OPEN MEETING ITEM

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

ARIZONA CORPORATION COMMISSION

DATE: FEBRUARY 27, 2006

DOCKET NOS: G-2528A-05-0314 and G-02528A-03-0205

TO ALL PARTIES:

Enclosed please find the recommendation of Chief Administrative Law Jane Rodda. The recommendation has been filed in the form of an Opinion and Order on:

DUNCAN RURAL SERVICES CORPORATION
(RATES/FINANCING)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **<u>4:00</u>** p.m. on or before:

MARCH 8, 2006

The enclosed is <u>NOT</u> an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has <u>tentatively</u> been scheduled for the Commission's Working Session and Open Meeting to be held on:

MARCH 15, 2006 and MARCH 16, 2006

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Secretary's Office at (602) 542-3931.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

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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 DUNCAN RURAL SERVICES CORPORATION FOR A RATE INCREASE.	DOCKET NO. G-02528A-05-0314
IN THE MATTER OF THE APPLICATION OF DUNCAL RURAL SERVICES COPORATION FOR APPROVAL OF A LOAN IN THE AMOUNT OF $400,000.	DOCKET NO. G-02528A-03-0205 DECISION NO. ____________ **OPINION AND ORDER**

DATE OF HEARING:	December 15, 2005
PLACE OF HEARING:	Tucson, Arizona
ADMINISTRATIVE LAW JUDGE:	Jane L. Rodda
APPEARANCES:	Michael Grant, Gallagher & Kennedy, P.A., on behalf of Duncan Rural Services Corporation; and Jason Gellman, Staff Attorney, Legal Division, on behalf of the Utilities Division for the Arizona Corporation Commission.

BY THE COMMISSION:

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Arizona Corporation Commission ("Commission") finds, concludes, and orders that:

FINDINGS OF FACT

1. On April 4, 2003, Duncan Rural Services Corporation ("DRSC" or "Company") filed an application to incur debt with the Commission.

2. On May 2, 2005, DRSC filed the above-captioned rate application with the Commission.

3. On May 26, 2005, the Commission's Utilities Division Staff ("Staff") notified the Company that its rate application was not sufficient under A.A.C. R14-2-103.

4. On June 9, 2005, DRSC filed revised schedules that essentially comprised a new rate application.

5. On June 21, 2005, Staff notified the Company that its June 9, 2005, application met the sufficiency requirements as outlined in A.A.C. R14-2-103, and classified the Company as a Class C utility.

6. By Procedural Order dated July 13, 2005, the Commission established procedural guidelines and set the matter for hearing on December 15, 2005, at its Tucson offices.

7. In its rate application, DRSC requested that the finance and rate applications be consolidated.

8. On October 25, 2005, Staff filed a Motion to Consolidate the two applications.

9. By Procedural Order dated October 28, 2005, the Commission consolidated the two matters.

10. On August 9, 2005, DRSC mailed notice of the hearing to its customers.

11. On November 8, 2005, Staff filed Direct Testimony. On November 21, 2005, DRSC filed Rebuttal Testimony. On December 5, 2005, Staff filed Surrebuttal Testimony. On December 12, 2005, DRSC filed Rejoinder Testimony.

12. The hearing convened on December 15, 2005, as scheduled, before a duly authorized Administrative Law Judge, at the Commission's offices in Tucson, Arizona.

13. DRSC and Staff filed Closing Briefs on January 24, 2006.

14. DRSC is a non-profit corporation that provides service to approximately 760 consumers in Greenlee County, Arizona. In its last rate case, using a test year of 2000, DRSC had 800 customers.

15. DRSC acquired the gas system in 1989 from General Utilities, Inc. ("General Utilities"). The General Utilities' system at the time of purchase was in serious disrepair. See Decision No. 58356.

16. Duncan Valley Electric Cooperative, Inc. ("DVEC") manages the operations of DRSC, including its operational and capital expenditures.

17. DRSC's current rates were established in Decision No. 64869 (June 5, 2002) based on a 2000 test year. In that case, the Commission found that DRSC had suffered a net loss in the test year of approximately $19,000, and approved a 24 percent increase in gross annual revenues.

18. In filing the current rate application, DRSC states that its financial condition has not improved since its last rate case because its purchased gas costs have significantly increased during the test year and other costs have increased as well. In addition, in the years 2001 to 2004, DRSC invested over $331,000 in plant additions. Further exasperating its financial condition, DRSC's customer base is decreasing.

19. In the test year ended December 31, 2004, DRSC posted adjusted Total Revenue of $323,238, which resulted in a negative Operating Margin of $47,976, and a Net Loss of $70,958.

