OPEN MEETING AGENDA ITEM ORIGINAL

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BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE APPLICATION OF UNS ELECTRIC, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS ELECTRIC, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA AND REQUEST FOR APPROVAL OF RELATED FINANCING.	DOCKET NO. E-04204A-06-0783

UNS ELECTRIC, INC.'s

EXCEPTIONS

May 5, 2008

Arizona Corporation Commission
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UNS Electric, Inc. ("UNS Electric" or the "Company"), through undersigned counsel, hereby respectfully submits its exceptions to the Recommended Opinion and Order ("ROO") issued in this case. The Company respectfully requests that the Arizona Corporation Commission ("Commission") issue its Order in this case approving the ROO as amended by these exceptions. In support hereof, UNS Electric states as follows:

I. INTRODUCTION.

UNS Electric is teetering on the brink of a financial crisis.

The Company's rates have been frozen since 2003. While UNS Electric's rates have remained flat, the cost of providing electric service has escalated over the past 5 years, resulting in the Company operating at a significant revenue deficiency.

Also, on May 31, 2008, less than four weeks from today, UNS Electric's full requirements power supply contract with Pinnacle West Energy Capital Corporation ("Pinnacle West") terminates requiring the Company to obtain a new supply of electricity for all of its customers. This will further increase the Company's cost of providing electric service. It will also require that UNS Electric be sufficiently financially stable and creditworthy to meet the requirements of power suppliers.

Further, in August 2008, less than 3 months from today, UNS Electric will have to repay or refinance $60 million in debt. UNS Electric does not have the funds to repay the debt. UNS Electric's ability to refinance the debt and the reasonableness of the terms thereof are dependent upon the Company's financial condition and strength.

The rate treatment requested in this case is designed to provide UNS Electric with a financial lifeline that will stabilize the Company and avoid the fall into a financial crisis. The ROO, rather than providing stability for UNS Electric, places the Company in a more financially precarious situation at this critical time.

For example, the ROO would reduce the Company's revenue request of $8.5 million (5.5%) to $4.0 million (2.5%; less than half of the request) and its cost of equity from 11.8% to

10% (indicating a belief that UNS Electric is a less risky utility than Tucson Electric Power Company and Arizona Public Service Company ("APS").

Additionally, the ROO rejects (i) placing the Black Mountain Generating Station ("BMGS") in rate base, even though there is indisputable evidence in the record that BMGS will not be placed in rate base before it is in commercial operation or before June 1, 2008 even though it is operationally and economically advantageous for UNS Electric's customers if BMGS is rate based; (ii) allowing UNS Electric to collect Construction Work in Progress ("CWIP") for capital investments that already are or will shortly be placed in service for the benefit of the Company' customers and (iii) using a Return on Equity ("ROE") that reflects the risks UNS Electric is facing – indeed the proposed rate is 0.75% less than the Commission recently approved for APS. The ROO further adds a cap to the Purchased Power and Fuel Adjustment Clause ("PPFAC') rate that will result in substantial deferred recovery of fuel and purchased power costs and also proposes that the rate to be used to reimburse UNS Electric for the cost of financing fuel and purchased power cost deferrals under the PPFAC be less than the actual cost of such financing. This reimbursement plan is unreasonably low and would require the Company to subsidize customers at a time when it cannot financially afford to do so.[1]

Each of these recommendations erodes UNS Electric's financial standing. The Company's rate request, on the other hand, is a modest proposal for ensuring that UNS Electric will be able to continue to provide reliable electric service to its customers.

In these exceptions, UNS Electric addresses the recommendations in the ROO that are in error or contrary to the best interests of the Company, its customers, employees and shareholders. UNS Electric also hereby submits for Commission consideration the attached proposed

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[1] As set forth hereinafter, UNS Electric requests that, if the Commission does implement a cap, the interest rate on deferrals should be equal to LIBOR plus 1%, which is equal to the actual cost that the Company would have to pay to finance any deferrals through its short-term revolving credit facility.

amendments to the ROO which (i) place BMGS in rate base; (ii) amend the current PPFAC[2]; (iii) allow for the collection of CWIP; (iv) award an appropriate ROE, (v) grant recovery of UNS Electric's requested rate case and employee compensation expenses; and (vi) use Fair Value to set the Company's rate base (Attachment 1).

II. UNS ELECTRIC'S PROPOSAL TO RATE BASE BMGS WOULD ALLOW THE COMPANY TO OWN THE FACILITY, WHICH IS IN THE PUBLIC INTEREST.

BMGS is an important element in UNS Electric's efforts to replace its entire power portfolio by June 1, 2008. UNS Electric acknowledges that its request to include BMGS in rate base beginning in June of 2008 is unusual – but UNS Electric is facing unique and difficult circumstance that warrant this non-traditional treatment. Although the ROO (at page 76) worries that granting UNS Electric's request would "set unwarranted precedent," it is unlikely any electric utility will ever face the circumstances confronting the Company at this time. UNS Electric is proposing rate basing BMGS because, as the record makes clear, it is the only means by which the Company can acquire BMGS. Without the proposed post-test year rate basing of BMGS, the electricity from BMGS would only be available through a purchased power agreement and UNS Electric and its customers would not enjoy the full operational and financial benefits of BMGS.

Moreover, the ROO's concerns (at page 76) about the "uncertainties" surrounding BMGS are unfounded. The record is clear that BMGS will be rate based only if UNS Electric owns BMGS (which, the record also shows will occur upon approval of UNS Electric's rate base proposal). BMGS will be placed in rate base only when it is operational – and therefore used and useful. As the record states, UNS Electric will not put BMGS in rate base at an amount more than \$60 million at this time. Any cost in excess of \$60 million will be deferred until the next rate case. And the Commission also is not bound by the \$60 million cost for BMGS to be included in rate base. UNS Electric has agreed on the record that the Commission is not making a prudency

[2] UNS Electric is supportive of the structure of the PPFAC recommended in the ROO; it objects to the ROO's recommendation to place a cap on the PPFAC and to set the rate for financing purchased power and fuel cost deferrals at a level below the Company's actual cost.

finding on BMGS cost at this time – again that is reserved until the next rate case. The ROO should be amended to allow UNS Electric the means to acquire this important and beneficial asset.

A. BMGS Provides Substantial Operational and Financial Benefits to UNS Electric and its Customers.

BMGS is a 90 MW peaking facility being developed by UniSource Energy Development Company ("UED") in Mohave County for the needs of UNS Electric.[3] As of May 1, 2008, both gas combustion turbines of the BMGS have been in operation and have synchronized with the grid, producing power. Performance testing is planned for the next two weeks and commercial operation is scheduled for mid-May 2008. The original cost estimate for the construction of this facility includes $46 million under a turnkey construction contract, and additional costs between $14 and $19 million.[4] A more current estimate of the final cost to complete BMGS is approximately $65 million. However, UNS Electric requested rate base treatment of only $60 million in this rate proceeding. No party disputed this amount as being reasonable for BMGS.[5]

Once BMGS is actually serving customers, the Company proposes that 0.6 cents per kWh be moved out of the base power supply charge and 0.6 cents per kWh be added to the base delivery charge simultaneously in order to recognize the $60 million in rate base.[6]

Under this proposal, UNS Electric would purchase BMGS from UED at cost and, as confirmed through testimony at the hearing, the Company would own BMGS.[7] Therefore, there is no uncertainty about which entity would own the facility if UNS Electric's proposal is approved; if the Commission approves the Company's proposal, then UNS Electric would own BMGS.[8] Any and all cost issues would be reviewed and trued-up during the next rate case. Under UNS Electric's proposal, the Company would add critical facilities that are under Commission jurisdiction in the most expeditious means possible.

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[3] Ex. UNSE-15 (DeConcini Rebuttal) at 4.
[4] Ex. UNSE-8 (Larson Direct) at 4.
[5] Ex. UNSE-15 (DeConcini Rebuttal) at 4.
[6] Ex. UNSE-8 (Larson Direct) at 3; Ex. UNSE-9 (Larson Rebuttal) at 2, 11.
[7] Ex. UNSE-9 (Larson Rebuttal) at 12; Tr. (Larson) at 193-94; Tr. (DeConcini) at 309.
[8] In order for UED to transfer ownership to UNS Electric, a filing would have to be made at the Federal Energy Regulatory Commission ("FERC") and FERC would have to approve that transaction.

1. Operational Benefits.

The ROO denies the Company's request despite the operational benefits that the post-test-year adjustment would provide UNS Electric and its customers including:

- Full operational flexibility, utilizing capabilities to meet required reserves and ancillary services, and allowing full, unlimited and economic dispatch in any market to optimize the Company's portfolio;
- Full control over maintenance and operations to ensure high standards of reliability and safety; and
- An improved power portfolio. UNS Electric will own a 90 MW generation peaking facility versus having to replace the full requirements purchase power agreement with Pinnacle West starting June 1, 2008.[9]

The Company presented testimony of these and other benefits.[10] The testimony established that the LM6000 turbines (that UED purchased at a 25-percent discount) are quick start units and allow for compliance with several reliability criteria, especially within UNS Electric's load area. These turbines reduce the likelihood of transmission interruptions and can restore and/or supply load during transmission contingencies – as well as potentially providing alternatives to transmission expansion.[11]

Staff recognized the benefits to UNS Electric. For instance, Staff witness Ralph C. Smith testified that BMGS presents a "good opportunity" for the Company.[12] Further, Staff's engineering witness, Prem Bahl, indicated in data responses that BMGS "could provide enhanced reliability benefits over contracting for power because the generating resource would be close to the load center"; and BMGS is "a beneficial addition to UNS Electric's existing generation portfolio" because it would reduce the need to rely on purchase power.[13]

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[9] Ex. UNSE-15 (DeConcini Rebuttal) at 3.
[10] Ex. UNSE-14 (DeConcini Direct) at 7-8; Ex. UNSE-15 (DeConcini Rebuttal) at 6-7.
[11] Ex. UNSE-14 (DeConcini Direct) at 10-11; Tr. (DeConcini) at 382.
[12] Tr. (R. Smith) at 1237.
[13] Ex. UNSE-52.

