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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF) DOCKET NO. G-04204A-06-0463
UNS GAS, INC. FOR THE ESTABLISHMENT OF)
JUST AND REASONABLE RATES AND)
CHARGES DESIGNED TO REALIZE A)
REASONABLE RATE OF RETURN ON THE)
FAIR VALUE OF THE PROPERTIES OF UNS)
GAS, INC. DEVOTED TO ITS OPERATIONS)
THROUGHOUT THE STATE OF ARIZONA.)

IN THE MATTER OF THE APPLICATION OF) DOCKET NO. G-04204A-06-0013
UNS GAS, INC. TO REVIEW AND REVISE ITS)
PURCHASED GAS ADJUSTOR.)

IN THE MATTER OF THE INQUIRY INTO THE) DOCKET NO. G-04204A-05-0831
PRUDENCE OF THE GAS PROCUREMENT)
PRACTICES OF UNS GAS, INC.)

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INITIAL POST-HEARING BRIEF
OF UNS GAS, INC.

JUNE 5, 2007

Arizona Corporation Commission
DOCKETED

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1 On January 10, 2006, UNS Gas filed an application requesting that the Arizona
2 Corporation Commission ("Commission") review and revise its Purchased Gas Adjustor ("PGA").
3 On September 8, 2006, the Commission consolidated the PGA Review Case with the UNS Gas
4 Rate Case. The revisions UNS Gas is requesting will provide for more timely recovery of the
5 Company's gas commodity-related costs.

6 On November 10, 2005, the Commission opened the Gas Procurement Review Case to
7 review the prudence of the gas procurement practices of UNS Gas. On September 8, 2006, the
8 Commission consolidated the Gas Procurement Review Case with the UNS Gas Rate Case. The
9 Gas Procurement Review Case was intended to determine whether UNS Gas' past gas
10 procurement practices were prudent.

11 **A. Overview of Gas Rate Case.**

12 UNS Gas is requesting: (i) a base rate increase of \$9.6 million, or approximately 7 percent;
13 (ii) key changes to its rate design that allow UNS Gas to cover more of its fixed costs through a
14 higher monthly customer charge and reduce the current subsidization of warm-weather customers
15 by cold-weather customers; (iii) adoption of a rate decoupling mechanism addressing the *volume*
16 of gas sold to help UNS Gas more timely recover fixed costs (UNS Gas has referred to this
17 mechanism as the "Throughput Adjustment Mechanism" or "TAM"); and (iv) the inclusion of
18 Construction Work in Progress ("CWIP") in rate base to keep up with customer growth.

19 A brief overview of some significant aspects of the Company's rate request is provided
20 herein to demonstrate the broad scope of relief that is necessary for UNS Gas to meet the needs of
21 its customers in the future.

22 UNS Gas requests that \$7.2 million in CWIP be included in rate base. This CWIP is the
23 result of unprecedented growth that has occurred in the UNS Gas service area. Since UNS Gas
24 acquired the gas assets, it has made over \$50 million in capital improvements. UNS Gas
25 anticipates that it will continue to make substantial capital investments for the foreseeable future.
26 Unless CWIP is included in rate base, UNS Gas will suffer inadequate returns on its investment
27 and a deteriorating financial condition

1 UNS Gas also requests recovery of its Geographic Information System (“GIS”) and
2 software in costs. There is no dispute that this system is critical to the safe, efficient and reliable
3 operation of the gas facilities. However, other parties contest its inclusion due to an honest
4 accounting error for this significant investment. UNS Gas believes it is fair and appropriate to
5 include this valuable system in our rate base.

6 UNS Gas requests a return on equity (“ROE”) of 11 percent. UNS Gas is by no means a
7 large company. However, it faces the same significant challenges and related risks that larger gas
8 companies face, due to factors such as high growth and unstable gas prices. The 11 percent ROE
9 is both reasonable and necessary to attract the capital needed by UNS Gas.

10 UNS Gas proposes changes to its rate design because a large portion of its fixed costs are
11 being covered by revenues that are dependant upon volumetric usage charges. The cost of serving
12 individual customers does not vary significantly based on the amount of gas they use; UNS Gas
13 incurs the fixed costs regardless of whether it sells a single cubic foot of gas. However, the current
14 rate design compels high-usage customers – typically those living in the colder areas of UNS Gas’
15 service territory – to pay a greater share of the Company’s fixed costs than low-usage customers in
16 warmer climates. UNS Gas has proposed increasing the fixed monthly customer charge and
17 decreasing the volumetric charge to reduce this substantial cross-subsidization.

18 Despite the higher monthly customer charge, a portion of the Company’s fixed costs would
19 continue to be recovered through the volumetric margin charge. The proposed TAM would
20 monitor the recovery of those costs and adjust rates up or down to ensure that usage-based
21 revenues more accurately track anticipated levels. In this way, the TAM would ensure that UNS
22 Gas does not over-earn or under-earn as a result of the sales volumes being higher or lower than
23 anticipated.

24 UNS Gas believes the relief it is requesting is fair, just and reasonable. First, UNS Gas has
25 experienced annual customer growth exceeding 5 percent. Second, UNS Gas’ cost of providing
26 service has increased, accentuated by volatile wholesale gas costs that have reached unprecedented
27 price spikes. Third, UNS Gas is involved in increased efforts to reduce consumption of gas

1 through conservation, demand-side management and other energy efficiency initiatives. The
2 success of these efforts will lead to lower revenues, particularly given UNS Gas' current rate
3 design, which attempts to recover the bulk of the Company's fixed costs through volumetric
4 charges.

5 To date, UNS Gas has managed to meet the challenges of growth and the gas market,
6 mostly through tight budgeting and capital infusion by its ultimate parent company, UniSource
7 Energy Corporation ("UniSource Energy"). But without adequate rate relief to cover the cost of
8 capital and other expenses, it is unlikely that any serious investor would continue to infuse money
9 into UNS Gas.²

10 **B. Overview of PGA Review.**

11 UNS Gas is seeking to have its PGA reviewed and revised, and has requested the following
12 modifications to its current PGA: (i) the bandwidth should be eliminated or, in the alternative,
13 temporarily increased to \$.25 per therm, and then eliminated; (ii) the interest earned on the PGA
14 bank balance should reflect UNS Gas' actual cost of new debt, which is LIBOR plus 1.5 percent,
15 (iii) when the bank balance is greater than two times the threshold level, UNS Gas should earn its
16 weighted average cost of capital as determined in its most recent rate case; (iv) a new threshold
17 level of \$6,240,000 should be adopted for over-collected bank balances; (v) debt related to the
18 bank balance in UNS Gas' capital structure should be excluded for the purpose of calculating UNS
19 Gas' weighted average cost of capital; and (iv) when surcharges are needed, the surcharge should
20 be large enough to eliminate the bank balance within a reasonable time period. Such revisions are
21 particularly important in times of volatile gas prices.

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25 _____
26 ² Attachment 1 to this brief is an updated version of Exhibit DJD-1, which provides a comparative summary of the
27 adjustments to rate base, to operating income and to operating expenses that reflects the Company's final position on
those adjustments as set forth in Rejoinder Testimony. The Company's final position is also set forth in the
schedules that are being submitted along with this brief.

1 **C. Overview of Gas Procurement Review.**

2 The Commission Utilities Division Staff ("Staff") initiated the review of UNS Gas' gas
3 procurement practices. After its review, Staff has concluded that UNS Gas' gas procurement
4 policies and practices are prudent. UNS Gas concurs with Staff's conclusion. UNS Gas also is
5 requesting in this docket that the Commission approve its gas procurement policies (the "Price
6 Stabilization Policy") on a going forward basis.

7 **I. UNS GAS' REVENUE REQUIREMENT AND RELATED RATE INCREASE IS**
8 **JUST AND REASONABLE.**

9 UNS Gas has requested a rate increase of \$9,646,901, or approximately 7 percent. Its
10 current rates are insufficient to allow the Company to recover its costs and earn a reasonable rate
11 of return on its investment. This is due to increased growth in UNS Gas' service territory and the
12 related increase in capital expenditures and operating costs. UNS Gas has an original cost test year
13 rate base of \$161,661,362, a fair value test year rate base of \$191,177,715, and an adjusted test
14 year net operating income of \$8,429,000. The Company also seeks an overall rate of return
15 ("ROR") and weighted average cost of capital of 8.80 percent. This overall ROR is based on a 6.6
16 percent cost of debt, an 11.0 percent cost of common equity capital, and a capital structure
17 consisting of 50 percent long-term debt and 50 percent common equity. The rate of return on fair
18 value rate base is 7.43 percent.

19 Based on its requested rate base, current operating income and requested rate of return,
20 UNS Gas presently has an operating income deficiency of \$5,794,198, thus entitling it to an
21 increase in revenues of \$9,646,901. Absent a rate increase, UNS Gas has projected it will earn a
22 return on average common equity without adjustments or allocations of 4.53 percent in 2006.

23 **A. UNS Gas' Proposed Rate Base is Reasonable.**

24 Due to agreements made in the course of UniSource Energy's acquisition of Citizens'
25 assets, UNS Gas' current rates are based upon an original cost less depreciation rate base of
26 \$117,661,030. Since then, UNS Gas has spent \$61,616,006 through the end of the test year on its
27 transmission and distribution facilities. Most of this investment has been related to growth in its

1 natural gas system. UNS Gas has made substantial additions to utility plant and equipment that
2 have improved service reliability for existing customers while meeting the demand of customer
3 growth.

4 UNS Gas requests an original cost test year rate base of \$161,661,362 and a fair value test
5 year rate base of \$191,177,715. UNS Gas provided the information pursuant to three valuation
6 methodologies: (i) original cost; (ii) reconstruction cost new less depreciation ("RCND"); and (iii)
7 fair value. Pursuant to Commission precedent, the fair value was determined by adding together
8 original cost and RCND rate base amounts and dividing that total by two.

9 There are few issues with UNS Gas' rate base. Staff challenged only two adjustments
10 directly: the CWIP adjustment and the GIS adjustment. RUCO raised several other challenges to
11 rate base that neither UNS Gas nor Staff support.

12 **1. Methods for protecting UNS Gas' financial integrity in the face of**
13 **extraordinary growth.**

14 UNS Gas faces the real and significant risk of financial deterioration without adequate rate
15 relief. It is undisputed that UNS Gas has faced, and will continue to face, high levels of growth.³
16 UNS Gas has a low embedded cost of plant, so rate base per customer is much higher for new
17 customers than for existing customers.⁴ Thus, extra revenue from new customers will not be
18 sufficient to cover the capital costs required to serve them. Therefore, UNS Gas will likely be
19 unable to earn its authorized rate of return in the foreseeable future.⁵ Yet, UNS Gas faces very
20 high capital expenditure requirements.⁶ It is essential that UNS Gas maintain an ability to attract
21 capital to meet these capital expenditure requirements.

22 UNS Gas proposes several measures to reduce the detrimental financial impact of these
23 high capital requirements. These proposed measures include tariff changes to increase
24 contributions from developers, thereby somewhat reducing the amount of required investment per
25

26 ³ Ex. UNSG-29 at Ex. KCG-15; Tr. at 920, 1004-5, 1020.
27 ⁴ Ex. UNSG-28 at 8; Tr. at 956.
⁵ Ex. UNSG-28 at 8.
⁶ Id.

1 customer. Such proposals are beneficial, to an extent, and help ease the burden of attracting new
2 capital.

3 Even with these proposals, however, UNS Gas will need to attract tens of millions of
4 dollars in new capital in the next few years.⁷ Without a timely way to recover these capital
5 expenditures, UNS Gas' financial integrity will suffer, forcing it to file rate cases in rapid
6 succession. There is a better way to protect UNS Gas' financial integrity, while providing a bit of
7 breathing room between rate cases. To do so, the Commission must use tools that, while legally
8 permissible and within the Commission's discretion, are often shunned.

9 **a. Construction Work in Progress.**

10 UNS Gas' primary request is to include CWIP in rate base. CWIP is an accepted aspect of
11 ratemaking that has been used in many states for many years.⁸ There is nothing novel or cutting
12 edge about it. Indeed, the Arizona Supreme Court has specifically ruled that the Commission may
13 include CWIP in rate base. *Arizona Community Action Assoc. v. Arizona Corp. Comm'n*, 123
14 Ariz. 228, 230, 599 P.2d 184, 186 (1979). The court referred to one of its earlier decisions which
15 found the use of CWIP to be within the Commission's discretion. Quoting that earlier decision,
16 the Court remarked: "[it] appears to be in the public interest to have stability in the rate structure
17 within the bounds of fairness and equity rather than a constant series of rate hearings." *Id.*

18 Such is the case here. Again, UNS Gas will not be able to earn its authorized rate of return,
19 even if its full rate request is approved, due to growth and a higher rate base per customer for new
20 customers. Including CWIP in rate base will help address this problem.

21 RUCO claims that growth is positive, generating "more revenue and cash flow."⁹ Staff
22 argues along the same lines. These assertions may be true in a generic sense, but they do not fit
23 the circumstances of UNS Gas. As already described, the higher capital costs associated with new
24 UNS Gas customers creates a severe drain on the Company's financial integrity. It also negatively
25

26 ⁷ See, e.g., Ex. UNSG-27 at 27 (\$43 million in additional capitalization through 2009); Ex. UNSG-15 at 4 (noting
more than \$61 million in capital spending from 2001 to 2005).

27 ⁸ Ex. UNSG-28 at 7.

⁹ Ex. RUCO-5 at 9.

1 impacts cash flow, because new plant creates additional fixed costs, and because growth leads to
2 capital requirements far in excess of the Company's internal cash flow.¹⁰ As a result, the "impact
3 of regulatory lag on UNS Gas is more pronounced than most utilities."¹¹

4 UNS Gas' financial data clearly shows the negative financial effects of growth. For
5 example, in 2006, UNS Gas added \$17 million in net plant, resulting in an additional \$3 million in
6 fixed costs (depreciation, property taxes, etc).¹² But new customers added in 2006 provided only
7 \$1.8 million in new revenues.¹³ Therefore, UNS Gas lost \$1.2 million due to new growth in
8 2006.¹⁴ Notably, Staff and RUCO did not dispute this example in their testimony.

9 **b. Post Test Year Plant.**

10 If the Commission does not allow CWIP into rate base, then it should include post test year
11 plant in rate base. The Commission approved post test year plant in a number of recent cases.¹⁵
12 UNS Gas faces faster growth than other utilities in Arizona¹⁶ and the required amount of capital
13 per customer is much higher for new customers than for existing customers. Given the large
14 number of other cases approving post test year plant, it is certainly justified in this case.
15 Therefore, if the Commission does not allow CWIP, it should include post test year plant in rate
16 base.

17 **c. Customer Advances should have no net impact on rate base.**

18 If the Commission rejects both CWIP and post test year plant from rate base, it should at
19 the very least ensure that rate base is not reduced even more from customer advances related to
20 CWIP. Customer advances are funds provided by customers to pay for new facilities. Typically,
21 advances are deducted from rate base. The theory behind this is clear: advances are customer-

22
23 ¹⁰ Ex. UNSG-28 at 9.

24 ¹¹ Ex. UNSG-27 at 28.

25 ¹² Ex. UNSG-28 at 10.

26 ¹³ Id.

27 ¹⁴ Id.

¹⁵ See e.g., *Arizona-American Water Co. (Paradise Valley)*, Decision No. 68858 (July 28, 2006); *Chaparral City Water Co.*, Decision No. 68176 (September 30, 2005); *Rio Rico Utilities, Inc.*, Decision No. 67279 (October 5, 2004); *Arizona-American Water Co.*, Decision No. 67093 (June 30, 2004); *Arizona Water Co.*, Decision No. 66849 (March 19, 2004); *Bella Vista Water Co., Inc.*, Decision No. 65350 (November 1, 2002).

¹⁶ Ex. UNSG-29 at Ex. KCG-15; Tr. at 920, 1004-5, 1020.

1 supplied capital and should reduce rate base. For example, if a customer advances \$1,000 for new
2 facilities that are in service, the net impact should be zero (plant in service increases by \$1,000;
3 rate base then decreases by \$1,000 for a zero net impact).

4 UNS Gas requests \$7 million in CWIP.¹⁷ UNS Gas received \$4 million in advances
5 related to this CWIP.¹⁸ Thus, if CWIP is allowed in rate base, the net impact will be \$3 million
6 (\$7 million less \$4 million in advances). But if CWIP is denied, then there is no reason to deduct
7 the \$4 million from rate base. Staff and RUCO suggest that this \$4 million still be deducted from
8 rate base. Under their proposal, the net impact of the advances will be a \$4 million reduction in
9 rate base (\$0 million in extra plant in service, less \$4 million in advances).

10 That proposal is simply unfair. It would be bad enough if UNS Gas must forego recovery
11 of the capital costs on \$7 million in plant, which is almost entirely in service today.¹⁹ Under the
12 Staff / RUCO approach, UNS Gas would be required to forego recovery of a further \$4 million.
13 The effect is to substitute \$4 million of "cost free" capital that financed test year CWIP for real
14 debt and equity capital that financed test year plant in service.

15 There is no rule that requires advances to be deducted from rate base when the related plant
16 is not yet in service. The purpose of deducting advances from rate base is to recognize the effect
17 of customer-supplied capital. That purpose is not served when the plant funded by the advances is
18 not in service. RUCO recently recognized this when it agreed that contributions collected to fund
19 a water treatment plant should not be deducted from rate base until that plant is in service.²⁰ In
20 that case, RUCO's witness also suggested that the same rationale could apply to other cases.²¹
21 While RUCO does not make that recommendation in this case, the same considerations suggest
22 that a \$4 million reduction in rate base is not warranted unless the related plant is recognized in
23 plant in service.

24
25
26 ¹⁷ Ex. UNSG-29 at 9.

¹⁸ Id.

¹⁹ Thus, AFUDC accruals have ceased.

²⁰ Tr. at 1005-1006.

²¹ Ex. UNSG-36.

1 Moreover, some Commissioners have suggested that some utilities should collect more
2 advances and contributions through mechanisms like hook-up fees. Taken in moderation, such
3 proposals are beneficial, providing "cost free" capital for new construction. The additional plant
4 funded by hook-up fees results in no net change in rate base. Such proposals become a poisoned
5 chalice, though, if they lead to net decreases in rate base. Under those circumstances, the
6 Commission would be sending an economic signal that utilities should try as hard a possible to
7 avoid advances and contributions. Such a result would not serve the public interest.

