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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

Arizona Corporation Commission
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REPLY BRIEF
OF UNS GAS, INC.

SEPTEMBER 30, 2009

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UNS Gas, Inc. ("UNS Gas" or "Company"), through undersigned counsel, hereby submits its Reply Brief in support of its requested relief in Docket G-04204A-08-0571. In support hereof, UNS Gas states as follows:

I. INTRODUCTION.

A review of the parties' initial post-hearing briefs reveals that there is clear and convincing evidence in the record in support of UNS Gas' requested rate increase.

It is undisputed that since the Company's last test year (2005), UNS Gas prudently invested more than $50 million to provide its customers with safe and reliable service. It is undisputed that UNS Gas is not currently recovering or earning a return on any of that investment. It is undisputed that UNS Gas faces tight debt and credit markets. In light of these facts, it is important that UNS Gas maintain its financial integrity and that it have sufficient revenue to meet the needs of its customers and attract capital at reasonable cost and terms. The evidence in the record establishes that UNS Gas' requested rate increase of approximately $9.5 million is just, reasonable and in the best interest of its customers.

As fully explained in the Company's Initial Post-Hearing Brief, UNS Gas took affirmative steps to minimize the amount of its requested rate increase. In recognition of the current economic climate, UNS Gas has moved forward to mitigate the impact of the requested rate increase. The Company has accelerated the filing of its Purchased Gas Adjustor Credit Application. Although the application would not be normally filed until late January 2010, the Company submitted it on September 22, 2009 and requested that an eight cent per therm credit be approved, effective November 1, 2009 through October 31, 2010. (See ACC Docket No. G-04204A-09-0459). Thus, if the Commission were to grant both the Company's requested rate increase and the PGA credit application, UNS Gas' customers would experience a significant decrease in their monthly bills.

This Reply Brief further solidifies the record in support of the Company's requested rate increase. Herein, UNS Gas responds further to the arguments of Staff and RUCO that would attempt to undermine the Company's rate request, and consequently, financial integrity. When the

evidence in the record is reviewed and its sufficiency weighed, it is clear that UNS Gas' requested rate increase is just and reasonable and should be granted.

II. RATE BASE.

A. Post-Test Year Plant.

1. Response to Staff.

In UNS Gas' last rate order (Decision No. 70011), the Commission denied UNS Gas' request for post-test year plant, noting that UNS Gas made no attempt to limit its request to revenue-neutral plant. UNS Gas took this criticism to heart, and in this case UNS Gas limited its request to revenue-neutral plant. In response, Staff contends that Decision No. 70011 "did not give instructions to UNSG on how to more favorably position" its request for post-test year plant.[1] It is true that the Commission did not give UNS Gas specific directions. UNS Gas has simply noted that it addressed the specific criticism that the Commission raised in Decision No. 70011.

Staff also claims that none of the post-test year plant was "associated with the test year."[2] But UNS Gas made all of these investments during the test year.[3] This plant is certainly "associated with the test year." The only aspect of this plant that is outside the test year is its in-service date. UNS Gas invested in this plant during the test year, to serve customers that existed during the test year. This plant is prudent, used and useful and should be included in rate base.

Staff also points to two Commission decisions approving post-test year plant. Staff contends that these decisions (*Chaparral City* and *Bella Vista*) limit post-test year plant to one year. But those decisions did not establish a fixed cut-off point for post-test year plant. Indeed, Staff admits that the Commission reviews "post-test year plant on a case-by-case basis".[4] Thus, there is no fixed cut-off.

Although Staff did not argue for a fixed cut-off point of one year in its pre-filed testimony or at the hearing, UNS Gas did provide evidence related to the in-service dates of the requested

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[1] Staff Br. at 3:12-13.
[2] Staff Br. at 3:3.
[3] Ex. UNSG-16 (Dukes Direct) at 11.
[4] Staff Br. at 4:8-9.

post-test year plant. All of UNS Gas' requested post-test year plant was placed into service within one year of the test year.[5] Thus, even applying Staff's belated "one-year" test, all $1,527,588 of requested post-test year plant should be included in rate base.

