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BEFORE THE ARIZONA CORPORATION CC.

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COMMISSIONERS

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WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF
UNS ELECTRIC, INC. FOR APPROVAL OF
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.

DOCKET NO. E-04204A-06-0783

STAFF'S REPLY BRIEF

REDACTED

I. INTRODUCTION.

UNS Electric, Inc. ("UNSE" or "Company") the Company has not met its burden of proof for its proposed rate increase or for its rate design proposals that are different than those recommended by Staff. Nothing in the Company's Opening Brief compels adoption of the Company's position on disputed matters. The following discussion, as well as Staff's Opening Brief, demonstrates why Staff's recommendations should be adopted.

II. RATE BASE.

UNSE's Brief fails to recognize Staff's Final Accounting Schedules. Staff's final accounting schedules were filed on October 16, 2007. These are identical to Staff Exhibit S-60 which was filed when Staff witness Ralph Smith testified. In those schedules, Staff updated certain adjustments in response to UNSE's rejoinder testimony. Attached to UNSE's brief is UNSE witness Dukes' Rejoinder Exhibit DJD-6. UNSE's Brief apparently has relied upon that rejoinder exhibit but ignores changes made to the Staff's final rate base, net operating income and revenue requirement by Staff witness Ralph Smith at the hearings. UNSE's Brief does not recognize Staff's final recommendations on any of these areas, but only addresses the positions in Staff's surrebuttal schedules. For an accurate presentation of Staff's recommendations, one should therefore look to ...

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1 Staff's final accounting schedules, filed on October 16, 2007, and not to the presentation in and
2 attached to UNSE's brief, to the extent inconsistent with those schedules.

3 **A. The Commission Should Not Include Construction Work in Progress ("CWIP")**
4 **in Rate Base.**

5 1. **The company has not justified any compelling circumstances to justify**
6 **CWIP's inclusion in rate base.**

7 UNSE's Brief at pp.10-15 reiterates the Company's arguments for including CWIP in rate
8 base. Staff continues to recommend that the \$10.8 million of CWIP UNSE has proposed not be
9 included in rate base because of the reasons described in the direct and surrebuttal testimony of Staff
10 witness Ralph C. Smith. The Company has not justified including CWIP in rate base.

11 The Company's Brief at page 15 argues that "utility commissions across the country have
12 incorporated CWIP in rate base to address needs far less exigent than those facing UNS Electric."
13 However, many state regulatory commissions do not allow CWIP in rate base. UNSE's Brief cites a
14 handful that do, but fails to acknowledge the many others that do not. Additionally, while
15 elaborating extensively on the findings that UNSE has selectively cited from other states, UNSE
16 fails to address the standard for including CWIP in rate base in Arizona. This Commission has a
17 longstanding policy of not including CWIP in rate base except under extraordinary circumstances,
18 such as the construction of a major nuclear plant or a small water company that is in extreme
19 financial difficulty. Ordinary utility operations in Arizona with some CWIP are quite common, but,
20 except in such extraordinary circumstances, CWIP is not included in rate base.

21 Moreover, there are good reasons for not including CWIP in rate base. To briefly
22 summarize:

- 23 (1) Inclusion of CWIP in rate base is an exception to the Commission's normal practice,
24 and UNS Electric has not met its burden of proof showing why it requires such an
25 exceptional ratemaking treatment. UNS Electric has not demonstrated that it is in
26 financial distress, or that it would be unable to obtain financing at a reasonable cost if
27 the normal practice of excluding CWIP from rate base is followed in the current case.
28 Staff witness David Parcell addresses how Staff's recommendations should enable
UNS Electric to continue to have access to financing at a reasonable cost. Mr. Parcell

1 also addresses the determination of a fair rate of return that would allow UNS Electric
2 to attract new capital on reasonable terms. In making his cost of capital
3 recommendations, Mr. Parcell has been made aware of and has taken into
4 consideration UNS Electric' proposal to include CWIP in rate base and Staff's
5 recommendation that CWIP not be included in rate base in this case. UNS Electric is
6 experiencing rapid growth in customers, but it is not in financial distress. At page 27
7 of his rebuttal testimony, at lines 8-12, Mr. Grant agrees with Mr. Parcell's
8 conclusion that CWIP is not necessary for UNS Electric to attract capital, and
9 concedes that: "over the short-term, assuming no significant changes occur in the
10 capital markets, that UNS Electric could probably attract additional capital without
11 having CWIP in rate base."

12 (2) The CWIP was not in service at the end of the test year. As of June 30, 2006, the
13 construction projects were not serving customers.

14 (3) The Company has not demonstrated that its June 30, 2006 CWIP balance was for
15 non-revenue producing and non-expense reducing plant. Much of the construction
16 appears to be related to serving customer growth, i.e., to be revenue producing. Test
17 year revenues have been annualized to year-end customer levels. However, revenues
18 have not been extended beyond the test year to correspond with customer growth.
19 Hence, including the investment in rate base, without recognizing the incremental
20 revenue it supports, would be imbalanced. Some of the facilities that are being
21 constructed will be used subsequent to the test year ending June 30, 2006 to serve
22 additional customers. It would not be appropriate to include the investment that will
23 serve those new customers without also including the revenues that would be
24 received from those customers. In other words, allowance of CWIP in rate base
25 would result in a mismatch in the ratemaking process. Additionally, some of the
26 plant being added, such as main replacements, could result in a reduction in
27 maintenance expenditures which would not be reflected in the test period. The
28 inclusion of CWIP in rate base, therefore, creates an imbalance in the relationships

1 between rate base serving customers and the revenues being provided to the utility
2 from customers who were taking service during the test year. Consequently, CWIP
3 should not be allowed in rate base unless there are very compelling circumstances
4 which would warrant an exception to the general rule.

5 (4) UNS Electric accrues a return, representing its financing costs during the construction
6 period, called Allowance for Funds Used During Construction (AFUDC). This
7 AFUDC return accounts for the utility's financing cost during the construction
8 period.

9 (5) Other large Arizona utilities are also facing customer growth and similar "regulatory
10 lag" issues to UNS Electric. Yet, Staff's research has revealed that none of the large
11 Arizona utilities have CWIP in rate base. UNS Electric has failed to demonstrate that
12 its circumstances are so different and unique that it requires a significantly different
13 regulatory treatment for CWIP.

14 (6) While the Company has stated that inclusion of CWIP in rate base could result in
15 deferring the filing of its next rate case, the Company has made no specific
16 enforceable commitments to a filing moratorium period.

17 In the current case, UNS Electric has not demonstrated convincingly that it requires an
18 exception to the Commission's standard ratemaking treatment of excluding CWIP from rate base.
19 The situation for UNSE with respect to CWIP is virtually identical to the recently decided rate case
20 involving UNSE's affiliate UNS Gas. The Commission rejected UNS Gas' request for inclusion of
21 CWIP in rate base (and UNS Gas' other variations of this request, including post-test-year plant and
22 an attempt by UNS Gas to not reflect Customer Advances as a rate base reduction. The situations
23 for UNSE and UNS Gas regarding CWIP are virtually indistinguishable with respect to the
24 ratemaking principles. The Commission should therefore reach the exact same decision for UNSE
25 that it just recently reached for UNS Gas.

26 The Company presented testimony on the growth rates in both Mohave and Santa Cruz
27 counties through witness Thomas Ferry. Mr. Ferry testified that UNSE serves the majority of
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1 Mohave and Santa Cruz Counties.¹ It serves approximately 72,200 customers in Mohave County
2 and 19,650 customers in Santa Cruz County.² The Counties include the cities of Kingman, Lake
3 Havasu City and Nogales. Customer growth during the test year period, according to Mr. Ferry, was
4 4.8 percent for Mohave County and 5.8 percent for Santa Cruz County.³ Mr. Ferry also testified that
5 approximately 85% of UNSE's customers are residential, and 15% are commercial.⁴ Less than one
6 percent of customers are industrial.⁵

7 The Staff does not dispute that the Company is experiencing growth. But as Staff witness
8 Smith pointed out during cross-examination, so are most other utilities in Arizona.

9 "Q. [BY UNSE ATTORNEY PATTEN]: You haven't disputed Mr. Grant's
10 statement that UNS Electric's net plant investment on a per customer basis
increased by 19.1 percent?

11 A. [BY STAFF WITNESS SMITH]: I didn't dispute it, but then I didn't --
12 you know, I didn't really try to -- I didn't think it was particularly relevant
13 in view of the CWIP issue, because other utilities in the state also have
14 growth. It's true that UNS's growth might be at a more rapid rate
recently, but other utilities that don't have CWIP in rate base are also
experiencing growth. They operate in the state and the state is growing."⁶

15 A review of recent Commission orders reveals that almost all Applicants had requested
16 Commission authorization to include CWIP in rate base.⁷ One of the predominant reasons given by
17 the Applicants was customer growth.⁸ In Arizona, customer growth is the norm rather than the
18 exception.

19 UNSE also relies upon other "unique and unprecedented factors" to justify inclusion in rate
20 base in this case. For instance, other than growth, it urges the Commission to allow CWIP in rate
21 base because its wholesale full requirements contract with PWCC is set to expire at the end of May,
22 2008 and at the same time it must refinance all of its debt, approximately \$60 million, in August,

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¹ Thomas J. Ferry Direct Test. (Ex. UNSE-20) at 3.

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ Tr. at 1206.

⁷ See Arizona Public Service Co., ACC Docket No. E-01345A-05-0816, E-01345A-05-0826 & E-01345A-05-0827,
28 Decision No. 69663 (June 28, 2007).

⁸ UNSE Initial Br. At 10-11.

1 2008.⁹ The Company's attorney implied through questions on cross-examination that the Company
2 may have to rely on entirely upon the spot market if the Commission does not allow CWIP in rate
3 base.¹⁰ But, the Company has a procurement plan in place and it is already lining up power
4 contracts to replace the PWCC contract:

5 "Q. [BY MR. PATTEN]: Would you still reject an allowance for CWIP in
6 rate base if it led to higher costs for acquiring replacement power?

7 A. [BY MR. SMITH]: The costs of acquiring replacement power and
8 CWIP are two different issues.

9 Q. Do you understand that if UNSE's credit is poor enough it may be unable
10 to acquire certain power resources except through the spot market?

11 A. I've reviewed the company's procurement plan for purchased power, and
12 that plan...doesn't indicate that that's the company's plan to only procure
13 power on the spot market.

14 * * * *

15 Q. It's fair to say that if the company's credit is not where the power
16 marketers think it should be that the cost of that power will go up or it may
17 even become unavailable; correct?

18 A. Or there could be other arrangements reached such as some sort of credit
19 backing from UniSource Energy or one of the other affiliated companies
20 that would stand behind it and help UNS Electric obtain the temporary
21 credit support it needed.

22 But the company's procurement plan, which understand reflects the
23 company's understanding of its current situation, reflects a variety of
24 power purchases. It's not limited to 100 percent spot power. So your
25 hypothetical is inconsistent with the company's own procurement
26 documents.

27 Q. Well, the procurement plan is a plan that they would hope to execute. If
28 the company's financial situation is such that it may interfere with that, is
29 it fair to say that they may be unable to execute that plan?

30 A. They may not be able to execute it exactly as planned. I mean, it's a plan.
31 They have already been executing it and lining up some power contracts to
32 cover the period after May 31, 2008. So they're already executing the
33 plan, and the way that they're executing it is not by exclusively relying on
34 spot power."¹¹

35 Further, some of the benefits alleged by the Company of including CWIP in rate base are
36 speculative in this case at best:

37 ⁹ K. Grant Direct Test. (Ex. UNSE-34) at 3.

38 ¹⁰ Tr. at 1219-20.

¹¹ Tr. at 1219-20.

1 "Q. [BY MR. PATTEN]: First, is it fair to say that it can reduce need for
2 construction driven rate proceedings?

3 A. [BY MR. SMITH]: No. I don't think that that's – I don't tend to agree
4 with that. I mean, if the company is constructing something that's going
5 to have a major impact on rate base, they're probably going to need a rate
6 case one way or the other.

7 * * * *

8 Q. So some of the reasons to allow it might include reducing regulatory lag?

9 A. I think it could reduce regulatory lag, but then it creates other problems
10 such as creating a mismatch between rate base and operating income.

11 Q. It also could provide additional cash flow to preserve financial health of a
12 utility; correct?

13 A. It would tend to provide a cash return on the construction as opposed to an
14 AFUDC return which eventually becomes a cash return. So it kind of
15 accelerates the company's receipt of cash. But again, that creates a
16 mismatch, which is one of the reasons why the states that don't allow
17 CWIP don't allow it.

