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AZ CORP COMMISSION
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BOB STUMP

IN THE MATTER OF THE 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 **STAFF'S INITIAL POST-HEARING BRIEF**

The Utilities Division of the Arizona Corporation Commission ("Staff") hereby files its closing brief in the above-captioned matter. In this brief, Staff will address the major disputed issues. On any issue not specifically addressed in this brief, Staff maintains its position as presented in its testimony.

I. INTRODUCTION.

UNS Gas, Inc. ("UNSG" or the "Company") is a public service corporation that provides natural gas distribution services to approximately 140,000 customers in Mohave, Coconino, Navajo, Yavapai and Santa Cruz counties in Arizona. UNSG was formerly a part of the Arizona local gas distribution operations of Citizens Communications Company, prior to its 2003 acquisition by UniSource Energy. UNSG, at the conclusion of a rate moratorium, filed an application for a rate increase in 2006. The Commission approved new rates for UNSG in November 2007.[1] UNSG filed an application for a rate increase on November 7, 2008.

UNSG is seeking an increase in its base rates of approximately $9.5 million, a 6 percent increase over its test year revenues. The effect on the proposed fixed monthly and delivery charges will be an increase of approximately 19% over test year revenues, exclusive of gas recovery costs. UNSG used a test year ending June 30, 2008.[2]

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[1] Decision No. 70011 (November 27, 2007).
[2] Ex UNSG-16 (Dukes Direct) at 3.

There are several major contested issues between Staff and UNSG. Those issues include cost of capital, post-test year plant, the treatment of customer advances, cash working capital, customer annualization and rate design.

II. SUMMARY OF STAFF'S POSITION.

Staff has recommended a revenue increase of $3,539,982. Staff's recommended weighted average cost of capital is 8.24%. For its cost of equity, Staff is recommending 10.0%. Staff has proposed two rates for its fair value rate of return; the first applies 0% return to the fair value increment which results in a FVROR of 6.03%. Staff's alternative method would apply a 1.25% return to the fair value increment, resulting in a FVROR of 6.36%.

III. RATE BASE.

The Company's proposed rate base computed on both an Original Cost and Fair Value basis respectively are as follows: $184,379,086 (adjusted) and $255,779, 939.[3] Staff's proposed rate base computed on both an Original Cost and Fair Value basis respectively are as follows: $178,548,361 and $251,524,153.[4] The Company's Reconstructed Cost New rate base ("RCND") is $329,265,770.[5] Staff has recommended an RCND rate base of $324,538,937.[6] The most significant issues revolve around the treatment of post test year plant and the treatment of customer advances.

A. <u>The Company's request to include post-test-year plant is inconsistent with the Commission's normal treatment of post-test-year plant.</u>

The Company has sought the inclusion of post-test-year plant in the amount of $1,527,888. UNSG has alleged that the plant it seeks to include in rate base is non-revenue producing. According to Company witness Dallas Dukes, inclusion of certain post-test-year plant should be allowed in order to provide the Company a more reasonable opportunity to earn its authorized rate of return.[7] Staff has recommended the exclusion of post-test-year plant for those systems. The inclusion of post-test-year plant violates principles of ratemaking and results in a mismatch of that plant with the revenues, expenses, and rate base of the test year.[8]

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[3] Ex UNSG-2 (Schedules) A-1.
[4] Ex S-12 (Fish Direct).
[5] Ex UNSG-2 (Schedules) A-1.
[6] Ex S-12 (Fish Direct) Schedule THF-A-1.
[7] Ex UNSG-16 (Dukes Direct) at 11.
[8] Ex S-12 (Fish Direct) at 3.

According to Mr. Dukes, UNSG proposed to include in rate base vehicles, leak detection equipment, A&G costs for structures, and replacement and relocation of mains. None of these items was in service or associated with the test year.[9] The Company identified these items as "non-revenue producing", stating that its selection of these items were made in an attempt to address concerns raised in Decision No. 70011. The Company's rationale for the inclusion of post test year plant is flawed and should be rejected by the Commission.

The discussion of post-test-year plant in Decision No. 70011 is relatively short. The Commission rejected the UNSG proposal to include post-test-year plant for some of the same reasons it rejected the Company's argument regarding the inclusion of Construction Work In Progress. The Commission found that in several instances where the inclusion of post-test-year plant was approved, there were assurances that there would not be a mismatch in revenue. The Commission, in Decision No. 70011, did not give instructions to UNSG on how to more favorably position post-test-year plant for inclusion in rate base in its next rate case.

