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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-04204A-08-0571

INITIAL POST-HEARING BRIEF OF UNS GAS, INC.

SEPTEMBER 18, 2009

Arizona Corporation Commission
DOCKETED
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I. INTRODUCTION.

This initial post-hearing brief presents a summary of the evidence in the record of this proceeding. Reference is made herein to:

(i) prefiled testimony and exhibits;

(ii) transcripts of testimony and exhibits produced at hearing; and

(iii) post-hearing information made a part of the record.

Also, where appropriate, UNS Gas, Inc. ("UNS Gas" or the "Company") has referenced relevant court cases and decisions of the Arizona Corporation Commission ("Commission").

The evidence in the record fully supports the Company's request for a rate increase and related relief. Further, as detailed herein, the evidence fully rebuts the opposing arguments of Commission Staff and RUCO. UNS Gas reserves the right to address, in its reply post-hearing brief, any argument or evidence raised by any other party in its initial post-hearing brief and not discussed herein.

On November 7, 2008, UNS Gas filed its Application for the establishment of just and reasonable rates. UNS Gas requests a variety of relief, including: (i) a base rate increase of $9.5 million; (ii) modifications to its rate design that allow UNS Gas to cover more of its fixed costs through a higher monthly customer charge and reduce the current subsidization of warm-weather customers by cold-weather customers; (iii) approval of a rate design for eligible low-income customers that will hold those customers harmless from the proposed rate increase; (iv) minor revisions to its Rules and Regulations; and (v) a minor modification to the Company's Purchased Gas Adjuster ("PGA").

Over the past three years, UNS Gas spent significant time and money to improve the aged system it took over from Citizens Utilities while meeting the demands of the rapid growth that occurred prior to the current economic downturn. All of the Company's income has been put back into the system. The Company has never paid a dividend to its parent company and has managed to build a healthy debt to equity ratio. Consequently, the main factors driving the requested rate increase in this case are: (i) UNS Gas' current rates do not reflect the substantial capital investment – approximately $54 million – that the Company made in facilities that are used and useful since the end of the 2005 (the end of the prior test-year) and (ii) the Company's expense levels continue to increase beyond the amount it recovers in rates. For example, operating expenses recovered through UNS Gas' current rates are $34.8 million, while operating expenses in this current rate filing are $37.7 million.[1] UNS Gas is entitled to a just and reasonable return of that significant investment and to recover its costs of operating a safe and reliable system.

UNS Gas requests a rate increase of $9,480,876, or approximately 6 percent above test year revenues. Its current rates are insufficient to allow the Company to recover its costs and earn a reasonable rate of return on its investment, particularly given the investment to serve prior growth in UNS Gas' service territory and the related increase in capital expenditures and operating costs.

UNS Gas projects it will earn a return on average common equity of 7.2% for 2009, significantly less that its currently authorized 10% return on equity ("ROE").[2] Its return in 2010 will be even lower without relief. Even if UNS Gas is granted its full rate increase request of approximately $9.5 million before the end of 2009, UNS Gas projects that it will earn a return on equity ("ROE") of 10.1% in 2010.[3] Given UNS Gas' significant investment since the last rate case and its rising expenses for operations, the recommendations of Staff and RUCO fall well short of providing the Company with an opportunity to earn a just and reasonable return. The Company will earn a ROE of only 6 to 7% if Staff's revenue requirement is adopted and only 5 to 6% if RUCO's revenue requirement recommendation is adopted.[4] No party has disputed those numbers – indeed, neither Staff nor RUCO even considered the impact of their recommendations on UNS Gas.[5] And these returns on equity capital are substantially below the requested 11.0% ROE and are even well below the unreasonably low ROEs of 10.0% and 8.61% recommended by

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[1] Ex. UNSG-5 (Hutchens Direct) at 5.
[2] Ex. UNSG-14 (Grant Rebuttal) at 24.
[3] Ex. UNSG-14 (Grant Rebuttal) at 24.
[4] Ex. UNSG-14 (Grant Rebuttal) at 24.
[5] See Ex. UNSG-24 (Staff Response to UNSG 3.6); Ex. UNSG-41 (RUCO Response to UNSG 2.48).

Staff and RUCO, respectively. The following chart compares the key recommendations of the Company, Staff and RUCO:

	UNS Gas	Staff	RUCO
Gross Revenue Increase	$9,480,876	$3,539,982	$841,000
ROE	11.00%	10.0%	8.61%
Fair Value Return	7.30%	6.03% or 6.37%	5.38%

The Company's requested rate relief in this case is intended to maintain its financial integrity. Maintaining financial integrity is critical for UNS Gas. UNS Gas recently achieved the lowest level investment grade rating of Baa3. This rating, the lowest investment grade rating assigned by Moody's, should benefit the Company and its customers in the future through better credit terms and a lower cost of debt.[6] However, maintaining the rating requires a financially healthy utility. The Company requests the bare minimum to ensure that financial health.

UNS Gas understands the concern about raising rates in a down economy. However, the economy also presents circumstances that help mitigate the proposed rate increase. In particular, the cost of gas has declined significantly and those lower commodity costs are being reflected through the PGA – that is significant given that the commodity cost reflects over 60% of a customer's bill. Moreover, the Company will be filing for approval of a PGA credit that would overlap with and mitigate the first few months of the requested new rates. Finally, UNS Gas has proposed that all of its Customer Assistance Residential Energy Support ("CARES") program customers be held harmless from the proposed rate increase – they will still realize the benefits of the declining PGA rate and the proposed PGA credit.

Further, much of UNS Gas' request in this case is uncontested.[7] For several of the contested issues, UNS Gas applied the Commission's analysis and conclusions from the prior

[6] Ex. UNSG-13 (Grant Direct) at 6-8, 27-28.
[7] Attached as Appendix A is the final Joint Issues Matrix that was submitted to the Hearing Division after the close of the hearing. This Matrix identifies the issues that are contested or uncontested.

UNS Gas rate case (Decision No. 70011 (November 27, 2007)), while Staff and RUCO have deviated from that Decision without sufficient justification – often asserting positions contrary to what they asserted in that prior case, and contrary to what the Commission adopted in Decision No. 70011. Several of those deviations have significant impacts on the requested revenue requirement, in particular Staff's unprecedented Customer Annualization method and Staff's proposals on the Fleet Fuel, Call Center, Bad Debt and Outside Legal expenses.

In sum, UNS Gas believes that the relief requested is critical for maintaining its financial integrity and ability to provide safe and reliable service. UNS Gas' requested revenue requirement is reasonable, fully supported by the record, results in just and reasonable rates and should be approved by the Commission.

II. RATE BASE.

The three rate base adjustments that are contested in this matter are: (i) Post-Test Year Non-Revenue Plant Adjustment; (ii) the Customer Advance Adjustment; and (iii) the Working Capital Adjustment.

A. Post-Test Year Non-Revenue Plant in Service.

The Company proposes an adjustment to include $1,527,588 of Post-Test Year Non-Revenue Plant in rate base. In Decision No. 70011 (November 27, 2007), the Commission rejected UNS Gas' request for post-test year plant, noting that there was no segregation of revenue-producing plant from non-revenue producing plant. In compliance with that ruling, the adjustment here seeks only non-revenue producing post-test year plant. The Company has identified specific post-test year plant that is non-revenue producing.[8] It is undisputed that these post-test year plant additions are already in service or will be in service prior to new rates going into effect.[9] Moreover, no party has claimed that these plant additions are imprudent.[10]

Staff and RUCO oppose UNS Gas' prudent post-test year plant additions because it could result in a mismatch between post-test year revenue and costs. Staff and RUCO also both argue

[8] Ex. UNSG-42 (Response to RUCO 1.88); Tr. (Dukes) at 908, 916-918.

[9] Ex. UNSG-17 (Dukes Rebuttal) at 5; Tr. (Dukes) at 917-918.

[10] Ex. UNSG-24 (Staff Response to UNSG 3.9); Ex. UNSG-41 (RUCO Response to UNSG 3.2).

that because any investment in plant would result in reduced expenses, without citing any empirical evidence to support that assertion. Staff and RUCO have provided no data to support their speculative allegations of reduced expenses.[11] Indeed, both acknowledge that certain operation and maintenance costs would continue even if brand new plant was installed.[12] For example, Dr. Fish agreed that UNS Gas would still have to perform the same leak surveys if it replaces a section of main.[13] Staff and RUCO further acknowledged that the post-test year plant would improve system reliability and improve service to existing customers.[14] Investments in post test year plant can also address safety issues.[15] As Dr. Fish explained, it "Safety is a very good thing to invest in."[16]

Under Staff's and RUCO's analyses, it appears that non-revenue producing Post Test Year Plant would never be included in rate base, which is simply inconsistent with prior Commission decisions. Indeed, prior to the hearing, Dr. Fish conceded that he did not review relevant Commission decisions concerning post test year plant in preparing his testimony.[17] Consequently Dr. Fish was unable to defend his recommendation in light of those prior decisions.[18]

Staff and RUCO have made similar arguments in the past – and they have been rejected. For example, in Decision No. 65350 (November 1, 2002), the Bella Vista Water Company requested inclusion of numerous system improvement projects into rate base as post test year plant. In that case, Staff and RUCO argued that the plant should be excluded, because the plant "may improve system reliability resulting in lower expenses and increased revenues."[19] The Commission rejected Staff and RUCO's argument, noted that while plant constructed to serve

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[11] Ex. UNSG-24 (Staff Response to UNSG 3.7.g).
[12] Hearing Transcript ("Tr.") (Fish) at 591; Tr. (R. Smith) at 882.
[13] Tr. (Fish) at 591.
[14] Tr. (Fish) at 591-593; Tr. (R. Smith) at 882.
[15] Ex. UNSG-24 (Staff Response to UNSG 3.7).
[16] Tr. (Fish) at 591.
[17] Ex. UNSG-24 (Staff Supplemental Response to UNSG 3.10).
[18] Ex. UNSG-24 (Staff Responses to UNSG 3.11 to 3.15).
[19] Decision No. 65350 (Nov. 1, 2002) at 9.

existing customers could have some impact on revenues or expenses, the evidence did not show a *material impact* on revenues and expenses.[20]

Along similar lines, in Decision No. 68176 (September 30, 2004) the Commission explained that "inclusion of post test year plant always causes some mismatch between revenues and expenses, even if the post test year plant is revenue neutral."[21] The Commission nevertheless included the post test year plant in rate base. The Commission emphasized materiality again in Decision No. 67279 (October 5, 2004) noting that "there would not be a material impact on revenue or expenses."[22]

Staff and RUCO also assert that that post test year plant should only be approved in "compelling" or "very compelling" circumstances.[23] But the Commission has rejected such arguments before. For example, in Decision No. 65350 (November 1, 2002), the Commission stated that "We do not agree with Staff and RUCO that the Commission has always required extraordinary circumstances to allow post test year plant."[24] The Commission has summarized its past cases as follows: "In the past, the Commission has allowed the inclusion of post test year plant in circumstances where the new plant is revenue neutral and there is no evidence of a material mismatch between revenue and expenses and where the post test year plant is required for system reliability or to provide adequate service."[25]

Here, the record confirms that UNS Gas: (i) reviewed the projects and indentified investments that had been made in projects that would not produce additional revenue and that would have been invested in regardless of customer growth, and (ii) included communication equipment, vehicles, tools, power equipment and natural gas detector equipment, which are all necessary to serve the existing customer base as well as service and main replacements to ensure safe and reliable service to our existing customers.[26] Moreover, the evidence supports UNS Gas'

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[20] Decision No. 65350 (Nov. 1, 2002) at 10.
[21] Decision No. 68176 (Sept. 30, 2004) at 5.
[22] Decision No. 67279 (Oct. 5, 2004) at 7.
[23] Ex. RUCO-20 (Smith Direct) at 14; Ex. S-13 (Fish Surrebuttal) at 2.
[24] Decision No. 65350 (Nov. 1, 2002) at 11.
[25] Decision No. 67279 (Oct. 5, 2004) at 6.
[26] See Ex. UNSG-17 (Dukes Rebuttal) at 5.

position that there is not a material mismatch between revenues and expenses. The evidence and prior Commission orders rebut the position of Staff and RUCO on this issue.

UNS Gas has met the standard for including post-test year plant in rate base and the Commission should allow UNS Gas to recover its investment in this prudent plant needed to serve existing customers.

B. Customer Advances.

UNS Gas proposes an adjustment to rate base of $589,152 for customer advances. These advances should not be deducted from rate base because they are tied to plant that is not yet in rate base. Staff and RUCO both oppose the adjustment on the basis that customer advances should be deducted from rate base whenever possible – even if it reduces pre-existing rate base of UNS Gas. In fact, the impact of Staff's and RUCO's position is to reduce UNS Gas' pre-existing rate base by $589,152. Staff's and RUCO's position are inconsistent with regulatory theory, as well as governing legal requirements.

1. Staff and RUCO reduce UNS Gas' pre-existing rate base.

Staff and RUCO's approach has the effect of reducing pre-existing rate base. Staff's witness Dr. Fish agreed with the following example: a utility has a rate base of $100, and receives an advance of $10, which is invested in new plant.[27] Under that example, Dr. Fish stated that the utility's rate base is $90, explaining "you would actually have a reduction."[28] Dr. Fish conceded that even though the rate base has been reduced by $10 to $90, the "economic value would still be $100."[29]

UNS Gas' witness, Mr. Dukes, provided a slightly more elaborate example.[30] Under this example, the utility starts with a rate base of $100 million. It then receives an advance of $10 million, which it invests in plant. The utility's rate base "drops to $90,000,000 – even though the utility's investment in rate base has not changed. Ten million dollars in existing rate base is just

[27] Tr. (Fish) at 593-594.
[28] Tr. (Fish) at 594.
[29] Tr. (Fish) at 594.
[30] Ex. UNSG-17 (Dukes Rebuttal) at 6-7.

wiped out."[31] The rate base returns to $100 million only when the related plant is placed in service.[32] Regardless of the amount discussed regarding customer advances, Staff's and RUCO's approach is wrong.

2. Staff's and RUCO's approach is contrary to regulatory theory.

Staff and RUCO note that non-investor supplied capital should not be reflected in rate base. This is the reason that advances are deducted from rate base. UNS Gas wholeheartedly agrees. UNS Gas has not included any advances in rate base. Rather, UNS Gas proposes that its pre-existing rate base not be reduced due to the receipt of a customer advances that are invested but not yet in service. UNS Gas' position simply allows it to continue to recover a return on investments it previously made.

