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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
MIKE GLEASON – CHAIRMAN
WILLIAM A. MUNDELL
JEFF HATCH–MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF 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.	DOCKET NO. G-04204A-06-0463
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

REPLY BRIEF

OF UNS GAS, INC.

Arizona Corporation Commission
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ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

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ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

UNS Gas, Inc. ("UNS Gas" or "Company"), through undersigned counsel, hereby submits its Reply Brief in support of its requested relief in the following consolidated dockets: (i) G-04204A-06-0463 (the "UNS Gas Rate Case"); (ii) G-04204A-06-0013 (the "PGA Review Case") and (iii) G-04204A-05-0831 the ("Gas Procurement Review Case"), collectively referred to as the "UNS Gas Rate Case". In support hereof, UNS Gas states as follows:

INTRODUCTION.

UNS Gas has proposed innovative and necessary measures to address the issues of rapid growth, increasing capital requirements and volatile gas prices. UNS Gas also has proposed a rate design to reduce significant cross-subsidies that currently exist among its customers. In response, the other parties remain rooted in the past, ignore the new circumstances facing UNS Gas and oppose UNS Gas' proposals on the basis of historical practices that do not comport with today's reality. UNS Gas has presented a bare bones rate case and needs the relief requested to continue to provide safe and reliable service to its expanding customer base. Some of its "non-traditional" proposals are intended to allow UNS Gas, and the Commission, some time before it must file its next rate case. UNS Gas submits it is in the public interest to adopt measures that comport with the realities of gas distribution service in rapidly growing Arizona and requests that the Commission grant the relief UNS Gas requested in this case.

UNS Gas' Initial Post-Hearing Brief anticipated and addressed many of the arguments presented by other parties in their opening briefs. This Reply Brief focuses primarily on key issues relating to UNS Gas' ability to effectively address the demands it faces in its service area.

I. UNS GAS' REVENUE REQUIREMENT.

A. Rate Base Issues.

The Company stands by its position on all rate base issues discussed in its Initial Post-Hearing Brief. UNS Gas' original cost test year rate base should be determined to equal $161,661,362 and a fair value test year rate base of $191,177,715. The Company will not repeat

its position on all of the rate base issues here, but will focus on (1) Construction Work in Progress ("CWIP"); (2) Geographic Information System ("GIS") costs; (3) Plant in Service; and (4) Accumulated Depreciation.

1. The Commission should approve inclusion of Construction Work in Progress to address the substantial growth the Company faces and protect UNS Gas' financial integrity.

The record supports including CWIP in rate base. The other parties' opposition to CWIP cites primarily the Commission's trend of not including CWIP in rate base, without addressing the actual circumstances underlying UNS Gas' request. Nevertheless, in this case, the inclusion of CWIP in rate base will assist the Company in meeting the rapid growth in its service area while supporting the Company's financial integrity *and* its reasonable opportunity of actually earning its authorized rate of return ("ROR").

UNS Gas Witness Mr. Kentton Grant testified extensively about how the Company has faced, and will face, continued high growth in its service territory.[1] Mr. Grant attached evidence to his Rejoinder Testimony showing the growth rates actually experienced by UNS Gas is higher than other Arizona utilities.[2] Because of this growth, the Company faces high capital expenditure requirements.[3] No one disputed that UNS Gas must attract substantial capital to address the growth it will likely incur in the future. Mr. Grant testified that UNS Gas will need about $43 million in additional capital through 2009.[4] Further, growth erodes the Company's financial integrity due to the higher capital costs associated with larger capital outlays. It also creates capital requirements far in excess of the Company's internal cash flow.[5] Finally, Mr. Grant provided evidence that new growth in 2006 caused a $1.2 million revenue deficiency, and that it is highly unlikely that UNS Gas will be able to earn its authorized ROR, even if the Company's rate request is granted in its entirety.[6] Neither Staff nor RUCO dispute these facts. Nor do Staff or RUCO

[1] Tr. at 920, 1004-05, 1020.
[2] Ex. UNSG-29 at Ex. KCG-15.
[3] Ex. UNSG-28 at 8.
[4] Ex. UNSG-27 at 27.
[5] Ex. UNSG-28 at 9.
[6] Id. at 10.

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ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

dispute that including CWIP will positively address the Company's cash flow concerns and its financial integrity.

The Commission has the legal authority to include CWIP in rate base. *Arizona Community Action Assoc. v. Arizona Corp. Comm'n*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979). Without inclusion of CWIP, the Company stands little chance to earn its authorized ROR and will have to return to the Commission with another rate case in the near future. Mr. Grant repeatedly testified to this from the time the Company originally filed its application through the evidentiary hearing.[7] If the Company waits until it is in financial distress before requesting such treatment, as Staff suggests, the utility already will be damaged and its access to capital on favorable terms will be severely hindered.[8] UNS Gas is merely requesting that the Commission be proactive in providing a regulatory tool to help the Company maintain its financial integrity in the face of this substantial growth.

If the Commission decides not to include CWIP, it should include post-test-year plant in rate base. As discussed in the Company's Initial Post-Hearing Brief, the Commission has allowed post-test-year plant in several cases. Including post-test-year plant is justified because the Company's net plant investment, on a per customer basis, is growing much faster than for other Arizona utilities.[9]

2. If the Commission does not allow Construction Work in Progress or post-test-year plant in rate base, the evidence and common sense support removing advances directly related to Construction Work in Progress from the rate base calculation.

Although Staff and RUCO oppose removing $4.158 million of customer advances from the rate base calculation if CWIP is excluded, both Staff and RUCO ignore that those customer advances are directly related to CWIP.[10] If Staff and RUCO's recommendations are followed, the Company will be penalized for about $4 million that should not be deducted from rate base. Staff

[7] Ex. UNSG-27 at 27; Ex. UNSG-28 at 8; Ex. UNSG-29 at 4; Tr. at 920-21.
[8] Ex. UNSG-29 at 4.
[9] Ex. UNSG-29 at Ex. KCG-15; Tr. at 920, 1004-5, 1020.
[10] Ex. UNSG-29 at 9.

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misinterprets A.A.C. R14-2-103 because nothing in that rule *requires* that advances be deducted from rate base when the related plant is not yet in service and will not be in rate base. If CWIP is allowed in rate base, then the $4.158 million deduction makes sense. But without CWIP in rate base, the result is a substitution of cost-free capital for actual debt and equity capital supplied by UNS Gas. This is not a fair proposition.

Staff cites no testimony or evidence to justify its assertion that threat of a "double rate of return" exists through the AFUDC; nor does Staff provide any support that the Company would violate the Federal Energy Regulatory Commission ("FERC") Uniform System of Accounts by failing to specifically deduct the appropriate amount of customer advances out of AFUDC.[11] Moreover, any AFUDC accruals are very small due to the short duration of projects.[12] And AFUDC accruals must cease once the plant is in service. Here, the vast majority of plant is in service. There is no danger of double recovery and there are certainly no grounds for prohibiting any recovery by reducing existing rate base as suggested by Staff. RUCO simply argues that it is "the Commission's historic practice to include all CIAC as an offset to rate base . . ."[13] But RUCO's blind adherence to historic practice ignores the fact that the $4.158 million relates directly to the roughly $7 million in CWIP. If the Commission decides not to include CWIP, then at the very least it should make the corresponding adjustment to remove $4.158 million in advances *directly related* to that CWIP amount from the rate base calculation. UNS Gas' request is in accordance with the evidence and common sense.