18 Q. Allowing CWIP in rate base also could improve access to capital on
19 favorable terms; correct?

20 A. I think that's kind of speculative. I mean, there's a bunch of states that
21 don't allow CWIP where the utilities access capital on favorable terms.
22 So I think, you know, saying that you need CWIP to access capital on
23 favorable terms, I think, is speculation.

24 Q. Allowing CWIP in rate base also would lead to an improved financial
25 situation that could lower borrowing costs; correct?

26 A. I think that's kind of speculative also. It's possible, but there are a lot of
27 utilities operating that don't have CWIP in rate base that have reasonable
28 borrowing costs. So it's not necessary for CWIP to be included in rate
base for utilities to have reasonable borrowing costs."¹²

29 Staff witness Ralph Smith also discussed the cases in Arizona in which the Commission has
30 allowed CWIP in rate base.¹³ The cases date back to the 1970s where CWIP was allowed in rate
31 base.¹⁴ One of the cases involved a small water company where they weren't financially viable
32 without including CWIP in rate base.¹⁵ And the other was when APS was building Palo Verde.¹⁶

33 ¹² Tr. at 1210-12.

34 ¹³ Tr. at 1212-13.

35 ¹⁴ Tr. at 1213.

36 ¹⁵ *Id.*

37 ¹⁶ *Id.*

1 He testified that both of these cases presented a compelling need which is not present in UNSE's
2 case.¹⁷ UNSE witness Grant stated in response to Staff data requests that UNSE is not in financial
3 distress.¹⁸ Company witness Grant also stated in his rebuttal testimony that over the short term,
4 assuming no significant changes occur in the capital markets, that UNSE could probably attract
5 additional capital without having CWIP in rate base.¹⁹ Further, Mr. Grant testified that with respect
6 to Palo Verde, [t]here are certainly differences from the standpoint of...one large, vertically
7 integrated company building a nuclear plant and a small distribution company adding distribution
8 and transmission plant."²⁰

9 Staff witness Smith also discussed all of the other components of this case which undermine
10 any argument on the Company's part that without CWIP in rate base it would be in financial
11 distress.²¹ The Staff has recommended that the Commission approve the Company's request for
12 additional financing.²² The Staff is recommending a PPFAC mechanism for UNSE that includes a
13 forward-looking component which prospectively should more closely match the Company's
14 recovery of fuel and purchased power expense in the designated FERC accounts with their
15 incurrence.²³ Mr. Smith noted that the PPFAC in and of itself should "tremendously help the
16 company's cash flow in terms of providing cash inflows to meet its cash outflows for fuel and
17 purchased power expenses, which are by far the biggest expense on the company's income
18 statement."²⁴

19 The Company also argues that it should be allowed to put at least \$8.7 million of the \$10.8
20 million in rate base because it estimates that \$8.7 million was in service as of June 30, 2007.²⁵ Mr.
21 Grant estimates that the remaining \$ 2.1 million will get closed to plant in service sometime over the
22 next year or two.²⁶ But the \$8.7 million went into service a whole year outside of the end of the test
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24 ¹⁷ *Id.*

¹⁸ *Id.* at 1213-14.

25 ¹⁹ Tr. at 1215.

²⁰ Tr. at 1001.

26 ²¹ Tr. at 1213.

²² Alexander Igwe Direct Test. (Ex. S-54) at 7.

27 ²³ Ralph Smith Surrebuttal Test. (Ex. S-58) at 9-10.

²⁴ Tr. at 1216.

28 ²⁵ Tr. at 995.

²⁶ *Id.*

1 year and therefore there is the same mismatch problem which is inconsistent with sound ratemaking
2 principles.²⁷ Mr. Smith testified: "...to go outside of the test year, especially a whole year outside
3 the test year, and say we want to pump up rate base for one item while ignoring all of the other
4 related consequences that tend to go in the opposite direction, it's mismatching and it's
5 inappropriate."²⁸

6 The Company belatedly suggested in its Initial Brief that much of the CWIP was non-
7 revenue producing.²⁹ Mr. Smith testified that the Company during the case did not present any clear
8 information as to what portion of CWIP is non-revenue producing. But even if it had, Mr. Smith
9 noted that some of the non-revenue producing CWIP can be expense reducing as well.³⁰ The
10 Company made demonstration that the CWIP in issue is either non-revenue producing or non-
11 expense producing.³¹ Adding further ambiguity to the issue, the Company conceded on cross-
12 examination that a portion of the \$10.8 million was funding line extension, services, meters which
13 are required for new customers.³² These customers will provide additional revenues to the Company
14 yet the Company did not make any adjustment to impute these revenues because the Company has a
15 very large number of line extensions and different projects embedded in the \$10.8 million and it is
16 hard to predict when customers are actually going to hook up to the system and start using
17 electricity.³³

18 Finally, Staff witness Parcell's testimony pointed out that while the Company has not had
19 CWIP since it was formed in 2003, it has earned 11 percent in 2004, 11 percent in 2005 and 10.5%
20 in 2006.³⁴ He testified that the rating agencies describe the operations of UNSE as low risk.³⁵ He
21 also stated that UNSE receives its financing based on the credit quality of UniSource Energy and/or
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24 ²⁷ *Id.* at 1223.

25 ²⁸ *Id.*

26 ²⁹ Company's Initial Br. at 11.

27 ³⁰ Tr. at 1222.

28 ³¹ *Id.*

³² Tr. at 992.

³³ Tr. at 992.

³⁴ Tr. at 1145.

³⁵ David C. Parcell Direct Test. (Ex. S-52) at 14.

1 UES, not based on the situation of the Company itself and that it was not necessary to provide CWIP
2 treatment in order for the Company to attract capital.³⁶

3 In the end, Staff's testimony is that if Staff's recommendations were adopted in their entirety,
4 including the revenue requirement, the PPFAC, the capital structure, and rate of return
5 recommended by Mr. Parcell, and the approval of the financing, then it's Staff's belief that this
6 would continue to allow UNSE to obtain financing at reasonable terms.³⁷

7 **2. Inclusion of post-test-year plant would violate well recognized**
8 **ratemaking principles.**

9 UNSE's alternative proposal, if CWIP in rate base is rejected, is to include post-test year
10 plant in rate base. UNSE's Brief addresses this at pages 15-16. This proposal suffers from many of
11 the same problems related to CWIP, including, but not limited to the mis-match of rate base and net
12 operating income that would result.

13 The situation for UNSE with respect to post-test year plant is virtually identical to the
14 recently decided rate case involving UNSE's affiliate UNS Gas. The Commission rejected UNS
15 Gas' request for inclusion of post-test year plant in rate base. The situations for UNSE and UNS
16 Gas regarding post-test year plant are virtually indistinguishable with respect to the ratemaking
17 principles. The Commission should therefore reach the exact same decision for UNSE that it just
18 recently reached for UNS Gas.

19 **3. Contrary to the Company's position, customer advances should be**
20 **deducted from rate base to prevent a double rate of return.**

21 UNSE's second level fall back position, if CWIP is not allowed in rate base, is that Customer
22 Advances, which are a deduction from rate base according to the Commission's rules at A.A.C.
23 R14-2-103, Appendix B, Schedule B-1, should **not** be deducted from rate base. UNSE's Brief at
24 page 16 even claims that Staff's and RUCO's position, which follow the Commission rules and
25 reflect Customer Advances as a deduction to rate base is "simply unfair." What UNSE ignores,
26 however, is not only that the Commission rules require Customer Advances to be deducted to rate
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28 ³⁶ *Id.*

³⁷ *Id.* at 1224.

1 base, but also that this longstanding practice is, in fact, eminently fair, when the interaction between
2 CWIP, Customer Advances and the AFUDC calculation are considered.

3 Further, when the Company computes AFUDC, it does not reduce the project balance to
4 which the AFUDC rate is applied, by Customer Advances.³⁸ AFUDC is a financing cost of
5 construction allowing the Company to earn a non-cash return on its investment during the
6 construction period.³⁹ UNSE records Customer Advances in a liability account.⁴⁰ The Company has
7 the use of the funds provided by Customer Advances until they are returned to the developer or
8 contributor.⁴¹

9 As explained by Staff witness Ralph Smith,

10 “One additional reason why Customer Advances should be deducted from rate
11 base is to prevent a double rate of return. In accruing AFUDC by applying the
12 AFUDC rate to a CWIP balance, Customer Advances are typically not deducted
13 from the construction cost base upon which AFUDC is computed. If the
14 Customer Advances have not been specifically deducted in the AFUDC
15 calculations (which would be contrary to the prescribed treatment for a utility
16 following the AFUDC formula in the FERC Uniform System of Accounts), the
17 non-investor provided cost-free capital in the form of Customer Advances needs
18 to be reflected as a rate base deduction.

19 “Consequently, the request by Mr. Grant to adjust the balance of Customer
20 Advances, if CWIP is excluded from rate base, is contrary to precedent, would be
21 improper for ratemaking purposes, and should be rejected.”⁴²

22 Finally, the situation for UNSE with respect to Customer Advances is virtually identical to
23 the recently decided rate case involving UNSE’s affiliate UNS Gas. The Commission rejected UNS
24 Gas’ request for inclusion of Customer Advances in rate base. The situations for UNSE and UNS
25 Gas regarding Customer Advances are virtually indistinguishable with respect to the ratemaking
26 principles. The Commission should therefore reach the exact same decision for UNSE that it just
27 recently reached for UNS Gas.

28 ³⁸ Tr. at 1039.

³⁹ Tr. at 1039-40.

⁴⁰ Tr. at 1040-41.

⁴¹ Tr. at 1041.

⁴² Ralph C. Smith surrebuttal testimony (Ex. S-58) at 17.

⁴⁷ Ralph C. Smith Surrebuttal Test. (Ex. S-56) at 45-46.

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4. If CWIP were allowed in rate base, which it should not be, UNSE's AFUDC proposal must be rejected.

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Page 17 of UNSE's Brief presents the Company's proposal that, even if CWIP were allowed to be included in rate base, the Company wants to be permitted to continue accruing AFUDC on all eligible construction projects. This identical issue was also addressed in the recent UNS Gas rate case. If the Commission excludes UNSE's CWIP from rate base, the calculation of AFUDC is not a problem. However, if CWIP were to be included in rate base, this Company proposal is highly inappropriate, would result in a double-return on construction (a cash return on CWIP in rate base plus an AFUDC return on all new construction), and should therefore be rejected.

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B. Accumulated Deferred Income Taxes.

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UNSE's brief at pages 17-18 only addresses RUCO adjustments to ADIT. Staff has made an adjustment (which was described in Staff witness Smith's direct testimony and shown on Schedule B-5) to decrease rate base by \$161,555 for the impact of the following:

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- 1) removal of the ADIT related to the Supplemental Executive Retirement Plan ("SERP"); and
- 2) removal of the ADIT relating to stock-based compensation.

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Staff's adjustment to ADIT is necessary to properly coordinate the impact of Staff's related adjustments to operating expenses with the ADIT amount included in rate base. Whether the rate base adjustment to ADIT should be made is dependent upon whether the related adjustments to operating expense are used. UNSE does not appear to question the need to coordinate the ADIT adjustments recommended by Staff with these adjustments to operating expenses.

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C. Cash Working Capital.

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UNSE and Staff are in agreement that the Cash Working Capital allowance in rate base should be negative, and that the calculation is dependent upon the operating expenses and rate base allowed. Staff's final accounting schedules, filed on October 16, 2007, show Staff's final adjusted CWC amount of negative \$2.405 million on Schedule B-4, column G, line 23.

1 **D. Reconstruction Cost New Less Depreciation.**

2 UNSE used the method of trending the Original Cost Rate Base (OCRB) using available
3 inflation indexes such as the Handy-Whitman Index. Staff accepted UNSE's RCND methodology,
4 but cautioned against granting UNSE a revenue requirement on fair value rate base (FVRB) that was
5 substantially higher, because the recent acquisition of UNSE from Citizens Telecommunication
6 Company at a substantial discount to book value cast doubt upon whether the traditional RCND
7 measurement was a good indicator of the fair value of the property in this particular fact situation.

8 **E. Fair Value Rate Base.**

9 As shown on Staff's final accounting schedules, Staff's recommended FVRB was \$167.551
10 million. The primary reason why Staff's FVRB differed from the FVRB proposed by UNSE was
11 UNSE's proposed inclusion of CWIP in rate base, which, as explained above, is contrary to
12 Commission precedent and unjustified in this case.