Staff further argues that the Commission only approves post-test year plant in "special and unusual" circumstances. Staff does not cite any Commission decisions establishing such a rule. Indeed, as noted in UNS Gas' initial brief, the Commission has expressly rejected such stringent standards in the past.[6] Instead of citing a Commission decision, Staff claims the rule was established in the testimony of Dr. Fish, but then cites a docket from eight years ago.[7] Whatever the source of Staff's asserted rule, it is not Commission decisions. Further, Staff's position is inconsistent with the Commission's discussion in Decision No. 70011. By addressing the issue and specifically tailoring its comments regarding UNS Gas' request for post-test year plant, the Commission indicated that it will consider non-revenue producing post-test year plant without requiring a finding of "special and unusual" circumstances.

Staff next claims that "Staff has traditionally recognized two scenarios" where post-test year plant can be approved.[8] Of course, it is the Commission – not Staff – that determines when post-test year plant is approved. Moreover, Staff attempts to prove this "tradition" by citing Dr. Fish, who has only recently begun testifying in Arizona after an absence of more than 20 years. Staff does not cite its own prior positions, and there is no evidence in the record that Staff has consistently followed the test it touts.

As demonstrated in UNS Gas' initial brief, UNS Gas' financial performance significantly lags behind other gas utilities.[9] UNS Gas is simply not in a position to make this substantial investment in the test year, and then wait multiple years to begin earning a return. UNS Gas made this investment of over $1.5 million in the test year, which ended 15 months ago. Ratepayers have

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[5] Ex. UNSG-42 (UNSG Response to RUCO DR 1.88); See Tr. (Dukes) at 309-310 (all plant in service as of the hearing), 916-918.
[6] See UNS Gas Br. at 6.
[7] Staff Br. at 4:20-21 and fn. 15.
[8] Staff Br. at 4:21-5:3.
[9] UNS Gas Br. at 27-28 and 34-36.

already had the use of this plant for some time. Rates from a new rate case would likely not take effect for two years or more from now – more than three years from when this investment was made. UNS is not in a financial position to forego a return for such an extended period of time.

Staff suggests that such an extended delay for any return on an investment of more than $1.5 million would not "be detrimental to the Company's financial health" because it is made up of numerous smaller projects, rather than one large one.[10] But it is the amount of the investment, not the number of projects, that determines the impact on the utility. While $1.5 million may be a rounding error for some utilities, it is a very big investment for a small gas utility like UNS Gas.

2. Response to RUCO.

On brief, RUCO asserts that the post-test year plant "would appear to support growth."[11] But RUCO does not provide any examples or support for its assertion. Further, UNS Gas specifically selected plant intended to serve existing customers.[12] RUCO's point seems to be that the plant may have some incidental or indirect benefit to new customers. But that is true of any post-test year plant. New customers are not isolated from the rest of the system; and UNS Gas is not required to prove that none of the gas to serve them ever goes through the post-test year plant. Rather, UNS Gas has shown that the post-test year plant was intended to serve existing customers, and that it would have made these investments even without growth.[13]

RUCO next speculates that the post-test year plant could result in some reduction in expenses, thus potentially creating a mismatch. As an example, RUCO points to a replacement of a section of gas main.[14] But RUCO does not explain how expenses related to a buried gas main would decrease. In fact, Staff agrees that UNS Gas should not reduce its leak surveys (and implicitly the costs associated with those inspections) due to the installation of new mains.[15] RUCO has not demonstrated a reduction in expenses -- but even if they did, any expense reduction

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[10] Staff Br. at 5:4-5.
[11] RUCO Br. at 4.
[12] Ex. UNSG-17 (Dukes Rebuttal) at 4-5.
[13] Ex. UNSG-17 (Dukes Rebuttal) at 5.
[14] RUCO Br. at 5.
[15] Tr. (Fish) at 591.

would not be material, and the Commission has emphasized that it is only interested in material changes to expenses when evaluating post-test year plant.[16]

RUCO also suggests that the post-test year plant may not be revenue-neutral. But RUCO's suggestion is merely speculation, not backed by any data. Even Staff's witness Dr. Fish conceded that "I have no reason to say that it isn't nonrevenue producing."[17] And even if there were some impact on revenue, RUCO has not shown that impact is material.

