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BEFORE THE ARIZONA CORPORATION C

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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
 CORPORATION COMMISSION.

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

**STAFF'S NOTICE OF ERRATA AND
ADDITIONAL AUTHORITY**

Staff files this Notice of Errata and Additional Authority as it inadvertently left out the
 information and supporting authority. The new addition can be found on page 31, lines 16 through
 23.

RESPECTFULLY SUBMITTED this 21st day of June, 2007.

Maureen A. Scott, Senior Staff Counsel
 Keith A. Layton, Staff Attorney
 Legal Division
 Arizona Corporation Commission
 1200 West Washington Street
 Phoenix, Arizona 85007
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BEFORE THE ARIZONA CORPORATION COMMISSION

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JUNE 21, 2007

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1 **I. INTRODUCTION**

2 UNS Gas has not met its burden of proof supporting either the magnitude of its requested rate
3 increase or the changes it proposes to its rate design to achieve that increase. The Company's
4 proposals are designed to chip away at the "historic" test year, and to improve its financial
5 performance beyond that to which it is entitled under Commission rules by placing more financial
6 burden on ratepayers.

7 **II. DISCUSSION**

8 **A. UNS Gas has not Met its Burden of Proof on its Requested Rate Increase.**

9 **1. The Company's Projected Growth Rate Does Not Justify UNS Gas'**
10 **Proposal Regarding CWIP in Rate Base.**

11 As the Staff pointed out in its Initial Brief, UNS Gas proposes to include \$7.189 million of
12 Construction Work in Progress ("CWIP") in rate base.¹ There is no doubt under Arizona law, that the
13 Commission has the discretion to include CWIP in rate base as the Company argues.² However,
14 under well established ratemaking principles, inclusion of CWIP in rate base is the exception, not the
15 rule. The question that needs to be asked then is does the Company meet the criteria for
16 extraordinary treatment of CWIP. Staff's position is that the Company does not meet these criteria.

17 One of the few instances where the Commission has authorized CWIP in rate base was in
18 1984 when the Commission allowed Arizona Public Service Company ("APS") to include CWIP
19 associated with the Palo Verde nuclear plant in its rate base.³ However, there were extraordinary
20 circumstances facing APS at that time related to the tremendous investment in Palo Verde and its
21 associated CWIP balance. Because of those extraordinary circumstances the Commission was guided
22 more by "the economic benefits to ratepayers from further CWIP inclusion and the avoidance of 'rate
23 shock' in the APS service territory."⁴ The Commission was apparently dealing with approximately
24 \$600 million in CWIP associated with Palo Verde. From the evidence presented in that case the
25 Commission determined that inclusion of CWIP in that case would "substantially reduce costs which

26 _____
¹ Staff Opening Brief at p. 2-5.

27 ² See *Arizona Community Action Association v. Arizona Corporation Commission*, 599 P.2d 184 (1979); UNS Gas Initial
Post-Hearing at p. 11.

28 ³ See *In Re Arizona Public Service Company*, Decision No. 54247, 64 P.U.R.4th 147 (Nov. 28, 1984).

⁴ Decision No. 54247, at p. 19.

1 would otherwise be properly chargeable to ratepayers.”⁵ That the Commission viewed inclusion of
2 some CWIP in APS’ rate base to be appropriate given the extraordinary circumstances in the case.

3
4 Even if the commission were to accept RUCO’s and CREE’s estimates
5 for the total value of Palo Verde, we are still faced with nearly doubling
6 APS’ rate base in little over two (2) years. Unless substantial efforts
7 are made to phase in this tremendous investment over a longer period,
8 the APS service territory faces a significant potential for economic
9 disruption. CWIP inclusion is the logical first step for such a phase-in.
10 Indeed, any commission which contemplates some sort of rate
11 moderation program involving a postcommercialization phase-in of
12 plant investment (a clear violation of the ‘used and useful’ doctrine)
13 should equally consider beginning its program during the
14 precommercialization phase of construction, i.e., DWIP. This will
15 spread the increase over an even longer period of time without
16 accumulating the substantial level of deferred costs which ordinarily
17 accompanies delays in recognizing plant investment.

18
19 In consideration of the above discussion, we find that an additional
20 \$200 million in PV-I CWIP should be included in APS’ “fair value”
21 rate base. Although this still leaves some \$400 million in PV-I costs to
22 be addressed upon the in-service date of that facility (as well as the
23 costs of PV-II and PV-III), any greater amount might tend to cause rate
24 shock today in an effort to avoid it tomorrow.⁶

25
26 This case, in turn, has none of the attributes of the APS case in which CWIP was allowed.
27 The investment at issue is approximately \$7 million as opposed to \$200 million of a total CWIP
28 balance of \$600 associated with the PV plant in the APS case. Moreover, certainly inclusion of the
29 \$7 million does not raise the same concerns of “rate shock” as inclusion of \$200 million or \$600
30 million, over two years, the scenario the Commission was presented with in the APS case. It is small
31 wonder in the APS case that the Commission desired to ameliorate the impact upon ratepayers with
32 \$600 million in rate base ultimately at issue.

33
34 In addition, the Commission noted in the APS case, that it was exceptional to include CWIP
35 in rate base, and that it was generally only done as a means of addressing critical cash-flow problems
36 for public service corporations or to prevent certain types of earnings attrition.⁷ In this case, the
37 Company has no cash flow problems. The lead-lag study indicates that operations are providing a
38 source of cash flow to the utility.

39
40 _____
41 ⁵ *Id.*

42 ⁶ Decision No. 54247 at p. 20.

43 ⁷ Decision No. 54247 at p. 19.

1 Furthermore, it is the Company, not Staff, the Commission or RUCO, that chooses the test
2 year. UNS Gas could have waited and chosen a later test year; it is not in a dire financial crisis which
3 necessitated it seeking an immediate increase in rates. This is evidenced by the fact that the overall
4 increase in revenues requested by the Company is only 7%. Here the Company appears to requesting
5 that the Commission include CWIP in rate base only to improve its financial performance. Allowing
6 CWIP to improve financial performance would ultimately lead to the exception swallowing the rule.

7
8 **2. The Company's Prior Accounting for GIS Costs Makes its Inclusion in
Rate Base at this Time Unreasonable.**

9 The Company acknowledges in its Opening Brief that the costs associated with the
10 Geographic Information System ("GIS") should be expensed unless the Commission authorizes a
11 deferral.⁸ The Company also acknowledged that "[a]ll parties agree that approval of a deferral would
12 be needed because GIS costs ordinarily would be treated as expenses."⁹

13 The Company did not obtain a deferral from the Commission. Therefore, the Company
14 should not be allowed to now treat the GIS costs as a regulatory asset.

15 Further, Staff Witness Smith testified that a review of the Company's October 3, 2005 memo
16 and the supporting documentation provided by UNS Gas, lead Staff to believe that the deferred GIS
17 costs were not an appropriate rate base item, do not qualify as a "regulatory asset," were not pre-
18 approved for deferral by the Commission, are non-recurring costs that should have largely been
19 expensed by the Company in periods prior to the 2005 test year, and therefore are not appropriate to
20 include in test year rate base.¹⁰ These expenses have almost all been expensed by the Company in
21 periods prior to the 2005 test year and therefore are not appropriate to include in the test year rate
22 base.¹¹

23 The Company asks the Commission to disregard the accounting treatment of GIS costs to-
24 date, ignore the fact that it did not seek pre-approval for a deferral as it was required to do, and
25 ignore the fact that almost of the costs associated with GIS have already been expensed, because it
26

27 ⁸ UNS Gas Initial Post-Hearing Brief at 11.

⁹ UNS Gas Initial Post-Hearing Brief at p. 11.

28 ¹⁰ Ex. S-27 (Smith Surrebuttal) at 19.

¹¹ *Id.*

1 made a "mistake."¹² The customers of the Company should not be held responsible for the
2 Company's past mistakes.

3
4 **3. Certain of UNS Gas' Proposed Revenue and Expense Adjustments are Not Appropriate.**

5 **a. The Company's Revenue Annualization Adjustment is Skewed in its Favor.**
6

7 UNS Gas also argues that due to its cyclical growth pattern, the traditional, "simplistic"
8 annualization method should be rejected in favor of a "slightly more advanced mathematical model
9 based on the exponential growth model."¹³ The Company argues that given the seasonal nature of a
10 significant portion of its customer base, the traditional method used to annualize customer
11 adjustments utilized by Staff and RUCO is not as accurate as the Company's proposed
12 methodology.¹⁴

13 Staff Witness Ralph Smith testified that it was unnecessary for the number of customers to
14 grow in stair-step fashion for the traditional approach to be valid for rate-making purposes.¹⁵ What is
15 important is that the growth that occurred during the test year is matched with the other elements of
16 the ratemaking formula, including year-end plant in service, etc.¹⁶

17 In addition, the Company's "slightly advanced mathematical model" suffers from some pretty
18 significant flaws. The traditional method utilized by Staff and RUCO is straight-forward and
19 transparent so that other parties can follow the calculations and results and reproduce them without
20 difficulty.¹⁷ The calculations produced by the Company's "slightly advanced mathematical model"
21 which applied percentage growth factors instead of customer bill counts, were difficult to follow
22 especially with respect to being able to verify percentages used. The Company's model actually
23 appears to understate growth.¹⁸

24 ...

