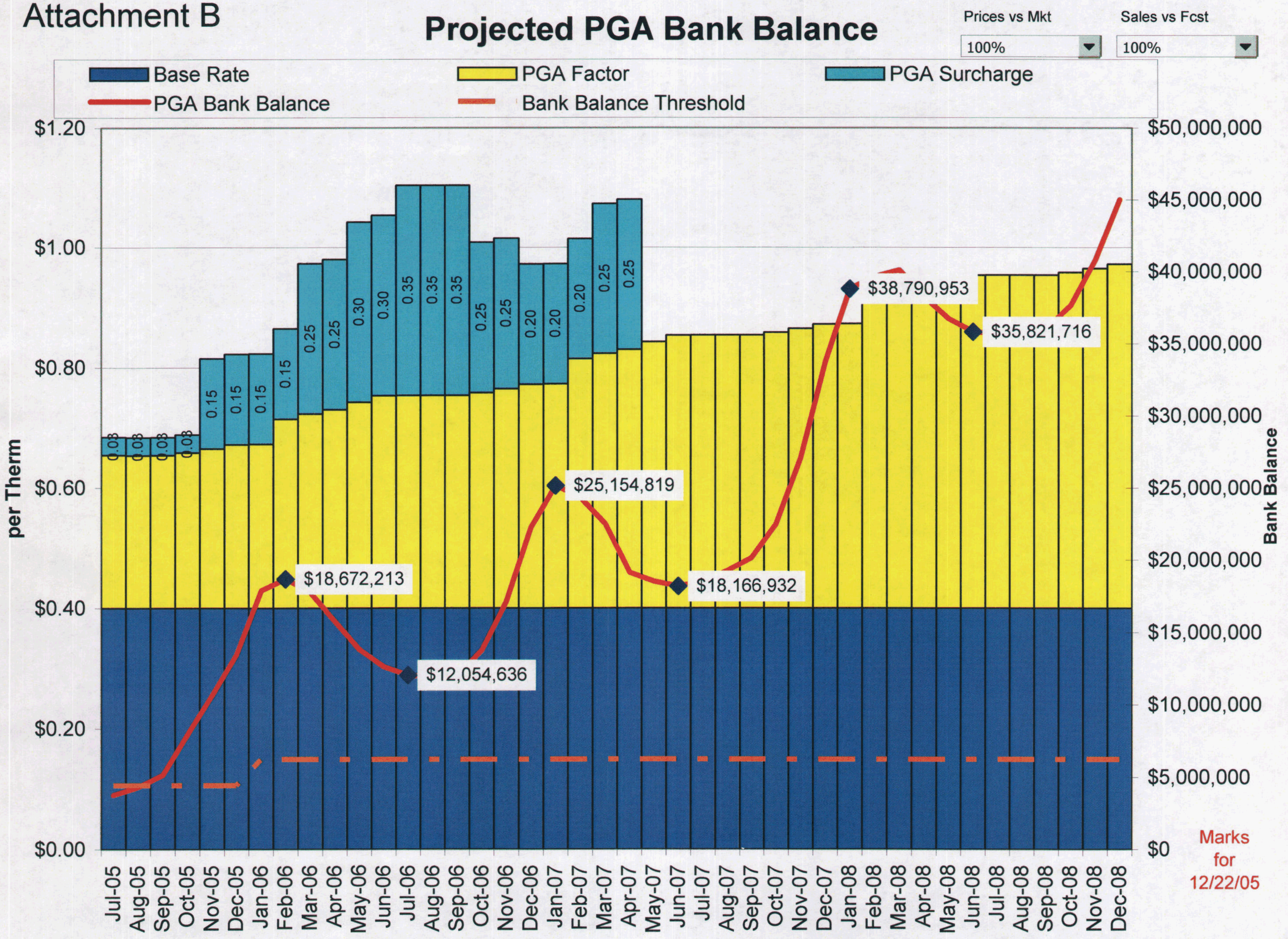
ATTACHMENTS

Attachment A

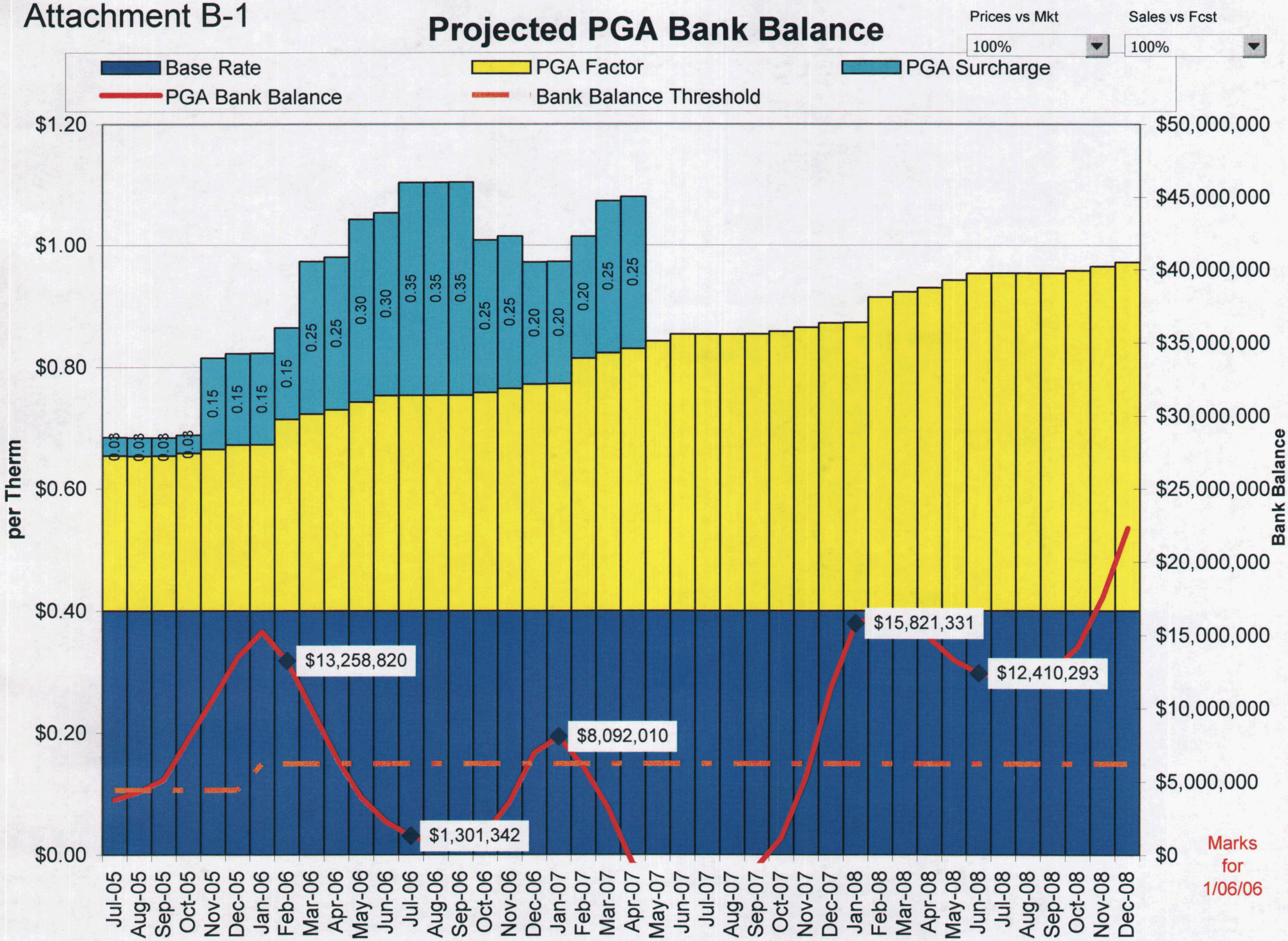


Attachment B



Attachment B-1

Projected PGA Bank Balance



Attachment C

(a) Interest Coverage Ratio

Each Borrower shall not permit its Interest Coverage Ratio for the four-fiscal-quarter period ended on the last day of each fiscal quarter, commencing with the fiscal quarter ending September 30, 2005, to be less than 2.25 to 1.00.