RUCO further argues that UNS Gas' test year investment in plant placed in service after the test year should be denied because UNS Gas is not a water company. However, there is no reason that post-test year plant should be limited to water companies. RUCO suggests that water companies are more capital-intensive. But UNS Gas' operations are similarly capital intensive, as shown by the large investments UNS Gas has made in these systems after they were acquired from Citizens Utilities. As a result of the substantial investments it has had to make, and the delays in recovery, UNS Gas has had financial results significantly worse than most gas utilities in the sample group.[18] These funds were spent during the test year to serve customers that existed during the test year. They should be included in rate base.

B. Advances.

1. Response to Staff.

UNS Gas has emphasized throughout this case that it only seeks a return on investments it has made, not on customer advances. UNS Gas has shown that Staff's approach actually reduces the pre-existing value of the rate base.[19] Staff's witness, Dr. Fish, concedes this, testifying that there is "actually… a reduction" even though the economic value of UNS Gas' investment remains the same.[20] This reduction is caused by an artificial timing difference in how advances are recorded. On brief, Staff makes no attempt to justify this timing difference or the mismatch it creates. Instead, Staff simply ignores the issue, and incorrectly asserts that UNS Gas wants to

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[16] See UNS Gas Br. at 6:1-8, citing Decisions Nos. 65350, 67279, and 68176.
[17] Tr. (Fish) at 628.
[18] Ex. UNSG-13 (Grant Direct) at 5.
[19] See UNS Gas Br. at 7-8.
[20] Tr. (Fish) at 593-594.

"include customer advances… into rate base."[21] UNS Gas has made no such request, and it only seeks to earn a return on investments it has already made – as Dr. Fish's testimony shows.

Staff argues that UNS Gas has not offered a "compelling reason" to support its proposal. But Staff's timing difference arbitrarily reduces UNS Gas' rate base by reducing the pre-existing value of rate base. Thus, Staff's approach does not accurately reflect the fair value of UNS Gas' properties devoted to public service, as required by the Arizona Constitution. UNS Gas submits that fairness and compliance with the Arizona Constitution are compelling reasons.

Staff also takes issue with UNS Gas' citation to Decision No. 69914 in support of cutting pre-existing value out of rate base. Staff contends that "the Commission, in that decision, accorded special treatment to hook-up fees, allowing them to be treated as contributions."[22] But this is not special treatment – hook up fees are always treated as contributions. In Decision No. 69914, the Commission was faced with a timing difference – just as in this case. In that case, Arizona-American proposed collecting hook-up fees to fund a new surface water treatment plant. The plant would take some time to construct. If the hook-up fees (as contributions) were immediately deducted from rate base, Arizona-American's pre-existing rate base would be reduced until the treatment plant was placed in service and included in rate base. The Commission recognized that such a timing difference was inequitable, and allowed Arizona-American to not deduct the contributions from rate base until the related plant was in service.[23] That is exactly what UNS Gas seeks here.

2. Response to RUCO.

RUCO's brief acknowledges the existence of a timing difference. RUCO argues that the timing difference is justified because UNS Gas "has the use of non-investor supplied capital from the moment it gets the money."[24] Essentially, RUCO is making a working capital argument – that

[21] Staff Br. at 5:10.
[22] Staff Br. at 5:20-21
[23] Decision No. 69914 (September 27, 2008) at 6-7 and 29.
[24] RUCO Br. at 6:19-20.

once UNS Gas receives an advance, it can use those funds for other things because the funds are not "in an escrow account."[25]

This is a legitimate concern – which is why UNS Gas limited its request to exclude only those advances that (i) have been spent by the end of the test year and (ii) were applied toward plant not yet placed into service.[26] Once advances are spent on utility plant, UNS Gas no longer has the "use" of those funds. For example, advanced funds spent on a service line cannot be used to meet payroll or to pay any other costs. Thus, RUCO's working capital-based approach misses the mark.