3. Geographic Information System costs were incurred for the direct benefit of ratepayers and a request to recover those costs here is reasonable and appropriate.

UNS Gas has acknowledged its mistake in improperly accounting for its GIS costs. Citizens Communications ("Citizens") originally capitalized work orders relating to this project when those work orders should have been expensed. UNS Gas discovered this late in the test year

[11] Staff's Opening Brief at 8.
[12] Ex. UNSG-29 at 7.
[13] Initial Closing Brief of RUCO at 8.

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and corrected the mistake. UNS Gas understands it needs approval to defer $897,068, the costs incurred for GIS, as a regulatory asset; the Company makes that request here.

Rather than recognizing that the Company made an honest mistake, Staff and RUCO propose penalizing the Company by recommending rejection of this request. Both parties ignore ample evidence that the GIS has provided substantial benefit to UNS Gas customers. No party disputes that the GIS improves safety and productivity for the direct benefit of UNS Gas customers. No party disputes that the GIS allows faster emergency response, improved modeling, better planning, improved accuracy of maps, quicker mapping and the numerous other benefits Mr. Gary Smith describes in his pre-filed testimony.[14] Staff explicitly acknowledges that "GIS helps the Company maintain an accurate, up-to-date record of its facilities."[15] Although Staff argues that UNS Gas' investors "also benefit from cost decreases and increased revenues that occur between rate cases,"[16] it cites no evidence that the GIS led to increased revenues or reduced costs. Further, no party disputes that Staff requested that UNS Gas undertake the GIS project and incur these costs.[17] This evidence overwhelmingly supports the Company's assertion that the GIS directly benefits UNS Gas customers.

The Company did not intend to violate any accounting principles, and it corrected the error as soon as it was discovered. No evidence suggests any malice or wanton disregard of accounting principles afoot. The Company did not "decide" to treat GIS as an asset, as Staff proclaims in its Opening Brief. RUCO acknowledges the Company mistakenly booked GIS costs and corrected this error.[18] The Company acknowledges it is making a retroactive request to defer these costs as part of this rate case. Nevertheless, the Commission can and should consider this request. The evidence is clear that the GIS directly benefits UNS Gas customers. For that reason, approving the Company's request is appropriate.

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[14] Ex. UNSG-15 at 6-7.
[15] Staff's Opening Brief at 8.
[16] Staff's Opening Brief at 9.
[17] Tr. At 690-92, 837-38.
[18] Initial Closing Brief of RUCO at 9.

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PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

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4. RUCO's proposed adjustment to plant in service is unsupported by the record and should be rejected.

The Company provided RUCO with ample documentation justifying the final plant in service numbers from Citizens. This included both electronic files and records.[19] Ms. Karen G. Kissinger describes in detail in her Rebuttal Testimony how:

- She received a letter from Director of FERC Division of Regulatory Accounting Policy, Mr. James K. Guest, approving proposed accounting for the gas and electric assets acquired from Citizens, dated July 17, 2003.[20]
- She provided an analysis of plant adjustments, additions and retirements for UNS Gas covering the period August 2003 through December 2005. She further indicates that UNS Gas provided a reconciliation of recorded plant balances as of December 31, 2001, with final adjusted plant amounts in the Citizens gas rate case application and with those implicit in the Settlement Agreement that was approved in Decision No. 66028 (July 3, 2003), as well as monthly financial reports for Citizens Arizona Gas from December 2001 to August 2003.[21]
- She also provided fixed asset and accumulated depreciation files for UNS Gas and combined financial statements for calendar year 2002.[22]

Ms. Kissinger also described how RUCO's so-called "unsubstantiated" plant additions were based on differences between two amounts not consistent with one another.[23] Further, Ms. Kissinger describes that the full plant-in-service figure ($248 million) comes from what UNS Gas filed with FERC, supported by an electronic file used to record beginning balances.[24]

RUCO provides no evidence that the $3.1 million in dispute is inconsistent with the level of historic capital expenditures during the disputed period. In fact, the evidence shows otherwise.

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[19] Tr. at 194-97.
[20] Ex. UNSG-7 at 4, Ex. KGK-3, Ex. KGK-4.
[21] Id. at 6.
[22] Id.
[23] Id. at 5.
[24] Tr. at 194-95.

RUCO's own witness agreed that the Company spends more than $1 million per month in capital expenditures.[25] The Commission also imposed less stringent record retention requirements for the sale of gas assets, as RUCO Witness Mr. Moore testified.[26] Indeed, Staff did not challenge UNS Gas' plant in service. The evidence supports UNS Gas' plant in service and the Commission should reject RUCO's unique and unsupported adjustment.

5. The evidence supports the Company's accumulated depreciation.

RUCO continues to assert that it believes the depreciation rates established in Decision No. 58664 (June 16, 1994) ("1994 Rate Order") should be the depreciation rates used here. RUCO's position on accumulated depreciation is not supported by the record. RUCO ignores the fact that the 1994 Rate Order only discusses two out of 28 depreciation accounts.[27] RUCO further admits the 1994 Rate Order did not include the then Santa Cruz Division of Citizens' Arizona Gas operations.[28] RUCO had to refer to the rate application to determine the depreciation rates for the remaining 26 accounts, *as well as* assuming all 28 depreciation rates for the then Santa Cruz Division for purposes of this case. RUCO simply has not provided sufficient evidence to support its contention.

By contrast, Ms. Kissinger provides ample justification to conclude that Company's current depreciation rates were approved in Docket No. G-01032A-02-0598.[29] Citizens Direct Testimony in that case included a request for new depreciation rates, which was incorporated in calculating pro forma depreciation expense.[30] The Settlement Agreement approving the acquisition of Citizens gas and electric assets by UniSource Energy Corporation (Decision No. 66028) had an Appendix B, Schedule 1 attached to it. That schedule, as Ms. Kissinger describes, shows how the depreciation rates applied for in Docket No. G-01032A-02-0589 are incorporated in the settled

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[25] Tr. at 658-59.
[26] Ex. UNSG-7 at 6-7.
[27] Tr. at 673-74.
[28] Tr. at 674-75.
[29] Ex. UNSG-7 at 8.
[30] Id at Ex. KGK-6, KGK-7, KGK-8, KGK-9 (operating expense adjustments in the original Citizens 2002 Gas Rate Filing), KGK-10 (operating income statement in the same rate filing).

ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
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amount of operating expenses.[31] Decision No. 66028 incorporates the rate increase agreed upon in the settlement. Therefore, new depreciation rates were approved in Decision No. 66028. Staff agrees with the Company regarding proper depreciation rates.

Further, the adjustment RUCO makes for accumulated depreciation due to what it describes as "unsubstantiated plant" should also be rejected. RUCO's proposal to increase accumulated depreciation by $6.7 million ($2,855,454 using outdated depreciation rates and $3,857,413 for its "unsubstantiated" plant adjustment) should be rejected.