UNSG attempts to bolster its position by citing several previous Commission decisions involving water companies that allowed post-test-year plant into rate base. Those decisions are distinguishable from the instant case. For example, UNSG cites Decision No. 68176 as supportive of its position.[10] In *Chaparral City Water Company*, Chaparral City Water Company ("Chaparral") was seeking recovery of an expansion of a water treatment plant used to treat Central Arizona Project water. Construction of the plant in question was commenced in 2003 and completed in March 2004, three months after the end of the test year. During the test year in that matter, Chaparral's peak demand exceeded 10 million gallons per day, but it only had the capacity to treat 8 million gallons per day. The Commission found that Chaparral needed the plant to serve existing customers during the summer, when demand peaks. The Commission was also persuaded by the fact that the plant was placed into service shortly after the end of the test year. In this instance, Chaparral also needed the capacity to aid in its maintenance and provide a safe operating margin.[11] The situation faced by Chaparral is far different than the situation faced by UNSG.

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[9] TR 309:3-10.

[10] UNSG-6 (Hutchens Rebuttal) at 5.

[11] In the Matter of the Application of Chaparral City Water Company, Docket No. W-02113A-04-0616.

In Chaparral, it proposed to include plant that was in service a mere three months after the end of the test year. This is not the case for UNSG. Mr. Dukes admits that the plant UNSG is seeking to include is placed in service more than three months after the test year. [12] In fact, Mr. Dukes testified that its requested post-test-year plant could be more than a year after the test year. He further testifies that UNSG does not have an issue with a safety operating margin, nor does it have a problem making routine repairs. The Chaparral decision is not supportive of the UNSG position.

UNSG also cites Decision No. 65350 as supportive of its position that post-test year plant should be included in rate base.[13] In *Bella Vista Water Co., Inc.*, the Commission held that post-test year plant should be reviewed on a case-by-case basis. Further in that matter, Bella Vista was seeking to include plant that had been placed in service one year and three days after the end of the test year. Again, UNSG admits that its requested plant may be placed into service more than a year after its test year.

Commission rules require the end of the test year, which is the one-year historical period used in determining rate base, operating income and rate of return, to be the most recent practical date available prior to the filing. A.A.C. R14-2-103(A)(3)(p). Compliance with Commission rules and recognition of Commission policy on appropriate test year selection requires a utility to choose a test year that includes all major rate base and operating income items needed to support its rate application, and to include pro forma adjustments to its chosen test year that are consistent with past Commission action under similar circumstances. While the Commission has allowed the inclusion of post-test-year plant in rate base,[14] as Staff witness Dr. Thomas Fish testified, those situations are special and unusual and thus warrant the recognition of post-test-year plant.[15] Staff has traditionally recognized two such scenarios: (1) when the magnitude of the investment relative to the utility's total investment is such that not including the post-test-year plant in the cost of service would jeopardize the utility's financial health, and (2) when conditions such as the following exist: (a) the cost of the post-test-year plant is significant and substantial, (b) the net impact on revenue and expenses for the

[12] TR 72:16-19.
[13] Ex S-2 (Decision No. 68176) at 5-6.
[14] Ex S-3 (Bella Vista Water Co., Inc., Docket No. W-02465A-01-0776).
[15] *See* In the Matter of Arizona Water Company, Docket No. W-01445A-02-0169.

post-test-year plant is known and insignificant or is revenue-neutral, and (c) the post-test-year plant is prudent and necessary for the provision of services and reflects appropriate, efficient, effective, and timely decision-making.[16]

The Company has not demonstrated that the amount it is seeking to include is so large that the failure to include it would be detrimental to the Company's financial health. The Company is seeking to include routine items, such as trucks. The Commission should reject the Company's argument. The Staff's position is reasonable and should be adopted.

B. UNSG's request for the inclusion of Advances in Aid of Construction into Rate Base is contrary to traditional ratemaking practices and should be rejected.

UNSG argues that it should be allowed to include customer advances of approximately $600,000 that was received during the test year into rate base. Mr. Dukes testified that, because the projects associated with the advances were not in service during the test year, but the amount of advances were spent on projects not included in rate base, the associated funds should be included.[17] This position is contrary to traditional ratemaking practices. Customer advances represent non-investor supplied capital and should be reflected as a deduction to rate base.[18] The Commission's rules (A.A.C. R14-2-103, Appendix B, Schedule B-1) require that Customer Advances be reflected as a deduction from rate base.

In support of its position, the Company cites Decision No. 69914.[19] According to UNSG witness Dukes, the Commission, in that decision, authorized the treatment of contributions in a similar manner to that presently being sought by UNSG.[20] The Commission, in that decision, accorded special treatment to hook-up fees, allowing them to be treated as contributions. UNSG however, is asking for special treatment for advances. While the Company argues that it will not be receiving a return on advances, that is precisely what will happen if advances are not deducted from rate base. The Company has offered no compelling reason to deviate from normal ratemaking treatment and its proposal should be rejected.

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[16] TR 565:1-5.
[17] Ex S-13 (Fish Surrebuttal) at 2-3.
[18] Ex UNSG-16 (Dukes Direct) at 12.
[19] Ex. S-13 (Fish Surrebuttal) at 3.
[20] Docket No. W-01303A-05-0718 (Arizona-American Water Co.).