8 2. Geographic Information System.

9 UNS Gas has aggressively increased productivity to lower costs to its customers. From the
10 date of the purchase of the gas system to the end of the test year, UNS Gas increased productivity
11 by nearly 11 percent.²² For example, UNS Gas moved from needing one employee for every 616
12 customers to needing only one employee for every 666 customers.²³ These productivity gains
13 created savings of \$1.8 million – a direct benefit to ratepayers.²⁴

14 A core strategy for increasing productivity is the increased use of information technology.
15 The best example of this is UNS Gas' new Geographic Information System ("GIS").²⁵ The GIS
16 creates many benefits, including:

- 17 (i) faster emergency response due to the ability to quickly locate system controls (such
18 as valves);
- 19 (ii) better informed planning through computer modeling of the gas system;
- 20 (iii) faster work processes, including quicker mapping of the system, which is especially
21 important in a fast-growing system; and
- 22 (iv) increased accuracy and safety because field employees can access up-to-date maps
23 on their portable computers.²⁶

24
25
26 ²² Ex. UNSG-15 at 8.

27 ²³ Id.

²⁴ Id.

²⁵ Id. at 6.

²⁶ Id. at 6-7.

1 The GIS therefore provides clear benefits in safety and productivity that benefit customers.
2 A key question in this case is how the costs of the GIS should be recovered. The answer offered
3 by Staff and RUCO, that no recovery should be allowed, is simple but unfair. UNS Gas suggests
4 that the Commission treat the GIS costs as a regulatory asset, to be amortized over the estimated
5 period rates from this case will be in place.²⁷

6 Staff and RUCO justify their complete disallowance of GIS costs by noting that UNS Gas
7 did not obtain an accounting order authorizing the deferral of the GIS costs.²⁸ UNS Gas requests
8 that the Commission retroactively approve such a deferral. All parties agree that approval of a
9 deferral would be needed because GIS costs ordinarily would be treated as expenses.

10 UNS Gas did not seek an accounting order earlier due to a mistake. Originally, the work
11 orders relating to the project were prepared on the assumption that the project would be
12 capitalized, not expensed.²⁹ These work orders were created by Citizens and UNS Gas did not
13 discover this mistake when the work orders were converted to UNS Gas work orders.³⁰

14 UNS Gas now accepts that the GIS costs should be expensed unless the Commission
15 authorizes a deferral. But this realization came late in the test year, after almost all of the costs had
16 been incurred. Only then did the Company realize that Commission approval of a deferral would
17 be needed.

18 RUCO and Staff have not said they would have opposed an accounting order if one had
19 been requested earlier, and they have not questioned the amount of GIS costs. Nevertheless, they
20 claim these costs should be disallowed because of a bookkeeping error. Rate cases should reflect
21 the reality of the costs incurred rather than the results of a regulatory game of "gotcha." RUCO's
22 and Staff's proposal unfairly penalizes UNS Gas for an honest mistake and fails to allow recovery
23 of costs that resulted in substantial safety and productivity gains.

26 ²⁷ Ex. UNSG-12 at 9-10.

27 ²⁸ See, e.g., Ex. RUCO-6 at 8-9.

²⁹ Tr. at 221-22; see Ex. S-6.

³⁰ Ex. S-6 at 7.

1 Staff's position is especially harsh given that Staff requested that UNS Gas undertake the
2 GIS project and thus incur these costs.³¹ In setting rates, the Commission "must consider" the
3 costs of complying with the Commission's requirements. *Arizona Corp. Comm'n v. Palm Springs*
4 *Utility Co., Inc.*, 24 Ariz. App. 124, 130, 536 P.2d 245, 251 (1975). Because the GIS costs were
5 incurred at the request of the Commission's representatives, the Commission should allow
6 recovery of these costs.

7 RUCO also argues that the Company actually did recover its GIS costs in the test year.³²
8 There is no evidence to support this claim, since even RUCO does not contend that GIS costs were
9 included in the last rate case for the Company. RUCO's argument should therefore be rejected.

10 **3. Plant in Service.**

11 Staff has not challenged UNS Gas' plant in service. However, RUCO proposes
12 disallowing \$3.1 million in plant it considers "unsubstantiated." This adjustment should be
13 rejected because UNS Gas provided adequate documentation of these items. RUCO's
14 disallowance appears to relate to the final months the system was owned by Citizens (June through
15 August 2003). By that point, Citizens had agreed to sell the system to UniSource Energy, and
16 Citizens was scrambling to wrap up its accounting for those months.³³ It is not surprising that
17 Citizens' records from that period were less extensive than normal.

18 However, sufficient detail still exists to verify the final plant in service totals at the closing
19 of the sale. UNS Gas provided RUCO with records from Citizens documenting the final plant in
20 service numbers, as well as electronic files containing a detailed plant listing.³⁴ RUCO attempts to
21 justify its disallowance through RUCO Exhibit 1, which includes paper documents provided by
22 UNS Gas. However, RUCO Exhibit 1 does not include the electronic files provided to RUCO.
23 Moreover, RUCO's counsel seemed unfamiliar with the existence of these electronic files.³⁵

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26 ³¹ Id.

³² Ex. RUCO-6 at 8-9.

³³ Tr. at 197.

³⁴ Tr. at 194-97.

³⁵ Id.

1 Because RUCO Exhibit 1 does not include the electronic files provided to RUCO, it is not reliable
2 evidence.

3 Moreover, RUCO's witness, Mr. Rodney Moore, said that he "can't imagine" that Citizens
4 added \$3 million in plant in its last few months.³⁶ Yet Mr. Moore admitted that the Company
5 spends more than \$1 million per month in capital expenditures;³⁷ \$1 million per month over 3
6 months amounts to \$3 million in additional plant in service.³⁸

7 In addition, Mr. Moore stated that Citizens continued "business as usual" regarding rate
8 base records up to the closing.³⁹ Thus, Citizens' records for those months should be accepted, just
9 as Citizens' records for the previous months have been accepted by all parties.

10 Mr. Moore also states that Citizens' rate base records are "notoriously inadequate" and that
11 it "is commonly accepted by those who have attempted (in past proceedings and in the instant
12 case) to establish an accurate rate base... from Citizens' records that these records are
13 inaccurate."⁴⁰ Notably, Mr. Moore did not point to any similar adjustments in those prior cases.
14 That is because such adjustments were not made in those prior cases. For example, the rate cases
15 for Citizens' former water and wastewater assets did not have any proposed adjustment similar to
16 that proposed by RUCO here.⁴¹ There are no grounds for treating UNS Gas any differently than
17 other buyers of Citizens' assets.

18 Further, treating the gas system more harshly than other former Citizens systems makes
19 little sense because the Commission imposed less stringent records retention requirements for the
20 sale of the gas assets. The Commission order approving the sale of the gas system by Citizens did
21 not include standard record retention requirements.⁴² Such requirements have been included in
22 orders relating to the sales of other Citizens assets.⁴³ The absence of these requirements indicates
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24 ³⁶ Tr. at 653.

25 ³⁷ Tr. at 658-59.

26 ³⁸ Id.

27 ³⁹ Tr. at 644-45.

⁴⁰ Ex. RUCO-4 at 4.

⁴¹ See *Arizona-American Water Co.*, Decision No. 67093 (June 30, 2004).

⁴² Tr. at 644.

⁴³ Ex. UNSG-7 at 6.

1 that the Commission likely anticipated that less documentation would be available from Citizens,
2 because the gas and electric systems were the last systems in Arizona to be sold.

3 UNS Gas directly transferred the final plant in service numbers from Citizens to its books
4 as the opening values for plant in service. The Commission requires UNS Gas to follow FERC
5 accounting standards, and this accounting procedure was expressly approved by FERC.⁴⁴
6 Moreover, UNS Gas' financial statements were audited and approved by a nationally recognized
7 audit firm.⁴⁵

8 In sum, UNS Gas provided adequate documentation from Citizens to support the full
9 amount of plant in service transferred from Citizens. RUCO appears to have ignored electronic
10 records provided to it. Staff did not support RUCO's adjustment. Moreover, the disputed \$3.1
11 million is consistent with historical capital expenditures during the disputed period. No similar
12 disallowances were made in other rate cases involving former Citizens systems. In addition, UNS
13 Gas' position is consistent with FERC-approved accounting for the transaction and the
14 Company's audited financial statements. Accordingly, RUCO's proposal to disallow more than \$3
15 million in plant should be rejected.

16 4. Accumulated Depreciation.

17 RUCO proposes increasing accumulated depreciation by more than \$6.7 million, which has
18 the effect of reducing rate base by the same amount. Staff did not support this adjustment.
19 Because RUCO's adjustments are unfounded, they would have the effect of taking away \$6.7
20 million of property from UNS Gas. There is no support for RUCO's extreme position.

21 RUCO's adjustment has two parts. First, RUCO used outdated depreciation rates to
22 calculate its accumulated depreciation total. This adjustment totals \$2,855,454.⁴⁶ Second, RUCO
23 witness Mr. Moore adjusted accumulated depreciation to match his disallowance of
24 "unsubstantiated" plant and to incorporate RUCO's outdated depreciation rates. This adjustment

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27 ⁴⁴ Ex. UNSG-7 at Ex. KGK-3, Ex. KGK-4.

⁴⁵ Ex. UNSG-7 at 2; Ex. UNSG-6 at Ex. KGK-1.

⁴⁶ Ex. RUCO-3 at 13-14.

1 totaled \$3,857,413.⁴⁷ This adjustment should be rejected for the same reasons RUCO's
2 "unsubstantiated plant" adjustment and first accumulated depreciation adjustments should be
3 rejected.

4 RUCO suggests that accumulated depreciation should be based on depreciation rates
5 approved in Decision No. 58664 (June 16, 1994)("1994 Rate Order").⁴⁸ Those rates predate the
6 test year by more than a decade. RUCO fails to recognize that the Commission approved new
7 depreciation rates in Decision No. 66028 (July 3, 2003)("2003 Rate Order"). The 2003 Rate Order
8 resolved Citizens' gas rate case, and also approved the sale of the gas system.

9 RUCO argues that the 2003 Rate Order did not expressly approve the new depreciation
10 rates. However, unless a ratemaking proposal is disputed, it is commonplace for the Commission
11 to not explicitly address the proposal.⁴⁹ No party disputed the depreciation rates in 2003. While
12 RUCO seems to contend that the 2003 Rate Order was a "black box" settlement, in fact the
13 settlement agreement contained a specific schedule showing how the revenue requirement was
14 calculated.⁵⁰ The numbers in this schedule presume the new depreciation rates.⁵¹ The settlement
15 agreement, including the schedule, were approved by the Commission in the 2003 Rate Order.⁵²
16 Thus, the new depreciation rates were approved in the 2003 Rate Order.

17 Moreover, RUCO's insistence on explicit approval language contradicts its own actions in
18 this case. RUCO supports the depreciation rates from the 1994 Rate Order, but that order
19 discusses only two of 28 depreciation accounts.⁵³ Thus, for the remaining 26 accounts, RUCO had
20 to refer to the rate application to see what depreciation rates were approved.⁵⁴ Yet RUCO refuses
21 to take this same step and refer to the rate application that led to the 2003 Rate Order.

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24 ⁴⁷ Id. at 12; Ex. RUCO-4 at 6.
25 ⁴⁸ Ex. RUCO-3 at 13-14.
26 ⁴⁹ Tr. at 201-202.
27 ⁵⁰ Ex. UNSG-7 at Ex. KGK-11.
⁵¹ Tr. at 202-203; Ex. UNSG-7 at 9.
⁵² Decision No. 66028 (July 3, 2003) at 30.
⁵³ Tr. at 674.
⁵⁴ Id.

1 In addition, RUCO applied its outdated depreciation rates to the entire gas system.
2 However, prior to the 2003 Rate Order, the gas system was divided into two ratemaking divisions
3 – the Santa Cruz Division, and the Northern Arizona Division.⁵⁵ RUCO’s witness admitted that
4 the 1994 Rate Order did not apply to the Santa Cruz Division.⁵⁶ Therefore, it would not be
5 appropriate to apply those 1994 depreciation rates to the Santa Cruz portion of the gas system, yet
6 that is exactly what RUCO did here.

7 If RUCO is correct that the 2003 Rate Order did not change depreciation rates, then there
8 are still separate depreciation rates for Santa Cruz County that were unaffected by the 1994 Rate
9 Order. However, that would be inconsistent with the Commission’s decision in the 2003 Rate
10 Order to approve unified, statewide rates for the gas system.

11 **5. Working Capital.**

12 A number of ratemaking adjustments will have an impact that should be recognized in
13 working capital. In addition, RUCO’s proposed working capital should be rejected because
14 RUCO failed to use a simultaneous equation to compute two elements of cash working capital:
15 synchronized interest and current income taxes.⁵⁷

16 **6. Accumulated Deferred Income Tax.**

17 RUCO makes two major, but deeply flawed, adjustments to rate base for “unsubstantiated
18 plant” and “unauthorized depreciation rates.” Those adjustments should be rejected for the
19 reasons already stated. There is a further flaw in RUCO’s approach. While RUCO adjusted
20 current income taxes to reflect its rate base adjustments, RUCO failed to make the corresponding
21 adjustments to accumulated deferred income taxes and to deferred income tax expense.⁵⁸
22 Therefore RUCO’s computation of accumulated deferred income taxes and deferred income tax
23 expense should be rejected. This flaw provides a further reason to reject RUCO’s
24 “unsubstantiated plant” and “unauthorized depreciation rates” disallowances.

25
26 ⁵⁵ See Decision No. 66028 (July 3, 2003) at 27.

27 ⁵⁶ Tr. at 673.

⁵⁷ Ex. UNSG-7 at 12.

⁵⁸ Id. at 11-12.

1 **7. Reconstruction Cost New less Depreciation.**

2 RUCO's calculation of RCND rate base is flawed. RUCO used a ratio of original cost rate
3 base ("OCRB") to RCND.⁵⁹ But the proper and widely accepted method is to perform a trending
4 study using the final OCRB as the starting point and then adding increased costs though accepted
5 indexes of inflation, such as the Handy-Whitman Index.⁶⁰ Because RUCO failed to use the
6 accepted method of calculating RCND, its RCND rate base should be rejected.

7 **8. Fair Value Rate Base.**

8 UNS Gas, Staff and RUCO agree that fair value rate base ("FVRB") should be calculated
9 by averaging OCRB and RCND. Thus, the Commission should approve this traditional method.

10 **9. Uncontested Adjustments.**

11 The Commission should approve the following uncontested rate base adjustments as shown
12 on Attachment 1: (1) Southern Union Acquisition Premium; (2) Griffith Power Plant; (3) Build-
13 Out Plant; (4) Customer Assistance Residential Energy Support Program ("CARES") asset; (5)
14 customer contributions; (6) Y2K; and (7) Warm Spirit.

15 **B. UNS Gas' Operating Income Determination is Appropriate.**

16 As shown in Attachment 1, UNS Gas proposed six operating revenue adjustments. Staff
17 and RUCO proposed modifications only to the customer annualization and weather normalization
18 adjustments. UNS Gas also proposed 26 operating expense adjustments. Staff and RUCO
19 opposed several of these adjustments and proposed several additional operating adjustments. UNS
20 Gas disagrees with Staff's and RUCO's adjustments and most of their modifications to UNS Gas'
21 adjustments. UNS Gas's adjusted operating income for the test year is \$8,428,981, as opposed to
22 Staff's calculation of \$9,900,381 and RUCO's calculation of \$10,219,499. UNS Gas submits that
23 its adjustments are fully supported by the record and should be adopted by the Commission.

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27 ⁵⁹ Ex. RUCO-3 at 9.

⁶⁰ Ex. UNSG-6 at 20.

1 **1. Operating Revenue.**

2 **a. Customer Annualization.**

3 UNS Gas is experiencing high growth. However, that growth is not simple straight-line
4 expansion. Instead, the seasonal pattern of UNS Gas' growth is cyclical.⁶¹ UNS Gas' witness,
5 Mr. D. Bentley Erdwurm, graphically demonstrated this cyclical growth rate on his Exhibit DBE-
6 5.⁶² As Mr. Erdwurm explained, "in cases of cyclical growth, the mathematics break down and...
7 the practical problem is that [the traditional model] will often give you a totally counterintuitive
8 result, where you would actually have a negative customer adjustment on a growing system."⁶³
9 For example, Mr. Erdwurm demonstrated that in certain situations, applying the traditional method
10 to UNS Gas results in negative customer growth for a class that has a positive growth trend, which
11 has the nonsensical effect of pushing rates higher when the customer normalization should lower
12 them.⁶⁴

13 Due to UNS Gas' cyclical growth pattern, the traditional, simplistic annualization method
14 should be rejected in favor of a slightly more advanced mathematical model based on the
15 exponential growth model.⁶⁵ The Company believes that, given the seasonal nature of a
16 significant portion its customer base, the traditional method used to annualize customer
17 adjustments is not as accurate as the Company's proposed methodology. The results under the
18 Company's method make more sense because the standard deviation is lower, producing the more
19 accurate result in UNS Gas' climate.⁶⁶ Staff and RUCO offer no justification for rejecting the
20 Company's system other than to say it is not as simplistic and it has not been adopted before.
21 These arguments should not be used as an excuse to sacrifice accuracy. The accuracy of the
22 Company's method justifies its adoption in this case over the traditional method.

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24
25 ⁶¹ Tr. at 447.

26 ⁶² Ex. UNSG-20 at Ex. DBE-5.

27 ⁶³ Tr. at 447.

⁶⁴ Tr. at 447; Ex. UNSG-20 at 4-5.

⁶⁵ Ex. UNSG-20 at 3.

⁶⁶ Ex. UNSG-19 at 8.

1 **b. Weather Normalization.**

2 The weather normalization adjustment should reflect the other positions taken herein,
3 including the customer annualization adjustment described above.

4 **c. Uncontested Income Adjustments.**

5 The Commission should approve the following uncontested operating income adjustments
6 as shown on Attachment 1: (1) Griffith Plant Operations; (2) Purchased Gas Adjustor and Gas
7 Cost Revenue; (3) NSP Revenue and Gas Cost; and (4) CARES.