25
26 ¹² UNS Gas Initial Post-Hearing Brief at p. 11.

¹³ UNS Gas' Initial Post-Hearing Brief at 18.

¹⁴ UNS Gas' Initial Post-Hearing Brief at 18.

¹⁵ Ex. S-27 (Smith Surrebuttal) at 21.

¹⁶ *Id.*

¹⁷ Ex. S-27 (Smith Surrebuttal) at 24.

¹⁸ Ex. S-27 (Smith Surrebuttal) at 24.

1 **b. Rate Case Expense Should be Reduced as Recommended by Staff**
2 **and RUCO.**

3 UNS Gas argues that its request for \$900,000.00 in rate case expense is reasonable.¹⁹ In its
4 Rebuttal Testimony the Company provided two reasons for the amount of this expenditure including:
5 1) that the organization is going through the first rate for UNS Gas and is thus having to research and
6 address all issues for the first time; 2) the volume, complexity and magnitude of data requests from
7 Staff, RUCO and other intervenors.”²⁰

8 Staff Witness Ralph addressed both of the two justifications proffered by the Company in his
9 Surrebuttal Testimony. Mr. Smith testified that the transfer of ownership should not be an excuse for
10 charging ratepayers for what appear to be excessive amounts of rate case cost.²¹ In addition, the
11 Southwest Gas rate case raised many of the same issues that are being raised by UNS Gas in this
12 case, with the Commission approving far less in rate case expense. Southwest Gas is also a larger
13 utility.

14 Staff Witness Ralph Smith testified that the recent Southwest Gas rate case actually provides
15 a reasonable benchmark for what a reasonable allowance for rate case cost should be in the current
16 UNS Gas rate case.²² The amount requested by UNS Gas is over 3.8 times as high as the amount of
17 rate case expense allowed by the Commission in the Southwest Gas case.²³

18 The Company claims that the comparison with Southwest Gas is not appropriate because of
19 the different accounting methods used by UNS Gas and Southwest Gas.²⁴ However, the record is
20 simply not clear and there is simply not sufficient evidence in the record to support UNS Gas’
21 contention that Southwest Gas, due to its accounting allocation methods, had a lot of hidden rate case
22 expense that it did not identify or did not seek recovery of in its most recent rate case.²⁵ It is not
23 known whether Southwest Gas attempted to identify its rate case expense separately for Arizona and
24

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26 ¹⁹ UNS Gas’ Opening Brief at 21-23.

27 ²⁰ Ex. UNSG-13 (Dukes Rebuttal) at 34.

28 ²¹ Ex. S-27 (Smith Surrebuttal) at 43.

²² Ex. S-27 (Smith Surrebuttal) at 43.

²³ *Id.*

²⁴ UNS Gas’ Initial Post-Hearing Brief at 22.

²⁵ See UNS Gas’ Initial Post-Hearing Brief at 22.

1 included that in its case or whether some rate case expense was included as overhead, as UNS Gas
2 claims.²⁶

3 The Company also heavily relies upon the number of data requests promulgated in this case as
4 opposed to the Southwest Gas case.²⁷ However, as Staff Witness Smith testified, the Commission
5 needs to consider more factors than the number of data requests sent in any given case.²⁸ The
6 Commission also needs to consider the similarity of the utilities and the type of issues that are being
7 addressed.²⁹

8 UNS Gas also complains that Staff developed its position "on-the-fly" and waited until its
9 Surrebuttal Testimony to comment on the issue.³⁰ This is a curious comment given that UNS Gas
10 significantly increased the amount of proposed rate case expense it was requesting in its Rebuttal
11 Testimony. Moreover, the Staff positions that UNS Gas complain were developed by Staff "on-the-
12 fly" were actually responses to questions posed by UNS Gas itself at the hearing. Certainly, Staff
13 has the right to respond to questions posed at the hearing and is not required to limit its responses to
14 its pre-filed testimony in the case.

15
16 **c. The Company's Request for an Accounting Order for its El Paso**
17 **Proceeding Expenses Was First Made in its Initial Brief and**
18 **Should Not be Considered in this Proceeding.**

19 At page 64 of its Initial Post-Hearing Brief, UNS Gas makes the following request:

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

27 This request should be denied for several reasons. First, it was not presented in UNS Gas' testimony,
28 but is being raised for the first time in the Company's Brief.

26 *Id.*

27 UNS Gas Initial Post-Hearing Brief at 23.

28 Tr. Vol. 5 at 901-02.

29 *Id.*

30 UNS Gas Opening Brief at 23.

1 Second, the request is based upon a mistaken premise, i.e., that FERC legal expense is being
2 disallowed. While Staff and RUCO have both recommended adjustments to the level of FERC legal
3 expense that UNS Gas incurred in the test year, it is clear that the adjustment proposed by Staff and
4 the similar adjustment proposed by RUCO is a normalization. The purpose of such adjustment is to
5 remove a level of nonrecurring expense such that the expense remaining in the test year reflects a
6 normal ongoing level. Moreover, neither Staff nor UNS Gas itself proposed shifting rate recovery of
7 FERC legal expense from base rates into a deferral account for recovery through the Company's
8 PGA.

9 Third, the legal expense is not part of the Company's cost of gas. The expense is recorded in
10 Account 923, outside services, and not in a gas cost account. Such expense should not be shifted into
11 the PGA, and especially not without a full and complete record examining the ramifications of such a
12 shift.

13 Fourth, it is clear from the record that not all FERC pipeline rate case expense has been
14 removed from operating expenses in the test year.³¹ Consequently, the request by UNS Gas to "allow
15 all legal expenses related to FERC gas rate cases to be included in the cost of gas covered by the
16 PGA" is clearly improper and would double-recover the amount of such costs that has been
17 unadjusted by Staff and RUCO which thus remains in base rates. Double-charging UNS Gas
18 ratepayers for legal expense should not be permitted.

19 Fifth and finally, Staff is aware of no other gas utility operating in the state for which the
20 Commission has granted similar authority. UNS Gas's brief cites no authority or precedent for
21 granting such an extraordinary ratemaking treatment. This request by UNS Gas is highly
22 inappropriate and should be denied for the reasons stated above.

23
24 **d. Disallowance of Part of the Company's Claimed Expenses related**
25 **to Incentive Performance Plans Is Justified by Prior Commission**
26 **Orders.**

26 The Company argues that its Performance Enhancement Program ("PEP") is "part of its cost
27 of service" and that there are no grounds to disallow it.³² The structure of the Company's PEP

28 ³¹ See, e.g., Ex R-5 (Diaz Cortez' Direct) at 21; Ex R-6 (Diaz Cortez Surrebuttal) at 14.

³² UNS Gas Initial Post-Hearing Brief at 26.

1 determines eligibility for certain bonus levels by measuring Unisource Energy Services' ("UES") (the
2 subsidiary of UniSource Energy Corporation and the parent company of UNS Gas) performance in
3 three areas: (1) financial performance; (2) operational cost containment; and (3) core business and
4 customer service goals.³³

5 The Commission has found in prior Orders that where the Incentive Performance Plan
6 benefits both shareholders and ratepayers, the costs of such plan should be shared equally among
7 both groups.³⁴ In the most recent Southwest Gas case, the Commission found:

8
9 In Decision No. 64172, the Commission adopted Staff's
10 recommendation regarding MIP expenses based on Staff's claim that
11 two of the five performance goals were tied to return on equity and thus
12 primarily benefited shareholders. We believe that Staff's
13 recommendation for an equal sharing of the costs associated with MIP
14 compensation provides an appropriate balance between the benefits
15 attained by both shareholders and ratepayers. Although achievement of
16 the performance goals in the MIP, and the benefits attendant thereto,
17 cannot be precisely quantified there is little doubt that both
18 shareholders and ratepayers derive some benefit from incentive goals.
19 Therefore the costs of the program should be borne by both groups and
20 we find Staff's equal sharing recommendation to be a reasonable
21 resolution.³⁵

22 The same reasoning applies in this case. A review of the performance indicators or targets
23 shows that at least two of those directly benefit shareholders; i.e., financial performance and
24 operational cost containment. Therefore, shareholders should share in the costs of such a program.
25 Staff Witness, Ralph Smith testified "In terms of whether the cost of the UNS Gas incentive
26 compensation under the company's PEP plan should be similarly allocated between shareholders and
27 ratepayers, I see no meaningful distinction in the UNS Gas situation that would require a different
28 ratemaking treatment than the 50/50 sharing applied by the Commission in the SWG rate case."³⁶

29 UNS Gas also argues that if the PEP were eliminated, base salaries would have to be
30 increased in order for UNS Gas to attract and retain the necessary employees.³⁷ But, there is
31 nothing in the record which would substantiate the Company's anecdotal statements that employee

32
33 Ex. S-25 at (Smith Direct) 24.