As Mr. Dukes explained, "advances should neither increase nor decrease rate base – the net impact should be zero."[33] Staff's and RUCO's approach results in a net decease to pre-existing rate base from the receipt of an advance.

In addition to denying UNS Gas a return on its investment, Staff's and RUCO's approach creates a serious matching issue. Staff and RUCO recognize the advance (the deduction from rate base) much earlier than the related addition to plant in service (the corresponding addition to rate base).[34] This timing difference reduces UNS Gas' pre-existing rate base.

Finally, Staff suggests that this plant should be excluded due to a Commission rule. But there is no rule that expressly requires advances to be deducted from rate base when the related plant is not yet in service. At the hearing, Staff witness Dr. Fish conceded that the Commission could follow UNS Gas' approach.[35] The purpose of deducting advances from rate base is to recognize the effect of customer-supplied capital. That purpose is not served when the plant funded by the advances is not in service. The Commission has the discretion to not deduct

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[31] Ex. UNSG-17 (Dukes Rebuttal) at 6.
[32] Ex. UNSG-17 (Dukes Rebuttal) at 6.
[33] Ex. UNSG-17 (Dukes Rebuttal) at 6.
[34] Ex. UNSG-17 (Dukes Rebuttal) at 6.
[35] Tr. (Fish) at 595-596.

advances or contributions from rate base and has done so in the past.[36] In this case, the evidence supports the Company's approach as a matter of equity, fairness and matching.

C. Working Capital.

Natural gas is the primary expense for UNS Gas. Staff's witness, Dr. Fish, agreed that gas is "by far the single biggest expenditure" of UNS Gas, representing two-thirds of total costs.[37] It has an enormous impact on UNS Gas' cash flow, and thus its working capital requirements.

UNS Gas' largest supplier is British Petroleum (BP). Despite UNS Gas' financial weakness (compared to other gas utilities), BP still provides more credit to UNS Gas than any other supplier.[38]

BP's request for credit support took the form of a requirement to pay for gas twice a month, rather than the previous once-a-month schedule. The change occurred during the test year, and continued after the test year. Staff's witness, Dr. Fish, did not dispute these facts.[39] Dr. Fish also recognized that "management determined to pay it that way in order to meet its obligation to serve."[40]

Nevertheless, Dr. Fish testified that the working capital adjustment associated with this change in payment terms should be rejected. Dr. Fish opined that these credit terms were "not realistic and... not representative of normal credit terms."[41] Dr. Fish also speculated that UNS Gas "has the discretion to obtain more favorable terms and conditions from another supplier."[42] Dr. Fish's testimony on this issue is contrary to fact and he should not speculate on this matter. Dr. Fish testified that he was not a gas procurement expert, and he did not conduct a survey of the credit terms available to gas utilities.[43] Nor has he identified a single supplier willing to extend

[36] In Decision No. 69914 (Sept. 27, 2008) at page 29, the Commission did not require Arizona-American Water Company to deduct from rate base contributions associated with hook-up fees pertaining to a specific surface water treatment plant that was not yet in service.
[37] Tr. (Fish) at 601-602.
[38] Ex. UNSG-15 (Grant Rejoinder) at 5.
[39] Tr. (Fish) at 597-598.
[40] Tr. (Fish) at 598.
[41] Ex. S-13 (Fish Surrebuttal) at 4.
[42] Ex. S-13 (Fish Surrebuttal) at 4.
[43] Tr. (Fish) at 601.

better terms to UNS Gas than those offered by BP. Staff's gas procurement expert in this case – Ms. Rita Beale – reviewed how UNS Gas procured its natural gas supply. She noted that UNS Gas procurement practices were generally consistent with industry standards. However, she did make several suggestions intended to improve UNS Gas' natural gas procurement process. UNS Gas has agreed to implement Ms. Beale's suggestions.[44] It is important to note, however, that Ms. Beale did not mention or question the credit terms required by BP and accepted by UNS Gas. Therefore, Staff's own natural gas procurement expert, through her silence, undermines Dr. Fish's position.

UNS Gas' witness, Mr. Grant, testified that UNS Gas explored all available options for obtaining supply.[45] He testified that all of these alternatives would have been more costly.[46] Mr. Grant also noted that UNS Gas' credit options are limited because "UNS Gas' credit profile is weaker than most gas utilities."[47] Mr. Grant explained that obtaining a higher credit allowance "quite frankly, it's not something that we can just do unilaterally."[48] Mr. Grant testified that UNS Gas' credit manager "tried to work out some additional credit. It was just not forthcoming."[49]

Dr. Fish's speculation that UNS Gas could obtain more favorable credit terms elsewhere is simply unsupported by any evidence. The evidence is that BP is still the most generous supplier of trade credit, and options other than twice-a-month payments would have been more expensive. Additionally, the record supports that UNS Gas' management acted prudently in evaluating all other credit options and in its choice to accept BP's credit terms as they produced the lowest cost.[50] UNS Gas' working capital adjustment reflects the unfortunate reality of its situation, and should be adopted. Further, the situation with BP highlights UNS Gas' need for rate relief in order to improve its credit profile.

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[44] See Ex. UNSG-6 (Hutchens Rebuttal) at 8-12; Ex. UNSG-7 (Hutchens Rejoinder) at 4.
[45] Ex. UNSG-15 (Grant Rejoinder) at 4-5.
[46] Ex. UNSG-15 (Grant Rejoinder) at 4.
[47] Ex. UNSG-15 (Grant Rejoinder) at 5.
[48] Tr. (Grant) at 288.
[49] Tr. (Grant) at 289.
[50] See Ex. UNSG-15 (Grant Rejoinder) at 4-5; Tr. (Grant) at 282-283.

D. Accumulated Deferred Income Taxes.

UNS Gas, Staff and RUCO all propose some adjustment for accumulated deferred income taxes. The differences in those adjustments are the result of other proposed adjustments.

E. Reconstruction Cost New Less Depreciation.

The Company proposed a Reconstruction Cost New Less Depreciation ("RCND") of $329,266,770.[51] None of the parties proposed a different RCND.

F. Fair Value Rate Base.

UNS Gas, Staff and RUCO agree that fair value rate base ("FVRB") should be calculated by averaging OCRB and RCND. Thus, the Commission should approve this traditional method.

G. Uncontested Adjustments.

The Company proposed several adjustments to rate base that the other parties did not contest and therefore should be adopted.[52] The uncontested rate base adjustments: (1) Citizens Acquisition; (2) Southern Union Acquisition; (3) Griffith Power Plant; (4) Build-Out Plant; (5) Golden Valley Pipeline; and (6) Customer Assistance Residential Energy Support Program ("CARES") regulatory asset.

III. <u>OPERATING REVENUE.</u>

There is only one contested item regarding adjustments to operating revenue – customer annualization. As demonstrated below, the evidence fully supports the adoption of the Company's use of the traditional customer annualization methodology.

A. Customer Annualization.

UNS Gas has applied the traditional methodology for customer annualization in this case.[53] The record overwhelmingly supports UNS Gas' position that the "traditional" method of annualization should be used by the Commission in this case. Further, UNS Gas' position is

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[51] In preparing its Final Schedules, UNS Gas discovered a computational error for the RCND. Its Final Schedule reflects a corrected RCND of $330,365,912 that includes UNS Gas' final position on its adjustments. However, this correction does not change UNS Gas' requested increase in revenue requirement.

[52] See Appendix A.

[53] Ex. UNSG-20 (Erdwurm Direct) at 7-8; Ex. UNSG-21 (Erdwurm Rebuttal) at 1-2; Ex. UNSG-22 (Erdwurm Rejoinder) at 2-5.

consistent with the "traditional" methodology strenuously argued for by Staff and RUCO – and ultimately adopted by the Commission – in UNS Gas' last rate case (Decision No. 70011). In the prior UNS Gas rate case, Staff's witness Mr. Ralph Smith (now RUCO's witness) testified that the "traditional method of customer annualization has been effective in appropriately coordinating the revenue element of the ratemaking formula with the other components, such as rate base."[54] Likewise, RUCO's witness in the prior case, Ms. Marylee Diaz-Cortez, stated that UNS Gas does not experience "extreme seasonality" and that there is no "reason to depart from the "traditional" or Commission-accepted methodology of revenue annualization."[55] The Commission agreed that it should continue to use the traditional method, noting that there is no "valid case for departing from the traditional method" and the "lack of any significant demonstrated seasonality" at UNS Gas.[56]

Staff and RUCO now reject the traditional method, pointing to seasonality, which undermines and contradicts their position just two years ago. This is especially true since neither Staff nor RUCO placed any evidence into the record that proves or even suggests that during the test year, UNS Gas experienced any change in seasonality as compared to the prior rate case. In fact, the record is clear that UNS Gas' level of seasonality is unchanged.[57]

Staff and RUCO seem to complain that a test year ending in the summer renders the traditional method invalid. Staff's witness Dr. Fish proposed an alarming and extreme solution to this supposed problem. Dr. Fish adjusted residential (R-10) customer counts using an assumed 2.5% growth rate. Yet Dr. Fish testified that "I didn't do any type of forecast analysis of the company's growth rate."[58] UNS Gas certainly is not experiencing such a growth rate now.[59] Indeed, Dr. Fish stated that "I think the company is in a situation where its growth is difficult."[60]

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[54] Ex. UNSG-21 (Erdwurm Rebuttal) at 3, quoting Surrebuttal Testimony of Ralph C. Smith, Docket No. G-04204A-06-0463, page 21, lines 16-18.
[55] Ex. UNSG-21 (Erdwurm Rebuttal) at 3, quoting Surrebuttal Testimony of Marylee Diaz-Cortez, Docket No. G-04204A-06-0463, page 12, lines 20-23.
[56] Decision No. 70011 (Nov. 27, 2007) at 19.
[57] Ex. UNSG-21 (Erdwurm Rebuttal) at 10.
[58] Tr. (Fish) at 604.
[59] Ex. UNSG-7 (Hutchens Rejoinder) at 3-4; Ex. UNSG-21 (Erdwurm Rebuttal) at 11, lines 16-20.
[60] Tr. (Fish) at 610.

Dr. Fish admitted that he adjusted residential (R-10) customer counts to a level not seen before, during, or after the test year.[61] There is no telling when, if ever, UNS Gas will reach Dr. Fish's hypothetical customer count. In short, Dr. Fish's R-10 customer count is drastically different from reality. This is visually shown by the graph admitted as UNS Gas Exhibit 23.[62] As shown on that exhibit, the actual customer count from July 2006 to May 2009 never approaches Dr. Fish's inflated number.

Dr. Fish's customer count (and thus his annualization adjustment) does not represent a "known and measurable" change from the test year. UNS Gas has still not reached Dr. Fish's inflated customer count, and it does not know when in the future that customer count will occur.

Moreover, Dr. Fish creates significant matching issues by using a customer count far outside the test year. In the last UNS Gas rate case, Staff's witness Mr. Smith testified that "customers added after the test-year are not considered in the annualization adjustment."[63] Mr. Smith elaborated that "Customers that are added after the end of the test-year are typically not considered in an annualization adjustment, unless it is a major customer addition and the other elements of the ratemaking formula (rate base, depreciation, etc.) have been appropriately synchronized."[64] Dr. Fish's approach is again directly contrary to Staff's testimony in UNS Gas' last rate case.

Significantly, Staff has not pointed to any case before this Commission – or any utility commission – that has ever accepted such a procedure. And, Dr. Fish admitted that he has never testified on residential customer annualization before.[65]

Staff's untried and unprecedented approach is no mere technicality. It unreasonably slashes more than <u>$1.1 million</u> from UNS Gas' revenue requirement. Staff's experimental method fails basic ratemaking principles such as matching and the known and measurable standard. It is

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[61] Tr. (Fish) at 607-608.

[62] See also Ex. UNSG-21 (Erdwurm Rebuttal) at 11 and Ex. DBE-3 thereto.

[63] Ex. UNSG-21 (Erdwurm Rebuttal) at 6, quoting Surrebuttal Testimony of Ralph C. Smith, Docket No. G-04204A-06-0463, page 21, lines 25-26.

[64] Ex. UNSG-21 (Erdwurm Rebuttal) at 6, quoting Surrebuttal Testimony of Ralph C. Smith, Docket No. G-04204A-06-0463, page 22, lines 2-5.

[65] Tr. (Fish) at 602.

also contrary to the Commission's express ruling in UNS Gas' last rate case, as well as Staff's own testimony in that case. Further, the record does not support such an unjust and unreasonable adjustment.

RUCO's approach, while different from Staff, still is erroneous. RUCO simply makes no annualization adjustment at all. RUCO's approach also defies the Commission's traditional approach. Annualization should not be a one-way street, using the traditional method only when it is unfavorable to the utility. The evidence in this case supports continued use of the traditional annualization methodology employed by UNS Gas. There is no evidence to support a sudden diversion from that approach in this case.

B. Weather Normalization.

The parties do not dispute the Company's weather normalization methodology. Accordingly, the Commission should adopt the Company's methodology in this case.

C. Revenue Annualization.

The parties propose different Revenue Annualization adjustments. However, this difference is solely a result of the contested Customer Annualization described above. For the same reasons stated above and based upon the same evidence, the Company's adjustments should be adopted by the Commission.

D. Uncontested Income Adjustments.

The Commission should adopt the following uncontested operating income adjustments: (1) Griffith Plant Operations; (2) Golden Valley Plant Revenue and Expense; (3) Purchased Gas Adjustor and Gas Cost Revenue; (4) Negotiated Sales Program ("NSP") Revenue and Gas Cost; (5) DSM Revenue and Expense; and (6) Service Fees and Late Fees.[66]

IV. <u>EXPENSES</u>.

A. Legal Standard for Recovery of Expenses.

The Commission is required "to allow a recovery for all reasonable expenses." *Tucson Electric Power Co. v. Arizona Corp. Comm'n,* 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982). In

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[66] See Appendix A.

other words, the Commission must provide sufficient income to permit full recovery of "operating costs" in addition to the return on rate base. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978). In addition, the Commission "must consider" any "expenditures made in compliance with the Commission's decision[s]." *Arizona Corp. Comm'n v. Palm Springs Utility Co.*, 24 Ariz. App. 124, 536 P.2d 245 (1975).