B. Operating Income

UNS Gas maintains its position on all Operating Income issues stated in its Initial Post-Hearing Brief. UNS Gas' adjusted Operating Income for the test year is $8,428,981. The Company anticipated and addressed most of the other parties' concerns in its Initial Post-Hearing Brief and will not repeat all of its arguments here.

The Company, however, specifically responds to criticism on a few key issues below, including: (1) Customer Annualization; (2) Legal Expense; (3) Rate Case Expense; (4) Small Expenses; (5) Performance Enhancement Program; (6) Supplemental Executive Retirement Program; and (7) Call Center Expenses.

1. Operating Revenue.

a. Customer Annualization.

The Company stands by its position. The evidence is that UNS Gas' seasonal growth pattern is cyclical.[32] UNS Gas showed this cyclical pattern in Exhibit DBE-5, attached to Mr. D. Bentley Erdwurm's Rejoinder Testimony. The traditional method proposed by Staff and RUCO is not as accurate as what the Company proposes. The traditional method also leads to the nonsensical result of showing negative customer growth for a class that has a positive growth trend.[33] The accuracy of the Company's method justifies its adoption in this case over the traditional method.

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[31] Id. at 9, Ex. KGK-11 (Appendix B – Schedule 1 from the Settlement Agreement approved in Decision No. 66028).
[32] Tr. at 447.
[33] Tr. at 447; Ex. UNSG-20 at 4-5.

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400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

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400 EAST VAN BUREN STREET - SUITE 800
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2. Operating Expenses.

a. Legal Expenses.

Staff and RUCO argue that the El Paso Natural Gas Company ("El Paso") rate case before the FERC is a non-recurring legal expense. But such proceedings are recurring events, such as the rate case for Transwestern Pipeline Company and the new El Paso rate case,[34] are part of the Company's ordinary business. UNS Gas provided historic data showing that its actual legal expenses were $373,174 in 2004, $488,380 in 2005 and $425,540 in 2006. UNS Gas projects that its legal expenses will be in the $400,000 range for the foreseeable future.[35] The test-year expense for legal expenses was $488,380. UNS Gas has proposed that a legal expense of $430,777 be included in rates.[36] This amount is entirely reasonable based on the record.

If the Commission disallows these legal expenses as an operating expense, then the Company reiterates its request for an accounting order to allow all legal expenses related to FERC pipeline rate cases to be included in the cost of gas covered by the Purchased Gas Adjustor ("PGA").

b. Rate Case Expense.

Both Staff and RUCO use an analogy to the recent Southwest Gas Corporation ("Southwest Gas") rate case to justify their adjustments to rate case expense. Their positions are fundamentally flawed. The evidence in this case is that Southwest Gas and UNS Gas have substantial accounting differences. That evidence is that:

- Southwest Gas' internal personnel and support services are built into its base rates; in contrast, UNS Gas does not have those costs built in and must recover them through the rate case expense.[37]
- Southwest Gas' overhead costs for rate cases, including in-house experts, lawyers, and support and administrative personnel, are allocated using the Massachusetts

[34] Ex. UNSG-13 at 17; Tr. at 293.
[35] Ex. UNSG-14 at 9.
[36] Ex. UNSG-13 at 18.
[37] Ex. UNSG-13 at 33-35.

formula to the three states it serves. UNS Gas does not have the same structure. When TEP employees perform UNS Gas activities, they must be directly recorded so that only those costs are charged to UNS Gas.[38]

- If UNS Gas used the Southwest Gas Massachusetts Formula, its test-year expenses would be $2.5 million higher.[39]
- If UNS Gas used Southwest Gas' system-allocated labor costs (6.38 percent of operating expenses), its operating costs would jump up by $1.8 million.[40] This is because UNS Gas' system-allocated labor costs were only 1.75 percent.[41]

Staff and RUCO do not dispute the evidence concerning those differences. This evidence undermines RUCO's unsubstantiated characterization that UNS Gas' rate case functions were performed merely by "in-house staff" just like Southwest Gas."[42] Although RUCO's brief cites Mr. Moore's Direct Testimony in support of that position, under cross-examination, Mr. Moore testified that UNS Gas does not have in-house staff for most rate case functions.[43]

c. Small Expenses.

Apparently, RUCO continues to believe that every single individual expense must be proved reasonable beyond any shadow of a doubt, including hundreds of expenses under $50 and more than 1,500 expenses that are under $200.[44] RUCO states "the Company's mere avowal that expenses are prudent and necessary to provide gas service is not sufficient to satisfy its burden of proof."[45] To the contrary, the Company, through Mr. Gary Smith, provided testimony that these expenses were necessary because UNS Gas personnel were conducting leak surveys, safety audits, training, participating in Commission pipeline safety audits, and purchasing tools to maintain the pipeline system.[46] The Company further justified generally the "meals, lodging and refreshments."

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[38] Ex. UNSG-13 at 33-35; Ex. UNSG-14 at 9-11; Tr. at 281, 887-88.
[39] Ex. UNSG-14 at 10.
[40] Initial Post-Hearing Brief of UNS Gas at 22, FN 87; Ex. UNSG-25 at subpart d.
[41] Id.
[42] Initial Closing Brief of RUCO at 20.
[43] Tr. at 623, 629-30.
[44] Tr. at 636; Ex. UNSG-13 at 31.
[45] Initial Closing Brief of RUCO at 19.
[46] Ex. UNSG-16 at 5-6.

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This is contrary to RUCO's claims that these were for "extravagant corporate events (and) advertising." Surely, RUCO cannot be requesting that UNS Gas incur significant expense to specifically justify each particular expense one by one, either through providing explicit testimony on each and every expense, or by providing a specific description of why a dinner at TGI Friday's was a reasonable expense for personnel conducting a leak survey in northwest Flagstaff, for example. That would be an expensive and inappropriate proposition. In fact, the Company put forth evidence justifying these expenses. RUCO did not rebut that evidence. The Company further agreed to deduct $12,254 of expenses related to five specific expenses. The Company met its burden to justify the remaining expenses.

d. Performance Enhancement Program ("PEP").

UNS Gas offered substantial evidence that the PEP is a reasonable cost for customers to bear. Mr. Dukes testified that the PEP is a key component to employee compensation.[47] Without the PEP, base salaries would have to increase to attract and retain employees.[48] These employees are vital to the Company. Similar programs are standard practice at most companies, and UNS Gas' average cash compensation was below that of comparable firms.[49] Neither Staff nor RUCO dispute that the PEP is a necessary component to attracting and retaining qualified and dedicated employees. Nor do they dispute that the overall compensation, including base salary plus PEP, is unreasonable. Further, neither Staff nor RUCO dispute that these employees provide service directly to customers. Mr. Dukes also testified that the benefits warrant a much greater sharing than 50/50 and that the PEP reduces the ultimate cost passed on to customers in the form of reduced payroll and benefits costs.[50]

RUCO and Staff merely argue that incentive compensation programs benefit both shareholders and ratepayers to justify their request for a 50 percent disallowance.[51] But if an expense is reasonable, the Commission must allow recovery for it. *Tucson Electric Power Co. v.*

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[47] Ex. UNSG-13 at 9.
[48] Id.
[49] Id.
[50] Id. at 8.
[51] Staff's Opening Brief at 13; Initial Closing Brief of RUCO at 15.