20. In this case, DRSC requests approval for total revenues of $523,488, an increase over test year revenues of $200,250, or 61.9 percent. Duncan requests that $32,437, or 16.2 percent, of the requested increase be deferred until 2007 and 2008. (Ex A-4 Rejoinder Schedule A-2) In the first phase of its requested increase, DRSC is requesting a revenue requirement of $491,051, an increase of $167,705, or 51.8 percent, over adjusted test year revenues. Using the Company's schedules, the first phase revenue increase would produce a net margin of $39,187 and a Times Interest Earned Ratio ("TIER") of 2.00 based on the Company's requested debt level. (Ex A-4) DRSC's first phase increase would produce a 10.30 percent rate of return on its adjusted original cost rate base of $758,057. The final phase of DRSC's requested increase would, based on the Company's schedules, produce an Operating Margin of $102,774, TIER of 2.63, DSC of 1.61 and a 13.56 percent rate of return on original cost rate base. (Ex A-4) Under the Company's proposal the first phase of the increase would become effective immediately; the second phase, a five percent increase, would become effective a year later, or in 2007; the third phase, an additional five percent increase, would be effective a year after that, or in 2008.

21. Staff recommends a revenue requirement of $473,219, a $149,981, or 46.3 percent, increase over test year revenues. Under Staff's recommendation, DRSC would have an operating

margin of $65,665, and an 8.66 percent rate or return on an adjusted original cost rate base of $758,057. Staff's analysis indicates that under its recommendation, DRSC would have a TIER of 2.28 and a DSC of 1.64.

22. The rates DRSC is requesting are attached hereto as Exhibit A.

23. The rates Staff recommends are attached as Exhibit B.

24. DRSC agreed to Staff's adjustments to the Company's proposed rate base. (Ex A-3 at 1) We concur that Staff's recommended adjusted Original Cost Rate Base ("OCRB") of $758,057 is reasonable and should be adopted. DRSC waived a reconstruction cost new rate base and thus, its OCRB of $758,057 is deemed to be its fair value rate base.

25. There is little or no disagreement over adjusted test year operating expenses. The small difference of opinion concerning expenses involves rate case expense and income tax expense. DRSC states that if the Commission does not adopt DRSC's revenue level, it recommends that rate case expense be amortized over a two year period and Staff's adjustment to rate case expense of $4,851 be rejected.

26. In this case, DRSC and Staff disagree about the size of the necessary revenue increase, rate design, the design of the Purchased Gas Adjustor, and the appropriate level of debt.

27. At the end of the test year, DRSC had total capital of $363,884, comprised of long term debt of $516,958 and negative equity of $153,074. (Ex A-6, Sch D-1)

28. Staff recommends that DRSC improve its capital structure by five percent each year until equity comprises at least 30 percent of its total capital. Under Staff's proposal, the amount of DRSC's total capital would be determined as of the end of 2005; and each year thereafter, DRSC would be responsible for increasing the dollar amount of its equity by five percent of the year end 2005 figure. Thus if at the end of 2005, DRSC were to have total capital of $300,000, during 2006, DRSC would need to increase equity by $15,000, or five percent of $300,000. The amount of the equity increase would not change as capital changed unless DRSC incurred additional long-term debt. Thus, if DRSC's total equity were to be $315,000 in year two, DRSC would still only need to contribute an additional $15,000 for that year. If DRSC contributed $20,000 in year one, then it would only need to contribute $10,000 in year two to be in compliance because the Company would

have contributed an average of five percent per year over the two years. Under Staff's proposal, if DRSC were to incur additional long-term debt, it would be expected to contribute an additional five percent of the new debt. Thus if in year two, DRSC received $30,000 in debt financing, then it would be expected to contribute a total of $16,500 ($330,000 times five percent) for that year only. In year three the requirement would revert back to $15,000, assuming no new additional debt was incurred.

29. As discussed later, Staff is recommending that $171,516 of the $502,000 advanced by DVEC not be approved to be converted to long-term debt, but rather be treated as an equity infusion. Staff recommends that this equity infusion be counted toward the five percent per year benchmark.

30. In addition, Staff recommends that its equity improvement recommendation not be punitive in that there be no automatic punishment should DRSC not achieve the five percent equity growth target. Instead, Staff recommends that DRSC file a rate case should it not achieve the target. Staff states that its intent is not to punish DRSC but to ensure that DRSC makes progress towards improving its capital structure. Staff believes the most important thing is that DRSC and the Commission institute a concrete plan to improve its financial condition.

31. The parties' differences concerning the revenue requirement arise primarily from DRSC's belief that to build equity as Staff recommends and to fund its capital improvement program, it requires more revenue than Staff recommends. DRSC believes its proposed three step increase is consistent with the Commission's preference for smaller and more regular rate increases, and will save the Commission and DRSC the costs associated with two rate cases. DRSC believes its revenue level assumes a more realistic interest level of 5 percent, instead of 3 percent, on its borrowings from DVEC. Furthermore, DRSC states it will require approximately $80,000 annually to fund its capital budget, and DRSC believes that Staff's recommended revenue level will not allow it to build capital, make increased debt service payments and fund its planned capital investments.