C. Cash Working Capital.

Working Capital is composed of materials and supplies prepayments and cash working Capital. Cash working capital is the cash needed by a utility to cover its day-to-day operations. It may be either increase or decrease rate base. If the Company's cash expenditures, on an aggregate basis, precede the cash recovery of expenses, investors must provide cash working capital. In that situation a positive cash working capital requirement exists. On the other hand, if revenues are typically received prior to when expenditures are made, on average, then ratepayers provide the cash working capital to the utility, and the negative cash working capital allowance is reflected as a reduction to rate base. In this case, the cash working capital requirement is a reduction to rate base as ratepayers are essentially supplying these funds.[21] Companies perform a lead-lag study to determine its requirements. The lead-lag study measures the timing differential between accounts receivable and accounts payable and weights this differential by dollars. The method is used to determine a company's cash working capital requirements.[22]

Staff proposes an adjustment to the cash working capital component. Staff, in its review of the Company's lead-lag study, noticed an anomaly in the payment of purchased gas.[23] The Company's payment averaged 17.83 days for several months and not the normal 35 days. Staff made an adjustment to the working capital requirements of $(1,624,840).[24]

In its Rebuttal testimony, the Company increased its cash working capital to $2,133,948 from $97,967 in its direct filing. Company witness Dukes explained:

> The payment lag is actually much shorter than the 35 days used by Staff. In fact the payments made to that vendor early in the test year were not reflective of payment terms later in the test year or of the current payment terms. The Company's payment terms were altered during the test year because of credit limitations.[25]

The vendor in question is British Petroleum ("BP"). Mr. Dukes testified that, because of the company's credit, BP required the Company to make payments twice a month.[26] Company witness Kentton Grant testified that the consequences of those payment terms should be borne by the

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[21] Ex UNSG-17 (Dukes Rebuttal) at 7.
[22] Ex UNSG-16 (Dukes Direct) at 13.
[23] Ex S-12 (Fish Direct) at 18.
[24] *Id.*
[25] *Id.*
[26] Ex UNSG-17 (Dukes Rebuttal) at 8.

ratepayers because the Company is purchasing gas on their behalf.[27] While the Company feels that this is a risk that should be borne by the ratepayers, Staff disagrees and would contend that ratepayers should not be saddled with additional costs associated with the unusual payment terms.[28]

IV. INCOME STATEMENT.

Staff and the Company disagree on various adjustments made to the Company's Operating Income. Staff's adjustments are reasonable and should be adopted.

A. Customer Annualization.

Staff's customer annualization adjustment creates a level of test year customers that reflects a level of operating revenues and expenses and net plant investment that is representative of normal conditions be expected to exist during the time that the resulting rates will be in effect. [29] Staff witness Dr. Fish used the end of the calendar year values as suggested by Company witness Edwurm instead of the end of the test year values. Staff based its calculations on December 2007 values. Since December 2007 is the midpoint of the test year, Staff used the growth factor of 2.5% presented by Company witness Hutchens, and adjusted the mid-year customer count by 1.25 percent. Staff's adjustment results in an adjustment of $869,221. Contrary to the assertions made by Company witness Bentley Edwurm, Staff did not use a "future test year approach", but based its calculations on the growth rate provided by UNSG, which it estimated to be 2.5%.[30]

B. Weather Normalization Adjustment.

Staff's customer annualization adjustment resulted in an increase in the number of customers for the test year. Because the test year was cooler than normal, these additional customers could be expected to consume more gas than in a normal year. Staff made a corresponding weather normalization adjustment.[31]

C. Postage.

Staff agreed with the Company's postage adjustment to reflect the May 2009 postage increase. Staff calculated an increase in test year postage expenses of $49,247, and also added

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[27] TR 324:3-14.
[28] TR 285:12-18.
[29] Ex S-13 (Fish Surrebuttal) at 4.
[30] TR 561:23-25, TR 562:1-2.
[31] Ex S-13 (Fish Surrebuttal) at 10.

additional postage for the additional test year customers that resulted from its customer annualization adjustment.[32]

D. Bad Debt Expense.

Staff made an adjustment to the Company's bad debt expense of $(186,627). In reviewing the Company's allowance for doubtful accounts, Staff noted an increase of 322.55 percent from 2006 until the end of the test year. It is Staff's position that the Company is over accruing its allowance for doubtful accounts.[33]

Company witness Dukes testified that the Company experienced problems when the Company transferred its accounting system for a third-party vendor to an in-house system and that the numbers for the allowance may be inaccurate.[34] But despite the numbers "looking out of whack in the test year", the Company still maintains that its expense is appropriate.[35]

E. Incentive Compensation,

1. Performance Enhancement Program ("PEP").

The Company has requested full recovery of its expenses associated with its PEP.[36] Staff had made a pro forma adjustment of one-half of PEP expenses in recognition that benefits accrue to both ratepayers and shareholders from incentive programs.[37] The removal of 50% of the expense related to such programs provides an equal sharing of the cost of such programs between shareholders and ratepayers, since the programs benefit both groups.