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Arizona Corp. Comm'n, 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982). The Commission must provide sufficient income to permit full recovery of a utility's operating costs. *Scates v. Arizona Corp. Comm'n,* 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 178). Staff does not argue that the PEP expenses are unreasonable. Although RUCO argues that the Special Recognition Award to PEP-eligible employees was arbitrary,[52] Mr. Dukes testified that each individual employee is evaluated to determine whether they qualify and, if so, how much they receive.[53]

Finally, the PEP is for all non-union employees and is not limited to upper management or Officers of the Company.[54] As discussed in the Initial Post-Hearing Brief, significant differences exist between UNS Gas' PEP and Southwest Gas' Management Incentive Program.

e. Supplemental Executive Retirement Plan ("SERP").

The record confirms that SERP is a standard offering in executive compensation programs. Mr. Dukes testified that 2005 Officer Total Direct Compensation was below the median of the peer group from the 2005 Executive Compensation Review.[55] Further, SERP is offered by every company in that peer group and it is used to evaluate executive compensation.[56] SERP allows executives to receive the same level of retirement benefits as other employees of the Company.

Apparently, Staff and RUCO believe, without any record support, that SERP is not important to the attraction and retention of highly qualified professionals. For instance, RUCO mischaracterizes SERP by arguing that "supplemental benefits for high-ranking officers is not a necessary cost of providing gas service."[57] But SERP merely gives executives the same level of benefits as other employees, no more and no less, by holding executives harmless from the Internal Revenue Code. Neither party disputed that these overall compensation costs are unreasonable or that SERP is a commonly-used tool by companies to evaluate executive compensation. The record is clear that SERP does not result in "excessive" compensation for utility executives.

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[52] Initial Closing Brief of RUCO at 15.
[53] Ex. UNSG-14 at 6.
[54] Ex. UNSG-14 at 5.
[55] Ex. UNSG-14 at 8.
[56] Id.
[57] Initial Closing Brief of RUCO at 22.

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f. Call Center Expenses.

RUCO tries to link customer complaints with the Commission as the sole factor in deciding whether call center consolidation was a cost-efficient measure and a good idea. RUCO's theory is flawed in several aspects. First, RUCO does not dispute that call volume doubled.[58] Second, as Mr. Dukes testified, the previous system could not have handled the call volume in 2006.[59] Third, if it were not for call center consolidation, UNS Gas would have needed increased staffing, increased phone lines, increased hardware and software and more supervisor positions to meet these service demands.[60] Finally, many of those customer complaints dealt with the PGA surcharges and not with customer service per se.[61] The evidence makes clear that UNS Gas' call center expenses as reasonable and that call center consolidation has benefited UNS Gas customers.

C. Cost of Capital.

1. UNS Gas' projected capital structure should be used.

In its Initial Post-Hearing Brief, UNS Gas argued that cost of capital is inherently forward-looking, and that its projected capital structure should therefore be used. The other opening briefs did not dispute the forward-looking nature of cost of capital or the accuracy of UNS Gas' projected capital structure. RUCO agrees that UNS Gas' proposed capital structure should be used.[62] But Staff argues that the Commission should look backwards and use UNS Gas' historical capital structure. Staff argues that adopting UNS Gas' proposed capital structure would result in an "excessive" return on equity "exceeding that intentionally approved by the Commission."[63] Staff points to an example where UNS Gas' proposed capital structure is approved but its historic capital structure remains actually in place.[64] Staff's example is flawed because it is unlikely that UNS Gas' historic capital structure will be in place when rates go into effect. UNS Gas' proposed

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[58] Tr. at 638.
[59] Ex. UNSG-14 at 16.
[60] Id.
[61] Id.
[62] Initial Closing Brief of RUCO at 22.
[63] Staff's Opening Brief at 20-21.
[64] Id.

capital structure should be used since it more accurately reflects the Company's plans and provides further support for the Company's financial integrity.

As explained in the Company's Initial Post-Hearing Brief, the Commission has approved hypothetical capital structures on many occasions.[65] Under Staff's argument, the Commission unintentionally gave each of those companies excessive returns. The Commission's many decisions approving hypothetical capital structures do not suffer from such a flaw, however. Instead, they appropriately recognize that backwards-looking capital structures will be out-of-date when rates go into effect. Further, such decisions help preserve the financial integrity of companies. In addition, such decisions are especially appropriate when the utility is making a concerted effort to strengthen its capital structure.[66] UNS Gas has made a very concerted and disciplined effort to strengthen its capital structure, and the results are evident in its rapidly improving capital structure.[67] The Commission should recognize these efforts and approve UNS Gas' proposed capital structure, as recommended by RUCO.

2. RUCO's DCF analysis is flawed.

While Staff and UNS Gas reach essentially the same result in their DCF studies, RUCO reaches a far different result. RUCO's approach places too much emphasis on analyst projections of short-term growth of various companies. RUCO's brief points out the similarity between its approach and that of the FERC.[68] But the Commission rejected such FERC-based approaches on several occasions.[69] The short term projections used by RUCO are widely different for the various companies in RUCO's sample group.[70] Yet RUCO assumes that these differences will persist forever. Given that the sample group companies are all in the same highly-regulated industry, that would be very unlikely.[71] Moreover, RUCO also assumes that some of its sample companies will

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[65] Initial Post-Hearing Brief of UNS Gas at 33.
[66] *Arizona-American Water Co. (Mohave)*, Decision No. 69440 (May 1, 2007) at 13-14.
[67] See Initial Post-Hearing Brief of UNS Gas at 32 – 33 for background and citations.
[68] Initial Closing Brief of RUCO at 24.
[69] Tr. at 1002-1003; see also Ex. UNSG-33 (*Chaparral City Water Co.*, Decision No. 68176 (Sept. 30, 2005)) at 23-26 and *Arizona Water Co. (Western Group)*, Decision No. 68302 (Nov. 14, 2005) at 37.
[70] Ex. UNSG-28 at 4.
[71] Id.

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forever grow at a rate less than half that of the economy as a whole.[72] RUCO's growth assumptions are unrealistic and contrary to well-established Commission practice, and should therefore be disregarded.

3. Staff and RUCO's CAPM models are flawed.

Staff and RUCO both make a critical error in their CAPM models. They both rely in part on geometric means to calculate the market risk premium for the CAPM. Staff does not defend, or even mention, this dispute in its Opening Brief, although it was clearly a hotly contested item at the hearing. However, RUCO did make two arguments in favor of geometric means. First, RUCO argues that geometric means are "widely available" and should therefore be used to calculate market risk premium.[73] But the overwhelming consensus among both academics and real-world financial professionals is that geometric means should not be used for that purpose.[74] Moreover, the "if it's out there use it" argument leads to absurd results, such as when Staff's witness suggested that rational investors would use the results of a Suns' game to make investment decisions.[75]

RUCO's second argument is that geometric means are better at showing the "effects of compounding... when return variability exists."[76] RUCO's witness supported this statement with a mathematical example of calculating historical returns on an investment.[77] UNS Gas' witness, Mr. Grant, demonstrated at length the errors in RUCO's example.[78] The most fundamental of those errors is that RUCO used an example of historic returns. And the geometric mean is better at reporting historic returns. The expected market risk premium in the CAPM is clearly forward-looking, and the arithmetic mean is best for calculating future returns of this type.[79]

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[72] Id.
[73] Initial Closing Brief of RUCO at 25, citing Ex. RUCO-8 at 12.
[74] Initial Post-Hearing Brief of UNS Gas at 35-36 for background and citations.
[75] Tr. at 1021-22.
[76] Initial Closing Brief of RUCO at 25, citing Ex. RUCO-8 at 12.
[77] Ex. RUCO-12 at 13-14.
[78] Ex. UNSG-29 at 17-18.
[79] Ex. UNSG-28 at 19-19.