32. Staff believes that DRSC's request for two 5 percent step increases was based on a misunderstanding that the total 2005 capital figure would include the $330,484 portion of the cash advance from DVEC. Thus, Staff believed DRSC had the impression that it would be required to contribute an additional $16,525 above what Staff is recommending. Staff believes that DRSC's year end 2005 capital will be lower than the $363,884 in total capital as of the end of the test year.

33. DRSC is requesting authorization to borrow $600,000 from DVEC. This amount reflects the $502,000 already advanced by DVEC to DRSC and an additional advance of $98,000 to fund DRSC's capital budget.

34. Staff recommends that the Commission authorize long term borrowings from DVEC of $330,484. Of the $502,000 advanced by DVEC, Staff's audit determined that $330,484 was used for capital investments and that $171,516 was advanced to cover operating expenses. Staff argues that it is inappropriate to treat funds for operating expenses as long-term debt because it shifts costs, such that customers in later periods pay for benefits received by customers in earlier periods. Staff argues that even with a declining customer base, customers are being burdened with operating expenses of past years. According to Staff, not only is the reclassification of the $171,516 as equity in accord with sound financial principles, it helps DRSC meet Staff's recommended annual five percent equity improvement target.

35. Staff believes that it is not in accordance with sound financial principles to approve any additional long-term debt over what is absolutely necessary at this time. Staff does not recommend approving the $98,000 in additional borrowings from DVEC for DRSC's on-going capital budget. Staff believes that DRSC can fund its annual $80,000 capital budget and meet the five percent equity improvement target at Staff's recommended revenue level. Staff argues that approving additional long-term debt of $98,000 would exacerbate DRSC's already highly leveraged capital position.

36. Staff recommends that the Commission approve a $70,000 revolving line of credit with DVEC to be used to assist DRSC in dealing with the rising cost of natural gas and to help finance any increase in the under-collected bank balance after the date that new rates become effective. Staff recommends an interest rate equal to AEPCO's rate of interest paid on "270 Day Fixed Rate Notes," which at the time of Staff's testimony was 2.725 percent.[1] Staff recommends that the line of credit be used exclusively to fund DRSC's under-collected PGA bank balance. Under Staff's proposal, DRSC could use the line of credit to finance amounts greater than the balance of the

[1] At the hearing, testimony from Mr. Wallace on behalf of DRSC indicated that the interest rate on deposits with AEPCO recently increased to 4.8 percent. (TR at 48)

under-collected PGA bank balance at the time that rates from this proceeding are implemented. For example, under Staff's recommendation, if DRSC's under-collected bank balance at the implementation of the approved rates is $30,000 and then after three months the under-collected PGA bank balance increased to $45,000, DRSC would be able to borrow $15,000 against the line of credit. If the under-collected bank balance subsequently decreased to $35,000, DRSC would be required to repay $10,000 of the line of credit balance so that the borrowed balance each month is maintained at, or below, the amount of the bank balance that exceeds $30,000. In the example, DRSC would not be able to borrow on the line of credit if the under-collected balance drops below $30,000 (the balance at the date the new rates became effective).

37. DRSC recognizes that the addition of $98,000 of long-term debt would not improve its capital structure, but that nonetheless, the funds are needed now for required repairs and replacements on its aged system. DRSC argues that denying this request may improve its capital structure on paper but would jeopardize its ability to provide safe, reliable and adequate service.

38. DRSC does not disagree with Staff that as a general principle, long-term loan funds should not be used to fund operating expenses. DRSC argues, however, that in the case of a non-profit corporation like DRSC, there are no stockholders or other source of funds for DRSC to continue to meet its obligations other than the advances it received from DVEC. DRSC asserts that A.R.S. § 40-302.A gives the Commission authority to authorize debt to cover operating expenses[2] and argues that this case presents the ideal circumstances for the Commission to exercise such discretion. The Company states that it has filed four rate cases in 12 years, but each time unexpected capital requirements have negated the granted rate relief. DRSC states that it filed for timely approval of the advances, but had to defer its finance case until the rate case could be processed. The rate case was delayed somewhat by resource constraints. DRSC asserts that many of the advances since the last rate case were caused by the high price of natural gas and a PGA mechanism that does not allow a timely matching of those expenses to the recovery.

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[2] A.R.S. § 40-302.A provides that "except as otherwise permitted in the order, such [loan] purposes are not, wholly or in part, reasonable chargeable to operative expenses or to income." (emphasis added).

39. DRSC and Staff agree on the monthly service charges for each service category as well as the service charges. The parties disagree on the appropriate commodity rates and whether there should be a summer/winter differential for the commodity rate. Staff advocates that there be different commodity rates for each customer class and that the current seasonal rate differential be discontinued. DRSC proposes to maintain the uniformity of commodity charges between customer classes as well as the seasonable differential in commodity rates.

