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BEFORE THE ARIZONA CORPORATION COMMISSION

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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.

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Maureen A. Scott, Senior Staff Counsel
Keith A. Layton, Staff Attorney
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

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STAFF'S ERRATA REPLY BRIEF

JUNE 21, 2007

INDEX

I. INTRODUCTION

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

II. DISCUSSION

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

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

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

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

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[1] Staff Opening Brief at p. 2-5.

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

[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.

would otherwise be properly chargeable to ratepayers."[5] That the Commission viewed inclusion of some CWIP in APS' rate base to be appropriate given the extraordinary circumstances in the case.

> Even if the commission were to accept RUCO's and CREE's estimates for the total value of Palo Verde, we are still faced with nearly doubling APS' rate base in little over two (2) years. Unless substantial efforts are made to phase in this tremendous investment over a longer period, the APS service territory faces a significant potential for economic disruption. CWIP inclusion is the logical first step for such a phase-in. Indeed, any commission which contemplates some sort of rate moderation program involving a postcommercialization phase-in of plant investment (a clear violation of the 'used and useful' doctrine) should equally consider beginning its program during the precommercialization phase of construction, i.e., DWIP. This will spread the increase over an even longer period of time without accumulating the substantial level of deferred costs which ordinarily accompanies delays in recognizing plant investment.
>
> In consideration of the above discussion, we find that an additional $200 million in PV-I CWIP should be included in APS' "fair value" rate base. Although this still leaves some $400 million in PV-I costs to be addressed upon the in-service date of that facility (as well as the costs of PV-II and PV-III), any greater amount might tend to cause rate shock today in an effort to avoid it tomorrow.[6]

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

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

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[5] *Id.*
[6] Decision No. 54247at p. 20.
[7] Decision No. 54247 at p. 19.

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

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

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

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

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

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

[8] UNS Gas Initial Post-Hearing Brief at 11.
[9] UNS Gas Initial Post-Hearing Brief at p. 11.
[10] Ex. S-27 (Smith Surrebuttal) at 19.
[11] *Id.*

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

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

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

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

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

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

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[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.

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

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

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

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

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

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[19] UNS Gas' Opening Brief at 21-23.
[20] Ex. UNSG-13 (Dukes Rebuttal) at 34.
[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.

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

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

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

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

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

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

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

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[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.

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

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

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

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

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

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

[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.

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

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

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

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

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

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[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.

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

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

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

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

UNS Gas also argues that the Internal Revenue Code should not dictate which compensation 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.

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

The Commission stated the following in its Southwest Gas Order:

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

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

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

Pages 19-20 of UNS Gas' Brief address property tax expense. The Arizona State Legislature passed House Bill No. 2779 which set a new rate schedule for property tax assessments. The new assessment rate schedule provides for decreasing the 25 percent rate applicable in 2005 in 0.5 percent steps each year until a 20 percent rate is attained in 2015. The Company's calculation used a 24.5 percent assessment rate and thus fails to recognize the impact of this known tax change prospectively. The adjustment proposed by Staff (and RUCO) for property tax expense is necessary to reflect the known statutory assessment ratio of 24 percent applicable for 2007.[45] Reflecting the impact of this known and measurable change in tax law is appropriate, and is fully consistent with the final

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[44] Decision No. 68487 at 19.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[47] Ex. UNSG-27 (Grant Direct) at p. 9.
[48] Ex. UNSG-27 (Grant Direct) at p. 8.
[49] Decision 69440 at p. 13.
[50] *Id.*

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

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

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

Hypothetical Capital Structure

	Percent	Cost	Wgt. Cost
Debt	50%	6.6%	3.65%
Equity	50%	11.0%	5.15%
Total			8.80%

Actual Capital Structure

	Percent	Cost	Wgt. Cost
Debt	55.33%	6.6%	3.65%
Equity	44.67%	11.5%	5.15%
Total			8.80%

In general, a hypothetical capital structure is employed where the Company's actual capital structure is unreasonable or where the actual capital structure contained higher cost equity capital that

[51] Decision No. 68487 at 23.
[52] Decision No. 68487 at 23.
[53] Ex. S-36 (Parcell Direct) at p. 21.

