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IN THE MATTER OF THE APPLICATION OF UNS ELECTRIC, INC. 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 ELECTRIC, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA AND REQUEST FOR APPROVAL OF RELATED FINANCING.	Docket No. E-04204A-06-0783

RUCO'S CLOSING BRIEF

November 5, 2007

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INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits the following points in support of its position that the Arizona Corporation Commission ("Commission") should not authorize a rate increase of more than $1,189,270 for UNS Electric, Inc. ("UNS" or "Company"). In addition to RUCO's other recommendations set forth below, the Commission should approve RUCO's recommended return on common equity of 9.30 percent because it is fair, well reasoned and balanced, and is consistent with the current environment of historically low interest rates.

1) GENERATION

BLACK MOUNTAIN GENERATING STATION ("BMGS")

The Company is proposing the inclusion in rates of the investment and expenses associated with the planned purchase of the Black Mountain Generating Station in 2008. The purchase of BMGS is one aspect of the Company's Procurement Plan to acquire power supplies when its power supply contract with Pinnacle West Capital Corporation ("PWCC") expires in June 2008. RUCO-8 at 5.[1] The new plant will be a 90 MW peaking facility located in Mohave County and the Company plans on acquiring BMGS from its affiliate – Unisource Energy Development Company. Company's Application at 4. The Company estimates its cost to be at least $60 million. Id. The Company is proposing to recover its costs through a "post-test-year adjustment to rate base of $60 million, effective June 1, 2008, the date when commercial operation will commence." Id. The Company will seek recovery in its next rate

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[1] For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The Transcript page number will identify references to the Transcript.

case for any cost beyond $60 million. Id. The Company's proposal is contrary to nearly every applicable regulatory ratemaking principle and should be rejected.

For example, the total costs of the BMGS are not known and measurable at this time. The Company is requesting recovery of $60 million in this case and it will request an unknown balance in its next rate case. The Company characterized the $60 million as a "... very good educated guess" of the total costs. Transcript at 161. The actual total cost will not be known until, at the very least May 1, 2008. Id. at 166. Even at that point only the plant costs will be known, not the operation and maintenance costs. Id . at 167. In sum, the cost of the BMGS is not known with certainty and the Commission should reject the Company's proposal to include $60 million in rate base.

Normally, the Commission makes its determination of prudency after plant improvements have been completed. Here, the Company is asking the Commission to determine prudency before the improvements are completed. Should the Commission accept the Company's proposal and allow rate base treatment of the plant prior to completion, ratepayers would already have begun paying for the plant should it later be determined that BMGS was not a prudent investment. The Commission should not establish a precedent of determining prudency before plant is even built.

The Company's proposal also violates the matching principle. The matching principle requires that revenues and expenses are matched within the test year. Here, the matching principle is violated because the customer count at the project's anticipated completion date in May 2008 will be different than the customer count in this rate case based on a test year ended June 30, 2005[2]. RUCO-10 at 5. Given the post-test-year date of completion, the

[2] The Surrebuttal testimony of Ms. Diaz Cortez should be corrected to reflect that the test-year end date is June 30, 2005.

Company, as well as the Commission, does not know what the incremental costs as well as the cost savings will be. Id.

Next, the Company's proposal violates the used and useful principle of ratemaking. The used and useful principle simply provides that plant subject to rate base consideration should be used and useful during the test year. BMGS is not scheduled to be completed until May 2008, seventeen months after the test-year end date, and is not currently used and useful.

The Company's proposal violates the historical test-year principle which provides for consideration of only test-year expenses and revenues. The Company's proposal is also a related party transaction since the Company proposes to acquire it from its affiliate. Related party transactions require a high level of scrutiny to insure there are no related party abuses and that the transaction is equivalent to one that would happen at arms length. RUCO-8 at 7.

Finally, the Company's proposal would result in piecemeal ratemaking. The Company's phased-in rate proposal rates would consider only the incremental cost changes in the later phase resulting from the acquisition of the generating station, but not changes in any other ratemaking elements. Id.

In short, there is little if any reason why the Commission should approve the Company's proposal to include BMGS in rate base at this time. It is counter to almost every regulatory principle, would result in bad ratemaking, and is not necessary at this time.

RELIEF REQUESTED: The Commission should reject the Company's proposal to include BMGS in rate base.

PURCHASED POWER AND FUEL ADJUSTMENT CLAUSE ("PPFAC")

The Company originally proposed that the PPFAC rate be based on a historical twelve month rolling average. RUCO-10 at 7. In its rebuttal case, the Company changed its recommendation and is now proposing the PPFAC rate be based on estimated projected fuel and purchase power costs. Id. Consistent with many of the Company's recommendations in this case, the Company seeks to go outside the test year to set rates.

In support of its proposal, the Company claims that a PPFAC rate based on estimated projected fuel and purchase power costs is very similar to the PSA recently authorized for APS. Id. Such a comparison is misplaced. APS' fuel and purchased power requirements are entirely different than UNS Electric's. Unlike the Company, APS owns the majority of its generation. Thus, APS' PSA is comprised primarily of fuel costs. Whereas, UNS Electric is subject primarily to market prices and purchased power contracts. Id. at 8. The historical price of the Company's purchased power is a more accurate measure of future costs than market projections.