13 **III. OPERATING INCOME AND EXPENSE ADJUSTMENTS.**

14 As noted above, with respect to rate base, UNSE's Brief ignored Staff adjustments to net
15 operating income for various expenses made after UNSE's rejoinder filing that were presented by
16 Staff witness Ralph Smith when he testified at the hearings, and which are also reflected in Staff's
17 final accounting schedules that were filed on October 16, 2007.

18 Staff's Brief on net operating income issues focuses on the items that remain in dispute
19 between Staff and UNSE. For clarity sake, Staff's Brief addresses some issues where Staff and
20 UNSE are in agreement, but which UNSE, by ignoring Staff's final accounting schedules in UNSE's
21 brief, appears to still be assuming that such items remain in dispute.

22 **A. CARES Discount.**

23 UNSE's Brief addresses operating revenue at page 21. The only remaining difference
24 between Staff and UNSE with respect to operating revenue is the treatment of CARES discount.
25 Staff's adjustment of CARES discount revenue and Staff's proposed treatment of the CARES
26 discount in the current UNSE rate case is consistent with Staff's treatment in the recent UNS Gas
27 rate case. UNSE's proposal to reduce test year revenue by \$56,564 to remove CARES revenue was
28 rejected by Staff and should be rejected by the Commission.

1 **B. Payroll Expense.**

2 UNSE's Brief at pages 22-23 presents a highly misleading discussion of payroll expense.
3 UNSE is attempting to increase payroll expense in its rebuttal testimony by \$139,201 for overtime.
4 UNSE claims this is based upon Staff witness Ralph Smith's calculation of an overtime adjustment
5 from the recent UNS Gas rate case. However, UNSE witness Dukes' testimony and the presentation
6 in UNSE's brief concerning this make it clear that the Company did not understand and has failed to
7 accurately portray the analysis used in the UNS Gas case.

8 As explained in Staff witness Smith's surrebuttal testimony at page 44-45, the Staff analysis
9 and recommendation of the overtime adjustment for UNSE was fully consistent with the analysis of
10 overtime for UNSE.

11 Also presented with Staff witness Smith's surrebuttal testimony was Attachments RCS-9
12 which clearly presented the calculations of the overtime adjustment in the UNS Gas case, which
13 used two calculations, and the same analysis and methodology used by Mr. Smith in the UNSE case
14 to determine that no adjustment was necessary or warranted in the UNSE case. UNSE's brief failed
15 even to acknowledge the two separate calculations to evaluate an overtime adjustment in the UNS
16 Gas case, and the same two calculations Mr. Smith used to evaluate an overtime adjustment in the
17 UNSE case. As explained by Mr. Smith, in the UNS Gas case, both alternative calculations (which
18 were filed in the UNS Gas case as part of the Staff accounting schedules, and which were also
19 reproduced in the UNSE case in Mr. Smith's Attachment RCS-9, filed with his surrebuttal) showed
20 a reduction to the overtime that had been calculated by UNS Gas, so he used the lower of the two
21 reduction amounts. In the UNSE situation, one of the two calculations showed a reduction and the
22 other showed an increase to the overtime amount, so Mr. Smith appropriately concluded that: "my
23 analysis of overtime expense, which is presented in Attachment RCS-9, and which followed the
24 same analysis format that I used in the UNS Gas case, indicates that the overtime expense in UNS
25 Electric's original filing is within a range of reasonableness (i.e., it was bracketed by the results of
26 the two alternative calculations I performed). Consequently, no additional adjustment to overtime for
27 UNS Electric is necessary."⁴⁷ As noted, detailed calculations considered in not proposing an
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1 adjustment to test year overtime for UNSE, and the calculations of the overtime adjustment filed in
2 the UNS Gas were filed with Mr. Smith's surrebuttal in Attachment RCS-9.

3 The overtime expense adjustment proposed by UNSE is unwarranted, contrary to the
4 analysis performed by Staff witness Smith (which was fully consistent with his overtime adjustment
5 in the UNS Gas case), and should be rejected.

6 **C. UNSE's Rebuttal Testimony Payroll Adjustment.**

7 UNSE's rebuttal payroll expense adjustment would more than triple the Company's
8 previously filed payroll and overtime adjustment. This adjustment, which is comprised of the
9 overtime adjustment addressed above, and an additional post-test year payroll increase occurring on
10 January 1, 2007 should be rejected in total.⁴⁸ The Company's attempt in Mr. Dukes' rebuttal
11 testimony to add to test year payroll expense an additional round of post-test year payroll increases
12 is inconsistent with the derivation of payroll in the UNS Gas case, which was annualized to year-
13 end, but not beyond. In summary, the additional increases proposed by the Company for the first
14 time in rebuttal for a post-test year payroll increase should be rejected.

15 **D. Workers Compensation (Injuries and Damages).**

16 UNSE's Brief at pages 23-24 was apparently written without considering the revisions to
17 Staff's Adjustment C-6 discussed by Staff witness Smith when he testified at the hearings, and
18 which are also reflected in Staff's final accounting schedules. As indicated on the contents page of
19 Staff's final accounting schedules and described by Mr. Smith during his summary, Staff's
20 adjustment for Injuries and Damages expense was modified to agree with the revised normalized
21 amount stated in UNSE witness Dukes' rejoinder testimony at page 4. Page 24, lines 15-17, of
22 UNSE's Brief states: "The Company believes a negative adjustment for workers compensation
23 expense – equaling \$98,161 – is appropriate because the test-year level of \$173,456.03 appeared
24 'abnormally high due to the timing of when activity was actually expensed.'" Staff's final
25 accounting schedules clearly show on Schedule C-6, that Staff's adjustment is the negative \$98,161.

26 _____
27 ⁴⁸ Another disturbing factor about UNSE's tripling of its payroll adjustment in its rebuttal filing is the fact that, despite
28 data requests from Staff requesting UNSE to identify changes and corrections to its filing, the Company did not identify
any change related to a post-test year payroll increase or present an additional request for a substantially increased
payroll adjustment until its rebuttal filing on August 14, 2007. See Dallas Dukes Rebuttal Test. (Ex. UNSE-24) at 20-21.

1 The Company's Brief at page 25 on this issue is totally irrelevant in view of the above.
2 Additionally, UNSE's Brief at page 25, line 11 presents an incorrect amount. The \$64,241.71
3 mentioned there should be \$464,242, which, again can be clearly found in the Staff's final
4 accounting schedules on Schedule C-6, line 2, and which is clearly labeled there as: "Staff
5 Recommended Normalized Injuries and Damages Expense." The \$464,242 also appears in UNSE
6 witness Dukes' rejoinder testimony at page 4, line 14.

7 **E. Fleet Fuel Expense.**

8 UNSE's Brief at pages 32-33 fails to acknowledge Staff's final accounting schedules or Mr.
9 Smith's oral testimony, which clearly indicate that Staff's fleet fuel adjustment had been modified to
10 use the pro forma fleet fuel expense of \$605,498 per UNSE witness Dukes' rejoinder testimony at
11 page 2.

12 **F. Edison Electric Institute Dues Expense.**

13 UNSE's Brief at page 33 addresses EEI dues expense. UNSE claims that it would be
14 unreasonable to disallow 49.93 percent of EEI core dues. Staff witness Smith testified and presented
15 evidence that this disallowance percentage is based upon NARUC-designated categories of EEI core
16 functions.

17 The benefits cited by UNSE for EEI largely relate to lobbying, which is a disallowable cost.
18 As explained at page 37 of Staff witness Smith's surrebuttal testimony:

19 "The benefits claimed by Mr. Dukes are apparently those listed in the response to
20 STF 11.11, parts a and c. Those subparts had requested a listing of what EEI did
21 during the test year to represent the interests of its members in advocating
22 positions in the legislative and regulatory arenas and a statement of "exactly what
23 advocacy activities before Congress and government agencies EEI engaged in
24 during the test year." Neither UNS Electric nor its affiliates have performed a
25 study or evaluation of whether its ratepayers are receiving a benefit from the EEI
26 membership that is commensurate with the cost."

24 The categories of EEI dues to be disallowed are the following activities and should be
25 excluded from rates:

- 26 o Legislative Advocacy
- 27 o Regulatory Advocacy
- 28 o Advertising

- 1 o Marketing
- 2 o Public Relations

3 The sum of EEI Core Dues activities for these NARUC categories totals 49.93 percent, as
4 shown on Staff's final accounting schedules, Schedule C-12, page 2.

5 Moreover, as stated by Staff witness Smith on page 39 of his surrebuttal testimony, this same
6 disallowance percentage was recently applied in the context of another electric utility rate case:

7 "The Arkansas Public Service Commission in Docket No. 06-101- U, an Entergy
8 Arkansas, Inc., rate case, in Order No. 10 (6/15/07) adopted a similar adjustment
9 to reflect the disallowance of 49.93 percent of EEI core dues. This 49.93 percent
 disallowance of EEI core dues corresponds to the above-identified activity
 categories."

10 The Staff adjustment to reduce EEI expense by \$8,470 shown on Schedule C-12 of Staff's final
11 accounting schedules should be adopted in full, including the \$2,993 reduction relating to the
12 removal of 49.93 percent of the expense for EEI core dues.⁴⁵

13 **G. Affiliate SES Mark-Up Above Cost**

14 UNSE's Brief at page 36 claims that Staff's proposed disallowance of a mark-up above cost
15 for charges from an affiliate, SES, should not be adopted because the Company incurred the cost and
16 Staff presented no evidence that the cost incurred was unreasonable. In fact, Staff presented
17 evidence that an affiliate, SES, was charging UNSE amounts in excess of SES's cost of providing
18 services. Affiliated charges to a utility in excess of cost are prima facie unreasonable. Staff's direct
19 testimony of Ralph Smith identified the need for removing the above-cost affiliate charges on pages
20 42-43 and explained that Staff was awaiting responses to data requests in order to quantify the
21 adjustment. Staff's adjustment to remove the mark-up above cost for affiliated charges from SES to
22 UNSE reduces test year expense by \$10,906. In making that adjustment, Staff witness Smith noted
23 that this amount may understate the necessary adjustment.⁴⁶

24 **H. CWIP Depreciation And Property Taxes.**

25 As discussed in its Opening Brief, because Staff did not include CWIP in rate base, the
26 companion adjustments to flow through the exclusion of CWIP from rate base are necessary to

27

28 ⁴⁵ UNSE has agreed with the remainder of Staff's EEI dues adjustment, which removes expense for EEI UARG, as
 shown on Schedule C-12 of Staff's final accounting schedules.

⁴⁶ Ralph Smith Surrebuttal Testimony (Ex. S-58) at 41.

1 depreciation and property taxes. UNSE's brief at page 35 agrees with Staff's adjustment of \$26,582
2 if CWIP is excluded from rate base.

3 **I. Incentive Compensation.**

4 UNSE's Brief addresses incentive compensation and its components at pages 25-29. UNSE's
5 brief on PEP is essentially a condensation of UNSE witness Dukes' rebuttal testimony and a
6 selective recitation of limited decisions from other jurisdictions. UNSE's Brief does not
7 acknowledge or refute the precedent in Arizona for sharing incentive compensation expense between
8 shareholders and ratepayers, as was determined in the most recently decided rate cases for
9 Southwest Gas Corporation and for UNSE's affiliate UNS Gas. The issues concerning incentive
10 compensation are virtually identical between the UNSE rate case and the recently decided UNS Gas
11 rate case. In the UNS Gas rate case, the Commission adopted Staff's recommendation of a 50/50
12 sharing between shareholders and ratepayers of the various components of incentive compensation.

13 **1. Performance enhancement plan.**

14 UNS Electric participates in the same incentive compensation arrangement, the Performance
15 Enhancement Plan ("PEP"), as its affiliate, UNS Gas. As explained in the Company's supplemental
16 response to data request STF 11.5 in the recent UNS Gas rate case, Docket Nos. G-04204A-06-0463
17 et al, the utility's non-union employees participate in UniSource Energy Corporation's PEP.
18 UniSource Energy Services ("UES") is a subsidiary of UniSource Energy Corporation and the
19 parent company of UNS Electric.