34 See Decision No. 64172 at p. 11-12; Decision No. 68487 at 17-18.

35 Decision 68487 at 18.

36 Ex. S-25 (Smith Direct) at 29.

37 UNS Gas Initial Post-Hearing Brief at 26.

1 salaries would increase. Nor did the Company provide any basis for its statement that “similar
2 programs are standard practice at most companies.”³⁸ There is also evidence in the record that the
3 alleged advantages over base pay rate increases identified by the Company are overstated. The
4 Company claims that the financial goals contained in the PEP provide enhanced motivation for better
5 performance as compared to increased base compensation.³⁹ Staff Witness Ralph Smith testified
6 that the Company’s actual recent payouts under the Plan, call into question how real the “at risk”
7 feature of the PEP is in practice.⁴⁰

8 As explained by the Company in response to STF 11.5(b):

9
10 ...the financial performance goal, which was a trigger under the PEP
11 program for UNS electric, UNS Gas and Tucson Electric Power
12 Company (“TEP), was not met. The financial performance goal was
13 not met, in part, because of unplanned outages at the coal generating
14 unites which required TEP to purchase power on the open market. In
15 discussions with the board of directors, the desire was to recognize
16 employee achievements distinct from financial measures. The board
17 deemed it appropriate to implement a special recognition award to
18 employees for achievements in 2005. Normally, PEP is paid at 50% to
19 150% of target, the special recognition award was paid at
20 approximately 42% of the target for each of the operating companies.⁴¹

21 Like Southwest Gas, UNS Gas also has a Supplemental Executive Retirement Plan (“SERP”).
22 The Company argues that the Commission’s recent Southwest Gas decision disallowing SERP costs
23 should not apply to UNS Gas because the decision was issued after the test year in this case.⁴² Staff
24 is not aware of any requirement that a Commission decision cannot apply to a case unless that
25 decision was issued before the test year selected by the Company. The costs associated with SERP
26 have oftentimes been at issue in cases that come before the Commission before the test year selected
27 by the Company. The Commission is not bound by prior determinations but may change course if it
28 provides a rational basis for doing so.

29 UNS Gas also argues that the Internal Revenue Code should not dictate which compensation
30 costs should be recovered.⁴³ But, as Staff Witness Smith pointed out, typically SERPs provide for

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38 UNS Gas Initial Post-Hearing Brief at 26 (citing UNSG-13 at 9).

39 UNS Gas Initial Post-Hearing Brief at 27.

40 Ex. S-27(Smith Surrebuttal) at 28.

41 Ex. S-27 (Smith Surrebuttal) at 28.

42 UNS Gas Initial Post-Hearing Brief at 28.

43 UNS Gas Initial Post-Hearing Brief at 29.

1 retirement benefits in excess of the limits placed by IRS regulations on pension plan calculations for
2 salaries in excess of specified amounts. The Commission found in the Southwest case, that if the
3 Company provided additional retirement benefits above those allowed under IRS regulations, its
4 shareholders, not ratepayers, should shoulder the burden of those.

5 The Commission stated the following in its Southwest Gas Order:

6
7 Although we rejected RUCO's arguments on this issue in the
8 Company's last rate proceeding, we believe that the record in this case
9 supports a finding that the provision of additional compensation to
10 Southwest Gas' highest paid employees to remedy a perceived
11 deficiency in retirement benefits relative to the Company's other
12 employees is not a reasonable expense that should be recovered in
13 rates. Without SERP, the Company's officers still enjoy the same
14 retirement benefits available to any other Southwest Gas employee and
15 the attempt to make these executives "whole" in the sense of allowing a
16 greater percentage of retirement benefits does not meet the test of
17 reasonableness. If the Company wishes to provide additional
18 retirement benefits above the level permitted by IRS regulations
19 applicable to all other employees it may do so at the expense of its
20 shareholders. However, it is not reasonable to place this additional
21 burden on ratepayers."⁴⁴

22 Staff Witness Smith also found no material differences between the Southwest Gas SERP
23 Plan which disallowed by the Commission and the UNS Gas Plan. Accordingly, the Commission
24 should disallow the costs associated with UNS Gas' SERP Plan in their entirety.

25 **e. UNS Gas' proposed property tax expense fails to reflect the known
26 and measurable change in tax law affecting the assessment ratio.**

27 Pages 19-20 of UNS Gas' Brief address property tax expense. The Arizona State Legislature
28 passed House Bill No. 2779 which set a new rate schedule for property tax assessments. The new
29 assessment rate schedule provides for decreasing the 25 percent rate applicable in 2005 in 0.5 percent
30 steps each year until a 20 percent rate is attained in 2015. The Company's calculation used a 24.5
31 percent assessment rate and thus fails to recognize the impact of this known tax change prospectively.
32 The adjustment proposed by Staff (and RUCO) for property tax expense is necessary to reflect the
33 known statutory assessment ratio of 24 percent applicable for 2007.⁴⁵ Reflecting the impact of this
34 known and measurable change in tax law is appropriate, and is fully consistent with the final

35 ⁴⁴ Decision No. 68487 at 19.

36 ⁴⁵ Ex. S-26 (Smith Surrebuttal) at p. 35.

1 positions taken by all parties (the utility, Staff and RUCO) in the recent Southwest Gas rate case, as
2 summarized in the following table:

3	Utility:	UNS Gas, Inc.	Southwest Gas Corp.
4	Docket:	G-04204A-06-0463	G-01551A-04-0876
	Test Year Ended:	December 31, 2005	August 31, 2004
5	New Rates Effective:	mid-2007	Order issued 2/23/06
	Estimated Filing Interval:	3 years	3 to 4 years
6	Assessment Rate Used:	24 percent	24.5 percent
	Corresponding Effective Year:	2007	2006

7
8 **f. Staff's recommended postage expense adjustment reasonably
reflects all known and measurable changes and should be adopted.**

9 Page 30 of UNS Gas' Brief claims that Staff's adjustment for postage expense should be
10 rejected because of "several errors." However, UNS Gas fails to recognize that Staff's recommended
11 postage adjustment was revised to eliminate all such perceived "errors" in surrebuttal. Moreover,
12 Staff's adjustment was further refined in surrebuttal to also include the known and measurable impact
13 of the May 2007 postage expense increase, which was not reflected by UNS Gas. As explained in his
14 surrebuttal testimony, Staff Witness Ralph Smith accepted \$445,171 as the appropriate starting point
15 for the calculation, as discussed in UNS Gas Witness Dukes' rebuttal testimony at pages 19-20. This
16 produces an annualized postage expense of \$476,960. An annualized postage expense of \$476,960
17 properly recognizes the postage expense increase that occurred on January 8, 2006 and the customer
18 growth that occurred during the 2005 test year. Staff also reflected the known and measurable May
19 14, 2007 postage increase that raised the cost of a first class letter from \$0.39 to \$0.41. Staff
20 recommends allowing annualized postage expense of \$503,356. The adjustment to the \$529,380
21 amount in the UNS Gas filing would be a decrease of \$26,024.

22 The Company's proposal to compare 2006 postage expense is misplaced and inappropriate
23 because the 2006 expense reflects the impact of additional customer growth beyond the end of the
24 test year that has not been recognized in revenues. Customer growth has only been reflected through
25 December 31, 2005, the end of the test year. Reflecting increased postage expense related to post-test
26 year growth in the number of customers without reflecting the related additional revenues is
27 inappropriate and should be rejected.⁴⁶

28 ⁴⁶ Ex. S-27 (Smith Surrebuttal) at 39.

1
2 **g. UNS Gas Has Failed to Meet its Burden of Proof Concerning**
3 **Industry Association Dues, and the Commission Should Therefore**
4 **Adopt Staff's Recommended Adjustment.**

5 Page 31 of UNS Gas's Brief addresses American Gas Association dues and misstates the
6 basis for Staff's recommended adjustment. UNS Gas has failed to meet its burden of proof
7 concerning industry association dues, and the Commission should therefore adopt Staff's
8 recommended adjustment. As explained in the Surrebuttal Testimony of Ralph Smith, Staff agrees
9 with RUCO that the marketing and lobbying-related portion of the AGA dues should definitely be
10 removed from rates. However, Staff disagrees with UNS Gas that an adjustment limited to only the
11 marketing and lobbying portion of AGA dues is sufficient to fully remove the portions of AGA dues
12 that should not be charged to ratepayers. In the recent Southwest Gas rate case, Decision No. 68487,
13 at page 14, after having removed the portion of the AGA dues directly attributable to marketing and
14 lobbying, Southwest Gas was found to have demonstrated that the remainder of the AGA dues should
15 be recoverable as legitimate test year expenses. However, in that Order, of which UNS Gas should
16 have been aware, the Commission also provided a clear directive (at page 14 of that order) by stating
17 that: "in its next rate case filing the Company should provide a clearer picture of AGA functions and
18 how the AGA's activities provide specific benefits to the Company and its Arizona ratepayers." This
19 directive to Southwest Gas should have put UNS Gas on notice concerning the type of information
20 the Commission would expect them to produce in a rate case in order to justify the inclusion of AGA
21 dues in rates.