RUCO agrees with the Company's original proposal and recommends that the PPFAC rate be based on a historical twelve month rolling average. Id. The advantage of the historical rolling average is that it allows for a price signal when costs increase or decrease. Id. At the same time the historical rolling average smoothes out any wide fluctuations. RUCO's proposal also provides a number of safeguards and protections including a cap on the magnitude the surcharge can move in a given year and a 90/10 sharing mechanism that is designed to incent the Company to control its fuel and purchased power costs. Id.

RELIEF REQUESTED: The Commission should accept RUCO's proposed use of the historical rolling average to set the PPFAC rate.

2) RATE BASE

<u>RATE BASE ADJUSTMENT NO. 2 - ACCUMULATED DEPRECIATION</u>

The Company has failed to substantiate its December 31, 2003 accumulated depreciation balance which is understated by $1,764,719. RUCO-10 at 6. The Company has provided extensive rhetoric trying to explain the shortfall but when all is said and done the

Company cannot account for the difference in its accumulated depreciation balance account between the acquisition date, August 11, 2003 and the end of the year, December 31, 2003.

The Company provided RUCO with clear and accurate spreadsheets which stated the levels of gross plant and accumulated depreciation as of August, 11, 2003 and December 31, 2003. Id. at 4. There were no recorded plant additions or retirements during this period. Id. at 5. The calculation of the appropriate increase in accumulated depreciation over these 142 days associated with the Company's stated level of gross plant is a simple calculation of increasing the Company's stated level of accumulated depreciation as of August 11, 2003 by the sum of the products of each plant account level times the Company's designated depreciation rate for each plant account, and apportioning the total by 142/365 to recognize the partial year of accrual. Id. The Company disregarded this basic accounting and ratemaking procedure and understated the accumulated depreciation balance of December 31, 2003 by $1,764,719. Id.

RUCO's total calculation of accumulated depreciation through the end of the test year also adds an additional $503,393 to the Company's filed level of accumulated depreciation. RUCO-7 at 5.

RELIEF REQUESTED: The Commission should adopt RUCO's adjustment which increases the test-year accumulated depreciation balance by $2,295,112

RATE BASE ADJUSTMENT NO. 3 - CONSTRUCTION WORK IN PROGRESS (CWIP)

The Company proposes to include $10.8 million of CWIP in rate base. UNSE-34 at 27. The Company claims that it will continue to be dependant on outside capital for the foreseeable future in order to fund system growth and capital improvements, and to refinance its long-term notes. Id. According to the Company, allowing $10.8 million in rate base will provide the Company with approximately $2.1 million dollars in additional annual revenues. Id.

Other reasons the Company offers in support of ratebasing CWIP are that it would help mitigate regulatory lag and extend time between rate case filings. Id. at 28. It would also help recognize the large negative acquisition adjustment that resulted from the Citizens purchase. Id. Finally, the Company finds further validation in its position by noting that a large portion of the CWIP balance has already been transferred to plant-in service. Id. Many of the reasons cited by the Company are faced by most if not all utilities at any given time and do not warrant the extraordinary ratemaking treatment requested by the Company. In fact, as more fully explained below, none of the reasons cited by the Company warrant the ratemaking treatment requested by the Company.

In Arizona, the Commission has seldom allowed a Company to ratebase CWIP. Among the many reasons, the most obvious is that the plant under consideration is not used and useful at the time of the request and is not providing a benefit to ratepayers. As the name suggests, the plant is under construction and is a work in progress. Ratepayers should not pay for assets that are not used and useful or providing benefit to them. Moreover, current ratepayers should not have to pay for assets that they may never benefit from. Allowing CWIP in rate base is not standard ratemaking in Arizona and would be bad ratemaking in this case.

RUCO recognizes that there have been instances in the past where the Commission has allowed CWIP in rate base. For instance, during the 1970's and 1980's, many electric utilities experienced large drains of cash flows building nuclear power plants. Id. at 16. The huge drain on cash flows coupled with the very long lead time before such plants entered service, resulted in situations where the utilities became unable to service their debt. Id. To the extent the Commission allowed CWIP in rate base during those times the Commission considered the inclusion of CWIP an emergency measure as well as a temporary measure. Id.

In the absence of emergency circumstances, the Commission has not allowed CWIP in rate base. Most recently, the Commission denied Arizona Public Service Company's ("APS") request for the recognition of CWIP in rate base.[3] Id.

The Company has failed to provide an adequate reason why CWIP should be allowed in rate base in this case. First, the Company's argument that CWIP should be allowed in rate base in order to maintain financial integrity is without merit. APS has not lost its financial integrity as a result of the Commission's denial to allow CWIP in rate base. In fact, the Company has not shown one Arizona utility that has lost its financial integrity as the result of the Commission denying it CWIP in rate base. Id. This argument is a red herring and should be rejected.