2. Financial Benefits.

UNS Electric provided testimony regarding the numerous financial benefits rate basing BMGS would provide the Company, such as:

- A long-term cost advantage versus a purchased power agreement or a lease agreement and a reduction of the Company's revenue requirement due to the cumulative effects of depreciation and deferred income taxes.[14]
- An additional $10 million in non-fuel base rate revenues, $6 million to utility operating cash flows, and approximately $3 million in net income.[15]
- Avoiding the possibility of having to provide additional cash or a letter of credit should a purchase power agreement's market value exceed the credit limit specified by a seller for UNS Electric.[16]
- Another source of funding for transmission and distribution projects, which improves UNS Electric's credit profile and allows the Company to attract financing on more reasonable terms.[17]

B. Absent Commission Approval of UNS Electric's Request, the Company Cannot Afford to Acquire BMGS.

As the evidence in the record sets forth, UNS Electric simply cannot finance acquiring BMGS without its rate basing proposal being approved. And the ROO has not suggested otherwise. UNS Electric is a small company with limited financial resources. The approximate $60 million cost of BMGS represents 42.56 percent of the Company's original cost rate base ("OCRB"). The Company needs an extra $10 million in non-fuel revenues to finance the acquisition of BMGS.[18] Otherwise, the Company has an additional $60 million of debt and/or equity capital without any additional cash flow. This would lead to a $3 million net income

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[14] Ex. UNSE-8 (Larson Direct) at 13-14 and Ex. KPL-3.
[15] Ex. UNSE-8 (Larson Direct) at 3, 10 and Ex. KPL-2.
[16] Ex. UNSE-8 (Larson Direct) at 11.
[17] Ex. UNSE-9 (Larson Rebuttal) at 4.
[18] Ex. UNSE-8 (Larson Direct) at 7.

reduction in the first year.[19] Neither a deferral nor a short-term purchase power agreement ("PPA") will satisfactorily address the Company's financial issues. Approval of rate basing BMGS is critical to allow UNS Electric and its customers to realize the full operational and financial benefits of BMGS.

C. In Light of the Many Benefits That Rate Basing BMGS Would Provide, UNS Electric's Proposal Should Not be Rejected for the Reasons Set Forth in the ROO.

Although the ROO (at page 76) summarizes perceived concerns in rejecting the proposal to rate base BMGS, the Company believes those concerns have been addressed in the record and are unfounded. UNS Electric has never disputed that the Commission's rate analysis starts with using the historical test year. And, the Company does not believe that the inclusion of BMGS in rate base in this case will necessarily have a binding precedent for other rate cases. In addition, UNS Electric provided additional assurance about the amount and timing of the request in this case:

- UNS Electric would not seek any additional cost to construct BMGS over $60 million in this case.[20]
- If the costs to construct BMGS turned out to be less than $60 million, the Company would only seek the lesser amount as part of this treatment.
- UED will transfer BMGS to UNS Electric at cost.[21]
- UNS Electric commits to having both Staff and RUCO evaluate the prudence of the construction costs for BMGS.[22]
- UNS Electric's rate reclassification would not occur until the plant was in commercial operation – and no sooner than June 1, 2008.[23]
- Even so, UNS Electric would submit a project completion report 30 days before its proposal would take effect.

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[19] Ex. UNSE-8 (Larson Direct) at 10.
[20] Ex. UNSE-9 (Larson Rebuttal) at 3, 10.
[21] Ex. UNSE-14 (DeConcini Direct) at 9; Ex. UNSE-9 (Larson Rebuttal) at 12.
[22] Ex. UNSE-15 (DeConcini Rebuttal) at 4.
[23] Ex. UNSE-9 (Larson Rebuttal) at 2.

In short, the Company's proposal makes the cost of the plant known and measurable in this case. The Company's proposal further ensures the plant is serving *existing* customers when its proposal takes effect.[24] Finally, the Company's proposal provides material benefits to both the Company and its customers. While unusual, the facts and circumstances in this case justify BMGS' inclusion in UNS Electric's rate base in this case. Without approval of its proposal, UNS Electric cannot finance the acquisition of BMGS. Therefore, UNS Electric requests that BMGS be included in rate base in this case as set forth in its rate reclassification proposal.

III. THE COMMISSION MUST MODIFY THE PROPOSED PPFAC CAP AND BANK BALANCE INTEREST RATE TO AVOID DEVASTATING IMPACTS FROM OVERWHELMING COST DEFERRALS.

UNS Electric and Staff have agreed upon the general form and operation of a PPFAC. However, towards the end of the hearing, Staff submitted additional testimony: (i) suggesting that, given developments in the natural gas markets at that time, the Commission may want to consider including a cap on adjustments to the PPFAC rate and (ii) proposing a specific cap based on the current estimates for natural gas pricing. The ROO proposes adopting a cap for the PPFAC rate based on Staff's testimony last September and October. However, given the current circumstances in the natural gas market, the ROO's cap proposal will likely result in a substantial deferral of fuel and purchased power costs of almost $20 million in the first year alone. UNS Electric is simply not in a financial condition to finance such a large deferred recovery and the cap proposed by the ROO – based on last fall's circumstances – must be eliminated or significantly modified.

UNS Electric initially proposed a purchased power and fuel adjustment clause ("PPFAC") that would automatically adjust based on a 12-month rolling average, but later agreed with Staff's recommendation for a PPFAC similar to the Power Supply Adjustor ("PSA") approved for APS in Decision No. 69663 (June 28, 2007). In its pre-filed testimony supporting its PPFAC, Staff did not advocate imposing a "cap", but Staff later changed its testimony to support the potential imposition of a cap on the Forward Component of the PPFAC. Staff's reasoning in its Direct Testimony on why a cap would be inappropriate in this matter is still valid. The fact that natural

[24] Ex. UNSE-9 (Larson Rebuttal) at 12.

gas and power prices, and the foreseeable forward prices of natural gas, have increased since the filing of this rate case only strengthens the argument of why a cap is inappropriate for UNS Electric.

UNS Electric objects to the application of a cap on the Forward Component of the PPFAC rate as the cap will result in substantial deferrals of fuel and purchased power costs. These large deferrals would have a negative impact on (i) UNS Electric's ability to secure financing on reasonable terms; and (ii) the Company's overall creditworthiness.[25] Additionally, it is unlikely that UNS Electric's revolving credit facility would cover these deferral costs, increasing the Company's uncertainty regarding its financing and costs of financing.[26] This additional risk translates into increased credit costs and higher debt costs, which ultimately results in higher electric bills for ratepayers.

UNS Electric does not have stable nuclear and coal facilities in its fleet. In fact, UNS Electric owns minimal natural gas-fired generation and is almost entirely reliant on the market for the acquisition of generation. However, the Company is in the process of acquiring resources elsewhere, including the potential acquisition of the BMGS.[27] Precarious supply resources are further exposing the Company to the volatility of the short-term energy markets.[28]

The cap of 1.73 cents per kWh was derived by assuming natural gas prices of approximately $7.50 per MMBtu. Although an estimate of future natural gas prices of $7.50 per MMBtu was reasonable at the time of the initial PPFAC rate filing in December of 2007, forward energy prices are dramatically higher today. As shown in Attachment 2, attached hereto, the forward natural gas prices average nearly $10 per MMBtu in the first PPFAC year from June 2008 through May 2009 and $9 per MMBtu in the second PPFAC year from June 2009 through May 2010. Forward wholesale electricity prices have increased commensurate with natural gas prices. Imposing a 1.73 cent per kWh cap will surely compromise the Company's ability to recover fuel

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[25] Ex. UNSE-15 (DeConcini Rebuttal) at 14; Ex. S-27; Tr. (DeConcini) at 328-29.
[26] Tr. (Grant) at 1411-12.
[27] Ex. UNSE-15 (DeConcini Rebuttal) at 14.
[28] Tr. (DeConcini) at 326.

and purchased power costs in a timely manner. In fact, UNS Electric could face up to $20 million in deferrals in the first year alone, based on current natural gas and power forecasts. The Company has provided a forecast of these deferrals at different gas prices, attached hereto as Attachment 3. UNS Electric recommends rejection of the proposed cap.

IV. RATHER THAN IMPOSING A CAP, THE COMMISSION SHOULD ACCEPT THE COMPANY'S PPFAC RATE FILING SUBMITTED ON DECEMBER 21, 2007.

The Company submitted its forecasted PPFAC rate in accordance with its draft Plan of Administration ("POA") on December 21, 2007. In its December 21, 2007 filing, UNS Electric provided the rate components, supporting forecasts and workpapers and a request for the rate to become effective June 1, 2008. To date, the Company has received no response from Staff as to UNS Electric's filing. The Company recognizes the difficulty Staff may have in reviewing an updated filing with enough lead time to allow UNS Electric to populate and test its bill production prior to the implementation date of June 1. The December filing was based on the market prices at that time ($7.59 per MMBtu gas), which is significantly lower than the current forward prices of nearly $10 per MMBtu shown in Attachment 4. The Forward Component rate in that filing was 1.9274 cents per kWh. This rate is 0.1974 cents per kWh above the Forward Component cap suggested in the ROO. It should also be noted that the current over-collection of the existing UNS Electric PPFAC would reduce the total PPFAC rate by 0.2554 cents per kWh as detailed in the December filing. This leads to a total PPFAC rate of 1.672 cents per kWh for the first PPFAC Year. If the Company was to use current forecasted prices for natural gas and power prices, the PPFAC Forward Component would be 2.783 cents per kWh. The December filed PPFAC rate could lead to significant deferrals of fuel and purchased power costs (approximately $12 million in PPFAC Year 1). However, UNS Electric's proposed PPFAC rate more appropriately balances the Commission's desire to avoid rate shock with UNS Electric's need to recover the costs of fuel and purchased power in a timely manner.

UNS Electric requests that the Commission approve the rate included in its PPFAC Rate Filing submitted on December 21, 2007 of 1.672 cents per kWh. UNS Electric also requests that this rate become effective June 1, 2008.

V. <u>IF THE COMMISSION IMPOSES A CAP AS DELINEATED IN THE RECOMMENDED OPINION AND ORDER, THE COMMISSION NEEDS TO CLARIFY THE SCOPE OF AND INCREASE THE AMOUNT OF THE CAP.</u>

A. The Cap Should Only Apply To The Forward Component And Should Not Apply To The True-UP Component.

If the Commission approves a PPFAC that includes a cap, the Commission needs to clarify in its Decision that the cap only applies to the Forward Component of the PPFAC. The language in the ROO creates some doubt regarding the proposed PPFAC cap and its potential application to the Forward and True-up Components. The ROO, on page 70 lines 14 through 16, states: "Based on UNSE's base forecast of power costs (assuming gas at $7.50/MMBtu), Staff recommended a cap of 1.73 cents per kWh for the *forward component*, which could not be exceeded without a Commission Order." [Emphasis added] Further, the ROO, on page 70, lines 25 through 27, continues, "We believe Staff's cap recommendation provides an appropriate balance between the need to protect customers from potential rate shock with the Company's need to recover fuel and purchased power costs in a timely manner." However, in Finding of Fact 30 and the second to last ordering paragraph on page 85, the ROO finds there should be "an implementation of a PPFAC cap of 1.73 cents per kWh." This implies a cap on the entire PPFAC rate (the Forward Component plus the True-up Component), rather than just the Forward Component as recommended by Staff. UNS Electric believes that the intention of the Administrative Law Judge was to agree with Staff's recommendation that the cap should only apply to the Forward Component of the PPFAC. However, in order to avoid any confusion, the Company requests that Finding of Fact 30 and the referenced ordering paragraph be amended, and such amendment should include language that explicitly applies the "cap" to only the Forward Component.