22 In the current rate case, UNS Gas has not produced such information. Staff asked UNS Gas
23 discovery to try to obtain such information, and it was not provided by UNS Gas. As illustrative
24 examples, the Company's response to STF 5.62(c) stated: "The Company did not receive any
25 materials from the AGA specifying what percentage of their expenses is dedicated to lobbying or
26 advocacy activities. UNS Gas has not excluded any portion of dues paid to the AGA during the test
27 year." Similarly, the Company's response to STF 5.62(b) stated: "UNS Gas does not maintain any
28 descriptive material regarding the financial statements, annual budgets or activities of the AGA."

1 Consequently, the Company has not met its burden of proof for including AGA dues in rates, and
2 Staff is asking the Commission to consider a larger disallowance of AGA dues in the current UNS
3 Gas rate case than was proposed by RUCO Witness Moore.

4 Specifically, Staff has proposed to reduce test year expense by \$26,868, as shown on
5 Schedule C-14 that was filed with my direct testimony. This adjustment removes 40 percent of UNS
6 Gas' 2005 AGA dues for 2005, which were \$41,854. Staff adjustment C-14 also removed other
7 discretionary membership and industry association dues which are not needed for the safe and
8 reliable provision of gas utility service.

9 UNS Gas claims in its Brief, at page 31, that "Staff's adjustment is based on an antiquated
10 2001 report which used 1999 data." However, this misstates the support for Staff's recommended
11 adjustment. Staff's adjustment is supported not only by the two most recent National Association of
12 Utility Regulatory Commissioners (NARUC) sponsored Audit Reports of the Expenditures of the
13 American Gas Association. Copies of relevant pages from those audit reports are in the record in
14 Attachment RCS-3 to Staff witness Smith's Direct Testimony. Staff Witness Smith also included
15 with his Direct Testimony, in Attachment RCS-4, for the Commission's consideration, an excerpt
16 from a Florida Public Service Commission Staff Memorandum (dated 12/23/03) in a City Gas
17 Company rate case addressing this issue, where 40% of that gas distribution utility's AGA dues
18 amount was disallowed for ratemaking purposes. Moreover, those additional supporting materials
19 indicate that disallowances of AGA dues of approximately 40% were applied in a series of cases, and
20 were accepted by the respective utility.

21 Because UNS Gas has failed to meet its burden of proof concerning industry association dues,
22 and failed specifically to demonstrate how each category of AGA's activities provide specific
23 benefits to the Company and its Arizona ratepayers, the Commission should adopt the Staff's
24 recommended 40 percent disallowance of AGA dues, which is supported by the two most recent
25 NARUC-sponsored audits as well as documentation from other state regulatory proceedings
26 concerning gas distribution utilities. The Commission should also remove from expenses the other
27 industry dues listed in Staff's adjustment.

1 **4. The Company's Cost of Capital Proposal is Inflated.**

2 **a. A Hypothetical Capital Structure is not Appropriate in This Case.**

3 The Company notes, and the Staff agrees, that it has made considerable progress toward
4 improving its equity ratio in the last few years which stood at only 36% several years ago.⁴⁷ The
5 Company's existing capital structure is now 45% common equity and 55% debt, which is in line with
6 comparable companies.

7 Nonetheless, both the Company and RUCO are proposing a 50% debt and 50% equity
8 hypothetical capital structure in this case. Staff, on the other hand, is proposing use of the
9 Company's actual existing capital structure of 45% common equity and 55% debt. While the
10 Commission has utilized hypothetical capital structures in the past in appropriate circumstances, Staff
11 believes the circumstances of this case are different, and that use of a hypothetical capital structure is
12 no longer necessary or appropriate in this case.

13 First, Company Witness Grant concedes on page 8 of his Direct Testimony that the test-year
14 capital structure for UNS Gas is in line with industry averages.⁴⁸ Many commissions utilize a
15 hypothetical capital structure when the existing capital structure of the Company is unreasonable, or
16 out of line with the capital structures of comparable companies. Since the Company's existing
17 capital structure is not overly expensive for ratepayers nor is it highly leveraged, there is no need to
18 employ a hypothetical capital structure in this case.

19 The Commission has utilized hypothetical capital structures in the past; but under different
20 circumstances than exist in this case. For instance in the Arizona American Mohave case, Decision
21 No. 69440, Arizona American Mohave's actual capital structure was 37.2% equity and 62.8% debt.⁴⁹
22 In that case, the Commission agreed with the Company that a hypothetical capital structure was
23 appropriate because as the Company pointed out the Commission has in the past utilized a
24 hypothetical capital structure in prior cases involving highly leveraged utilities.⁵⁰ In that case, the
25 Commission adopted a hypothetical capital structure of 60% debt and 40% equity. Here the actual
26

27 ⁴⁷ Ex. UNSG-27 (Grant Direct) at p. 9.

⁴⁸ Ex. UNSG-27 (Grant Direct) at p. 8.

28 ⁴⁹ Decision 69440 at p. 13.

⁵⁰ *Id.*

1 capital structure of UNS Gas is similar to comparable companies. Its capital structure is not highly
2 leveraged.

3 The Commission also adopted a hypothetical capital structure in the recent Southwest Gas
4 case.⁵¹ Southwest Gas' actual average capital structure was highly leveraged. During the test year,
5 its capital structure consisted of 34.5% common equity, 5.3% preferred stock, and 60.2% long-term
6 debt.⁵² Because of the Company's highly leveraged capital structure, the Commission accepted
7 Staff's recommendation of a 40% equity ratio. UNS Gas, by comparison, has an equity ratio of 45%.
8 Its actual capital structure is not unreasonable nor does it produce a result that is unfair or
9 unreasonable to ratepayers. It would be inappropriate to utilize a hypothetical capital structure in
10 this case simply to improve the Company's financial performance.

11 As pointed out by Mr. Parcell in his Direct Testimony at page 21 the use of hypothetical
12 capital structure would have the impact of increasing the actual return on equity by 50 basis points.⁵³

13 Hypothetical Capital Structure

	<u>Percent</u>	<u>Cost</u>	<u>Wgt. Cost</u>
14 Debt	50%	6.6%	3.65%
15 Equity	50%	11.0%	<u>5.15%</u>
16 Total			8.80%

17 Actual Capital Structure

	<u>Percent</u>	<u>Cost</u>	<u>Wgt. Cost</u>
18 Debt	55.33%	6.6%	3.65%
19 Equity	44.67%	11.5%	<u>5.15%</u>
20 Total			8.80%

21 In general, a hypothetical capital structure is employed where the Company's actual capital
22 structure is unreasonable or where the actual capital structure contained higher cost equity capital that
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28 ⁵¹ Decision No. 68487 at 23.

⁵² Decision No. 68487 at 23.

⁵³ Ex. S-36 (Parcell Direct) at p. 21.

1 was unduly expensive to ratepayers.⁵⁴ While Commissions have also utilized hypothetical capital
2 structures in other limited situations, those circumstances are not present in this case.⁵⁵

3
4 **b. RUCO and the Staff's Use of the Geometric Mean in their CAPM
Analysis was Appropriate.**

5 The Company does not give any weight to its DCF results. The exclusive reliance upon
6 CAPM results in an excessive cost of equity recommendation by the Company. The two primary
7 differences in Staff's and the Company's CAPM analyses are 1) the use of a risk free rate (5.3
8 percent) by the Company which is outdated and exceeds the current level of U.S. Treasury bond
9 yields; and 2) the Company's use of an equity risk premium (7.1 percent) that relies exclusively on
10 the arithmetic means of common stock returns and bond returns over the period 1926-2005.⁵⁶

11 The Company also argues that Staff and RUCO erred in using the geometric means returns in
12 calculating the market risk premium in their CAPM models.⁵⁷ The Company argues that the use of
13 geometric means is contrary to well-established financial theory, sound financial practice, and basic
14 mathematics.⁵⁸

15 Staff's cost of capital expert, Mr. David Parcell, addressed this issue in his Surrebuttal
16 Testimony.

17 What is important is not what Mr. Grant and I believe, but what
18 investors rely upon in making investment decisions. It is apparent that
19 investors have access to both types of returns, and correspondingly use
both types of returns, when they make investment decisions.

20 In fact, it is noteworthy that mutual fund investors regulatory receive
21 reports on their own funds, as well as prospective funds they are
22 considering investing in, that show only geometric returns (see for
23 example, Schedule 1 which shows historic performance information for
one of the nation's largest mutual funds). Based on this, I find it
difficult to accept Mr. Grant's position that only arithmetic returns are
considered by investors and, thus, only arithmetic returns are
appropriate in a CAPM context.⁵⁹

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26 ⁵⁴ See *Re Chesapeake Utilities Corp.*, 75 Md.P.S.C. 89 (1984).