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

The Supplemental Executive Retirement Plan ("SERP") is a retirement plan designed for certain Company employees whose compensation exceeds IRS defined limits to receive certain retirement benefits. The current limit is $240,000.[38] The Company argues for 100% recovery of this expense. According to Company witness Grant, notwithstanding the current state of the economy,

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[32] Ex S-13 (Fish Surrebuttal) at 10.
[33] Ex S-13 (Fish Surrebuttal) at 16-17.
[34] Ex S-12 (Fish Direct) at 24.
[35] TR 389:1-11.
[36] *Id.*
[37] Ex UNSG-17 (Dukes Rebuttal) at 11.
[38] Ex S-13 (Fish Surrebuttal) at 15.

this is a cost that was prudently incurred and should be recovered in rates.[39] Staff would contend that these costs incurred on behalf of the Company's most highly compensated employees should be borne by the Company's shareholders. The Commission, in the last UNSG rate application, disallowed 100% of the SERP expense.[40] The Company has not presented any rationale or support for the Commission to treat its incentive compensation plans differently. Staff would urge that its adjustment, removing 100% of the expense associated with the SERP, be adopted.[41]

F. Call Center.

The Company has requested recovery of call center expense allocated to UNSG from Tucson Electric Power. The total test year call center charge to UNSG was $1,399,522, which averages $116,627 a month. In its previous rate case, the Company asked to recover an increase in costs because of the benefits and efficiencies of its call center. Staff, concerned by the average monthly cost increase from $76,227 to $116,667 in the face of a declining number of service calls, contends that the Company has not demonstrated that the increased call center expense resulted in additional savings or that customers have benefited from this increase. Staff therefore disallowed the UNSG requested recovery and adjusted the Call center expense to $(484,789).[42] The Company seems to suggest that, if it is not allowed to recover the entire expense requested, it would reduce call center activity.[43] Staff would suggest that the Commission not be held hostage by such "threats" and adopt the Staff adjustment.

V. RATE DESIGN.

The Company has proposed a phased-in customer charge for its residential class. In year 1, the customer charge would increase from $8.50 to $10; year 2 would increase to $12, and year 3 to $14.[44] Staff proposes an increase in the customer charge of $9.50 for residential customers. The Company is attempting to capture more of its fixed costs through its customer charge. The

[39] TR 338:17-21.
[40] TR 343-344.
[41] Decision No. 70011 at 28.
[42] Ex S-13 (Fish Surrebuttal) at 16.
[43] Ex UNSG-6 (Hutchens Rebuttal) at 6.
[44] UNSG-20 (Erdwurm Direct) at 14.

Company's proposal is actually a proposal for decoupling, as admitted by Company witness Bentley Edwurm.[45]

According to Mr. Edwurm, under the Company's proposal, in order for a customer to reduce the impact of the proposed customer charger, a customer would have to reduce usage by 25%.[46] He admits that, for such a reduction in usage, a customer would have to experience a substantial life style change.[47] As pointed out by RUCO witness Frank Radigan, the proposed change in the customer charge might be a disincentive to conserve.[48] Staff has proposed rates designed to recover the proposed base rate increase that are efficient, equitable, and would provide the Company the opportunity to recover its cost of providing service. The proposal by the Company could have an impact on conservation; with a high customer charge relative to volumetric charges, there could be a perceived disconnect between a customer's usage of natural gas and the cost of natural gas. This proposal should be rejected.

VI. COST OF CAPITAL.

In UNSG's previous rate proceeding, Staff Witness David Parcell stated that a utility's rate of return "is developed from the cost of capital, which is estimated by weighting the capital structure components (i.e., debt, preferred stock, and common equity) by their percentages in the capital structure and multiplying these values by their cost rates."[49] Thus, "[t]he first step in performing an analysis of the Company's cost of capital is the development of the appropriate capital structure."[50]

A. <u>Capital Structure.</u>

UNSG proposed using the June 30, 2008 test period capital structure of 49.99 percent common equity and 50.01 percent long-term debt.[51] Staff concurred.[52]

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[45] TR 425:22-25.
[46] TR 422:1-13.
[47] TR 469:1-3.
[48] TR 751:16-24.
[49] Docket No. G-04204A-06-0463, Parcell Direct, 5:18-21.
[50] Ex S-14 (Parcell Direct) at 2.
[51] Ex UNSG-13 (Grant Direct) at 8.
[52] Ex S-14 (Parcell Direct) at 3.