				12 Months Ended September 30, 2005	
$ in thousands				**UNS Electric**	**UNS Gas**
		Net Income		$3,846	$6,277
		Total Interest Expense		4,846	6,374
		AFUDC		(270)	(306)
	a)	Interest Charges	+	5,116	6,680
	b)	Income Tax Expense	+	2,231	3,822
	c)	Depreciation and Amortization	+	9,530	5,842
as defined		Consolidated Income Available for Interest Charges	=	$20,723	$22,621
		Interest Charges		$5,116	$6,680
		Interest Coverage Ratio		**4.05**	**3.39**
		Minimum Required		**2.25**	**2.25**

Attachment D

Calculation of Additional UNSG Borrowing Capacity at 9/30/05

(a)	Consolidated Income Available for Interest Charges	$22,621
(b)	Required Interest Coverage Ratio for Debt Issuance	2.50
(c)	Maximum Interest Charges Permitted [= (a) / (b)]	$9,048
(d)	Interest Charges Incurred for 12 months ended 9/30/05	$6,680
(e)	Incremental Interest Charges Permitted [= (c) - (d)]	$2,368
(f)	Interest Rate on New Debt	6.03%
	Additional Borrowing Capacity [= (e) / (f)]	$39,277

Attachment E

ATTACHMENT

"F"

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
JEFF HATCH-MILLER - CHAIRMAN
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR.	DOCKET NO. G-04204A-06-_____ **OPINION AND ORDER** **Decision No. ________**

BY THE COMMISSION:

INTRODUCTION

In this Order, we take action to remedy structural flaws in the Purchased Gas Adjustor (PGA) of UNS Gas, Inc. (UNSG). Due to these flaws, UNSG and its customers face substantial difficulties resulting from the operation of the PGA. We will remedy these flaws by modifying the PGA to solve the problems facing UNSG and its customers, to prevent these problems from recurring, and to ensure that the PGA reflects the unique characteristics of UNSG and its service territory. Specifically, we: (1) eliminate the band that limits the 12 month rolling average of the PGA; (2) increase the interest on the PGA bank balance to LIBOR plus 1.5%; (3) when the bank balance exceeds two times the threshold, increase the interest on the PGA bank balance to UNSG's authorized weighted average cost of capital as determined in its last rate case; (4) increase the threshold for over-collected bank balances to equal the threshold for under-collected bank balances; (5) declare that debt associated with the bank balance shall not be included in UNSG's capital structure for ratemaking purposes; and (6) declare that when surcharges are needed in the future, they should be set at a level sufficient to reduce the bank balance to zero within a reasonable time period.

These actions will enable the PGA to fulfill its purpose of enabling UNSG to recover its prudently incurred cost (but no profit) of acquiring natural gas (commodity and transportation), while protecting customers from price volatility to the extent possible.

PROCEDURAL HISTORY

On January 10, 2006, UNSG filed an Application requesting that the Commission review and revise UNSG's PGA, together with a proposed order. On [DATE], Staff filed a memorandum and proposed order. We considered these proposed orders at a duly noticed open meeting on [DATE].

OPINION

A. UNSG's Application.

In its Application, UNSG notes that the current structure of the PGA causes four substantial problems: (1) a large and rapidly increasing bank balance, which places financial strain on UNSG; (2) funding for other needed projects maybe constrained because of resources devoted to funding the bank balance; (3) the PGA band is too narrow, resulting in a PGA which does not reflect the reality of the cost of gas; (4) UNSG suffers a loss on each positive dollar in the bank balance, because it pays more in interest funding the balance than the interest we currently allow on the bank balance. UNSG also points to recent changes in natural gas markets, which have resulted in higher and more volatile prices.

UNSG also reviewed the history of its PGA, suggesting that this history supports its proposed modifications. Further, UNSG describes eight regulatory principles that should guide the Commission's review of the PGA:

1) Fairness
2) Cost Recovery
3) Responsibility
4) Financially healthy utilities
5) Price signals
6) Minimize Changes in Prices

7) Recognize Uniqueness

8) Symmetry

UNSG also asserts that by law a PGA must be just and reasonable, and non-confiscatory. UNSG notes that the PGA under-collected bank balance was $10.6 million at the end of November 2005. By the end of February 2006, UNSG projects that the bank balance will reach $18.6 million. In January 2007, UNSG projects that the bank balance will reach at least $ 25 million. These projections were based on forward price data as of December 22, 2005. Due to the high volatility of the natural gas markets, the projections may vary greatly depending on the date of the projection.