20 Staff adjusted UNSE's claimed expenses for various incentive compensation plans including
21 the Performance Enhancement Plan (PEP) by 50%. The 50% decrease in expenses for incentive
22 compensation reflects an appropriate 50/50 sharing between the company's shareholders and its
23 ratepayers since both benefit from the incentive programs. Staff's adjustment reduced the
24 Company's expenses by \$104,357 for incentive programs and \$4,160 for related payroll taxes.
25 UNSE' brief does not establish why Staff's more than reasonable 50/50 adjustment should not be
26 adopted by the Commission.

27 At page 6 of his rebuttal, UNSE witness Mr. Dukes claimed that the evidence he discusses in
28 his rebuttal testimony shows that UNS Electric's total employee compensation including the PEP

1 program is reasonable. At page 7 of his rebuttal, he claimed that the PEP program costs “are
2 actually a net savings to customers.” He claimed further that “the goals and targets of the current
3 PEP program are also heavily weighted toward providing benefits to customers.” At page 8, he
4 claimed that “if the PEP program is eliminated, there would be considerable increased pressure on
5 base compensation.” At page 9 of his rebuttal, Mr. Dukes claimed that direct savings result because
6 PEP is not part of base compensation, and “the impact of reduced compounding wage increases that
7 would be based on a higher base pay total is another benefit.” At page 10, he cited a Commission
8 Decision No. 69663 in a recent Arizona Public Service Company rate case where cash-based
9 incentive compensation expense was allowed. At pages 10-11 of his rebuttal, Mr. Dukes claimed
10 that UNS Electric’s PEP incentive compensation is different than the Southwest Gas Corporation
11 (“SWG”) Management Incentive Plan (“MIP”) because the SWG MIP appears limited to
12 management personnel, whereas UNS Electric’s PEP plan covers all non-union employees. He
13 claimed that the PEP is based on broader and more wide-ranging factors, of which financial
14 performance is only part of the consideration. Finally, on pages 11-13, he selectively cited to a few
15 decisions from other regulatory commissions where the cost of a utility incentive compensation
16 program was allowed to be included in rates.

17 However, as Staff witness Ralph Smith pointed out⁵¹, Mr. Dukes has not demonstrated that
18 base salaries were not reduced when PEP was implemented. The information provided by UNSE
19 suggests, to the contrary, that base salaries were increased upon UNSE’s acquisition of the utility
20 operation from the prior owner, Citizens Telecommunications. Moreover, base salaries have
21 continued to increase each year. Thus, the PEP expense is an additional cost to the base salaries and
22 other employee benefits.

23 There is also evidence that the Company has made PEP payments even in situations
24 where the pre-established PEP goals were not met. As described by Staff witness Ralph Smith in
25 his surrebuttal testimony:

26 “As explained in the Company’s supplemental response to data request
27 STF 11.5(c) in the recent UNS Gas rate case, Docket G-04204A-06-0463:

28 ⁵¹ Surrebuttal Test. (Ex. 2-58) at 27.

1 “In 2005, PEP had a similar structure as 2004 with two primary goals.
2 However, the primary financial goal was now a combined financial measure for
3 UNS Electric, UNS Gas and TEP. The second primary goal measured UNS
4 Electric financial performance, customer and reliability goals, integration goals,
5 and safety and employee goals. Similar to the prior year, each of the two primary
6 goals was weighted equally and PEP only paid if the primary financial goal was
7 met. As stated in the response to STF 11.5 b, the 2005 primary financial goal was
8 not met.”

9 As explained in the utility’s supplemental response to STF 11.5(b): in the recent UNS Gas
10 rate case, Docket No. G-04204A-06-0463, which describes the same UniSource Energy PEP in
11 which UNS Electric also participates:

12 “... the financial performance goal, which was a trigger under the PEP program
13 for UNS Electric, UNS Electric and Tucson Electric Power Company (“TEP”),
14 was not met. The financial performance goal was not met, in part, because of
15 unplanned outages at the coal generating units which required TEP to purchase
16 power on the open market. In discussions with the Board of Directors, the desire
17 was to recognize employee achievements distinct from financial measures. The
18 Board deemed it appropriate to implement a Special Recognition Award to
19 employees for achievements in 2005. Normally, PEP is paid at 50% to 150% of
20 target; the Special Recognition Award was paid at approximately 42% of the
21 target for each of the operating companies.”

22 The structure of the PEP determines eligibility for certain bonus levels by measuring UES’
23 performance in three areas: (1) financial performance; (2) operational cost containment; and (3)
24 core business and customer service goals. Levels of achievement in each area are assigned
25 percentage-based “scores.” Those scores are combined to calculate the final payout. The amount
26 made available for bonuses pursuant to the PEP formula may range from 50 percent to 150 percent
27 of the targeted payment level. The financial performance and operational cost containment
28 components each make up 30 percent of the bonus structure, while the core business and customer
29 service goals account for the remaining 40 percent. The PEP program uses financial performance
30 measures weighted at 30 percent, operational cost containment weighted at 30 percent, and customer
31 service goals weighted at 40 percent. Shareholders benefit from financial performance, and also
32 benefit between rate cases from any operational cost containment that is produced. Achieving the
33 financial performance goals would clearly benefit shareholders. Additionally, achieving the cost
34 containment goals would benefit shareholders between rate cases. There is also a concern that
35 attempts to achieve the cost containment goals could come at the risk of deteriorating customer
36 service. While a 60/40 or some other sharing allocation could be used for ratemaking purposes, the

1 50/50 sharing recommended by Staff considers that there is benefit to both shareholders and to
2 customers and is a reasonable allocation. Consequently, given the structure of the PEP incentive
3 compensation program, a sharing of the cost of the program 50/50 between shareholders and
4 ratepayers, similar to what the Commission decided in the UNS Gas rate case, is also reasonable and
5 appropriate for UNSE.

6 Staff's recommendation for a 50/50 sharing of PEP expense is consistent with the
7 Commission's recent decision in the affiliated UNS Gas rate case. The Commission also recently
8 disallowed a portion of APS's incentive compensation expense in Decision No. 69663 and
9 disallowed a portion of SWG's incentive compensation in Decision 68487, the most recently
10 decided rate case decision for SWG.

11 **2. Supplemental executive retirement plan (SERP).**

12 UNSE's Brief at pages 29-30 argue for SERP. However, UNSE's SERP expense is virtually
13 indistinguishable from Southwest Gas' SERP and is identical to UNS Gas' SERP. In the most
14 recently decided rate cases for Southwest Gas Corporation and for UNSE's affiliate, UNS Gas,
15 SERP expense was disallowed by the Commission.

16 **3. Stock based compensation and long-term incentive.**

17 UNSE's Brief at pages 30-31 addresses Stock Based Compensation. UNSE's brief at pages
18 31 claims that: "Staff does not dispute the reasonableness of UNS Electric's total executive
19 compensation, which includes these costs." In fact, a copy of the most recent "Unisource Energy
20 Executive Compensation – Competitive Compensation Review" dated October 25, 2005 that was
21 prepared by Frederic W. Cooke & Co., Inc. was filed as a confidential attachment (Attachment RCS-
22 10) to Staff witness Ralph Smith's surrebuttal testimony. That study shows the compensation of
23 TEP officers in comparison to a peer group that was selected by the Company. Staff questions how
24 UNSE could make the assertion about the alleged reasonableness of executive compensation in view
25 of the aforementioned study. Stock based compensation should be disallowed because it puts the
26 executive compensation into an excessive range, well beyond the peer group.

27 In the most recently decided APS rate case, the Commission disallowed APS' stock-based
28 compensation. Page 36 of Decision 69663 in a recent APS rate case indicates that the Commission

1 rejected an argument by APS that the Commission not look at how compensation is determined or
2 its individual components:

3 “APS argues that the issue is whether APS compensation, including
4 incentives, is reasonable. APS does not believe that the Commission should look
5 at how that compensation is determined or its individual components, but rather
6 should just look at the total compensation. The Company argues that the interests
of investors and consumers are not in fundamental conflict over the issue of
financial performance, because both want the Company to be able to attract
needed capital at a reasonable cost.

7 “We agree with Staff that APS’ stock-based compensation expense should
8 not be included in the cost of service used to set rates. Contrary to APS’
9 argument that we should not look at how compensation is determined, we do not
10 believe rates paid by ratepayers should include costs of a program where an
11 employee has an incentive to perform in a manner that could negatively affect the
12 Company’s provision of safe, reliable utility service at a reasonable rate. As
13 testified to by Staff witness Dittmer and set out in Staff’s Initial brief, “[e]nhanced
14 earnings levels can sometimes be achieved by short-term management decisions
15 that may not encourage the development of safe and reliable utility service at the
16 lowest long-term cost. ... For example, some maintenance can be temporarily
17 deferred, thereby boosting earnings. ... But delaying maintenance can lead to
18 safety concerns or higher subsequent ‘catch-up’ costs.” [cite omitted] To the
19 extent that Pinnacle West shareholders wish to compensate APS management for
20 its enhanced earnings, they may do so, but it is not appropriate for the utility’s
21 ratepayers to provide such incentive and compensation.”

22 Thus, in Decision No. 69663, the Commission did make an adjustment to disallow a portion
23 of that utility’s incentive compensation expense, specifically the stock-based portion of APS’
24 incentive compensation was disallowed.

25 Confidential Attachment RCS-10, which was attached to Staff witness Ralph Smith’s
26 surrebuttal testimony presented a copy of the “UniSource Energy Executive Compensation –
27 Competitive Compensation Review” dated October 25, 2005 that was prepared by Frederic W. Cook
28 & Co., Inc. (which was provided in a supplemental response to STF 22.10 in the recent UNS Gas
rate case). That document indicates that [BEGIN CONFIDENTIAL] [REDACTED]

[END

CONFIDENTIAL]

29 Staff’s cross examination of UNSE’s Chairman and CEO, Mr. Pignatelli, confirmed that TEP
30 (and UNSE) officers have been receiving compensation that is [BEGIN CONFIDENTIAL]

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[REDACTED] [END CONFIDENTIAL]⁵²

At page 8, lines 12-13 of his rebuttal, Mr. Dukes stated that: "The Company's compensation philosophy is to pay at approximately 50% of the market rate for its employees." Compensation that is substantially in excess of 50% of the market rate could presumably be viewed as unreasonable and even excessive. In addition to the reasons described in Staff witness Ralph Smith's direct testimony for disallowing this cost, an additional argument could be made that the compensation is in excess of 50% of the market rate, and consequently is excessive and should be borne by shareholders and not charged to ratepayers.

Additionally, Staff's cross examination of RUCO witness Rodney Moore confirmed that the long term incentive compensation expense as described in the UniSource Proxy Statement⁵³ (1) is targeted at the 75th percentile of market⁵⁴, (2) would make a UniSource Energy Corporation executive's total compensation, including the base salary, short-term incentive (PEP), and long term incentive at the 75th percentile of market rates or higher⁵⁵. Using RUCO's criteria for disallowing portions of utility incentive compensation, the long term incentive and stock based compensation would need to be disallowed.

"Q. [BY MS. SCOTT]:... If the officers' long-term incentive program and the stock-based compensation puts the total compensation of the small select group of high-ranking officers of UniSource Energy Corporation above the average compensation for the similar officer positions at the peer group companies, would you agree that ratepayers of UNS Electric should not have to pay for that excess compensation?

A. [BY MR. MOORE]: Certainly it is the criteria or the rationale that RUCO uses to make its adjustment to the SERP."⁵⁶

The long-term incentive compensation and stock based compensation is similar to the SERP expense that was disallowed in the UNS Gas rate case in the follow important respects: (1) it involves the provision of additional compensation to the Company's highest paid employees, (2) it is restricted to

⁵² Tr. at 109-129 (Confidential portion).
⁵³ Ex. S-2 (UNSE 2007 Annual Shareholders Meeting).
⁵⁴ Tr. at 919-920.
⁵⁵ Tr. at 920.
⁵⁶ Tr. at 921-22.

1 a select group of highly-compensated executives, and (3) like SERP, if the Company wishes to
2 provide additional benefits to executives that are in excess of the compensation programs applicable
3 to all other employees it may do so at the expense of its shareholders. Moreover, per UniSource's
4 own proxy statement, the purpose of such compensation is to align the interests of the participating
5 executives with stockholders, and such compensation would place the participating executives with
6 total compensation at the 75th percentile level, which by definition exceeds the market average of the
7 peer group (which is measured at the 50th percentile). Consequently, like SERP, it is not reasonable
8 to place this additional burden on ratepayers.