B. Fleet Fuel Expense.

The Company proposed an adjustment to its test year fleet fuel expense of ($51,258). This adjustment is based on a three year historical average of fleet fuel expense.[67] This approach mitigates the volatility of fleet fuel prices.[68]

In its surrebuttal testimony, RUCO used a three year historical average of fleet fuel gallons, but applied a fuel cost of $2.95 based on the average of prices from January 2006 through June of 2009, resulting in an adjustment of ($71,963).[69]

Staff objects to the Company's adjustment and proposes an adjustment based on test year gallons and a forecasted fuel price of $1.96 per gallon resulting in reduction of $226,352.[70] Staff witness Dr. Fish acknowledges that the $1.96 represented a forecasted price that was not limited to UNS Gas' service area and did not include diesel prices.[71] However, UNS Gas uses diesel fuel.[72] He also acknowledged that the forecast he used changes over time and that it is "hard to forecast" with respect to energy.[73] Yet Dr. Fish testified that he did not update his forecast although much more recent data was available.[74] UNS Gas opposes the fuel cost estimate being used by Staff because it is not reflective of the actual cost being incurred by UNS Gas. Moreover, Staff concedes that its projection of future fuel costs is not known and measurable.[75] UNS Gas

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[67] Ex. UNSG-17 (Dukes Rebuttal) at 31.
[68] Ex. UNSG-17 (Dukes Rebuttal) at 30-31.
[69] Ex. RUCO-21 (Smith Rebuttal) at 61-63.
[70] Ex. S-13 (Fish Surrebuttal) at 19).
[71] Tr. (Fish) at 625-627.
[72] Tr. (Fish) at 626.
[73] Tr. (Fish) at 626.
[74] Tr. (Fish) at 626.
[75] Ex. UNSG-24 (Staff Response to UNSG 3.40).

proposes an adjustment reflecting the average cost incurred over the last three years, a cost that is known and measureable.

C. Call Center Expense.

UNS Gas has included its actual test year allocated Call Center expense. RUCO agrees with the Call Center expense. Staff does not dispute the actual level of test year Call Center expense.[76] However, Staff proposes reducing Call Center expense to the expense level of the previous UNS Gas rate case, asserting that "service orders" have declined and that the expense for the Call Center has increased too much. The last UNS Gas rate case used a 2005 test year and the level of expense in that test year was an annualized amount because the call center was only serving UNS Gas for part of the year.

Staff's narrow focus on "service orders" ignores the reality of the Call center operations. Service orders are only a minor portion of the services provided by the Call Center to UNS Gas.[77] In fact, since 2005: (i) the Call Center has seen UNS Gas' call volume and call duration grow by approximately 150% over the 2005 levels; (ii) UNS Gas is using more of the Call Center's capacity (as one of the three affiliates) than it was in 2005; and (iii) the overall annual operating cost of the Call Center has increased 22% from 2005 to 2008.[78] Moreover, the overall capital investment in the facility, computers, and phones has increased as UNS Gas works to ensure that customers have improved mechanisms to access the Company. For example, in 2007, a new billing system was implemented.[79] UNS Gas customers now have credit card processing and on-line bill presentment.[80] These new services cost money that increase UNS Gas' expenses but ultimately provide the customer with better options and a better service level experience.

The Commission should allow UNS Gas to recover the actual test year costs for its Call Center.

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[76] Tr. (Fish) at 621; Ex. UNSG-24 (Staff Response to UNSG 3.41).
[77] Ex. UNSG-17 (Dukes Rebuttal) at 22, 24.
[78] Ex. UNSG-17 (Dukes Rebuttal) at 22.
[79] Ex. UNSG-17 (Dukes Rebuttal) at 23.
[80] Ex. UNSG-17 (Dukes Rebuttal) at 25.

D. Payroll and Payroll Tax Expense.

The Company proposes adjustments that include certain upcoming payroll (increase of $362,018) and payroll tax expenses (increase of $2,557) that will to go into effect January 1, 2010. This treatment is consistent with the last UNS Electric rate case, Decision No. 70360 (May 27, 2008), and the most recent Southwest Gas Rate Case, Decision No. 70665 (December 24, 2008).[81] Staff did not contest this payroll adjustment and modified the payroll tax adjustment to reflect its position on incentive compensation. IBEW's witness, Mr. Frank Grijalva, strongly supported the Company's adjustment.[82]

RUCO agrees with an adjustment that includes the January 1, 2009 payroll, but argues that the January 1, 2010 payroll is too far from the test year and is not presently known. However, the rates in this case are not likely to go into effect until year end and will be in effect for the 2010 calendar year. The increased wages are being applied to employee levels as of the end of test year; therefore, there is no mismatch of revenue and expenses.[83] Moreover, much of the January 2010 increase is attributable to classified employees covered by existing contracts.[84]

Based upon the evidence presented by UNS Gas, Staff and IBEW, the Commission should allow the adjustment to reflect the upcoming wage increases that will be in place when new rates go into effect.

E. Rate Case Expense.

UNS Gas agrees with Staff's proposed rate case expense of $141,667.[85] RUCO proposes rate case expense of $100,000 based primarily on the rate case expense awarded in Decision No. 70011. That amount would not even cover the cost of UNS Gas (with almost 150,000 customers) employing an in-house regulatory counsel considering salary, benefits and overhead.[86] The

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[81] Ex. UNSG-17 (Dukes Rebuttal) at 10.
[82] Ex. IBEW-1 (Grijalva Direct) at 5.
[83] Ex. UNSG-17 (Dukes Rebuttal) at 10.
[84] See Ex. UNSG-17 (Dukes Rebuttal) at 10.
[85] Ex. UNSG-17 (Dukes Rebuttal) at 19. The rate case expense is $500,000 less the test year amortization of rate case expense allowed in Decision No. 70011. That amount is then amortized over three years. See Ex. S-12 (Fish Direct) at 29.
[86] Ex. UNSG-17 (Dukes Rebuttal) at 20.

Company has analyzed the cost-effectiveness of its legal expenses and believes they are just and reasonable.[87] Moreover, RUCO was unable to explain how UNS Gas could present this case within the rate case expense it recommends.[88] The rate case expense advocated by Staff and the Company is reasonable and reflective of actual costs, and should be adopted.

F. Postage.

UNS Gas originally proposed an adjustment for postage that reflected the May 2008 postage rate increase. Staff subsequently recommended using the May 2009 postage rate. Both the Company and RUCO agree with adjusting the postage expense to reflect the new 2009 postage rates. Any difference in the parties' proposed adjustments for postage reflects differing customer annualization numbers. The Commission should allow an adjustment for postage to reflect the May 2009 postage increase in accordance with the Company's current proposal.

G. AGA dues.

UNS Gas included $45,964 of American Gas Association ("AGA") dues as expense – this reflects the amount of the annual dues less 4%.[89] Staff has agreed with the Company's AGA expense. UNS Gas' proposal is consistent with the approach used in Decision No. 70011.

RUCO is recommending that the AGA dues expense be reduced well beyond the portion identified as marketing and lobbying expense by the AGA. However, UNS Gas has provided substantial and uncontested support of and for the many benefits provided by the AGA membership,[90] and the expense sought for recovery is reasonable and should be recoverable.

H. Outside Legal Expense.

UNS Gas proposes an Outside Legal expense of $305,984, based on a three-year historical average of legal costs.[91] This approach is based on a similar three-year historical average methodology used in Decision No. 70011. The requested expense is lower than the expense allowed in Decision No. 70011, even though UNS Gas will be participating in significant ongoing

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[87] See Ex. UNSG-17 (Dukes Rebuttal) at 20.
[88] Ex. UNSG-41 (RUCO Response to UNSG 3.31).
[89] Ex. UNSG-8 (G. Smith Direct) at 9-10; Ex. UNSG-17 (Dukes Rebuttal) at 21.
[90] Ex. UNSG-8 (G. Smith Direct) at 10-13.
[91] Ex. UNSG-16 (Dukes Direct) at 25.

litigation and FERC matters – including an El Paso Natural Gas rate case and a Transwestern rate case. There is no real dispute of the benefits of UNS Gas' participation in such matters or the benefits that its customers derive from keeping gas transportation rates as low as possible.[92]

Staff and RUCO have opposed the Company's adjustment to outside legal expense. Staff excluded the entire normalization adjustment with no explanation other than the Company did not support its request. However, the Company has supported its request. The record is clear as to the historical costs and to the benefits of UNS Gas' outside legal expense.[93] RUCO essentially reduced the Company's adjustment by two-thirds to $88,310, leaving an amount they believed representative of an on-going level of outside legal expense. However, RUCO's position is wrong and not reflective of historical averages or realistic anticipated future costs. The Company believes the historical average is still a better indicator of on-going expense then RUCO's analysis that excludes activity deemed as non-recurring. In fact, UNS Gas faces a current El Paso Natural Gas rate case, as well as an upcoming Transwestern rate case.[94] Pipeline rate cases are a recurring fact of life for gas utilities. RUCO's speculation that these expenses are "non-recurring" does not reflect historical reality or known present and future cases.

The Commission should adopt the Company's Outside Legal expense adjustment and ensure that UNS Gas continues to participate in litigation that directly benefits its customers.

I. Bad Debt Expense.

The Company has proposed a Bad Debt expense adjustment of $63,211 based on a three year historical average for the percentage of bad debt expense as a percentage of revenue in its adjustment.[95] The Bad Debt expense adjustment was prepared and calculated in the same manner as was approved by the Commission in Decision No. 70011.[96] This approach allows for a smoothing and normalization of the pro forma bad debt expense, which can fluctuate due to

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[92] Tr. (Gray) at 521-523.
[93] Ex. UNSG-16 (Dukes Direct) at 24-25; Tr. (Gray) at 521-523.
[94] Ex. UNSG-17 (Dukes Rebuttal) at 27-28
[95] Ex. UNSG-16 (Dukes Direct) at 23-24.
[96] Ex. UNSG-16 (Dukes Direct) at 24.

unusual events such as a large customer going bankrupt or economic conditions causing defaults to significantly increase.

The only party that has contested this adjustment is Staff. Staff has reduced the Company's pro forma bad debt expense, asserting that the Company has overstated its historical actual bad debt expense levels. Staff asserts that because of this over-expensing, the pro forma adjustment is distorted. Staff's assertion is simply wrong. The financial statements of UNS Gas are audited by the independent accounting firm PricewaterhouseCoopers LLP, both on a standalone basis and as a part of the consolidated statements of UniSource Energy Corporation.[97] Moreover, bad debt expense is the accrual-based expense to match expected net write-offs with revenue as it is recorded.[98] For ratemaking purposes the preferred method is to take net write offs (or bad debt expense) as a percentage of retail revenue over a long period of time and use that normalized relationship to apply to pro forma retail revenue to calculate pro forma bad debt expense.[99] The expense level being requested by the Company is reflective of anticipated levels of net write-offs, is reasonable and should be adopted here.

The proper allowance for bad debt expense is an accounting matter. Dr. Fish, while experienced in other matters, is not a CPA and has not taken accounting classes.[100] In contrast, RUCO's witness, Mr. Smith is a CPA and did not contest UNS Gas' approach.[101] The Commission should adopt the bad debt proposal agreed to by the Company and RUCO.

J. Depreciation and Property Tax.

RUCO has proposed an adjustment to depreciation and property tax expenses that is related to its position on the Company's Post-Test Year Plant adjustment.[102] The Company opposes this adjustment because it believes the Post-Test Year Plant adjustment is appropriate. The Commission should adopt the Company's position and reject RUCO's proposed adjustment.

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97 Ex. UNSG-17 (Dukes Rebuttal) at 25.
98 Ex. UNSG-17 (Dukes Rebuttal) at 26.
99 Ex. UNSG-17 (Dukes Rebuttal) at 26-27.
100 Ex. UNSG-24 (Staff Response to UNSG 3.4 and 3.5).
101 Tr. (R. Smith) at 898.
102 Ex. RUCO-20 (R. Smith Direct) at 28-29.

K. Incentive Compensation.

The Company proposes to include its cash-based incentive paid to non-union employees under its Performance Enhancement Program ("PEP") as a test year expense. UNS Gas requests a positive $30,930 adjustment to the test-year level of these expenses, taking the average of the incentive compensation expense for the past two years and adjusting the amount reflected in the test-year operating expenses to that level.[103]

The Company's PEP is a core component of its employees' compensation – promoting cost containment and customer service. PEP puts a portion of an employee's total compensation at risk and should be seen as a means to encourage and enhance group and individual performance. It provides an additional tool for the Company to encourage further cost savings, motivate individuals and to encourage employees to impact goals.[104] Without the PEP, the pressure to increase base compensation would become considerable because UNS Gas would have to compete with other companies to attract and retain a skilled workforce.[105] The Company would have to increase its base compensation so that its total compensation would be equivalent to what other utilities provide. Further, offering a PEP provides cost savings to customers versus paying median market wages as base compensation. Employee costs including vacation pay, sick leave, long-term disability, 401K matching and other post-retirement benefits are reduced.[106] No party disputes that the PEP program reduces the ultimate cost passed onto customers in the form of reduced payroll and benefit costs.

Staff and RUCO concede the benefits and importance of incentive-based compensation in the private sector. For example, Staff's witness Dr. Fish stated that "an organization may be more likely to achieve specified goals when achieving specific goals is part of a comprehensive compensation plan that may include incentives."[107] RUCO's witness, Mr. Smith, also recognized

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[103] Ex. UNSG-16 (Dukes Direct) at 22; Ex. UNSG-18 (Dukes Rebuttal) at Ex. DJD-1.
[104] Ex. UNSG-17 (Dukes Rebuttal) at 14.
[105] Ex. UNSG-17 (Dukes Rebuttal) at 14.
[106] Ex. UNSG-17 (Dukes Rebuttal) at 14-15.
[107] Ex. UNSG-24 (Staff Response to UNSG 3.60).

the benefits of incentive compensation.[108] Indeed, Mr. Smith contends that the "optimal result as a matter of regulatory policy" is for a utility's compensation structure to include incentive compensation.[109] Moreover, Mr. Smith agrees that incentive compensation "is not uncommon" and he specifically avoids claiming UNS Gas' incentive compensation costs are imprudent.[110]

Although they do not challenge the prudence or reasonableness of the total cash compensation paid to the non-union employees, both Staff and RUCO propose reducing the incentive compensation expense by 50%. Staff and RUCO both argue that incentive compensation benefits both shareholders and customers and thus should be shared equally. They argue that this is consistent with prior UNS Gas rate order and is still appropriate treatment in this case.