40. DRSC states that the most troubling aspects of Staff's proposed rate design is the effect on the irrigation class and consequent effect on total revenues. DRSC states that its current and proposed design recognizes that the irrigation class uses very little gas during the peak winter months and does not cause capacity and capital investment system costs. DRSC fears that a large increase in the rates of the irrigation class will cause these customers to drop off the system because they are extremely price sensitive. DRSC testified that in 2005, it lost three of its 20 irrigation customers when they switched from natural gas to electricity, and that all of its irrigation customers are dual-facility customers, with the ability to use either gas or electricity. (Tr. at 76-77)

41. DRSC believes another advantage of its proposed rate design is that it has been in effect for the past four years and meets the key cost of service goal of uniformity. Because the rates approved in this case would go into effect after the peak winter season, DRSC states that Staff's concerns about the impact of the seasonal differentiation would be minimized. Furthermore, DRSC states it has not received any complaints about the seasonal differentiation and offers a levelized bill payment program that allows customers to even out payments throughout the year.

42. Staff believes that its rate design, which employs a year round commodity rate, mitigates the impact of the rate increase on all customer classes. Staff asserts that the rate design advocated by DRSC will severely impact residential ratepayers, especially during the winter months when residential customers use the most gas.

43. Staff states that its design does not impact irrigation customers much differently than under DRSC's proposal. In the summer months, DRSC proposes a commodity rate for irrigation customers of $0.26000 per therm. Staff proposes irrigation customers pay $0.28480 per therm. Staff states that the Company's cost of service study, as modified by Staff, supports separate commodity

rates by class. Staff argues its design distributes the burden of the increase on both irrigation and residential customers better than under DRSC's proposal that hits residential customers hard in the high use winter months.

44. DRSC's current base cost of gas is $0.36 per therm. At the time of the hearing, DRSC's current Purchased Gas Adjustor ("PGA") rate, based on the previous 12 months PGA rate, was $.27 per them, for a total of $0.63. Currently, DRSC's PGA may not fluctuate by more than $0.10 per therm from any rate in the past 12 months.

45. Decision No. 61225 (October 30, 1998) set a PGA balance threshold of $35,000 for Duncan. The threshold requires that Duncan either seek a surcharge or surcredit upon reaching a balance of $35,000 in its PGA bank balance, or alternatively seek a waiver from a surcharge or surcredit. On September 30, 2005, DRSC filed an application for a surcharge. Its August 2005 bank balance was under-collected $22,000. While the balance was within the threshold, Duncan had expected the balance to reach $192,000 under-collected by February 2006. In Decision No. 68297 (November 14, 2005) the Commission approved a $0.45 per therm surcharge. The current surcharge stays in effect for one year or until the bank balance reaches zero. The surcharge became effective on December 1, 2005.

46. Staff recommends to zero out the base cost of gas and move the entire cost of gas into Duncan's PGA. Staff believes this will enhance the customer's ability to understand his or her bills, and better track the cost of natural gas. Under Staff's proposal, if the entire cost of gas is accounted for in the PGA, the $0.10 band for the PGA must reference against the previous 12 months total cost of gas instead the previous 12 months adjustor rate for the first 12 months following the change. In the thirteenth month, the $0.10 band must then reference against the adjustor rate for the previous 12 months, since by then the PGA rate will include the entire cost of gas for over a year.

47. The parties agree that moving the entire cost of gas to the PGA is a simpler method for tracking the cost of the gas and will facilitate consumer understanding of bills. They disagree, however, on how much monthly variation in the price of gas should be allowed.

48. DRSC proposes that in order to manage its bank balance as close to zero as possible, it should be allowed to adjust its PGA monthly, by no more than 10 cents per therm based on its 12

month rolling average cost of gas. DRSC claims that over time, this will allow it to gradually move the rate charged closer to its actual cost of gas, which it believes will minimize its need to carry and finance large under-collected balances. DRSC states that its proposal benefits consumers by avoiding the interest costs necessary to finance the under-collections and sending them gradual rate signals rather than the abrupt and much larger increases that result when surcharges are imposed. DRSC asserts that surcharge applications are costly and time consuming to prepare and argues that surcharges do not send timely price signals to consumers.

49. DRSC asserts that its current PGA, which allows only a narrow band of adjustment annually, has aggravated its cash flow. DRSC complains that the current PGA mechanism, which was designed in the late 1990's when natural gas rates had been stable for several years and were at a fraction of today's levels, no longer works for a Company of DRSC's size and resources.

50. Staff opposes DRSC's proposal to apply the $0.10 bandwith on a monthly basis, as Staff believes that allowing a 10 cent change in the adjustor rate each month will increase the volatility in customer bills, especially on top of the $0.45 surcharge that customers currently pay pursuant to Decision No. 68297. Staff believes that the current mechanism of an annual 10 cent band better promotes gradualism and overall rate stability while not eliminating price signals to customers. As described earlier, to assist finance increases in the PGA account, Staff's recommends a $70,000 credit line.