9 **J. Rate Case Expense.**

10 The Company is requesting \$600,000 for rate case expense normalized over three year for an
11 annual allowance of \$200,000. Staff's testimony demonstrated that \$600,000 is inflated and instead
12 allowed \$265,000 for rate case expense normalized over a three year period resulting in an
13 allowance of \$88,333 per year. Although the Company attempts to justify its inflated expense by
14 asserting in part that this is the first case under its current ownership. However, a transfer of
15 ownership is not an excuse to make ratepayers pay excessive costs for rate cases.

16 The Company also justifies the high level of expense because it uses a form of direct
17 assignment rather than the Massachusetts formula in assigning costs which it claims Southwest Gas
18 uses.⁵⁷ Company witness Dukes argued that Staff's reliance on the level of Southwest Gas rate case
19 expense was misplaced since TEP and Southwest Gas use different allocation procedures.⁵⁸ UNSE
20 argues that SWG is one entity with operations in Arizona, Nevada and southern California.⁵⁹ The
21 Company further argues that because TEP is a completely separate regulated utility, it indirectly
22 allocates Executive administration cost through a similar Massachusetts Formula approach.⁶⁰ The
23 Commission approved an allocation policy for UniSource Energy which uses the Massachusetts
24 formula in Decision No. 60480 dated November 25, 1997.⁶¹

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26 _____
⁵⁷ UNSE Initial Br. at 31.

27 ⁵⁸ Dallas Dukes Rebuttal Test. (Ex. UNSE-24) at 16.

28 ⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ Dallas Dukes Direct Test. (Ex. UNSE-23) at 14.

1 The Company goes on to state while TEP indirectly allocates Executive Administration cost
2 through the Massachusetts Formula, it directly allocates the actual cost for services provided to UNS
3 Electric by shared service departments of TEP.⁶² The Company states that Southwest Gas'
4 jurisdictional operations get approximately 55% of all shared service cost from their Corporate
5 entity. The Company further states that if it used the Massachusetts Formula for all administrative
6 and general support costs from TEP, that its allocations to TEP for shared services (labor & burdens)
7 would increase approximately \$2.3 million annually.⁶³

8 TEP labor costs allocated to the rate case as of July 2007, were approximately \$428,000.
9 Other outside labor costs totaling \$202,246 consist of outside legal counsel expenses, Dr. White, the
10 Company's depreciation expert and other out of pocket costs.⁶⁴ This totals \$629,966 for outside
11 services related to the rate case for April, 2006 through July, 2007.⁶⁵

12 Surely, the Company cannot be arguing that it would be entitled to even more rate case
13 expense if it changed its allocation methodology. But this appears to be the case. Staff cannot
14 verify that Southwest Gas' Arizona operations are actually allocated 55% of all shared service costs
15 from their corporate entity. But assuming that to be the case, even with the Massachusetts
16 allocation, the Southwest Gas rate case expenses were much less than UNSE is proposing here. So
17 it is difficult to understand how the Company believes that the different allocation processes support
18 its extremely high level of rate case expense.

19 In the recent UNS Gas rate case, the Commission adopted the ALJ's recommendation of
20 \$300,000 normalized over a three year period. In the discussion, the Commission specifically noted
21 that the allocation method utilized by the Company may pose some problems as well:

22 "On cross-examination, Mr. Smith also expressed a concern with the overall
23 allocation methodology used by TEP for UNS expenses. He testified that the
24 direct allocation methodology used by TEP may result in a double recovery, to the
25 extent that the same personnel are used for different companies, because 'it could
potentially result in loading a disproportionate amount of their cost onto each
utility to their rate case they are working on' (Tr. at 896097)."⁶⁶

26 ⁶² Dallas Dukes Rebuttal Test. (Ex. UNSE-24) at 16.

27 ⁶³ Id. at 6-17.

28 ⁶⁴ Tr. at 812.

⁶⁵ Tr. at 811.

⁶⁶ UNS Gas Recommended Opinion and Order at p. 21-22 (adopted with modifications by the Commission on November 8, 2007).

1 But more importantly, this issue does not come down solely to an accounting issue as the
2 Company argues. It comes down to what is reasonable in terms of rate case expense for UNSE. As
3 Staff witness Ralph Smith noted:

4 "The amount of \$600,000 requested by UNS Electric is over 2.5 times as high as
5 the amount of rate case expense allowed by the Commission in the Southwest Gas
6 rate case, which was \$235,000 in total, and which was normalized over a three-
year period."⁶⁷

7 In addition, the case was similar in size to the UNS Gas rate case as well. The Company was
8 able to benefit from the work done in UNS Gas because a good number of the issues were the same
9 for both UNS Gas and UNS Electric.

10 In summary, the rate case expense recommended by Staff of an annual allowance of \$83,333
11 is in line with the annual allowances the Commission recently granted for UNS Gas, for a similar
12 rate case. It is also comparable to the normalized annual allowance for rate case expense granted in
13 the most recently decided Southwest Gas rate case. UNSE argues that the methods of charging for
14 corporate operations for Southwest Gas and TEP differ. Staff recommends that this be investigated
15 in the current TEP and Southwest Gas rate cases. UNSE is requesting a normalized annual
16 allowance of rate case expense of \$200,000, based on a total of \$600,000, normalized over three
17 years. Staff does not believe that UNSE has justified a level of normalized rate case expense that is
18 double the \$100,000 recently granted to its affiliate UNS Gas.

19 **IV. COST OF CAPITAL**

20 **A. The Commission Should Utilize the Staff's Proposed Capital Structure.**

21 The Company discusses cost of capital at pages 40 through 53 of its Brief. Staff's
22 recommendation to use the Company's actual capital structure should be adopted. The capital
23 structures used by the Company and Staff are actually very close. Staff has proposed a common
24 equity ratio of 48.83% compared to the Company's proposed equity ratio of 48.85%. Staff has
25 proposed long-term debt of 47.21% and short-term debt of 3.96%, compared to the Company's
26 47.81% long-term debt and 3.97% short-term debt ratios.⁶⁸ Staff's proposed capital structure is
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28 ⁶⁷ Ralph C. Smith Surrebuttal Test. (Ex. S-58) at 35.

⁶⁸ Kentton C. Grant Direct Test. (Ex. UNSE-34) at 8.

1 based upon the actual capital structure of the Company as of June 30, 2006.⁶⁹ The Company's is
2 based upon the actual capital structure of the Company as of June 30, 2007.⁷⁰ The difference is due
3 to the fact that Staff used actual data as of the end of the test year; while the Company's data is
4 based upon their financials as of June 30, 2007.

5 The Company's testimony confirms that this capital structure is in line with industry norms
6 and represents a reasonable target for the Company to maintain over the long-run.⁷²

7 **B. The Commission Should Adopt Staff's Cost of Debt.**

8 Again the Company and Staff are very close in their proposals. The Staff has proposed a
9 cost of long-term debt of 8.26% and a cost of short-term debt of 6.36%.⁷³ The Company has
10 proposed a cost of long-term debt of 8.22% and a cost of short-term debt of 6.36%.⁷⁴ The difference
11 is due to the fact that Staff used actual data as of the end of the test year; while the Company's data
12 is based upon their financials as of June 30, 2007.

13 **C. The Commission Should Adopt Staff's Cost of Equity.**

14 The real difference between the Company and Staff comes down to the cost of equity.
15 Staff's recommended cost of equity is 10% as compared to the Company's proposed cost of equity
16 of 11.8%.

17 But there are several serious problems with the Company's analysis. Company witness
18 Grant's DCF analysis resulted in a range of 9.7 percent to 10.5 percent.⁷⁶ The Company's CAPM
19 analysis produced a range of 9.8% to 11.2%.⁷⁷ Mr. Grant states that he went to the high end of the
20 scale for his recommendation due to high levels of customer growth, the use of historical test year,
21 refinancing debt and replacing the Company's energy supply in 2008.⁷⁸ Mr. Grant then added 60
22 basis points as the minimum risk premium applicable to UNSE.⁷⁹ He determined that 60 basis

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24 ⁶⁹ David C. Parcell Direct Test. (Ex. S-52) at 18.

25 ⁷⁰ *Id.*

26 ⁷² Kentton C. Grant Direct Test. (Ex. UNSE-34) at 9.

27 ⁷³ *Id.*

28 ⁷⁴ Kentton C. Grant Direct Test. (Ex. UNSE-34) at 3.

⁷⁶ Kentton C. Grant Direct Test. (Ex. UNSE-34) at 19.

⁷⁷ Kentton C. Grant Direct Test. (Ex. UNSE-34) at 18.

⁷⁸ Tr. at 985.

⁷⁹ Kenton C. Grant Direct Test. (Ex. UNSE-34) at 20.

1 points was appropriate based upon observable differences in required rates of return on speculative
2 grade versus investment grade corporate bonds.⁸⁰ Mr. Grant further testified that the minimum
3 credit spread between a BB-plus and a BBB-minus utility was approximately 60 basis points.⁸¹

4 Yet on cross-examination Mr. Grant conceded that the Company had likely been
5 experiencing similar growth rates of 3 to 4% under Citizen's ownership.⁸² He also conceded that he
6 was not aware of any instances in which the Commission had increased its allowed return for a
7 utility due to high customer growth.⁸³

8 Mr. Grant's recommendation is based upon the high end of the CAPM range, and he
9 acknowledged on cross-examination that the 11.2% recommendation for the proxy group under the
10 CAPM was determined by the results for just one company, UIL Holdings.⁸⁴ In fact, UIL Holdings
11 is the only proxy company with a CAPM result as high as 11 percent.⁸⁵ Had he used the mid-point
12 of the ranges, his recommendation would have been very similar to Mr. Parcell's.⁸⁶

13 Further, as discussed in Staff's Initial Brief, the Company's CAPM results are also much
14 different than Staff's because it relied only upon arithmetic average difference between large
15 company stock and long-term Treasury bonds, rather than using multiple sources of risk premium
16 measures.⁸⁷ In the UNS Gas case, the Commission also found that the Company's use of arithmetic
17 returns only in calculating a comparable company CAPM was inappropriate. The Commission
18 stated:

19 "We agree with the Staff and RUCO witnesses that it is appropriate to consider
20 the geometric returns in calculating a comparable company CAPM because to do
21 otherwise would fail to give recognition to the fact that many investors have
access to such information for purposes of making investment decisions."⁸⁸

22 When it comes right down to it, the Company relies upon the same factors in this case,
23 growth, smaller size, and lower credit ratings to justify a rate of return at the highest point of its

24 _____
25 ⁸⁰ *Id.* at 986.

⁸¹ *Id.*

⁸² Tr. at 987.

26 ⁸³ *Id.* at 988.

⁸⁴ Tr. at 1024-25.

27 ⁸⁵ Tr. at 1024.

⁸⁶ David C. Parcell Direct Test. (Ex. S-52) at 35.

28 ⁸⁷ *Id.* at p. 32.

⁸⁸ UNS Gas Recommended Opinion and Order at 45 (Docket No. G-04204A-06-0463 *et al.*).

1 analysis plus a 60 basis point adjustment.⁸⁹ In the UNS Gas case, the Commission adopted the
2 ALJ's recommendation of 10.0% which had been proposed by Staff witness Parcell.⁹⁰

3 Additionally, UNSE's alleged above-average risk which it attributes to its non-investment
4 grade bond rating and its small size are of the Company's own making. When UNS Electric was
5 formed from the Citizens' properties, UniSource Energy chose to finance the new company with
6 only 35% common equity, which is less equity than the typical electric utility. At the time TEP and
7 UniSource Energy did not have investment grade ratings on their own. The combination of these
8 two factors largely account for the ratings of UNSE. In addition, UNSE was a "new" company in
9 2003 since it had previously been a division of Citizens and not a separate entity. As far as its
10 smaller size, if UniSource Energy wanted UNSE to be a bigger entity, it could have combined it
11 with TEP or with UNS Gas.

12 **D. The Company's Solution to the Chapparral Case Would Produce a Windfall.**

13 As discussed above, UNSE used the method of trending the Original Cost Rate Base
14 (OCRB) using available inflation indexes such as the Handy-Whitman Index. Staff accepted
15 UNSE's RCND methodology, but cautioned against granting UNSE a revenue requirement on fair
16 value rate base (FVRB) that was substantially higher, because the recent acquisition of UNSE from
17 Citizens Telecommunication Company at a substantial discount to book value cast doubt upon
18 whether the traditional RCND measurement was a good indicator of the fair value of the property in
19 this particular fact situation.