8 **2. Expenses.**

9 **a. Legal Standard.**

10 The Commission is required "to allow a recovery for all reasonable expenses." *Tucson*
11 *Electric Power Co. v. Arizona Corp. Comm'n*, 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982). In
12 other words, the Commission must provide sufficient income to permit full recovery of "operating
13 costs" in addition to the return on rate base. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-
14 34, 578 P.2d 612, 614-15 (App. 1978). In addition, the Commission "must consider" any
15 "expenditures made in compliance with the Commission's decision[s]." *Arizona Corp. Comm'n v.*
16 *Palm Springs Utility Co.*, 24 Ariz. App. 124, 536 P.2d 245 (1975).

17 **b. Property Tax.**

18 Three elements are needed to calculate property tax: the property's value, the assessment
19 ratio, and the tax rate.⁶⁷ RUCO proposes using the 2005 tax rate and property values but a 2007
20 assessment ratio.⁶⁸ While RUCO "feels strongly about avoiding mismatches,"⁶⁹ its property tax
21 proposal creates a classic mismatch. Indeed, RUCO's witness, Mr. Moore, admits that actual
22 property taxes never will be calculated using RUCO's method.⁷⁰ Instead, taxes for a particular
23 year are calculated using the property value, assessment ratio and tax rate for that year. For
24 example, property taxes never will be calculated using a 2005 tax rate and a 2007 assessment
25

26 ⁶⁷ Tr. at 632; Tr. at 843-44.

27 ⁶⁸ Tr. at 633.

⁶⁹ Tr. at 632.

⁷⁰ Tr. at 635.

1 ratio.⁷¹ Yet that is exactly what RUCO proposes in this case. Staff's proposal is identical. The
2 RUCO / Staff adjustment creates a mismatch and should be rejected.

3 **c. Legal Expense.**

4 The dispute over legal expenses concerns expenses for UNS Gas' participation in a FERC
5 rate case for El Paso Natural Gas Company ("El Paso"). No party denies that UNS Gas actually
6 incurred these expenses in the test year. Instead, Staff argues the test year expense level is not
7 normal and should therefore be reduced to eliminate "non-recurring" FERC-related costs. Staff
8 proposes disallowing \$311,051 in expenses on that basis.⁷²

9 Staff's adjustment suffers from numerous flaws. Most fundamentally, Staff ignores the
10 fact that UNS Gas must deal with two new rate cases. Transwestern Pipeline Company has
11 already filed a rate case, and El Paso will be filing a new rate case this year.⁷³ This shows that
12 FERC rate cases are not atypical, non-recurring items. Instead, they are a normal part of the cost
13 of doing business for a gas distribution utility. Staff did not estimate the costs of participating in
14 these new cases,⁷⁴ and Staff's adjustment clearly does not include an adequate provision for
15 participating in those new cases.

16 Staff's adjustment also ignores historical data concerning such expenses. Staff's proposal
17 is far below the level of legal expense for any recent year:⁷⁵

Staff Proposal	\$177,329
2004 Actual	\$373,174
2005 Actual	\$488,380
2006 Actual	\$425,540
2007 Projected	\$425,208

25 _____
26 ⁷¹ Id.

⁷² Ex. UNSG-13 at 17-18; UNSG-14 at 9.

⁷³ Ex. UNSG-13 at 17; Tr. at 293.

⁷⁴ Tr. at 843.

⁷⁵ Table derived from Ex. UNSG-13 at 17-18 and UNSG-14 at 9.

1 UNS Gas also projects that its legal expenses will be “in the \$400,000 range for the foreseeable
2 future.”⁷⁶ Staff’s proposal is inconsistent with the Company’s actual historic level of legal
3 expense, the Company’s projections of legal expense in future years, and the reality that the
4 Company faces two new FERC rate cases. Staff’s adjustment should therefore be rejected.

5 The record evidence clearly supports recovery of the actual test year legal expenses of
6 \$488,380. However, UNS Gas is willing to accept a lower, averaged figure of \$430,777.⁷⁷ This
7 level of legal expense clearly is recurring and should be included in rates. However, if there is any
8 doubt or concern about the recurring nature of these expenses, there is a simple solution. The
9 Commission could approve recovery of legal expenses related to FERC rate cases – which affect
10 the cost of gas that UNS Gas must pay – through the PGA. If there are lower expenses in the
11 future, which seems to be the concern of Staff and RUCO, then only the actual expenses will be
12 recovered. This proposal makes sense, since other gas transportation costs are included in the
13 PGA.

14 **d. Rate Case Expense.**

15 RUCO proposes to dramatically reduce rate case expense. RUCO’s proposal is based on
16 an analogy to the Southwest Gas Corporation (“Southwest Gas”) rate case.⁷⁸ This analogy is
17 severely flawed due to substantial accounting differences between UNS Gas and Southwest Gas’.
18 The result of these differences is that rate case expense simply cannot be compared between these
19 two companies.

20 The difference is that the costs of Southwest Gas’ internal personnel and support services
21 are built into its base rates, while UNS Gas must recover the equivalent costs through rate case
22 expense.⁷⁹ It is thus no surprise that UNS Gas’ rate case expense is higher, because UNS Gas’
23 expense includes many items that Southwest Gas recovers though other expenses.

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26 ⁷⁶ Ex. UNSG-14 at 9.

⁷⁷ Ex. UNSG-13 at 18.

⁷⁸ Ex. RUCO-3 at 25-26.

⁷⁹ Ex. UNSG-13 at 33-35.

1 More specifically, Southwest Gas has various in-house experts, lawyers and other support
2 or administrative personnel who participated in its rate case. Those in-house costs amount to
3 overhead that is recovered in base rates rather than through rate case expense. Because Southwest
4 Gas serves in three states, those overhead costs are allocated to each state using a "Massachusetts
5 formula."⁸⁰ In contrast, UNS Gas does not have in-house legal or rate departments.⁸¹ Instead,
6 UNS Gas uses the rate and legal departments of Tucson Electric Power Company ("TEP").

7 When non-executive TEP employees work on UNS Gas activities, they record those tasks
8 on their time sheets and those expenses are directly charged to UNS Gas.⁸² This ensures that TEP
9 customers do not subsidize UNS Gas operations.⁸³ RUCO's witness, Mr. Moore, agreed that it is
10 important to avoid such cross-subsidies.⁸⁴ No party filed testimony challenging UNS Gas' cost
11 allocation method.

12 Because RUCO failed to consider the different accounting methods used by UNS Gas and
13 Southwest Gas, its attempt to compare figures from these two companies is not appropriate. Once
14 the different accounting methods are considered, it is clear that UNS Gas customers benefit from
15 the Company's method. If UNS Gas used the Massachusetts formula method used by Southwest
16 Gas, its test year expenses would be \$2.5 million higher.⁸⁵ RUCO's adjustment would unfairly
17 penalize the Company for using an accounting method that saves UNS Gas customers money.

18 RUCO fails to note other important cost comparisons between UNS Gas and Southwest
19 Gas. Southwest Gas' system-allocated labor costs amounted to 6.38 percent of operating
20 expenses, while UNS Gas' were only 1.75 percent.⁸⁶ If UNS Gas had a comparable percentage, its
21 operating costs would increase by nearly \$1.8 million.⁸⁷ This is much more than the difference in
22 rate case expense between the two companies. Once the whole picture is considered, UNS Gas

23 _____
24 ⁸⁰ Ex. UNSG-13 at 33-35; Ex. UNSG-1 at 9-11.

25 ⁸¹ Id.; Tr. at 625.

26 ⁸² Ex. UNSG-13 at 33-35; Ex. UNSG-14 at 9-11; Tr. at 281, 887-88.

27 ⁸³ Id.

⁸⁴ Tr. at 624.

⁸⁵ Ex. UNSG-14 at 10.

⁸⁶ Ex. UNSG-25 at subpart d.

⁸⁷ See id. for underlying data (\$38,740,547 times 0.0638 is \$2.47 million, less actual expense of \$679,468 equals \$1.79 million).

1 compares favorably. RUCO's attempt to look at one expense category in isolation, when that
2 expense contains different elements due to different accounting methods, is deeply flawed and
3 should be rejected.

4 Moreover, even if the rate case expense of the two companies could be directly compared,
5 the two cases are different. For example, UNS Gas received more than twice as many data
6 requests as Southwest Gas.⁸⁸

7 Staff did not propose an adjustment to rate case expense in its direct testimony. In
8 Surrebuttal Testimony, however, it adopted RUCO's adjustment using the same arguments as
9 RUCO.⁸⁹ Staff's position should be rejected for the same reasons RUCO's should be rejected.
10 Indeed, Staff's witness, Mr. Ralph Smith, testified that he was not familiar with Southwest Gas'
11 accounting.⁹⁰ Thus, Staff did not add any additional support to RUCO's position.

12 However, while on the stand, Mr. Smith attempted to articulate a new justification for the
13 disallowance.⁹¹ Although the exact basis of Mr. Smith's on-the-fly justification is unclear, it
14 seems to have something to do with the relationship between TEP's rate case expense and UNS
15 Gas' rate case expense. Whatever Staff's new argument may be, it should not be considered
16 because it was not included in pre-filed testimony. Staff, like the other parties, was ordered to pre-
17 file its testimony. The Commission recently rejected a similar attempt by Staff to introduce a new
18 argument at hearing, explaining "the timing of Staff's changed recommendation is problematic
19 because it did not afford other parties an opportunity to explore fully the underlying basis of
20 Staff's proposal."⁹² The same is true here. Indeed, this example is even more problematic because
21 Staff did not reveal its new argument on direct examination. Instead, Staff waited until re-direct
22 and re-cross to introduce its new argument. As such, other parties were not afforded a fair
23 opportunity to explore this new argument. Staff may consider exploring its "concerns" more fully
24 in the rate case TEP is preparing to file.

25 _____
26 ⁸⁸ Tr. at 632; Ex. UNSG-13 at 13-14.

27 ⁸⁹ Ex. S-27 at 42-44.

⁹⁰ Tr. at 886-894.

⁹¹ Tr. at 895-898.

⁹² *Arizona-American Water Co. (Mohave)*, Decision No. 69440 (May 1, 2007) at 15.

1 In summary, RUCO's comparison suffers from an "apples to oranges" problem because
2 UNS Gas' rate case expense includes costs that Southwest Gas recovers in other ways. Moreover,
3 if UNS Gas' allocated labor costs were similar (on a percentage basis) to Southwest Gas, the
4 Company's operating expenses would be \$1.8 million higher.⁹³ In ignoring this, RUCO
5 considered only half the picture. Further, UNS Gas' direct allocation method actually saves UNS
6 Gas ratepayers \$2.5 million.⁹⁴ Once UNS Gas' accounting method is considered, its rate case
7 expense is reasonable and should be approved.

8 **e. Call Center Expenses.**

9 UNS Gas uses TEP's call center to respond to customer calls. Some of the call center costs
10 are allocated to UNS Gas. RUCO proposes that all of these costs be disallowed and replaced with
11 much lower hypothetical costs based on regional offices used in a previous year. RUCO's
12 proposal, which is not supported by Staff, is flawed in several respects. RUCO does not dispute
13 that call volume doubled.⁹⁵ RUCO did not adjust its hypothetical costs to reflect this doubling of
14 call volume.⁹⁶ Nor did RUCO calculate the cost of updating the old regional office system to be
15 able to deal with the much higher call volumes.⁹⁷ RUCO's proposal is based on speculation that
16 the doubling of call volume is due to fewer walk-in visits. But RUCO admits it has no evidence of
17 a correlation between call volume and the number of walk-in visits.⁹⁸ In addition, RUCO
18 acknowledges that new PGA surcharges during the test year may have been the source of many of
19 the calls.⁹⁹ Further, the new call center provides longer hours and other enhancements. For
20 example, it allows the Company to track wait times, which could not be done under the old,
21 decentralized system.¹⁰⁰ RUCO's speculation does not provide sufficient support for this
22 disallowance, and it should be rejected.

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24 ⁹³ Ex. UNSG-25 at subpart d.

25 ⁹⁴ Ex. UNSG-14 at 10.

26 ⁹⁵ Tr. at 638.

27 ⁹⁶ Tr. at 640.

⁹⁷ Tr. at 643.

⁹⁸ Tr. at 642.

⁹⁹ Tr. at 643.

¹⁰⁰ Tr. at 640-41.

1 select those alternatives.¹⁰⁹ Instead it selected the most expensive, impractical method. And when
2 the Company did not comply, RUCO recommended that each of those 1,995 expenses be
3 disallowed, even though RUCO never made a specific objection to any of them.

4 Mr. Moore did provide a specific explanation of his concerns about five expenses. Those
5 expenses total \$12,254. To limit the areas of disagreement, UNS Gas will accept a disallowance
6 in that amount. Indeed, UNS Gas agrees to a larger disallowance of \$27,968 to address any
7 concerns with these expenses.¹¹⁰ The remaining expenses should be allowed for the reasons
8 explained by Mr. Gary Smith, and because RUCO has not provided a specific explanation as to
9 why any of them should be disallowed.

10 **g. Performance Enhancement Program.**

11 The Company's Performance Enhancement Program ("PEP") is a core component of its
12 employees' compensation, and it promotes important goals such as cost containment and customer
13 service. Such plans are standard practice at nearly four out of every five companies and are
14 essential to attracting and retaining qualified employees¹¹¹. Accordingly, the PEP is part of the
15 cost of service, and there are no grounds for disallowing it.

16 Mr. Dukes testified that the PEP is "an integral part of the fair and reasonable
17 compensation necessary to attract and retain employees."¹¹² He explained that average cash
18 compensation was below that of comparable firms.¹¹³ Thus, if the PEP were eliminated, base
19 salaries would have to be increased in order for UNS Gas to attract and retain the necessary
20 employees.¹¹⁴ Further, he testified that similar programs are standard practice at most
21 companies.¹¹⁵

22 The PEP has several advantages over increased base compensation. The PEP's goals
23 include financial targets (30 percent), cost containment (30 percent) and customer service (40

24 _____
25 ¹⁰⁹ Tr. at 637-38.

26 ¹¹⁰ Ex. UNSG-17 at 3.

27 ¹¹¹ Id.

¹¹² Ex. UNSG-13 at 9.

¹¹³ Id.

¹¹⁴ Id.

¹¹⁵ Id.

1 percent).¹¹⁶ The PEP therefore provides enhanced motivation for better performance as compared
 2 to increased base compensation. In addition, lower base pay results in lower expenses for vacation
 3 pay, sick pay, long-term disability, 401(k) matching, pension expense and other post-retirement
 4 benefits.¹¹⁷

5 There is therefore no doubt that the PEP is a legitimate part of the Company's cost of
 6 service. Staff does not dispute this. Nevertheless, Staff still proposes that one-half the PEP be
 7 disallowed because the plan "can provide benefits to both shareholders and ratepayers."¹¹⁸ But
 8 nearly any expense can be claimed to benefit shareholders. Arizona law requires that all
 9 reasonable operating expenses be included in rates. *Tucson Electric Power, supra; Scates, supra.*
 10 The Commission must determine whether the expense is a reasonable operating expense rather
 11 than engaging in a vague "benefits" analysis. Staff says that the PEP expense "should be allocated
 12 equally to shareholders and ratepayers."¹¹⁹ Whatever words Staff wants to use, its
 13 recommendation amounts to a disallowance. Because legitimate operating expenses cannot be
 14 disallowed, Staff's disallowance must be rejected.

15 RUCO's position is even more extreme. RUCO suggests that the entire PEP program be
 16 disallowed. During the test year, PEP payments were not made directly under the PEP but under a
 17 related special recognition award authorized by the Board of Directors.¹²⁰ RUCO seizes on this to
 18 argue that no expenses should be allowed. But the special award is clearly equivalent to the PEP
 19 payments.¹²¹

20 UNS Gas proposes an average of the costs from 2004 and 2005. RUCO objects, touting its
 21 "strict implementation of the Historical Test Year principle."¹²² A strict test year approach would
 22 allow recovery of all of the test year special recognition award. UNS Gas would accept such an
 23

24 _____
 25 ¹¹⁶ Id. at 8.

¹¹⁷ Id. at 9.

¹¹⁸ Ex. S-27 at 29.

¹¹⁹ Id.

¹²⁰ Ex. RUCO-3 at 16-17.

¹²¹ Tr. at 228-32.

¹²² Ex. RUCO-3 at 16-17.

1 approach. RUCO's attempt to reject both the averaged PEP expense and the actual test year
2 expense is inconsistent, which is unreasonable.

3 **h. Officers' Long-Term Incentive Program.**

4 This program is an integral part of the officer's total compensation program.¹²³ The
5 arguments regarding this program are essentially identical to the PEP, and these costs should be
6 allowed for the same reasons.

7 **i. Supplemental Executive Retirement Plan.**

8 Staff and RUCO both recommend that UNS Gas' Supplemental Executive Retirement Plan
9 ("SERP") be completely disallowed. Staff and RUCO have not presented evidence that the SERP
10 is an atypical cost for a utility, or that UNS Gas' overall executive compensation costs are
11 unreasonable or out of line with industry practice. Both Staff and RUCO place great emphasis on
12 the recent Southwest Gas decision. That decision disallowed expenses for Southwest Gas' SERP
13 program.¹²⁴ However, neither Staff nor RUCO prepared a detailed comparison of the Southwest
14 Gas SERP program and the UNS Gas SERP program. Moreover, this new Southwest Gas
15 decision was issued after the test year. Prior to this new decision, the Commission had allowed
16 SERP costs. In the previous Southwest Gas case, for example, the Commission allowed recovery
17 of SERP costs.¹²⁵ This older decision was the only guidance available to UNS Gas during the test
18 year about what expenses were acceptable. Had UNS Gas been notified that SERP costs would
19 not be allowed, it could have restructured its executive compensation package to take that into
20 account. It would not be fair to hold UNS Gas to this new, unexpected standard.

21 Again, no party has presented evidence that overall executive compensation costs are
22 unreasonable. UNS Gas believes the Commission's earlier *Southwest Gas* ruling was correct in
23 that it declined to dictate the details of executive compensation methods. Instead, that decision
24 focused on whether the utility's "overall compensation package is excessive."¹²⁶

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26 ¹²³ Ex. UNSG-13 at 11.

27 ¹²⁴ *Southwest Gas Corp.*, Decision No. 68487 (Feb. 23, 2006) at 18-19.