The Company's growth argument should also be rejected as growth has a positive effect on the Company, generating more revenue and cash flow. Id. at 16-17. Regulatory lag always is a characteristic of rate of return regulation. Every company that files a rate case is subject to regulatory lag. Moreover, regulatory lag is a two way street that works both for and against the Company. Id. For example, regulatory lag benefits the Company when considering plant retirements, accumulated depreciation, and expired amortizations. In all of these instances the Company continues to earn a return on assets whose costs have already been recovered by the Company. Id. The Company's one-sided view that the Commission should mitigate the regulatory lag that does not favor the Company, yet continue to allow the effects of regulatory lag that benefit the Company, should be rejected.

The Company's argument that CWIP in rate base will lengthen the period between rate cases also should be rejected. It has been almost thirteen years since the Company's last rate case in 1995, and it currently has no CWIP in rate base. Id. at 17. RUCO is not aware of any

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[3] Decision No. 69663, Docket Nos. E-01345A-05-0816, E-01345A-05-0826, AND E-01345A-05-0827.

large Arizona utility denied CWIP in its rate base that is filing back-to-back rate cases. Id. Finally, the Company's argument that the large negative acquisition it agreed to when it acquired Citizens gas properties now justifies the inclusion of CWIP in rate base, is disingenuous. Id. The Company, during the acquisition case, touted the negative acquisition as an attractive feature of the agreement that would provide substantial benefits to ratepayers. Id. at 18. Company witness, and then-Unisource Vice President, Steven Glaser stated the following in his testimony in that proceeding:

> A further benefit of the settlement is that Citizens' gas customers will have use of approximately $30.7 million of facilities and Citizens' electric customers will have use of approximately $93.6 million of facilities that they will never have to pay for because Unisource has agreed not to seek recovery of the negative acquisition adjustments.[4]

It is not appropriate to now use the benefit of the negative acquisition adjustment as a reason to increase rates by including CWIP in rate base. Id.

RELIEF REQUESTED: The Commission should deny the Company's request to include CWIP in the rate base.

RATE BASE ADJUSTMENT NO. 4 - ACCUMULATED DEFERRED INCOME TAXES – CONTRIBUTIONS IN AID OF CONSTRUCTION ("CIAC")

The Company argues that RUCO has confused water and wastewater CIAC accounting with electric CIAC accounting. RUCO-10 at 10. The Company claims that electric utilities do not have a separate CIAC account, but rather any CIAC funds are credited directly to the plant accounts. Id. The Company is mistaken. Contrary to the Company's position, the NARUC Uniform System of Accounts for A & B Electric companies contains an account 271 for CIAC.

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[4] Rebuttal Testimony of Steven Glaser, Docket No. E-01933A-02-0914, page 2.

Id. The Company has not accounted for CIAC in its account 271. Id. Accordingly, RUCO has removed the deferred income taxes related to these non-existent balances.

RELIEF REQUESTED: The Commission should remove ($888,390) for the CIAC deferred tax asset from the Company's rate base.

RATE BASE ADJUSTMENT NO. 5 - ACCUMULATED DEFERRED INCOME TAXES (ADIT) – A&G CAPITALIZATION

This is a companion adjustment to ADIT resulting from RUCO's A&G capitalization adjustment. RUCO's A&G capitalization adjustment is more fully discussed in the Operating Income section of this Brief.

RELIEF REQUESTED: The Commission should increase the pro-forma test-year ADIT balance by $116,258.

3) OPERATING INCOME

OPERATING INCOME ADJUSTMENT NO. 2 – PENSION AND BENEFITS

The Company is requesting recovery of test-year expenses identified as gifts, awards, employee dinners, picnics and social events. RUCO-5 at 10. The Company believes that these expenses should be recovered because they are normal and recurring business expenses. RUCO-7 at 7. These benefits are an inappropriate financial burden on ratepayers and not necessary to the provision of service. Id.

RELIEF REQUESTED: The Commission should remove ($11,612) of pension and benefits from test-year operating expenses.

OPERATING INCOME ADJUSTMENT NO. 4 – INCENTIVE COMPENSATION

The issue concerns the recovery of incentive payments awarded by the Company to certain employees under its Performance Enhancement Plan ("PEP"). The PEP is only eligible for a select group of non-union employees and is paid after meeting certain performance goals, including certain financial goals. RUCO-5 at 14. In 2005, Unisource Energy Corporation did not meet the PEP financial goals, and therefore no payments under the PEP program were awarded. Id. Nevertheless, the Board of Directors authorized a Special Recognition Award to these non-union employees in recognition of their accomplishments. The Special Recognition Award was less than the PEP payment awarded in 2004. Id.

The Company's proposed adjustment incorporates the average of the 2004 PEP bonus and the 2005 Special Recognition Award. As a general rule, RUCO does not generally vary from the use of historical test-year data to avoid mismatches in the ratemaking elements. Id. at 15. The Commission should not consider data outside the test year for incentive pay and the Commission should reject the Company's proposal to average the 2005 Special Recognition Award with the 2004 PEP program.

Ratepayers should not be burdened with the Board of Directors' arbitrary decision to authorize a Special Recognition Award to select UNS employees who did not meet the Company's financial performance goals. Id. This "Special" award is unique and does not meet the criteria of a typical and recurring test-year expense - it rewards employees for non-performance. Id.