⁵⁵ See *Re Walnut Hill Tel. Co.*, 56 P.U.R.4th 501 (Arkansas 1983).

27 ⁵⁶ Ex. S-37 (Parcell Surrebuttal) at 3.

⁵⁷ UNS Gas' Initial Post-Hearing Brief at 35.

28 ⁵⁸ *Id.*

⁵⁹ Ex. S-37 (Parcell Surrebuttal Testimony) at 3.

1 Further, Mr. Parcell pointed out that UNS Gas used Value Line information in its cost of
2 capital analysis.⁶⁰ Value Line reports show historic returns on a geometric, or compound growth rate
3 basis. As Mr. Parcell testified, investors have access to both arithmetic and geometric growth rates.
4 In all likelihood, there is more geometric growth readily available to investors (e.g., mutual fund
5 reports and Value Line) than arithmetic growth.⁶¹

6
7 **c. Staff's Adjusted Cost of Capital Is The Only Lawful Proposal**
8 **Supported by the Record and in Conformance with the *Chaparral***
9 ***City Decision.***

10 All of the parties in this proceeding agree that the Commission must use a fair value rate base
11 ("FVRB") in setting just and reasonable rates. The question presented in this case is simple and
12 straight forward. What is the rate of return that should be applied to a FVRB? Even though the
13 question is easy to articulate, the answer is quite complex. Nevertheless, Staff agrees with the
14 Company that an appropriate rate of return must be supported by the record. And it must conform to
15 existing requirements in Arizona's Constitution and case law.

16 UNS Gas frames the issue as "how to address the *renewed* emphasis on fair value."⁶² The
17 Company's description is a reference to the recent decision of the Arizona Court of Appeals in
18 *Chaparral City Water Company v. Arizona Corporation Commission.*⁶³ The Company then
19 incorrectly describes Staff's adjusted cost of capital as the "prudent investment theory."⁶⁴ UNS Gas
20 relies on a number of court decisions to support the rejection of the "prudent investment theory."⁶⁵

21 The Company relies primarily on language in *Arizona Corporation Commission v. Arizona*
22 *Water Company.*⁶⁶ None of the cases cited by the Company address the question presented in this
23 case. In *ACC v. AWC*, for example, the issue was whether a purchase price of a utility could be relied
24 upon as the fair value of the utility's rate base.⁶⁷

25 ⁶⁰ *Id.*

26 ⁶¹ Ex. S-37 (Parcell Surrebuttal) at 4.

27 ⁶² UNS Gas' Initial Post-Hearing Brief at 42, ll. 19-20 (emphasis added).

28 ⁶³ Unpublished Memorandum Decision, Arizona Court of Appeals, Division One, Case No. 1 CA-CC 05-0002, February 13, 2007 ("*Chaparral City*").

⁶⁴ UNS Gas' Initial Post-Hearing Brief at p. 42.

⁶⁵ See *Id.* at ll. 6-16.

⁶⁶ See *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959).

⁶⁷ *Id.*, 85 Ariz. at 203, 335 P.2d at 415.

1 The court explained that purchase prices could be under or over the book value of a utility's
2 property. It then held, "[T]he purchase price of a public utility does not constitute, as a matter of law,
3 its fair value."⁶⁸ The court stated, "[T]he Commission must consider all available evidence related to
4 the fair value, and an inquiry into a recent purchase transaction might be of assistance, in the
5 discretion of the Commission."⁶⁹ Therefore, the Commission cannot rely entirely on a purchase price
6 to determine FVRB.⁷⁰

7 In *Chaparral City*, the court criticized the Commission's method for determining a "fair value
8 rate of return." A fair value rate of return is simply a rate of return that is appropriate for use with a
9 FVRB. Historical and current financial theories and methods are derived using original cost rate base
10 ("OCRB") instead of FVRB.⁷¹

11 The question presented in *Chaparral City* was not how to determine FVRB. The question
12 was how to determine an appropriate rate of return to use with FVRB. The case does not represent a
13 "renewed emphasis on fair value." Staff has not found a case in Arizona directly on point other than
14 the recent decision. As discussed below, a few other "fair value states" have case law on point.

15 In *Chaparral City*, the Commission first calculated a revenue requirement by multiplying the
16 OCRB by the cost of capital. The cost of capital was determined using traditional financial theories.
17 Thus, it was derived from OCRB, not FVRB. An adjustment is necessary to determine just and
18 reasonable rates. After determining the revenue requirement, the Commission then determined a
19 "fair value rate of return" which would produce the same revenue requirement.⁷²

20 The court concluded that the Commission's method used OCRB and not FVRB to determine
21 just and reasonable rates. The court acknowledged that application of traditional cost of capital
22 methods are not be appropriate for FVRB.⁷³ Finally, the court stated that "the Commission has the
23 discretion to determine the appropriate methodology."⁷⁴

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25 _____
26 ⁶⁸ *Id.*

27 ⁶⁹ *Id.*

28 ⁷⁰ *Id.*

⁷¹ S-37 (Prcell Surrebuttal) at 8, line 7 to 9, line 2.

⁷² *Chaparral City* at 12, ¶ 14.

⁷³ *Id.* at ¶ 17.

⁷⁴ *Id.*

1 UNS Gas asks the Commission to use a cost of capital based on OCRB with its FVRB.⁷⁵ The
2 Company further argues that its request “is the only approach presented in this case that complies
3 with the Arizona Constitution.”⁷⁶ The *Chaparral City* court specifically recognized that the
4 Company’s proposed method would result in excessive rates. Excessive rates are not just and
5 reasonable rates and do not comply with the Arizona Constitution.

6 Staff is the only party in this case to propose an adjustment to the cost of capital which is
7 necessary for FVRB. The Company admits that an adjustment is appropriate.⁷⁷ Instead of proposing
8 an adjustment, UNS Gas criticizes Staff’s method. The Company has the initial burden of proof for
9 revenue requirements and rates. The Company is attempting to shift its burden of proof to Staff.

10 Staff recognizes that the Commission may decide to respond to *Chaparral City* in this case.
11 Therefore, Staff proposed an interim method for calculating a fair value rate of return even though it
12 had no burden to do so. Staff will continue to evaluate methods for determining rate of return that
13 may be used for FVRB. Nevertheless, Staff’s proposal in this case is well reasoned and fairly
14 balances the interests of ratepayers and investors.

15 The problem of determining a fair value rate of return is complex and not easily resolved.
16 Several states have evaluated the problem and have developed possible solutions. The most recent
17 case Staff found is a 2001 Indiana case. In *Re Harbour Water Corporation*,⁷⁸ the Indiana Utility
18 Regulatory Commission (“IURC”) described the problem and identified a solution:

19 As the Commission has frequently noted, the capital structure is
20 related to the book value of utility property. Therefore, the cost of
21 capital calculated in the manner above, is related primarily to an
22 original cost depreciated rate base. If the fair value rate base
23 reflects the current value of Petitioner’s utility property, as it must,
24 determining a fair return by multiplying the cost of capital,
25 including a consideration of prospective inflation by a fair value
26 rate base, which includes historic inflation, *may overstate the
required return by reflecting inflation twice. In order to avoid any
such redundancy, it is necessary to make an adjustment to the cost
of capital in arriving at a reasonable rate of return to be applied to
the fair value rate base.* On the basis of the evidence presented,
the Commission finds the prospective rate of inflation, 2.5%,

27 ⁷⁵ UNS Gas’ Initial Post-Hearing Brief at 42, ll. 19-24.

28 ⁷⁶ *Id.*

⁷⁷ *Id.* at 42, line 23 and at 43, ll. 5-6

⁷⁸ *Re Harbour Water Corporation*, 2001 WL 170550 (Ind. U.R.C.), unpublished.

1 should be removed from Petitioner's 12.0% cost of equity, to
2 arrive at a deflated cost of common equity capital of (9.5%), to be
3 used in computing a fair rate of return on the fair value of
4 Petitioner's utility property. When this is done, the resulting rate
5 of return, which we find should be applied to Petitioner's fair value
6 rate base of \$10,700,000, is 6.10%.⁷⁹

7 In a 1992 decision, the Indiana Court of Appeals discussed the problem in dicta. The above
8 decision focusing entirely on inflation may not fully address the issues discussed by the Indiana Court
9 of Appeals. Staff also believes that inflation may understate redundancies embedded in cost of
10 capital models.

11 In *Gary-Hobart Water Corporation v. Indiana Utility Regulatory Commission*, the
12 commission's staff argued, "[T]here is no legal reason a return on a fair value rate base must be
13 substantially greater than a return on an original cost rate base."⁸⁰ The court remanded case because
14 the Indiana commission did not make specific findings of fact to support its decision. The court cited
15 the following language in the commission's order:

16 After considering the effects of inflation on the embedded costs of
17 equity and debt, the Commission further finds that the fair value
18 rate of return on Petitioner's fair value rate base should be 5.35%.