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4. Growth and Risk.

The extraordinary financial pressures created by UNS Gas' customer growth makes the Company more risky than those included in the sample group. While RUCO and Staff argue that growth is positive, they offer little economic or financial analysis specific to UNS Gas. RUCO points to a single positive reference to growth in an annual letter to stockholders.[80] But that same letter noted that extensive "financial restructuring" was necessary to cope with "dramatic growth."[81] Taken in context, this letter is fully consistent with UNS Gas' testimony about the severe financial stress created by growth. UNS Gas' testimony demonstrated that UNS Gas has very high capital expenditure requirements, far exceeding its cash flow.[82] UNS Gas also has a low embedded cost of plant, so extra revenue from new customers is not sufficient to cover the capital and fixed costs associated with the new plant.[83] Therefore, growth hurts UNS Gas' earnings and cash flow.[84] UNS Gas is more risky than the companies included in the sample group, and the Commission should adopt a return on equity higher than the cost of equity for the sample group.

D. The Commission must use fair value to set rates.

The Company continues to believe that its approach, applying weighted average cost of capital to the fair value rate base, is the most straightforward method to determine operating income.[85] In the future, other lawful methods may be devised. But no other lawful methods have been presented in this case. Tellingly, neither Staff nor RUCO presented any legal argument in their briefs that their "backing-in" method was legal. Instead, they try to avoid the issue, or to attack the Company's proposal. The Commission must comply with the Arizona Constitution, so the issue cannot be avoided. Even if Staff's and RUCO's criticisms of the Company's proposal were valid, the only alternative they presented is clearly unconstitutional. In contrast, no party has questioned the legality of the Company's proposal.

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[80] Initial Closing Brief of RUCO at 25.
[81] Ex. RUCO-8 at Exhibit E (last paragraph under "Growth").
[82] Ex. UNSG-28 at 8-10.
[83] Id.
[84] Id.
[85] Ex. UNSG-29 at 12.

Attempting to avoid the issue, Staff and RUCO note that the *Chaparral City* opinion is unpublished. UNS Gas' Initial Post-Hearing Brief cited many published Arizona cases that are binding precedent. These cases clearly require the Commission to use fair value in setting rates. Staff and RUCO "use" fair value merely as façade – it has no impact on their revenue requirements. Under their approach, fair value literally makes no difference. That approach cannot be squared with the central importance the Arizona Constitution places on fair value. *See* Arizona Constitution, Article XV § 14. The Arizona Supreme Court has emphasized the importance of fair value time and time again. *U.S. West Communications, Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242, 246, 34 P.3d 351, 355 (2001); *Simms v. Round Valley Light & Power Co.,* 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

In response to UNS Gas' proposal that the weighted average cost of capital be applied to the fair value rate base, Staff and RUCO emphasize the Court of Appeals' statement that this approach is not required. Indeed, Staff sarcastically states that the Company's witness "must have missed" that sentence.[86] In fact, the Company's witness testified about that sentence.[87] UNS Gas has never contended that its proposal was required or the only lawful approach. The Company does contend, however, that the discredited "backing-in" approach is <u>not</u> lawful and must not be used.

Staff argues that that the Commission should only consider "investor-supplied funds"[88] (and thus ignore fair value). But "the amount invested is immaterial." *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959). Rates must be based on fair value, not the value invested. *Id.*

RUCO objects that it is prejudiced by this issue because it was raised in rebuttal testimony. But it is commonplace for new legal and factual issues to be raised in subsequent rounds of testimony. For example, during the hearing, Staff introduced an exhibit from January 2007 and

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[86] Staff's Opening Brief at 23:22.
[87] Tr. at 987.
[88] Staff's Opening Brief at 24:15.

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another from April 2007.[89] RUCO also cites a Commission rule about modifying rate applications. However, that rule only applies if an amendment "changes the amount sought by the utility or substantially alters the facts."[90] Here, the amount requested has not changed, and no substantially altered facts are used. Instead, UNS Gas simply addressed a legal issue based upon new case law. Moreover, RUCO has expressly declined the only remedy (additional time) provided by that rule.[91]

RUCO also claims that it would have analyzed cost of capital and reconstruction cost differently if it had more time.[92] But RUCO provides no information about how its analysis would be affected in any way, or what different approaches it might have considered.[93] Moreover, questions about the legality of the "backing-in" method have been percolating for years, and RUCO has addressed the issue in several prior cases.[94] Regardless, UNS Gas recognized the timing issue by limiting its request to the amount in its original rate application.

The Company's approach is clearly lawful, although it is not the only possible lawful approach. The "backing-in" approach chosen by Staff and RUCO is clearly unlawful because it does not use fair value as required by the Arizona Constitution. The Company's approach is straightforward and should be adopted.

II. THE COMPANY'S PROPOSED RATE DESIGN INCORPORATES COSTOF-SERVICE AND REVENUE STABILITY WHILE REDUCING CROSS-SUBSIDIZATION AMONG CUSTOMERS.

Rate design is often considered as much an art as a science. Yet some fundamental principles should always be considered when designing rates. Cost-of-service and revenue stability are two of those principles. UNS Gas, through Mr. Erdwurm's testimony and as summarized in the Company's Initial Post-Hearing Brief, describes how the current monthly

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[89] Ex. S-32 (dated January 30, 2007); Ex. S-35 (dated April 2, 2007).
[90] A.A.C. R14-2-103(B)(11)(e)(i).
[91] Initial Closing Brief of RUCO at page 28, footnote 152; Ex. RUCO-6 at 4.
[92] Initial Closing Brief of RUCO at 27, citing Ex. RUCO-6 at 4.
[93] Ex. RUCO-6 at 4-5.
[94] *See Arizona-American Water Co.*, Decision No. 67093 (June 30, 2004) at 31-33; *Chaparral City Water Co.*, Decision No. 68176 (Sept. 30, 2005) at 26-28.

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residential customer charge ($7) is far below the actual fixed cost of providing service to residential customers ($26).[95] The current charge recovers just over a quarter of the Company's fixed costs of service.[96] The evidence also clearly shows that cold-climate customers subsidize those living in warmer climates, and often to a substantial degree.[97] The Company believes its proposed rate design appropriately takes cost-of-service into account while substantially reducing the level of subsidization by cold climate customers in favor of warm climate customers for the fixed costs of providing natural gas service. Since neither Staff nor RUCO takes these considerations into account, they appear to condone a continuation of the substantial cross-subsidies.