B. If A Cap Is Adopted, It Must Be Increased From The Current Rate Of $1.73.

In the event the Commission chooses to implement any cap on the Forward Component of the PPFAC rate, UNS Electric recommends that the cap should at least reflect the current level of natural gas and power prices. This level would be 2.873 cents per kWh, based on current fuel and purchased power prices as previously mentioned. The Company makes this recommendation based upon its earlier arguments regarding the increase in natural gas and power price increases since the filing of this rate case and for the foreseeable future.

While the ROO is hesitant to address changes in circumstances that occur outside of a test year, in this case equity demands that the Commission make an exception. UNS Electric filed this rate case in December of 2006 and the hearing concluded in late September 2007. Based on the evidence in the record, it is clear that UNS Electric is in dire need of rate relief. This need has only been exacerbated by circumstances beyond the Company's control. Therefore, the Commission must consider the increases in the natural gas and power prices that have occurred since the filing of this rate case almost one and a half years ago, and it should increase the cap to 2.783 cents per kWh. Such an increase is just and reasonable based upon the facts and circumstances of this particular case.

C. If A Cap Is Adopted, It Should Be An Annual Cap.

In the event the Commission adopts any cap on the Forward Component, UNS Electric recommends that the cap be a cap on the annual adjustment to the Forward Component. This will allow the Forward Component to rise over time (in step with the natural gas market prices) if necessary, will prevent cost deferrals from being even greater in the future and will not shift untoward amounts into the True-Up Component for recovery.

VI. IF THE COMMISSION ADOPTS A CAP, A MINIMUM BANK BALANCE NEEDS TO BE ESTABLISHED.

While the POA's emergency clause allows for an adjustment to the Forward Component in the event of an emergency, UNS Electric recommends including a statement in the Commission's Order which permits UNS Electric to file a PPFAC surcharge application for Commission approval when UNS Electric's PPFAC bank balance reaches a threshold of $5 million. The reason the Company chose $5 million as the threshold is because that amount is approximately equivalent to UNS Electric's annual earnings in the test year.

VII. THE PPFAC POA INTEREST RATE SHOULD BE LIBOR PLUS 1%.

The ROO recommends that the short-term borrowing rate of the U.S. Treasury be used to reimburse UNS Electric for the cost of financing fuel and purchased power cost deferrals under the PPFAC. The ROO adopts Staff's recommendation for a cap and Staff's recommendation for maintaining the PPFAC POA interest rate at the applicable one-year Nominal Treasury Constant Maturities. As stated above, a cap on the Forward Component of the PPFAC would impose a substantial hardship on the Company in the form of an expensive PPFAC deferral that would have to be financed by UNS Electric.[29] This hardship would be exacerbated if the Commission adopts the PPFAC POA interest rate as recommended in the ROO; the proposed interest rate on under-collected balances would not be sufficient to cover the Company's actual financing costs. Therefore, UNS Electric requests that, if the Commission does implement a cap, the interest rate on deferrals should be equal to LIBOR plus 1%. UNS Electric makes that recommendation because it is equal to the actual cost that UNS Electric would have to pay to finance any deferrals through its short-term revolving credit facility.[30] The short-term credit facilities and its terms were previously approved by the Commission in Decision No. 69395 (March 22, 2007).

VIII. THE EVIDENCE IN THIS CASE SUPPORTS THE INCLUSION OF CWIP IN RATE BASE.

UNS Electric has requested that $10.8 million of CWIP be included in rate base in this case for ratemaking purposes. Although the ROO suggests (at page 8) that the Commission rejected "nearly identical" arguments for the inclusion of CWIP in the recent UNS Gas rate case, there are, in fact, significantly different circumstances in this case that fully justify the inclusion of CWIP here. In rejecting the Company's request to include CWIP in its entirety, the ROO does not acknowledge the substantial and undisputed evidence in the record about the financial difficulties that UNS Electric is facing if CWIP is not included in rate base. The ROO also does not

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[29] If the cap were to apply to both the Forward and True-up Components, the financial strain would be even worse.

[30] Tr. (Grant) at 1405-06, 1413.

acknowledge significant evidence in the record that is contrary to its rationale for disallowing CWIP.

UNS Electric faces unique and unprecedented circumstances that create extraordinary financial challenges that more than justify including CWIP in rate base. In particular:

1. The Company must develop an entirely new power supply portfolio by June 1, 2008, which will require the establishment and maintenance of trade credit with a variety of wholesale market counterparties.

2 The Company must re-finance all of its $60 million in long-term notes in August 2008.

3. The Company faces a continuing high growth rate that requires significant plant investment.

Staff witness Ralph C. Smith acknowledged that the Company is in a "unique" situation of replacing a full requirements contract and refinancing all of its long-term debt within a couple of months in 2008.[31] Moreover, the extraordinary financial circumstances may be further exacerbated if the proposed PPFAC cap is adopted. UNS Electric may find itself in a situation where it must carry undercollected bank balances of $20 million in the near future, and even higher (and continually increasing) under-collected balances over time.[32] UNS Electric's financial condition would be further compromised if UNS Electric is not allowed to charge an adequate and appropriate interest rate. Approving the one-year Nominal Treasury Constant Maturities rate, as the ROO recommends, would impose a further, substantial hardship as that interest rate would not be sufficient to cover the Company's actual, Commission-approved, financing costs of LIBOR plus 1%. UNS Electric's financial situation clearly meets or exceeds any "extraordinary circumstances" standard for the inclusion of CWIP in rate base.

Moreover, the nature of UNS Electric's CWIP further supports its inclusion in rate base. Over $5.6 million of the $10.8 million of requested CWIP is related to substations, transmission

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[31] Tr. (Smith) at 1207.

[32] As discussed earlier, UNS Electric proposes to use the actual interest rate that would apply to finance those balances.

and distribution, improvement, and other infrastructure reinforcements.[33] These expenditures will not produce new revenue or reduce the Company's expenses; rather, they will improve service reliability for new and existing customers alike. Staff agreed that several projects included in CWIP (valued at more than $3.7 million) would neither produce revenue nor reduce expenses.[34] Any conclusory concerns about "mismatching" of revenues do not justify disallowing a large portion of CWIP.

Finally, the Arizona Supreme Court has explicitly endorsed the use of CWIP, stating that "we wish to make it clear that construction work in progress ("CWIP") but not yet in service may be included in determining a fair value rate base."[35] The Court said that it "is obvious that the Commission can consider matters subsequent to the historic year. Construction projects contracted for and commenced during the historical year may certainly be considered by the Commission."[36] And the Court recognized the benefit of CWIP allowing the utility and customers some time between rate cases, commenting that "a constant series of extended rate hearings are not necessary to protect the public interest."[37]

The requested CWIP must be in rate base in order for just and reasonable rates to be set for the Company at this time.

A. UNS Electric Faces Financial Distress Without the Inclusion of CWIP in Rate Base.

Although the ROO states that UNS Electric is not facing an "extraordinary situation that would justify the inclusion of CWIP in rate base", the undisputed record about the Company's financial picture, including its immediate future condition, confirms the opposite.

As the record made clear in this docket, this is a critical time for UNS Electric. As previously stated herein, the Company must refinance $60 million in long-term debt in August

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[33] Tr. (Grant) at 1068-69.
[34] Ex. UNSE-53; Ex. S-55 (Taylor Direct) at Ex. 4 to Engineering Report.
[35] *Arizona Community Action Assoc. v. Arizona Corp. Comm'n*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979)(quoting *Arizona Corp. Comm'n v. Arizona Public Service Co.*, 113 Ariz. 368, 371, 555 P2d 326, 329 (1976).
[36] *Id.*
[37] *Id.*, 123 Ariz. at 230-31, 599 P2d. at 186-87.

2008. It is currently in the process of procuring approximately 450 MW of capacity by June 1, 2008, to replace the Pinnacle West contract.[38] It faces continuing high growth in its service area, contributing to "very high expenditure levels and very weak operating cash flow."[39] Without its requested relief, UNS Electric will face higher costs when refinancing its long-term debt. It will face higher credit costs when procuring fuel and purchased power, potentially to a point that limits its access to certain types of wholesale power resources. And it will face higher costs in acquiring the necessary capital to meet needs created by growth in its service area.

UNS Electric faces real and significant risks of financial deterioration absent adequate rate relief. Its annual cash flow after capital expenditures fell from negative $447,000 in 2004 to negative $9,414,000 in 2005 and was forecast to drop precipitously to negative $33,100,000 in 2007.[40] Net Cash Flow as a percentage of Capital Expenditures was only 35 percent in 2006, compared to the industry median of 86 percent.[41] This means that UNS Electric will largely depend on outside capital to fund ongoing capital expenditures.[42] Also, in 2006, UNS Electric's Funds from Operations ("FFO") interest coverage was at 3.1X when the industry median was 4.3X.[43] In 2003, UNS Electric was assigned a credit rating from the National Association of Insurance Commissioners ("NAIC") of NAIC-3, which is the equivalent to a speculative grade rating of Ba from Moody's or BB from Standard & Poor's or Fitch.[44] Furthermore, it is highly unlikely that the Company would be eligible for a higher rating today.[45] Although the Company based its rate request on historical test year data, financial forecasts are a necessary component in any determination of just and reasonable rates.[46] Even Staff conceded during the evidentiary hearing that the markets do care about future financial performance.[47]

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[38] Ex. UNSE-36 (Grant Rejoinder) at 4.
[39] Ex. UNSE-34 (Grant Direct) at 3; Tr. (Grant) at 1001-02.
[40] Ex. UNSE-34 (Grant Direct) at 4.
[41] Ex. UNSE-35 (Grant Rebuttal) at Ex. KCG-12, page 2 of 3.
[42] Ex. UNSE-34 (Grant Direct) at 21.
[43] Ex. UNSE-34 (Grant Direct) at 6.
[44] Ex. UNSE-34 (Grant Direct) at 5 (UNS Electric received an NAIC-3 rating).
[45] Ex. UNSE-34 (Grant Direct) at 5.
[46] Ex. UNSE-36 (Grant Rejoinder) at 8.
[47] Tr. (Smith) at 1248.