RUCO also points to the Allowance for Funds Used During Construction ("AFUDC"), suggesting that AFUDC accruals are inconsistent with UNS Gas' proposal. But, as the name implies, AFUDC accrues only during the construction process. AFUDC accruals cease as soon as the newly constructed plant is placed into service. As UNS Gas's witness Mr. Dukes explained, AFUDC accruals on plant constructed with customer advances are insignificant and do not come close to compensating UNS Gas for taking pre-existing plant out of rate base.[27]

C. Working Capital.

In its initial post-hearing brief, UNS Gas pointed out that during the test year, the Company agreed to change its payment terms with its sole gas supplier British Petroleum ("BP") in order to continue receiving natural gas and to avoid the higher costs of posting cash collateral or obtaining letters of credit. These modified payment terms required payments twice a month instead of once a month.[28] UNS Gas also showed that (1) these terms continued after the test year; (2) these were the best terms that could be obtained from BP; (3) all other options were more expensive; (4) these costs were incurred to serve customers and are part of the cost of service. On brief, Staff disputes none of these points. Staff simply states that "ratepayers should not be saddled with additional costs associated with unusual payment terms."[29] However, from an

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[25] RUCO Br. at 6:21.
[26] Ex. UNSG-18 (Dukes Rejoinder) at 5.
[27] Ex. UNSG-18 (Dukes Rejoinder) at 6; Tr. (Dukes) at 314-315.
[28] UNS Gas Br. at 9-10.
[29] Staff Br. at 7:1-3.

evidentiary standpoint, Staff does not dispute that these costs were incurred to serve customers. And these terms were the least-cost option under the circumstances.[30]

Staff seems to be suggesting that UNS Gas should have chosen a more expensive approach. However, Staff's gas procurement expert, Ms. Rita Beale, closely scrutinized UNS Gas' gas procurement practices, and made numerous detailed recommendations for improvements. Ms. Beale made no recommendations for changes to the payment schedule to BP.

RUCO contends that the change in payment terms was "made subsequent to the test year."[31] RUCO cites Mr. Duke's rebuttal testimony in support of this claim, but Mr. Dukes makes no such claim. In fact, on that page, Mr. Dukes specifically testifies that the "Company's payment terms were altered during the test year because of credit limitations… those payment requirements continue today and for the foreseeable future."[32] Staff's witness Dr. Fish agrees, testifying that the change occurred during the test year and continued thereafter.[33]

RUCO next points to various alternatives UNS Gas had. RUCO complains that UNS Gas "failed to provide any cost-benefit analysis." But UNS Gas' witness, Mr. Grant, testified that UNS Gas explored all the options and the twice-a-month payment schedule was the lowest cost option.[34] RUCO's brief cites to no contrary testimony, nor does RUCO provide any citation to support its erroneous claim that the revised payment terms "may have been the greatest cost option."[35]

D. Prepayments.

RUCO argues for a reduction to rate base for prepayments. RUCO did <u>not</u> include this issue in the joint issues matrix prepared by the parties and accordingly UNS Gas did not address this issue at hearing. RUCO's belated attempt to raise this issue should be rejected. Moreover, if

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[30] Ex. UNSG-15 (Grant Rejoinder) at 4-5.
[31] RUCO Br. at 8:11-12.
[32] Ex. UNSG-17 (Dukes Rebuttal) at 8.
[33] Tr. (Fish) at 597-598.
[34] Ex. UNSG-15 (Grant Rejoinder) at 4-5.
[35] RUCO Br. at 9:3.

UNS Gas had the chance to introduce testimony on this point, it would have offered testimony showing that its approach was the same approach approved in Decision No. 70011.

E. Customer Deposits.

On brief, RUCO argues for adjustment to customer deposits. However, RUCO did not include this issue in the joint issues matrix prepared by the parties. Again, RUCO's belated attempt to raise additional issues should be rejected. Moreover, UNS Gas used the test year-end balance for customer deposits,[36] and "RUCO recommends that a year-end balance be used for Customer Deposits."[37] Thus, RUCO and UNS Gas are in agreement. RUCO's position seems to be that if it loses various other issues, then (and only then) RUCO's alternative 13 month average approach should be used. The test year-end balance approach is consistent with standard ratemaking practice, which is why it was used by UNS Gas, Staff and RUCO. Moreover, Arizona courts have criticized the test year average approach to rate base.[38]

III. REVENUE.

A. Customer Annualization.

Staff's brief provides only a few words in support of its unprecedented customer annualization proposal. Staff claims that UNS Gas witness Bentley Erdwurm proposed the use of December 2007 values as a starting point. But Staff provides no citation for this claim. Moreover, Staff's witness Dr. Fish adjusted the December 2007 customer count to a level not seen before, during, or after the test year. UNS Gas has yet to approach the inflated level proposed by Dr. Fish.