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

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

The Company does not give any weight to its DCF results. The exclusive reliance upon CAPM results in an excessive cost of equity recommendation by the Company. The two primary differences in Staff's and the Company's CAPM analyses are 1) the use of a risk free rate (5.3 percent) by the Company which is outdated and exceeds the current level of U.S. Treasury bond yields; and 2) the Company's use of an equity risk premium (7.1 percent) that relies exclusively on the arithmetic means of common stock returns and bond returns over the period 1926-2005.[56]

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

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

> What is important is not what Mr. Grant and I believe, but what investors rely upon in making investment decisions. It is apparent that investors have access to both types of returns, and correspondingly use both types of returns, when they make investment decisions.
>
> In fact, it is noteworthy that mutual fund investors regulatory receive reports on their own funds, as well as prospective funds they are considering investing in, that show only geometric returns (see for 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]

[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).
[56] Ex. S-37 (Parcell Surrebuttal) at 3.
[57] UNS Gas' Initial Post-Hearing Brief at 35.
[58] *Id.*
[59] Ex. S-37 (Parcell Surrebuttal Testimony) at 3.

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

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

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

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

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

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[60] *Id.*
[61] Ex. S-37 (Parcell Surrebuttal) at 4.
[62] UNS Gas' Initial Post-Hearing Brief at 42, ll. 19-20 (emphasis added).
[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.

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

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

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

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

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

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[68] *Id.*
[69] *Id.*
[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.*

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

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

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

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

> As the Commission has frequently noted, the capital structure is related to the book value of utility property. Therefore, the cost of capital calculated in the manner above, is related primarily to an original cost depreciated rate base. If the fair value rate base reflects the current value of Petitioner's utility property, as it must, determining a fair return by multiplying the cost of capital, including a consideration of prospective inflation by a fair value 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%,

[75] UNS Gas' Initial Post-Hearing Brief at 42, ll. 19-24.
[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.

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

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

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

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

The court explained:

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

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

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

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

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

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

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

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

> This is not to say that the Commission must now revise its order so as to permit Duke to make an additional increase of its rates sufficient to yield additional net income equal to 11 per cent[85] of the fair value increment. It is for the Commission, not this Court, to determine what is a fair rate of return....
>
> [T]he capital structure of the company is a major factor in the determination of what is a fair rate of return for the company upon its properties. There are, at least, two reasons why the addition of the fair value increment to the actual capital structure of the company tends to reduce the fair rate of return as computed on the actual capital structure. First, treating this increment as if it were an actual addition to the equity capital of the company....enlarges the equity component *so that the risk of the investor in common stock is reduced*. Second, the assurance that, year by year, in times 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]

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

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[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*").
[83] *Id.*, 285 N.C. at 392, 206 S.E.2d at 279-280.
[84] *Id.*, 285 N.C. at 393, 206 S.E.2d at 280.
[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*")..

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

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

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

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

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

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[88] *Id.* 285 N.C. at 413, 206 S.E.2d at 295.
[89] *Id.*
[90] S-37 (Parcell Surrebuttal) at 8, line 23 to 9, line 2.
[91] UNS Gas' Initial Post-Hearing Brief at 39, line 15 to 40, line 7.
[92] *Id.* at 43, ll. 1-2.

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

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

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

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

> [1] [T]he fact cannot be denied that the return to book common equity *is used as a performance indicator by the investor and cannot be ignored by blindly applying a rate of return to the fair value rate base without noting the consequences 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]

> [2] [T[he fairness of the rate base or the rate of return can be measured by the cash requirements of the utility. All are interdependent and ultimately need to be reconciled....a 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]

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

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[93] 599 S.W.2d 292 (Tx. 1980).
[94] *Id.* at 297.
[95] *Id.* at 298.
[96] *Id.* at 299 (emphasis added).
[97] *Id.*

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

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

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

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

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

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

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[98] S-37 (Parcell Surrebuttal) at 9, ll. 4-9

[99] *Id.* at 9, ll. 11-20.