UNS Electric continues to face very high capital expenditure requirements. It is undisputed that UNS Electric has faced, and will continue to face, high levels of plant growth.[48] The Company's growth in net plant investment was 68.6 percent over the period 2003 to 2006. APS, by contrast, experienced 28.9 percent growth over this same period.[49] This growth is compelling the Company to raise large sums of money to fund necessary plant investment.[50] The Company's capitalization is projected to grow 84 percent (from $115 million to at least an estimated $212 million) between 2005 and 2009.[51] None of the Company's figures – actual or projected – were specifically challenged during the hearing. Over the short-run, due to a reliance on an historical test year for rate setting purposes, the Company's earnings and cash flow are adversely affected by high customer growth. Meeting the needs created by this growth requires substantial capital investment at a level far exceeding the Company's internal cash flow.[52] Therefore, it is essential that UNS Electric maintain an ability to attract capital at reasonable rates to meet these capital expenditure requirements.

The evidence is clear that, absent its requested relief, UNS Electric's financial performance will deteriorate significantly, thus affecting its credit ratings and numerous key elements of its operations.[53] CWIP is an important element to UNS Electric's revenue requirement -- allowing CWIP in rate base would add about $2.1 million in additional annual revenues,[54] improving the Company's cash flow and bolstering its financial integrity. Without it, UNS Electric faces a difficult future. Neither Staff nor RUCO addressed or refuted these future impacts. And the ROO does not acknowledge or address these undisputed impacts on UNS Electric if adequate relief is not granted here.

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[48] Ex. UNSE-35 (Grant Rebuttal) at Ex. KCG-10 and Ex. KCG-11.
[49] Ex. UNSE-35 (Grant Rebuttal) at 16.
[50] Ex. UNSE-35 (Grant Rebuttal) at Ex. KCG-11, page 1 of 2.
[51] Ex. UNSE-34 (Grant Direct) at 27, Ex. KCG-9.
[52] Ex. UNSE-35 (Grant Rebuttal) at 13.
[53] Exhibits KCG-9, KCG-12 and KCG-13 attached to Mr. Grant's Direct and Rebuttal Testimonies set forth what UNS Electric's financial performance likely will be under both the Company's requested relief and Staff's proposed relief. The ROO has closely followed Staff's recommendation and the impact of the ROO on UNS Electric will be similar to the impact of Staff's recommendations.
[54] Ex. UNSE-34 (Grant Direct) at 27.

B. Much of the CWIP Does Not Produce New Revenues.

The ROO justifies the disallowance of CWIP, in part, on the basis that the CWIP plant "required to serve new customers will help produce new revenues" and that the "allowance of CWIP would undermine the balancing of test year revenues and expenses."[55] However, as set forth in detail in the record, a large portion of the CWIP does not serve new customers and is revenue-neutral, thus not affecting the balancing of test year revenues and expenses. At a minimum, that portion of CWIP should be included in rate base.

Approximately $5.6 million of the $10.8 million CWIP total is related to substations, transmission and distribution improvements, and other infrastructure reinforcements.[56] These expenditures will not produce new revenue or reduce the Company's expenses; rather, they will improve service reliability for new and existing customers alike. As previously mentioned, Staff agreed in response to Company data requests that several projects listed in CWIP would neither produce revenue nor reduce expenses – including facilities related to the Valencia Turbine No. 4, the West Golden Valley Substation, GIS Systems Integration Projects and the North Havasu to Griffith 230 kV transmission line.[57] Thus, Staff confirms that at least $3.7 million out of the $10.8 million of CWIP – according to Exhibit 4 of Staff's Engineering Report submitted with Mr. Steve Taylor's Direct Testimony – was neither revenue producing nor expense reducing.[58]

C. UNS Electric is No Longer Accruing AFUDC on Most of the CWIP Because the Plant Is In Service.

The ROO also justifies disallowing CWIP by noting the availability of AFUDC to mitigate the effect of the CWIP investment. However, given the nature of UNS Electric's CWIP, almost all of the plant is in service and is no longer accruing AFUDC. Therefore, plant that went into service in July 2006 (the month after the close of the test year in this case) will have to be carried by the Company – without any return – until the end of the next UNS Electric rate case. That may be as

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[55] ROO at 8.
[56] Tr. (Grant) at 1068-69.
[57] Ex. UNSE-53.
[58] Ex. S-55 (Taylor Direct) at Ex. 4 to the Engineering Report.

long as three and a half years from the decision in this case (i.e. June of 2011), even if UNS Electric promptly files another rate case. Therefore, UNS Electric will have invested capital that will not realize any return for five (5) years. Having to carry over $10 million of capital investment for four to five years without any return is both unfair to the Company and clearly detrimental to its creditworthiness. And this impact is exacerbated by the continuing capital expenditure demands of a growing system, the demands of acquiring an entirely new power portfolio from the wholesale market and the likely need to finance substantial undercollected PPFAC bank balances, potentially with an interest rate that does not cover the financing cost.

IX. ALTERNATIVELY, THE EVIDENCE IN THIS CASE SUPPORTS THE INCLUSION OF POST TEST YEAR PLANT IN RATE BASE.

UNS Electric has requested that, alternatively, $8.7 million of Post Test Year Plant that was in service as of June 30, 2007 be included in rate base.[59] The ROO rejects the Company's request in its entirety "for the same reasons stated . . . with respect to the Company's request for CWIP."[60] However, in attempting to distinguish the Commission's decisions allowing post test year plant, the ROO expressly notes previous decisions allowed post test year plant in rate base if the plant was revenue neutral and did not result in a mismatch of revenues. And, contrary to the ROO's summary conclusion, UNS Electric did provide (as set forth above) substantial and undisputed evidence in the record from both Staff and the Company that up to $5.6 million of the CWIP was in fact revenue neutral.

Moreover, even if allowing post test year plant may result in the possibility of a partial mismatch due to extra revenues relating to some of the new plant, as already discussed above, revenues from new customers do not come close to covering the fixed costs related to those new customers.[61] Thus, unless some adjustment is made, UNS Electric will continue to realize a sizeable revenue deficiency on the post test year assets.

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[59] Ex. UNSE-35 (Grant Rebuttal) at 19, 35; Tr. (Grant) at 995.
[60] ROO at 9.
[61] Ex. UNSE-35 (Grant Rebuttal) at 13, Ex. KCG-16.

Therefore, if the full amount of CWIP is not included in rate base, post test year plant should be in rate base in order for just and reasonable rates to be set for the Company at this time. Accordingly, the Commission should amend the ROO to include $8.7 million of post test year plant in rate base.

X. IF THE COMMISSION FAILS TO ALLOW CWIP IN RATE BASE, IT SHOULD NOT FURTHER PENALIZE UNS ELECTRIC BY DEDUCTING CWIP-RELATED ADVANCES.

If CWIP or Post Test Year Plant is not included in rate base, then the Company should not be penalized further by the deduction from rate base of $1.9 million in customer advances related to the CWIP. The Company should not be effectively forced to substitute $1.9 million of "cost free" capital that financed test year CWIP for the debt and equity capital that actually financed the test year plant in service. And the Commission should not further harm the Company's financial integrity by allowing the deduction.

Generally, advances are deducted from rate base because customer-supplied advances are a "cost-free" source of capital for the utility. However, when the advance will be used to pay for plant that is not yet in rate base, the logic supporting this calculation breaks down – which is the case here. In this situation, UNS Electric's existing rate base, which was financed with investor-supplied capital is arbitrarily reduced by $1.9 million in advances related to CWIP.[62] The effect of excluding these customer advances from rate base is to wipe $1.9 million of existing investor-supplied capital off the books for purposes of setting rates. Such a confiscation of capital is unlawful.

The Commission should amend the ROO by not deducting the $1.9 million in CWIP related advances from rate base, if it does not allow CWIP or Post-Test Year Plant in rate base.

XI. UNS ELECTRIC'S RETURN ON EQUITY SHOULD REFLECT THE ACTUAL RISK.

Although the ROO did not address in detail UNS Electric's testimony concerning the risk underlying UNS Electric's proposed ROE, the ROO effectively found UNS Electric to be a much

[62] Ex. UNSE-35 (Grant Rebuttal) at 19.

less riskier investment than APS because it adopts an ROE of 10% (compared to the recent 10.75% granted to APS). In fact, the cost of capital is a function of the risk to which the Company is exposed. Risk is the operative word in evaluating what the appropriate ROE awarded to any utility should be; investors are willing to accept risk as long as the potential reward is commensurate. The evidence UNS Electric presented shows that the risk facing it far exceeds that of the comparable company group used by any cost of capital witness in this proceeding. Therefore, UNS Electric should be awarded an 11.8 percent ROE in this case – and not the 10 percent recommended in the ROO.

The evidence in this case is that investing in UNS Electric is "decidedly riskier" because of UNS Electric's small size, high customer growth, $60 million maturity of long-term debt in August 2008 and the need to replace all of its power needs by June 1, 2008. [63] Further, UNS Electric pays no dividends and has the equivalent of a speculative-grade credit rating.[64] Further, no other electric utility experienced 70 percent growth in its net plant investment over the last three years, nor expects to add another 50 percent to net plant investment for the next three years.[65] By comparison, the comparable company group Mr. Grant used for his DCF and CAPM approaches all had investment grade ratings and pay dividends to their shareholders.[66] Given the unique combination of challenges UNS Electric faces, an 11.8 percent ROE is commensurate with the risk the Company is facing.

UNS Electric also presented evidence of investors demanding higher risk premiums – as shown by the widening spreads between long-term utility bonds and long-term U.S. Treasury bonds. The cost for debt and equity capital for utilities with speculative-grade credit ratings increased substantially since December 2006.[67] This development strongly suggests that the 10 percent ROE proposed in the ROO is even less sufficient to attract necessary capital.

Finally, by way of comparison, APS was awarded an ROE of 10.75 percent in its last rate

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[63] Ex. UNSE-34 (Grant Direct) at 19; Tr. (Grant) at 957-58.
[64] Ex. UNSE-35 (Grant Rebuttal) at 24.
[65] Tr. (Grant) at 957.
[66] Ex. UNSE-34 (Grant Direct) at 19-20.
[67] Ex. UNSE-36 (Grant Rejoinder) at 13.

case.[68] By awarding an ROE to UNS Electric that is 75 basis points below what was awarded to APS, the ROO is implicitly stating that UNS Electric is less risky than APS. But APS is much larger, has investment grade credit ratings, a long history of shareholder dividend payments, and did not have to procure all of its capacity needs by a certain date. Unlike APS, UNS Electric has to refinance all of its long-term debt in August 2008. APS also has a diversified portfolio of owned generation, including nuclear, coal and natural-gas-fired units – including the assets rate-based as part of Decision No. 67744. Other than the Valencia turbines in Santa Cruz County, UNS Electric has none. The ROO's recommendation begs the question, "why would anyone invest in UNS Electric instead of APS?" It is illogical to assume an investor would invest in a riskier company for a lesser return. The evidence justifies UNS Electric having an ROE that is at least 100 or more basis points *above* that for APS. For all of these reasons, an 11.80 percent ROE is more than reasonable for UNS Electric.