Staff argues that the Company's rate design violates principles of gradualism by touting the "staggering" *percentage* increase in the monthly customer charge. This argument ignores the relatively small *actual* increase in the monthly charge – about $10, on average. Staff further obfuscates the issue by ignoring the corresponding decrease in the volumetric charge per the Company's proposal.[98] In fact, the Company's proposal would result in a rate *decrease* for customers in cold climates who use 100 therms per month. The true percentage increases shown in Schedule H are nowhere near "staggering," and many customers – including those eligible for low-income assistance – will receive relatively minor increases.

Further, Staff does not dispute that gas utilities are in a fixed-cost business, as shown through the testimony of UNS Gas Witness Mr. Grant. [99] But UNS Gas' proposal is hardly a straight fixed variable rate design, as Staff suggests, because 40 to 45 percent of fixed distribution costs will still be recovered through volumetric rates under the Company's proposal. Staff provides no evidence to evaluate the percentage of fixed cost recovery through the monthly customer charge allowed for other utilities around the country. Finally, Staff says absolutely

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[95] Ex. UNSG-18 at 9; Ex. UNSG-19 at 12.
[96] Ex. S-27 at Ex. RCS-S1R; Ex. RUCO-5 at 28; Tr. at 700, 822.
[97] Ex. UNSG-18 at 8 and Ex. TLV-1; Ex. UNSG-19 at 10; Tr. at 704.
[98] See Staff's Opening Brief at 24-25 (portraying just the increase in monthly customer charges without any showing of the corresponding decrease in volumetric rates and the overall net rate impact under the Company's proposal.)
[99] Ex. UNSG-29 at 23, Ex. KCG-18 at 4.

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nothing about the need to reduce the subsidy cold-climate customers provide to warm-climate customers. Staff does not dispute that the Company's rate design reduces the impact of that subsidy.

RUCO's main argument is that recovering 36 percent through the monthly customer charge amounts to a fair compromise between Staff and the Company. But RUCO's monthly customer charge proposal is only $8.13 per residential customer – even less than what Staff proposes. Even so, 36 percent is hardly a compromise between Staff's proposal (only 30 percent) and the Company's proposal (roughly 60 percent). Mr. Erdwurm, who has 25 years of actual cost allocation and utility rate design experience, testified that 60 percent is an appropriate level of recovery of fixed costs through the monthly customer charge.[100] Staff Witness Mr. Ralph Smith testified that 50 percent recovery through the monthly customer charge could be reasonable.[101] Even the exhibits of Staff Witness Mr. Ruback justifies a monthly customer charge of *at least* $11.88.[102] That charge would recover about 45.7 percent of fixed distribution costs. This evidence clearly shows that monthly customer charge proposals of $8.50 (Staff) and $8.13 (RUCO) are not adequate.

There is no dispute that cold-climate customers currently subsidize warm-climate customers for fixed distribution costs associated with providing gas service. This will still occur under *any* of the rate design proposals. But there is no evidence to support statements about customers "choosing" to live in certain areas. While the Company's proposed rate design improves revenue stability, a perfectly appropriate rate design goal, it is not a "backdoor way to increase Company profits," as Mr. Magruder would suggest.[103] The Company could accept seasonal monthly charges of $11 (winter) and $20 (summer), or a year-round charge of $17 for residential customers. The Company supports its entire rate design proposal as fair and reasonable for *all* its

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[100] See Ex. UNSG-18 at 2; Tr. at 512.

[101] Tr. at 824.

[102] Ex. S-24 at 4-5 (assuming only customer costs are included in the monthly customer charge; as the Company shows, fixed costs entail far more than just customer costs.)

[103] *See* James C. Bonbright et. al., Principles of Public Utilities Regulation, 389 (Public Utilities Reports, Inc. 1988) (1961).

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customers and believes it balances important considerations like cost-of-service and revenue stability. Further, no party provides any evidence that conservation will be thwarted by the Company's proposal – especially given that the actual cost for natural gas hovers between 60 and 70 cents per therm.

In sum, the record and accepted rate design principles confirm that the Company's proposed rate design as reasonable and appropriate.

III. THE THROUGHPUT ADJUSTMENT MECHANISM PROVIDES FOR MORE STABLE REVENUES.

UNS Gas explained in its Initial Post-Hearing Brief that the Throughput Adjustment Mechanism ("TAM") frees the Company from depending on natural gas consumption to achieve its authorized ROR and maintain its financial integrity.[104] The TAM breaks the link between natural gas use and revenue recovery, encourages increased conservation measures and protects both the Company and its customers from over- or under-earning due to variations in usage caused by the weather. Moreover, because increased costs beyond the test-year cannot be recovered through the TAM, the Company still retains ample incentive to keep its costs down. Finally, the Company's TAM, and the reasons for the TAM, differ from the decoupling mechanism proposed by Southwest Gas in its most recent rate application (Docket No. G-01551A-04-0876).

Both Staff and RUCO continue to oppose the TAM. Staff argues that traditional ratemaking has not left the Company in poor financial health, that it already has decoupling mechanisms, and that the Commission has rejected other decoupling mechanisms. RUCO argues that UNS Gas is a Company with low business risk and that the TAM unduly strays from the historical test-year. Both Staff and RUCO appear willing to roll the dice and to allow UNS Gas to either over-earn or under-earn depending on the weather. They also believe the TAM will somehow reduce the incentive to conserve. Mr. Magruder, who also opposes the TAM, argues

[104] Initial Post-Hearing Brief of UNS Gas at 49-53.

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that transmission and distribution operational costs are dependent upon volumetric demand. The record does not support these arguments.

A. The TAM will improve financial integrity of the Company.

UNS Gas is not an entity with "low business risk." Specifically, high customer growth, increasing capital expenditures and high growth investment on a per-customer basis have contributed to the large revenue deficiency at UNS Gas.[105] While UNS Gas may ultimately derive some benefits from customer growth at some point in the future, the evidence is clear that this growth puts pressure on the Company and adversely impacts the Company's financial integrity.[106] Further, Mr. Grant cites Moody's Investors Service Special Comment from June 2006, which concludes that decoupling mechanisms help improve a utility's financial integrity:

> "LDCs (local distribution companies) that have, or soon expect to have, RD (revenue decoupling) stand a better chance than others in being able to maintain their credit ratings or stabilize their credit outlook in face of adversity. This difference between those companies that have RD and those that do not will tend to be further accentuated as the credit demarcation reflected through ratings actions becomes more evident."[107]

Mr. Grant has over 20 years experience performing financial analyses and preparing, financial forecasts in the utility industry. His testimony supports the fact that decoupling mechanisms, like the TAM, stabilize revenue and improve the financial integrity of utilities with such a mechanism. Further, Mr. Grant explained that while the Company's financial condition is improving, it still suffers from weak operating cash flows, large construction spending needs and a limited borrowing capacity.[108] Stabilizing revenue recovery through the TAM, to allow the Company a better opportunity to earn its authorized ROR, will improve UNS Gas' financial condition, which will be of benefit to both its present and future customers.

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[105] Ex. UNSG-28 at 5, 10-11, Ex. KCG-11.
[106] Id. at Ex. KCG-12.
[107] Ex. UNSG-29 at 23, Ex. KCG-18.
[108] Ex. UNSG-27 at 3-5.

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B. UNS Gas does not have a decoupling mechanism in place.