[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.).

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

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

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

> Moreover, the testimony of Staff's own witnesses suggests a charge much higher than $8.50 per month is appropriate. First, Staff's witness, Mr. Smith, agreed the Company should move toward cost-based rates. He also indicated that, in his opinion, recovering 50 percent of the Company's fixed costs through the monthly customer charge could be reasonable. That would amount to a monthly customer charge of $13.00.[105]

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

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

> Q. Would you agree at least 50 percent ultimately over a series of rate cases would be a reasonable target?
>
> A. Perhaps, and the rate design in each particular case should reflect consideration of all the various factors, including avoiding [rate] shock and gradualism.
>
> So, I mean, beyond what happens in this current rate case, you know, *I don't know if I really want to present a Staff philosophy that you should ultimately end up at some percentage.*[106]

. . .

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[101] UNS Gas' Initial Post-Hearing Brief at 45-47.
[102] *Id.* at 43.
[103] *Id.* at 44-45.
[104] *Id.* at 48.
[105] *Id.* at 46.
[106] TR. Vol. V at 824.

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

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

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

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

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

Therefore, the Company does not share the same goal as Staff. Increasing customer monthly charges by a modest amount is appropriate in this proceeding. But Staff is not trying to reach a 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.

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

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

At hearing, RUCO witness Ms. Mary Lee Diaz-Cortez provided testimony related to Company exhibit TVL-1.[110] Exhibit TVL-1 is titled "Residential Use and Margin by Location." The exhibit shows the number of customers billed by location for the test year. Ms. Diaz-Cortez testified that the schedule includes cold-weather areas, warm-weather areas, and areas with weather conditions in between the other two categories. She testified that the following locations experience cold weather: Flagstaff, Sedona, Winslow, Holbrook, Prescott, and Show Low. She further testified that the following locations experience warm weather: Santa Cruz and Lake Havasu. Finally, she testified that the following locations experience in between weather: Kingman and Cottonwood.[111]

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

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

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

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[110] Ex. UNSG 18 (Voge Direct).
[111] TR. Vol. IV at 716-717.
[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%.
[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.

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

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

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

The Company argues, "The TAM *is a type of decoupling mechanism* that has gained growing support throughout the industrial and environmental communities."[115] The Company supports its argument with various comments by utility participants and with a National Association of Regulatory Commissions ("NARUC") resolution.[116] Finally, the Company attempts to distinguish its mechanism from the Conservation Margin Tracker ("CMT") proposed by Southwest Gas and rejected by the Commission in Decision No. 68487.[117] In addition to arguments on the merits of the TAM, UNS Gas criticizes other parties for not proposing an acceptable alternative.[118] None of the Company's arguments or positions has merit.

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

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

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[115] UNS Gas' Initial Post-Hearing Brief at 50.
[116] *Id.*.
[117] *Id.* at 52.
[118] *Id.* at 53.

conservation and energy efficiency.[119] For example, the statement included the following explanation:

> [M]any state's rate structures offer – quite unintentionally – a significant financial disincentive for natural gas utilities to aggressively *encourage their customers to use less natural gas, such as by providing financial incentives and education to promote energy-efficiency and conservation techniques....*
>
> When customers use less natural gas, utility profitability almost always suffers, because recovery of fixed costs is reduced in proportion to the reduction in sales. Thus, *conservation* may prevent a utility from recovering its authorized fixed costs and earning its state-allowed rate of return....Public utility commissions should consider utility rate proposals and other innovative programs that *reward utilities for encouraging conservation* and managing customer bills to avoid certain negative impacts associated with colder-than-normal weather. There are a number of ways to do this, and NRDC and AGA join in *supporting mechanisms that use* ***modest*** *automatic true-ups* to ensure that a utility's opportunity to recover authorized fixed costs is not held hostage to fluctuations in retail gas sales.[120]

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

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

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

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

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[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.