XII. UTILITY COMMISSIONS ARE REQUIRED TO PROVIDE RECOVERY OF OPERATING EXPENSES.

Under the United States Constitution, utility commissions are required to provide recovery of both operating expenses and capital costs.[69] And under the Arizona Constitution, the Commission is further required "to allow a recovery for all reasonable expenses."[70] In other words, the Commission must provide sufficient income to permit full recovery of "operating costs" in addition to the return on rate base.[71] In addition, the Commission "must consider" any "expenditures made in compliance with the Commission's decision[s]."[72] On repeated occasions, the ROO fails to recommend proper recovery of reasonable UNS Electric expenses.

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[68] *See* Decision No. 69663 (June 28, 2007) at 49.
[69] *See Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1943).
[70] *Tucson Electric Power Co. v. Arizona Corp. Comm'n,* 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982).
[71] *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978).
[72] *Arizona Corp. Comm'n v. Palm Springs Utility Co.*, 24 Ariz. App. 124, 536 P.2d 245 (1975).

A. UNS Electric is Entitled to its Requested Rate Case Expense.

1. The Record Supports UNS Electric's Entire Request for Rate Case Expense.

The record in this matter overwhelmingly documents in great detail the "actual and legitimate outside services costs incurred in the process of preparing and defending the UNS Electric case."[73] In fact, the testimony by both Staff and RUCO do not deny that the costs were actually incurred. While there was some debate about the characterization of "outside services,"[74] the actual figures were never disputed. Instead of attacking the figures based on a prudency review with countervailing facts and figures as to the reasonable costs for prosecuting this particular rate case, Staff and RUCO make the unsupported and general statements that UNS Electric's request "appears to be excessive and would represent an unreasonable burden on ratepayers,"[75] and a concern about "such a large financial burden to the ratepayers from this requested adjustment."[76] The ROO adopts these unsubstantiated statements and proposes limiting UNS Electric's rate case expenses. However, UNS Electric's request for its rate case expense must prevail as it is the only figure that has been documented and proven in the record.

2. UNS Electric's Proposed Rate Case Expense is not "Excessive."

Both Staff and RUCO argue, again without supporting facts or figures, that UNS Electric's proposed rate case expense is "excessive" or a "large financial burden." The ROO, however, does not find that the costs incurred by UNS Electric for the prosecution of the rate case were not prudent, actual or legitimate. Instead, the ROO proclaims that it agrees with Staff and RUCO and finds that UNS Electric's proposed rate case expense figure is "excessive and should be reduced significantly."[77]

Neither Staff nor RUCO conducted a financial analysis of the impact to the ratepayers. And there is nothing in the record to support the contention that the proposed rate case expense

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[73] Ex. UNSE-24 (Dukes Rebuttal) at 17.
[74] Tr. (Dukes) at 802-15.
[75] Ex. S-58 (Smith Surrebuttal) at 35.
[76] Ex. RUCO-5 (Moore Direct) at 17.
[77] ROO at 24.

figure is "excessive" or a "large financial burden" to ratepayers. In fact, the testimony in this matter states that in the 2006 test year, UNS Electric had roughly 92,000 customers.[78] UNS Electric's request for rate case expense was for $600,000 amortized over three years. Thus, the costs attributable to this rate case to UNS Electric ratepayers would be approximately $2.17 per year on a per-customer basis, or 18 cents per month for three years. It is impossible to conclude that an 18 cent per-month increase, for only three years, is either "excessive" or a "large financial burden" to the ratepayers, especially when the increase is due to actual and legitimate expenses that UNS Electric incurred. Therefore, UNS Electric's proposal is not excessive.

3. The ROO, Staff and RUCO Ignore the Commission's Duty To Evaluate Each Case On Its Own Individual Merits.

Staff and RUCO also argue that two recent gas company rate case decisions should be the benchmark for determining the rate case expense in this electric company rate case. In fact, Staff's recommendation expressly relies on the rate case expense allocated to Southwest Gas Corporation in Decision No. 68487 (February 23, 2006).[79] RUCO also stated that the rate case expense allowed in the Southwest Gas case was a factor it considered in making its recommendation.[80] In fact, RUCO admitted, indirectly, that it actually was an important factor in making the recommendation in this case.[81]

Staff and RUCO use Southwest Gas as a benchmark and make their recommendation to reduce UNS Electric's actual and legitimate rate case expense even though they acknowledge that UNS Electric is very different from Southwest Gas. RUCO agrees there are fundamental differences between Southwest Gas and UNS Electric.[82] Further, Staff and RUCO do not dispute that the differences in corporate structure between Southwest Gas and UNS Electric are very material in evaluating rate case expense. They also make no attempt to normalize for this difference or adjust the costs in their recommendations. The clear difference is that Southwest Gas

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[78] Ex. UNSE-5 (Pignatelli Direct) at 4.
[79] Ex. S-58 (Smith Surrebuttal) at 35-37.
[80] Tr. (Moore) at 878.
[81] Tr. (Moore) at 878-79.
[82] Tr. (Moore) at 877.

uses a large number of in-house or corporate personal to prepare a significant portion of its rate case. UNS Electric has only one in-house or corporate employee who testified in this rate case. That employee's testimony was compiled with minimal support and assistance by a few other UNS Electric employees. In Southwest Gas' case, the "costs" associated with the in-house or corporate employees are embedded in the base rates that are charged to the customers of Southwest Gas. So the line item referred to as "rate case expense" that was approved by the Commission in the Southwest Gas case was only comprised of the outside costs associated with non-employees of Southwest Gas. Since UNS Electric essentially had only one in-house or corporate employee that worked on this rate case, the vast majority of its rate case was compiled by people or entities that are not UNS Electric employees. Therefore, the vast majority of UNS Electric's rate case expense was not reimbursed through base rates.

Staff side steps the differences between Southwest Gas and UNS Electric by stating, essentially, that the issues are the same, and therefore the costs should be the same.[83] RUCO makes a similar argument, but uses the UNS Gas case as a surrogate.[84] Again, RUCO's argument is the same as Staff's as RUCO indirectly relies on the rate case expense approved in the Southwest Gas case.

The issues in this case are not identical to the Southwest Gas or UNS Gas rate cases, nor are the witnesses. In fact, the glaring differences include a request to rate base the Black Mountain Generating Station and a request for a revised PPFAC. This application for a rate increase for electric service is different from an application for a rate increase for natural gas service. Additionally, the fact that some arguments may be similar does not relieve UNS Electric of its burden to file a rate application, compile testimony, answer approximately 30 sets of data requests, including numerous subparts, which amounted to 1,700 individual questions to be answered, file briefs, participate in a hearing and respond to the ROO, all of which cause UNS Electric to incur legitimate costs. The procedural timetable proves that, although there were some similarities, the

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[83] Ex. S-58 (Smith Surrebuttal) at 35.
[84] Tr. (Moore) at 875-788.

issues in the UNS Electric case were sufficiently different from the UNS Gas and Southwest Gas cases to grant UNS Electric's requested rate case expense. In fact, the hearing alone lasted eight days and the transcript spanned almost 1,200 pages. Further, this case has been litigated approximately 17 months. This case is not as simple as Staff and RUCO suggest.

The ROO adopts Staff's and RUCO's position that the Southwest Gas case and the UNS Gas case are appropriate comparisons to UNS Electric."[85] Again the ROO makes no specific finding that the costs incurred by UNS Electric were not legitimate and does not address the difference in corporate structure between UNS Electric and Southwest Gas. Essentially, the ROO is stating that the findings in Southwest Gas and UNS Gas have precedential value, regardless of the differences between the companies that are propounded in the record.

Based on the foregoing, it is logical that UNS Electric's rate case expense is larger than Southwest Gas' rate case expense, as the true cost of Southwest Gas' rate case is being largely paid for through its base rates. Therefore, the comparison to Southwest Gas is not a true benchmark and it is not reasonable to rely on Southwest Gas's approved rate case expense to reduce UNS Electric's rate case expense. Further, simply substituting the rate case expense that was granted in the UNS Gas case, without making a determination that the costs incurred by UNS Electric were not legitimate or prudent, lacks any support in the record. If the Commission adopts the ROO's recommendation, it will send a clear policy message that rate case expense will not be decided on a case-by case basis. UNS Electric would urge the Commission to continue to evaluate the merits of each case based upon the individual facts and circumstances presented in the record.

4. If The Commission Adopts The Recommendation In The ROO, TEP Customers Will Subsidize UNS Electric Customers.

As stated previously, UNS Electric does not have the in-house ability to prepare a rate case. Most of the accounting, rate design, legal and related personnel used in the rate case are shared services employees at TEP. TEP only charges UNS Electric for the services that UNS Electric

[85] ROO at 24.

obtains from TEP. The expenses incurred and requested for recovery as "rate case expense" is the incremental cost based on actual usage versus just simply allocating portions of TEP departments and charging UNS Electric a rate for the use of those departments, whether or not those services are actually used. These facts were presented by UNS Electric and were unchallenged by Staff or RUCO. Staff did mention that such costs should be reviewed in the pending TEP rate case.[86] While the issue of whether TEP is properly allocating and removing those shared costs from TEP's expenses is legitimate, it is not a reason to deny the actual and legitimate costs that were incurred by UNS Electric and that should be repaid to TEP. If the rate case expense is reduced, then those costs would likely be born by the ratepayers of TEP. This is an unreasonable subsidy and a burden that should not befall the ratepayers of TEP.

5. Adopting the Recommendation Of The ROO May Have Long-Term Ramifications.

If the Commission adopts the reasoning of the ROO that Southwest Gas is an appropriate benchmark for UNS Electric when evaluating rate case expense, then it is likely that TEP would seriously consider whether or not to share services with UNS Electric. If TEP stopped providing shared services, UNS Electric would have to contract with a third party to prepare its next rate case, or would have to hire employees to duplicate the shared services that are currently provided by TEP. While either option would probably result in higher rate case costs, hiring more employees at UNS Electric would not be in the best interests of UNS Electric ratepayers due to the cyclical nature of the workload.

Under its current arrangement, UNS Electric pays TEP for only the actual cost of services provided to UNS Electric by TEP. Essentially, UNS Electric is hiring TEP employees on a part-time basis. Thus, UNS Electric ratepayers do not have to be burdened with the salary and expenses of full-time employees. This arrangement benefits both UNS Electric and its ratepayers. Fully staffing regulatory, legal, accounting and various other departments, including all the

[86] Ex. S-58 (Smith Surrebuttal) at 36-37.

supplemental and support services and personnel, at UNS Electric would be far less cost effective than sharing those costs with TEP. In fact, the costs of adding the necessary staff to UNS Electric would far outstrip UNS Electric's request for rate case expense of $200,000 a year for three years. However, if UNS Electric is not allowed to recover its actual and legitimate rate case expenses in order to repay TEP for its services, it is possible that TEP will no longer provide those services.