¹²⁵ *Southwest Gas Corp.*, Decision No. 64172 (Oct. 30, 2001) at 14-15.

¹²⁶ *Id.*

1 Moreover, the SERP exists only to hold executives harmless from certain provisions of the
2 Internal Revenue Code. That Code is a determination of what should be taxed, not a determination
3 of the appropriate level of executive compensation. The Commission should not allow the Internal
4 Revenue Code to dictate what compensation costs should be recovered.

5 **j. Bad Debt Expense.**

6 Staff and UNS Gas are basically in agreement as to bad debt expense. RUCO's proposal to
7 disallow \$100,000 is based on a mismatch and should be rejected. RUCO used the Company's
8 historic uncollectible or write-off percentage and applied that to the adjusted test year revenues. In
9 theory, that approach is acceptable. However, RUCO excluded the Griffith Plant and NSP
10 revenues from test year revenue, but did not exclude those same items from the calculation of the
11 write-off percentage.¹²⁷ RUCO's adjustment therefore creates a mismatch between revenues and
12 the write-off percentage. Applying actual revenues to the actual write-off percentage would be
13 appropriate. Applying adjusted revenues (excluding Griffith and NSP) to an adjusted write-off
14 percentage (excluding Griffith and NSP) would also be appropriate. But mixing the two is
15 inconsistent and a mismatch.¹²⁸ RUCO's disallowance should therefore be rejected.

16 **k. Payroll Expense and Payroll Tax Expense.**

17 In Rebuttal Testimony, UNS Gas corrected an error to its original payroll expense
18 adjustment.¹²⁹ Staff and RUCO failed to pick up this correction. The corrected amount should be
19 approved. A corresponding adjustment also should be made to payroll tax expense.¹³⁰

20 **l. Fleet Fuel Expense.**

21 UNS Gas proposes an average fleet cost of fuel of \$2.48 per gallon.¹³¹ This reflects the
22 historical average fuel costs of UNS Gas.¹³² Staff proposes a lower adjustment based on state-
23 wide average costs.¹³³ This proposal should be rejected because it does not reflect UNS Gas'

24 _____
25 ¹²⁷ Ex. UNSG-13 at 24-25.

26 ¹²⁸ Id.

27 ¹²⁹ Id. at Ex. DJD-1, page 2.

¹³⁰ Id.

¹³¹ Ex. UNSG-13 at 19.

¹³² Id.

¹³³ Id.

1 actual costs.¹³⁴ It is not surprising that UNS Gas has slightly higher fuel costs because its service
2 area is far from major urban centers like Phoenix and Tucson and is larger in scope (e.g., square
3 miles covered within the service territory). RUCO's proposal to use an even lower cost of fuel
4 does not reflect UNS Gas' known, current costs. Indeed, UNS Gas' proposal of \$2.48 per gallon is
5 far below current gas costs of over \$3.00 per gallon.

6 **m. Out-of-Period Expenses.**

7 RUCO did locate some out-of-period invoices inadvertently included in test year expenses
8 and proposes disallowing these expenses. However, RUCO fails to recognize that test year
9 invoices of a nearly equivalent total amount were inadvertently excluded from test year
10 expenses.¹³⁵ These mistakes essentially cancel each other out, so that no adjustment is necessary.
11 If the out-of-test year invoices are excluded, the additional test year invoices should be added to
12 test year expenses.¹³⁶

13 **n. Postage Expenses.**

14 Staff's and RUCO's postage expense calculations should be rejected due to several errors.
15 Staff and RUCO understate test year postage expense because they fail to account for a prior
16 period adjustment of \$58,498.¹³⁷ In addition, Staff and RUCO fail to recognize that postage
17 expense is affected by a number of factors outside of simple customer numbers, such as the
18 number of required mailings and the weight of mailings.¹³⁸ The Company therefore proposed a
19 two-year average of \$529,380. The Company's proposal is less than its actual 2006 postage
20 expense of \$553,648¹³⁹, and the 2006 expense does not reflect the known and measurable change
21 in postage rates effective May 14, 2007.

22
23
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25 ¹³⁴ Id.

26 ¹³⁵ Id. at 14.

27 ¹³⁶ Id.

¹³⁷ Id. at 19-21, 28.

¹³⁸ Id.

¹³⁹ Id.

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o. Industry Association Dues.

UNS Gas accepts RUCO's adjustment to industry association dues. RUCO appropriately excludes portions relating to lobbying and marketing. RUCO's adjustment is consistent with the American Gas Association's ("AGA") 2007 budget for lobbying and marketing.¹⁴⁰ In contrast, Staff's adjustment is based on an antiquated 2001 report which used 1999 data.¹⁴¹ Moreover, Staff's adjustment fails to consider that some AGA activities are not funded by dues.¹⁴²

p. Training Expenses.

RUCO suggests disallowing MARC training expenses. While any particular training event may be non-recurring, training costs in total are recurring.¹⁴³ Moreover, the Company's productivity gains cannot entirely offset the need for new employees to help serve its rapidly growing customer base. As such, the Company expects training costs to continue to increase for the foreseeable future, including those required by a new regulatory requirement imposed after the test year.¹⁴⁴ If anything, test year training expenses understate future expense levels. As such, they certainly should not be decreased.

q. Miscellaneous Expenses.

A number of expenses are directly tied to rate base issues. Examples include depreciation expense, GIS amortization expense, property tax expense and CWIP-related expenses. These expenses should reflect the correct rate base level of the corresponding rate base accounts as discussed in the rate base portion of this brief. Likewise, other expenses (such as income taxes) are tied to other calculations and should reflect the positions taken herein.

r. Undisputed Expenses.

The Commission should approve the following uncontested expense adjustments, as shown on Exhibit Attachment 1: (1) Griffith Plant Operations; (2) Purchased Gas Cost and Gas Cost Revenue; (3) NSP Revenue and Gas Cost; (4) Post Retirement Medical; (5) Worker's

¹⁴⁰ Id at 18.

¹⁴¹ Ex. S-25 at Ex. RCS-2 (2001 NARUC Committee Report on AGA for period ending December 31, 1999).

¹⁴² Id. (expenses total 107 percent because some expenses "not funded by dues").

¹⁴³ Ex. UNSG-17 at 4.

¹⁴⁴ Id.

1 Compensation; (6) Interest on Customer Deposits; (7) Year End Accruals; (8) Advertising &
2 Donations; (9) CARES; (10) Gain on Sale of Prescott Property; (11) Corporate Cost Allocations;
3 (12) Depreciation annualization; (13) Emergency Bill Assistance; and (14) Cancellation of RUCO
4 Operation Income Adjustment No. 20.

5 **C. UNS Gas' Proposed Cost of Capital is Reasonable.**

6 The Company requests a weighted average cost of capital of 8.80 percent. This is based on
7 a 6.6 percent cost of debt, an 11.0 percent cost of common equity capital, and a capital structure
8 consisting of 50 percent long-term debt and 50 percent common equity. The rate of return on fair
9 value rate base is 7.43 percent. Both Staff and RUCO agree with UNS Gas' cost of debt but have
10 recommended a much lower cost of equity. RUCO, but not Staff, has agreed with the Company's
11 proposed capital structure. UNS Gas' proposed cost of capital is critical to attract necessary
12 capital to meet the growth it is facing in its service area and should be adopted by the Commission.

13 **1. Capital Structure.**

14 UNS Gas proposes a capital structure of 50 percent debt and 50 percent equity. This
15 capital structure is based on the projected capital structure for the time period in which the rates
16 will be in effect.¹⁴⁵ As the Commission stated "cost of capital is forward-looking in nature [so] the
17 most current capital structure available should be used when determining a company's cost of
18 capital, as it will more closely represent the company's true level of financial risk."¹⁴⁶ Here, UNS
19 Gas' projected capital structure is the most current information available, and it best reflects the
20 forward-looking nature of the cost of capital.

21 UNS Gas' projection is consistent with the clear trend in the Company's capital structure.
22 UNS Gas had just 33 percent equity upon its inception in 2003.¹⁴⁷ By the end of the test year,
23 UNS Gas had increased its equity ratio to 45 percent.¹⁴⁸ This is the result of an aggressive
24 program to increase UNS Gas' equity level. UNS Gas has retained all of its earnings; it has never
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26 ¹⁴⁵ Tr. at 964.

27 ¹⁴⁶ *Black Mountain Gas Co.*, Decision No. 64727 (April 17, 2002) at 12.

¹⁴⁷ Ex. UNSG-27 at 9.

¹⁴⁸ *Id.*

1 paid a cent in dividends.¹⁴⁹ In addition, its shareholder injected \$16 million of new equity into
2 UNS Gas. The Commission should recognize and encourage such strengthening of the Company

3 While the Company's equity ratio has improved, other key metrics have deteriorated. This
4 includes weak earnings and cash flow.¹⁵⁰ Increased equity helps offset these other weaknesses,
5 because lenders are more willing to lend to a well-capitalized firm.¹⁵¹

6 RUCO supports UNS Gas' proposed capital structure.¹⁵² RUCO's witness, Mr. William
7 Rigsby, testified that UNS Gas' proposed 50 / 50 capital structure is in line with the capital
8 structures of his sample group of companies.¹⁵³

9 Staff's capital structure should be rejected because it does not recognize the forward-
10 looking nature of cost of capital. Staff's capital structure would be out of date by the time rates go
11 into effect. Moreover, Staff's proposal does not recognize the results of the Company's concerted
12 efforts to improve its capital structure and would not offset the negative effects of weak earnings
13 and cash flow.

14 The Commission has used hypothetical or projected capital structures in many cases in the
15 past. For example, the Commission used a hypothetical capital structure in the recent Southwest
16 Gas rate case.¹⁵⁴ In the last month, the Commission approved another such structure, rejecting
17 arguments by Staff that are similar to its position in this case.¹⁵⁵ Hypothetical or projected capital
18 structures help remedy financial weakness. Further, such structures may be especially appropriate
19 when the utility is making "a concerted effort to improve its equity ratio in the future,"¹⁵⁶ as UNS
20 Gas is doing here. Lastly, a projected capital structure properly recognizes the forward-looking
21 nature of the cost of capital.

24 ¹⁴⁹ Id.

25 ¹⁵⁰ Ex. UNSG-27 at 10.

26 ¹⁵¹ Id.

27 ¹⁵² Tr. at 999.

¹⁵³ Id.

¹⁵⁴ *Southwest Gas Corp.*, Decision No. 68487 (Feb. 23, 2006).

¹⁵⁵ *Arizona-American Water Co. (Mohave)*, Decision No. 69440 (May 1, 2007) at 13-14.

¹⁵⁶ Id. at 14.

1 2. **Cost of Debt.**

2 UNS Gas' proposed cost of debt is 6.60 percent.¹⁵⁷ No party disputed the cost of debt at
3 the hearing. Accordingly, this cost should be approved by the Commission.

4 3. **Cost of Equity.**

5 There are three main disputes concerning cost of equity in this case. First, RUCO's
6 Discounted Cash Flow ("DCF") analysis is inconsistent with UNS Gas' and Staff's DCF studies,
7 and RUCO uses methods that have been rejected by the Commission in the past. Second, Staff's
8 and RUCO's use of geometric mean returns in their application of the Capital Asset Pricing Model
9 ("CAPM") is contrary to both academic and financial literature. Third, RUCO and Staff base their
10 cost of equity for UNS Gas on the cost of equity they calculate for their sample group. But they
11 disregard the fact that UNS Gas is substantially more risky than the sample group companies
12 because it is much smaller, faces extreme growth, has regulatory lag, and has never paid a
13 dividend. UNS Gas is very different from any of the sample companies, and it defies logic to say
14 that it has the same cost of equity as those companies.

15 a. **RUCO's Discounted Cash Flow Study is unsound.**

16 UNS Gas and Staff reach nearly identical results from their DCF studies.¹⁵⁸ RUCO's
17 results, however, are far different. RUCO places too much reliance on near-term analyst growth
18 forecasts. As the Commission has noted, "exclusive reliance on analyst forecasts" is erroneous.¹⁵⁹
19 RUCO supports its use of analyst growth forecasts by pointing to FERC's DCF method. RUCO's
20 witness, Mr. Rigsby, candidly admitted that he got this idea from another cost of capital witness,
21 Dr. Zepp.¹⁶⁰ Mr. Rigsby also admitted that the Commission rejected Dr. Zepp's FERC-based
22 approach in two recent cases.¹⁶¹ All Mr. Rigsby could say is that "the Commission has been
23 known to change its mind" in the past.¹⁶²

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25 ¹⁵⁷ Ex. UNSG-27 at 24.

¹⁵⁸ Tr. at 1015.

¹⁵⁹ *Arizona Water Company (Eastern Group)*, Decision No. 66849 (March 19, 2004) at 22.

¹⁶⁰ Tr. at 1001.

¹⁶¹ Tr. at 1002-1003; see also Ex. UNSG-33 (*Chaparral City Water Co.*, Decision No. 68176) at 23- 26; *Arizona Water Co. (Western Group)*, Decision No. 68302 (Nov. 14, 2005) at 37.

¹⁶² Tr. at 1008.

1 Moreover, Mr. Rigsby only uses a single-stage DCF model. Because of this, Mr. Rigsby's
2 approach assumes that wide differences between company growth rates will continue forever.¹⁶³ It
3 is more realistic to expect such growth rates to converge towards the industry average.¹⁶⁴ In
4 addition, when adjusted for inflation, Mr. Rigsby assumes perpetual growth rates much lower than
5 projected or historic long-term growth rates in the U.S. economy.¹⁶⁵ Indeed, long-term growth in
6 the U.S. economy has been remarkably consistent.¹⁶⁶ By contrast, UNS Gas used a multi-stage
7 DCF model while Staff used both a multi-stage model and a single-stage model. In recent years,
8 Staff has used both single-stage and multi-stage DCF models.¹⁶⁷ The Commission has approved
9 such Staff recommendations in numerous recent orders.¹⁶⁸

10 RUCO's DCF model relies too heavily on analyst forecasts, an approach rejected by the
11 Commission in the past. Those analyst forecasts project widely varying growth rates for different
12 companies. RUCO assumes that those divergent growth rates will continue forever. It is much
13 more logical to assume that growth rates for those companies eventually will converge toward
14 historical growth rates for the gas industry or the economy as a whole. RUCO also failed to use
15 the multi-stage DCF model that the Commission has approved on many occasions. For these
16 reasons, RUCO's DCF model should be rejected.

17 **b. Use of geometric means in the Capital Asset Pricing Model is without**
18 **merit.**

19 Staff and RUCO both use geometric means returns in calculating the market risk premium
20 in their CAPM models. The use of geometric means is contrary to well-established financial
21 theory, sound financial practice, and basic mathematics. Staff's witness, Mr. David Parcell, did
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23 ¹⁶³ Ex. UNSG-28 at 4.

24 ¹⁶⁴ Id.

24 ¹⁶⁵ Id.

25 ¹⁶⁶ Tr. at 993.

25 ¹⁶⁷ Tr. at 1009.

26 ¹⁶⁸ See e.g., *Arizona-American Water Co. (Mohave)*, Decision No. 69440 (May 1, 2007) at 18-19; *Arizona-American*
Water Co. (Paradise Valley), Decision No. 68858 (July 28, 2006) at 25-29; *Arizona Water Co. (Western Group)*,
27 Decision No. 68302 (Nov. 14, 2005) at 35-40; *Chaparral City Water Co.*, Decision No. 68176 (Sept. 30, 2005) at
21-26; *Arizona-American Water Co.*, Decision No. 67093 (June 30, 2004) at 25-31; *Arizona Water Co. (Eastern*
Group), Decision No. 66849 (March 19, 2004) at 22.

1 not dispute that the overwhelming academic consensus supports the use of arithmetic means for
2 this purpose. Instead, Mr. Parcell implies that the overwhelming academic consensus is
3 unrealistic, contending that “the cost of capital determination is not an academic exercise made in
4 some laboratory or university classroom.”¹⁶⁹ However, the CAPM model was developed by
5 academics, and it makes no sense to disregard academic views of how it should be used.

6 Real world financial professionals also reject the use of geometric means. Mr. Parcell
7 testified that he uses the Ibbotson Yearbook, as do the other witnesses in this case, and that “a lot
8 of copies are sold” of that publication.¹⁷⁰ Yet this widely-used resource specifically rejects the use
9 of geometric means, expressly stating that “[f]or use as the expected equity risk premium in... the
10 CAPM... the arithmetic mean... is the relevant number.”¹⁷¹

11 The use of geometric means also runs counter to basic mathematics. An arithmetic mean is
12 best suited for forming expectations of future returns.¹⁷² In contrast, the geometric mean is best
13 suited for stating historical returns.¹⁷³ This basic concept is shown by Mr. Kentton Grant’s
14 mathematical example.¹⁷⁴ The Commission has recognized that cost of capital is a forward
15 looking endeavor. It makes no sense to use a backward looking statistic when estimating
16 expectations of future returns.

17 Mr. Parcell did not attempt to defend the use of geometric means by referring to academic
18 articles, the practices of real world financial professionals, or basic principles of mathematics.¹⁷⁵
19 Instead, Mr. Parcell points out that both types of means are available, and therefore “presumably”
20 both types are used.¹⁷⁶ Mr. Parcell admits there is no empirical data to support his speculation on
21 this point.¹⁷⁷ The Commission should not rely on such unsupported conjecture. Mr. Parcell’s
22 speculation amounts to saying “if it’s out there, people will use it.” This leads to absurd results.

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24 ¹⁶⁹ Ex. S-37 at 4.

¹⁷⁰ Tr. at 1020-21.

¹⁷¹ Ex. UNSG-28 at 18-19.

¹⁷² Ex. UNSG-29 at 17-19.

¹⁷³ Id.

¹⁷⁴ Id.

¹⁷⁵ Ex. S-36 at 30; Ex. S-37 at 3-4.

¹⁷⁶ Id.; Tr. at 1023-24.

¹⁷⁷ Tr. at 1024.

1 For example, Mr. Parcell contended that investors may look to the result of a Suns basketball game
2 to make their investment decisions.¹⁷⁸

3 Mr. Parcell agreed that the CAPM model assumes the existence of a rational and informed
4 investor.¹⁷⁹ It defies common sense to say that a rational and informed investor will base
5 investment decisions on sporting events. Instead, an informed investor would understand basic
6 mathematics, would know that both academics and financial professionals reject the use of
7 geometric means in the CAPM model and would surely use that knowledge to select the arithmetic
8 mean.