20 Mr. Pignatelli acknowledged during the hearing that the rate base is 45 percent lower than
21 the actual cost of those assets. Mr. Grant testified that "[b]y virtue of the acquisition, we reduced the
22 company's investment in the plant by approximately \$93 million."⁹¹ The \$93 million acquisition
23 adjustment is still there as a reduction to rate base and its being amortized over time.

24 The price paid by UniSource Energy in 2003 indicates that the price a willing and informed
25 buyer (UniSource) paid to a willing and informed seller (Citizens) was far less than the RCND
26

27 ⁸⁹ See UNS Gas Recommended Opinion and Order, p. 41.

28 ⁹⁰ *Id.* at 44.

⁹¹ Tr. at 1002.

⁹³ Tr. at 1048-50.

1 measurement presented by the Company in this case, casting considerable doubt on RCND's value
2 for rate making purposes.

3 "Q. [BY MS. SCOTT]: Would you agree that one method for determining fair
4 value is to look at the price a willing and informed buyer would apply to a
willing and informed seller?

5 A. [BY MR. GRANT]: I think that's one indication of fair value.

6 Q. Did the price that UniSource paid to Citizens Utilities for the natural gas
7 utility represent a price a willing and informed buyer would pay to a
willing and informed seller?

8 A. Are you referring to the 2003 purchase of UNS Gas?

9 Q. Yes.

10 A. We were both willing and informed parties to that transaction.

11 Q. UNS Electric was also acquired in August of 2006; correct: Or 2003. I'm
12 sorry.

13 A. Right.

14 Q. And the acquisition price there represented an arm's length transaction
between a willing and informed seller Citizens, and a willing and informed
15 buyer, TEP/UniSource, did it not?

16 A. UniSource Energy was the purchaser. And yes, we were willing and
informed.

17 Because of the recent acquisition, shouldn't the original cost approximate
18 the fair value because of the acquisition from Citizens Utilities was
between a willing and informed buyer and seller?

19 A. Could you repeat that question for me?

20 Q. Because of the recent acquisition, shouldn't the original cost approximate
21 the fair value because of the acquisition of Citizens Utilities – from
Citizens Utilities, which was between a willing and informed buyer and
22 seller?

23 A. Well, the value that exchanged hands in 2003 was what I would consider
to be fair market value. The definition of fair value for rate setting
24 purposes could very well be different. And I believe historically the
Commission has taken into account replacement cost of plant and that of
25 depreciation as one of those factors. So I can see how the two could be
different.

26 Q. But in your opinion could they be the same?

27 A. Could they be the same? Well, you're talking about a value in 2003
28 versus a value in 2006. So they could be the same, but I doubt it because
the fair value you're talking about for rate setting is as of June of '06.

1 Q. But shouldn't the original cost approximate the fair value here?

2 A. Again, it depends on the context in which you're using the term fair value.
3 If you're using the term fair value for rate setting, I think there are
4 additional factors over and above the purchase price in 2003 that need to
5 be considered. If you're talking about a transaction between two willing
6 and informed buyers, it's possible that the fair market value today would
7 approximate original cost.⁹³

8 Even though Mr. Grant attempts to distinguish fair value from fair market value in the above
9 testimony, there is little doubt that there are unique circumstances in this case which make the
10 RCND calculated by the Company of little value for ratemaking purposes.

11 Rote application of the weighted average cost of capital to the Company's "fair value" rate
12 case, as urged by UNSE, would produce a windfall to the Company, even more so in this case,
13 because of the limited value of the Company's RCND for rate making purposes.

14 Mr. Smith testified as to this issue at the hearing:

15 "I and Staff witness Dave Parcell describe how Staff has properly adjusted
16 weighted cost of capital that was developed for an application to an original cost
17 rate base to derive the fair value rate of return that is applied to the fair value rate
18 base.

19 Staff's position is that the proposed method of determining the rate of return that
20 is applied to fair value rate base is appropriate and supported by valid economic
21 and financial theory.

22 Moreover, Staff's position is that this method appropriately complies with the
23 guidance provided by the Arizona Court of Appeals in a recent decision involving
24 Chaparral City Water Company.

25 My testimony describes how Unisource Energy acquired the electric utility from
26 Citizens Communications in August of 2003. Consequently, as of the day of the
27 acquisition, the fair value of the assets acquired from Citizens would be equal to
28 the purchase price paid by UniSource. The acquisition of the electric utility was
the result of an arm's length transaction between a willing and informed buyer
and a willing and informed seller.

UniSource has told us in response to data requests, which are cited in my direct
and surrebuttal testimony, that information concerning reconstruction cost new,
reconstruction cost new depreciated, Handy-Whitman Index information,
Marshall Index information, Bureau of Labor Statistics information was given
little or no weight by UniSource in deciding how much to pay for the electric
utility. The arms length transaction that has occurred, therefore, demonstrates that
the RCND was not a good estimate of the fair value of this utility as of the date of
the acquisition.

The price paid in an arms-length transaction would represent the fair value of the
utility as of the date of the acquisition. The price paid was substantially below the

1 original cost depreciated book value. Because the acquisition occurred fairly
2 recently in August of 2003, this suggests that using RCN and RCND information
3 to establish the fair value of the utility rate base in the current rate case could
4 potentially result in a substantial overstatement of the fair value rate basing of the
5 Commission's traditional methods for determining the fair value rate base."⁹⁴

6 At the hearing, the Company attempted to suggest that Staff's methodology did not give
7 recognition to fair value rate base and that it would produce the same results no matter what the fair
8 value of the Company was.⁹⁵ The Company also tried to suggest that Staff's method was just
9 another way of merely backing into a fair value rate of return using OCRB, and that Staff's method
10 did not produce any increment to recognize fair value.⁹⁶ But this is incorrect as Mr. Parcell testified
11 in the following passage.

12 "Q. [BY STAFF ATTORNEY SCOTT]...[D]o you recall Mr. Smith
13 addressed that calculation in his testimony?

14 A. [BY STAFF WITNESS PARCELL]: Yes. In fact, based upon working
15 the case and other cases with Mr. Smith on this issue, I'm informed of the
16 fact that it has different results for every company used. It's not a circular
17 result at all. It produces different types of numbers for each company in
18 Arizona as it is applied."

19 The Commission should accept Staff's methodology for recognizing fair value rate base in
20 this case. The Company's proposal would result in a windfall at the expense of ratepayers.

21 **V. BLACK MOUNTAIN GENERATING STATION ("BMGS").**

22 Staff opposes the Company's proposal to include \$60 million for BMGS in rate base.⁹⁷ No
23 argument asserted in the Company's opening brief alters Staff's position during the course of these
24 proceedings that the inclusion of \$60 million for BMGS is post test year adjustment that violates the
25 traditional test year matching concept. Although the Staff acknowledges there may well be financial
26 and operational benefits for the Company if it actually acquires BMGS, the timing of inclusion of
27 \$60 million for the plant in this rate case is not in accordance with sound ratemaking principles.⁹⁸

28 Contrary to the Company's assertions, this is not the case in which the Commission needs to
determine the allowance of \$60 million for post test year plant in rate base.⁹⁹ Staff continues to

26 ⁹⁴ Tr. at 1197-98.

27 ⁹⁵ Tr. at 1181-84.

28 ⁹⁶ *Id.*

⁹⁷ Tr. at 1231-32.

⁹⁸ Tr. 15 1236-37; R. Smith Direct Test. (Ex. S-5 at 89-92; R. Smith Surrebuttal Test. (Ex. S-58 at 64-65.

⁹⁹ UNSE Initial Brief at 77.

1 recommend that if the Company pursues its plans concerning BMGS, it should consider an
2 application for deferred accounting treatment.¹⁰⁰ If approved by the Commission, this would allow
3 the Company to defer the recovery of expenses related to the plant until its next rate case. This
4 would more closely synchronize the timing of the operation of the plant with rate recovery.¹⁰¹

5 Although the Company argues that an accounting order is not a satisfactory option because
6 of alleged cash flow impacts, its position ignores the fact that the plant will be built by an affiliate,
7 not the Company itself.¹⁰² If its affiliate constructs the plant, it can sell the power from the plant on
8 the open market and recover its operational expenses.¹⁰³ There is no issue of cash flow impact from
9 construction of BMGS by the affiliate on the regulated utility, unless there is a transfer from the
10 affiliate. The timing of any transfer of the plant to UNSE could be coordinated with a rate case
11 filing for appropriate rate recovery. Ralph Smith Direct 90-91, Surrebuttal, 64-67.

12 The Company stated at page 5 of Mr. Larson's direct testimony that, if the Commission
13 rejects its proposal for a post-test year adjustment to rate base for BMGS, it could elect to enter into
14 a purchased power agreement ("PPA") with its affiliate, UEDC. He states that the terms of the PPA
15 would be subject to approval by the Commission and by FERC. Bypassing these approvals, by
16 permitting UNSE to include BMGS in rate base in the current rate case, is not necessarily a good
17 idea. Approval of PPAs with affiliated parties is intended to provide a safeguard for ratepayers to
18 prevent abuses.

19 There are several concerns with approving rate base treatment of BMGS in the current rate
20 case, including the uncertainties relating to the plant. One of the primary deficiencies is that the
21 plant is not expected to be in commercial operation until May or June of 2008. This is well beyond
22 the end of the test year in the current UNS Electric rate case, and is several months beyond even the
23 scheduled hearing. Consequently, this plant addition does not qualify as a pro forma adjustment to
24 plant in service.

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27 ¹⁰⁰ R. Smith Direct Test. (Ex. S-56) at 90.

¹⁰¹ R. Smith Direct Test. (Ex. S-56) at 91.

¹⁰² Tr. at 192-93.

¹⁰³ Tr. at 1232-33.

1 In the current UNS Electric rate case, BMGS would not qualify for an exception to the
2 inclusion of CWIP in rate base because only minimal, if any, costs have been incurred by UNS
3 Electric in the test year. As of the end of the test year, it appears the Company had not incurred any
4 cost for BMGS construction. The response to STF 11.2 states that none of the Company's end-of-
5 test-year CWIP balance includes BMGS cost. Additionally, Staff's engineering report, which
6 reported on the results of a site visit made in June 2007 among other things, revealed very little work
7 has apparently been done at the plant site. It appears that costs related to BMGS construction are
8 being recorded on the books of the affiliate, UEDC, rather than on UNS Electric's books.

9 Additionally, there is uncertainty regarding the total cost of the plant. There is uncertainty
10 regarding whether the ownership of the plant would be at the utility, UNS Electric, or with the
11 affiliate, UEDC. There is uncertainty regarding whether it would be more economical for UNS
12 Electric and its ratepayers for the utility to own the plant or to obtain power by some other means.
13 Given the substantial uncertainties regarding BMGS, Staff believes it would be premature and
14 inappropriate to approve the Company's request for rate base inclusion.

15 It not known whether having UNS Electric purchase a peaking unit such as BMGS is the
16 most economical alternative to obtain power for the short, intermediate or long-term. While UNSE
17 has alleged that owning BMGS would provide operational and financial benefits to the Company,
18 and Staff has found that there appears to be some merit to such assumptions, it is difficult to
19 adequately evaluate whether BMGS will cause additional rate increases, or to estimate the extent of
20 such future rate increases, since the total cost of the plant is not known.

21 In terms of the impact on cash flow, the Company's proposal is to have BMGS included in
22 rate base by a "revenue neutral" rate reclassification that apparently would not result in any net rate
23 adjustment. It is unclear how the Company's proposed "revenue neutral" rate reclassification would
24 result in a substantial improvement in the Company's cash flow if it were to be implemented in a
25 truly "revenue neutral" manner that did not result in a substantial net rate increase.

26 In conclusion, the Company's requested rate base inclusion of BMGS in the current case is
27 premature and would bypass too many regulatory safeguards. The Company's proposed rate base
28

1 inclusion of BMGS in the current case should be rejected. The ratemaking treatment of BMGS
2 would most appropriately be addressed in the context of UNS Electric's next rate case.

3 For the reasons listed above, Staff continues to believe that inclusion of BMGS in rate base
4 in the current rate case would be premature and inadvisable.