51. Staff also recommends that: a) DRSC implement a customer education effort to inform customers how to read their bills in order to reduce any confusion from the proposed change to the PGA; b) DRSC's educational materials be submitted to the Director of the Utilities Division for review at least two weeks prior to release; c) the base cost of gas be reset to zero in the first complete billing period following a Decision in this case, but no sooner than 30 days to allow for the preparation and approval of educational materials; and d) to ensure the veracity of the monthly PGA reports, that a DRSC officer certify, under oath in an affidavit, that the monthly adjustor reports are true and accurate.

52. Since it acquired the General Utilities system in 1989, DRSC has struggled to find financial stability. DRSC was completely debt funded at its inception. It acquired a system that was

already showing its age and which had been cited for numerous safety violations. It continues to have to make significant capital investments to maintain the safety and reliability of the system. In recent years it has faced a volatile natural gas market which has further aggravated its cash flow. Adding to the factors conspiring against it, is a declining customer base. It has been forced to borrow from its affiliate DVEC to meet its on-going obligations. As a non-profit association with no shareholders, it had no other source of funds. DRSC has always relied on DVEC to provide financing when needed, but DVEC has its own financial challenges and may not be a reliable source for funds in the not too distant future. At this juncture, it is critical that the Commission work with DRSC to reach financial stability as quickly as possible.

53. We are somewhat sympathetic to DRSC's plea that we make an exception in this case and allow it to authorize long-term debt to finance approximately $171,000 in advances from DVEC that were used for operating costs. After all, with a declining customer base, the risk that costs are being shifted to consumers who did not benefit from the expenditures is minimal. We are also mindful of the fact that there is not a direct correlation between DVEC customers and DRSC customers, meaning not all DVEC members take gas service from DRSC. However, although DVEC may not technically be DRSC's parent, it created and financed DRSC in 1989 and the same individuals sit on both Board of Directors. The directors must have been aware of DRSC's need for additional revenue and could have sought rate relief sooner. Given DRSC's precarious financial position and extremely high leverage, we do not believe that it is prudent to approve additional long term debt in the amount of $171,516 as these funds have been expended and are no longer required to fund DRSC's operations.

54. We agree with Staff that $330,484 of the $502,000 already advanced by DVEC should be authorized as long-term debt for a term of 25 years.

55. Even as we recognize that this Company is already highly leveraged, it still must make significant capital investments that are expected to average $80,000 over the next few years. DRSC requests authorization to incur additional indebtedness of $98,000 for this purpose. These capital improvements are necessary to the safe and reliable operation of the system, and would not be able to be funded solely from internal funds. The rate increase that would be required to allow DRSC to

make the needed capital investments without outside financing would be too high to be tenable. Thus, we authorize DRSC to borrow $98,000 from DVEC to be used solely for capital improvements.

56. In Decision No. 64869 (June 5, 2002), the Commission approved a $400,000 loan from DVEC at a variable interest rate equivalent to AEPCO's deposit rate. At the time of Staff's testimony, that rate was 2.725 percent. Under the terms of Decision No. 64869, that rate can increase up to 8 percent. The rate is currently 4.8 percent. But AEPCO's deposit rate is not a long term debt interest rate. DRSC offered evidence that the current interest rates offered by the National Rural Utilities Cooperative Finance Corporation ("CFC") for a loan with a 25 year term is 6.25 percent. Testimony also indicates that the corporate bond rate is approximately 5.4 percent for a corporation with a rating of Aaa, and 6.36 percent for a corporation with a rating of Baa. DRSC's financial condition is nowhere near the level necessary for these ratings and would need to borrow at a significantly higher rate from a third party lender. DRSC's proposal that its loans from DVEC bear a 5 percent annual interest rate is fair and reasonable to both entities. Although it may be slightly higher than the current AEPCO deposit rate, it is an attractive long-term rate and its fixed nature will protect DRSC in times of rising interest rates.

57. Based on Staff's proposed revenue levels, it appears that with the additional debt authorized herein, DRSC would have a TIER of 2.17 and DSC of 1.36. Although on their face, the TIER and DSC ratios appear to indicate that Duncan would have sufficient ability to service its debt, we are concerned this revenue level would not provide adequate funds to allow for debt service, unexpected expenses, and to allow DRSC to improve its capital structure. DRSC requested a revenue level of $491,051 to be implemented immediately, which is a little higher than the $473,218 recommended by Staff. Employing the Company's proposed first phase revenues and expenses and the debt levels approved herein, DRSC would have a TIER of 2.65 and DSC of 1.54. (Ex A-4) At this revenue level, we would expect DRSC to have approximately $38,000 available after debt service for contingencies and equity improvement.