With regard to the PEP bonus, 60 percent of the PEP bonus is directly related to financial performance and operational cost containment. Id. Stockholders are the beneficiaries of the achievement of these financial components. This is particularly true between rate cases. Any additional profit the Company is able to achieve between rate cases accrues solely to the Company's stockholders. Id. Since stockholders stand to gain from the achievement of the financial component of the PEP, stockholders should bear the cost of this portion of the incentive compensation. These costs should not be considered for inclusion in rates. Id.

RUCO scrutinizes any incentive compensation thoroughly to ensure ratepayers receive adequate benefit from the expense incurred. Id. at 16. The majority of the Company's customers deal directly with the rank and file unionized employees (who are not eligible for any PEP compensation) and the perceived incremental increase in customer service generated by this incentive package is not cost beneficial to ratepayers. Id. at 16

RELIEF REQUESTED: The Commission should decrease adjusted test-year expenses by ($168,060) to remove incentive compensation.

<u>OPERATING INCOME ADJUSTMENT NO. 5 – RATE CASE EXPENSE</u>

The Company is seeking recovery of $600,000 for rate case expenses. RUCO-7 at 10. The Company's request is unreasonable. There are many issues in this case but the issues are straightforward and are not complex. By comparison, this case is similar to UNS Gas, Inc's[5] ("UNS Gas") application currently pending before the Commission (Docket No. G-04204A-06-0463). In that case, UNS Gas sought $900,000 in rate case expense. See Recommended Opinion and Order ("ROO"), Docket No. G-04204A-06-0463 et al. issued on October 15, 2007 at 20. RUCO recommended $251,000 for rate case expense in the UNS Gas case[6]. Id. The ROO recommends $300,000 in rate case expense. ROO at. 22.

[5] UNS Gas, Inc. is a sister company to UNS Electric, Inc.
[6] RUCO is recommending the same amount ($251,000) in the present case.

In the present case, the Company argues that the primary reason why it should be allowed to collect all of the $600,000 in rate case expense is because of the "...actual and legitimate outside service costs incurred in the process of preparing and defending the UNS Electric rate case." UNSE-17 at 17. The Company's argument is similar to the claim of its sister company in the UNS Gas case. The ROO rejected this argument in the UNS Gas case. ROO at 22. The ROO noted that there were potential problems with the method the parent company used to allocate rate costs in that case. Id. Staff noted that the allocation methodology could result in double recovery. Id. at 21-22. According to Staff, double-recovery may occur if the same personnel are used for the different companies. Id. The same concerns apply here where the Company affiliation is the same as UNS Gas and the allocation methodology is similar.

Further, the ROO's recommendation in UNS Gas was based, in part, on the fact that the Company had to answer a substantial number of data requests compared to the other rate cases being considered. Id. Unlike UNS Gas, there was not an abnormal amount of discovery in the subject case. RUCO's rate case expense is fair and reasonable and should be approved by the Commission.

RELIEF REQUESTED: RUCO's adjustment reduces annual rate case expense from the Company's proposed level of $200,000 ($600,000 / 3 years) to RUCO's recommended level of $83,667 ($251,000 / 3 years).

OPERATING INCOME ADJUSTMENT NO. 6 – BAD DEBT

The Company agrees with RUCO that the bad debt ratio should be based on net bad debt expense write-off. RUCO-10 at 12. However, the Company argues that the bad debt ratio should be applied to the average bad debt expense over several years. RUCO believes that the bad debt ratio should be applied to RUCO's adjusted revenues.

In ratemaking, the methodology where the Company uses average expense levels as opposed to test-year actuals for purposes of setting rates is known as normalization. Id. The standard in ratemaking is to normalize expense levels only when specific abnormal conditions are identified in the test-year data. Id. The Company has presented no evidence of events that transpired during the test year that would require special normalization treatment for its bad debt expense. Where abnormal events are not identified, the appropriate ratemaking treatment is to apply the bad debt ratio to adjusted revenues.

RELIEF REQUESTED: The Commission should adopt RUCO's adjustment to decrease test-year expenses by ($203,038).

OPERATING INCOME ADJUSTMENT NO. 8 – POSTAGE EXPENSE

The Company's postage expense adjustment was calculated by averaging the postage expenses for the 2.5 years from January 2004 through June 2006. The Company's adjustment is based on the Company's position that the cost per customer bill fluctuates fairly significantly from month to month. However, postage rates change infrequently and postage costs from an electric utility should be consistent from month to month. The Company has failed to provide documentary or substantive evidence that shows the bills actually vary significantly from month to month. RUCO-7 at 11.

RELIEF REQUESTED: RUCO's postage expense adjustment decreases adjusted test-year expenses by ($55,459).

OPERATING ADJUSTMENT NO. 10 – A&G CAPITALIZATION

The Company proposes to increase its test-year expenses by $301,187 to reclassify costs that were capitalized during the test year. RUCO-10 at 13-14. The Company claims that this is a recurring "prospective adjustment." Id. The Company did not make a corresponding adjustment to its rate base. Id.