B. Embedded Costs Of Long-term Debt and Preferred Stock.

UNSG recommended using a 6.49 percent cost of debt,[53] "which reflects the Company's cost at June 30, 2008."[54] Staff concurred.[55]

C. Cost of Common Equity.

Staff utilized methodologies well accepted by the industry and two of which have been extensively utilized by this Commission in the past to determine the cost of common equity: Discounted Cash Flow ("DCF"), Capital Asset Pricing Model ("CAPM"), and Comparable Earnings ("CE").[56] Because UNSG is not publicly traded and does not raise its own equity capital, it is not possible to apply these models directly to UNSG. However, it is generally desirable to analyze groups of comparison or "proxy" companies as a substitute.[57] As a result, each of these methodologies is applied to two groups of proxy utilities.[58]

The first group of proxy utilities consisted of electric utilities similar to UNSG and Unisource.[59] The second group consisted of the natural gas utilities selected by UNSG's witness Kentton Grant.[60]

Each of the methodologies produced a range of potential results:[61]

Methodology	Range
Discounted Cash Flow	9.5-10.5%
Capital Asset Pricing Model	7.3-7.7%
Comparable Earnings	9.5-10.5%

Finally, Staff considered the generally prevailing economic and financial conditions in deciding upon a specific value within that range.

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[53] Ex UNSG-13 (Grant Direct) at 26.
[54] Ex S-14 (Parcell Direct) at 3.
[55] Ex S-14 (Parcell Direct) at 23-24.
[56] *Id* at 3.
[57] Ex S-14 (Parcell Direct) at 24.
[58] *Id.*
[59] Ex S-14 (Parcell Direct) at 3.
[60] Ex S-14 (Parcell Direct) at 24.
[61] *Id.*

1. Discounted Cash Flow.

The Discounted Cash Flow ("DCF") model is based on the 'dividend discount model' of financial theory, which maintains that the value (price) of any security or commodity is the discounted value of all future cash flows.[62] The most common variant of the DCF model assumes that dividends are expected to grow at a constant rate.[63] In utilizing the DCF model, Staff combined the current dividend yield for each group of proxy utility stocks described in the previous section with several indicators of expected dividend growth.[64]

The dividend growth rate component of the DCF model is usually the most crucial and controversial element involved in using this methodology.[65] The objective of estimating dividend growth is to "reflect the growth expected by investors".[66] A wide array of indicators exists for estimating [such] growth,[67] and no single indicator is always used by all investors."[68] Therefore, Staff considered five indicators of growth[69] in performing its DCF analysis. Staff believes these growth indicators reflect the types of information that investors consider in making their investment decisions.[70]

The results of Staff's analysis are reflected in Parcell Schedule 7. Staff gave less weight to the extreme lower and upper ends of the groups and, as a result, concluded that "9.5 percent to 10.5 percent reflects the proper DCF cost for UNSG."[71]

2. Capital Asset Pricing Model.

The Capital Asset Pricing Model ("CAPM"), a version of the risk premium method, describes and measures the relationship between a security's investment risk and its market rate of return.[72]

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[62] Ex S-14 (Parcell Direct) at 25.
[63] Ex S-14 (Parcell Direct) at 26.
[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] Ex S-14 (Parcell Direct) at 27.
[68] *Id.*
[69] Ex S-14 (Parcell Direct) at 28.
[70] *Id.* at 29.
[71] *Id.*
[72] Ex S-14 (Parcell Direct) at 30.

CAPM specifically recognizes the risk of a particular company or industry.[73] Staff conducted a CAPM analysis for "the same groups of proxy utilities evaluated in [its] DCF analysis."[74]

The first term of the CAPM is the risk-free rate," which "reflects the level of return that can be achieved without accepting any risk.[75] "[T]he risk-free rate is generally recognized by the use of U.S. Treasury securities", whether "short-term U.S. Treasury bills" or "long-term U.S. Treasury bonds."[76] Rational investors will naturally demand higher expected rates of return on investments that entail a greater risk of loss.[77] The market risk premium component ... represents the investor-expected premium of common stocks over the risk-free rate, or government bonds.[78] Therefore, "[b]y adding an incremental risk premium to observed bond yields, an estimate can be made for the required rate of return on a common stock investment (i.e., the cost of equity capital for that stock)."[79] To make this comparison, Staff compared the actual annual returns on equity of the S&P 500 with the actual annual yields of U.S. Treasury bonds.[80] Based on this analysis, Staff concluded that this version of the risk premium is about 6.45 percent.[81]

Staff then considered the total returns for the S&P 500 group as well as for long-term government bonds, using both arithmetic and geometric means.[82] Staff supports the use of a combination of arithmetic and geometric means since investors have access to both types of means and, presumably, both types are reflected in investment decisions, stock prices, and cost of capital.[83] Staff's calculations using the risk premium are illustrated in Schedule 9 of Mr. Parcell's Direct Testimony. Staff's CAPM results collectively indicate a cost of 7.3 percent to 7.7 percent for the groups of comparison utilities.[84] In total, Staff concluded that the CAPM cost of equity for UNSG is 7.3 percent to 7.5 percent.[85]

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[73] *Id.*
[74] Ex S-14 (Parcell Direct) at 30.
[75] Ex UNSG-13 (Grant Direct) at 20.
[76] Ex S-14 (Parcell Direct) at 31.
[77] Ex UNSG-13 (Grant Direct) at 20.
[78] Ex S-14 (Parcell Direct) at 31.
[79] *Id.*
[80] *Id.*
[81] *Id.*, at 32.
[82] *Id.*
[83] *Id.*
[84] *Id.*
[85] Ex S-14 (Parcell Direct) at 32.