19 The court explained:

20 This court has concluded that original cost is one of the factors the
21 Commission should consider in arriving at a fair value figure, but
22 "it is not necessarily, in and of itself, an accurate reflection of the
23 fair value of the company's property upon which today's investors
24 should be allowed to earn a return."⁸¹

25 Staff agrees that the most important consideration is whether current investors expect or
26 should be allowed to receive an incremental return. Investors' expected returns on any increment is
27 already be embedded in cost of capital methodologies. The difficult question is whether all or only a
28 portion of the expected returns are already embedded in the methodologies.

29 In two 1974 decisions issued on the same day, the Supreme Court of North Carolina also
30 struggled with the problem. In *State of North Carolina ex rel. Utilities Commission et al. v. Duke*
31 *Power Company*, the North Carolina Supreme Court concluded, "[the] computation of the cost of

32 ⁷⁹ *Id.* at *10 (emphasis added). Note that RUCO argued that applying the weighted average cost of capital to the FVRB
33 resulted in double counting inflation in *Chaparral City*. *Chaparral City* at ¶ 17.

34 ⁸⁰ *Gary-Hobart Water Corporation v. Indiana Utility Regulatory Commission*, 591 N.E.2d 649, 653 (Ind. App. 1992).

35 ⁸¹ *Id.* (citations and quotations omitted) (emphasis added).

1 capital *must be adjusted* by the Commission in order to take into account the effect of the fair value
2 increment on the fair rate of return.”⁸² In a strained analysis, the Supreme Court of North Carolina
3 held that the fair value increment must be added to the equity portion of a utility’s capital structure.⁸³

4 However, the court held that inclusion of the fair value increment in capital structure should
5 reduce the overall rate of return. The court recognized that the fair value increment “is an unrealized
6 paper profit to the utility.”⁸⁴ The court provided the following analysis and guidance to the
7 commission:

8 This is not to say that the Commission must now revise its order so
9 as to permit Duke to make an additional increase of its rates
10 sufficient to yield additional net income equal to 11 per cent⁸⁵ of
11 the fair value increment. It is for the Commission, not this Court,
12 to determine what is a fair rate of return....

13 [T]he capital structure of the company is a major factor in the
14 determination of what is a fair rate of return for the company upon
15 its properties. There are, at least, two reasons why the addition of
16 the fair value increment to the actual capital structure of the
17 company tends to reduce the fair rate of return as computed on the
18 actual capital structure. First, treating this increment as if it were
19 an actual addition to the equity capital of the company....enlarges
20 the equity component *so that the risk of the investor in common
21 stock is reduced*. Second, the assurance that, year by year, in times
22 of inflation, the fair value of the existing properties will rise, and
the resulting increment will be added to the rate base so as to
increase earnings allowable in the future, *gives to the investor in
the company’s common stock an assurance of growth of dollar
earnings per share, over and above the growth incident to the
reinvestment in the business of the company’s actual retained
earnings*. As indicated by the testimony of all of the expert
witnesses....this expectation of growth in earnings is an important
part of their computations of the present cost of capital to the
company. When these matters are properly taken into account, the
commission may, in its own expert judgment, find that a fair rate
of return on equity capital in a fair value state, such as North
Carolina, is presently less than 11 per cent.⁸⁶

23 In *State of North Carolina ex rel. Utilities Commission et al. v. Virginia Electric and Power*,⁸⁷
24 the North Carolina Supreme Court further discussed fair value rate of return. The court held, “[T]he

25 ⁸² *State of North Carolina ex rel. Utilities Commission et al. v. Duke Power Company*, 285 N.C. 377, 397, 206 S.E.2d
269, 294 (N.C. 1974) (emphasis added) (“*Duke Power*”).

26 ⁸³ *Id.*, 285 N.C. at 392, 206 S.E.2d at 279-280.

27 ⁸⁴ *Id.*, 285 N.C. at 393, 206 S.E.2d at 280.

28 ⁸⁵ The 11% was the rate of return based on OCRB.

⁸⁶ *Duke Power*, 285 N.C. at 396, 206 S.E.2d at 282.

⁸⁷ *State of North Carolina ex rel. Utilities Commission et al. v. Virginia Electric and Power*, 285 N.C. 398, 206 S.E.2d
283 (N.C. 1974) (“*Virginia Electric and Power*”).

1 Commission may, in its own expert judgment, find that a fair rate of return on Vepco's equity capital,
2 including the fair value increment, is less than 12 per cent (the rate of return it found fair without
3 taking the fair value increment into account). How much less, if any, is for the Commission, not for
4 this Court, to determine."⁸⁸

5 The North Carolina Supreme Court's analysis was founded on its interpretation of a state
6 statute. The court held that the statute specifically required fair value increment to be added to the
7 equity capital of a utility.⁸⁹ In Arizona, there is no express authority requiring a specific treatment of
8 a fair value increment in a capital structure. But Staff agrees in this case that a capital structure can
9 be adjusted to properly account for fair value increment.

10 The problem identified in all of the above cases is rooted in the concepts of fair value and
11 FVRB. The concepts predate modern financial theory and practice. They predate models such as the
12 discounted cash flow ("DCF") model and the capital asset pricing model ("CAPM"). The concepts
13 were created to solve a problem that no longer exists.

14 They were used to provide a return to utilities based on the current value of their assets.
15 Modern financial models account for investor expectations related to increases in the value of a
16 utility's assets. Therefore, applying a cost of capital derived from modern models to FVRB creates
17 redundancies and double counting. Staff witness Mr. David Parcell described the problem in his
18 surrebuttal testimony. He explained that "the cost of capital cannot be applied to the fair value rate
19 base since there is no financial link between the two concepts."⁹⁰ Modern financial models must be
20 adjusted to eliminate double counting prior to use with FVRB.

21 UNS Gas argues that Staff's recommended adjustment in this case is no different than the
22 adjustment at issue in *Chaparral City*.⁹¹ The Company claims that Staff is still using a "backing in"
23 method to calculate a fair value rate of return.⁹² Staff disagrees. Staff uses the Company's fair value
24

26 _____
⁸⁸ *Id.* 285 N.C. at 413, 206 S.E.2d at 295.

27 ⁸⁹ *Id.*

⁹⁰ S-37 (Parcell Surrebuttal) at 8, line 23 to 9, line 2.

28 ⁹¹ UNS Gas' Initial Post-Hearing Brief at 39, line 15 to 40, line 7.

⁹² *Id.* at 43, ll. 1-2.

1 increment in its capital structure. Staff did not expressly use the increment in its mathematical
2 calculation of a fair value rate of return in *Chaparral City*.

3 In *Railroad Commission of Texas v. Entex, Inc.*, the Texas Supreme Court expressly discussed
4 the so called "backing in" method to determine a fair value rate of return.⁹³ The problem is not as
5 simplistic as UNS Gas suggests. UNS Gas makes the same arguments made by Entex.

6 Entex argued "that by basing the rate of return on the return to book common equity,the
7 Commission has determined the reasonable revenues allowed on the original cost less depreciation
8 and "backed into" the fair return on adjusted value rate base....by means of a much lower rate of
9 return."⁹⁴ The court acknowledged, "[I]n a fair value jurisdiction the rate of return multiplied by the
10 rate base usually resulted in a higher return to the book common equity than in an original cost
11 jurisdiction because of the inclusion of the reproduction cost new factor."⁹⁵

12 The court still rejected the arguments by Entex. The court provided the following two
13 considerations relevant for fair value states:

14 [1] [T]he fact cannot be denied that the return to book common
15 equity *is used as a performance indicator by the investor*
16 *and cannot be ignored by blindly applying a rate of return*
17 *to the fair value rate base without noting the consequences*
18 *of such rate of return on the elements of the capital*
structure. The return to book equity even in a fair value
jurisdiction should not be grossly out of line with such a
*return in an original cost jurisdiction.*⁹⁶

19 [2] [T]he fairness of the rate base or the rate of return can be
20 measured by the cash requirements of the utility. All are
21 interdependent and ultimately need to be reconciled....a
22 return to book common equity which is out of
proportion....cannot be ignored since it is more than
necessary to attract capital, and therefore, unfair to the
ratepayer.⁹⁷

23 Staff recognizes that its new calculation presents a similar, but different question than the one
24 at issue in *Chaparral City*. The new question is whether investors expect an additional return
25 separate from variables already used in financial models. Some of the cases cited above seem to

26 ⁹³ 599 S.W.2d 292 (Tx. 1980).

27 ⁹⁴ *Id.* at 297.

⁹⁵ *Id.* at 298.

28 ⁹⁶ *Id.* at 299 (emphasis added).

⁹⁷ *Id.*

1 assume that there is some incremental return expected by investors. The cases all support a lower
2 return than the return for OCRB. There is no evidence in this proceeding supporting an assumption
3 that investors expect additional return. On the other hand, the only evidence on point suggests an
4 opposite conclusion.