Staff argues that its inflated level is justified by a 2.5% growth rate reported by UNS Gas. Staff takes the 2.5% figure radically out of context. As UNS Gas witness Mr. Hutchens explained, the 2.5% was a projected 10-year average growth rate.[39] It was not intended as a short-term

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[36] RUCO Br. at 9:22.

[37] RUCO Br. at 10:4-5.

[38] *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 202, 335 P.2d 412, 414 (1959)(noting that rate base must be determined "at the time of inquiry, or as near as possible thereto", rather than using test year average rate base.)

[39] Ex. UNSG-7 (Hutchens Rejoinder) at 3.

estimate of growth, and it has nothing to do with the test-year itself. Moreover, recent estimates of growth are much lower.[40]

Staff witness Dr. Fish has never testified on residential customer annualization before.[41] And until this case, Dr. Fish has not participated in an Arizona rate case in over 20 years.[42] In contrast, UNS Gas' witness, Mr. Erdwurm has 27 years of experience in customer annualization, starting with the Public Utility Commission of Texas.[43] Mr. Erdwurm has testified in Arizona for many years.[44] Mr. Erdwurm has used the Commission's traditional method in countless cases since 1982.[45] In all these years of experience, Mr. Erdwurm has never seen the radical, untested method proposed by Dr. Fish.[46]

RUCO does not support Dr. Fish's unorthodox proposal. RUCO unfortunately also rejects the traditional customer annualization method approved in Decision No. 70011, and simply makes no adjustment at all. RUCO argues that the traditional method should be rejected because it produces a "counterintuitive" result.[47] But in Decision No. 70011, the Commission was fully aware of the possibility of a counterintuitive result – indeed it used that very word in the quote from Decision No. 70011 cited by RUCO in its initial post-hearing brief.[48]

RUCO has not shown any change of circumstance to justify rejecting the traditional method re-affirmed by Decision No. 70011. Now that the "shoe is on the other foot", RUCO suddenly opposes the same traditional approach it so passionately supported in UNS Gas' last rate case. The Commission should follow a consistent approach, rather than RUCO's "heads I win, tails you lose" approach.

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[40] Ex. UNSG-7 (Hutchens Rejoinder) at 3-4.
[41] Tr. (Fish) at 602.
[42] Tr. (Fish) at 581.
[43] Ex. UNSG-22 (Erdwurm Rejoinder) at 2.
[44] Ex. UNSG-20 (Erdwurm Direct) at 1.
[45] Ex. UNSG-22 (Erdwurm Rejoinder) at 2.
[46] Tr. (Erdwurm) at 412.
[47] RUCO Br. at 13.
[48] RUCO Br. at 12:10-13, quoting Decision No. 70011 at 18.

B. Weather Normalization.

Staff raises weather normalization in its brief, but the difference is entirely a result of the differences in customer annualization.

IV. EXPENSES.

A. Call Center Expense.

Staff has proposed a partial disallowance of the Call Center expense even though Staff does not contest the total test year Call Center cost. [49] Staff's position appears to continue to rest on a single factor – reduced service calls. However, it is undisputed in the record that: (i) handling service calls are just one of numerous functions of the Call Center,[50] (ii) the Call Center has seen UNS Gas' call volume and call duration grow by approximately 150% over the 2005 levels and; (iii) the overall annual operating cost of the Call Center has increased 22% from 2005 to 2008.[51] Moreover, contrary to Staff's unsupported assertion that the are no benefits to the increased expense level, since the last rate case customers have benefitted from the increased Call Center costs through the implementation of such elements as an improved billing system, credit card processing and on-line bill presentment.[52] Finally, the Company has not made any "threats" as asserted by Staff. It has simply requested recovery of its undisputed test-year Call Center expense.

UNS Gas' test-year Call Center expense is reasonable and should be adopted without the adjustment proposed by Staff.