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Total Revenue	$491,051
Operating Expenses	412,943
Operating Margin	78,108
Depreciation and Amortization	49,645
Cash available before debt service	127,753
Debt Service (intr. and princ.)	89,715
Cash Available after debt service	38,038

58. Based on the foregoing, we authorize a revenue requirement of $491,051, as this level allows DRSC to meet its on-going operating expenses and debt service obligations as well as contribute to an equity improvement plan. It represents an increase of $167,813, or 51.9 percent, over test year revenues, and would produce an Operating Margin before debt service of $78,108, and a 10.30 percent rate of return on an OCRB of $758,057. We do not find that the additional five percent step increases as requested by the Company are necessary to provide DRSC with the funds it needs over the next two to three years. We are approving less debt than the Company requested and although we approve an equity improvement target for DRSC, we do not impose penalties for failure to meet that target. Although the Company's requested step increases might be able to avoid the costs of a rate case in two years, it is not certain they would. One of the justifications given for the Company's request is anticipated cost increases. It is not our practice to approve rates based on anticipated future cost increases unless they are known and measurable with reasonable certainty. The Company did not propose pro-forma adjustments to capture post test year expense increases.

59. No party disputes that increasing equity must be a goal for DRSC. We believe the rates we approve herein are sufficient to allow the Company to improve its equity. We will require the DRSC to file an annual report that will keep the Commission informed as to the status of its equity position. The report should include a breakdown of the components of the Company's most recent year-end capitalization, and a comparison with the prior year. In any year in which the Company's equity does not increase by five percent or more of its year-end 2005 level, the Company shall include an explanation why the five percent target increase was not met. In each year, the Company shall include its projection of the equity balance in the next year and a description of any factors that may prevent it from achieving the five percent annual goal. If the Company has been

unable to increase equity by an average of five percent annually over three years, the Company shall file a rate case, or seek a waiver of such requirement.[3]

60. The parties also disagree on the appropriate rate design, with Staff favoring different commodity rates for each class, but a uniform "per therm" charge year round, and the Company advocating a uniform commodity rate among the customer classes, but a higher "per therm" charge in the winter than in the summer.

61. Under current rates, a residential consumer using 76 therms, the average winter consumption, would have a monthly bill of $92.28. Under the Company's proposed rates, a residential customer using 76 therms in the winter would receive a monthly bill of $119.13, a $26.85, or 29.09 percent, increase. Under Staff's proposed rates the same customer using 76 therms in the winter would see a bill of $107.11, a $14.83, or 16.07 percent, increase.[4] (Ex S-6, SPI-5) In the summer, a residential customer using 20 therms (the summer average) would see a bill under current rates of $29.42. Under DRSC's proposed rates, the same customer would receive a bill for $36.45, a $7.02, or 23.87 percent, increase. Under Staff's recommended rates, the residential customer using 20 therms would receive a bill for $42.67, a $13.25, or 45.02 percent, increase. (Ex S-6, SPI-5) In addition, regardless of the rate design, customers pay a surcharge of $.45 per therm for a year, or until its under-collected PGA bank balance reaches zero. In the winter, the surcharge would add an additional $34.20 to the monthly bill for the average residential user consuming 76 therms, while in the summer, the surcharge would add $9.00 to the monthly bill of a consumer using 20 therms.

62. Under the Company proposed design, the impact of the increase on irrigation customers is minimized. The Company is very concerned that it will lose irrigation customers if the increase in the summer causes them to switch to electric power. The loss of irrigation customers, who contribute a large portion of the Company's revenues, would force residential customers to incur a greater burden. The seasonal rates, which we approved in the last rate case, have not appeared to have caused customer confusion. When it designed its rates, Staff was not aware that all of the irrigation customers have the ability to switch between gas and electricity. We find that the

[3] The five percent annual increase is based on year end 2005 capital levels as proposed by Staff.
[4] Staff's rates produce revenues of only $473,218, $17,833 less than those we approve herein.

Company's proposed seasonal rate design continues to be reasonable and should be adopted in this case. Although Staff's proposed rates may mitigate the impact of the rate increase on residential customers in the winter, we agree with DRSC's position the likely effects of the increase on its total revenues. DRSC offers annualized levelized billing which should help consumers in the winter months. The higher winter rates should help alleviate the chronic cash flow crunch that has forced DRSC's increased borrowings from DVEC.

63. We adopt Staff's proposal to include the entire cost of gas in the PGA. This change will facilitate Commission oversight and should make bills easier to understand.

64. We find also that Staff's proposed PGA rate, which continues to employ a $0.10 annual band should be approved. We are concerned that under the Company's proposal, the increased fluctuation that would be allowed in the PGA rate in conjunction with the current $.45 per therm surcharge and the higher winter commodity rates, could result in an unreasonable burden on ratepayers.

65. Staff recommends a $70,000 line of credit that the Company could use to finance gas purchases when gas prices are rising faster than the PGA rate. By utilizing the line of credit for gas purchases, Duncan would be able to utilize its available cash flow for operating expenses. Presumably, DVEC would be the source of such line of credit. We do not know if DVEC has the resources to make such line of credit available to DRSC, but it appears that such credit facility would be beneficial to DRSC. Thus, we authorize DRSC to enter into a revolving line of credit in an amount up to $70,000, from DVEC on the terms as recommended by Staff and at an interest rate equivalent to AEPCO's variable deposit rate.