Although Staff infers that the Company already has a sufficient decoupling mechanism (the PGA) in place, the evidence does not support that inference. The TAM and the PGA serve different purposes. The PGA recovers gas costs that fluctuate constantly; the Company earns no return on these gas costs. And, unlike the TAM, the PGA is not designed to address any revenue shortfall or excess due to variations in usage. Further, the TAM does not increase rates to address increases in operating expenses, as does the PGA with respect to gas costs.

C. Arizona law does not prohibit the TAM's adoption.

Although the historical test-year (with appropriate pro forma adjustments) may be the established method to determine rates, the Arizona Constitution does not require its use. The Arizona Supreme Court has only stated that original cost can be considered a fair guide when establishing a fair value for rate base.[109] However, the *Simms* Court did not ban implementing a decoupling mechanism like the TAM in a rate case. Moreover, under RUCO's argument, all adjustor mechanisms are prohibited. But, under Arizona law, adjustor mechanisms are clearly lawful when adopted in a rate case. *See Scates v. Arizona Corp. Comm'n,* 118 Ariz. 531, 535-36, 578 P.2d 612, 616-17 (App. 1978). Contrary to RUCO's contentions, Arizona law does not prohibit implementing the TAM just because the Commission uses the historical test year as a starting point to establish just and reasonable rates.

D. The TAM provides symmetrical benefits.

Since all parties agree that the TAM will not recover additional distribution costs and expenses not established in the rate case, UNS Gas will retain ample incentive to control costs.[110] Indeed, Staff Witness Mr. Ruback admits that, even with the TAM in place, the Company would have to control its costs to avoid a drop in net income.[111] So the assertion that risk of recovery is

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[109] *See Simms v. Round Valley Power & Light Co.*, 80 Ariz. 145, 153, 294 P.2d 378 (1956); *see also Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 335 P.2d 412 (stating that there is no formula given for determining fair value and no mention of the historical test-year is mentioned); *Arizona Public Service Co. v. Arizona Public Service Co.*, 113 Ariz. 368, 555 P.2d 326 (1976) (permitting but not prescribing use of the historical test-year method as the formula in determining fair value).

[110] Ex. UNSG-19 at 14-15; Ex. UNSG-20 at 6.

[111] Tr. at 794.

removed with the TAM is not supportable in this case. Also, no party presents any evidence that the TAM will discourage conservation – especially considering that natural gas costs will likely remain at 60 to 70 cents per therm. In short, the arguments against the TAM cannot be supported by the evidence or Arizona law.

The TAM treats both the Company and its customers fairly. With the TAM in place, customers would not be at risk of overpaying the Company's fixed service costs during periods of colder-than-expected weather.[112] The Company, meanwhile, would be protected from unanticipated revenue shortfalls linked with unusually warm weather. Because the financial community supports revenue decoupling mechanisms as a way to protect utilities' financial integrity, they also provide the benefits associated with lower costs of attracting capital.[113] Finally, by reducing the Company's dependence on natural gas consumption to earn its authorized ROR, the TAM would align UNS Gas' financial interests with its conservation initiatives. For these reasons, the TAM supports important rate policy goals such as revenue stability and predictability and should be approved

IV. UNS GAS' DEMAND-SIDE MANAGEMENT PROGRAMS ARE APPROPRIATE AND ITS REQUEST TO INCLUDE COSTS FOR ITS BASELINE STUDY IS MODEST AND REASONABLE.

Staff argues that it needs additional time to consider the Company's Demand-Side Management ("DSM") program proposals to be able to "review the plan in detail" and "perform its own cost effectiveness evaluation."[114] The Company filed its program proposals in a separate docket (Docket No. G-04204A-07-0274) on May 4, 2007. The Company, however, also filed those proposals in this docket on March 23, 2007 to accommodate Staff's request to have them filed as soon as possible. That filing also accommodated Commissioner Mayes' request – made at the pre-hearing conference – to have the DSM programs approved in this case.[115] Although the Company requested approval of the programs in this docket,[116] its primary concern is to have a

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[112] Ex. UNSG 19 at 15.
[113] Ex. UNSG-29 at Ex. KCG-18 at 6.
[114] Staff's Opening Brief at 40.
[115] See April 13, 2007 Pre-Hearing Conference Transcript at 25:3-14. See also Tr. at 597-98.
[116] Ex. UNSG-15 (Gary Smith Direct) at 13, 17.

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DSM cost recovery mechanism adopted in this case. The Company has not changed its request, as Staff implies, and it desires to get these programs up and running as soon as possible.[117]

Staff also opposes including the costs of the baseline study ($82,000) in the initial DSM adjustor charge. As a result, Staff supports a DSM adjustor charge of $0.0025 per therm versus the Company's proposal of $0.0031 per therm.[118] No party disputes the necessity of the baseline study to thoroughly evaluate the effectiveness of DSM programs.[119] Staff argues that the baseline study costs *could* include costs for UNS Electric and TEP but does not provide any evidence to support that notion. By contrast, Ms. Smith testifies that the total cost of the baseline study for TEP, UNS Electric and UNS Gas is estimated at $370,000.[120] The cost related to UNS Gas for the baseline study is $82,000.[121] Since Staff supported the inclusion of $4.385 million for DSM at Southwest Gas and $16 million for DSM at Arizona Public Service Company before detailed program proposals were approved for those utilities, it is difficult to understand Staff's position on UNS Gas' request to include baseline study costs for UNS Gas in its DSM adjustor charge. This is especially troubling because UNS Gas has made major concessions on the DSM charge – agreeing to only 25 percent of its actual costs for new DSM programs ($230,000) plus the costs for the expanded Low-Income Weatherization ("LIW") programs ($113,400) in its initial surcharge.

Indeed, ample support exists in the record to allow the Commission to fund UNS Gas' entire request for DSM programs in this case – $1,051,616 – through the DSM adjustor. UNS Gas' proposed DSM programs are supported by multiple tests, including Staff's Societal Cost Test, the Participant Test, the Total Resource Cost Test, and the Ratepayer Impact Measure test. The evidence further confirms that UNS Gas' existing and proposed DSM programs are effective programs backed by solid management, despite unsupported remarks to the contrary by Mr. Magruder. The Company is working with local groups and providing training to those city and

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[117] Tr. at 554-55.
[118] Staff's Opening Brief at 39; UNSG-22 at 3; Tr. at 554.
[119] Ex. UNSG-21 at 9.
[120] Ex. UNSG-22 at 2.
[121] Id.

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county inspectors who desire such assistance.[122] At a minimum, the Commission should approve the cost underlying the initial DSM surcharge and the surcharge itself.