UNS Gas acknowledges that Decision No. 70011 allowed UNS Gas to recover only 50% of PEP expense. However, the Commission's prior UNS Gas order did not address Decision No. 69663 (June 28, 2007), which allowed Arizona Public Service Co. ("APS") full recovery of its cash-based incentive compensation expense for a program very similar to the PEP. Staff and RUCO also do not address Decision No. 69663.

It is undisputed that at-risk compensation is paid to all non-union employees. The PEP provides a portion of employees' overall compensation based on whether individual employee performance helps the Company meet its objectives. Employees whose individual goals are met as part of the PEP are likely to receive more compensation. In turn, customers benefit from the improved performance of employees whose jobs directly relate to serving the customer. Therefore, UNS Gas's PEP Expense provides direct customer benefits, is reasonable and should be allowed. Lastly, the Commission is required "to allow a recovery for all reasonable expenses." *Tucson Electric Power Co. v. Arizona Corp. Comm'n,* 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982). Staff and RUCO have not argued that incentive compensation is not a reasonable expense. Indeed, as Mr. Smith conceded, incentive compensation is a normal expense for a gas utility, and

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[108] Ex. UNSG-41 (RUCO Response to UNSG 3.16).
[109] Ex. UNSG-41 (RUCO Response to UNSG 3.16, subpart h).
[110] Ex. UNSG-41 (RUCO Response to UNSG 3.18 and 3.20).

incentive compensation brings important benefits. The Company's proposed prudent and beneficial incentive compensation expense should be allowed.

L. Stock-Based Compensation.

The Company proposes to include its stock-based incentive compensation as an expense. Staff did not contest this adjustment.

RUCO opposes the inclusion of stock-based compensation and proposes to remove test year Officers' compensation properly allocated to UNS Gas from TEP. RUCO bases this exclusion on the recent APS Decision No. 69663 and the UNS Electric Decision No. 70360. The Commission's concern in Decision No. 69663 was that stock-based compensation could promote inappropriate short-term management decision making. However, that concern is not relevant to UNS Gas' stock-based compensation plan. Here, stock-based compensation or equity compensation is primarily awarded in the form of stock options, which vest over a period of years and whose ultimate value is based on the *future* strength and performance of the Company.[111] As such, the stock-based compensation strongly promotes long-term employee and director retention and long-term sustainable performance activities. This program is designed to put individual employee's compensation at risk with a focus on long-term planning and the long-term success of the Company. Clearly customers benefit from the long-term planning and success of the Company. Moreover, no party has questioned that the program provides benefits to customers, its prudency, the reasonableness of the cost, or that it was incurred to provide service to customers. Indeed, RUCO's witness Mr. Smith conceded that such programs are "not uncommon" for gas utilities.[112] Because the customers benefit from this program and it does not result in unreasonable cost to customers it should be a fully recoverable cost of providing service.

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[111] Ex. UNSG-17 (Dukes Rebuttal) at 17.
[112] Ex. UNSG-41 (RUCO Response to UNSG 3.21).

M. Supplemental Executive Retirement Plan ("SERP").

The Company proposes to include this element of executive compensation as an expense. UNS Gas believes the test-year expense for SERP, $101,021 is reasonable and appropriate and should be recoverable in rates.

Staff and RUCO, however, both proposed adjustments that fully disallow that UNS Gas' test-year SERP expense. Staff and RUCO believe SERP expense as an excess benefit provided to select executives. The Company strongly opposes this representation as misleading and incorrect. This expense and program is not an "excess" benefit or cost. It is the cost required to keep retirement benefits "equal" as a percentage of compensation for the eligible employees.[113] Staff's witness Dr. Fish specifically denied that SERP is an atypical cost for gas utilities.[114] RUCO's witness, Mr. Smith, agrees.[115] Because the expense is a normal, reasonable and recurring expense associated with compensation of employees, and is incurred to provide service to customers, it should be fully recoverable.

N. Property Tax.

UNS Gas proposed a Property Tax expense adjustment of $1,354,074 to reflect the 2009 statutory assessment ratio of 22% and the most currently known average property tax rates.[116] Staff did not dispute the adjustment. RUCO agreed that an adjustment was necessary but used a different assessment rate period. The Company believes its proposal is consistent with prior Commission orders on the issue and should be adopted.

O. Uncontested Operating Expenses.

The Commission should approve the following proposed expense adjustments that the other parties did not contest: (1) Griffith Plant Operations; (2) Golden Valley Revenue and Expenses; (3) Gas Cost Revenue and Purchased Gas Cost; (4) NSP Revenue and Gas Cost; (5) Demand Side Management ("DSM") Revenue and Expense; (6) Pension and Benefits; (7) CARES

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[113] Ex. UNSG-17 (Dukes Rebuttal) at 18.
[114] Ex. UNSG-24 (Staff Response to UNSG 3.57).
[115] Ex. UNSG-41 (RUCO Response to UNSG 3.22).
[116] Ex. UNSG-11 (Kissinger Direct) at 8.

Expense; (8) CARES Regulatory Asset Annualization; (9) Y2K Amortization; and (10) Depreciation and Amortization Expense Annualization.

V. COST OF CAPITAL.

A. Overview.

It is frequently remarked that determining the cost of capital, especially the ROE, is more of an art than a science. However, that does not mean that basic financial principles or guidelines can be ignored. As Staff's witness Mr. Parcell testified, a core principle is that the "return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[117] UNS Gas' expert, Mr. Grant, prepared a sample group of other gas utilities, and then compared UNS Gas' risk to those utilities. In particular, Mr. Grant found that UNS Gas was decidedly riskier than the sample group of utilities.[118] While RUCO and Staff also used a sample group of other utilities, they did not adjust their results to reflect the fact that UNS Gas is riskier than the sample group – they simply ignored that fact.

Mr. Grant is the Vice President of Rates and Finance for Unisource Energy, and he has long experience in cost of capital, both practical experience in the industry and regulatory experience as an expert for the Public Utilities Commission of Texas.[119] No other cost of capital witness in this case has such a well-rounded, diverse background.

B. Capital Structure.

Mr. Grant testified that UNS Gas' actual test year capital structure was 50.01% debt and 49.9% equity.[120] He recommended that this actual capital structure be used to for ratemaking.[121] No party disputed this recommendation,[122] and it should be adopted.

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[117] Ex. S-14 (Parcell Direct) at 7, quoting *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591 (1942).
[118] Tr. (Grant) at 194; Ex. UNSG-13 (Grant Direct) at 24-25.
[119] Ex. UNSG-13 (Grant Direct) at 1.
[120] Ex. UNSG-13 (Grant Direct) at 8.
[121] Ex. UNSG-13 (Grant Direct) at 8.
[122] Ex. S-14 (Parcell Direct) at 22; Ex. RUCO-13 (Rigsby Direct) at 50.

C. Cost of Debt.

Mr. Grant also testified that UNS Gas' actual, test year cost of debt was 6.49%, and that this actual cost should be used for to set rates in this case.[123] Again, no party disputed this recommendation,[124] and it should be adopted.

D. Return on Equity.

1. UNS Gas' ROE Recommendation.

Mr. Grant prepared a comprehensive analysis of UNS Gas' cost of equity. He used the Capital Asset Pricing Model ("CAPM"), the multi-stage Discounted Cash Flow ("DCF") model and a risk premium ("RP") model. The CAPM and multi-stage DCF models have been accepted in countless Commission decisions. The Company's RP approach is based on the fundamental concept that equity is more costly than debt. Mr. Grant computed the historical "spread" or risk premium between utility bond yields and ROEs allowed by utility commissions as reported by SNL Financial.[125] The Company then added this risk premium to the current yield to maturity of utility bonds to derive an estimated cost of equity.[126]

The Company used data ending in August 2008 in these three models. These results were therefore not impacted by the unprecedented market disruptions beginning in September 2008. Staff's witness, Mr. Parcell, complimented the Company's approach, stating that it was a "gutsy move" and "I give them credit; they chose not to jump on the bandwagon of high interest rates."[127] In addition, Mr. Parcell acknowledged that data from September 2008 through at least March 2009 is of questionable value.[128] Regardless of his views on the questionable nature of this data, Mr. Parcell used this time period in his ROE analysis.[129]

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[123] Ex. UNSG-13 (Grant Direct) at 26.

[124] Tr. (Rigsby) at 758 (RUCO witness Rigsby agrees that the cost of debt is 6.49%); Ex. S-14 (Parcell Direct) at 23 (using 6.49% cost of debt)

[125] Ex. UNSG-13 (Grant Direct) at Ex. KCG-11.

[126] Ex. UNSG-13 (Grant Direct) at 23.

[127] Tr. (Parcell) at 839.

[128] Tr. (Parcell) at 839.

[129] See Ex. S-14 (Parcell Direct) at 40 (use of February to April 2009 data for CAPM analysis); Ex. S-14 (Parcell Direct) at 26 (use of February to April 2009 data)

Using the DCF, CAPM and RP models, the Company determined the following range of ROEs for the sample group of gas companies:[130]

Summary of Comparable Company Analysis

	DCF Model	CAPM	Risk Premium	Conclusion
Low end of range	9.5%	10.2%	10.2%	10.2%
High end of range	11.2%	11.3%	11.5%	11.2%

Thus, the Company ultimately determined that the sample gas companies had a cost of equity in the range of 10.2% to 11.2%. However, the Company witness, Mr. Grant noted that UNS Gas was more risky than the sample group of companies, and he therefore recommends an ROE of 11.0%.[131]

2. UNS Gas is riskier than the sample group.

A key flaw in Staff's and RUCO's analyses is that they do not adjust their ROEs to recognize that UNS Gas is riskier than the sample groups. Staff's expert Mr. Parcell testified that the ROE should reflect the returns earned by companies "having corresponding risks."[132] He also testified that the proxy group should have a similar risk to the utility in question.[133] Mr. Parcell undermines his argument by not adjusting his ROE to reflect the fact that UNS Gas is riskier than the sample group. This is even more puzzling given that Mr. Parcell has recommended such an adjustment before, in his testimony in the most recent TEP rate case.[134] In the TEP case, Mr. Parcell recommended an ROE for TEP above the midpoint of his range, because TEP had a higher risk that the sample group.[135] The higher risk was due to "[l]ower bond ratings... verses the bond

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[130] Ex. UNSG-13 (Grant Direct) at 24.
[131] Ex. UNSG-13 (Grant Direct) at 24-27.
[132] Ex. S-14 (Parcell Direct) at 7, quoting *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591 (1942).
[133] Tr. (Parcell) at 860.
[134] Tr. (Parcell) at 856-857.
[135] Ex. UNSG-39 (Excerpt from Parcell Feb. 29, 2008 testimony).

ratings of the proxy companies" and a "[l]ower equity ratio… versus the proxy companies."[136] Although UNS Gas now has an equity ratio that is consistent with industry norms, the Company's credit rating is certainly well below the average for the sample group of gas companies used by both Mr. Grant and Mr. Parcell.[137]

Indeed, Mr. Parcell acknowledged a myriad of factors indicating UNS Gas is more risky than the sample group. He acknowledged that UNS Gas is smaller than any of the companies in either of his sample groups.[138] Additionally, Mr. Parcell acknowledged that only two of the 17 sample group companies he used have a credit rating as low as UNS Gas.[139] A lower credit rating, of course, indicates higher risk.[140] Further, UNS Gas has not earned its authorized ROE. As Company witness Mr. Grant noted, both *Value Line* and Mr. Parcell's own comparable earnings analysis show that the comparable gas utilities are earning actual returns of 11 to 12%.[141] Lastly, Mr. Parcell stated that the comparable group companies pay dividends, while UNS Gas has never paid a dividend.[142] In all of these ways, UNS Gas is riskier and less attractive to investors than the companies in the sample groups, and it should therefore have a higher ROE.

3. Importance of dividends to equity investors.

UNS Gas' inability to pay a dividend – *ever* – puts it at a great disadvantage compared to other gas utilities seeking capital. Mr. Parcell emphasized the importance of dividends, noting that he would not include a company in his sample group if it did not pay dividends.[143] If anything, RUCO's witness, Mr. Rigsby, was even more adamant about the importance of dividends to equity investors: "Utilities typically attract income-oriented investors, people that are interested in **getting a regular steady dividend** from the utility."[144] Mr. Rigsby emphasized the point:

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[136] Ex. UNSG-39 (Excerpt from Parcell Feb. 29, 2008 testimony).
[137] Ex. UNSG-13 (Grant Direct) at 25.
[138] Tr. (Parcell) at 860; *see* Decision No. 57944 (July 6, 1992) at 16 (agreeing with Staff's recommendation to increase ROE for sewer division over average of sample group due to small size risk).
[139] Tr. (Parcell) at 861.
[140] Ex. UNSG-13 (Grant Direct) at 25.
[141] Tr. (Grant) at 223.
[142] Tr. (Parcell) at 862.
[143] Tr. (Parcell) at 862.
[144] Tr. (Rigsby) at 799 (emphasis added).

"dividend yield… again, if you are an income-oriented investor, then that is what you want to look at."[145] He repeated the point again: "investors can rely on them [utilities] to pay out fairly stable dividends over a period of time."[146] Mr. Rigsby's remarks on the importance of dividends are profoundly ironic given UNS Gas' inability to pay a dividend and Mr. Rigsby's ultimate recommendation of an ROE for UNS Gas of only 8.61%. Staff's and RUCO's recommendations would ensure that UNS Gas would remain unable to pay dividends; as such UNS Gas would remain highly unattractive to the income investors extolled by Mr. Rigsby. Without the ability to pay steady dividends, UNS Gas is at a competitive disadvantage relative to other gas utilities, and would have to offer a higher return compared to such utilities in order to entice investors to invest in UNS Gas. Consequently, the Commission should adopt the Company's ROE recommendation.

4. Impact of Economy.

UNS Gas is aware of the current economic situation and its effect on its ratepayers and employees. In response, the Company has proposed: (i) exempting CARES customers from proposed changes in non-commodity rates (i.e., excluding gas commodity costs),[147] (ii) auto-enrolling LIHEAP-qualified customers into CARES,[148] and (iii) a lower rate request than could otherwise be justified.[149]

RUCO erroneously implied that the Presiding Administrative Law Judge had determined to adjust the ROE to reflect the economy.[150] However, the Presiding Administrative Law Judge quickly corrected that misstatement.[151] To the extent that RUCO, or any party, suggests that the Commission should put its "thumb on the scale" and alter the ROE due to the economy, any such suggestion can and should be firmly rejected. Instead, the ROE should be based on the evidence in the record.