5 VI. RATE DESIGN.

6 A. Mandatory TOU Rates.

7 In its Initial Brief UNSE tries to misconstrue Staff's position on TOU rates in an attempt to
8 bolster its desire to make TOU rates mandatory. UNSE states that the primary objective of a TOU
9 rate is to reduce peak demand by shifting consumption to off-peak periods.¹⁰⁴ This is true. UNSE
10 then goes on to state that the Company cannot achieve its goal if customers do not participate in its
11 TOU program and that Staff Witness Radigan agreed with this premise.¹⁰⁵ This is only true in part.
12 A true reading of Mr. Radigan's answer is that he agreed and that is actually why he disagreed that it
13 should be mandatory TOU rates.¹⁰⁶ As he stated on the stand "If you have voluntary customers and
14 they're not changing their behavior, what good do you think you're going to get by putting in all of
15 these new meters and then amortizing the cost of the old meters if you don't expect that anyone is
16 going to change their behavior."¹⁰⁷

17 The Company argues the time for experiments, workshops and discussions regarding TOU
18 programs are over, it is time for action.¹⁰⁸ This is the face that "in both the short and long term,
19 there is simply no evidence that mandatory TOU rates are cost effective"¹⁰⁹

20 And that, as they say, is the problem. While it is clear that TOU meters are more costly and
21 the Company shareholders will gain more profit from their installation, and while it is known that
22 customers that are currently on TOU rates have not changed their behavior, and while it is known
23 that most customers have usage so small that they can never pay for the added cost of the meter even
24 if they did shift usage.¹¹⁰ The real question is not whether its time for action but rather what could

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¹⁰⁴ UNSE Initial Br. At 53.

26 ¹⁰⁵ *Id.*

27 ¹⁰⁶ Tr. at 1259.

¹⁰⁷ *Id.*

¹⁰⁸ UNSE Initial Br. at 57.

28 ¹⁰⁹ F. Radigan Surrebuttal Test. (Ex. S-62) at 4.

¹¹⁰ F. Radigan Direct Test. (Ex. S-61) at 9-10.

1 be done to make existing TOU rates more effective. Staff would support a mandatory TOU only if it
2 is demonstrated to be cost effective. The Company has not demonstrated that its proposed
3 mandatory TOU is cost effective. Therefore, the Company's proposal should be rejected.

4 Mr. Radigan provided testimony on this point at the hearing:

5 "Q. [BY UNSE ATTORNEY LIVENGOOD]: Mr. Erdwurm testified last
6 week regarding time-of-use meters and the cost of those meters?

7 A. [BY STAFF WITNESS RADIGAN]: ... I would disagree with that
8 strongly. I have seen that in several utilities across the country where
9 utilities are both playing and praying on commissions' desire for
10 customers to change their usage behavior. And what you're seeing is that
11 utilities are now proposing system wide deployment of advanced meter
12 technologies and pulling out all of the meters.

13 I've seen utilities that just had finished putting in AMR meters all through
14 their service territory to save on meter reading costs, and now, because of
15 the commission's desire for time-of-use meters, they say, oh, now give me
16 \$300 million more so I can put in these new advanced meters. And by the
17 way, the 112 million that I just put in, you need to amortize that over a
18 couple of years. That's the case in Connecticut by Connecticut Light and
19 Power, a subsidiary of Northeast Utilities.

20 Con Edison in New York, the Staff in the rate case there just
21 recommended against the utility's investment of \$400 million for the same
22 thing. It's just you have to look at these things on a benefit/cost ratio.
23 Most customers there use very, very little energy.

24 Con Edison, for instance, has the highest rates of any utility in the country.
25 The usage, though, is very, very low. It's only 250 kilowatt hours a
26 month. So you need to trade these things off and see what is cost
27 effective."¹¹¹

28 Company witness Erdwurm conceded on cross-examination that he had done no cost benefit
analysis for the designated classes for mandatory time-of use rates.¹¹² In fact it appears to be the
Company's position that it intends to change out its existing meters to TOU capable meters
regardless of whether it is cost effective or not.¹¹³ Staff in general supports TOU rates however it
also believes in this case a cost benefit study should be done before mandatory TOU rates are
implemented.

¹¹¹ Tr. at 1262-63.

¹¹² Tr. at 476-477.

¹¹³ Tr. at 476-479.

1 **B. Inclining Block Rates**

2 Staff agrees with the concept of inclining block rates to encourage conservation. In the
3 specific situation faced by Staff in the current case with respect to developing a rate design for UNS
4 Electric, Staff found it impractical to do because some customers would have received decreases in
5 their bills because of the small rate increase and the increase to the customer charge. Decreasing a
6 customer's bill encourages consumption not conservation. Consequently, it was not practical to
7 implement an inclining block rate structure in the current UNS Electric rate case in conjunction with
8 Staff's proposed revenue requirement and the increase in customer charges recommended by Staff.

9 Again, at the hearing, Staff witness Radigan discussed the difficulties of implementing this
10 type of rate structure at the current particularly with the revenue requirements recommended by Staff
11 and RUCO:

12 “Q. [BY STAFF ATTORNEY SCOTT]: On the inverted rate structure, you
13 said that when you look at implementing that with the size of the increase
14 here, it just looked impractical. Is that because of the decreases for some
15 customers and the increases for others, or are there other reasons why it
16 seemed impractical to you?

17 A. [BY WITNESS RADIGAN]: A large part of it was the increase in the
18 customer charge was taking up a lot of the revenue increase that was being
19 allocated to the class, and then there was the unbundling feature of taking
20 out the power supply from the base rate. So that left a resultant small
21 number. And when I tried to put a penny a kilowatt hour differential and
22 then go back and redesign the rates to you know, recover the targeted
23 revenue requirement, I just found that some customers were getting a rate
24 decrease. And it just – my back ground is you just generally don't want to
25 give rate decreases when the company is getting an increase.”¹¹⁴

26 At the hearing, the Company's witness Bentley Erdwurm appeared somewhat indifferent to
27 the potential rate impacts upon customers of all of the multiple rate design changes the Company
28 was proposing:

29 Q. [BY STAFF ATTORNEY SCOTT]: And you would agree with me,
30 wouldn't you, that Mr. Radigan's testimony is that his concern stems more
31 from the implementation of this type of inclined block rate structure in
32 addition to all of the other changes that are being proposed, including the
33 increases in customer charges, that this could result in a wide variety of
34 rate impact; correct?

35 A. [BY COMPANY WITNESS ERDWURM]: Yes. And I would like a
36 wide variety o rate impacts to accomplish a conservation goal.

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¹¹⁴ Tr. at 1268-69.

1 Q. But per those wide variety of rate impacts that you speak of, those could
2 be ameliorated, could they not, if some of these different rate design
3 proposals of the Company's were implemented in stages as Mr. Radigan
4 has proposed?

5
6 A. They could also be ameliorated if consumers would respond by shifting
7 usage from on-peak to off-peak and trying to reduce usage.¹¹⁵

8 Mr. Erdwurm also agreed that some significant educational efforts would be required to
9 implement so many changes in one case.¹¹⁶ In summary, while Staff supports the concept of an
10 inclining block structure, it believes that it would be more practical to implement it in the
11 Company's next rate case.¹¹⁷

12 **C. Merging Mohave and Santa Cruz.**

13 Staff continues to support a more gradual merger of the rate structures for Mohave and Santa
14 Cruz counties.¹¹⁸

15 Full merger of rate structures should occur over the Company's next rate case rather than in
16 this case. The gradual approach would mitigate the rate impact and send a more appropriate price
17 signal to customers.¹¹⁹

18 Staff's rate design proposal in this case took steps toward making the rate designs of both
19 Counties the same. Even the Company's witness, Bentley Erdwurm, conceded that Staff witness
20 Radigan's proposed rate design too a major step in significantly decreasing the Santa Cruz/Mohave
21 rate differential in this case.¹²⁰

22 However, Staff believes that any remaining changes to both rate structures to make them
23 identical should occur in the next case. Mr. Radigan, Staff's witness, responded to claims that
24 having different rate structures was somehow discriminatory or not appropriate at the hearing on
25 this matter:

26 "Q. [BY RUCO ATTORNEY POZEFSKY FOR MARSHALL
27 MACGRUDER]: Since the last rate case in 1997, residential and small

28 ¹¹⁵ Tr. at 480-81.

¹¹⁶ Tr. at 455-459.

¹¹⁷ Tr. at 1269-70.

¹¹⁸ Frank Radigan Direct Test. (Ex. S-61) at 14.

¹¹⁹ *Id.* at 14-15.

¹²⁰ Tr. at 462.

1 business customers in Santa Cruz service area have been paying higher rates
2 that their equivalents in Mohave service area. The company, RUCO and I
3 want to end this discriminatory practice. Why do you feel it is not fair to
4 end this practice?

5 A. [BY STAFF WITNESS RADIGAN]: Well, as a given, I assume that the
6 Arizona Commission set just and reasonable rates for Santa Cruz in 1997, so
7 at that time they were providing the cost of service. And now that you have
8 one utility owning two service territories and the rates of one are slightly
9 higher than the other, it just means a utility with less expensive rates or a
10 utility with more expensive rates.

11 Now over time that utility is going to operate it as a single entity. And as
12 costs increase, those two costs are going to merge for those two service
13 territories. But it's not a given that the Santa Cruz customers right now
14 are paying too much. I assume in 1997 the Arizona Commission set just
15 and reasonable rates.

16 So it's just a matter of you want postage stamp rates for a utility that has
17 the service territories within the same state. It's just a matter, then, of a
18 rate design goal of how soon do we do that."¹²¹

19 **D. Differential in Demand Charge.**

20 Staff continues to oppose a change in the demand charge differential because the Company's
21 proposal lacked cost justification.¹²² As discussed in the record and in Staff's Opening Brief, the
22 Company should conduct a specific cost of service study to support a proposed change in the
23 differential, and include the issue in its next rate proceeding.¹²³ Company witness Erdwurm
24 conceded on cross-examination that he had done no such study and was relying only upon his own
25 judgment and the rate differentials of another Arizona company to support his position.¹²⁴ Yet, he
26 conceded that cost is a very important factor in setting any rates.¹²⁵ He also testified that the
27 Company could perform such a study to determine the appropriate demand charge differentials for
28 its next rate case.¹²⁶

29 **E. Purchased Power.**

30 The last area where there is disagreement is the purchased power. Neither party used the
31 cost of service study to reallocate revenues between service classifications, but Staff did use it in the

32 ¹²¹ Tr. at 1322-23.

33 ¹²² *Id.* at 18.

34 ¹²³ *Id.* at 5.

35 ¹²⁴ Tr. at 465-469.

36 ¹²⁵ Tr. at 469.

37 ¹²⁶ Tr. at 469.

1 rate design.¹²⁷ The Company has presented no new arguments in its Initial Brief to prompt Staff to
2 change its position on this issue.

3 **VII. PURCHASED POWER FUEL ADJUSTMENT CLAUSE.**

4 In its rebuttal testimony, UNSE accepted Staff's proposed PPFAC mechanism and the
5 proposed Plan of Administration (POA) that set forth the details of the PPFAC's operation.¹²⁸ Both
6 Staff and UNSE believe that Staff's proposed forward-looking PPFAC mechanism will effectively
7 mitigate the volatility in UNSE's power supply and delivery cost and send a better price signal to
8 customers. The proposed PPFAC would go into effect on June 1, 2008, when UNSE starts using the
9 power supplies that will replace its current all-requirements contract with Pinnacle West.

10 UNSE and Staff agree on the PPFAC mechanism with the exception of two issues. Staff has
11 opposed UNSE's proposal to include an open-ended category of "Other Allowable Costs" in the
12 PPFAC. Second, after reviewing the confidential information that UNSE provided after Staff's
13 surrebuttal testimony had been completed, Staff became aware of a real possibility of a rate shock
14 situation, depending upon the market price of natural gas¹²⁹, and therefore recommended a rate cap
15 to appropriately balance (1) the interests of UNSE in achieving current recovery of fuel and
16 purchased power cost and avoiding large deferred balances with (2) the interests of customers in
17 experiencing rate shock due to temporary fluctuations in the cost of gas-fired generation used to
18 supply UNSE with its purchased power.

19 **A. UNSE's Proposed "Other Allowable Costs" Should Not Be Included In The** 20 **PPFAC.**

21 Staff recommends excluding an open-ended category of "Other" costs from the PPFAC. If
22 fluctuations in these costs, along with fluctuations in all of UNSE's other non-PPFAC includible
23 costs become significant, the Company could request recovery in base rates. Basically, the non-
24 PPFAC costs are treated as any other utility operating expenses that fluctuate between rate cases.

25 UNSE has failed to demonstrate that any other utilities in Arizona have been allowed to
26 include such costs in a PPFAC. With respect to APS, upon which the Staff-proposed PPFAC for

27 ¹²⁷ Tr. at 1256.