The Company cannot simply increase its expenses without making a corresponding adjustment decreasing its rate base to remove the amount it no longer intends to capitalize. If the Company continues to reclassify its test-year capitalized expenses to test-year expenses, it should make a corresponding adjustment offsetting its rate base by the same amount that it is increasing expenses. Otherwise, ratepayers will be required to pay for the reclassified expenses twice – once through depreciation expense and return on rate base and again as part of operating expense. RUCO-8 at 26

RELIEF REQUESTED: The Commission should adopt RUCO's adjustment and decrease the Company's pro-forma operating expenses by ($301,187) to remove the double count.

OPERATING EXPENSE ADJUSTMENT NO. 11 – CWIP PROPERTY TAXES

This issue relates to the Company's proposal to include CWIP in rate base. The Company claims it should also be allowed to recover the property taxes related to those CWIP balances. RUCO-10 at 14-15.

For the reasons stated above, the Company should not be allowed to recover CWIP in its rate base. Likewise, property taxes associated with CWIP should not be recovered through rates. If the Commission were to allow CWIP in rate base it should still deny the Company recovery of its property taxes related to the CWIP. The formula the Arizona Department of Revenue uses to assess property taxes does not include CWIP balances. The Company has no liability for property taxes related to its CWIP balances and there is no need for rate recovery of such taxes. Id. The Company's proposal is unnecessary and results in higher rates.

RELIEF REQUESTED: The Commission should adopt RUCO's adjustment and remove the Company's pro-forma CWIP property taxes of ($239,697) from test-year expenses.

OPERATING INCOME ADJUSTMENT NO. 12 - CORPORATE COST ALLOCATIONS

This adjustment concerns the Company's request for the recovery of $8,187 related to Advertising – Corporate Relations/Communications. These expenses primarily benefit shareholders and as such should appropriately be recovered from shareholders. Id. at 16.

RELIEF REQUESTED: The Commission should adopt RUCO's adjustment and decrease the Company's pro-forma operating expenses by ($8,187) to remove advertising expenses whose primary benefit inures to shareholders and not ratepayers.

OPERATING ADJUSTMENT NO. 14 – VALENCIA TURBINE FUEL

The Company maintains that its test-year expenses should be increased by $266,198 to include its estimated cost of Valencia Fuel. Id. at 16. These costs, however, were included in the test-year PPFAC. RUCO-8 at 29. The Company argues that the adjustment is necessary to "accurately reflect the base cost of fuel and purchased power and energy". RUCO-10 at 16. Id.

Since the Valencia Fuel costs were included in the test-year PPFAC balance, allowing recovery by increasing test-year operating expenses would result in a double-count.

RELIEF REQUESTED: The Commission should remove ($266,198) from pro-forma operating expenses for fuel costs the Company will recover through the new adjusting PPFAC.

OPERATING INCOME ADJUSTMENT NO. 15 – PROPERTY TAX COMPUTATION

The level of RUCO's recommended test-year property tax expenses is directly related to RUCO's recommended value of test-year gross plant in service. Id. at 12. RUCO's recommended value of test-year gross plant in service is directly affected by RUCO's adjustment to accumulated depreciation as was discussed previously in Rate Base Adjustment No. 2. Id. RUCO's adjustment reconciles RUCO's recommendation of the Company's test-year gross plant in service value adjusted for depreciation expense.

RELIEF REQUESTED: RUCO's property tax calculation decreases adjusted test-year expenses by ($356,711).

<u>OPERATING INCOME ADJUSTMENT NO. 16 – SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN ("SERP")</u>

The SERP is a retirement plan that is provided to a small select group of high-ranking officers of the Company. RUCO-5 at 20. The high-ranking officers who are covered under the SERP receive these benefits in addition to the regular retirement plan. Id. The Company's test-year operating expenses include $83,506 related to the SERP. Id.

The cost of supplemental benefits for high-ranking officers is not a necessary cost of providing electric service. Id. These individuals are already fairly and generously compensated for their work and are provided with a wide array of benefits including a medical plan, dental plan, life insurance, long term disability, paid absence time, and a retirement plan. Id. To the extent the Company feels it is necessary to provide additional perks to a select group of its higher paid employees the Company should do so at its own expense. Id.

Recently, the Commission agreed with RUCO that SERP expenses should not be the burden of ratepayers. In Southwest Gas' latest rate case, (Decision No. 68487, dated February 23, 2006) the Commission agreed with RUCO that SERP should be excluded from operating expenses. Id. In Arizona Public Service's most recent rate case, (Decision No. 69663 at 26-27, June 28, 2007), the Commission voted to disallow SERP. The Commission should reject the Company's request to include SERP in this case.

RELIEF REQUESTED: RUCO's adjustment decreases test-year expenses by ($83,506).

<u>OPERATING INCOME ADJUSTMENT NO. 17 – INAPPROPRIATE AND/OR UNNECESSARY EXPENSES</u>

The Company has requested the recovery of various miscellaneous expenses that are not a necessary cost of service and should be excluded from consideration. Those expenses include:

1. Liquor, Coffee, Water, Bagels, Donuts, Submarine sandwiches, etc.
2. Flowers, Sympathy Cards, Gift Certificates, Photographs, etc.
3. Charitable/Community/Service Club Donations, etc.
4. Recognition Events, Sports Events, Club Memberships, etc.
5. Numerous purchases at Circle K, Walgreen, Wal-Mart, Basha's, Fry's, Safeway, etc.

RUCO-7 at 14.