V. THE COMPANY'S LOW-INCOME PROPOSALS ARE REASONABLE AND APPROPRIATE.

Because the other parties did not speak to low-income issues in their initial briefs, the Company simply reiterates its belief that its CARES discount, and its requests related to other low-income customer issues, are supported in the record in this case, as set forth in its Initial Post-Hearing Brief.[123]

VI. UNS GAS' PROPOSED CHANGES TO ITS RULES AND REGULATIONS ARE REASONABLE.

First, although RUCO argues against the Company's proposed changes to its billing terms, there is no dispute that the Company's changes fully comport with A.A.C. R14-2-310.C. Moreover, in response to a concern raised by RUCO, the earliest gas service can be shut off is *at least* 30 days after a bill is received. Any customer who takes an extended vacation could make arrangements with UNS Gas to make a payment and avoid termination of service. To ameliorate the impact of this change, the Company has agreed to a six-month transition period before the change in billing terms take effect.[124]

Second, no party addressed UNS Gas' proposed changes to its line extension procedures. UNS Gas stands by its original proposals as significant improvements in line with Commission policy goals and objectives.[125]

Finally, the Company believes all of its proposed changes to its Rules and Regulations, including its changes to subsection 11.B.1.d, make them reader-friendly, accurate and helpful to customers. While the Company would be willing to translate the Rules and Regulations into Spanish, providing a hard copy to each customer, as suggested by Mr. Magruder, would be

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[122] Tr. at 537-38, 542-44.
[123] Initial Post-Hearing Brief of UNS Gas at 55-58.
[124] Ex. UNSG-17 at 2.
[125] Initial Post-Hearing Brief of UNS Gas at 58-60 for the Company's position on this issue.

ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

extremely costly to the ratepayer.[126] The Rules and Regulations are publicly available through the Company's and the Commission's Web sites.[127] The Company requests approval of its proposed changes of its Rules and Regulations.

VII. UNS GAS' PURCHASED GAS ADJUSTOR PROPOSALS SMOOTH VOLATILITY IN GAS PRICES, SEND ACCURATE PRICE SIGNALS TO CUSTOMERS, AND REFLECT THE COMPANY'S ACTUAL COSTS OF BORROWING.

Two disputed issues remain on the PGA. First, with respect to bandwidth, the Company believes only one smoothing mechanism (the 12-month rolling average) is needed and that a bandwidth overly dilutes the price signals customers need to receive for the gas costs they incur.[128] UNS Gas, however, believes the 20-cents-per-therm bandwidth proposed by RUCO represents a reasonable compromise among the Parties and should be adopted in the alternative.

Second, with respect to the appropriate level of interest on the PGA bank balance, the record provides:

- The London Inter-Bank Offered Rate ("LIBOR") plus one percent reflects UNS Gas' actual cost of borrowing under its revolving credit facility; it reflects the actual interest rate UNS Gas must pay to borrow funds to buy the natural gas customers demand.[129]
- That the PGA bank balance cannot be considered a short-term asset on the Company's balance sheet, once the balance exceeds two-times the Commission's threshold; it becomes more like working capital and requires commitment of longer-term investment capital. The weighted average cost of capital is the appropriate measure of carrying cost for this type of investment.[130]

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[126] Ex. UNSG-17 at 7-8.
[127] Id.
[128] Ex. UNSG-5 at 2-3; Tr. at 174.
[129] Ex. UNSG-4 at 7; Ex. UNSG-5 at 5 (noting the change in the revolving credit facility interest rate from LIBOR plus 1.5 percent to LIBOR plus 1 percent.)
[130] Ex. UNSG-4 at 8.

ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

Further, Mr. David Hutchens testified that the changing circumstances, and particularly the increased volatility of natural gas markets, justifies the need to change the approach about the interest rate for the PGA bank balance:

> While the interest rates may have been historically designed to reflect the LDC's expected cost of borrowing, the size, duration and one-directional nature of bank balances that the LDC's have seen over the last several years were likely not envisioned at the time the PGA mechanism was developed. It was anticipated that the bank balance would fluctuate around zero with no significant mismatch in over- and under-recovery periods. Therefore, any mismatch that did occur would be insignificant. In order to prevent the LDC from incurring costs that it cannot recover, the interest rate on the bank balance should reflect its cost of borrowing.[131]

Moreover, regardless of the interest rate, the Company still has incentive to rid itself of these balances. Staff never explains its assertion that the Company would not seek to reduce bank balances in a timely fashion. Staff's argument is especially odd considering the interest rate would apply symmetrically to both over- and under- collections. Customers would receive the benefit of the Company's proposal for over-collected balances. For these reasons, the revised interest rate should be approved.

VIII. THE COMPANY REQUESTS APPROVAL OF ITS PRICE STABILIZATION POLICY.

Staff devotes a significant amount of paper to argue against approval of the Price Stabilization Policy, ostensibly because it is opposed to insulating hedging policy and purchases from subsequent prudence reviews. Most troubling, though, is Staff's implication that "one leg of the proverbial milk stool" is the objective of getting the lowest possible costs.[132] Clearly, the Company strives to achieve the lowest possible cost that it can for its customers, but the main goal of its Price Stabilization Policy is, and should be, to mitigate volatility and stabilize natural gas prices that customers ultimately pay.[133] It would be dangerous and inappropriate to suggest that a

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[131] Ex. UNSG-5 at 6.
[132] Staff's Opening Brief at 31; Tr. at 744-45.
[133] Tr. at 129.

ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

goal of UNS Gas' Price Stabilization Policy should be to "beat the market."[134] UNS Gas is not clairvoyant, and it should not be required to be so if the Commission approves the Price Stabilization Policy. This concern was emphatically echoed by both Mr. Pignatelli and Mr. Hutchens for UNS Gas.[135] UNS Gas should not be compelled to predict what the lowest prices will be in the future, and then be penalized unfairly when its predictions may not become reality.

IX. CONCLUSION.

UNS Gas respectfully requests that the Commission issue a final order granting the relief requested by UNS Gas in this case, as set forth in its Initial Post-Hearing Brief.

RESPECTFULLY SUBMITTED this 19th day of June 2007.

UNS Gas, Inc.

By _____

Michael W. Patten
Timothy J. Sabo
ROSHKA DEWULF & PATTEN, PLC.
One Arizona Center
400 East Van Buren Street, Suite 800
Phoenix, Arizona 85004

and

Raymond S. Heyman
Michelle Livengood
UniSource Energy Services
One South Church Avenue
Tucson, Arizona 85701

Attorneys for UNS Gas, Inc.

ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

[134] If it is made clear that that is not the objective, then a finding stating that UNS Gas will not be obligated to and evaluated on whether it has "beat the market" is entirely appropriate and necessary.
[135] Tr. at 121-22; Ex. UNSG-4 at 7; Ex. UNSG-5 at 10-11.

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Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copy of the foregoing hand-delivered this 19th day of June, 2007, to:

Chairman Mike Gleason
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner William A. Mundell
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Jeff Hatch-Miller
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Kristen K. Mayes
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Gary Pierce
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Dwight D. Nodes, Esq.
Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Christopher Kempley, Esq.
Chief Counsel, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Ernest Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800

Scott Wakefield
Residential Utility Consumer Office
1110 West Washington, Suite 220
Phoenix, Arizona 85007

Cynthia Zwick
Arizona Community Action Association
2700 North 3rd Street, Suite 3040
Phoenix, Arizona 85004

Marshall Magruder
P. O. Box 1267
Tubac, Arizona 85646

By Mary Ippolito

ROSHKA DEWULF & PATTEN, PLC
ONE ARIZONA CENTER
400 EAST VAN BUREN STREET - SUITE 800
PHOENIX, ARIZONA 85004
TELEPHONE NO 602-256-6100
FACSIMILE 602-256-6800