3. Comparable Earnings.

The Comparable Earnings ("CE") methodology is "based upon the economic concept of opportunity cost."[86] It "is designed to measure the returns expected to be earned on the original cost book value of similar risk enterprises."[87] It "normally examines the experienced and/or projected returns on book common equity."[88] Staff examined the "realized returns on equity for several groups of companies" and evaluated "the investor acceptance of these returns by reference to the resulting market-to-book ratios,"[89] which makes it "possible to assess the degree to which a given level of return equates to the cost of capital."[90] Generally, market-to-book ratios of greater than one indicate that a company is able to attract new equity capital without dilution.[91]

Staff's CE analysis considers the experienced equity returns of the proxy groups of utilities for the period 1992-2008, a relatively long period of time necessary to determine trends in earnings over at least a full business cycle.[92] Schedules 10 and 11 of Mr. Parcell's Direct Testimony contain summaries of experienced returns on equity for several groups of companies, while Schedule 12 presents a risk comparison of utilities versus unregulated firms.[93]

Staff's CE analysis indicates that the cost of equity for the proxy utilities is no more than 9.5 percent to 10.5 percent" and that "[r]ecent returns of 8.3 percent to 12.1 percent have resulted in market-to-book ratios of 124 or greater."[94]

In utility rate setting, a fair rate of return is based on the utility's assets and the book value of the company's equity structure.[95] Maintenance of a financially stable utility's market-to-book ratio at 100 percent, or a bit higher, is fully adequate to maintain the utility's financial stability."[96] However,

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[86] *Id.* at 33.
[87] *Id.*
[88] *Id.*
[89] *Id*
[90] *Id at 34.*
[91] *Id..*
[92] Ex S-14 (Parcell Direct) at 36.
[93] *Id.* at 37.
[94] *Id.*
[95] *Id.*
[96] Ex S-14 (Parcell Direct) at 37.

a market price of a utility's common stock that is 150 percent or more above the stock's book value is indicative of earnings that exceed the utility's reasonable cost of capital.[97]

Staff's 9.5 percent to 10.5 percent CE recommendation is based on current market conditions and the proposition that ratepayers should not be required to pay rates based on earnings levels that result in excessive market-to-book ratios.[98]

4. General Economic Conditions.

The costs of capital are determined in part by current and prospective economic and financial conditions."[99] It is well chronicled that, over the past two years and especially over the past several months, the United States and global financial markets have been in turmoil with global credit markets virtually coming to a standstill.[100] However, this does not imply that the cost of equity for gas utilities such as UNSG has increased.[101] This is true for several reasons.

First, UNSG is a regulated utility that sells a product that has no real substitute and is a product for which that consumers can do little to control the amount they use.[102] Therefore, UNSG is partially, if not largely, insulated from the impacts of depressed economic conditions.[103] Second, since the major impact of a recession will be to depress the profits of most enterprises, it is to be expected that capital costs will decrease in tandem with a significant recession.[104] "The United States and global markets have and are taking extraordinary measures designed to put liquidity into the credit markets and make credit more accessible again,"[105] steps which are "clearly designed to lower the cost of capital."[106]

Further, despite this financial turmoil, there is no indication that UNSG's risks have increased since its last rate proceeding,[107] and absent such an indication, there is no justification for increasing

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[97] *Id* at 9.
[98] Ex S-14 (Parcell Direct) at 38.
[99] *Id.*
[100] *Id* at 39.
[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] *Id.*
[107] Ex S-14 (Parcell Direct) at 39.

its cost of equity."[108] However, even if UNSG were to incur higher costs of debt and/or other capital costs, these costs can be passed along to ratepayers at the next rate proceeding.[109]

Based upon the ranges resulting from each analysis, Staff concluded that the cost of common equity for UNSG is within a range of 9.5 percent to 10.5 percent.[110] Staff recommended that the Commission adopt the midpoint of its cost of equity range (10.0 percent), which is the same cost of equity approved by the Commission in UNSG's last rate case.[111]