B. Outside Legal Expense.

Staff did not address UNS Gas' Outside Legal Expense in its initial post-hearing brief and has waived any challenge to the expense.

Although RUCO agrees that normalizing the Outside Legal expense is appropriate, RUCO disagrees with the Company's use of historic levels of outside legal expenses. However, the Company's historic outside legal expenses reflect FERC litigation that is very similar to what the

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[49] Tr. (Fish) at 621; Ex. UNSG-24 (Staff Response to UNSG 3.41).
[50] Ex. UNSG-17 (Dukes Rebuttal) at 22, 24.
[51] Ex. UNSG-17 (Dukes Rebuttal) at 22.
[52] Ex. UNSG-17 (Dukes Rebuttal) at 23-25.

Company will face when the new rates from this case go into effect. It is undisputed that UNS Gas will be participating in at least two significant FERC rate cases (involving El Paso Natural Gas and TransWestern).[53] These cases clearly benefit the UNS Gas customers.[54] RUCO appears to be picking and choosing among historic and estimated legal expenses in arriving at its adjustment. However, RUCO's position is not reflective of historical averages or realistic anticipated future costs. UNS Gas believes the historical average is still a better indicator of on-going expense given the known FERC activity over the next few years.

The Company's Legal Expense adjustment of $305,984 is reasonable, supported by the record and should be adopted.

C. Fleet Fuel Expense.

Staff did not address UNS Gas' Fleet Fuel expense in its Initial Brief and has waived any challenge to the expense.

RUCO has proposed a slightly different normalization methodology than the normalization proposed by the Company. UNS Gas believes that the Company's approach is more appropriate because it does not use forecasted fuel prices, whereas RUCO tries to predict future fuel prices and apply those prices to historic fuel usage.

The Company's Fleet Fuel Expense adjustment of ($51,285) is a reasonable approach to normalize Fleet Fuel expenses and mitigate the volatility of fuel prices.

D. Rate Case Expense.

RUCO disagrees with Staff's proposed rate case expense of $141,667.[55] RUCO primarily relies on the recent Southwest Gas rate cases to support its rate case expense position. However, the record does not support the application of the Southwest Gas rate case expense to UNS Gas. RUCO does not address the fact that Southwest Gas rate cases are conducted entirely by in-house personnel, which is not the case for UNS Gas. Moreover, this case involved 507 data requests

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[53] Ex. UNSG-17 (Dukes Rebuttal) at 27-28

[54] Tr. (Gray) at 521-523.

[55] 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.

(944 including subparts) and required five hearing days over the course of two weeks. Despite UNS Gas' efforts to simplify the issues, this was not a "cheap" rate case.

Staff's proposed Rate Case Expense is reasonable and should be adopted.

E. Payroll Expense and Payroll Tax Expense.

RUCO opposes the Company's adjustment for these two items, arguing that the 2010 payroll increase is not known and measurable and that it is too attenuated from the test year. However, the payroll increase is known and measurable. Moreover, the payroll increase is only applied to the employee levels in the test year[56] and goes into effect at approximately the same time as the new rates will go into effect. Finally, RUCO's assertion that the Company should forgo the 2010 payroll increase ignores the fact that a large portion of the payroll increase results from the existing union contract.[57]

UNS Gas' Payroll and Payroll Tax adjustments are reasonable, reflect the Company's known payroll costs when the new rates go into effect, are consistent with the prior UNS Gas rate case and should be adopted.

F. AGA Dues.

RUCO proposes reducing the AGA Dues expense by 40% as opposed to the 4% reduction proposed by Staff and the Company. Although RUCO's proposal is contrary to the prior UNS Gas rate order, RUCO argues that UNS Gas has not provided evidence of the benefits realized by customers from the AGA activities and that the Commission should follow the Southwest Gas rate order, Decision No. 70665. However, the Company provided substantial evidence of those benefits.[58] RUCO provided no evidence to the contrary.

The AGA Dues expense proposed by Staff and the Company is reasonable and should be adopted.

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[56] Ex. UNSG-17 (Dukes Rebuttal) at 10.
[57] See Ex. UNSG-17 (Dukes Rebuttal) at 10.
[58] Ex. UNSG-8 (G. Smith Direct) at 10-13.