Upon review, RUCO inquired of 336 questionable expenses. A sample of the invoices that RUCO questioned include, but is not limited to: 1) $746.96 for a barbeque grill; 2) $608.40 for flags; 3) $8,078.22 for refreshments; 4) $1,377.50 to various Chambers of Commerce, and 5) $1,126.25 for chartered bus tours. Id. Despite RUCO's attempts to obtain substantiation for these expenses, the Company did not substantiate the expenses. Id. The burden of proof is on the Company to substantiate the appropriateness of the journal entries identified. Decision No. 68487 at 21. (In the Matter of Southwest Gas, Docket No. G-01551A-05-0876, February 23, 2006). The Company has failed to meet its burden and these expenses should be rejected by the Commission.

RELIEF REQUESTED: RUCO's adjustment decreased test-year expenses by ($63,607) for unnecessary expenses.

OPERATING INCOME ADJUSTMENT NO. 18 – MAINTENANCE OF OVERHEAD LINES

The issue concerns the expenses associated with maintenance of overhead lines. RUCO reviewed the overhead line maintenance expense from 2003 through 2006 and determined that this expense was volatile. RUCO-5 at 23. RUCO made an adjustment to acknowledge the wide variation in annual costs. Id.

RUCO calculated the three-year average of the "inflation adjusted" annual overhead line maintenance expenses for 2004 through 2006. Id. RUCO's adjustment is necessary to normalize the test-year level of overhead maintenance expenses. Id.

RELIEF REQUESTED: RUCO's adjustment decreased test-year expenses by ($95,879).

OPERATING INCOME ADJUSTMENT NO. 19 – CUSTOMER SERVICE COST ALLOCATIONS

This issue concerns cost allocations for customer service related expenses. By way of background, from January through April 2005, the Company's call center duties were performed in-house by sixteen UNS Electric Customer Service Representatives at seven office locations at a cost of approximately $321,640 per month. RUCO-6 at 23. From May through December 2005, Unisource Energy (the parent company) consolidated the call center operations of UNS Gas, UNS Electric and TEP at an actual allocated cost to UNS Electric of $362,013 per month, a 12.55 percent increase in cost. Id. at 24. The Company is proposing that the increase be included in rates. RUCO has disallowed the cost increase because the integrated call center and customer service functions continue to provide approximately the same quality of service as did in-house customer service. Id.

The Commission's Consumer Services Section indicates the quality of customer service has not improved since Unisource Energy chose to integrate similar job functions among its affiliates. Id. The Commission's Consumer Services Section Report ("Report") on UNS Electric states, in 2004, 15.3 percent of the consumer complaints were based on "quality of service" issues. As of May 23, 2007, the report states, 2007 year-to-date, 15.3 percent of the consumer complaints are based on "quality of service" issues. Id. The Report does not demonstrate that the improvements, enhancements and synergy promoted by the Company as justification for the increased expenditure has translated into increased customer satisfaction. Id. Nor has the Company provided RUCO with sufficient evidence to refute the findings of the Commission's Report. RUCO-6 at 16.

RELIEF REQUESTED: RUCO's recommended adjustment decreases test-year expenses by ($66,797).

<u>**OPERATING INCOME ADJUSTMENT NO. 20 – NON-RECURRING/ATYPICAL EXPENSES**</u>

RUCO made an adjustment eliminating expenses related to union training (designated by the Company as M.A.R.C. training) RUCO's adjustment is based on background information obtained by RUCO in recently filed UNS Gas Division rate case (Docket No. G-04204A-06-0463). RUCO-7 at 17. RUCO learned in the UNS Gas case that M.A.R.C. training was a one-time only instructional session to acquaint personnel with working in a unionized environment. The same training was also made available to the Company's employees in the present case. RUCO proposes that this expense be disallowed as it is not a recurring or typical test-year expense and is not appropriate for inclusion as a rate case operating expense[7].

RELIEF REQUESTED: RUCO's recommended adjustment decreases test-year expenses by test-year expenses by ($14,251).

OPERATING INCOME ADJUSTMENT NO. 21 – OUTSIDE SERVICES DSM

The Company agreed with RUCO's adjustment to remove $49,920 in DSM expenses. Id. at 17. However, the Company claims that $32,865 of this amount was already removed as part of its own DSM and renewables adjustment. Id.

RUCO reviewed the Company's workpapers detailing each item that was included in its DSM and renewables adjustment and agreed with the Company that the appropriate adjustment was a decrease of ($17,055).

RELIEF REQUESTED: The Commission should remove ($17,055) from test-year expenses for outside DSM services.

OPERATING INCOME ADJUSTMENTS NO. 25 and NO. 26 – PAYROLL EXPENSE AND PAYROLL TAX EXPENSE

The issue concerns the inclusion of payroll expense incurred outside the test year. The Company changed its position in its rebuttal testimony and now seeks inclusion of an additional post-test-year 2007 pay raise as a historical test-year expense. RUCO-7 at 19. RUCO had accepted the Company's original adjustment to include the test-year payroll

[7] The ROO in the UNS Gas case agrees with RUCO that M.A.R.C. training was a one-time training cost in that case that will not occur in the future and disallowed the expense. ROO at 35.

increase and thus, the inclusion of a 2007 pay raise would compound the pay increase and violate the ratemaking matching principle.