Under that scenario, UNS Electric would have to hire new employees. The cost of those new employees would ultimately be born by the ratepayers through base rates. UNS Electric would most likely have to hire some "outside" people or entitles to assist with the filing of a new rate case, but according to the logic of Staff, RUCO and the ROO, those outside entities would be included in a determination of "rate case expense," while the UNS Electric employee costs would be fully reimbursed through base rates. The result would be that UNS Electric would likely recover the entire cost of preparing and litigating rate cases through a combination of base rates and "rate case expense." Such a result would be inefficient and more expensive to both UNS Electric and its ratepayers when compared to the present system where UNS Electric uses the shared services of TEP. Therefore, UNS Electric argues that the current arrangement between UNS Electric and TEP is the most efficient and economical, and it is in the best interests of both the UNS Electric and TEP ratepayers to continue that relationship. However, to be truly equitable, UNS Electric requests that this Commission adopt its request and order that UNS Electric should be able to recover the full amount of its rate case expense.

B. UNS Electric is Entitled to its Requested Employee Compensation Expenses.

UNS Electric requested to recover $383,409 in expenses for three incentive compensation programs: the Performance Enhancement Program ("PEP"), the Supplemental Executive Retirement Plan ("SERP") and the Officer's Long-Term Incentive Program ("LTIP"). No party argued that UNS Electric's overall level of employee compensation expenses was imprudent. Indeed, UNS Electric's average cash compensation is below that of market.[87] Therefore, UNS Electric's employee compensation expenses should be recovered in rates. Although the ROO does

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[87] Ex. UNSE-24 (Dukes Rebuttal) at 8.

not claim that overall employee compensation costs are imprudent, it nevertheless disallows parts of three specific components of those costs.

1. Performance Enhancement Plan.

The ROO disallows 50% of UNS Electric's PEP costs. The ROO euphemistically calls this "sharing" between ratepayers and shareholders based on the notion that PEP benefits both shareholders and ratepayers. But this could be said of any expense incurred by UNS Electric. The Commission must allow recovery of the full amount of prudent costs. Moreover, the ROO is inconsistent with the recent APS rate order, which did not impose any restriction on the recovery of costs stemming from APS' similar cash-based incentive compensation program – the same type of cash-based compensation program as the PEP.

2. Supplemental Executive Retirement Plan.

The ROO disallows 100% of UNS Electric's SERP. It is especially troubling because during the test year, UNS Electric had every reason to believe that SERP costs were recoverable. The most recent guidance available prior to the test year was the 2001 Southwest Gas rate order, which allowed full recovery of SERP costs.[88] Only after the test year did the Commission change course and reject SERP costs in the 2006 Southwest Gas rate order.[89]

In fact, it is undisputed that UNS Electric's overall employee compensation costs are prudent and that cash compensation is lower than comparable companies. As such, those expenses should be approved in full. If the Commission desires to change its policy and disallow SERP, it should do so in a manner that does not punish UNS Electric for reasonably relying on past Commission decisions. If the Commission wishes to change its policy, it should at a minimum grant UNS Electric's SERP request, but set a sunset date. UNS Electric could then plan for the change in policy. Such action would allow the Commission to change its policy in a gradual fashion which would be a reasonable way to balance changing an existing policy with the need for regulatory certainty and consistency.

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[88] Decision No. 64172 (October 30, 2001) at 14-15.
[89] Decision No. 68487 (February 23, 2006) at 19.

3. Officer's Long-Term Incentive Program.

The ROO proposes disallowing 50% of the Officer's LITP. UNS Electric objects to this recommendation for the same reasons stated in the PEP section above. Like the PEP, this program provides incentive compensation that helps make up for UNS Electric's below average base pay while also providing employees with an economic incentive to perform well. The full amount of the expense should be allowed.

XIII. THE COMMISSION MUST USE FAIR VALUE TO SET RATES.

In response to the Arizona Court of Appeals decision in Chaparral City Water Company, UNS Electric proposed to use the weighted average cost of capital as the rate of return for fair value rate base, but agreed that the rate increase in this case should be no greater than the increase proposed in its application. The ROO, however, adopted Staff's proposed methodology, which was the mathematical equivalent of the methodology struck down in Chaparral City. The Commission should not adopt a methodology that has been found to violate the Arizona Constitution. Moreover, contrary to the ROO's implication, UNS Electric is not asserting that its proposal is the *only* acceptable methodology under Chaparral City[90]; rather UNS Electric believes that its methodology is the only methodology proposed *in this docket* that comports with the court's decision. Therefore, UNS Electric's methodology should be adopted in this specific docket.

A. The ROO's Use of Staff's "Zero-Investor Supplied Capital" Theory to Determine Fair ROR Still Ignores Fair Value.

The ROO follows Staff's "zero-investor supplied capital" theory regarding the use of the fair value rate base. This approach is inappropriate because it is mathematically equivalent to the approach rejected in *Chaparral City*[91] and results in the same revenue requirement using FVRB or OCRB. Any "difference" is simply due to rounding and represents less than 0.001 percent of the $162 million revenue requirement and roughly 0.4 percent of the $3.8 million revenue deficiency

[90] See UNS Electric's Initial Brief at page 48, line 24.
[91] Ex. UNSE-36 (Grant Rejoinder) at 2.

in Staff witness Smith's Direct Testimony.[92] This mathematically equivalent approach should be rejected.

Moreover, this approach ignores fair value. Staff's witness, Mr. Parcell, candidly admitted that under his approach, fair value has no impact on rates. Under his approach, otherwise identical companies will have the same rates, even if their fair value rate base differs.[93] Under this approach, fair value simply has no impact on rates.

B. UNS Electric's Method is the Only Permissible Method Proposed in this Case.

All parties, including UNS Electric, have struggled with how to address the renewed emphasis on fair value. Because this issue arose after the application was filed, UNS Electric has agreed that the rate increase in this case should be no greater than the increase proposed in its application. UNS Electric addressed the fair value issue by proposing to use the weighted average cost of capital as the rate of return for fair value rate base.[94] As UNS Electric has conceded, this is not the only possible approach. It is, however, the only approach presented in this case that complies with the Arizona Constitution.

The ROO states UNS Electric argues that this method must be used and asserts that UNS Electric is being "disingenuous" because the courts have stated that this method is permissible but not required.[95] But UNS Electric never said that this method must be used, and it explicitly stated that there were other permissible methods.[96] The problem in this case is that neither Staff nor RUCO proposed any of the other permissible methods. Instead, Staff and RUCO proposed methods that are clearly impermissible. Whatever the Commission does, it must not use either of the methods proposed by Staff and RUCO. UNS Electric has presented a permissible option. The Commission can choose that option, or it can devise a different permissible option. But the Commission should reject the ROO's decision to use a method that does not comport with the law.

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[92] Ex. UNSE-36 (Grant Rejoinder) at 2.
[93] Tr. at 1027.
[94] Ex. UNSE-35 (Grant Rebuttal) at 33; Tr. (Grant) at 1045.
[95] ROO at 47.
[96] UNS Electric Initial Brief at 48-49.

The Commission should amend the ROO to adopt UNS Electric's proposal on Fair Value.

XIV. TECHNICAL CORRECTIONS TO THE ROO.

UNS Electric has noted several necessary technical corrections to the ROO if it is adopted as written. These technical corrections may change depending on whether certain elements of the ROO are amended at the Open Meeting.

1. With respect to ADIT on pages 11 and 12 of the ROO, the ROO adopts Staff's proposed adjustment to Rate Base of $161,555 for the removal of deferred tax assets for stock based compensation and SERP, which is consistent with the removal of the stock based compensation and SERP from operating income. However, if CWIP is not allowed in rate base, an additional adjustment of $207,700 regarding CWIP deferred tax liabilities is necessary. The net adjustment to ADIT if CWIP is not allowed in rate base should be a $46,145 increase to rate base rather than the $161,555 decrease that is in the ROO.

2. With respect to Depreciation and Property Taxes for CWIP on page 28, the ROO denied $26,582 of depreciation expense and property tax related to a rate base adjustment of $442,255 that was accepted (Depreciation and Property Tax for CWIP Found in Service). Both of these adjustments, as proposed by ACC Staff, were necessary if CWIP in rate base was denied.

3. With respect to Net Operating Income on page 37 of the ROO, the ROO incorrectly states adjusted operating income as $9,334,283 based on adjusted revenues of $158,539,827 and adjusted operating expenses of $149,206,667. The operating income should be $9,333,160 ($158,539,827 - $149,206,667).

4. At page 80, in Findings of Fact 24, the ROO establishes an average base power supply charge of $0.05194 per kWh for residential customers. However, that is the base power supply rate included in <u>current</u> rates. The power supply charge should be revised to reflect the base cost within the revenue requirements established in this proceeding. The <u>average</u> base power supply charge for all classes should be

$0.07530 per kWh given the $113,298,027 base power supply cost (FERC accounts 547, 555 & 565) divided by adjusted test year sales levels of 1,606,376,397 kWhs used to establish revenue requirements within the ROO. The Residential customer Base Power Supply rate should be $.007739 for both Mohave and Santa Cruz counties and the delivery charges should be $0.01663 in Mohave and $0.02006 in Santa Cruz County to be consistent with Staff's recommended rated design. The combined charge in Finding of Fact 24 should therefore be $0.09402 per kWh in Mohave County and $0.09745 in Santa Cruz County to produce the expected 2.57% rate increase for the residential classes.

XV. CONCLUSION.

The Commission must take action to support UNS Electric's financial integrity in the face of unprecedented circumstances in a manner that will allow the company to: (i) acquire an important generation facility that will provide substantial operational and financial benefits to the Company and its customers; and (ii) raise much needed capital on reasonable terms. The Commission also should modify the PPFAC to ensure that UNS Electric will not face monumental fuel and purchased power cost deferrals that would completely undermine the Company's financial integrity.

Proposed language for amendments relating to each specific argument are included in Attachment XX as follows:

Amendment	**Issue**
1.	BMGS
2.	PPFAC (Amendments 2A through 2G)
3.	CWIP
4.	Post Test Year Plant
5.	Deduction of Advances
6.	Return on Equity
7.	Rate Case Expense

8. PEP

9. SERP

10. Long-Term Incentive Program

11. Fair Value

12. Technical Corrections

RESPECTFULLY SUBMITTED this 5th day of May 2008.

UNS Electric, Inc.

By [signature]
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Original and thirteen copies of the foregoing filed this 5th day of May 2008, with:

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Arizona Corporation Commission
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Phoenix, Arizona 85007

Copy of the foregoing hand-delivered This 5th day of May 2008, to:

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By ______________________

ATTACHMENT

"1"

ATTACHMENT 1

UNS ELECTRIC'S

SUGGESTED AMENDMENTS

TO THE

RECOMMENDED OPINION AND ORDER

Amendment 1

Approval of the Rate Basing of Black Mountain Generating Station

(1) Page 76, lines 8 through 19, **DELETE** entire text.