In concluding that the Commission should not deviate from the cost of equity adopted in the last UNSG rate case, Staff provided several reasons. "There is no indication that UNSG's level of risk has increased since the last proceeding."[112] [T]here are indications that capital costs have declined since the last case."[113] "[T]he current economic recession should have the effect of lowering the cost of equity."[114] Since the approval of a 10 percent return on equity in the last rate case, UNSG has been able to increase its equity from 33% in August of 2003 to approximately 50% as of the test year ending June 30, 2008.[115] Moody's Investors Service ("Moody's") initiated ratings on UNSG in October of 2008,[116] assigning UNSG a Baa3 investment-grade credit rating.[117] There is no justification for increasing UNSG's profit level at the same time that virtually all of its customers are suffering from lower incomes/profits.[118]

D. <u>Fair Value Rate Base Cost of Capital.</u>

UNSG is requesting that a 6.80 percent cost of capital be applied to the level of its fair value rate base. Staff proposes two alternative Fair Value Rate of Return ("FVROR") values for UNS Gas: a 6.03 percent value using a zero percent return on the Fair Value Increment (differential between Fair Value Rate Base and Original Cost Rate Base) and 6.37 percent value using a 1.25 percent inflation-adjusted risk-free return.

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[108] *Id.*
[109] Ex S-14 (Parcell Direct) at 3.
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] Ex UNSG-13 (Grant Direct) at 4.
[115] *Id.* at 6.
[116] *Id*
[117] Ex S-14 (Parcell Direct) at 41.
[118] Ex UNSG-13 (Grant Direct) at 3.

In Decision No. 70441, the Commission revised the method of calculating operating income.[119] The Commission calculated operating income by multiplying the FVROR times the FVRB. The Commission used a FVRB that reflects a 50/50 weighting of OCRB, and the reconstruction cost new rate base ("RCND"). This Decision left the door open for adjustments to the adopted formula. Specifically, the Remand Decision states: "Although we believe that the cost of debt may reflect the effects of inflation, we are not convinced that the evidence presented in this proceeding is developed sufficiently enough to make that determination with certainty."[120]

Cost of capital is designed to apply to OCRB. When the concept of FVRB is introduced, the link between rate base and capital structure is broken. The amount of FVRB that exceeds OCRB is not financed with investor-supplied funds. Since the increment ("Fair Value Increment") between fair value rate base and original cost rate base is not financed with investor-supplied funds, it is logical and appropriate, from a financial standpoint, to assume that this increment has no financing cost. As a result, the cost of capital, through the capital structure, can be modified to account for a level of cost-free capital in an equal dollar amount to the increment of FVRB over the OCRB. Such a procedure would still provide for a return being earned on all investor-supplied funds and would thus be consistent with financial standards. Thus applying a 6.03% rate to the UNSG FVRB provides for a return on all investor-supplied capital.[121]

However, should the Commission determine that there should be a specific return (greater than zero) applied to the Fair Value Increment, Staff has offered an alternative calculation. It should not be necessary to provide for <u>any</u> return on the Fair Value Increment since this is not investor-supplied capital. However, the Commission may choose to evaluate this issue from both a financial and a public policy perspective.

The weighted cost of capital ("WCOC") authorized by the Commission has already provided for a full cost of equity return and cost of debt return on the portions of equity and debt capital that

[119] Ex S-9 (Gray Direct) at 6-7.
[120] Ex S-6 (Beale Direct) at 2-5.
[121] TR 48:9-14.

are supporting the OCRB portion of the FVRB. As a result, there is no need to provide any additional return on the portions of FVRB supported by common equity and debt.[122]

Stated differently, both the cost of debt and the return on common equity (i.e., capital stock, paid-in capital, and retained earnings - the investment of common shareholders) are already provided for in a traditional WCOC. Only the portion of the FVRB that exceeds OCRB ("Fair Value Increment") needs to have a specific return identified in order to reflect a return component on that Fair Value Increment.

If it is determined that it is desirable to provide an additional (non-zero) return on the Fair Value Increment, the proper return should be no larger than the real (i.e., after inflation is removed) risk-free rate of return.

The Staff alternative FVROR proposal incorporates a return on the Fair Value Increment with a maximum value of 2.5 percent. Staff proposes the mid-point of this range, or 1.25 percent. As a result, in the alternative Staff proposes a 6.36 FVROR for UNSG.

The Company is critical of Staff's methodology used to calculate the FVROR. Company witness Grant maintains that the Staff FVROR recommendation to apply a zero percent return to the Fair Value Increment amounts to a "backing in" method of assigning a FVROR.[123] This is incorrect. The Staff recommendation specifically recognizes the value of the FVRB increment and applies the actual cost of this capital (which is zero) to it. As such, Staff specifically recognizes and utilizes the FVRB in establishing rates.

Staff's recommendations are consistent with the Commission's directive on calculating FVROR and should be adopted.

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[122]The *UNSG Inc. Price Stabilization Policy* essentially sets a non-discretionary portion of forecasted gas load (minimum 45 percent) to be hedged with fixed price instruments at ratable quantities of 1/27th over 27 different months leading up to the physical flow month, excluding August, September and October.

[123] A.R.S. 40-252 is the statutory vehicle to amend or modify a Commission decision after notice and an opportunity to be heard is provided to the affected public service corporation.