28 ¹²⁸ M. DeConcini Rebuttal Test. (Ex. UNSE-15) at 8, 16; Attachment Ex. MJD-3 (POA)

¹²⁹ UNSE's cost of purchased power is largely influenced by the cost of natural gas.

1 UNSE is modeled, the Commission's Decision No. 69663 (June 28, 2007), stated at page 107 that:
2 "APS has not demonstrated any reason that we should change the costs that are allowed to be
3 recovered in the adjustor ..." In that decision, the Commission rejected a request by APS to include
4 broker fees in the PSA. As noted in footnote 61 on page 108 of Decision No. 69663, "Staff
5 continues to believe that broker fees are not allowable PSA costs."

6 UNSE's PPFAC should be limited to expenses recorded in FERC accounts 501, 547, 555 and
7 565. Accordingly, in Staff's proposed POA, under item 9-B, "Other Allowable Costs" it provides as
8 follows: "None without pre-approval from the Commission in an Order." UNSE's attempt to add an
9 additional "Other" category of PPFAC costs to include broker's fees, credit costs and legal fees
10 should be rejected.

11 **B. Because Of The Real Possibility Of A Rate Shock Situation, An Appropriate**
12 **Cap Should Be Placed On The PPFAC.**

13 In prefiled testimony, Staff did not support a cap on UNSE's PPFAC. Staff generally agreed
14 with UNSE that: (1) because UNS Electric is in the process of acquiring and developing its
15 resource requirements, it would not be appropriate to force a cap on the PPFAC rate in this period of
16 flux; (2) an inappropriately narrow cap could improperly encourage short-term rate stability at the
17 expense of serving the long-term interests of customers and (3) putting inappropriately narrow caps
18 and collars for rate stability in the short-term can lead to large deferrals that can negatively impact
19 both the Company, making it a riskier investment, and its customers, who would be required to pay
20 for UNSE's prudently incurred deferrals of fuel and purchased power costs eventually.

21 UNSE's brief refers to Staff's PPFAC cap as an "eleventh hour proposal."¹³⁰ However, the
22 Company's projected fuel and purchased power costs, and consequently the potential impacts of the
23 PPFAC, i.e., the information contained in Exhibits UNSE 43 and 44, were received at a relatively
24 late point in the rate case. These key exhibits were received by Staff after Staff's surrebuttal had
25 been completed. Only upon review of such information, did Staff become fully aware of the very
26 real possibility that an uncapped PPFAC could lead to a serious customer rate shock issue for
27 UNSE's customers. Upon receipt of the largely confidential information contained in Exhibits

28 ¹³⁰ See UNSE Initial Brief at 70.

1 UNSE 43 and 44, Staff ultimately felt obligated to warn the Commission of the real potential of such
2 an PPFAC rate shock issue, and to offer appropriate recommendations for addressing such a
3 situation, should it occur.

4 Exhibit UNSE 43 illustrated how UNS Electric projects that its purchased power and fuel
5 cost for the period June 2008 through May 2009 is projected to vary, depending upon the price level
6 of natural gas. That exhibit shows the Company's estimated total rates, including the PPFAC
7 forward component rates, at natural gas prices of \$6.00, \$7.50 and \$9.00 per MMBtu, respectively.
8 It shows the Company's forecast of a PPFAC forward component of 0.48 cents/kWh at
9 \$6.00/MMBtu natural gas prices, and 1.73 cents and 2.98 cents at \$7.50 and \$9.00 natural gas prices.
10 The total percentage increases from present rates (including UNS Electric's proposed base rate
11 increase) range from 8.8% at \$6.00 natural gas, and were projected by the Company to be 21.5% and
12 34.2% at \$7.50 and \$9.00 natural gas prices, respectively.

13 Staff believes this information raises concerns about the potential for customer rate shock,
14 especially if natural gas prices move significantly higher than the \$7.50/MMBtu that UNS Electric
15 used as the basis for its bill impact estimates in Exhibit UNSE 44. Because natural gas prices can be
16 very volatile, no one currently knows with accuracy what natural gas prices, and, by reference, what
17 UNS Electric's power costs will be, for the period June 2008 through May 2009 when the first
18 PPFAC forward component would be in effect.

19 In order to provide a reasonable solution to the very real issue of a PPFAC rate shock
20 situation, Staff recommends that the Commission impose an annual cap to address the potential of
21 PPFAC rate shock given new information presented by UNSE. The PSA that the Commission
22 approved for APS contains an annual cap of 4 mills which limits the amount by which the new
23 annual rate can change from the current annual rate.¹³¹ That level of annual cap would not be
24 appropriate for UNSE because UNSE does not own any base load generation power costs and its
25 power costs are subject to a higher degree of volatility than are APS'. During cross examination by
26 Staff and under Commission questioning, UNSE witness DeConcini suggested that, if a cap were to

27 ¹³¹ APS' 4 mill cap, as it came out of the most recent rate case decision, is a limit on the amount of change that can
28 occur from the current annual rate to the new annual rate. The annual rate is the sum of the Forward, Historical, and
Transition components.

1 be imposed on the UNSE PPFAC, it would need to reflect a wider range than the 4 mill cap
2 contained in the APS PSA. Mr. DeConcini suggested that one way of determining a cap for the
3 UNSE PPFAC would be to examine the volatility of the PPFAC rates under a range of natural gas
4 prices. That type of analysis, including information on customer bill impacts, is essentially what
5 UNSE provided in Exhibits UNSE 43 and 44.¹³² Using the information provided in Exhibits
6 UNSE 43 and 44, an annual cap for UNSE's PPFAC could be developed that would be tailored to
7 UNSE's unique circumstances and exposure to power cost price volatility.

8 RUCO had recommended an annual cap of 6 mills in its direct testimony. However, a
9 review of the information provided in UNSE Exhibits 43 and 44, which were not available to the
10 parties at the time of the filing of direct (or even surrebuttal testimony) reveals that a cap set that low
11 could easily and predictably lead to large deferrals and seriously prevent UNSE from reasonably
12 prompt recovery of its prudently incurred fuel and purchased power costs. Therefore, Staff believes
13 the PPFAC cap for UNSE has to be substantially greater than the 4 mills used for APS or the 6 mills
14 RUCO had proposed for UNSE.

15 Using UNSE's "base forecast" of power costs (which are based on natural gas at \$7.50 per
16 MMBtu), an annual PPFAC cap could be developed using such information. Based on the
17 information shown in Exhibit UNSE 43, for example, Staff recommends a cap of were set at 1.73
18 cents per kWh for the PPFAC forward component. This would limit the total rate increase (under
19 UNSE's projections) to approximately the 21.5% shown on that exhibit.¹³³ If the cap for the UNSE
20 PPFAC were established in this manner, the 1.73 cents per kWh not be exceeded without a
21 Commission order.¹³⁴ (This would differ from APS' cap which is a limit on change.)

22 _____
23 ¹³² UNS Electric also provided additional bill impacts in Ex. UNSE 45, assuming "solid fuel resources," i.e., a coal
24 plant; however, Staff views that scenario as speculative, and accordingly, does not accord it any weight in evaluating
25 what an annual cap on the UNSE PPFAC could be.

26 ¹³³ The 21.5% increase assumes that UNSE's full base rate increase request and its requested ratemaking treatment of
27 Black Mountain Generating Station (BMGS) would be approved. If the Commission approves something less than
28 UNSE's full base rate request, the total increase would be lower. With respect to the impact of BMGS, UNSE witness
Grant testified under cross examination by Staff that the rate impacts shown on Ex. UNSE 43 would be similar with and
without the Company's requested ratemaking treatment for BMGS.

¹³⁴ Staff's recommendation, which is based on Ex UNSE 43, the 1.73 cents/kWh cap would apply to the PPFAC
forward component only and would "cap" the forward component. In the presentation of this, Staff's proposal was
referred to as a "hard cap"; however, that term carries connotations that were not intended. Even under Staff's proposed
cap, if the Company's cost of purchased power substantially exceeded the level in the Company's projections, the
Company could petition the Commission for a change to the PPFAC. The cap proposed by Staff is intended to prevent a

1 While other parties may differ as to the appropriate level of a rate cap, Staff's recommended
2 cap of 1.73 cents per kWh has been painstakingly developed with the objectives of appropriately
3 balancing (1) the need to shelter customers from rate shock resulting from temporary fluctuations in
4 UNSE's purchased power costs, and (2) the Company's need for timely recovery of prudently
5 incurred fuel and purchased power costs and desire to avoid unnecessary deferrals. In summary, the
6 Staff recommends an appropriate annual PPFAC cap as discussed herein to prevent the potential for
7 rate shock in this case.

8 **VIII. DEMAND SIDE MANAGEMENT, EPS/REST ADJUSTOR AND CARES.**

9 With respect to the Demand Side Management programs, the Company correctly noted in its
10 Initial Brief, that these would be the subject of a separate proceeding.¹³⁵ The Company and Staff
11 appear to be in agreement on how the DSM surcharge would operate and its level for purposes of
12 this proceeding.¹³⁶ The Company in its Initial Brief did not present any issues relating to Staff's
13 testimony on the EPS/REST Adjustor, so it appears to be in agreement with Staff's witness Jerry
14 Anderson's testimony on this point.

15 There are two issues in dispute regarding the Company's CARES program, however.

16 Ms. Zwick, in her opening comments, provided the following overview of the customer base
17 in both Counties and the importance of the CARES discount:

18
19 "Just for informational purposes, in Mohave County 15.3 percent of that
20 community are living in poverty, which means an annual income of \$20,650 for a
21 family of four, and in Santa Cruz County there are 24.5 percent of the population
22 living in poverty. So there's a great need for this discount, the CARES discount."

23 First, there is disagreement between the Staff and the Company regarding the discount
24 structure itself.¹³⁷ Staff recommends retaining the current declining tier structure, while the

25 rate shock situation from occurring. It is not intended to prevent the Company from recovering prudently incurred fuel
26 and purchased power costs. If the 1.73 cent PPFAC forward component produced an under-collection of cost, the under
27 collection would be addressed in the PPFAC true-up component for the next period. If gas prices and power costs
28 increase substantially in UNSE's PPFAC filing for the forward component beyond what they are expected to be currently
(i.e., beyond the 1.73 cents per kWh shown on Ex UNSE 43), the application of this cap on the PPFAC forward
component would essentially result in a deferral of cost recovery in order to avoid a rate shock situation.

¹³⁵ UNSE's Initial Br. At 63.

¹³⁶ *Id.*

¹³⁷ Tr. at 1330.

1 Company is recommending a flat discount of up to \$8.00 per month for CARES customers, and up
2 to \$10.00 per month for CARES-M customers.¹³⁸ The Company argues in its Initial Brief that there
3 is an inconsistency between Staff's opposition to implementation of an inclining block rate structure
4 for customer classes in general and its position with respect to the CARES discounts.¹³⁹ But again,
5 the Company misconstrues Staff's position on inclining block rate structure. Staff typically supports
6 inclining block rate structures since they tend to promote conservation, however, in this case,
7 because of the issues discussed above, Staff is recommending that any inclining block rate structure
8 be considered and implemented in the Company's next rate case.¹⁴⁰ This is not inconsistent with
9 Staff's position with respect to maintaining the current rate structure for the CARES discount.

10
11 The second issue regarding the CARES program has to do with the Company separately
12 reporting medical CARES disconnects in order to be assured that they do not violate the provisions
13 of A.A.C. R14-2-211.¹⁴¹ Staff continues to believe that separate reporting in this instance is
14 necessary for tracking and compliance purposes.

15 **IX. UNSE PROPOSED RULE CHANGES.**

16 Staff addressed the Company's proposed rule changes in its Initial Brief. None of the
17 arguments presented by the Company in its Initial Brief have led to any changes in Staff's positions
18 as expressed in its Initial Brief.

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27 ¹³⁸ *Id.* at 1330-31.

¹³⁹ UNSE's Initial Br. At 61.

28 ¹⁴⁰ Tr. at 1330.

¹⁴¹ Tr. at 1330; Julie McNeeley-Kirwan Direct Test. (Ex. S-66) at 15.

1 **X. CONCLUSION.**

2 In light of the record herein, Staff's positions reflect the appropriate rate making
3 treatment of the Company's application for a rate increase.

4 The Commission should adopt Staff's recommendations in this case for all the above reasons,
5 as well as those discussed in Staff's opening brief, and in Staff's testimony.

6 RESPECTFULLY SUBMITTED this 19th day of November 2007.

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