The companion tax adjustment should also be removed from operating expenses.

RELIEF REQUESTED: RUCO's recommended adjustment removes the post test-year payroll expense of ($231,750) and the tax expense associated with the payroll of ($17,729) from operating expenses.

<u>OPERATING ADJUSTMENT NO. 27 – INCOME TAX EXPENSE</u>

The Company claims that RUCO's income tax calculation is incorrect because it does not separate current income tax expense from deferred income tax expense. Id. at 17. The Company is wrong. It is a standard ratemaking practice to account for income tax *expense* on a current basis. Id. at 18. The accounting for tax timing differences is appropriately reflected for ratemaking purposes in the rate base. Id.

Tax timing differences that are assets (i.e. the Company pays taxes to the IRS prior to receiving payment from ratepayers) are reflected as rate base additions and tax timing differences that are liabilities (i.e. ratepayers pay the taxes to the Company prior to the Company paying the IRS) are reductions to rate base. In this manner, ratepayers and the Company are credited or debited with the impact of deferred income taxes in the rate base. Id. It is improper to repeat this process on the income statement.

RELIEF REQUESTED: The Commission should ignore the Company's position regarding current and deferred income taxes and adhere to its standard rate base treatment of income tax deferrals and its standard income tax treatment of current income tax expense.

COST OF CAPITAL

The Commission should adopt RUCO's recommended rate of return of 8.67 percent, which is the weighted cost of RUCO's recommended costs of debt and equity capital. RUCO-14 at 6. The Company and RUCO are in agreement on the recommended capital structure. Id. at 4. The Company and RUCO recommend a capital structure comprised of 3.97 percent short-term debt, 47.18 percent long-term debt and 48.85 percent common equity. Id.

The Company is recommending a cost of equity of 11.80 percent Id. at 5. RUCO is proposing a 9.30 percent cost of equity. Id. In assessing cost of equity, both the Company and RUCO utilized the Discounted Cash Flow ("DCF") model and the Capital Asset Pricing Model ("CAPM"). RUCO-13 at 30, 48. Both models are standards in the industry and have been used repeatedly by the Commission in determining a utilities cost of equity. The DCF model is based on the premise that the current price of a given share of common stock is determined by the present value of all of the future cash flows that will be generated by that share of common stock. RUCO-13 at 8. CAPM is used to analyze the relationships between rates of return on various assets and risk as measured by beta. Id. at 25.

The Company's final 11.80 percent cost of equity recommendation was determined by taking the 11.20 percent high end of the range of the Company's DCF and CAPM estimates and adding an upward adjustment of 60 basis points. Id. at 54. The Company's cost of capital expert, Kenton Grant made the 60 basis point upward adjustment based on his observed difference between utility bond yields with investment grade Triple-B credit ratings (Baa or BBB) and speculative Double-B credit ratings (Ba or BB). Id. at 54-55. Mr. Grant believes that the Company is riskier as a result of a number of factors including the Company's size, a speculative-grade credit rating associated with long-term notes issued in 2003, high customer growth rate, and the need to procure a new power supply in 2008. Id.

Many of these arguments have been raised by utilities and rejected by the Commission in the past. Id. at 55. The issue of high customer growth in UNS' service territory certainly never deterred the Company's parent, Unisource Energy Corporation ("Unisource"), from acquiring the natural gas and *electric* assets from Citizens Communications Company ("Citizens") in the first place. RUCO-14 at 14. There is no doubt that the management of Unisource, which is based in Tucson, was not blind to the fact that they were acquiring assets located in one of the fastest growing states in the U.S. High growth in Arizona is one of Unisource's biggest selling points to potential investors. Id. Unisource even presents high growth in a positive light in its Chairman's Letter to Shareholders that appears in Unisource's 2005 Annual Report. RUCO-14, Attachment C.

More recently, this same attitude toward growth was reflected in a Company press release dated August 6, 2007 that announced Unisource's second quarter earnings. RUCO-14 at 14. Nowhere in the press release is customer growth referred to as a negative factor in the Company's ability to turn a profit. The investment community does not view Unisource's high growth service territories in a negative light given the fact that shares of Unisource have increased from $25.25, at the time (2005) that RUCO successfully opposed an acquisition attempt by a limited liability partnership, to a current price of $30.05 as of August 21, 2007. Id.

In regard to regulatory lag, unless the utility is operating under an agreement that provides for a rate freeze, it is the utility that decides when to apply for rate relief. Generally utilities apply for rate relief at times when it is to their advantage Unisource's management was well aware of the regulatory environment that they would be operating in when they acquired the electric and natural gas assets from Citizens in 2003. Id.

In regard to UNS' need to procure a new power supply in 2008, RUCO witness Marylee Diaz Cortez, CPA, is recommending modifications to the Company's purchased power and fuel adjustor mechanism that will, if adopted by the Commission, mitigate the risks associated with this future event and improve UNS' overall financial condition. RUCO 13 at 55. In short, there is no basis for a risk adjustment.