5 Mr. Parcell testified that regulators should only provide, and investors should only expect, "an
6 opportunity to earn a return on the capital [investors] provided to the utility."⁹⁸ He explained that a
7 fair value increment is not financed by a utility's investors. He argued that "it is logical and
8 appropriate to assume that this excess has no cost."⁹⁹ Mr. Parcell's testimony is consistent with the
9 North Carolina Supreme Court's recognition that fair value increments are "unrealized paper profits."

10 To the extent that investors may expect a return on paper profits, the return is already
11 incorporated into cost of capital models. For example, forecasted earnings per share ("EPS") and
12 dividends per share ("DPS") will be higher if investors expect a utility's assets to grow in value.
13 Historical EPS and DPS would also incorporate growth between a utility's last rate case and its
14 current rate case.

15 Staff will continue to evaluate how to calculate a fair value rate of return. It is possible that
16 Staff may identify a mathematical adjustment superior to the one proposed in this case. For the
17 purposes of this proceeding, evidence in the record supports Staff's position. UNS Gas did not
18 provide any evidence on how to adjust cost of capital models for determining a fair value rate of
19 return.¹⁰⁰ UNG Gas's request would create excessive returns for the Company. Staff respectfully
20 requests the Commission to adopt its recommended adjustment for this case.

21 **B. The Company's Rate Design Proposal Should Be Rejected Because a Significant**
22 **Move Toward a Straight Fixed-Variable Rate Design Violates Long-Standing**
23 **Regulatory Principles and the Company Has Not Demonstrated a Material**
24 **Cross-Subsidization.**

25 UNS Gas's requested changes in monthly customer charges are excessive and should be
26 rejected. UNS Gas requests an unprecedented move toward a straight fixed-variable rate design. The

27 ⁹⁸ S-37 (Parcell Surrebuttal) at 9, li. 4-9

⁹⁹ *Id.* at 9, li. 11-20.

28 ¹⁰⁰ TR. Vol. I at 74, line 25 to 75, line 13; see also *Id.* at 72, line 20 to 73, line 16 (Mr. Pignatelli agreed that the Company did not evaluate adjustments to cost of capital methodologies for determining a fair value rate of return.).

1 Company argues that monthly customer charges should match non-volumetric revenue to fixed
2 costs.¹⁰¹

3 The Company also claims that the current rate design results in a cross-subsidization from
4 cold-weather residential customers to warm-whether residential customers.¹⁰² UNS Gas argues,
5 "Neither Staff nor RUCO offer any justification for the *substantial* level of cross-subsidization that
6 will result from their rate designs."¹⁰³ It further claims, "If consumers in Flagstaff, Prescott and other
7 cold weather communities were aware of the *degree* to which they were subsidizing gas service for
8 their peers in warmer climates, they would no doubt demand more exigent action."¹⁰⁴

9 In an attempt to justify its position, the Company mischaracterizes the testimony of Staff's
10 witnesses. The Company states:

11 Moreover, the testimony of Staff's own witnesses suggests a
12 charge much higher than \$8.50 per month is appropriate. First,
13 Staff's witness, Mr. Smith, agreed the Company should move
14 toward cost-based rates. He also indicated that, in his opinion,
15 recovering 50 percent of the Company's fixed costs through the
16 monthly customer charge could be reasonable. That would amount
17 to a monthly customer charge of \$13.00.¹⁰⁵

18 Mr. Smith did not testify that a target of 50% is an appropriate target in this case or in any future case.

19 Mr. Smith answered the Company's question as follows:

20 Q. Would you agree at least 50 percent ultimately over a series
21 of rate cases would be a reasonable target?

22 A. Perhaps, and the rate design in each particular case should
23 reflect consideration of all the various factors, including
24 avoiding [rate] shock and gradualism.

25 So, I mean, beyond what happens in this current rate case,
26 you know, *I don't know if I really want to present a Staff
27 philosophy that you should ultimately end up at some
28 percentage.*¹⁰⁶

...

...

26 ¹⁰¹ UNS Gas' Initial Post-Hearing Brief at 45-47.

27 ¹⁰² *Id.* at 43.

¹⁰³ *Id.* at 44-45.

¹⁰⁴ *Id.* at 48.

¹⁰⁵ *Id.* at 46.

¹⁰⁶ TR. Vol. V at 824.

1 Thus, Mr. Smith did not agree with a target of 50%. As Mr. Smith explained on page 61:

2
3 The UNS Gas proposals to drastically increase the customer charge
4 component of rates should be rejected because it violates principles of
5 gradualism and could cause 'rate shock' and would therefore likely be
6 unacceptable to the rate paying public. As I explained in my
7 supplemental testimony, rate design is an art, not a strict mathematical
8 exercise, and requires the application of informed judgment. The UNS
9 Gas proposal to increase residential customer charges from the current
10 \$7.00 to \$17.00 per month, an increase of 142 percent, does raise issues
11 of rate shock. Accordingly, Staff recommends that a more gradual
12 approach to raising the customer charge component of UNS Gas' base
13 rates should be employed.

14 The more gradual approach recommended by Staff was clearly to increase the customer charge for
15 residential service from the current \$7.00 per month to \$8.50 per month. Staff witness Smith clearly
16 did not agree with a 50% increase, or an increase to \$13.00 per month. Additionally, his testimony is
17 consistent with the testimony of Staff witness Mr. Steven Ruback. Mr. Ruback testified that only one
18 state allows a straight fixed-variable rate design. He explained that "according to rate design practice,
19 fixed costs do not have to be recovered with fixed charges."¹⁰⁷ Mr. Ruback did not agree that the
20 issue is simply matching fixed costs with fixed customer charges. He testified:

21
22 Natural gas distribution systems have long been recognized as
23 fixed cost systems, and Commissions throughout the Country have
24 designed rates which recover some amount of customer costs in a
25 fixed customer charge and the remainder of the revenue
26 requirement from demand charges and volumetric rates....I
27 disagree that the Company's proposal does not violate long-
28 standing regulatory principles. In my opinion, UNS' customer
charge proposals are not consistent with industry rate design
standards.¹⁰⁸

29 Finally, Mr. Ruback explained, "Cost of service is an important rate design criterion, but not the sole
30 criterion. The results of an allocated cost of service study are the starting point for rate design."¹⁰⁹

31 Therefore, the Company does not share the same goal as Staff. Increasing customer monthly
32 charges by a modest amount is appropriate in this proceeding. But Staff is not trying to reach a
33 targeted percentage. Moreover, Staff disagrees that a straight fixed-variable rate design is an

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¹⁰⁷ S-24 (Ruback Surrebuttal) at 5.

¹⁰⁸ *Id.* at 5.

¹⁰⁹ *Id.* at 5.

1 appropriate goal. Staff also disagrees that a major step toward this rate design is appropriate or
2 necessary.

3 The Company argues that putting more fixed charges in monthly customer charges is
4 necessary to eliminate substantial cross-subsidization. UNS Gas has not presented sufficient
5 evidence that cross-subsidization is substantial. The evidence shows that there is not a substantial
6 subsidy from cold-weather customers to warm-weather customers.

7 At hearing, RUCO witness Ms. Mary Lee Diaz-Cortez provided testimony related to
8 Company exhibit TVL-1.¹¹⁰ Exhibit TVL-1 is titled "Residential Use and Margin by Location." The
9 exhibit shows the number of customers billed by location for the test year. Ms. Diaz-Cortez testified
10 that the schedule includes cold-weather areas, warm-weather areas, and areas with weather conditions
11 in between the other two categories. She testified that the following locations experience cold
12 weather: Flagstaff, Sedona, Winslow, Holbrook, Prescott, and Show Low. She further testified that
13 the following locations experience warm weather: Santa Cruz and Lake Havasu. Finally, she
14 testified that the following locations experience in between weather: Kingman and Cottonwood.¹¹¹

15 The warm weather areas only have approximately 10% of the Company's customers.¹¹² On
16 the other hand, Flagstaff and Prescott alone represent approximately 53% of the Company's
17 customers.¹¹³ Ms. Diaz-Cortez testified that in her opinion there is not a large subsidy.¹¹⁴

18 Based on the customer count by location, there is no substantial cross subsidization from cold
19 weather customers to warm weather customers. It is extremely unlikely that customers in Flagstaff
20 and Prescott would believe that they are providing a substantial subsidy to warm weather customers.
21 The numbers just don't add up.

22 The UNS Gas proposals would, among other things, increase residential customer charges
23 from the current \$7.00 to \$17.00 per month, for an increase of 142 percent. Considering the many
24

25 _____
¹¹⁰ Ex. UNSG 18 (Voge Direct).

26 ¹¹¹ TR. Vol. IV at 716-717.

27 ¹¹² Santa Cruz has 79,990 customers and Lake Havasu has 74,743 customers. The Company's number of customers is
1,510,284. Accordingly: $(79,990 + 74,743)/1,510,284 = 10\%$.

28 ¹¹³ Flagstaff has 333,263 customers and Prescott has 467,420 customers. Accordingly: $(333,263 + 467,420)/1,510,284 =$
53%.

¹¹⁴ TR. Vol. IV at 717.