(2) Page 76, line 8 **INSERT** the following: "In response to its unique circumstances, UNS Electric makes an unusual request regarding acquisition of an important generation plant, BMGS. Although post-test year rate base treatment of an asset not yet commercial operation is not traditional ratemaking, because of the many financial and operational benefits owning BMGS would provide to the Company and its customers and due to the unique circumstances that the Company faces, we approve the Company's request for a post-test-year rate base adjustment for BMGS and the corresponding rate reclassification.

As detailed above, the record identifies numerous financial and operational benefits of BMGS. Among the operational benefits are the flexibility to dispatch, operational control over maintenance and operations, and UNS Electric having a generation resource close to the load pocket. (UNSE-14 at 7-8; UNSE-15 at 6-7). If UNS Electric is allowed to rate base BMGS in this case, those assets would be dedicated to the Company and its customers. Further, UNS Electric would have an improved power portfolio versus being almost entirely subject to the whims of the market. UNS Electric would own a 90 MW generation peaking facility not commonly available in the market. (UNSE-14 at 10; Tr. at 382). No party disputed that UNS Electric owning BMGS will result in lower costs than a long-term Purchase Power Agreement ("PPA"). (UNSE-8 at 13-14, Ex. KPL-3).

We further agree that, based on the evidence presented, UNS Electric would not be able to acquire BMGS without the proposed post test year rate base adjustment because it would not be able to provide the assurances needed to finance the acquisition. In other words, UNS Electric needs the additional $10 million in non-fuel revenue requirement, $6 million to the utility's operating cash flows, and $3 million in net income to finance acquiring BMGS. (UNSE-8 at 3, 7, 10). A request for deferral – as Staff recommends the Company undertake – will not provide the needed cash flow to finance the facility. While an unusual request, given the benefits rate basing BMGS provides to UNS Electric, we believe approving this proposal to allow acquisition of BMGS is in the public interest.

We understand the concerns of Staff and RUCO that approving UNS Electric's request regarding BMGS rate bases an asset that was not used and useful during the test year. But we believe that UNS Electric's proposal provides for certainty and alleviates the concerns expressed:

- UNS Electric's rate base request is for $60 million. This is the minimum cost to construct BMGS based on the undisputed evidence presented. Any additional cost above $60 million would not be sought to be recovered in this rate case. (UNSE-9 at 3, 10). The amount rate based would be known and measurable in this case for BMGS.
- UNS Electric would submit a project report 30 days before its requested post-test-year adjustment and corresponding rate reclassification would take effect. Even so, UNS Electric's proposal would not take effect until the plant was in commercial operation and no sooner than June 1, 2008. Therefore, the adjustments would not occur until after BMGS started serving customers.
- Under this proposal, UNS Electric would acquire BMGS at cost from UniSource Energy Development Company ("UED"). (UNSE-14 at 9). Staff and RUCO would have full opportunity to evaluate the prudence of the construction costs for BMGS in the Company's next rate case. (UNSE-15 at 4). Finally, upon approval of its proposal, UNS Electric commits to and will own BMGS.[1] (UNSE-9 at 12; Tr. at 193-94, 309).

Given these commitments by UNS Electric, the unique circumstances here and the numerous benefits BMGS would provide to UNS Electric and its customers, we believe the Company's proposal is in the public interest and we approve the Company's request to: (1) make a post-test-year adjustment to add no more than $60 million in rate base for BMGS; and (2) move 0.6 cents per kWh out of the base power supply charge and add 0.6 cents per kWh be

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[1] Such a transfer would also be subject to FERC approval.

added simultaneously to the base delivery charge at the time BMGS starts serving UNS Electric customers."

(3) At page 81, starting at line 26, **DELETE** existing Finding of Fact No. 37

(4) At page 81, line 26, **INSERT** new Finding of Fact No. 37: "The Company's proposal to include Black Mountain Generating Station in base rates is in the public interest and should be approved because of the numerous financial and operational benefits it would provide to both UNS Electric and its customers in light of the unique circumstances facing the Company, including the need to procure its entire full requirements for power by June 1, 2008, and the need to refinance all of its long-term debt (over $60 million) by August 2008. Further, UNS Electric's proposal will provide lenders with the assurance needed so that UNS Electric can finance acquiring BMGS."

(5) At page 83, line 9, **INSERT:**

"IT IS FURTHER ORDERED that UNS Electric is hereby authorized to: (1) make a post-test-year adjustment to add no more $60 million in rate base for Black Mountain Generating Station; and (2) move 0.6 cents per kWh out of the base power supply charge and add 0.6 cents per kWh be added simultaneously to the base delivery charge. Should Black Mountain Generating Station be completed at a cost of less than $60 million, the Company will reduce the size of the requested rate reclassification in proportion with the change in the final cost.

IT IS FURTHER ORDERED that UNS Electric will submit its project completion report 30 days before UNS Electric makes its post-test-year adjustment and corresponding rate reclassification. UNS Electric's proposal will not take effect until Black Mountain Generating Station is in commercial operation and no sooner than June 1, 2008.

IT IS FURTHER ORDERED that Staff and RUCO will be allowed to review the prudence of the construction costs for Black Mountain Generating Station in the Company's next rate case."

(6) **MAKE ALL CONFORMING CHANGES**

Amendment 2A

Rejection of a Cap on the PPFAC

(1) Page 70, line 22 through page 71, line 11, **DELETE** entire text.

(2) Page 70, line 22 **INSERT** the following: "At this time, we will not impose a cap on the Forward Component for UNS Electric's PPFAC. A cap will result in substantial deferrals – perhaps as much as $20 million – of fuel and purchased power costs. (Tr. at 1411). This would likely impose significant additional risk on the Company. That, in turn, would most likely make it more difficult for UNS Electric to secure fuel and purchase power on favorable terms, which translates to increased credit costs and high debt costs. (UNSE-15 at 14; S-27; Tr. at 328-29). Ultimately that results in higher electric bills for ratepayers. We remain mindful that fuel and purchase power costs are a highly-volatile resource subject to substantial price swings that can cause significantly increased costs to customers. We provide explicit notice here that we may decide that a cap is appropriate for UNS Electric's PPFAC in a subsequent rate case. But given that: (1) UNS Electric does not have stable nuclear and coal facilities in its fleet; (2) the Company would still be largely, if not entirely, reliant on the market for acquisition of generation with or without BMGS in its rate base; and (3) UNS Electric has a very volatile supply resource due to it being gas-based, we believe that a cap on UNS Electric's PPFAC is not appropriate at this time.

(3) At Page 81, starting at line 4, **DELETE** Finding of Fact No. 30.

(4) At Page 81, starting at line 4, **INSERT**: "With respect to the Company's PPFAC mechanism, we adopt most of Staff's recommendations, including limitation of expenses to those recorded in FERC Accounts 501, 547, 555 and 565. However, we will not adopt Staff's recommendation for a cap on the PPFAC.

(5) At Page 85, **DELETE** lines 20 through 22.

(6) At page 85, starting at line 20, **INSERT**: "IT IS FURTHER ORDERED that with respect to the Company's PPFAC mechanism as modified in its Rebuttal Testimony, Staff's recommended revision to the Company's modified PPFAC mechanism to limit expenses to those recorded in FERC Accounts 501, 547, 555 and 565, is approved."

(7) **MAKE ALL CONFORMING CHANGES.**

Amendment 2B

Approving the PPFAC rate of 1.672 cents per kWh for Year One

***i.e.* from June 1, 2008 through May 31, 2009).**

(1) Page 71, starting at line 11, **INSERT** the following new paragraph: "On December 21, 2007, the Company made a filing with its forecasted PPFAC rate in accordance with its Draft Plan of Administration. At the time of that filing, market prices were about $7.50 per MMBtu gas. The PPFAC Forward Component in that filing was 1.9274 cents per kWh. Given the current over-collection in UNS Electric's existing PPFAC bank balance (estimated to be at approximately $4,402,049 by May 31, 2008), the True-Up Component then would equal (0.2554) cents per kWh. This equals a total PPFAC rate of 1.672 cents per kWh in Year One (*i.e.* from June 1, 2008 through May 31, 2009). Because the current forward market prices are approaching $10 per MMBtu gas, as shown in Attachment 2, and the PPFAC approved herein is to take effect June 1, 2008, it is appropriate and reasonable to approve the PPFAC rate – including the Forward Component and True-Up Component – in this order as described above. Should actual market prices be less than $10.00 per MMBtu gas, that can be addressed in the True-Up Component for the following year (*i.e.* from June 1, 2009 through May 31, 2010).

(2) Page 81, starting at line 9, **INSERT** new Finding of Fact: "A total PPFAC rate of 1.672 cents per kWh in Year One (*i.e.* from June 1, 2008 through May 31, 2009) is reasonable and will be adopted. This is based on a Forward Component of 1.9274 cents per kWh and a True-Up Component of (0.2554) cents per kWh."

(3) Page 85, starting at line 25, **INSERT** new Ordering Paragraph: "IT IS FURTHER ORDERED that a total PPFAC rate of 1.672 cents per kWh in Year One (*i.e.* from June 1, 2008 through May 31, 2009) is approved.

Amendment 2C

<u>PPFAC Cap Clarification</u>

(1) Page 70, starting at line 28 after "manner.", **INSERT**: "Further, the 1.73 cents per kWh cap will be on the Forward Component only in accordance with Staff's proposal."

(2) Page 81, line 6, **INSERT** between "cap" and "of 1.73": "on the Forward Component".

(3) Page 85, line 22, **INSERT** between "cap" and "of 1.73": "on the Forward Component"

(4) **MAKE ALL CONFORMING CHANGES.**

Amendment 2D

PPFAC Cap Level Increase.

(1) Page 70, starting at line 28 after "manner.", **INSERT**: "However, we agree that the cap on the Forward Component should be 2.783 cents per kWh to reflect the current level of natural gas and power prices."

(2) Page 81, line 6, **DELETE** "1.73" and **INSERT** "2.783"

(3) Page 85, line 22, **DELETE** "1.73" and **INSERT** "2.783"

(4) **MAKE ALL CONFORMING CHANGES.**

Amendment 2E

Changing the Cap from a Hard Cap to an Annual Cap.

(1) Page 70, starting at line 28 after "manner.", **INSERT**: "In the most recent rate case for APS, we approved an annual cap of 4 mils on its Power Supply Adjustor. See Decision No. 69663 (June 28, 2007) at 112. We believe that the cap imposed on UNS Electric's PPFAC should also be an annual cap and not a "lifetime" cap. We believe this better maintains the balance we described earlier. Therefore, the cap of 1.73 cents per kWh will be an annual cap."