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145 Tr. (Rigsby) at 800.
146 Tr. (Rigsby) at 801.
147 Ex. UNSG-5 (Hutchens Direct) at 11.
148 Tr. (Hutchens) at 80-81.
149 See Ex. UNSG-13 (Grant Direct) at 30-32; Tr. (Grant) at 170.
150 Tr. (Rigsby) at 797-798.
151 Tr. (Rigsby) at 797-798

The impact of the economy is reflected in various inputs to the models used by the ROE experts. As previously noted, Staff's witness Mr. Parcell questioned the value of data from the height of the economic crisis. And, UNS Gas purposefully excluded those extreme data points from its analysis.

Fortunately, the most extreme market turbulence seems to be in the past. As Mr. Parcell testified, ROE is determined on a "forward looking" basis. [152] In addition, the Commission has stated that "cost of capital is forward-looking in nature"[153] Mr. Parcell testified that the economy is likely to improve.[154] The very concept of "business cycles" also suggests that improvement will be forthcoming after a prolonged downturn. Thus, data from the most extreme portion of the downturn should not be used.

This distorted data has the greatest impact on the CAPM model. The CAPM is based on the "efficient-market hypothesis" – the idea that markets always accurately price assets. As an article recommended by RUCO witness Mr. Rigsby notes, a key assumption of the CAPM is that "capital markets are perfect."[155] In reality, markets are not perfectly efficient – as shown by the "dot com" bubble, the recent housing bubble, and the extraordinary market turbulence experienced since September 2008.

The Commission has used the CAPM model, in combination with other models, for many years. But it does not make sense to use a model premised on efficient, rational markets while using data from a period when the markets have been inefficient, irrational and even bizarre. As Mr. Parcell colorfully noted, "the capital markets have been – its been so screwed up."[156] As Mr. Parcell explained, if "the Company sold debt today, it would probably be at the CAPM rate, and I think that the cost of equity should be higher than the cost of debt."[157] Thus, Mr. Parcell gave

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[152] Tr. (Parcell) at 859.
[153] Decision No. 64727 (April 17, 2002) at 12.
[154] Tr. (Parcell) at 859.
[155] Ex. UNSG-34 (RUCO Response to UNSG 2.30, attached article at 16).
[156] Tr. (Parcell) at 839.
[157] Tr. (Parcell) at 848.

little weight to his own CAPM analysis. The Company's approach, which uses data from before the unprecedented period, is a better gauge of ROE and should be adopted.

5. RUCO's aberrant ROE must be rejected.

RUCO's proposed ROE of 8.61% is outside any reasonable range accepted by utility commissions. Staff's Exhibit S-1 shows that from 1995 to 2008, the average ROE authorized by utility commissions for gas utilities was in a range from 10.03% to 11.43%. That is a wide range, and it covers a multitude of economic conditions. RUCO's proposed ROE lies far outside this range and is unreasonably low and unsupported by any rational approach.

RUCO's witness Mr. Rigsby testified that due to the economy, investors are more adverse to risk.[158] In UNS Gas' last rate case, Mr. Rigsby proposed a ROE of 9.84%.[159] Yet now, in a period of greater aversion to risk, Mr. Rigsby contradicts himself by proposing an ROE of 8.61%. In other words, Mr. Rigsby admits investors are more risk-adverse, yet he states those same investors will accept a return 123 basis points lower than his previous recommendation, and 139 basis points lower than approved by the Commission in UNS Gas' last rate case. Mr. Rigsby's analysis does not withstand scrutiny.

Mr. Rigsby's ROE recommendation is also difficult to understand in light of his remarks (previously quoted) on the importance of dividends to utility investors. UNS Gas has never been able to pay a dividend. It certainly will not be able to pay dividends if Mr. Rigsby's ROE is adopted. Mr. Rigsby would have the Commission believe that investors would be interested in UNS Gas, with his proposed ROE of 8.61%, over utilities with authorized ROEs of 10% to 11% (Exhibit S-1), and over utilities with actual, earned ROEs of 11 to 12%.[160] That is not realistic.

On a more technical level, Mr. Rigsby goes astray by excessively relying on his CAPM model, while using data from the height of the economic downturn. As already explained, the CAPM in particular is poorly suited for such situations. That is why Mr. Parcell placed little weight on his CAPM, and why Mr. Grant used inputs from before the height of the crisis for his

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[158] Tr. (Rigsby) at 768; see also Ex. UNSG-34 (RUCO Response to UNSG 2.30).
[159] Decision No. 70011 at 42.
[160] Tr. (Grant) at 223.

CAPM. Mr. Rigsby obtained a DCF result of 11.40% (within the range of the other experts), but his CAPM produced an ROE range of 5.25 to 6.39%.[161] Mr. Rigsby's CAPM results are **below** UNS Gas' cost of debt, as well as below the cost of new debt.[162] Mr. Rigsby's CAPM result is wholly implausible. Accordingly, RUCO's ROE recommendation should be rejected.

6. Staff's ROE should also be rejected.

Staff's ROE is also flawed. Most significantly, as already noted, Staff fails to recognize that UNS Gas is riskier than the sample group it references. Simply stated, UNS Gas, a smaller company with a lower credit rating, no dividends, and lower earned returns has more risk than the sample group.

Mr. Grant noted the large sell-off in utility stocks in recent months. In response, Mr. Parcell suggested that a drop in stock price results in a lower cost of capital. But in discovery, Mr. Parcell admitted that "stock price declines can be produced by changing perceptions of risk or changes in risk aversion, even if future expectations of dividends and earnings have not changed."[163]

Mr. Parcell also speculated that UNS Gas is insulated from the impact of the economy, because sales will not drop.[164] But Mr. Parcell admitted that he had not actually reviewed UNS Gas' sales data.[165] In fact, UNS Gas' sales have dropped significantly from the end of the test year due, in part, to the economy.[166]

Further, Mr. Parcell uses only the single-stage version of the DCF. However, the Commission uses the multi-stage version of the DCF.[167] Investors do not expect a single, uniform growth rate. The multi-stage DCF recognizes this and is therefore superior. As the Commission explained, the multi-stage DCF "properly recognizes that investors expect both non-constant

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[161] Ex. RUCO-13 (Rigsby Direct) at 32.
[162] See e.g. Ex. RUCO-19, showing updated utility bond yields of 6.62% for Baa bonds.
[163] Ex. UNSG-36 (Staff Response to UNSG 3.92).
[164] Ex. S-14 (Parcell Direct) at 39.
[165] Ex. UNSG-36 (Staff Response to UNSG 3.95.b).
[166] Tr. (Grant) at 207.
[167] Ex. UNSG-14 (Grant Rebuttal) at 12.

short-term growth as well as constant long term growth."[168] The Commission has considered both types of DCF, and often averages the results of the two to produce an overall DCF estimate. Staff has proposed, and the Commission has approved, that approach to the DCF in many orders.[169] Mr. Parcell does not explain why he rejected Staff's traditional approach, and his exclusive reliance on the single-stage DCF should be rejected in favor of the more accurate and realistic multi-stage DCF proposed by the Company.

In addition, Mr. Parcell is inconsistent regarding which company he is evaluating. At times, he states he is determining the cost of equity "for UNS Gas".[170] Yet at other times he implies he is really determining the cost of equity for Unisource Energy: "but the subject company for the raising of equity dollars is UNS West Energy [sic]"[171] And sometimes he implies that he is somehow looking to both UNS Gas and Unisource.[172] The proper analysis should focus on UNS Gas, not the holding company UniSource Energy Corporation.

Finally, Mr. Parcell's recommendation is detrimentally low when compared with Staff's own Exhibit 1. Staff presented an exhibit showing historical ROE's of 10% to 11%.[173] In fact, the most recent year suggested an average ROE of 10.37%. Mr. Parcell's recommendation is at the very bottom of the range when compared to other authorized ROEs – even though UNS Gas has never paid a dividend and the record is clear that it is decidedly riskier than the average utility. In spite of the evidence in the record, including Staff's own exhibit, Mr. Parcell recommends that UNS Gas' ROE should be 10%, which is below the average ROE authorized to other utilities. Further, Mr. Parcell's recommendation is inconsistent with his recommendation of an 11.0% ROE for APS. Mr. Parcell sought to avoid that comparison, claiming the 11% figure was Staff's decision.[174] But his APS testimony actually states "I recommend an 11.0 percent level".[175]

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[168] Decision No. 66849 at 22.
[169] See, e.g., Decision No. 68176 at 21 (stating Staff's approach) and 26 (agreeing with Staff); Decision No. 68858 at 25, 28; Decision No. 69164 at 23, 26; Decision No. 69440 at 18, 20; Decision No. 70209 at 27, 30.
[170] Ex. S-14 (Parcell Direct) at 38.
[171] Tr. (Parcell) at 860.
[172] Ex. S-14 (Parcell Direct) at 24.
[173] Ex. S-1 (Regulatory Focus Report).
[174] Tr. (Parcell) at 855.

VI. FINANCIAL INTEGRITY.

Mr. Parcell testified that the return must "be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[176] Unfortunately, Staff's recommendation (and RUCO's much lower recommendation) fails to meet this standard. Mr. Parcell did not project whether UNS Gas would actually be able to earn the ROE he recommends.[177] In contrast, Mr. Grant explained that UNS Gas has historically not earned its authorized ROE.[178] Mr. Grant also projected UNS Gas' future earnings under UNS Gas', Staff's and RUCO's proposed revenue requirements:[179]

	Allowed ROE	**Projected Earned ROE**
UNS Gas	11.0%	10.1% (2010); 9.0% (2011)
Staff	10.0%	6-7%
RUCO	8.61%	5-6%

The projected earned ROE under Staff's and RUCO's recommendations will not preserve the financial integrity of UNS Gas. Indeed, the earned ROE under Staff's revenue requirement will be in the same range as bond yields for gas utilities with UNS Gas' credit rating.[180] As Mr. Grant noted, "that's not a sustainable situation for UNS Gas."[181]

It is not only UNS Gas that is concerned with the Company's earned ROE. As Standard & Poor's explains, in analyzing the adequacy of rates, "the analysis does not revolve around "authorized" returns, but rather on actual earned returns."[182] And the Arizona Court of Appeals has held that the "rates established by the Commission should meet the overall operating costs of the utility and produce a reasonable rate of return. It is equally clear that rates cannot be considered just and reasonable if they fail to produce a reasonable return, or if they produce

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175 Ex. UNSG-38 (Parcell APS excerpt) at 32.

176 Ex. S-14 (Parcell Direct) at 7 (quoting *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1942)).

177 Ex. UNSG-36 (Staff Response to UNSG 3.78 and 3.98).

178 Ex. UNSG-14 (Grant Rebuttal) at 23.

179 Ex. UNSG-14 (Grant Rebuttal) at 24-28; see also Tr. (Grant) at 206.

180 Tr. (Grant) at 281 (reporting Baa yield of 6.7%)

181 Tr. (Grant) at 206.

182 Ex. UNSG-31 (S&P Report) at 4.

revenue which exceeds a reasonable rate of return." *Consolidated Water Utilities, Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 141, 875 P.2d 137, 482 (App. 1994). Thus, the rate of return actually "produced" or earned is at the core of ratemaking.

A utility is, of course, not guaranteed its authorized return – only an opportunity to earn the authorized return. But the historical and projected information shows that UNS Gas will not have that opportunity. No one has suggested – much less testified – that there are sufficient measures that UNS Gas could take that would allow it to earn its authorized return. And the prospect of earning the authorized return is a reality for most utilities – Mr. Parcell's comparable earnings analysis shows that the comparable gas utilities are earning actual returns of 11 to 12%,[183] which is in line with or higher than the authorized returns reported in Staff Exhibit S-1.

As discussed above, UNS Gas will not earn its authorized return – even if its full rate request is granted. Therefore, it is critical that the Commission not reduce the rate request which will thereby impair UNS Gas' financial integrity. UNS Gas has been able to steadily improve its equity ratio over time and has managed to obtain an investment grade debt rating. That would not have been possible without the Commission's assistance. It would be poor public policy to allow those gains to be wiped out. Ultimately, ratepayers pay the price for a financially challenged utility – in increased debt and equity costs, in reduced trade credit from wholesale energy providers and in services cut to the bone and beyond.

UNS Gas has worked hard to obtain a debt rating of Baa3 from Moody's.[184] That is the lowest possible investment grade rating. Keeping or improving that rating is of critical importance to both UNS Gas and its ratepayers. UNS Gas has $50 million in notes maturing in August 2011.[185] Those notes must be re-financed.[186] A lower credit rating will result in a higher debt cost than would otherwise be the case. In addition, UNS Gas' credit facility ($60 million, shared with UNS Electric) is maturing in August 2011 and will have to be renewed.[187] As Mr. Grant

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[183] Tr. (Grant) at 223.
[184] Ex. UNSG-19 (Moody's Report).
[185] Ex. UNSG-19 (Moody's Report).
[186] Tr. (Grant) at 231.
[187] Tr. (Grant) at 231.

explained, "an investment grade credit rating helps you tremendously when you're talking to a prospective lender."[188]

Mr. Rigsby could offer no assurance that UNS Gas' credit rating would not be downgraded under RUCO's proposal.[189] Mr. Parcell cannot provide any help in this area either. Instead, he states that "assuming UNS Gas earned my cost of capital recommendation", the results would be "consistent" with a BBB rating.[190] Mr. Parcell has, without any support, merely assumed that his cost that his cost of capital will actually be earned. Indeed, Mr. Parcell specifically denied making any prediction that his assumption will actually occur.[191] Likewise, Staff witness Dr. Fish did not estimate the likelihood of UNS Gas "actually recovering all of its prudent costs."[192] As shown above, there is no evidence that the earned ROE will come even close to the authorized ROE. Quite simply, UNS Gas' credit rating will be seriously imperiled under Staff's and RUCO's revenue requirements. Therefore, the Commission should reject their recommendations and approve the Company's requested revenue requirement.