9 The use of the arithmetic mean is supported by academics and financial professionals, as
10 well as by basic mathematics. Staff's speculation that rational investors will disregard these facts
11 and knowingly use the inappropriate geometric mean is without support and should be rejected.
12 Accordingly, the Commission should support the use of the arithmetic mean return in applying the
13 CAPM model.

14 **c. Staff's and RUCO's Cost of Equity estimates are unreasonably**
15 **low.**

16 As shown above, Staff's and RUCO's return on equity ("ROE") estimates are not
17 appropriate because they are based on clear technical errors. Even if that were not so, Staff's and
18 RUCO's results fail a basic test of reasonableness. The ROEs proposed by Staff (10 percent) and
19 RUCO (9.64 percent) fall far below those authorized by other state commissions. For example,
20 Staff Exhibit 34 shows that Staff's ROE is 45 basis points below the ROEs approved in 2006.
21 Staff's ROE is even further below the ROEs from previous years.

22 Therefore, if UNS Gas were an average gas utility company, the ROEs proposed by Staff
23 and RUCO would be far too low. But UNS Gas is not an average gas utility - it faces higher risks
24 in several areas. It is much smaller than the utilities in the sample group in this case.¹⁸⁰ It is
25 growing far faster than those companies - faster even than other utilities in Arizona, the fastest

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27 ¹⁷⁸ Tr. at 1021-22.

¹⁷⁹ Tr. at 1021.

¹⁸⁰ Tr. at 1020.

1 growing state in the nation.¹⁸¹ UNS Gas is not just adding new customers, its investment per
 2 customer is also growing at a high rate.¹⁸² In addition, as noted previously, UNS Gas has never
 3 paid a cent in dividends.¹⁸³ Finally, while most companies in the sample group have de-coupling
 4 mechanisms, UNS Gas does not.¹⁸⁴

5 UNS Gas is therefore more risky than the sample group. As Mr. Parcell testified, a sample
 6 group should have “similar risk and therefore a similar expected cost of capital to the subject
 7 company.”¹⁸⁵ Because UNS Gas is more risky than the companies in the sample group, it has a
 8 higher cost of equity. UNS Gas recognized this by selecting an ROE at the upper end of the range
 9 of results of the sample companies. In contrast, Staff and RUCO used the average results for the
 10 sample group companies, thereby failing to reflect UNS Gas’ higher risk.

11 Although Staff and RUCO prefer to treat UNS Gas as an average gas utility, they did little
 12 to rebut the Company’s showing that it is more risky, with the exception of Mr. Parcell’s
 13 suggestion that “growth is a positive factor for the Company.”¹⁸⁶ This vague statement fails to
 14 consider the actual challenges imposed by growth on UNS Gas. In particular, the explosive
 15 growth in UNS Gas’ service territory “requires substantial capital investment, currently at a level
 16 far exceeding the Company’s internal cash flow.”¹⁸⁷ This extra capital investment “creates
 17 additional fixed costs that UNS Gas must bear, including interest expenses, depreciation expense
 18 and property taxes.”¹⁸⁸ Thus, the Company’s earnings and cash flow are negatively impacted by
 19 growth.¹⁸⁹ Staff and RUCO have not rebutted these specific points.

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¹⁸¹ Ex. UNSG-29 at Ex. KCG-15; Tr. at 920, 1004-5, 1020.
¹⁸² Id.
¹⁸³ Tr. at 939.
¹⁸⁴ Tr. at 932; Ex. UNSG-37.
¹⁸⁵ Tr. at 1019; Ex. UNSG-34.
¹⁸⁶ Tr. at 1020.
¹⁸⁷ Ex. UNSG-28 at 9-10.
¹⁸⁸ Id.
¹⁸⁹ Id.

1 **D. UNS Gas' Depreciation Rates Should be Approved.**

2 The Company submitted a depreciation study as part of its rate case application. Neither
3 Staff nor RUCO opposed any element of that study. UNS Gas requests that the Commission
4 approve the depreciation rates set forth in that study.

5 **E. The Commission Should Consider the Impact of the *Chaparral City* Ruling.**

6 UNS Gas has raised the *Chaparral City* decision to preserve the issue in this docket while
7 it is being resolved on remand from the court. However, the Commission's position in response to
8 *Chaparral City* in this case is as flawed as the position rejected by the court.

9 **1. The Commission should abandon the discredited "backing-in" method.**

10 **a. Staff used the unlawful backing-in method.**

11 The witnesses for UNS Gas and Staff agree on at least one thing: that the Commission
12 should comply with the Court of Appeals ruling involving the Chaparral City Water Company.¹⁹⁰
13 As Staff's witness, Mr. Parcell, explained, the *Chaparral City* decision requires the Commission
14 to "consider the fair value of a utility's assets in setting rates."¹⁹¹

15 Unfortunately, Staff never explains how its approach differs from the now-discredited
16 approach used in *Chaparral City*. That is not surprising, because there is no material difference
17 between Staff's approach here and the Commission's approach in *Chaparral City*. Staff's
18 approach is to "re-cast" its cost of capital as a "fair value cost of capital."¹⁹² In other words, Staff
19 "lowered the overall ROR applied to fair value rate base in order to achieve the same level of
20 operating income calculated using Mr. Parcell's cost of capital and Staff's original cost rate
21 base."¹⁹³

22 In *Chaparral City*, the Commission adopted Staff's approach of determining rates by
23 multiplying the original cost rate base by the cost of capital.¹⁹⁴ Only then did Staff calculate the
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26 ¹⁹⁰ Ex. UNSG-28 at 28; UNSG-29 at 12-13; Ex. S-37 at 7-9.

27 ¹⁹¹ Ex. S-37 at 7.

¹⁹² Ex. S-37 at 9.

¹⁹³ Ex. UNSG-28 at 28.

¹⁹⁴ Ex. UNSG-33 (Decision No. 68179) at 26-28.

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1 “fair value rate of return.”¹⁹⁵ This approach is often called the “backing-in” method because the
2 revenue requirement is determined using the cost of capital and the original cost rate base; the fair
3 value numbers are simply a meaningless exercise determined after the fact.

4 Staff has clearly used this same discredited “backing-in” method here. The uncontraverted
5 evidence is that Staff’s approach in this case “is mathematically equivalent to the approach
6 previously used by Staff and expressly rejected by the Court of Appeals in the *Chaparral City*
7 case.”¹⁹⁶ The Commission should reject this unlawful, discredited method.

8 **b. Staff’s approach ignores fair value.**

9 Staff witness Mr. Parcell candidly admitted that under his approach, fair value has no
10 impact on rates. Under his approach, otherwise identical companies will have the same rates, even
11 if their fair value rate base differs.¹⁹⁷ Mr. Parcell testified that, all other factors remaining equal,
12 the following three hypothetical companies have the same return dollar requirement:¹⁹⁸

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Company	Original Cost Rate Base	Fair Value Rate Base	Return Dollar Requirement
1	\$10 million	\$ 10 million	Same for all three
2	\$10 million	\$ 20 million	Same for all three
3	\$10 million	\$100 million	Same for all three

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19 Under Staff’s approach, fair value simply has no impact on rates.

20 **c. The Commission must use fair value.**

21 The Arizona Constitution contains a clear command: “The Corporation Commission
22 shall... ascertain the fair value of the property within the State of every public service corporation
23 doing business therein”¹⁹⁹ Fair value is not optional. As the Arizona Supreme Court recently
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25 _____
26 ¹⁹⁵ Id.

¹⁹⁶ Ex. UNSG-29 at 13.

¹⁹⁷ Tr. at 1027.

¹⁹⁸ Tr. at 1024-1027.

¹⁹⁹ Arizona Constitution, Article 15, § 14.

1 held, the fair value section “is an imperative... [t]he constitutional provision in question does
2 not... say or imply anything about the existence of discretion in the commission.” *U.S. West
3 Communications, Inc. v. Arizona Corp. Comm’n*, 201 Ariz. 242, 246, 34 P.3d 351, 355 (2001).

4 Not only is the Commission required to find fair value, but it must also use that fair value
5 finding in ratemaking. *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d
6 378, 382 (1956); *Scates v. Arizona Corp. Comm’n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15
7 (App. 1979). Therefore, the Court of Appeals ruled that the Constitution requires “utilization of
8 the fair-value finding” in setting rates. *Phelps Dodge Corp. v. Arizona Electric Power Co-op*, 207
9 Ariz. 95, ¶ 38, 83 P.3d 573, 586 (App. 2004).

10 As shown above, under Staff’s approach, fair value has no impact on rates. Although Staff
11 calculates a “fair value rate of return,” this calculation can be completed only after the revenue
12 requirement is determined through the “backing-in” method. This after-the-fact calculation is
13 simply a meaningless exercise. The constitutional requirement to use fair value cannot be satisfied
14 when fair value is used merely as window dressing. Staff’s approach therefore must be rejected.

15 RUCO suggests that that the Commission ignore the *Chaparral City* decision for two
16 reasons: (i) the issue is “premature” because the Commission obtained an extension of time to
17 seek review in the Arizona Supreme Court; and (ii) the decision is an unpublished opinion.²⁰⁰ The
18 additional time granted by the Court has now expired, and the Commission did not file a petition
19 for review.²⁰¹ Thus, RUCO’s first argument is no longer relevant. It is true that the *Chaparral*
20 *City* decision is unpublished, and while this means that the decision should not be cited, the
21 principle behind the decision remains valid. That principle is that the Commission must use fair
22 value in setting rates. Staff’s and UNS Gas’ witnesses testified in support of this principle.
23 Moreover, the holdings of many published cases adopt this principle, as shown above. Contrary to
24 RUCO’s suggestion, this issue cannot be ignored.

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27 ²⁰⁰ Ex. RUCO-6 at 4-5.

²⁰¹ The Commission may take official notice of the Court of Appeals docket sheets, which are available on-line. See
A.A.C. R14-3-109.T.5.

1 Staff attempts to defend its approach by arguing that the Commission should allow
2 investors “a return on the capital they provided the utility” – or, in other words, a “return on their
3 invested capital.”²⁰² Staff then argues that any difference between the original cost and the fair
4 value should be disregarded or assigned a zero cost “because there are no investor-supplied funds
5 supporting the difference between fair value rate base and original cost rate base.”²⁰³ Staff’s focus
6 on the value of invested capital is called the “prudent investment theory.” *See Simms*, 80 Ariz. at
7 151, 294 P.2d at 382. Whatever the merits of this theory, under the Arizona Constitution, the
8 Commission is forbidden to use it. *Id.*; *Consolidated Water Utilities, Ltd. v. Arizona Corp.*
9 *Comm’n*, 178 Ariz. 478, 141, 875 P.2d 137, 482 (App. 1994); *City of Tucson v. Citizens Utilities*
10 *Water Co.*, 17 Ariz. App. 477, 482, 498 P.2d 551, 556 (1972). The ban on the use of the prudent
11 investment theory has been made very clear by the Arizona Supreme Court: “[the] Commission
12 cannot be guided by the prudent investment theory.... The amount invested is immaterial.”
13 *Arizona Corp. Comm’n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959). As
14 the court explained, “under the law of fair value a utility is not entitled to a fair return on its
15 investment; it is entitled to a fair return on the fair value of its properties devoted to the public use,
16 no more and no less.” *Id.*

17 **2. UNS Gas’ approach is the only lawful approach supported by the**
18 **record.**

19 All parties, including UNS Gas, have struggled with how to address the renewed emphasis
20 on fair value. Because this issue arose after the application was filed, UNS Gas has agreed that the
21 rate increase in this case should be no greater than the increase proposed in its application. UNS
22 Gas addressed the fair value issue by proposing to use the weighted average cost of capital as the
23 rate of return for fair value rate base.²⁰⁴ This is not the only possible approach. It is, however, is
24 the only approach presented in this case that complies with the Arizona Constitution.

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27 ²⁰² Ex. S-37 at 8-9.

²⁰³ Tr. at 1016.

²⁰⁴ Ex. UNSG-28 at 28; Ex. UNSG-29 at 12-13.

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1 Staff and RUCO continue to use the discredited "backing-in" approach. That approach
2 does not use fair value, and it therefore does not comply with the Arizona Constitution. Moreover,
3 the rationale offered by Staff, the prudent investment theory, has been specifically and repeatedly
4 rejected by the courts.

5 It is possible that other constitutionally permissible methods may be developed in future
6 cases. For now though, UNS Gas' approach is the only available choice in this case.

7 **II. UNS GAS' PROPOSED RATE DESIGN IS REASONABLE.**

8 The Company's rate design proposes to move a portion of costs currently collected
9 through the volumetric charge to a fixed charge. Under UNS Gas' current rates, high-usage
10 customers are paying a far greater share of the Company's fixed costs through volumetric charges
11 on their monthly bills.

12 UNS Gas proposes increasing the monthly customer charge from \$7 to \$20 during the
13 months of April through November, and to \$11 from December through March, resulting in an
14 average monthly charge of \$17. The Company further proposes dropping the commodity, or
15 volumetric, rate from \$0.3004 to \$0.1862 per therm. Under this proposal, a residential customer
16 using 100 therms in the winter would see a net decrease in his/her bill from \$37.04 to \$29.62. A
17 residential customer using 20 therms in the winter would see an increase from \$13.01 to \$14.72.
18 In the summer, a residential customer using 100 therms would experience an increase from \$37.04
19 to \$38.62, while a customer using 20 therms would see an increase from \$13.01 to \$23.72.²⁰⁵
20 Under UNS Gas' rate design, the average customer will experience approximately a 7 percent
21 increase in rates over the course of a year.

22 UNS Gas' proposed rate design is intended to mitigate significant cross-subsidization of
23 warm weather customers by cold weather customers and to better match non-volumetric revenues
24 to fixed costs. Presently, UNS Gas incurs \$26 per month in fixed costs to serve a customer. The
25 monthly customer charge, though, is just \$7. The remaining fixed costs are covered by a
26 volumetric per-therm charge. As a result, a residential customer in Flagstaff pays almost twice as
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²⁰⁵ See Ex. UNSG-9 (Schedule H-4, Page 1 of 6).

1 much for the Company's fixed costs as a residential customer in Lake Havasu City.²⁰⁶ UNS Gas'
2 proposed rate design is more equitable and represents better policy in the new environment of
3 higher gas commodity costs.

4 UNS Gas' proposed rate design recognizes that most of the Company's distribution
5 expenses are fixed costs.²⁰⁷ The Company incurs these fixed costs regardless of how much gas
6 customers consume. Mr. Erdwurm testified that UNS Gas' current rate design only collects
7 approximately 25 percent of fixed distribution costs through the monthly customer charge.²⁰⁸ This
8 is inadequate from a financial perspective and inequitable in light of the cross-subsidies that result.
9 Mr. Grant's testimony regarding the June 2006 Moody's Investors Service Report further
10 highlights this problem with the traditional gas utility rate design. Specifically, that report notes
11 that "As the fixed charges appear year in and year out regardless of gas usage, the volumetric
12 approach to cost recovery for operating a gas distribution system is a faulty equation which needs
13 to be rectified in ratemaking."²⁰⁹ Further, the American Gas Association report "Natural Gas Rate
14 Round-Up" notes that gas utilities are "in a fixed-cost business," and that a gas utility's profits and
15 earnings will decline if customers use less gas under a traditional volumetric rate design.²¹⁰ These
16 reports support the adoption of higher fixed cost recovery through fixed charges and decoupling
17 mechanisms. It is time to address this inequity by raising the percentage of fixed costs recovered
18 through the monthly customer charge, which will also reduce the subsidy cold climate customers
19 provide to warm climate customers. This is what the Company proposes and what the evidence
20 supports in this case.

21 The rate designs proposed by Staff and RUCO fail to address the cross-subsidy or
22 matching problems to any material degree. Both Staff and RUCO assert "gradualism" and "rate
23 shock" in response to proposed changes to the monthly customer charge without addressing the
24 more moderate, gradual scale of the overall increase. Neither Staff nor RUCO offer any

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26 ²⁰⁶ Ex. UNSG-18 at 8 and Ex. TLV-1 thereto.

²⁰⁷ Ex. UNSG-19 at 9.

²⁰⁸ Tr. at 445.

27 ²⁰⁹ Ex. UNSG-29 at 23:14-16 and Ex. KCG-18 thereto (Moody's Investor Service Special Comment, June 2006 at 4).

²¹⁰ Ex. UNSG-37 at 2.

1 justification for the substantial level of cross-subsidization that will result from their rate designs.
2 They also cannot justify their failure to match non-volumetric revenues to fixed charges. Finally,
3 their complaint that a higher customer charge reduces customers' incentive to conserve fails to
4 recognize the impact of the remaining per-therm gas commodity charge, which will remain high
5 enough (60 to 70 cents per therm) to make conservation worthwhile. After all, the gas
6 commodity charge is the largest and most visible component of the total volumetric rate,
7 representing 60-70 cents per therm, which is two-thirds of total volumetric rate of approximately
8 90 cents per therm (30 cents volumetric margin and 60 cents commodity).

9 **A. UNS Gas' Proposed Monthly Customer Charge Will Better Match Non-**
10 **Volumetric Revenue to Fixed Costs.**

11 UNS Gas' current monthly residential customer charge is \$7. The actual cost of providing
12 service to residential customers, excluding the cost of natural gas itself, is approximately \$26.²¹¹
13 Both Staff and RUCO agree that the current monthly charge covers just over one fourth of the
14 Company's fixed costs.²¹²

15 The Company proposes increasing the monthly customer charge from \$7 to an average of
16 \$17 per month, an amount that would cover approximately 60 percent of the fixed costs of serving
17 an individual residential customer.²¹³ At the same time, UNS Gas would reduce its volumetric
18 margin charge from approximately 30 cents per therm to 18 cents per therm to pare back the
19 usage-based recovery of fixed costs.²¹⁴ As set forth in Schedule H-4, these changes would result
20 in an overall rate increase of approximately 7 percent (and less than that in certain circumstances).
21 Further, the Company's rate design hardly guarantees revenue recovery. A significant portion of
22 the fixed cost recovery would remain subject to volumetric charges,²¹⁵ and these costs will
23 continue to increase.²¹⁶

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25 ²¹¹ See UNSG-18 at 9; Ex. UNSG-19 at 12.