UNSG requests that the Commission make six revisions to the PGA:

1. Bandwidth. The band should be eliminated, or in the alternative, temporarily increased to $.25 per therm and then eliminated.
2. Increase Interest. The interest earned on the PGA bank balance should reflect UNSG's actual cost of new debt, which is LIBOR plus 1.5%.
3. Regulatory Asset. When the bank balance is greater than two times the threshold level, UNSG should earn its weighted average cost of capital as determined in its most recent rate case. Currently, this is 9.05%.
4. Symmetrical threshold. The new threshold level for under-collected bank balances established in Decision No. 68325 ($ 6,240,000) should be adopted as the threshold level for over-collected bank balances.
5. Capital Structure. The Commission should declare that it will not include debt related to the bank balance in UNSG's capital structure for the purpose of calculating UNSG's weighted average cost of capital.
6. Surcharges. When surcharges are needed, the Commission should approve a surcharge large enough to eliminate the bank balance within a reasonable time period.

B. Staff's Memorandum.

Staff, in its Memorandum, recommends [describe Staff Recommendations].

C. Analysis.

We agree with UNSG that the eight regulatory principles it describes should guide our review of the UNSG PGA. We also agree that the six revisions proposed by UNSG should be adopted. Our comments on each specific revision follow.

1. *Bandwidth.*

During much of the 1990s, the UNSG systems (then owned by Citizens Utilities) operated successfully under a 12 month rolling average PGA. We used this PGA as the model for the generic PGA we adopted for all Arizona gas utilities in Decision No. 61225 (October 30, 1998)(First PGA Order). But we added a "band" that limits the movement of the rolling average. This band was \$.07 per therm. We always recognized that this band was experimental and that the band was set at an arbitrary level. We increased the band to \$.10 per therm in Decision No. 62994 (November 3, 2000)(Second PGA Order). We temporarily increased the band to \$.15 per therm in Decision No. 66028 (July 3, 2003)(Citizens Sale Order).

In the Staff report that led to Decision No. 61225, Staff noted that if "the banding is set too tight, the bank balance would have a strong tendency to build up sizable over or under collections and the price signal to the customer would be largely muted."[1] This is exactly what occurred. We therefore conclude that the band is too narrow. In the same report, Staff stated that the "banding of the PGA rate needs to be set so that in most cases the changing PGA rate will accurately track the 12-month rolling average" and that the banding should come into play only in "extreme circumstances."[2] UNSG notes that the band has constrained the movement of the PGA in five months in 2005, and is projected to be in effect for every month of 2006. Repeated modifications of the band have not produced a band that satisfies the standards proposed by Staff. Rather than continuing to modify this experimental mechanism, we will eliminate the band.

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[1] "Staff Report on Purchased Gas Adjustor Mechanisms", October 19, 1998, Docket No. G-00000C-98-0568 at 3.
[2] *Id.* at 3 and 14.

We note that customers will still be protected from price volatility by the twelve month rolling average of the PGA. The rolling average will serve to smooth out price changes in natural gas, while still accurately reflecting the average cost of the gas. We also note customer's exposure to price volatility is reduced by UNSG's hedging program. We will review this program as part of our review of UNSG's gas procurement practices.[3] UNSG's levelized billing option offers even greater price stability to those customers that choose to participate. We strongly urge customers that desire stable monthly bills to explore the levelized billing option, and we expect UNSG to continue its outreach efforts in informing customers of this option.

2. *Interest.*

We agree that we are obligated to allow UNSG to recover its cost of providing service. These costs include the cost of complying with the generic PGA that we created. Currently, UNSG must fund the bank balance by borrowing money at a higher interest rate than the interest rate allowed on the bank balance. We find that the interest on the bank balance should match UNSG's cost of borrowing, which currently is LIBOR plus 1.5%.