> **RESOLVED**, That NARUC recognizes that the best approach ***toward promoting energy efficiency programs*** for any utility, State, or region may likely depend on local issues, preferences, and conditions.[122]

The NARUC resolutions are obviously limited to conservation and energy-efficiency programs. Therefore, the Company's characterization of the resolutions is not complete and accurate.

The evidence in the record is undisputed that the TAM would include weather fluctuations and changing economic conditions.[123] Staff urges the Commission to reject the TAM because it goes much farther than what is accepted by the industry. Mr. Erdwurm admitted that the TAM is not limited to conservation and energy-efficiency.[124]

Nevertheless, he testified that the TAM would not shift risk associated with revenue recovery from the utility to ratepayers. The Company further argues, "The TAM was designed to cut the yoke that tethers revenues to usage, a change that serves the interests of both the Company and its customers."[125] Staff disagrees. The TAM shifts risk from the Company to its ratepayers. Therefore, while it may serve UNS Gas' interests, it does not serve the interests of ratepayers.

The Company addressed the issue in both pre-filed testimony and at hearing. In his Rebuttal Testimony, Mr. Erdwurm explained, "First, the Company will continue to bear all risk associated with revenue recovery of margin costs from those customers whose Pricing Plans are not subject to adjustment through the TAM. Second, the TAM is intended to true up the revenue requirement of participating customers established in the test year."[126] On cross-examination, Mr. Erdwurm testified that 92% of the Company's customers would be subject to the TAM.[127] The evidence supports a finding that the TAM would shift risk of revenue recovery from UNS Gas to its ratepayers.

UNS Gas also tries to discount Staff's position that a substantial TAM surcharge would undercut conservation efforts. The Company argues that a TAM surcharges would be "dwarfed" by the costs of natural gas. It also argues that the TAM is based on system-wide reductions, which would not affect incentives for individual ratepayers.[128]

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[122] UNSG-19, Exhibit DBE-4 at 2 (emphasis in the original except bold italic).
[123] See *e.g.* TR Vol. III at 497- 498.
[124] *Id.* at 499.
[125] UNS Gas' Initial Post-Hearing Brief at 51.
[126] UNSG-19 at 14-15.
[127] TR Vol. III at 497.
[128] UNS Gas' Initial Post-Hearing Brief at 51-52.

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

UNS Gas also attempts to distinguish its proposed TAM from Southwest Gas's CMT.[131] The two mechanisms are substantially similar because they true-up revenues for any variation in customer usage. Mr. Ruback cited reasons for the Commission rejection of Southwest Gas' CMT in Decision No. 68487.[132] The Commission was concerned the CMT would be a disincentive for ratepayers to conserve. The Commission held, "[T]he likely effect of adopting the proposed CMT would be a disincentive to undertake conservation efforts because ratepayers would be required to pay for gas not used in prior years."[133]

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

> The department concludes that more extensive decoupling mechanisms, *such as mechanisms that eliminate usage-based 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]

The evidence in this proceeding supports similar conclusions by this Commission.

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[129] S-23 at 12.
[130] *Id.* at 15.
[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.

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

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

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

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

III. Conclusion

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

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
(602) 542-3402

Original and Seventeen (17) copies of the foregoing filed this 21st day of June 2007 with:

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

Copies of the foregoing e-mailed/ mailed this 21st day of June 2007 to:

Michael W. Patten
Roshka DeWulf & Patten PLC
One Arizona Center
400 East Van Buren Street
Suite 800
Phoenix, Arizona 85004

Scott S. Wakefield
RUCO
1110 West Washington Street
Suite 220
Phoenix, Arizona 85007

Raymond S. Heyman
Michelle Livengood
UniSource Energy Services
One South Church Avenue
Suite 1820
Tucson, Arizona 85701

Cynthia Zwick, Executive Director
ACAA
2700 North 3rd Street, Suite 3040
Phoenix, Arizona 85004

Marshall Magruder
Post Office Box 1267
Tubac, Arizona 85646

Monica A. Martinez