26 ²¹² See Ex. S-27 at Ex. RCS-S1R; Ex. RUCO-5 at 28; Tr. at 700, 822.

27 ²¹³ Tr. at 512.

²¹⁴ See Ex. UNSG-9 (Schedule H-3).

²¹⁵ Ex. UNSG-19 at 12.

²¹⁶ Ex. UNSG-19 at 14.

1 In an effort to mitigate the impact of winter gas bills, UNS Gas proposed two seasonal tiers
2 for the monthly customer charge: \$11 in the winter and \$20 in the summer. This structure would
3 provide a measure of bill levelization for all customers, making it easier to budget for monthly gas
4 bills.²¹⁷ Given that Staff does not support this proposal because there is no cost basis for seasonal
5 customer charges,²¹⁸ the Company would accept a year-round monthly customer charge at \$17.

6 Staff and RUCO agree that an increased monthly customer charge is appropriate, but they
7 disagree about the amount. Staff proposes an increase to \$8.50 per month, while RUCO would
8 limit the increase to \$8.13 per month. Unfortunately, even Staff's proposal of \$8.50 per month
9 would recover just 30 percent of the Company's fixed costs through the customer charge, an
10 increase of only 3 to 5 percent over the current level.²¹⁹ As a result, these proposals run directly
11 contrary to the concepts of cost-based rates and revenue stability and should be rejected.

12 Moreover, the testimony of Staff's own witnesses suggests a charge much higher than
13 \$8.50 per month is appropriate. First, Staff's witness, Mr. Smith, agreed the Company should
14 move toward cost-based rates.²²⁰ He also indicated that, in his opinion, recovering 50 percent of
15 the Company's fixed costs through the monthly customer charge could be reasonable.²²¹ That
16 would amount to a monthly customer charge of \$13.00. Mr. Ruback asserted that only direct
17 customer costs, such as billing and meter reading, should be the basis for the monthly customer
18 charge.²²² Even if one were to accept Mr. Ruback's theory, the monthly customer charge should
19 be at least \$11.88.²²³ Mr. Ruback also acknowledged, though, that gas distribution costs are
20 indeed fixed costs that currently are recovered mainly through volumetric charges.²²⁴

21 Neither Staff nor RUCO support a customer charge that realistically attempts to match
22 costs to the cost causation or revenues to expenses. Given that \$26 is the actual average monthly
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24 ²¹⁷ Ex. UNSG-18 at 10; Tr. at 452.

25 ²¹⁸ Tr. at 792.

26 ²¹⁹ Tr. at 822.

27 ²²⁰ Tr. at 824.

²²¹ Id.

²²² Tr. at 792; see also Ex. S-24 at Exhibit SWR-2.

²²³ Id.

²²⁴ Ex. S-24 at 4-5.

1 fixed cost per residential customer, UNS Gas' proposal to recover an average of \$17 through the
2 monthly customer charge is reasonable. The average increase of \$10 from the current charge is not
3 drastic, will not result in rate shock and does not violate "gradualism," particularly given the
4 proposed reduction in the volumetric charge and the overall rate increase of 7 percent. In sum, the
5 Company's proposed rates have a sound cost basis and would better match revenue to costs per
6 class than the Company's current rates, which recover approximately three quarters of its fixed
7 costs through volumetric rates.²²⁵

8 **B. The Company's Proposed Rate Design Will Reduce Existing Cross-Subsidies.**

9 It is undisputed that cold weather customers subsidize those living in warmer climates,
10 often to a substantial degree.²²⁶ Currently, the average Flagstaff customer pays \$133 more in
11 annual margin than customers in Lake Havasu City for the same fixed costs.²²⁷ Moreover, the
12 cross-subsidy is difficult for cold weather customers to avoid (through reduced usage) because
13 they rely on natural gas to heat their homes and for other inelastic needs. The changes proposed by
14 UNS Gas would ease this disparity. Under the Company's recommended rates, an average
15 residential customer in Flagstaff would pay an annual margin of \$333, while the average Lake
16 Havasu customer would pay \$250.²²⁸ Although the Flagstaff customer still would pay \$83 more
17 for the same fixed costs, the annual cross-subsidy would be reduced by \$50 – a significant change.
18 The Company's proposal better matches revenues to the actual costs of providing service.²²⁹ By
19 gradually moving customers toward footing their actual costs, the proposal comports with the view
20 of RUCO and Staff that reducing cross-subsidies and promoting cost-based rates was
21 appropriate.²³⁰ In fact, some customers living in cold climates could experience a rate decrease
22 under the Company's proposed rates as a result of the reduced cross-subsidy.²³¹

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25 ²²⁵ Ex. UNSG-20 at 7:.

²²⁶ Ex. UNSG-18 at 8 and Ex. TLV-1 thereto; see Tr. at 704.

²²⁷ Ex. UNSG-19 at 10.

²²⁸ Ex. UNSG-18 at Ex. TLV-1.

²²⁹ Ex. UNSG-18 at 9.

²³⁰ See Tr. at 704, 824.

²³¹ See Ex. UNSG-9 (Schedule H-4).

1 The rate designs proposed by Staff and RUCO move so slowly toward their stated goals
2 that one might question if they are actually standing still. If consumers in Flagstaff, Prescott and
3 other cold weather communities were aware of the degree to which they were subsidizing gas
4 service for their peers in warmer climates, they would no doubt demand more exigent action.
5 Neither Staff nor RUCO dispute that their proposals would continue to allow a substantial portion
6 of fixed costs to be recovered through volumetric rates, and therefore be borne by those who use
7 more gas.²³²

8 **C. The Company's Proposed Rate Design Does Not Violate "Gradualism" or**
9 **Result in Rate Shock.**

10 Although Staff and RUCO acknowledge that UNS Gas' current rates are not cost-based
11 and result in substantial cross-subsidies among residential customers, both parties reject the
12 Company's progressive rate design on the grounds of rate shock and gradualism. However, their
13 opposition focuses solely on the monthly customer charge without taking into account the overall
14 rate design and the cost of the gas itself. In fact, as set forth in Schedule H-4, the rate increase
15 experienced by the average residential customer will be approximately 7 percent (or less in some
16 circumstances). There will not be rate shock with such a modest increase. Moreover, the
17 preference for gradualism is, in fact, satisfied in this case. UNS Gas is not proposing to raise its
18 monthly charge high enough to cover 100 percent of its fixed costs. Rather, its proposed monthly
19 charge will increase the portion of fixed costs covered by the monthly charge from 26 percent to
20 60 percent. Given the relatively high cost of the gas commodity itself compared to the Company's
21 fixed costs, UNS Gas can move toward cost-based rates more aggressively without sacrificing
22 gradualism.

23 Moreover, gradualism and rate shock must be balanced against other important rate design
24 concepts, including revenue stability and matching principles. In this case, given the overall rate
25 impact of UNS Gas' rate design, concerns about rate shock and gradualism have been managed
26 appropriately.

27 _____
²³² Ex. UNSG-19 at 10-11.

1 **D. UNS Gas' Rate Design Proposal Does Not Eliminate the Incentive to Conserve.**

2 Staff's and RUCO's contention that the Company's proposed rate design reduces the
3 incentive to conserve ignores the significance of the remaining volumetric charges – including the
4 cost of natural gas itself. While the Company has proposed reducing the volumetric margin charge
5 from \$0.3004 per therm to \$0.1862 per therm,²³³ the cost of gas passed through the PGA recently
6 has ranged between 60 and 70 cents per therm.²³⁴ Therefore, under the Company's proposal, the
7 overall volumetric charge (assuming a 60 cent per therm PGA charge) will drop from 90 cents per
8 therm to 78 cents, or approximately 13 percent. Such a decrease is not enough to stifle a
9 conservation incentive, particularly given that customers have seen substantial increases in gas
10 commodity costs over the past few years. A 12-cent per therm decrease in volumetric margin
11 (from 90 cents to 78 cents) is dwarfed by recent increases in gas commodity costs.

12 Although natural gas prices are difficult to predict, they are not expected to decrease
13 significantly in the foreseeable future. As such, the pass-through costs contained in the PGA will
14 continue to give customers ample incentive to conserve regardless of the Company's volumetric
15 margin rate. Neither Staff nor RUCO present any evidence to support their contention that a 12-
16 cent decrease in the volumetric margin rate will reduce conservation. Common sense suggests that
17 significant per-therm gas costs – not to mention the remaining 18 cent-per-therm margin rate – will
18 provide customers with ample incentives for conservation.

19 **III. THROUGHPUT ADJUSTMENT MECHANISM.**

20 In its application, UNS Gas has proposed a Throughput Adjustment Mechanism ("TAM").
21 The TAM would either reduce or increase the collection of volumetric margin revenues to match
22 anticipated levels. This mechanism also would allow UNS Gas to implement the proposed
23 comprehensive energy conservation program without threatening the volumetric margin revenues
24 needed to serve its customers' growing needs and earn a fair rate of return. Under the TAM, the
25 under-recovery in any period would be "trued-up" in future periods through use of a volumetric
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²³³ See Ex. UNSG-9 (Schedule H-3).

²³⁴ Ex. UNSG-19 at 11.

1 surcharge. Similarly, any over-recovery would be refunded to customers through a volumetric
2 credit on future bills. As an alternative to an annual true-up of the margin rate, establishing a
3 deferred throughput adjustment account is acceptable to UNS Gas.

4 The TAM is a type of decoupling mechanism that has gained growing support throughout
5 the industrial and environmental communities. As Mr. Erdwurm noted in his pre-filed Rebuttal
6 Testimony, in July 2004, the Natural Resources Defense Council ("NRDC"), the American
7 Council for an Energy-Efficient Economy ("ACE³") and the AGA issued a statement to the
8 National Association of Regulatory Utility Commissioners ("NARUC") supporting "mechanisms
9 that use modest automatic rate true-ups to ensure that a utility's opportunity to recover authorized
10 fixed costs is not held hostage to fluctuations in gas retail sales."²³⁵ Further, NARUC adopted a
11 resolution encouraging state commissions to approve rate designs such as the decoupling
12 mechanism UNS Gas has proposed here.²³⁶ At least 10 states have adopted some form of a
13 decoupling mechanism, while several others are considering such a move.²³⁷ Like these measures,
14 the TAM is designed to separate natural gas consumption from UNS Gas' revenue recovery ability
15 and, ultimately, its financial stability and viability.

16 **A. The TAM is an Effective Means to Break the Link Between Natural Gas Use**
17 **and Revenue Recovery that is Fair to Both the Company and the Customer.**

18 Due to the volumetric nature of UNS Gas' current rates, the Company's return is highly
19 dependent on customer usage. A cold winter can lead to a surge in usage-based revenues, while
20 lower than expected usage can impede the Company's opportunity to earn its authorized rate of
21 return.²³⁸ Since the costs of operating a gas distribution service are largely independent of
22 customer usage, this linkage makes little sense. Indeed, why should the Commission, Staff,
23 RUCO, the Company and other parties to this rate case devote months to establishing the precise
24 levels of recoverable cost, only to leave the actual recovery of those costs subject to the whims of
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26 ²³⁵ Ex. UNSG-19 at 17-18 and Ex. DBE-3 thereto.

27 ²³⁶ Ex. UNSG-19 at 18 and Ex. DBE-4 thereto.

²³⁷ Ex. UNSG-37.

²³⁸ Ex. UNSG-18 at 15; Tr. at 480.

1 consumer preference and Mother Nature? If the best answer to that question is that “we’ve
 2 always done it that way,” it may be time for another approach.

3 The TAM was designed to cut the yoke that tethers revenues to usage, a change that
 4 serves the interests of both the Company and its customers. If the Company under-recovers its
 5 margin due to less gas consumption, then a volumetric surcharge would “true-up” recovery in
 6 future periods. But if the Company over-recovers its margin due to increased gas consumption
 7 during a cold winter, those excess revenues can be refunded through a volumetric credit to
 8 customers.²³⁹ Exhibit TLV-2 details the Company’s proposal.²⁴⁰

9 By minimizing the impact of weather on customer bills, the TAM provides for more
 10 equitable rate design by ensuring that customers do not pay more or less for “fixed costs” than they
 11 would under normal weather conditions.²⁴¹ The TAM also encourages conservation by reducing
 12 the conflict between conservation efforts and the Company’s financial stake in the volumetric
 13 revenues associated with natural gas usage.²⁴² In so doing, it aligns the goals of conservation with
 14 the Company’s interest in achieving its authorized rate of return.²⁴³

15 **B. None Of The Criticisms Levied Against Approving The TAM Are Supported**
 16 **By The Evidence.**

17 RUCO asserts that the TAM would eliminate the incentive to conserve.²⁴⁴ This position
 18 reflects a fundamental misunderstanding of the TAM, which is based on system-wide usage
 19 levels, not individual consumption. All customers would receive bills with identical TAM
 20 adjustments based on cumulative system usage, not their own household consumption. So a
 21 customer would continue to benefit from conserving energy in his own home since his individual
 22 actions would represent a tiny fraction of the usage data reflected in future TAM adjustments.
 23 Moreover, any TAM-related adjustments to customer bills would be dwarfed by the natural gas
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25 ²³⁹ Ex. UNSG-18 at 12.

26 ²⁴⁰ Ex. UNSG-18 at Ex. TLV-2.

27 ²⁴¹ Ex. UNSG-19 at 15.

²⁴² Ex. UNSG-18 at 15.

²⁴³ Tr. at 481, 927.

²⁴⁴ Ex. RUCO-5 at 31.

1 costs an individual customer could avoid through conservation. So even though system-wide
2 reductions in usage could lead to higher TAM surcharges, individual customers will retain a
3 strong incentive to conserve gas.

4 The second criticism, leveled by both Staff and RUCO, is that the TAM will remove the
5 risk of revenue recovery. In fact, the TAM is designed to recover only those test year distribution
6 costs established in the rate case. It cannot recover increases in distribution costs that occur after
7 the test year, leaving the Company exposed to rising expenses.²⁴⁵ Staff's witness, Mr. Ruback,
8 admits that net income will fall if costs are not controlled even with the TAM in place.²⁴⁶ In
9 addition, the TAM does not address increased capital expenditures associated with the levels of
10 customer growth that UNS Gas will likely continue to experience.²⁴⁷ Because the Company has
11 incentive to maximize its net income, it has a strong incentive to control its costs.²⁴⁸ That
12 incentive remains with the TAM.

13 The proposed TAM differs significantly from the "conservation margin tracker" proposed
14 by Southwest Gas in its last rate case. UNS Gas has proposed associating the TAM with a
15 deferred throughput adjustment account.²⁴⁹ This could prevent the Company from imposing a
16 surcharge at the same time a colder than normal winter is anticipated. Also, small volume
17 customers are subject to the TAM under UNS Gas' proposal; only residential customers were
18 subject to the decoupling charge Southwest Gas originally proposed.²⁵⁰ In Decision No. 68487
19 (February 23, 2006), the Commission indicated its willingness to further consider a decoupling
20 mechanism; thus UNS Gas proposed a decoupling mechanism that is more flexible and more
21 inclusive than the one Southwest Gas offered.

22 Finally, Staff's witness Mr. Ruback asserted that the TAM does not satisfy the three tests
23 that determine what he considers to be an automatic adjustment clause.²⁵¹ Mr. Ruback concedes,

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25 ²⁴⁵ Ex. UNSG-19 at 14-15.

²⁴⁶ Tr. at 794.

²⁴⁷ Ex. UNSG-19 at 15.

²⁴⁸ Ex. UNSG-20 at 6.

²⁴⁹ Ex. UNSG-18 at 14.

²⁵⁰ Ex. UNSG-18 at 14.

²⁵¹ Tr. at 789.

1 though, that he has never supported any decoupling mechanism, as none have apparently met his
2 standard.²⁵²

3 If the Commission truly wants to align conservation goals with the Company's interest in
4 recovering its revenue requirement, it should provide UNS Gas with a better opportunity to do so.
5 The Company proposes the TAM as a reasonable way to achieve this alignment. While
6 innovative, it has support from NRDC, NARUC, and ACE³ and has been approved, in some form,
7 in at least ten other states. No other party has suggested any other means to align Company and
8 conservation interests. Moreover, UNS Gas has pledged to continue supporting DSM regardless
9 of the disposition of its TAM proposal. No party can accuse the Company of using the TAM as
10 leverage for its continued support of DSM. For all of these reasons, and based on evidence in the
11 record, the Commission should approve the TAM as being in the public interest and advancing the
12 goals of conservation without unduly jeopardizing the Company's financial stability.

13 **IV. DEMAND-SIDE MANAGEMENT.**

14 In this docket, the Company proposes an aggressive Demand-Side Management ("DSM")
15 portfolio with several new programs, including the Residential Furnace Retrofit Program, the
16 Residential New Construction Home Program, the Commercial HVAC Retrofit Program and the
17 Commercial Gas Cooking Efficiency Program.²⁵³ The total funding for these four new programs
18 is \$916,616.²⁵⁴ UNS Gas also proposes to expand its Low-Income Weatherization ("LIW")
19 program and reclassify that program as DSM. The total cost for the expanded LIW program is
20 \$135,000.²⁵⁵ UNS Gas is proposing \$1,051,616 annually for its DSM portfolio. Further, the
21 Company believes these programs will provide a net benefit to society.²⁵⁶

22 UNS Gas is largely in agreement with Staff's recommendations. For instance, UNS Gas
23 agrees to file (and indeed filed on May 4, 2007) specific program proposals with significant detail
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25 _____
26 ²⁵² Tr. at 796.

27 ²⁵³ Ex. UNSG-15 at 13-15; Tr. at 519.

²⁵⁴ Ex. UNSG-15 at 14-15.

²⁵⁵ Ex. UNSG-15 at 14.

²⁵⁶ Tr. at 519-20.

1 for Staff's review and the Commission's approval.²⁵⁷ As Ms. Denise A. Smith testified, the
2 Company prefers to have the new programs and the expanded LIW program approved in this
3 docket so those programs can be implemented as soon as possible.²⁵⁸ The Company's preference
4 also comports with Commissioner Mayes' request at the pre-hearing conference.²⁵⁹ UNS Gas also
5 understands that Staff believes it needs more time to examine the program proposals. In light of
6 that, the Company is attempting to be responsive to both Staff's position and the Commissioner's
7 request. In fact, UNS Gas has filed its program proposals both in this docket and as an application
8 in a separate docket, Docket No. G-04204A-07-0274 (May 4, 2007).