VII. FAIR VALUE.

A. The Arizona Constitution requires use of fair value in setting rates.

The Arizona Constitution requires that the Commission use fair value in setting rates. Arizona Constitution, Article XV § 14. That requirement has been enforced in numerous court cases. *See e.g. Phelps Dodge Corp. v. Arizona Electric Power Co-op,* 207 Ariz. 95 ¶ 38, 83 P.3d 573, 578 (App. 2004); *Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994). The Arizona Supreme Court requires that the "reasonableness and justness of the rates must be related to this finding of fair value." *Simms v. Round Valley*, 80 Ariz. 145, 151, 294 P.d 378, 382 (1956). In other words, "the Commission must first determine the "fair value" of a utility's property and use this fair value as the utility's rate base." *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (App. 1978).

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[188] Tr. (Grant) at 229.
[189] Tr. (Rigsby) at 777.
[190] Ex. S-14 (Parcell Direct) at 40.
[191] Ex. UNSG-36 (Staff Responses to UNSG 3.78 and 3.98).
[192] Ex. UNSG-24 (Staff Response to UNSG 3.6).

B. UNS Gas' method follows the Arizona Constitution and Commission decisions.

Implementing the fair value requirement has been controversial in recent times. Seeking to minimize contested issues in this case, UNS Gas proposed the fair value rate of return ("FVROR") method adopted by the Commission in the Chaparral City remand order, Decision No. 70441 (July 28, 2008). That decision was the first to comprehensively address these new issues. The decision is not generous to utilities.[193] Nevertheless, there is no reason to depart from it here.

Using the methodology described in the Chaparral remand decision, the Company calculated a FVROR of 7.30% (using UNS Gas' cost of capital adjusted for inflation) or 7.25% (using Staff's cost of capital adjusted for inflation).[194] No party disputed that the Company accurately reflected the Commission's methodology in the Chaparral remand order. Unfortunately, Staff's and RUCO's experts have not accepted the Commission's Chaparral remand methodology.

C. Staff's methods are constitutionally inadequate and unjustified.

Staff's witness, Mr. Parcell, presented two recommended methods. Mr. Parcell's primary method is to apply a 0% return on the "fair value increment", i.e. the portion of the fair value rate base that exceeds the original cost rate base. The Commission has rejected this recommendation at least twice.[195] Mr. Parcell's primary method also suffers from a fatal flaw – it does not use fair value, as required by the Arizona Constitution. Under Mr. Parcell's primary method, the fair value rate base has no impact on revenue requirement. Under that method, only original cost rate base impacts revenue requirement. Indeed, Mr. Parcell admits that his approach is "mathematically equivalent to assigning a zero weighting to fair value rate base for purposes of setting rates."[196] The Commission is required to use, not ignore, fair value, and therefore Mr. Parcell's primary method must be rejected.

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[193] Chaparral City has appealed that decision. Arizona Court of Appeals, Docket No. 1 CA-CC 08-0002.

[194] Ex. UNSG-13 (Grant Direct) at 30-32; Ex. UNSG-14 (Grant Rebuttal) at 32.

[195] Chaparral remand order, Decision No. 70441 (July 28, 2008); Southwest Gas rate case, Decision No. 70665 (Dec. 24, 2008) at 31-33 (the "Southwest Gas decision").

[196] Ex. UNSG-36 (Staff Response to UNSG 3.105).

Mr. Parcell's alternate method is based on the recent Southwest Gas decision. The Southwest Gas decision did not contain the extensive analysis of fair value set forth in the Chaparral remand decision. In the Southwest Gas decision, the Commission stated that it did not adopt the Chaparral remand method because: (1) the Chaparral remand order had not been issued by the time of the hearing, and therefore was not analyzed on the record by the experts in that case; (2) no party presented a method similar to the method approved in the Chaparral remand case; and (3) the utility agreed to the basics of Mr. Parcell's approach, disputing only the method of determining the risk-free rate.[197]

Those three reasons do not apply to this case: (1) the Chaparral remand order is available for guidance; (2) UNS Gas presented the Chaparral remand method in this case; and (3) UNS Gas does not concede the appropriateness of Mr. Parcell's alternative recommendation. Thus, the Southwest Gas decision does not support ignoring the Chaparral remand method – to the contrary, it shows that the Chaparral remand method is reasonable and appropriate in this case.

Moreover, Mr. Parcell did not attempt to explain why his alternate method is superior to the Chaparral remand method. He simply stated that he believes his method is "a viable procedure."[198] Indeed, Mr. Parcell admitted that he "has not examined the reasonableness" of the Chaparral remand method "as it pertains to UNS Gas."[199] In short, Mr. Parcel has failed to present any reason why the Commission should reject the Chaparral remand method.

Staff recently proposed a modified method in Chaparral City's new rate case.[200] The Company has stated that it would accept this modified Staff method.[201] Mr. Parcell did not respond to the Company's offer in his testimony, and he has never explained why he rejected the modified Staff method.

By his own admission, Mr. Parcell did not even consider the Chaparral remand method. He has not explained his failure to consider that method, or of the modified Staff method in the

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[197] See Decision No. 70665 at 32-33.
[198] Ex. UNSG-36 (Staff Response to UNSG 3.102.a).
[199] Ex. UNSG-36 (Staff Response to UNSG 3.102.b).
[200] See Ex. UNSG-13 (Grant Direct) at 30-31.
[201] Ex. UNSG-14 (Grant Rebuttal) at 32.

current Chaparral rate case. Further, he offers no evidence of why either of these methods should be rejected by the Commission. The Commission's reasons for not using the Chaparral method in the Southwest Gas decision do not apply in this case. Moreover, Mr. Parcell's alternative approach results in a revenue requirement too low to support UNS Gas' financial integrity.[202] And most fundamentally, it gives too little weight to fair value – a factor central to the Commission's constitutional mission.

D. RUCO's fair value method is arbitrary and constitutionally inadequate.

RUCO's witness Mr. Smith prepared a chart comparing four different methods for determining fair value rate of return. The chart was nothing but an interesting exercise because Mr. Smith chose none of those four methods. Nor did Mr. Smith create his own formula or mathematical model to determine the FVROR. Instead, Mr. Smith picked a number based on his "informed judgment."[203] Mr. Smith's approach is wholly arbitrary and unfair to the Company.

Moreover, Mr. Smith's number fails to give adequate weight to fair value. His number is only one basis point (0.01%) higher than a zero weighting of fair value. Mr. Smith apparently gave the smallest possible weight to fair value that he could without getting into fractional basis points (i.e. thousandths of a percent). Mr. Smith's recommendation provides only $38,000 in additional revenues over a pure original cost approach, even though UNS Gas' fair value rate base is over $70 million higher than its original cost rate base.[204]

Mr. Smith's approach fails to give any meaningful or material effect to UNS Gas' fair value rate base. It is constitutionally deficient and must be rejected.

VIII. RATE DESIGN.

UNS Gas proposed an increase its monthly charges for all classes of customers, except its residential CARES customers. For residential customers, the charge will increase from $8.50 to $14.00. This increase will take place in three phased steps. The initial new charge will be $10.00, effective when new rates go into effect in this case. The charge will then increase by $2.00 on the

[202] Ex. UNSG-14 (Grant Rebuttal) at 30.
[203] Ex. RUCO-20 (R. Smith Direct) at Schedule A, Page 2, Note [a].
[204] Ex. UNSG-14 (Grant Rebuttal) at 33.

first anniversary of the new charge (to $12.00) and then to $14.00 on the second anniversary. The increase to $12.00 and to $14.00 will be accompanied by a corresponding reduction in the non-commodity volumetric charge to make the change revenue-neutral for the average usage customer.[205]

UNS Gas' proposal better matches revenues to the actual costs of providing service and reduces cross-subsidies, particularly between cold weather and warm weather residential customers. It also provides more incentive and support for conservation measures. The Commission should approve the Company's proposed rate design.

A. UNS Gas' proposed monthly customer charge will better match non-volumetric revenue to fixed costs.

UNS Gas' proposed phase-in of customer charge increases better aligns rates with the cost of service.[206] UNS Gas' class cost-of-service study supports the increase. Under the class cost-of-service study, the "basic" monthly residential customer costs are calculated to be $18.15 for residential service, approximately $19.00 for small commercial/industrial customers and approximately $220.00 for large commercial/industrial customers.[207] These basic customer costs include metering, meter-reading, service (service drop) to the specific customer, and customer service and billing, but do not include demand-related distribution mains or distribution regulators.[208] UNS Gas is not seeking to fully recover all of its fixed costs through the monthly charges. Rather, the proposed rate design is another step towards realizing that goal to UNS Gas and its customers, which was started in the prior UNS Gas rate case.[209]

The move towards better matching customer charges to costs provides several benefits. First, having prices track cost is necessary for customers to make good economic decisions about resource use. Second, from the standpoint of UNS Gas, having higher cost-based residential charges brings revenue recovery more in line with cost incurrence. Currently, UNS Gas'

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[205] Ex. UNSG-20 (Erdwurm Direct) at 14-15.
[206] Ex. UNSG-20 (Erdwurm Direct) at 14; Ex. UNSG-22 (Erdwurm Rejoinder) at 6.
[207] Ex. UNSG-20 (Erdwurm Direct) at 14.
[208] Ex. UNSG-20 (Erdwurm Direct) at 14.
[209] See Decision No. 70011 at 56.

residential non-commodity (i.e., excluding the recovery of gas costs) revenue is recovered predominantly through volumetric energy charges ($/therm) as opposed to customer charges, whereas the majority of costs are fixed. Recovering fixed costs volumetrically through energy charges invariably leads to over-recovery or under-recovery of cost. A more appropriate recovery of fixed costs through customer charges promotes a matching of revenue collection with cost incursion. Third, UNS Gas' proposal to gradually phase-in its higher fixed monthly charge in a revenue-neutral manner serves an important emerging public policy, regarding the over-reliance on volumetric charges to recover fixed costs.

B. UNS Gas' proposed rate design will reduce existing cross-subsidies.

UNS Gas's cold weather residential customers subsidize those living in warmer climates, often to a substantial degree. Moreover, the cross-subsidy is difficult for cold weather customers to avoid (through reduced usage) because they rely on natural gas to heat their homes and for other inelastic needs. Currently, the average Flagstaff residential customer pays $145 more in annual margin than an average residential customer in Lake Havasu City for the same fixed costs.[210] If the customer charge is capped at $10 per month in this case, under the Company's new rates, the disparity will rise to $173.[211] The changes proposed by UNS Gas would ease this disparity. Although the Flagstaff customer still would pay $134 more for the same fixed costs, the annual cross-subsidy would be reduced by $39 – a significant change. [212]

These cross-subsidies are inequitable and UNS Gas is requesting another step in this docket to further reduce them. The Commission should continue to mitigate those cross-subsidies as it started to do in Decision No. 70011.

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[210] Ex. UNSG-20 (Erdwurm Direct) at 17 and Ex. DBE-1 thereto.
[211] Ex. UNSG-20 (Erdwurm Direct) at 18.
[212] Ex. UNSG-20 (Erdwurm Direct) at 18.

C. UNS Gas' proposal to phase-in its monthly charge is not confusing, and does not violate the principle of "gradualism" or result in rate shock.

Both Staff and RUCO oppose the phased-in monthly charge increases, claiming that they are confusing and that they result in rate shock. Neither contention outweighs the benefits provided by UNS Gas' proposed rate design.

First, with respect to concerns of rate shock, too much emphasis is placed on the percentage increase in the customer charge component, not the actual dollar impact. When presented in percentage terms, the increase in customer charges approximates 65% and appears high, but when viewed in absolute terms, the increase in the charge over three years, from $8.50 to $14.00 per month, totals $5.50 per month. That amount is not rate shock when the average bill, including the significant commodity charge, is in the range of $54 to $59.[213] Moreover, varying portions of the increase will be offset by lower non-fuel volumetric charges (per therm) – thus mitigating the customer charge increase. Again, for the sake of clarity, under the Company's proposal the customer charge will only increase $1.50 per month in the first year, $2.00 per month in the second year and finally $2.00 per month in the third year – combined with a revenue-neutral decrease in the non-commodity volumetric rate for the average customer.

UNS Gas' request is reasonable. The proposed increases are modest when considered in absolute dollar amounts. Further, any impact on our customers is ameliorated by the use of a phase-in structure. These increases do not result in "rate shock", and any "rate shock" reference is a distortion of the Company's proposal.

Second, with respect to the assertion of confusion, no rate design component is simpler than the customer charge. There is no basis for the idea that our customers are unable to understand a customer charge increase. Indeed, the Commission has approved – and occasionally insisted upon – phased-in rates in the past for other utilities.

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[213] Tr. (Radigan) at 749.

D. UNS Gas' rate design does not eliminate the incentive to conserve.

To the extent there is a concern that the Company's proposed rate design reduces the incentive to conserve, that concern is unfounded and ignores the significance of the remaining volumetric charges – including the cost of natural gas itself. While the Company has proposed a revenue-neutral reduction to the volumetric margin charge to offset the phased-in customer charge, that per therm charge is significantly smaller than the volumetric cost of gas passed through the PGA.[214] The relatively small decrease in the volumetric margin charge is not enough to stifle a conservation incentive.

Although natural gas prices are difficult to predict, they are not expected to decrease significantly in the foreseeable future. As such, the pass-through costs contained in the PGA will continue to give customers ample incentive to conserve regardless of the Company's volumetric margin rate. It is generally accepted that significant per-therm gas costs will provide customers with ample incentives for conservation.

E. UNS Gas allocates increased costs equally across customer classes.

UNS Gas proposes that the increased revenue requirement be allocated equally over all customer classes.[215] Staff and RUCO have proposed slightly different allocations that the Company does not oppose.

F. T-1 and T-2 price plan revisions are appropriate.

UNS Gas has proposed revisions to its T-1 and T-2 pricing plans.[216] No party has contested those revisions and they should be approved.

IX. LOW-INCOME ISSUES.

A. Retaining existing CARES rates will hold low-income customers harmless.

UNS Gas has proposed to maintain the same basic monthly charge for CARES customers at $7, and the same non-commodity volumetric charge at $0.1770 per therm for the first 100

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[214] Ex. UNSG-20 (Erdwurm Direct) at 21.
[215] Ex. UNSG-3, Schedule H-1.
[216] Ex. UNSG-8 (G. Smith Direct) at 8 and Exs. GAS-3, GAS-4 thereto.

therms per month in the billing months of November to April.[217] For all therms sold in excess of the initial 100 therms per month, the price is $0.3270 per therm. These charges cover non-commodity costs.