G. Property Tax Expense.

RUCO agrees that an adjustment was necessary, but proposes using a different assessment rate than used by the Company and Staff. 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.[59] Staff did not dispute the adjustment. The Company's proposal is consistent with the prior UNS Gas rate order on the issue.

RUCO's use of a 2010 assessment ratio reaches too far into the future and fails to consider other likely changes to property taxes in 2010. For example, RUCO assumes that future property tax rates will remain constant even as the assessment ratio drops. RUCO's assumption is not backed by any evidence. To the contrary, the Arizona Governor recently vetoed the legislature's bill to permanently end the long-dormant state-wide property tax.[60] UNS Gas will be subject to this additional tax. UNS Gas expects increased property tax expense in 2010 for this reason. RUCO's attempt to look only at the 2010 assessment ratio while ignoring the other changes in 2010 will create a mismatch and an unrealistic property tax allowance. UNS Gas' property tax expense of $1,354,074 is reasonable and should be adopted.

H. Bad Debt Expense.

Staff proposes an adjustment to the Bad Debt Expense due to its belief that the Company is over-accruing doubtful accounts. However, 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.[61] Moreover, bad debt expense is the accrual-based expense to match expected net write-offs with revenue as it is recorded.[62] 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

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[59] Ex. UNSG-11 (Kissinger Direct) at 8.

[60] See "Brewer Restores School Cuts, Axes Tax Repeal," The Arizona Republic, Sept. 5, 2009; "Gov. Brewer Nixes Equalization Tax Repeal," Phoenix Business Journal, Sept. 4, 2009.

[61] Ex. UNSG-17 (Dukes Rebuttal) at 25.

[62] Ex. UNSG-17 (Dukes Rebuttal) at 26.

relationship to apply to pro forma retail revenue to calculate pro forma bad debt expense.[63] That smoothes out expenses for a particular period that may be unusual, as was the case here. Indeed, the Company's proposed Bad Debt expense adjustment of $63,211 was prepared and calculated in the same manner as was approved by the Commission in Decision No. 70011[64] and should be adopted here.

I. Incentive Compensation.

Both Staff and RUCO argue that only 50% of the Company's Performance Enhancement Program ("PEP") expense should be allowed in rates, relying primarily on the prior UNS Gas rate order. 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 was issued after post-hearing briefing in the prior UNS Gas rate case and 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 do not address Decision No. 69663 even though UNS Gas discussed that decision in its testimony.[65] That Commission Decision supports full recover of UNS Gas' PEP expense.

Moreover, as set forth in detail in UNS Gas' Initial Brief, both Staff and RUCO concede the benefits and importance of incentive-based compensation and do not contest the reasonableness of the overall compensation paid. 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). The undisputed record here shows the PEP is a reasonable expense; therefore, the Commission should allow full recovery of the PEP expense.

J. Stock-Based Compensation.

Only RUCO challenges the Company's Stock-Based Compensation expense. RUCO does not challenge the reasonableness of the expense; rather, it simply relies on the prior UNS Electric rate order. RUCO fails to address the Company's rationale for including the Stock-Based

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[63] Ex. UNSG-17 (Dukes Rebuttal) at 26-27.
[64] Ex. UNSG-16 (Dukes Direct) at 24.
[65] Ex. UNSG-17 (Dukes Rebuttal) at 12.

Compensation Expense, which was set forth in detail in the Company's testimony.[66] Given that the undisputed record shows that the Stock-Based Compensation is a reasonable expense, UNS Gas is entitled to full recovery of that expense.

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

Both Staff and RUCO opposed any recovery for the Company's SERP expense. Neither Staff nor RUCO assert that the expense is improper, unusual in the industry or unreasonable. Indeed, both Staff and RUCO agree that such an expense is not atypical.[67] As such, UNS Gas is entitled to recover that reasonable expense.