(2) Page 81, line 6, between "of" and "PPFAC" **DELETE** "a" and **INSERT** "an annual".

(3) Page 85, line 22, between "of" and "PPFAC" **DELETE** "a" and **INSERT** "an annual".

(4) **MAKE ALL CONFORMING CHANGES**.

Amendment 2F

PPFAC Bank Balance Threshold and Surcharge Application.

(1) Page 70, starting at line 28 after "manner." **INSERT**: "Given that we are adopting a cap on the PPFAC, we will permit UNS Electric to file a surcharge application for Commission approval when UNS Electric's PPFAC bank balance equals or exceeds $5 million. This amount is approximately equivalent to UNS Electric's annual earnings in the test year."

(2) Page 81, starting at line 6, after "per kWh.", **INSERT**: "We also permit UNS Electric to file a surcharge application for Commission approval when UNS Electric's PPFAC Forward Component bank balance equals or exceeds $5 million."

(3) Page 85, starting at line 25, **INSERT** new ordering paragraph: "IT IS FURTHER ORDERED that UNS Electric is permitted to file a surcharge application for Commission approval when UNS Electric's PPFAC Forward Component bank balance equals or exceeds $5 million."

(4) **MAKE ALL CONFORMING CHANGES.**

Amendment 2G

PPFAC Interest Rate

(1) Page 71, from line 1 through line 11, **DELETE** entire text.

(2) Page 71, starting at line 1, **INSERT**: "Finally, we approve the Company's proposal that the applicable interest rate to any deferrals due to the PPFAC cap should be equal to LIBOR plus 1%. This is the actual cost that UNS Electric would have to pay to finance any deferrals through its short-term revolving credit facility. (Tr. at 1405-06, 1413). Approving the one-year Nominal Treasury Constant Maturities rate, as Staff recommends, would impose substantial hardship as that interest rate would not be sufficient to cover the Company's actual financing costs. Because the Company would not be earning any return for fuel and purchase power costs and is only recovering the actual financing cost to defer fuel and purchase power costs, we do not believe that approving an interest rate equal to LIBOR plus 1% provides any disincentive for UNS Electric against taking all possible measures to reduce the cost of fuel and purchased power for its customers."

(3) Page 81, lines 7 through 8, **DELETE** Finding of Fact No. 31.

(4) Page 81, at line 7, **INSERT** new Finding of Fact No. 31: "The interest rate for the Company's PPFAC tracking accounts will be the actual cost UNS Electric would have to pay to finance any deferrals through its short-term revolving credit facility. That rate is equal to LIBOR plus 1%."

(5) Page 85, at line 25 **INSERT** new ordering paragraph: "IT IS FURTHER ORDERED that the interest rate for the Company's PPFAC tracking accounts will be equal to LIBOR plus 1%."

(6) **MAKE ALL CONFORMING CHANGES.**

Amendment 3

<u>CWIP</u>

(1) Page 8, lines 3 through line 23 **DELETE** entire text.

(2) Page 8, line 3 **INSERT** the following: "Although Staff and RUCO make cogent arguments regarding why CWIP should not be allowed for many utilities, this case presents unique and extraordinary circumstances that may adversely affect UNS Electric's financial integrity if sufficient rate relief is not provided. In the long run, both ratepayers and shareholders benefit from financially healthy utilities. Accordingly, in this case, we will allow $10.8 million of CWIP as a means of addressing the financial stress caused by these unique and extraordinary circumstances."

(3) **MAKE ALL CONFORMING CHANGES**

Amendment 4

<u>Post Test Year Plant</u>

(1) Page 9, lines 9 though 25 **DELETE** entire text.

(2) Page 9, line 9 **INSERT** the following: "Staff's concerns are valid in a generic sense. However, the evidence in this case shows that much of the new plant does not create new revenues and that revenues from new customers do not come close to covering the costs associated with new plant to serve those customers. We have allowed post test year plant in many previous cases. UNS Electric's unique circumstances, extraordinary growth and financial stress make it a good candidate for post test year plant, and we will accordingly grant UNS Electric's request to include $8.7 million post test year plant in rate base."

(3) **MAKE ALL CONFORMING CHANGES**

Amendment 5

Deduction of Advances related to CWIP

(1) Page 10, line 19 to page 11, line 5 **DELETE** entire text.

(2) Page 10, line 19 **INSERT** the following: "As UNS Electric notes, the purpose of deducting advances is to ensure that the advance has no net impact on rate base. We would not permit advances to result in an increase to rate base, and by the same token, we agree that they should not result in a net reduction to rate base. We do not believe it is proper to reduce investor supplied capital in rate base by the amount of an advance that is related to plant that has not yet been included in rate base. We agree with UNS Electric and will not deduct $1.9 million in advances that relate to test-year CWIP that is not yet in rate base."

Amendment 6

Return on Equity

(1) Page 43, line 14 to page 44, line 8, **DELETE** entire text.

(2) Page 43, line 14 **INSERT** the following: "The evidence in this case is that UNS Electric is decidedly riskier than any of the comparable companies used by any cost of capital witness in their respective analyses This is because of factors including UNS Electric's small size, high customer growth, $60 million maturity of long-term debt in August 2008, lack of significant generation plant and the need to replace all of its power needs by June 1, 2008. The evidence is also clear that UNS Electric would have the equivalent of a speculative-grade credit rating. We note that we awarded Arizona Public Service Company an ROE of 10.75 in its last rate proceeding in Decision No. 69663 (June 28, 2007). APS is a much larger electric utility with a diversified portfolio of nuclear, coal and natural-gas filed generation. The evidence in this case shows that UNS Electric is riskier than APS and that an ROE for UNS Electric that is 105 basis points higher than that for APS appropriately takes that fact into account. Accordingly, we will approve an ROE of 11.8% for UNS Electric."

(3) Page 44, line 6 **INSERT** following revised chart:

	Percentage	Cost	Avg. Weighted Cost
Common Equity	48.85%	11.8%	5.76%
Long-Term Debt	47.18%	8.22%	3.88%
Short-Term Debt	3.97%	6.36%	0.25%
			9.89%

(4) **MAKE ALL CONFORMING CHANGES**

Amendment 7

Rate Case Expense

(1) Page 24, lines 1 through 11 **DELETE** entire text.

(2) Page 24, line 1 **INSERT** the following: "UNS Electric lacks the in-house rate and legal departments Southwest Gas relies on. Given the differences in employee structure and related rate case support, we agree with UNS Electric that its rate case expense cannot be directly compared to that of Southwest Gas. No party has suggested that UNS Electric has pursued frivolous issues or that their experts or lawyers cost more than normal. Accordingly, we will approve UNS Electric's proposed rate case expense of $600,000 amortized over three years."

(3) **MAKE ALL CONFORMING CHANGES**

Amendment 8

PEP

(1) Page 21, lines 1 through 21 **DELETE** entire text.

(2) Page 21, line 1 **INSERT** the following: "As long as a utility's overall employee compensation costs are reasonable, we will allow recovery of the costs of the underlying compensation programs. As UNS Electric notes, incentive compensation is standard, both in the utility industry and in business corporations in general. Accordingly, we will allow full recovery of UNS Electric's PEP costs."

(3) **MAKE ALL CONFORMING CHANGES**

Amendment 9

Officer's Long-Term Incentive Program

(1) Page 21, line 21 **INSERT** new section as follows:

Officer's Long-Term Incentive Program

Consistent with our treatment of the PEP, we will not disallow any of UNS Electric's costs for its Officer's Long-Term Incentive Program.

(2) **MAKE ALL CONFORMING CHANGES**

Amendment 10

SERP

(1) Page 22, lines 11 through 28 **DELETE** entire text.

(2) Page 22, line 11 **INSERT** the following: "While we disallowed SERP costs in the most recent Southwest Gas and UNS Gas rate cases, those decisions post-dated the filing in this case. Moreover, we had allowed SERP costs in the previous Southwest Gas rate case which was the most recent guidance at the time of the application here. As long as a utility's overall compensation costs are reasonable, we will allow recovery of the costs of the underlying compensation programs. Accordingly, we will allow full recovery of UNS Electric's SERP costs."

(3) **MAKE ALL CONFORMING CHANGES**

Amendment 11

Fair Value

(1) Page 46, line 4 to page 48 line 27 **DELETE** entire text.

(2) Page 46, line 4 **INSERT** the following: "We acknowledge that we must use fair value in setting rates. Staff's approach admittedly results in rates remaining the same no matter what fair value we find. We do not see how that approach properly reflects fair value. Therefore, we will approve UNS Electric's proposal to apply the weighted average cost of capital to the fair value rate base. We will also hold UNS Electric to its commitment that the rates approved herein may not exceed the amount requested in its original rate application."

(3) **MAKE ALL CONFORMING CHANGES**

Amendment 12

Technical Corrections

(1) Page 11, starting at line 19 after "below." **INSERT**: "However, to adjust for CWIP not being in rate base, ADIT must also be increased by $207,000 to properly reflect the CWIP deferred income tax liabilities. The net adjustment to ADIT is therefore a $46,145 net increase."

(2) Page 37, Line 18 **DELETE** "$9,334,283" and **INSERT** "9,333,160".

(3) Page 49, Line 4.5 **DELETE** "$9,334,283" and **INSERT** "9,333,160".

(5) Page 80, Line 14 (Finding of Fact No. 24) **DELETE** "$0.05194" and **INSERT** "$0.07530".

(6) Page 28, Line 8 after "adopted." **INSERT**: "Further, since we have denied CWIP in rate base, depreciation and property taxes for CWIP shall also be adjusted to reflect that we are not allowing CWIP in rate base."

(6) **MAKE ALL CONFORMING CHANGES.**

ATTACHMENT

"2"

Attachment 2
Forward Natural Gas Prices
San Juan Basin
$ per MMBtu

Month	Price		
Jun-08	9.568		
Jul-08	10.015		
Aug-08	10.171		
Sep-08	10.013		
Oct-08	9.782		
Nov-08	9.87		
Dec-08	10.42		
Jan-09	10.605		
Feb-09	10.61		
Mar-09	10.375		
Apr-09	8.475		
May-09	8.295	average	9.849917
Jun-09	8.38		
Jul-09	8.735		
Aug-09	8.785		
Sep-09	8.805		
Oct-09	8.615		
Nov-09	8.725		
Dec-09	9.275		
Jan-10	9.42		
Feb-10	9.385		
Mar-10	9.15		
Apr-10	7.94		
May-10	7.81	average	8.752083

ATTACHMENT

"3"

Attachment 3
Estimated PPFAC Balances
May 31,2009
$ 000

Average Gas Price per MMBtu	Unrecovered Balance
January Forecast - $7.38	$976
March Forecast - $9.24	$12,002
May Forecast - $9.97	$19,782