Ms. Cynthia Zwick has requested that the Commission also hold the CARES customers harmless for any changes to the Purchased Gas Adjustor rate. UNS Gas recommends against doing so because the PGA rate is simply a pass-through of gas commodity costs and can increase *or decrease* over time.[218] Moreover, the accounting for such a treatment, including how to allocate the impact of such treatment to other UNS Gas customers, would be challenging to say the least.

B. The Commission should approve the Warm Spirits "Round Up" program.

UNS Gas has proposed to add a "round-up" option to its Warm Spirits program: (i) customers signing up for the 'round-up' option would see their monthly bill rounded up to the next even dollar and (ii) the difference between their billed amount for actual usage and the next even dollar would be their contribution to the Warm Spirits Program.[219] These increased Warm Spirit funds will continue to be distributed to low-income customers by the Arizona Community Action Association ("ACAA").[220] The total amount of Warm Spirit Contributions is dispersed to the ACAA on a quarterly basis. As an independent agency, the ACAA identifies the eligible assistance agencies, determines which agencies should receive funding, and ultimately disperses the specific amounts to be given to individual agencies. The ACAA then distributes those funds to the respective assistance agencies within the same community from which the contributions were received. This process ensures that UNS Gas customers' contributions remain in the community to help their less fortunate neighbors.

No party has opposed this proposal and the Commission should approve the new option.

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[217] Ex. UNSG-5 (Hutchens Direct) at 11.
[218] See Tr. (Hutchens) at 82-83, 717.
[219] Ex. UNSG-8 (G. Smith Direct) at 4.
[220] Ex. UNSG-8 (G. Smith Direct) at 4.

C. Use of Pay Day Loan Centers.

Ms. Zwick has requested that UNS Gas discontinue any promotion of the use of pay day loan centers for the payment of bills, particularly any reference to such centers on the Company's website. The Company has removed all reference to pay day loan centers from its website and Ms. Zwick has indicated that the Company has addressed her concerns on pay day loan centers.[221]

D. CARES Eligibility.

Ms. Zwick has requested that the Company increase its CARES eligibility from 150% of poverty level to 200% of poverty level, which would track federal LIHEAP eligibility. The Company has recently started to auto-enroll into CARES all customers who have been qualified for LIHEAP.[222] UNS Gas recommends keeping the self certification level for CARES at 150% at this time.[223] Although the Company remains open to discussing increasing the eligibility level beyond 150% of poverty level with interested stakeholders, it does not believe any such requirement should be adopted in this rate case given the potential impact on other customers.

E. CARES Customer Deposits.

Ms. Zwick has requested that the Company waive any deposit requirements for CARES customers. UNS Gas has not agreed to do so. The Company believes that its deposit policy, which comports with the Commission's rules on deposits, should be applied non-discriminatorily across all customer classes.[224] To the extent customers forfeit on bills and are not covered by deposits, the remaining customers end up with the financial burden this imposes.

F. Increased Support of Warm Spirits.

Ms. Zwick has requested that the Company increase the level of matching funds for its Warm Spirits program. UNS Gas agrees to increase its matching funds from $25,000 to $50,000 annually.

[221] See Tr. (Zwick) at 34; Tr. (Hutchens) at 718.
[222] Tr. (Hutchens) at 80-81, 717-718.
[223] Tr. (Hutchens) at 81.
[224] See Tr. (Hutchens) at 85-87, 701-703.

X. <u>RULES AND REGULATIONS</u>.

A. Revised Rules and Regulation.

UNS Gas is proposing only a few substantive changes to its Rules and Regulations at this time. No party has contested these changes, which include:

- Section 2 – Add definitions for "Elderly", "Excess Flow Valve", "Service Transfer", "Special Call Out" and "Trip Charge". Delete the definitions of "Senior Citizen" and "Working Hours". Clarify the definition of "Service Reconnection Charge";
- Section 3 - Clarify the applicability of service establishment, reestablishment and reconnection charges, as well as the charges for service transfers and multiple attempts to connect;
- Section 6 - Increase the charge for service line establishments from $16.00 per foot to $22.50 per foot. For those customers who perform the trenching work, the charge for service line establishments will increase from $12.00 per foot to $16.50 per foot;
- Section 8 - Delete the "Table of Atmospheric Pressure Bases" by geographical zone descriptions in favor of a more simplified version that shows the atmospheric pressure bases within specific elevation ranges; and
- Section 17 - Add the Statement of Additional Charges to the end of the Rules and Regulations.[225]

The Commission should approve the Company's proposed revisions to its Rules and Regulations.

B. Revised Charges.

UNS Gas is proposing the following fees, which have increased due to the rising costs for these particular services:

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[225] Ex. UNSG-8 (G. Smith Direct) at 5.

•	Service Transfer	$20.00
•	Collection Fee	$20.00
•	Customer-Requested Meter Reread	$20.00
•	Multiple Attempts to Connect	$20.00
•	Service Establishment, Re-establishment or Reconnection	
	During Regular Business Hours	$35.00
	After Normal Business Hours (same day request scheduled)	$50.00
•	Special Call Out (Minimum one (1) hour)	
	After Normal Business Hours - per hour	$70.00
•	Customer Requested Meter Test	$90.00
•	Late Payment Finance Charge	1.5%
•	Interest on Customer Deposits	One-year Treasury Constant Maturities rate

Additionally, UNS Gas is proposing to reduce the NSF check charge from $15.00 to $10.00.[226] No party has contested these charges and the Commission should approve the proposed charges.

XI. THE PURCHASE GAS ADJUSTOR SHOULD INCLUDE A REALISTIC, COST-BASED INTEREST RATE.

UNS Gas proposes a single modification to its PGA: the interest rate on its PGA Bank Balance (both for under-collected and for over-collected balances) should be the 3-month LIBOR rate, plus 1.0% to cover the additional margin that UNS Gas must pay for short-term borrowings, which reflects the actual cost of carrying the bank balance.[227] The Company also would be amenable to using the financial commercial paper rate favored by Staff witness Mr. Robert Gray, plus a 1.0% credit spread.[228] UNS Gas should be entitled to recover its actual costs for carrying the bank balance. Its proposed modification to the PGA is reasonable and should be adopted.

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[226] Ex. UNSG-8 (G. Smith Direct) at 7.
[227] Ex. UNSG-13 (Grant Direct) at 33.
[228] Ex. UNSG-14 (Grant Rebuttal) at 35-36.

XII. GAS PROCUREMENT.

As stated above, Staff witness Ms. Rita S. Beale has proposed certain recommendation so the Company's gas procurement procedures. UNS Gas agrees with her recommendations and will implement those recommendations.[229]

XIII. THE COMMISSION SHOULD APPROVE THE LIMITED WAIVER REQUESTED IN DOCKET NO. G-04204A-08-0050.

UNS Gas filed a request in Docket No. G-04204A-08-0050 for the Commission to waive the following requirements placed on the Company by Decision No. 66028: (i) refrain from the use of contract personnel for the performance of operation and maintenance functions, such as leak surveys and valve maintenance; and (ii) independently inspect all new construction work performed by contractor personnel regarding the installation of new service lines and main extensions.[230] In its Application, UNS Gas noted that other local distribution companies use contract personnel in Arizona and that the Company's predecessor, Citizens, benefited from that practice as well.

Regarding the independent inspection of work performed by contractor personnel, UNS Gas states that since the acquisition it has entered into a sole contractor partnership with Northern Pipeline ("NPL") to comply more efficiently with the requirement; prior to the acquisition, Citizens was utilizing four (4) different pipeline contractors.[231] Moreover, from its inception, UNS Gas' Pipeline Safety Inspection Audits for the past five (5) years have been excellent.[232] The elimination of the independent inspection requirement should help reduce operating expenses in the future.

Commission Staff responded to UNS Gas' Application on February 14, 2008.[233] In its report, Commission Staff recommended that the Application for the waiver be approved. Citing UNS Gas' safety record, the progress of the Company beyond the transitional period of operations

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[229] Ex. UNSG-6 (Hutchens Rebuttal) at 8-12; Ex. UNSG-7 (Hutchens Rejoinder) at 4.
[230] Ex. UNSG-9 (Application).
[231] Ex. UNSG-6 (Hutchens Rebuttal) at 15.
[232] Ex. UNSG-6 (Hutchens Rebuttal) at 15.
[233] Ex. UNSG-10 (Staff Report).

following the acquisition, and its operating history, Commission Staff stated that it believes these requirements are no longer necessary.[234] Commission Pipeline Safety Staff has also reviewed, and supports, the Company's request for a waiver. However, the Commission has not yet taken action on those recommendations.

UNS Gas respectfully requests that the Commission approve a waiver of these requirements as part of its order in this case.

XIV. CONCLUSION.

UNS Gas respectfully requests that the Commission issue a final order:

(1) Granting UNS Gas the permanent rate increase sought herein;

(2) Approving the Company's proposed rate design;

(3) Approving the new or modified rate and service schedules with an effective date no later than December 1, 2009;

(4) Approving the requested modifications to UNS Gas' low-income support programs;

(5) Approving UNS Gas' revised Rules and Regulations;

(6) Approving the requested revisions to UNS Gas' Purchased Gas Adjustor;

(7) Approving the waiver requested in Docket No. G-04204A-08-0050; and

(8) Granting the Company such additional relief as the Commission deems just and proper.

[234] Ex. UNSG-10 (Staff Report).

RESPECTFULLY SUBMITTED this 18th day of September 2009.

UNS Gas, Inc.

By ______________________

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Original and 13 copies of the foregoing filed this 18th day of September, 2009, with:

Docket Control
Arizona Corporation Commission
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Phoenix, Arizona 85007

Copy of the foregoing hand-delivered/mailed this 18th day of September 2009, to:

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Arizona Corporation Commission
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Commissioner Gary Pierce
Arizona Corporation Commission
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APPENDIX

"A"

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August 26, 2009

Hand-Delivered

Dwight G. Nodes, Esq.
Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Re: Matrix of Issues
Docket No. G-04204A-08-0571

Dear Judge Nodes:

Enclosed is the final version of the Matrix of Issues in the 2008 UNS Gas Rate Case that reflects final revisions by Staff, RUCO, IBEW and Ms. Cynthia Zwick.

If you have any questions, please let me know.

Sincerely,

Michael W. Patten

MWP:mi
Enclosure
cc: Robin Mitchell
Dan Pozefsky
Nicholas Enoch
Cynthia Zwick

MATRIX OF ISSUES
UNS GAS, INC.
RATE CASE – DOCKET NO. G-04204A-08-0571

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
SUMMARY					
Adjusted Original Cost Rate Base	$184,379,086	$178,548,361	$179,884,439	No dispute with UNS Gas' position	No position
Weighted Average Cost of Capital	8.75%	8.24%	7.55%	No dispute with UNS Gas' position	No position
Required Operating Income	$17,486,492	$15,630,964	$13,604,657	No dispute with UNS Gas' position	No position
Adjusted Operating Income	$11,693,460	$13,464,910	$13,090,781	No dispute with UNS Gas' position	No position
Fair Value Operating Income Deficiency	$5,793,032	$2,166,054	$513,876	No dispute with UNS Gas' position	No position
Gross Revenue Conversion Factor	1.6366	1.6343	1.6366	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Increase in Gross Revenue Requirement	$9,480,876	$3,539,982	$841,000	No dispute with UNS Gas' position	No position
COST OF CAPITAL					
Capital Structure	Debt 50.01%; Equity 49.99%	No dispute	No dispute	No dispute with UNS Gas' position	No position
Cost of Equity	11.0%	10.0%	8.61%	No dispute with UNS Gas' position	No position
Cost of Debt	6.49%	No dispute	No dispute	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Fair Value Rate of Return	7.30%, using the FVROR methodology set forth in Decision No. 70441 and the FVROR methodology used by Staff in Docket No. W-02113A-07-0551. UNS Gas would agree to a lower rate if 7.30% resulted in a rate increase higher than sought in the Application.	6.03%; 6.37% (Alternative) Staff proposes two rates. The first applies a 0% return to "fair value increment" and the second applies a 1.25% rate.	5.38%	No dispute with UNS Gas' position	No position
RATE BASE					
Original Cost Rate Base-Unadjusted	$176,153,570	No dispute	No dispute	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
RATE BASE ADJUSTMENTS					
Acquisition Adjustment (UNSG)	$32,852,425	No dispute	No dispute	No dispute with UNS Gas' position	No position
Southern Union Acquisition Adjustment (UNSG)	($16,145,381)	No dispute	No dispute	No dispute with UNS Gas' position	No position
Griffith Plant (UNSG)	($4,942,600)	No dispute	No dispute	No dispute with UNS Gas' position	No position
Build-Out Plant (UNSG)	($7,896,628)	No dispute	No dispute	No dispute with UNS Gas' position	No position
Golden Valley Plant (UNSG)	($4,393,096)	No dispute	No dispute	No dispute with UNS Gas' position	No position

MATRIX OF ISSUES
UNS GAS, INC.
RATE CASE – DOCKET NO. G-04204A-08-0571

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Post-Test Year Non-Revenue Plant in Service (UNSG)	$1,527,888. UNS Gas seeks to include <u>non-revenue</u> producing post-test year plant in an effort to meet concerns raised in Decision No. 70011.	$0. Staff opposes Post-Test Year Plan adjustment in full because new plant may reduce operating expense.	$0. RUCO opposes in full based on prior Arizona Corporation Commission decisions and potential reduced operating expense.	No dispute with UNS Gas' position	No position
Customer Advances Adjustment (UNSG)	$589,152. UNS Gas does not reduce rate base for advances related to plant not yet included in rate base.	$0. Staff opposes adjustment because UNS Gas does not have option to do so.	$0. RUCO opposes the adjustment based on Rule 103, the fact that UNSG does not reduce the CWIP balance upon which AFUDC is calculated by the amount of Customer Advances, and prior ACC orders.	No dispute with UNS Gas' position	No position