9 UNS Gas also has agreed to use Staff's Societal Cost Test, despite its original uncertainty
10 about how Staff defined the test and how to calculate it.²⁶⁰ The Company has recognized that Staff
11 and the Commission have used a Societal Cost Test as its key measure to determine the cost-
12 effectiveness of DSM programs.²⁶¹ Ms. Smith also has highlighted the usefulness and the
13 importance of using all DSM tests to fully and completely analyze each DSM program.²⁶²
14 Specifically, the Participant Test, the Total Resource Cost Test, and the Rate Impact Measure Test
15 can provide valuable and different information directly relevant in determining the effectiveness of
16 a particular DSM program.²⁶³ In short, UNS Gas believes a more complete evaluation results from
17 using all available tests, including the Company's understanding of the Societal Cost Test.

18 Further, although the Company believes that a full year offers a more meaningful reporting
19 period, the Company will provide reports to the Commission every six months, with an option to
20 change that requirement to an annual basis once the programs are established and are meeting
21 goals in a cost-effective manner.²⁶⁴

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24 ²⁵⁷ See Ex. UNSG-21 at 8-9; UNSG-23.

²⁵⁸ Tr. at 518.

²⁵⁹ See April 13, 2007 Pre-Hearing Conference Transcript at 25:3-14.

²⁶⁰ Ex. UNSG-21 at 4, 7; Ex. UNSG- 22 at 2; Tr. at 556.

²⁶¹ Tr. at 556.

²⁶² Ex. UNSG-22 at 2-3.

²⁶³ Ex. UNSG-21 at 7 and Ex. DAS-2 thereto.

²⁶⁴ Ex. UNSG-21 at 10; Ex. UNSG-22 at 4.

1 Finally, the Company will agree to initially including just 25 percent of the new DSM
2 program costs (\$230,000) plus the expanded LIW program costs (\$113,400) and the cost of the
3 baseline study needed to thoroughly evaluate the effectiveness of DSM programs (\$82,000)
4 included in the DSM adjustor (for a total of \$425,400).²⁶⁵ This would produce a DSM adjustor
5 charge of \$0.0031 per therm upon approval of this case.²⁶⁶ Past Commission decisions offer
6 persuasive authority to justify approving the total amount, \$1,051,616, for its DSM programs in
7 this case. This higher amount is proportionally similar (based on a comparison of company size
8 vs. program cost) to what the Commission approved for Arizona Public Service Company (\$16
9 million) and Southwest Gas (\$4.385 million).²⁶⁷ Even so, the Company is willing to move
10 forward expeditiously with a DSM adjustor charge initially set at only \$0.0031 per therm.²⁶⁸

11 **V. CARES DISCOUNT/LOW-INCOME CUSTOMER ISSUES.**

12 **A. A Year-Round \$6.50 Per Month Discount to the Customer Assistance**
13 **Residential Energy Support Program with the Company's Proposed Rate**
14 **Design is in the Best Interest for Low-Income Customers.**

15 The Company has proposed a year-round discount of \$6.50 per month for qualifying low-
16 income customers, guaranteeing savings of \$78 per year.²⁶⁹ Under the volumetric discounts
17 offered through the current CARES program, customers can save up to \$15 per month during the
18 winter months, November through April, if they use up to 100 therms per month. Although this
19 allows a maximum annual discount of \$90, the average CARES participant realizes savings of
20 just \$58.²⁷⁰ In other words, customers under the current system only receive the maximum
21 CARES discount if their consumption is high – thus driving up their bills. The revised program
22 would eliminate this paradox.

23 Staff contends that the Company's proposal eliminates low-income customers' incentive to
24 conserve. Like other customers, though, CARES participants would still face significant

25 ²⁶⁵ Ex. UNSG-21 at 9; Ex. UNSG-22 at 3.

26 ²⁶⁶ Ex. UNSG-22 at 3.

27 ²⁶⁷ See Decision No. 67744 at 20; Decision No. 68487 at 61-63, 66.

²⁶⁸ Tr. at 554.

²⁶⁹ Ex. UNSG-15 at 10.

²⁷⁰ Ex. UNSG-18 at 10.

1 volumetric charges, including gas costs that currently amount to 60 to 70 cents per therm. These
2 costs would provide plenty of incentive to conserve independent of how the CARES discount is
3 structured.²⁷¹

4 Staff's other objections to the proposed CARES program echo its arguments against the
5 Company's proposed rate design in general – as do UNS Gas' responses. Eliminating the cross-
6 subsidies between customers in cold and warm climates would help low-income customers in cold
7 climates who depend on gas for necessities like heat and hot water. Meanwhile, UNS Gas'
8 proposal for seasonal monthly customer charges would reduce pressure on winter bills while
9 making it easier for low-income customers to budget for their energy expenses.

10 Finally, most low-income customers will face only modest increases under the Company's
11 proposed rate design. For instance, in the winter, a low-income customer on CARES using 100
12 therms per month would face an increase of \$1.12 per month, from \$22.00 to \$23.12. In the
13 summer, that same CARES customer using 20 therms would face an increase from \$13.01 to
14 \$17.22.²⁷² By scaling back the proposed higher customer charge for low-income customers, the
15 Company has attempted to minimize the impact of its new rates on CARES customers. Indeed,
16 some CARES customers with higher than average gas usage may actually experience a rate
17 decrease due to the Company's proposed reduction in per-therm charges.²⁷³ For these reasons,
18 UNS Gas believes the proposed monthly discount of \$6.50 for CARES participants serves the best
19 interests of its qualified low-income customers.

20 **B. UNS Gas Reiterates its Commitment to Work with the Arizona Community**
21 **Action Association on Low-Income Customer Issues.**

22 UNS Gas is aware that several other issues pertaining to low-income customers were
23 raised by other parties, including the Arizona Community Action Association ("ACAA"). To
24 address these issues, UNS Gas makes several commitments to improve its service to low-income
25 customers:

26 _____
27 ²⁷¹ Ex. UNSG-19 at 20.

²⁷² Ex. UNSG-9 (Schedule H-4 at 2).

²⁷³ Id.

- 1 • The Company is committed to automatically enrolling customers eligible for the Low-
2 Income Home Energy Assistance Program (“LIHEAP”) into the CARES program.²⁷⁴
3 The Company has made significant strides to enroll low-income customers, as Staff has
4 recognized, and will continue to expand its outreach efforts. These efforts include
5 distributing CARES applications to local assistance agencies, public libraries and local
6 municipal buildings and promoting the program through bill inserts included in
7 residential customer bills every quarter.²⁷⁵
- 8 • UNS Gas will conduct further inquiries about predatory practices at payday loan
9 businesses upon receiving specific information from the ACAA. UNS Gas is not
10 encouraging any customer to obtain loans from these operations and ACAA presents no
11 evidence to the contrary. UNS Gas covers any fees related to the payment of gas bills
12 at locations where it does not have an office. Further, the Company will continue its
13 efforts to provide low-income customers with numerous options for paying their bills.
- 14 • The Company is willing to explore further opportunities to increase the marketing of
15 its low-income programs to low-income customers.
- 16 • The Company has agreed to increase the LIW funds to the agencies.
- 17 • The Company will maintain its commitment to tap shareholder funds to match
18 customer contributions to the Warm Spirit program, which usually range from \$20,000
19 to \$25,000 per year.²⁷⁶
- 20 • Finally, UNS Gas agrees that the \$21,600 it originally proposed for emergency bill
21 assistance through the LIW program be moved to the Warm Spirit program and
22 recovered in base rates.²⁷⁷

23 These steps are clear evidence of the Company’s commitment to ease the burden on low-
24 income customers as much as possible.

26 ²⁷⁴ Ex. UNSG-16 at 8.
27 ²⁷⁵ Ex. UNSG-17 at 4.
 ²⁷⁶ Ex. UNSG-15 at 11.
 ²⁷⁷ Ex. UNSG-16 at 3.

1 VI. RULES AND REGULATIONS.

2 A. UNS Gas Proposes Changes to Increase Contributions from Developers and
3 Customers Seeking Service and Main Line Extensions.

4 UNS Gas has proposed a number of changes to its Rules and Regulations (“Proposed
5 Rules”) to reflect increased costs and current market conditions, and to ensure that developers and
6 new customers pay a fair cost for the infrastructure connecting new developments and new
7 customers to the UNS Gas system.²⁷⁸ The Company proposes changes to both its service line and
8 main line extension policies, as detailed in Exhibit GAS-2 to Mr. Gary Smith’s Direct Testimony.
9 The Company also presented other possible changes in these policies that could be adopted if the
10 Commission would prefer to have more of these facilities subsidized by new customers and
11 developers. The Company believes all of these changes allow for consideration of the specific cost
12 and impact of extensions and therefore represent an improvement over the hook-up fee concept.²⁷⁹

13 The Company’s proposals can be summarized as follows:

- 14 • For a new gas service line, the customer will reimburse the Company at a rate of \$16
15 per foot on the customer’s property. For customers who provide the trench for the
16 service line, the rate will be \$12 per foot. Currently, the rate is \$8 per foot.²⁸⁰
- 17 • There will be no free footage for developers under the UNS Gas proposals; developers
18 will have to contribute the entire amount up front.²⁸¹
- 19 • The incremental contribution study, or “ICS”, component will be modified to reduce
20 the credit to new customers and developers per service line or main extension.²⁸² This
21 ensures that the cost burden is initially put on the customer or developer for main or
22 service line extensions.²⁸³ The developer could be reimbursed over a five-year period
23 for line extensions.²⁸⁴ The purpose of the ICS, however, is to consider the specific cost

24
25 ²⁷⁸ Ex. UNSG-15 at 19-20.

²⁷⁹ Tr. at 919; Tr. at 1049.

²⁸⁰ Ex. UNSG-15 at 19.

²⁸¹ Tr. at 386.

²⁸² Ex. UNSG-35.

²⁸³ Tr. at 387.

²⁸⁴ Tr. at 384.

1 and benefit to the system for adding that customer.²⁸⁵ The Company's ICS was an
2 effort to have an economic feasibility system in accordance with A.A.C. R14-2-307.

- 3 • For line extensions over \$500,000, UNS Gas would add a gross-up amount equal to the
4 Company's estimated federal, state and local income tax liability in advance.²⁸⁶

5 It is estimated that these changes would bring in an additional \$3.6 to \$3.8 million per year,
6 on average.²⁸⁷ Later in the evidentiary hearing, UNS Gas presented two additional potential
7 modifications:

- 8 • Eliminating the ICS and retaining the language that customers pay for the entire length
9 of the service line on their property.²⁸⁸ This measure will provide an estimated \$1.2
10 million of additional contributions per year.²⁸⁹
11 • Requiring that customers/developers pay for the excess flow valves, mandatory for new
12 service lines starting in July of 2008. Those valves cost \$250 apiece.²⁹⁰

13 The Company does not recommend adopting both additional measures because they would
14 increase the contribution from \$310 to almost \$1,000. UNS Gas also would prefer its original
15 proposal.²⁹¹ The Company is mindful of potential competition from propane carriers and electric
16 providers and wants developers to be comfortable with the ICS modifications proposed in this
17 case.²⁹² Further, Staff witness Mr. Smith appeared to believe that a feasibility study could be
18 helpful in ensuring that the Company gets adequate margins to economically justify new lines.²⁹³
19 The ICS helps UNS Gas specifically tailor a new customer's or developer's up front payment and
20 is in accordance with Commission regulations. Further, because not all developments are fully
21 built-out after five years, any funds not refunded by that time become a contribution.²⁹⁴ All of the
22

23 ²⁸⁵ Tr. at 919.

24 ²⁸⁶ See Ex. UNSG-15 at Ex. GAS-2 (Subsection 7.D.16.)

25 ²⁸⁷ See Ex. UNSG-30; Tr. at 915.

26 ²⁸⁸ Ex. UNSG-31.

27 ²⁸⁹ Tr. at 916.

²⁹⁰ Ex. UNSG-32; Tr. at 1067.

²⁹¹ Tr. at 1069.

²⁹² Tr. at 1070-72.

²⁹³ Tr. at 869 - 871.

²⁹⁴ Tr. at 1055.

1 Company's proposals strive to hold developers and new customers responsible for a fair share of
2 the costs of additional facilities needed to serve growth.

3 **B. The Company's Proposed Billing Terms are Reasonable and in Accordance**
4 **with Commission Regulations.**

5 The Company proposes to modify its billing terms to conform its payment terms with the
6 Arizona Administrative Code.²⁹⁵ RUCO argues that this is unreasonable. RUCO is, in effect,
7 arguing that the Commission's own rules on this issue are unreasonable. Obviously, that is not the
8 case.

9 Under the Company's Proposed Rules, a customer would have 10 days to pay a bill before
10 it is considered late. The customer would have an additional 15 days before a late fee is assessed.
11 The Company would then wait an additional five days before beginning suspension of service
12 procedures.²⁹⁶ This timetable provides ample opportunity for customers who might be away from
13 their home when a bill arrives to make payment before their service is interrupted. Moreover, the
14 Company has the option of delaying suspension procedures in exigent or unusual circumstances.²⁹⁷
15 Nevertheless, the Company would agree to a six-month waiver so that customers can get used to
16 the change in the billing terms, if approved.²⁹⁸

17 **VII. THE PURCHASED GAS ADJUSTOR SHOULD BE MODIFIED.**

18 In its application for review and revision of the PGA, UNS Gas identified four substantial
19 problems with the current structure of the PGA: (1) a large and rapidly increasing bank balance,
20 which places financial strain on UNS Gas; (2) funding for other needed projects can be constrained
21 because of resources devoted to funding the bank balance; (3) the PGA band is too narrow,
22 resulting in charges that do not reflect the true cost of gas; and (4) UNS Gas suffers a loss on each
23 positive dollar in the bank balance because it pays higher interest to fund the balance than it is
24 allowed to recover from customers. UNS Gas requested that the PGA be modified as follows:

25
26 ²⁹⁵ See A.A.C. R14-2-310.C.

27 ²⁹⁶ Ex. UNSG-16 at 4; see Ex. UNSG-15 at Ex. GAS-2 (Subsection 10.C).

²⁹⁷ See Ex. UNSG-15 at Ex. GAS-2 (Subsection 11.C).

²⁹⁸ Ex. UNSG-17 at 2.

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

17 The Parties agree about the majority of issues regarding the PGA. For instance, all agree
18 that the entire cost for natural gas should be reflected in the PGA, and that the base cost of gas
19 should be zero. That way, customers will have an easier time recognizing what costs are
20 attributable to natural gas itself and how that expense affects their bill. All agree that some
21 widening of the bandwidth is appropriate. UNS Gas also agrees with Staff's recommendations to
22 eliminate the under-collection threshold for filing for a PGA Surcharge, and to set the over-
23 collection threshold at \$10 million.²⁹⁹ The two issues in dispute are (i) the appropriate levels for
24 the bandwidth; and (ii) the PGA bank interest rate.

25
26
27

²⁹⁹ Ex. UNSG-5 at 4.

1 The Company still believes that using a 12-month rolling average for gas costs provides a
2 significant smoothing of gas costs for customers.³⁰⁰ The bandwidth only increases the lag between
3 actual gas expenses and the costs customers pay for natural gas in a certain month.³⁰¹ In this way,
4 accurate price signals are diluted and, as one Commissioner is fond of noting, the proverbial can is
5 kicked further down the road. While UNS Gas supports having some smoothing mechanism in
6 place to restrict the month-to-month movement of natural gas costs, employing two such
7 mechanisms ultimately does more harm than good. With the 12-month rolling average in use, the
8 PGA bandwidth restrictions should be lifted entirely. The bandwidth creates an extra and
9 unnecessary disconnect from actual gas prices, causing large deferrals for the Company and
10 significant carrying costs to be passed along to customers.³⁰²

11 Understanding that neither Staff nor RUCO agree with the Company, UNS Gas proposed a
12 compromise by accepting RUCO's recommendation to expand the bandwidth to 20 cents per
13 therm from the current limitation at 10 cents per therm.³⁰³ Staff is recommending expanding the
14 bandwidth to 15 cents per therm. UNS Gas acknowledges Staff's recommendation is an
15 improvement and would help reduce the lag but maintains that a 20 cent-per-therm bandwidth is
16 still preferable for the reasons described above. Unfortunately, the natural gas market, like the
17 markets for gasoline, crude oil and other fossil fuels, will remain volatile for the foreseeable
18 future. While UNS Gas understands the need to smooth out natural gas prices for its customers,
19 that need must be balanced against the need to send more accurate price signals and avoid large
20 deferrals caused by volatile gas prices.³⁰⁴ UNS Gas simply believes that while one smoothing
21 mechanism (the 12-month rolling average) is appropriate, adding a second mechanism (the
22 bandwidth) goes too far. If there is going to be a bandwidth, however, it should be set no narrower
23 than 20 cents per therm.

24
25
26 ³⁰⁰ Ex. UNSG-5 at 2-3; Tr. at 173.

³⁰¹ Ex. UNSG-5 at 3.

³⁰² Tr. at 159, 174.

³⁰³ Ex. UNSG-5 at 4; Tr. at 159.

³⁰⁴ Tr. at 176-78.

1 The volatile energy market also has impacted UNS Gas' actual cost of borrowing to cover
2 larger-than-expected PGA bank balances in the past few years. In response, UNS Gas proposed
3 two PGA bank interest rates: first, LIBOR plus 1 percent; and second, the weighted average cost of
4 capital, to be used only when the bank balance exceeds \$6.24 million. While the PGA bank
5 interest rate may not have been created with the intent that it reflect the actual costs of borrowing,
6 it also was expected that the PGA bank balance would be close to zero. UNS Gas simply believes
7 the realities of the current landscape justify an interest rate that more accurately reflects the costs
8 UNS Gas actually incurs in carrying today's significant PGA bank balances.

9 **VIII. THE COMMISSION SHOULD CONFIRM THAT UNS GAS' PROCUREMENT**
10 **PRACTICES HAVE BEEN PRUDENT AND APPROVE UNS GAS' PRICE**
11 **STABILIZATION POLICY.**

12 There are two procurement issues in this docket. The first involves Staff's conclusions
13 regarding UNS Gas' procurement practices and the second involves UNS Gas' request for
14 approval of the Company's Price Stabilization Policy (i.e., its gas procurement and hedging
15 policy).