3. *Regulatory Asset.*

UNSG points out that under the current PGA and surcharge, the bank balance may never reach zero. That is, UNSG may not recover the funds it has been forced to invest in the bank balance for a substantial period of time, if ever. We agree that this violates the principles of cost recovery and fairness. UNSG proposes that, when the bank balance exceeds two times the threshold amount, it be allowed to recover its authorized weighted average cost of capital on the bank balance, rather than interest. It argues that this is appropriate because when the bank balance reaches such a high level, it becomes a long-term regulatory asset. Under basic rate-making principles, utilities earn their weighted average cost of capital on regulatory assets. We agree that when the bank balance exceeds two times the threshold amount, it will take a long period of time to pay off the balance. Under such circumstances, the bank balance is more like a regulatory asset

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[3] Docket No. G-04204A-05-0831.

than a short-term balancing account. Thus, we agree that UNSG should earn its authorized weighted average cost of capital, as determined in its most recent rate case, in such circumstances.

4. Symmetrical threshold.

Under the PGA, the threshold serves as a warning device, prompting action. When the threshold is breached, the utility must file for a surcharge (positive or negative) or explain why no surcharge is needed. In Decision No. 68325 (December 9, 2005), we raised the threshold for under-collected bank balances to $6,240,000 but left the bank balance for over-collected balances at $4,450,000. UNSG points to the principle of fairness, and to Staff's position that the threshold should be symmetrical "in fairness." Upon reflection, we can think of no principled reason that the same threshold should not apply to both under-collected and over-collected balances. Thus, we will increase the threshold level for over-collected balances to $6,240,000, so that it matches the level for under-collected balances.

5. Capital Structure.

UNSG requests that debt associated with the bank balance be excluded from its capital structure for ratemaking purposes, noting that this debt was incurred to comply with the PGA mandated by the Commission. We agree that UNSG should be held harmless from the effects of this extra debt. Accordingly, we declare that we will exclude this debt from UNSG's capital structure for ratemaking purposes.

6. Surcharges.

UNSG notes that the recent history of its PGA is full of surcharges that were not high enough to correct accumulated bank balances. Thus, UNSG recommends that, when future surcharges are necessary, the surcharge be high enough to eliminate the bank balance within a reasonable time period. Otherwise, the bank balance will not be reduced, and customers will be forced to pay a greater amount later. We are hopeful that the other modifications we adopt today will reduce the need for surcharges. But when they are necessary, we agree that they must be set at proper level. Thus, we declare that future surcharges should be set at a level sufficient to reduce the bank balance to zero within a reasonable time period.

FINDINGS OF FACT.

1. UNSG is engaged in providing natural gas service within portions of Apache, Coconino, Mohave, Navajo, Santa Cruz and Yavapai Counties, Arizona.

2. UNSG acquired its natural gas systems from Citizens Utilities. The Commission authorized this acquisition in Decision No. 66028 (July 3, 2003), which also granted UNSG a Certificate of Convenience and Necessity.

3. During most of the 1990s, the UNSG systems, then operated by Citizens, had a 12 month rolling average PGA with no band. The Commission determined that this PGA should be retained, noting that it avoids "severe impact on the Company's earnings and rate shock to the customers." (Decision No. 58664, June 16, 1994).

4. The Commission later established a generic PGA applicable to all Arizona gas utilities subject to the Commission's jurisdiction in Decision No. 61225 (October 30, 1998). The generic PGA was modeled on the prior Citizens PGA, with the exception of an experimental band. The band was originally set at $.07 per therm.

5. The band was increased to $.10 per therm in Decision No. 62994 (November 3, 2000).

6. The band was temporarily increased to $.15 per therm in Decision No. 66028 (July 3, 2003).

7. After the generic PGA was established, numerous surcharges were necessary. These include the surcharges authorized in Decision No. 64054 (September 27, 2001); Decision No. 66341 (September 30, 2003); Decision No. 66861 (March 23, 2004); Decision No. 67730 (March 31, 2005) and Decision No. 68241 (October 25, 2005).

8. In Decision No. 68325 (December 9, 2005), the Commission increased the threshold amount for UNSG for under-collected bank balances to $6,240,000 but kept the threshold for over-collected balances at $4,450,000.