RUCO derived its final cost of common equity recommendation of 9.30 percent by averaging its DCF and CAPM results. Id. at 30. RUCO's recommended cost of common equity is appropriate given the current environment of low inflation and low interest rates in which the Company is operating. RUCO 14 at 6-13. The Federal Reserve's recent decision to cut interest rates and Value Line analyst's projection of further cuts in interest rates further support RUCO's recommended cost of equity. Id. RUCO believes that the rates it is recommending in this case will provide the Company with the opportunity to recover its operating expenses and provide a fair and reasonable return on its invested capital. Id. at 15.

RELIEF REQUESTED: RUCO recommends the Commission adopt RUCO's proposed capital structure. RUCO further recommends the Commission adopt its recommended cost of equity of 9.30 percent and weighted average Cost of Capital of 8.67 percent.

RATE DESIGN

The Company supports RUCO's proposed rate design including RUCO's acceptance of rate consolidation, mandatory Time Of Use rates, inverted block rates, and modifications to the CARES discount. RUCO-10 at 18.

CONCLUSION

The Commission should not authorize a rate increase of more than $1,189,270 for UNS Electric, Inc. The Commission should reject the Company's proposal to include BMGS and CWIP in rate base. The Commission should accept RUCO's proposed use of a historical rolling average to set the PPFAC rate. Finally, RUCO recommends the Commission adopt its remaining recommendations to the following:

1) Rate Base Adjustment No. 2 - accumulated depreciation - the Commission should adopt RUCO's adjustment which increases the test-year accumulated balance by $2,295,112.

2) Rate Base Adjustment No. 4 - accumulated deferred income taxes – CIAC - The Commission should remove ($888,390) for the CIAC deferred tax asset from the Company's rate base.

3) Rate Base Adjustment No. 5 - accumulated deferred income taxes– A & G capitalization - the Commission should increase the pro-forma test-year ADIT balance by $116,258.

4) Operating income adjustment No. 2 – pension and benefits - the Commission should remove ($11,612) of pension and benefits from test-year operating expenses.

5) Operating income adjustment No. 4 – incentive compensation - the Commission should decrease adjusted test-year expenses by ($168,060) to remove incentive compensation.

6) Operating income adjustment No. 5 – rate case expense RUCO's adjustment reduces annual rate case expense from the Company's proposed level of $200,000 ($600,000 / 3 years) to RUCO's recommended level of $83,667 ($251,000 / 3 years).

7) Operating income adjustment No. 6 Bad Debt - the Commission should adopt RUCO's adjustment to decrease test-year expenses by ($203,038).

8) Operating income adjustment No. 8 – postage expense RUCO's postage expense adjustment decreases adjusted test-year expenses by ($55,459).

9) Operating income adjustment No. 10 – A &G capitalization - the Commission should adopt RUCO's adjustment and decrease the Company's pro-forma operating expenses by ($301,187) to remove the double count.

10) Operating expense adjustment No. 11 – CWIP property taxes - the Commission should adopt RUCO's adjustment and remove the Company's pro-forma CWIP property taxes of ($239,697) from test-year expenses.

11) Operating income adjustment No. 12 - corporate cost allocations- the Commission should adopt RUCO's adjustment and decrease the Company's pro-forma operating expenses by ($8,187) to remove advertising expenses whose primary benefit inures to shareholders and not the ratepayers.

12) Operating adjustment No. 14 – Valencia Turbine Fuel - the Commission should remove ($266,198) from pro-forma operating expenses for fuel costs the Company will recover through the new adjusting PPFAC.

13) Operating income adjustment No. 15 – property tax computation - RUCO's property tax calculation decreases adjusted test-year expenses by ($356,711).

14) Operating income adjustment No. 16 – supplemental executive retirement plan - RUCO's adjustment decreases test-year expenses by ($83,506).

15) Operating income adjustment No. 17 – inappropriate and/or unnecessary expenses - RUCO's adjustment decreased test-year expenses by ($63,607) for unnecessary expenses.

16) Operating income adjustment No. 18 – maintenance of overhead lines - RUCO's adjustment decreased test-year expenses by ($95,879).

17) Operating income adjustment No. 19 – customer service cost allocations - RUCO's recommended adjustment decreases test-year expenses by ($66,797).

18) Operating income adjustment No. 20 – non-recurring/atypical expenses - RUCO's recommended adjustment decreases test-year expenses by test-year expenses by ($14,251).

19) Operating income adjustment No. 21 – outside services DSM - the Commission should remove ($17,055) from test-year expenses for outside DSM services.

20) Operating income adjustments Nos. 25 and 26 – payroll expense and payroll tax expense - RUCO's recommended adjustment removes the post-test-year payroll expense of ($231,750) and the tax expense associated with the payroll of ($17,729) from operating expenses.

21) Operating adjustment No. 27 – income tax expense – the Commission should ignore the Company's position regarding current and deferred income taxes and adhere to its standard rate base treatment of income tax deferrals and standard income tax treatment of current income tax expense.

22) Cost of Capital - RUCO recommends the Commission adopt RUCO's proposed capital structure. RUCO further recommends the Commission adopt its recommended cost of equity of 9.30 percent and weighted average Cost of Capital of 8.67 percent.

RESPECTFULLY SUBMITTED this 5th day of November, 2007.

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