1 factors that should be weighed in rate design, Staff's gradual approach of increasing customer charges
2 is more appropriate than the UNS Gas proposals and, therefore, Staff's approach should be adopted in
3 this case.

4 Staff respectfully requests the Commission to adopt its rate design and monthly customer
5 charges. Staff's recommendations provide an appropriate amount of fixed costs in fixed monthly
6 charges. Staff's recommendations align rates closer to cost-of-service, while preserving other
7 regulatory goals in rate design.

8 **C. UNS Gas' Throughput Adjustment Mechanism ("TAM") Should be**
9 **Rejected Because it is Overly Broad, Shifts Risk From the Company To**
10 **Ratepayers, Constitutes Piecemeal Ratemaking, and Erodes the Benefits**
11 **of Conservation.**

12 The Company argues, "The TAM *is a type of decoupling mechanism* that has gained growing
13 support throughout the industrial and environmental communities."¹¹⁵ The Company supports its
14 argument with various comments by utility participants and with a National Association of
15 Regulatory Commissions ("NARUC") resolution.¹¹⁶ Finally, the Company attempts to distinguish its
16 mechanism from the Conservation Margin Tracker ("CMT") proposed by Southwest Gas and
17 rejected by the Commission in Decision No. 68487.¹¹⁷ In addition to arguments on the merits of the
18 TAM, UNS Gas criticizes other parties for not proposing an acceptable alternative.¹¹⁸ None of the
19 Company's arguments or positions has merit.

20 Staff first discusses industry acceptance of decoupling mechanisms. The Company points to
21 statements by industry associations submitted to NARUC and a NARUC resolution. None of the
22 statements supports the excessively broad mechanism proposed by UNS Gas.

23 Three organizations joined in on one statement: (1) the American Gas Association ("AGA"),
24 (2) the National Resource Defense Council ("NRDC"), and (3) the American Council for an Energy-
25 Efficiency Economy ("ACE³"). The joint statement to NARUC focused almost entirely on
26

27 ¹¹⁵ UNS Gas' Initial Post-Hearing Brief at 50.

28 ¹¹⁶ *Id.*

¹¹⁷ *Id.* at 52.

¹¹⁸ *Id.* at 53.

1 conservation and energy efficiency.¹¹⁹ For example, the statement included the following
2 explanation:

3 [M]any state's rate structures offer – quite unintentionally – a
4 significant financial disincentive for natural gas utilities to aggressively
5 *encourage their customers to use less natural gas, such as by providing*
6 *financial incentives and education to promote energy-efficiency and*
7 *conservation techniques....*

8 When customers use less natural gas, utility profitability almost always
9 suffers, because recovery of fixed costs is reduced in proportion to the
10 reduction in sales. Thus, *conservation* may prevent a utility from
11 recovering its authorized fixed costs and earning its state-allowed rate
12 of return....Public utility commissions should consider utility rate
13 proposals and other innovative programs that *reward utilities for*
14 *encouraging conservation* and managing customer bills to avoid certain
15 negative impacts associated with colder-than-normal weather. There
16 are a number of ways to do this, and NRDC and AGA join in
17 *supporting mechanisms that use modest automatic true-ups* to ensure
18 that a utility's opportunity to recover authorized fixed costs is not held
19 hostage to fluctuations in retail gas sales.¹²⁰

20 As discussed below, the TAM is much broader than the type of mechanism supported in the joint
21 statement. It cannot be described as a “modest” automatic true-up.

22 UNS Gas also points to a NARUC resolution to support its proposed TAM. UNS Gas
23 claimed, “NARUC adopted a resolution encouraging state commissions to approve rate designs such
24 as the decoupling mechanism UNS Gas has proposed here.”¹²¹ The Company attached the resolution
25 to Mr. Erdwurm's Rebuttal Testimony. The “resolution” does not support the broad decoupling
26 mechanism proposed by UNS Gas.

27 NARUC actually issued two separate resolutions, both of which are relevant to this
28 proceeding. The resolutions are:

29 **RESOLVED**, That the National Association of Regulatory
30 Commissioners (NARUC), convened in its November 2005 Annual
31 Convention in Indian Wells, California, encourages State commissions
32 and other policy makers to review the rate designs they have previously
33 approved *to determine whether they should be reconsidered in order*
34 *to implement innovative rate designs that will encourage energy*
35 *conservation and energy efficiency* that will assist in moderating
36 natural gas demand and reducing upward pressure on natural gas
37 prices; *and be it further*

38 ¹¹⁹ It also discussed hedging policies. See UNSG-19, Exhibit DBE-3.

¹²⁰ *Id.*, Joint Statement at 2.

¹²¹ UNS Gas Initial Post-Hearing Brief at 50.

1 The Company's arguments miss the point of Staff's position. Staff remains concerned that the
2 benefits of conservation would be eroded by the TAM.¹²⁹ High and volatile gas costs, especially
3 during the heating season, would be exacerbated by a TAM surcharge. Staff witness Steven Ruback
4 also provided an example where revenue deferrals accumulated to a high level in another state.¹³⁰
5 Unexpected increases in a TAM surcharge could undermine conservation. For example, if a
6 customer's bill is not reduced because of offsetting TAM increases, the customer's benefit of
7 reducing consumption would be diminished or lost. In addition to actual lost benefits, a customer's
8 perception of the benefits of conservation could be diminished.

9 UNS Gas also attempts to distinguish its proposed TAM from Southwest Gas's CMT.¹³¹ The
10 two mechanisms are substantially similar because they true-up revenues for any variation in customer
11 usage. Mr. Ruback cited reasons for the Commission rejection of Southwest Gas' CMT in Decision
12 No. 68487.¹³² The Commission was concerned the CMT would be a disincentive for ratepayers to
13 conserve. The Commission held, "[T]he likely effect of adopting the proposed CMT would be a
14 disincentive to undertake conservation efforts because ratepayers would be required to pay for gas not
15 used in prior years."¹³³

16 Recently, the Connecticut Department of Public Utility Control evaluated a similar type of
17 decoupling mechanism. In *Re Decoupling Energy Distribution Company Earnings from Sales*¹³⁴, the
18 Connecticut commission held:

19
20 The department concludes that more extensive decoupling
21 mechanisms, *such as mechanisms that eliminate usage-based*
22 *pricing completely, would be unacceptable to gas ratepayers,*
would not foster customer-initiated conservation measures, would
eliminate normal business risks for gas LDCs, and would lessen
*LDCs' incentive to manage their fixed costs.*¹³⁵

23 The evidence in this proceeding supports similar conclusions by this Commission.
24
25

26 ¹²⁹ S-23 at 12.

27 ¹³⁰ *Id.* at 15.

28 ¹³¹ UNS Gas' Initial Post-Hearing Brief at 52.

¹³² S-23 at 17-18.

¹³³ Decision No. 68487 at 42.

¹³⁴ *Re Decoupling Energy Distribution Company Earnings from Sales*, 2006 WL 280606 (Conn.D.P.U.C.).

¹³⁵ *Id.* at 1.

1 Another reason the TAM should not be approved because the TAM amount to piecemeal
2 ratemaking. The TAM deals with variations from expected used per customer. No other items in the
3 ratemaking formula are considered in the TAM.

4 Finally, the Company complained that no other party suggested an acceptable alternative. Not
5 only is the Company trying to shift the burden of proof, but it also did not follow the direction of the
6 Commission in Decision No. 68487. UNS Gas never consulted with Staff in its development of the
7 TAM. As Staff stated in its initial brief, it is willing to work with the Company to evaluate
8 appropriate decoupling mechanisms.

9
10 **D. Staff does not object to the Company's Proposed Changes to its Rules and**
11 **Regulations with the Following Modification which the Company has**
12 **Agreed to in its Rebuttal Testimony and in its Initial Post Hearing Brief.**

13 Staff and UNS Gas are in agreement concerning the Company's proposed changes to the rules
14 and regulations. Staff reviewed and found reasonable and consistent with the Commission's rules,
15 the vast majority of the changes proposed by UNS Gas. Staff agreed with the UNS Gas-proposed
16 changes to Section 10.C; however, in order that these changes not present a hardship on UNS Gas
17 customers, there should be a six month waiver in the late payment penalty change. The Company has
18 proposed to reduce the number of days, from 15 to 10, as the period a customer may avoid a late
19 payment penalty. For the first 6 months, the penalty should be waived from day 10. This temporary
20 six-month transition period should be able to charge the penalty after day 10. This temporary six-
21 month transition period should help alleviate any hardship on customers from this change in billing
22 terms. As described in UNS Gas witness Gary Smith's rebuttal testimony at pages 3-4, the Company
23 agreed to this waiver period.

24 **III. Conclusion**

25 UNS Gas' application for a rate increase should be granted to the extent discussed in Staff's
26 testimony in this Docket. The Commission should reject the Company's proposed rate design and
27 TAM which both attempt to shift an abnormally high degree of risk to ratepayers of the Company.
28

1 RESPECTFULLY SUBMITTED this 21st day of June 2007.

2
3 

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