MATRIX OF ISSUES
UNS GAS, INC.
RATE CASE – DOCKET NO. G-04204A-08-0571

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Accumulated Deferred Income Taxes (UNSG)	$4,450,108	$4,411,114. Difference reflects impact of other adjustments.	$4,253,852. Difference reflects impact of other adjustments, and removal of certain ADIT debit-balances for which the corresponding Accrued Liability amounts have not been reflected as rate base deductions.	No dispute with UNS Gas' position	No position
Working Capital (UNSG)	$2,183,948. This amount is revised from the original adjustment of $97,967 to fully reflect new twice-monthly gas payment schedule.	($1,530,037). Staff adjusted UNS Gas' calculation based primarily on purchased gas payment lag (modifying twice monthly payment schedule to 35 day period) as well as the impact of other adjustments.	RUCO agreed with UNS Gas' originally filed calculation except for $92,671 adjustment for prepaids. RUCO opposes UNSG's rebuttal adjustment to cash working capital.	No dispute with UNS Gas' position	No position
RCND	$329,266,770	Concerned that UNS Gas methodology may result in an overstated RCND.	No dispute after UNSG made correction identified in RUCO's direct testimony	No dispute with UNS Gas' position	No position

MATRIX OF ISSUES
UNS GAS, INC.
RATE CASE – DOCKET NO. G-04204A-08-0571

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
OPERATING INCOME					
Original Operating Income - Unadjusted	$13,447,491	No dispute	No dispute	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Operating Income Adjustments					
Griffith Plant Operations (UNSG)	($865,152)	No dispute	No dispute	No dispute with UNS Gas' position	No position
Golden Valley Revenue & Expense (UNSG)	($2,148,778)	No dispute	No dispute	No dispute with UNS Gas' position	No position
Gas Cost Rev & Purchased Gas Cost (UNSG)	($90,472,202)	No dispute	No dispute	No dispute with UNS Gas' position	No position
Negotiated Sales Program (NSP) Revenue & Gas Cost (UNSG)	($17,165,706)	No dispute	No dispute	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Revenue Annualization (UNSG)	$1,448,476	$1,797,514. The difference reflects the Customer Annualization adjustment discussed below.	No dispute	No dispute with UNS Gas' position	No position
Customer Annualization (UNSG)	($516,003). UNS Gas applied the customer annualization methodology used in Decision No. 70011.	$655,768. Staff used an estimated 2.5% growth rate to calculate estimated customers at the end of the test year (by applying 1.25% to the mid-test year customer number).	$0. RUCO opposes the adjustment because it believes that the UNS Gas system continued to grow during the test year.	No dispute with UNS Gas' position	No position
Weather Normalization (UNSG)	($882,453)	($903,889). The difference reflects Staff's customer annualization adjustment.	No dispute	No dispute with UNS Gas' position	No position
DSM Revenue & Expense (UNSG)	($130,917)	No dispute	No dispute	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Service Fees & Late Fees (UNSG)	$239,235	No dispute	No dispute	No dispute with UNS Gas' position	No position
Operating Expense Adjustments					
Griffith Plant Operations (UNSG)	($160,390)	No dispute	No dispute	No dispute with UNS Gas' position	No position
Golden Valley Rev & Exp (UNSG)	($1,763,947)	No dispute	No dispute	No dispute with UNS Gas' position	No position
Gas Cost Rev & Purchased Gas Cost (UNSG)	($90,472,202)	No dispute	No dispute	No dispute with UNS Gas' position	No position
NSP Revenue & Gas Cost (UNSG)	($16,696,668)	No dispute	No dispute	No dispute with UNS Gas' position	No position
DSM Revenue & Expense (UNSG)	($130,917)	No dispute	No dispute	No dispute with UNS Gas' position	No position

MATRIX OF ISSUES
UNS GAS, INC.
RATE CASE – DOCKET NO. G-04204A-08-0571

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Payroll Expense (UNSG)	$362,018. This applies 2010 pay increase which is similar to the treatment of pay increased in Decision No. 70011.	No dispute	$136,278. RUCO removed the 2010 pay increase, but allowed the 2009 increase.	IBEW supports UNS Gas' position. Payroll should be adjusted to match recent union contracts.	No position
Payroll Tax Expense (UNSG)	$2,557	($8,981). Staff adjustment reflects no incentive compensation and a 10% rate.	($22,325). RUCO adjustment reflects Payroll Expense adjustment.	IBEW supports UNS Gas' position. Payroll should be adjusted to match recent union contract.	No position
Pension and Benefits (UNSG)	$77,544	No dispute	No dispute	No dispute with UNS Gas' position	No position
Rate Case Expense (annual amount after amortization) (All)	$141,667. UNS Gas has modified its original adjustment to match Staff's adjustment.	$141,667. Staff reduced UNS Gas' initial adjustment by amortization of rate case expense from the prior rate case ($58,333).	$100,000 per year annual allowance which is in line with amount Commission allowed in last UNSG and UNS Electric rate cases.	No dispute with UNS Gas' position	No position
CARES Expense (UNSG)	($25,983)	No dispute	No dispute	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
CARES Regulatory Asset Amortization.(UNSG)	$164,197	No dispute	No dispute	No dispute with UNS Gas' position.	No position
Y2K Amortization (UNSG)	($76,753)	No dispute	No dispute	No dispute with UNS Gas' position.	No position
Miscellaneous Expenses (Postage and AGA dues) (Staff & RUCO)	($827,301). UNS Gas adjusted certain miscellaneous expenses, including postage (reflecting May 2009 postage increase) and AGA dues (reflecting a 4% reduction consistent with Decision No. 70011) resulting in the "Miscellaneous" adjustment.	($49,247). Staff agreed with the postage adjustment to reflect the May 2009 postage increase, but applied it to its customer count adjustment. Staff also adjusted the AGA dues by an additional 3.511% pursuant to Decision No. 70011, effectively duplicating the UNS Gas 4% reduction, but acknowledged error in data request response. Staff, in Surrebuttal, agreed with Company on AGA dues adjustment.	($844,063). RUCO agreed with the postage adjustment but applied it to test year customer levels in an adjustment filed with RUCO's surrebuttal. RUCO reduced the AGA dues expense by 40%, based on its analysis and upon Decision No. 70665, which was issued after Decision No. 70011.	No dispute with UNS Gas' position.	No position

ISSUE	**UNS GAS, INC.**	**STAFF**	**RUCO**	**IBEW**	**MS. ZWICK**
Normalize Outside Legal Expense (UNSG)	$305,984. This amount reflects the three-year average of outside legal costs for UNS Gas and is consistent with the approach used in Decision No. 70011.	$0. Staff removed this adjustment.	$88,310. RUCO allowed a normalized amount that was higher than test year actual but not as high as the backward looking amount requested by UNSG, which fails to recognize changed circumstances since Decision No. 70011..	No dispute with UNS Gas' position	No position
Bad Debt Expense (UNSG)	$63,211. Reflects a 3 year average.	($123,416). Staff adjusted the amount because it believes UNS Gas has been overstating Allowance for Doubtful Accounts.	No dispute	No dispute with UNS Gas' position	No position
Depr & Property Tax - CWIP-Post Test Year (RUCO)	Disputed	No position	($95,042). Related to RUCO's position on post-test year plant.	No dispute with UNS Gas' position	No position

MATRIX OF ISSUES
UNS GAS, INC.
RATE CASE – DOCKET NO. G-04204A-08-0571

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Incentive Compensation (Staff & RUCO)	$30,930. UNS Gas adjusts test year incentive compensation to reflect a normalized level	($86,463). Staff's adjustment is intended to allow only 50% of incentive compensation, but uses incorrect expense amount.	($121,581). RUCO's adjustment disallows 50% of incentive compensation.	No dispute with UNS Gas' position	No position
Stock-Based Compensation (RUCO)	Disputed. UNS Gas included all of the compensation in its expenses to be recovered through rates.	No position	($266,399). RUCO disallowed 100% of Stock-based compensation	No dispute with UNS Gas' position	No position
SERP (Staff & RUCO)	Disputed. UNS Gas believes that SERP is an appropriate expense to be recovered through rates.	($101,021). Staff rejected 100% of the SERP expense consistent with Decision No. 70011	($101,021). RUCO rejected 100% of the SERP expense consistent with Decision No. 70011.	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Fleet Fuel Expense (All)	($51,285). UNS Gas modified its original adjustment and has now proposed an adjustment based on its 3 year average fleet fuel expense in order to smooth the volatile nature of gas prices. RUCO's calculation is wrong because it includes a $230,913 error because a property tax adjustment is counted twice.	($226.352). Staff adjusted the actual fleet fuel test year expense by using an estimated cost of $1.96/gallon as reflected in the EIA as of March 2009.	($71,963). In surrebuttal RUCO adjusted the actual fleet fuel test year expense by applying average price of $2.95/gallon from January 2006 through June 2009 to the 3 and 1/2year average of gallons used.	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Call Center (Staff)	Disputed. UNS Gas' Call Center expense reflects the actual allocation of Call Center expenses being allocated to UNS Gas by TEP. Staff uses reduced "service order" levels in reducing Call Center expenses. However, "service orders" are only one of many Call Center function. Call volume and call duration have increased for UNS Gas.	($484,798). Staff adjusts the Call Center expense back to the 2005 test year level from the prior rate case, noting that service orders have decreased.	RUCO did not dispute the Call Center expense.	No dispute with UNS Gas' position	No position
Synchronized Interest (Staff)	Included with current income tax adjustment.	Included with current income tax adjustment	Included with current income tax adjustment.	No dispute with UNS Gas' position	No position
Depreciation & Amortization Expense Annualization (UNSG)	($227,976)	No dispute	No dispute	No dispute with UNS Gas' position	No position

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Property Tax (UNSG)	$1,354,074	No dispute	$1,123,161. RUCO adjusted the property rate to reflect the current assessment rate.	No dispute with UNS Gas' position	No position
Income Tax (All)	($808,257). Related to other adjustments.	$397,788. Related to other adjustments.	$161,975. Related to other adjustments.	No dispute with UNS Gas' position	No position
RATE DESIGN					
Monthly Customer Charge	Phased-In Increases: For residential, increase from $8.50 to $10.00 in Year 1 then to $12.00 (Year 2); then to $14.00 (Year 3) with corresponding adjustment to volumetric charge. (Similar design for other customer classes.)	Disputed. Staff agrees only to increase to $9.50 for residential. Similar objection for other classes.	Disputed. RUCO agrees only to increase to $10.00 for residential. Similar objection for other classes.	IBEW supports UNS Gas' request for increased monthly customer charges.	No position

MATRIX OF ISSUES
UNS GAS, INC.
RATE CASE – DOCKET NO. G-04204A-08-0571

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Allocation of Revenue Increase	UNS Gas proposes to allocate increased costs equally across customer classes except for CARES (which receives no increase)	Staff's rate design would result in generally equal increases across customer classes except that industrials would realize a larger increase.	No dispute	No dispute with UNS Gas' position	
CARES	Maintain current CARES rates, except for PGA rate	No dispute	No dispute	No dispute with UNS Gas' position	Hold CARES customers completely harmless, including PGA
Warm Spirits Roundup Program	Allow customers to choose to round up payment to nearest dollar and apply round up amount to fund Warm Spirits	No dispute	No position	No dispute with UNS Gas' position	No position
T-1 and T-2 Pricing Plans	UNS Gas proposes to modify its T-1 and T-2 pricing plans to reduce imbalance thresholds.	No dispute	No position	No dispute with UNS Gas' position	No position

MATRIX OF ISSUES
UNS GAS, INC.
RATE CASE – DOCKET NO. G-04204A-08-0571

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
OTHER ISSUES					
PGA Bank Balance Interest Rate (UNSG)	Increase rates to 3 month LIBOR + 1%, which is rate that UNS Gas actual pays.	Disputed. Keep at 3 month financial commercial paper rate.	No position	No dispute with UNS Gas' position	No position
Rules & Regulations (UNSG)	UNS Gas proposed certain revisions to its Rules & Regulations	Generally in agreement	No position	No dispute with UNS Gas' position	No position
Proposed Additional Charges in Rules and Regulations`	UNS Gas has proposed slight changes to certain charges in its Rules and Regulations	No dispute	No position	No dispute with UNS Gas' position	No position
Gas Procurement Practices (Staff)	UNS Gas generally agrees with Staff recommendations	Staff made several recommendations re gas procurement practices	No position	No dispute with UNS Gas' position	No position

MATRIX OF ISSUES
UNS GAS, INC.
RATE CASE – DOCKET NO. G-04204A-08-0571

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Use of Pay Day Loan Center (Zwick)	UNS Gas no longer subsidizes or promotes the use of payday loan centers for bill payments. Rather, UNS Gas has entered into an arrangement with Walmart to accept bill payments and actively promotes the use of Walmart and other methods for bill payments. UNS Gas has not completely discontinued the acceptance of bill payments through ACE Cash Express because some UNS Gas customers indicated a desire to continue to use such a payment option and have continued to do so.				Ms. Zwick proposes that UNS Gas will stop using payday loan centers for bills. Ms. Zwick opposes the Company's current use of payday loan centers and believes the use is disingenuous at best.

MATRIX OF ISSUES
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CARES Hold Harmless (Zwick)	UNS Gas agrees to hold CARES customers harmless from monthly charge and non-commodity volumetric rate increases, but not PGA-related increases or decreases.				Ms. Zwick proposes CARES customers be held harmless from a[illegible] increases.
Track Federal LIHEAP/ Weatherization Eligibility (Zwick)	UNS Gas has not proposed to do so. However, UNS Gas does automatically enroll in Lifeline or CARES all customers whose accounts are paid or guaranteed by agencies distributing federal LIHEAP funds.				Ms. Zwick proposes to match CARES eligibility to LIHEAP eligibility, which is now 200% of poverty level.
Exempt CARES customers from deposits (Zwick)	UNS Gas has not proposed to do so				Ms. Zwick proposes to exempt CARES customers from deposits

ISSUE	UNS GAS, INC.	STAFF	RUCO	IBEW	MS. ZWICK
Increase UNSG support of Warm Spirits/LIW (Zwick)	UNS Gas has not proposed to do so				Ms. Zwick proposes that UNS Gas increase support from $25,000 to $50,000 for Warm Spirits and to $200,000 for LIW.
Grant relief from restrictions on use of contract personnel as requested in Docket No. G-04204A-08-0050 (filed January 25, 2008) (UNSG)	UNS Gas requests relief from certain conditions contained in Decision No. 66028 (Citizens Asset Acquisition Order)	In its February 14, 2008 Staff Report in Docket No. G-04204A-08-0050, Staff supported the requested waiver. However, Staff opposes consideration in this docket.	No position	Disputed. IBEW opposes UNS Gas' requested relief.	No position