16 First, UNS Gas is pleased that Staff finds its procurement practices to have been reasonable
17 and prudent. UNS Gas requests that the Commission confirm that UNS Gas' past gas
18 procurement was prudent.

19 Second, UNS Gas believes that approving the Price Stabilization Policy is appropriate,
20 because it would provide some up-front assurance about its planned course of action regarding
21 future purchase. It would be far more productive to get all stakeholders involved on the front end,
22 versus after-the-fact.³⁰⁵ Because purchases are made as much as three years out, it is beneficial to
23 have some record in case personnel for the various parties have changed.³⁰⁶ It is for these reasons
24 that having some approval of the Price Stabilization Policy is warranted. Even so, the Company is
25 committed to continuing to look for ways to purchase gas most economically, including exploring
26

27 ³⁰⁵ Tr. at 137, 157.

³⁰⁶ Tr. at 139.

1 other providers of scheduling and system optimization services, and updating Staff with
2 information relating to negotiations or reconciliations.³⁰⁷

3 **IX. REQUEST FOR ACCOUNTING ORDER.**

4 UNS Gas has requested that its legal expenses for its participation in FERC rate cases that
5 will affect the cost of gas purchased by UNS Gas be included as an expense related to its test year
6 operating income. If the Commission decides to disallow those legal expenses as an operating
7 expense, the Company requests an accounting order that would allow all legal expenses related to
8 FERC gas rate cases to be included in the cost of gas covered by the PGA.

9 **X. CONCLUSION.**

10 UNS Gas respectfully requests that the Commission issue a final order:

- 11 (1) granting the Company the permanent rate increase sought herein;
- 12 (2) approving the new or modified rate and service schedules with an effective date
13 no later than October 1, 2007;
- 14 (3) authorizing UNS Gas' depreciation rates and classifications;
- 15 (4) approving the Throughput Adjustment Mechanism;
- 16 (5) approving the requested modifications to UNS Gas' low-income support
17 programs;
- 18 (6) approving UNS Gas' revised Rules and Regulations, including the Company's
19 revised line extension tariff;
- 20 (7) approving UNS Gas' Price Stabilization Policy;
- 21 (8) finding that UNS Gas' gas procurement was prudent;
- 22 (9) approving UNS Gas' proposed DSM adjustor mechanism and proposed resulting
23 charge;
- 24 (10) approving the requested revisions to UNS Gas' Purchased Gas Adjustor;
- 25
- 26
- 27

³⁰⁷ Tr. at 151-51, 155-56.

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- 1 (11) allowing certain UNS Gas' FERC rate case legal expenses be recovered through
2 the PGA (assuming those legal expenses are disallowed as part of operating
3 expenses); and
4 (12) granting the Company such additional relief as the Commission deems just and
5 proper.

6 RESPECTFULLY SUBMITTED this 5th day of June 2007.

7 UNS Gas, Inc.

8
9
10 By 

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26 Docket Control
27 Arizona Corporation Commission
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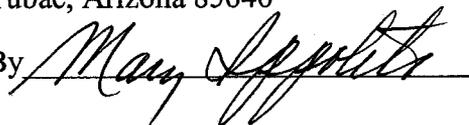
Copy of the foregoing hand-delivered
this 5th day of June, 2007, to:

Chairman Mike Gleason
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ATTACHMENT

"1"

UNSG GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005

	As Filed 7/13/06 UNSG \$149,791,159	Surrebuttal 4/4/07 ACC Staff \$149,791,159	Surrebuttal 4/4/07 RUCO \$149,791,159	Refinder 4/11/07 UNSG \$149,791,159	UNSG Witness Kissinger
Rate Base Adjustments					
Acquisition Adjustment (RUCO Rate Base Adjustment No. 3)	35,277,589	35,277,589	35,028,702	35,277,589	Kissinger
Southern Union Acquisition Premium	(17,053,753)	(17,053,753)	(17,053,753)	(17,053,753)	Kissinger
Griffith Power Plant	(5,254,086)	(5,254,086)	(5,254,086)	(5,254,086)	Kissinger
CWIP (Staff Adjustment B-1, RUCO Rate Base Adjustment No. 4)	7,189,231	-	-	7,189,231	Grant
Build-Out-Plant	(8,700,572)	(8,700,572)	(8,700,572)	(8,700,572)	Kissinger
CARES Asset	(1,662)	(1,662)	(1,662)	(1,662)	Kissinger
GIS Deferral (Staff Adjustment B-2, RUCO Rate Base Adjustment No. 5)	897,068	-	-	897,068	Dukes
Pre-Acquisition Plant in Service (RUCO Rate Base Adjustment No. 1)	-	-	(6,990,677)	-	Kissinger
Accumulated Depreciation (RUCO Rate Base Adjustment No. 2)	-	-	(2,855,454)	-	Kissinger
Customer Contributions	-	-	-	-	Kissinger
Other Rate Base (Y2K & Warm Spirit)	-	-	-	-	Kissinger
Accumulated Deferred Income Taxes (Staff Adjustment B-4)	2,807,892	3,003,228	2,807,892	2,807,892	Kissinger
Working Capital (Staff Adjustment B-3, RUCO Rate Base Adjustment No. 6)	(3,291,503)	(2,514,629)	(2,125,388)	(2,594,009)	Kissinger
Total Adjustments	11,870,204	4,756,115	(5,144,998)	12,587,898	
Pro Forma Original Cost Rate Base	161,661,362	154,547,273	144,646,160	162,369,855	
Requested Rate of Return	8.80%	8.12%	8.22%	8.80%	Grant
Required Operating Income	\$14,223,179	\$12,549,239	\$11,869,914	\$14,223,179	

RUCO adjusts the acquisition discount amortization claiming that the depreciation rates currently in use were not approved in the last rate case. UNSG is defending use of the rates. These were the rates used to derive depreciation expense in the Decision approving UNSG's current customer rates and were approved as such.

No adjustments

No adjustments

Staff & RUCO exclude CWIP as not in service at test year end. UNSG defends its position for economic reasons and because the plant is in service prior to new rates being established. UNSG also asserts double jeopardy as there is \$4.2 million in customer advances directly related to projects in this CWIP balance that have been included as a reduction of rate base.

No adjustments

No adjustments

Staff & RUCO exclude the GIS expenditures from rate base primarily because UNSG did not get an accounting order from the Commission. They believe the costs are non-recurring and not eligible for rate base treatment. UNSG asserts that the costs were initially thought to be capital costs and the error was not detected until the fourth quarter of 2005. At that point the expenditures had already been made and it was impossible to request an accounting order in advance. The income statement impact did happen in the test year and no one argued that the costs were imprudent. The record shows the costs were at least partially incurred at the request of the Commission and benefit present and future customers.

RUCO is claiming that UNSG cannot substantiate \$3.1 million of plant additions added between 12/31/01 and 8/11/03. RUCO also contends that the level of accumulated depreciation as of 12/31/03 was incorrect based on their recalculation. UNSG strongly disagrees with RUCO's assertion.

RUCO claims that since August 2003, UNSG has been using depreciation rates that were not approved by the Commission. UNSG is defending use of the rates. These were the rates used to derive depreciation expense in the Decision approving UNSG's current customer rates and were approved as such.

No adjustments

No adjustments

Staff's differences are because of proposed rate base adjustments. RUCO did not adjust deferred taxes to synchronize with their proposed adjustments.

Staff & RUCO agreed with UNSG's lead/lag study after the correction supplied to them in response to Staff Data Request 5.76. The remaining differences arise primarily from varying adjustments and as a result of not completing a simultaneous equation to synchronize. Staff and RUCO adjustments are revised as a result of changes in other pro formas in their Surrebuttal testimony.

Staff recommends a 10% ROE and no hypothetical capital structure. RUCO recommends a 9.64% ROE and a 50/50 hypothetical capital structure. RUCO also calculated the cost of debt excluding debt issuance cost. RUCO adjusted its recommendation for ROE to 9.84% and long-term debt to 6.23% to reflect current market conditions.

UNSG GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005

	As Filed 7/13/06	Surrebuttal 4/14/07	Surrebuttal 4/14/07	Rejoinder 4/11/07		Attachment 1 Page 2 of 4
Original Operating Income - Unadjusted	UNSG \$10,590,155	ACC Staff \$10,590,155	RUCO \$10,590,155	UNSG \$10,590,155	Summary	UNSG Witness Kissinger
Operating Income Adjustments						
Operating Revenue Adjustments						
Griffith Plant Operations	(865,152)	(865,152)	(865,152)	(865,152)	No adjustments	Dukes
Purchased Gas Cost & Gas Cost Revenue	(75,545,465)	(75,545,465)	(75,545,465)	(75,545,465)	No adjustments	Dukes
Customer Annualization (Staff Adjustment C-1, RUCO Operating Income Adjustment No. 14)	725,682	828,115	835,688	725,682	Both Staff & RUCO used year-end customer levels with no adjustments for the cyclical pattern of customer counts. UNSG used a slightly modified method to take into account the recurring customer level losses that happen each and every summer when customers leave the system.	Erdwurm
Weather Normalization (Staff Adjustment C-2, RUCO Operating Income Adjustment No. 15)	516,921	518,883	517,821	516,921	The differences here are primarily because the weather normalization adjustment starts with the annualized customer counts, revenues and sales.	Erdwurm
NSP Revenue & Gas Cost	(15,738,093)	(15,738,093)	(15,738,093)	(15,738,093)	No adjustments	Dukes
CARES	(203,181)	(203,181)	(203,181)	(203,181)	No adjustments	Dukes
Total Adjustments to Operating Revenues	(91,109,288)	(91,004,893)	(90,988,382)	(91,109,288)		
Operating Expense Adjustments						
Griffith Plant Operations						
Purchased Gas Cost & Gas Cost Revenue	(164,614)	(164,614)	(164,614)	(164,614)	No adjustments	Dukes
NSP Revenue & Gas Cost	(75,545,465)	(75,545,465)	(75,545,465)	(75,545,465)	No adjustments	Dukes
	(15,269,790)	(15,269,790)	(15,269,790)	(15,269,790)	No adjustments	Dukes
Payroll Expense (Staff Adjustment C-8 & C-9)	440,550	317,540	440,550	369,928	RUCO accepted UNSG's payroll adjustment. Staff adjusted UNSG's overtime levels and incorrectly adjusted an error that they found in our adjustment. UNSG accepted the overtime adjustment proposed by Staff and corrected the error in the original UNSG pro forma adjustment. Staff adjustment is revised to reflect that their original Adjustment No. C-8 is no longer necessary and that the \$52,388 credit to expense for the one-time severance should be excluded from payroll expense. However, Staff and RUCO still exclude the error correction of UNSG Gas original adjustment.	Dukes
Payroll Tax Expense (Staff Adjustment C-10)	25,907	16,559	25,907	20,667	Adjustments reflect changes to payroll expense. Staff adjustment is revised to reflect the change in their Adjustment No. C-8.	Dukes
Pension & Benefits (RUCO Operating Income Adjustment No. 11)	54,594	54,594	(38,481)	54,594	RUCO is excluding SERP charges allocated to UNSG. UNSG believes that SERP is a part of a fair and reasonable executive compensation program and should not be excluded based on IRS limits established to maximize tax revenues.	Dukes
Post Retirement Medical	57,676	57,676	57,676	57,676	No adjustments	Dukes
Worker's Compensation (Staff Adjustment C-13, RUCO Operating Income Adjustment No. 1)	34,234	-	-	-	The Company is agreeing with proposed adjustments.	Dukes
Incentive Compensation (Staff Adjustment C-6, RUCO Operating Income Adjustment No. 2)	137,262	(130,163)	(141,486)	137,262	Staff excluded 50% of the test year "incentive" compensation and 100% of SERP expenses; RUCO excluded all incentive compensation. UNSG is opposing all adjustments and asserts that programs like the Performance Enhancement Plan actually saves customers money and the other programs are part of a fair and reasonable compensation plan for the Officers and Directors of UniSource.	Dukes
Rate Case Expense (RUCO Operating Income Adjustment No. 8, Staff Adjustment No. C-19)	200,000	85,000	83,667	300,000	Staff proposed no change to the Company's original adjustment. RUCO compared UNSG to SWG and took the amount SWG got in their last rate case and adjusted it for inflation. UNSG is updating the record for the latest projected cost. Staff adjustment No. C-19 is added to reflect Staff's rate case expense of \$255,000 amortized at \$85,000 per year.	Dukes
Bad Debt Expense (Staff Adjustment C-3, RUCO Operating Income Adjustment No. 17)	317,758	319,021	222,175	317,758	Staff used the UNSG adjustment and inserted revised customer annualization revenues. RUCO recalculated using our historical write-off rate times pro forma revenues (excluding NSP and Griffith); this would be correct had they corrected the write-off percentage to reflect the exclusion of those revenues as well.	Dukes
Interest On Customer Deposits	16,507	16,507	16,507	16,507	No adjustments	

**UNSG GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005**

	As Filed	Surrebuttal	Surrebuttal	Rejoinder	UNSG	Witness
	7/13/06	4/4/07	4/4/07	4/11/07		
	UNSG	ACC Staff	RUCO	UNSG		
Operating Expense Adjustments (cont'd)						
Fleet Fuel Expense (Staff Adjustment C-15, RUCO Operating Income Adjustment No. 13)	73,726	61,068	24,176	61,068		Dukes
Amortization of GIS Expenditures (Staff Adjustment C-5, RUCO Operating Income Adjustment No. 12)	(541,344)	(840,367)	(840,367)	(541,344)		Dukes
Out of Period Expenses (RUCO Operating Income Adjustment No. 19)	(43,743)	(43,743)	(64,863)	(43,743)		Dukes
Year-End Accruals	(125,000)	(125,000)	(125,000)	(125,000)		Dukes
Advertising & Donations	(16,619)	(16,619)	(16,619)	(16,619)		Dukes
Postage Expense (Staff Adjustment C-16, RUCO Operating Income Adjustment No. 4)	142,707	116,683	90,856	142,707		Dukes
CARES	(16,899)	(458,410)	(16,899)	(16,899)		Erdwurm & Dukes
Depreciation & Property Tax for CWIP (Staff Adjustment C-4, RUCO Operating Income Adjustment No. 18)	363,150	-	196,266	363,150		Dukes
Gain on Sale of Prescott Property	(12,437)	(12,437)	(12,437)	(12,437)		
Corporate Cost Allocations (RUCO Operating Income Adjustment No. 16; Staff Adj. No. C-18)	130,471	117,706	117,706	117,706		Dukes
Customer Service Cost Allocations (RUCO Operating Income Adjustment No. 5)	325,422	325,422	(401,288)	325,422		Dukes
Depreciation Annualization	3,280	3,280	3,280	3,280		
Emergency Bill Assistance (Staff Adjustment C-7)	-	21,600	-	21,600		Dukes
Nonrecurring FERC Rate Case Legal Expense (Staff Adjustment C-11, RUCO Operating Income Adjustment No. 20)	-	(311,051)	(311,051)	(57,003)		Dukes
Membership & Industry Association Dues (Staff Adjustment C-14, RUCO Operating Income Adjustment No. 9)	-	(26,868)	(1,523)	(11,646)		Dukes
Pre-Acquisition Plant in Service Depr. Expense (RUCO Operating Income Adjustment No. 3)	-	-	(324,083)	-		Kissinger

Both Staff & RUCO used calculations similar to the UNSG adjustment, except that RUCO used test year average fuel cost and Staff used a recent three-month average for the State of Arizona. UNSG accepts Staff's proposed method, but used the most recent three-month average actual fuel cost for UNSG Gas instead of an Arizona average. Staff adjustment is revised to reflect the change in their Adjustment No. C-15 to match UNSG's rebuttal testimony amount.

Staff & RUCO excluded GIS, saying UNSG didn't have an ACC order to defer the cost. UNSG argues that the expense was booked in the test year and the Commission has authority to grant the Company's requested treatment.

RUCO is excluding some PWC invoices for services provided in 2004 and expensed in 2005; however, RUCO did not look at the 2005 invoices expensed in 2006 that were essentially equivalent. UNSG recommends no change to its original adjustment.

No adjustments

No adjustments

Staff took test year expense and increased it for the postage rate increase. RUCO took a similar approach, but has a formula error in their calculation and also forgot to pick up other postage expense. Both parties ignored the fact that there was a \$58k prior period adjustment in the test year that needed to be corrected in their starting number. When those issues are corrected, the approaches are very similar but, their proposed amount is inadequate when compared to the two year average cost and the actual 2006 cost. Staff adjustment is revised to reflect the correct starting test year postage expense used by UNSG and the May 2007 increase in postage rates of \$.02 for a first class letter. RUCO adjustment is revised to reflect the acceptance of UNSG test year total but still disallows the two-year average.

No adjustments. Staff adjustment No. C-20 is added to reflect their proposed change in the accounting for CARES program costs and the elimination of deferred program costs.

Staff excluded the adjustment for CWIP depreciation and property taxes completely. RUCO removed the property taxes and included the depreciation adjustment in their overall depreciation adjustment calculation. UNSG believes the CWIP in rate base should be allowed and disagrees with the proposed reductions.

No adjustments

Staff made no adjustments in direct testimony. RUCO found an invoice we had missed related to the KKR acquisition. Staff adjustment No. C-18 is added to reflect the change made by UNSG in response to RUCO's discovery of additional non-recurring merger costs.

Staff doesn't propose an adjustment. RUCO adjusts to an annualized incremental cost level based on having a handful of part-time CSR's, no system, inadequate phone lines and limited customer service. UNSG strongly opposes RUCO's adjustment.

Staff argues should be in base rates and not in DSM surcharge. Company agrees with Staff's adjustment.

Staff and RUCO exclude legal expenses related to the El Paso FERC case as non-recurring, despite the fact that we had legal expenses of \$373k in 2004, \$488k in the test year and \$425k in 2006. This would put a two-year average right at our 2006 expense level; UNSG is proposing a two year average of 2004 & 2005 actuals.

Staff excludes 40% of AGA dues. RUCO excludes 3.6%. UNSG originally viewed this as immaterial; UNSG agrees with RUCO's adjustment.

RUCO reduces test year depreciation expense based on the recalculated plant in service balance. UNSG strongly opposes any exclusion of plant in service and strongly disagrees with RUCO's calculation of depreciation expense.