VII. OTHER ISSUES.

A. Purchase Gas Adjustor.

1. Requested Change in Interest Rate.

The Company has requested a change in the interest rate to be applied to balances of under and over recovered gas costs under the company's purchased gas adjustor balance. While the Company in its application had proposed the 3-month LIBOR rate plus 1%, Company witness Grant has indicated that the Company would be willing to use the financial commercial paper rate plus 1% spread.[124] Staff witness Robert Gray testified that the Company has not offered a rationale or evidence of a change in circumstance to warrant a different interest rate that what was granted in Decision No. 70011.[125] Staff maintains that the interest rate granted to the PGA balance in Decision No. 70011 is appropriate, and the Company's request should be rejected.

B. Gas Procurement Practices.

Staff made a number of recommendations with respect to the Company's gas procurement practices. Staff witness Rita Beale conducted a prudency review of the gas procurement operations of UNSG, focusing on the period from January 2006 to June 2008. Ms. Beale provided nine findings and ten recommendations.[126] Company witness David Hutchens testified that the Company accepted the recommendations.[127] The ten recommendations are:

(1) UNSG should conduct a thorough analysis of excess interstate pipeline capacity that could be currently optimized through Asset Management Arrangements ("AMA").

(2) If excess pipeline capacity is available, UNSG should have Tucson Electric Power ("TEP") seek potential counterparties on UNSG' behalf, at least annually, to optimize all of its excess capacity on both Transwestern and also on the El Paso Pipeline, although not at the expense of incurring a net increase in El Paso charges and penalties.

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[124] Grant direct at
[125] Gray direct at 6-7
[126] Ex S-6 (Beale Direct) at
[127] TR 48:9-14

(3) UNSG should be required to supplement the information filed monthly to the Commission to tie out and support all entries of the Purchased Gas Adjustor Bank Balance, and specifically to include the *UNSG Core Market/ System Supply Imbalance Report,* which finalizes tie-out of the commodity balances by pipeline.

(4) To ensure accuracy of the PGA filings, personnel from the Energy Settlements and Billing Department should receive additional training in the operating practices and terminology used by the TEP Wholesale Department for gas procurement.

(5) The *UNSG Inc. Price Stabilization Policy* should be changed to require consideration of purchases during the three excluded months of August, September and October. Automatically excluding these months created missed opportunities to buy lower-priced gas during 2006, 2007 and 2008.

(6) To increase its hedge documentation, UNSG should create a record indicating the months that management decides to deviate from a ratable purchasing pattern,[128] even if it as simple as using a checklist denoting 'management decided not to hedge'.

(7) The *UNSG Inc. Price Stabilization Policy* should also be amended for any changes to gas purchasing strategy changes effective September 2008, when TEP took over gas procurement.

(8) The *UNSG Inc. Price Stabilization Policy* must be updated at least annually to reflect current practices and procedures.

(9) All parties involved with gas procurement should acknowledge the *UNSG Inc. Price Stabilization Policy* by signing annually, including Gas Scheduling, Transportation Contracts, Risk Management, and Risk Control; not just the traders.

(10) A single person should be assigned as the 'policy owner' of the *UNSG Inc. Price Stabilization Policy* to ensure, on an annual basis, that the policy is accurate before it is approved by the Corporate Risk Management Committee.

[128] The *UNSG Inc. Price Stabilization Policy* essentially sets a non-discretionary portion of forecasted gas load (minimum 45 percent) to be hedged with fixed price instruments at ratable quantities of 1/27th over 27 different months leading up to the physical flow month, excluding August, September and October.

C. Resolution of Company Request in Docket No. G-04204A-08-0050.

The Company has requested that its request for waivers filed in Docket No. G-04204A-08-0051 be approved in this docket. On January 25, 2008, in Docket No.G-04204A-08-0051, the Company filed a request for a waiver of certain requirements that had been placed upon the company in Decision No. 66028. Those requirements were to refrain from the use of contract personnel for the performance of operation and maintenance functions and to independently inspect all new construction work performed by contractor personnel regarding the installation of new service lines and mains. Staff, in a filing made February 14, 2008, recommended approval. Staff witness Corky Hanson testified that Staff's position has not changed. While Staff is not opposed to the waiver, this is not the proper docket to issue a decision. Company witness David Hutchens testified that the Company did not seek to consolidate the two dockets nor did it file a request pursuant to A.R.S. § 40-252.[129] Staff would recommend against approval of the requested waiver in this docket.

VIII. CONCLUSION.

The Commission should adopt Staff's recommendations in this case as contained in its testimony and herein. Staff's recommendations result in just and reasonable rates for the Company.

RESPECTFULLY SUBMITTED this 18th day of September, 2009.

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[129] ARS 40-252 is the statutory vehicle to amend or modify a Commission decision after notice and an opportunity to be heard is provided to the affected public service corporation.

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