9. UNSG states that the PGA under-collected bank balance was $10.6 million at the end of November 2005. By the end of February 2006, UNSG projects that the bank balance will

reach $18.6 million. In January 2007, UNSG projects that the bank balance will reach at least $ 25 million. These projections were based on forward price data as of December 22, 2005. Due to the high volatility of the natural gas markets, the projections may vary greatly depending on the date of the projection.

10. The UNSG PGA, as currently structured, poses an unacceptable level of risk to UNSG and its customers.

11. UNSG's current cost for new debt is LIBOR plus 1.5%.

12. The band has caused the PGA's rolling average to lose touch with the actual average cost of gas.

13. The band has come into play much more often than was originally intended.

14. On January 10, 2006, UNSG filed its Application and Proposed Order as described above.

15. On [Date], Staff filed its Memorandum and Proposed Order as described above.

16. The eight regulatory principles described by UNSG are appropriate guidelines to use in evaluating the PGA.

17. UNSG may incur substantial additional debt to fund the PGA bank balance.

18. UNSG requests that the Commission adopt the following six specific recommendations:

A. Bandwidth. The band should be eliminated, or in the alternative, temporarily increased to $.25 per therm and then eliminated.

B. Increase Interest. The interest earned on the PGA bank balance should reflect UNSG's actual cost of new debt, which is LIBOR plus 1.5%.

C. Regulatory Asset. When the bank balance is greater than two times the threshold level, UNSG should earn its weighted average cost of capital as determined in its most recent rate case. Currently, this is 9.05%.

D. Symmetrical threshold. The new threshold level for under-collected bank balances established in Decision No. 68325 ($ 6,240,000) should be adopted as the threshold level for over-collected bank balances.

E. Capital Structure. The Commission should declare that it will not include debt related to the bank balance in UNSG's capital structure for the purpose of calculating UNSG's weighted average cost of capital.

F. Surcharges. When surcharges are needed, the Commission should approve a surcharge large enough to eliminate the bank balance within a reasonable time period.

CONCLUSIONS OF LAW.

1. UNSG is an Arizona public service corporation within the meaning of Article XV, Section 2 of the Arizona Constitution.

2. The Commission has jurisdiction over UNSG and over the subject matter of the application.

3. A PGA must satisfy the just and reasonable requirement of Article XV, Section 3 of the Arizona Constitution.

4. Under the United States Constitution and the Arizona Constitution, a PGA must not be confiscatory.

5. Under the United States Constitution and the Arizona Constitution, the Commission must allow UNSG to recover its prudently incurred costs of acquiring natural gas for its customers.

6. The Commission, having reviewed UNSG's Application and Staff's Memorandum, concludes that it is in the public interest to grant the Application and approve the recommendations described in Finding of Fact No. 18.

ORDERING PARAGRAPHS.

IT IS THEREFORE ORDERED that UNSG's Application is granted.

IT IS FURTHER ORDERED that the recommendations described in Finding of Fact No. 18 are approved.

IT IS FURTHER ORDERED that the UNSG PGA is modified in accordance with the recommendations described in Finding of Fact No. 18.

IT IS FURTHER ORDERED that the UNSG PGA band is eliminated.

IT IS FURTHER ORDERED that the interest on the UNSG PGA bank balance shall be LIBOR plus 1.5%, except when the bank balance exceeds two times the threshold level.

IT IS FURTHER ORDERED that when the bank balance exceeds two times the threshold level, the interest on the UNSG PGA shall be the weighted average cost of capital as determined in UNSG's most recent rate decision.

IT IS FURTHER ORDERED that the threshold level for over-collected bank balances is increased to $6,240,000.

IT IS FURTHER ORDERED that the Commission declares that debt associated with the UNSG PGA bank balance shall not be considered when determining UNSG's capital structure for ratemaking purposes.

IT IS FURTHER ORDERED that the Commission declares that when surcharges are needed for UNSG, they shall be calculated so that the surcharge is large enough to reduce the bank balance to zero within a reasonable time period.

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IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN	COMMISSIONER	COMMISSIONER
COMMISSIONER	COMMISSIONER	

IN WITNESS WHEREOF, I __________, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this ____ day of _______, 2006.

Brian C. McNeil
Executive Director

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