CONCLUSIONS OF LAW

1. DRSC is a public service corporation pursuant to Article XV of the Arizona Constitution and A.R.S. §§ 40-250, 40-251, 40-301, 40-302, and 40-303.

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

3. Notice of the proceeding was provided in conformance with law.

4. The rates and charges approved herein, are reasonable.

5. The financing approved herein is compatible with the public interest, with sound

financial practices, and with the proper performance by DRSC of service as a public service corporation, and will not impair DRSC's ability to perform the service.

6. The financing approved herein is for the purposes stated in the application, is reasonably necessary for those purposes, and such purposes are not, wholly or in part, reasonably chargeable to operating expenses or to income.

7. Staff's recommendations, as set forth in Findings of Fact Nos. 34, 36 and 51 are reasonable and should be adopted.

ORDER

IT IS THEREFORE ORDERED that the rates and charges set forth below are approved and Duncan Rural Services Corporation shall file on or before March 31, 2006, a tariff that complies with the rates and charges approved herein:

Meter Sizes	**Approved Rates**
250 cfh & Below	
Monthly Service Charge	$20.00
Winter Commodity Rate per Therm	$0.73000
Summer Commodity Rate per Therm	$0.26000
Above 250 cfh to 425 cfh	
Monthly Service Charge	$30.00
Winter Commodity Rate per Therm	$0.73000
Summer Commodity Rate per Therm	$0.26000
Above 425 cfh	
Monthly Service Charge	$40.00
Winter Commodity Rate per Therm	$0.73000
Summer Commodity Rate per Therm	$0.26000

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Service Charges:

Establishment of Service (Regular Hours)	$35.00
Establishment of Service (After Hours)	$50.00
Re-establishment/Reconnection (Regular Hours)	$50.00
Re-establishment/Reconnection (After Hours)	$75.00
After Hours Service Calls (per hour)*	$50.00
Meter Re-Read Charge (No Charge for Read Error)	$30.00
Meter Test Fee	$50.00
Insufficient Funds Check	$20.00
Interest Rate on Customer Deposit	Variable**
Late/Deferred Payment (per month)	1.5%

* One hour minimum

** Variable Rate based on the Three Month Non-Financial Commercial Paper Rate as published by the Federal Reserve.

IT IS FURTHER ORDERED that the rates and charges approved herein shall be effective for all service provided on and after April 1, 2006.

IT IS FURTHER ORDERED that within 15 days of the effective date of this Order, Duncan Rural Services Corporation shall notify its customers of the rates and the effective dates approved herein, in a form and manner acceptable to the Commission's Utilities Division Staff.

IT IS FURTHER ORDERED that commencing in 2007, Duncan Rural Services Corporation shall file a report with the Director of the Utilities Division by May 15th of each year until it reaches a capital structure of at least 30 percent equity. The report should include a breakdown of the components of the Duncan Rural Services Corporation's most recent year-end capitalization, and a comparison with the prior year. In any year in which the Company's equity does not increase by five percent or more of its year-end 2005 level, the Company shall include an explanation why the five percent target increase was not met. In each year the Company shall include its projection of the equity balance for the next year and a description of any factors that may prevent it from achieving the five percent annual goal. If the Company has been unable to increase equity by an average of five percent annually over three years, the Company shall file a rate case, or seek a waiver of such requirement.

IT IS FURTHER ORDERED that Duncan Rural Service Corporation is authorized to incur long-term debt from Duncan Valley Electric Cooperative, Inc. in an amount not to exceed an aggregate of $428,484[5] for a term of twenty years, and at an interest rate not to exceed five percent per year.

IT IS FURTHER ORDERED that Duncan Rural Services Corporation is authorized to enter into a revolving line of credit with Duncan Valley Electric Corporation in an amount not to exceed $70,000 for the purpose of financing increases in its PGA under-collected bank balance after the effective date of this Order, at an interest rate not to exceed Arizona Electric Power Cooperative's deposit rate, and in conformance with the conditions as recommended by Staff and discussed herein.

IT IS FURTHER ORDERED that such finance authority shall be expressly contingent upon Duncan Rural Service Corporation's use of the proceeds for the purposes stated in its application and approved herein.

IT IS FURTHER ORDERED that approval of the financing set forth hereinabove does not constitute or imply approval or disapproval by the Commission of any particular expenditure of the proceeds derived thereby for purposes of establishing just and reasonable rates.

IT IS FURTHER ORDERED that Duncan Rural Services Corporation shall file copies of all executed financing documents setting forth the terms of the financing within 90 days of obtaining such financing.

IT IS FURTHER ORDERED that Duncan Rural Services Corporation is authorized to engage in any transactions and to execute any documentation necessary to effectuate the authorization granted.

IT IS FURTHER ORDERED that Duncan Rural Services Corporation shall implement a customer education effort that conforms to the recommendations set forth in Findings of Fact No. 51.

IT IS FURTHER ORDERED that Duncan Rural Services Corporation's base cost of gas be reset to zero in the first complete billing period following the effective date of this Decision, or thirty days following the effective date of this Decision, whichever is later, to allow for the preparation and approval of educational materials.

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[5] $330,484 for the purpose of financing past capital improvements and $98,000 to finance future capital improvements.

IT IS FURTHER ORDERED that to ensure the veracity of the monthly PGA reports, a Duncan Rural Service Corporation officer shall certify, under oath in an affidavit, that the monthly adjustor reports are true and accurate.

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, BRIAN C. McNEIL, Executive Secretary 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 SECRETARY

DISSENT ______________________________

DISSENT ______________________________

JR:mj

SERVICE LIST FOR: DUNCAN RURAL SERVICES CORPORATION

DOCKET NO.: G-02528A-05-0314
G-02528A-03-0205

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Mr. Jack Shilling
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LEGAL DIVISION
Arizona Corporation Commission
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Utilities Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

EXHIBIT A

Duncan Rural Services Corporation
Docket No. G-02528A-05-0314
Test Year Ended December 31, 2004

Rejoinder Schedule H-3

RATE DESIGN

METER SIZES	Present Rates	Proposed Rates	Proposed Rates With 5% Incr.	Proposed Rates With 10% Incr.
250 cfh & Below				
Monthly Service Charge	$15.00	$20.00	$20.00	$20.00
Winter Commodity Rate per Therm	$0.44000	$0.73000	$0.77000	$0.81000
Summer Commodity Rate per Therm	$0.15405	$0.26000	$0.27600	$0.28800
Above 250 cfh to 425 cfh				
Monthly Service Charge	$22.50	$30.00	$30.00	$30.00
Winter Commodity Rate per Therm	$0.44000	$0.73000	$0.77000	$0.81000
Summer Commodity Rate per Therm	$0.15405	$0.26000	$0.27600	$0.28800
Above 425 cfh to 1,000 cfh				
Monthly Service Charge	$30.00	$40.00	$40.00	$40.00
Winter Commodity Rate per Therm	$0.44000	$0.73000	$0.77000	$0.81000
Summer Commodity Rate per Therm	$0.15405	$0.26000	$0.27600	$0.28800

Service Charges:	Present Rates	Proposed Rates	Proposed Rates	Proposed Rates
Establishment of Service (Regular Hours)	$ 35.00	$ 35.00	$ 35.00	$ 35.00
Establishment of Service (After Hours)	$ 50.00	$ 50.00	$ 50.00	$ 50.00
Re-establishment/Reconnection of Service (Regular Hours)	$ 50.00	$ 50.00	$ 50.00	$ 50.00
Re-establishment/Reconnection of Service (After Hours)	$ 75.00	$ 75.00	$ 75.00	$ 75.00
After Hours Service Calls - Consumer Caused (Per Hour)*	$ 50.00	$ 50.00	$ 50.00	$ 50.00
Meter Re-read Charge (No Charge for Read Error)	$ 30.00	$ 30.00	$ 30.00	$ 30.00
Meter Test Fee	$ 50.00	$ 50.00	$ 50.00	$ 50.00
Insufficient Funds Check	$ 20.00	$ 20.00	$ 20.00	$ 20.00
Interest Rate on Customer Deposits**	3.0%	Variable	Variable	Variable
Late/Deferred Payment (Per Month)	0.0%	1.5%	1.5%	1.5%

* One hour minimum

** Variable Rate based on the Three Month Non-Financial Commercial Paper Rate as published by the Federal Reserve

Base Cost of Gas & Fuel Adjustor Included in Present Rates	$ -
Base Cost of Gas $ Fuel Adjustor Included in Proposed Rates	$ -

DECISION NO. ______

EXHIBIT B

	Present Rates	Proposed Rates Staff
MONTHLY USAGE CHARGE:		
< 250	$15.00	$20.00
250 < 425	22.50	30.00
425 < 1000	30.00	40.00
ENERGY (COMMODITY) RATE – PER THERM		
<250		
Winter	$0.80000	$0.57280
Summer	0.51405	0.57280
250<450		
Winter	$0.80000	$0.28480
Summer	$051405	$0.28480
425<1000		
Winter	$0.80000	$0.74480
Summer	0.51405	0.74480
SERVICE RELATED CHARGES:		
Establishment	$35.00	$35.00
Establishment (After Hours)	50.00	50.00
Reconnection (Regular Hours)	50.00	50.00
Reconnection (After Hours)	75.00	75.00
After Hours Service Call*	50.00	50.00
Meter Re-read (No charge for read error)	30.00	30.00
Meter Test Fee	50.00	50.00
NSF Check	20.00	20.00
Interest on Consumer Deposits	3.00%	6.00%
Late/Deferred Payment (Per Month)	0.00%	1.50%

*One hour minimum

DECISION NO. ______________