V. RETURN ON EQUITY.

A. Response to Staff.

Staff's brief only addresses Staff's ROE recommendation. Staff does not make any attempt to criticize or even respond to UNS Gas' recommendations, leaving UNS Gas with little to respond to in this brief. For example, Staff failed to address Mr. Grant's testimony that UNS Gas is more risky than the sample groups of gas companies used by Staff and UNS Gas.[68] As shown at length in UNS Gas' initial brief, UNS Gas remains far more risky than the sample group of utilities.[69] Staff's most recent data shows that gas utilities have an average allowed ROE of 10.37%.[70] Because UNS Gas is riskier, it should have a higher ROE. Moreover, Staff (and RUCO) have agreed to an 11% ROE for APS, yet UNS Gas is far smaller and is not paying a dividend.

Staff suggests that because UNS Gas' credit rating and equity ratio have increased, its ROE should not be increased. While UNS Gas has made substantial improvement, it remains far riskier than comparable utilities. And UNS Gas' improvement would not have occurred without strong backing from UNS Gas' management and board, who improved the capital structure by not

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[66] Ex. UNSG-17 (Dukes Rebuttal) at 17.
[67] Ex. UNSG-24 (Staff Response to UNSG 3.57); Ex. UNSG-41 (RUCO Response to UNSG 3.22).
[68] Ex. UNSG-13 (Grant Direct) at 24-27.
[69] See UNS Gas Br. at 27-29.
[70] See Ex. S-1 (Regulatory Focus), under "Gas Utilities" and "2008".

taking any dividends and by injecting $16 million of additional equity capital into UNS Gas.[71] These improvements will help the Company to save money on its borrowing costs which are ultimately passed on to UNS Gas' customers. If Staff's recommendation is adopted, it will effectively penalize UNS Gas' investors for the prudent and disciplined actions taken by UNS Gas' board and management.

Staff extols its single-stage or "constant growth" version of the DCF model. But as noted in UNS Gas' brief, the Commission has criticized the assumption that investors expect constant growth.[72] For this reason, the Commission has frequently used the more realistic multi-stage version of the DCF.

Staff also relies on a comparable earnings analysis. Staff's witness, Mr. Parcell, reports that comparable gas utilities earn between 11% and 12%.[73] That result supports UNS Gas' recommendation, not Staff's. Thus, Mr. Parcell "adjusts" his results down, claiming that the sample utilities are simply earning too much. In technical terms, Mr. Parcell refers to "market to book ratios." But UNS Gas does not compete for capital with Mr. Parcell's hypothetical adjusted utilities; it must compete in the real world with gas utilities that earn real returns between 11% and 12%.

Finally, Staff contends that the recent economic turbulence has not increased the cost of capital. First, Staff argues that customers have little control over their use, so UNS Gas faces little risk. But UNS Gas' sales have, in fact, dropped significantly.[74] Moreover, the Commission's strong support for demand side management (DSM) programs implies that customers can, in fact, adjust their usage. Second, Staff argues that the federal government actions are "clearly designed to lower the cost of capital."[75] However, the impact of the Government's effort is speculative at best, particularly for corporate borrowers such as UNS Gas. Regardless, the fact that the federal

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[71] Ex. UNSG-13 (Grant Direct) at 4.
[72] See UNS Gas Br. at 32-33.
[73] Ex. S-14 (Parcell Direct) at Schedule 10, Page 1, Average and Median ROEs for Grant Comparable Company Group.
[74] Tr. (Grant) at 207.
[75] Staff Br. at 15.

government has had to intervene so dramatically in the financial markets serves to underscore the severe extent to which the cost of capital has increased since September 2008.

B. Response to RUCO.

RUCO's proposed ROE is far outside any reasonable range of ROEs approved by this Commission for investor-owned gas and electric utilities. RUCO argues that the Commission should lower the ROE to reflect the economy. While RUCO's candor is commendable, its approach is not. The present economic difficulties have clearly increased the cost of capital, not decreased it. UNS Gas did not seek to benefit from this economic turmoil; instead it used data from before September 2008 in its cost of capital analysis. It did so because it believed that economic conditions were highly abnormal and would return to more normal levels by the time rates go into effect. That level-headed approach is preferable to overreacting to an economic cycle that will pass. While UNS Gas has not sought to increase its cost of capital beyond the level requested in its application, certainly those costs have not dropped during the economic crisis. There is no evidence of such a drop. RUCO seems to suggest simply ignoring the evidence; the Commission should reject such an approach.

Like Staff, RUCO argues for the use of only a single-stage version of the DCF. RUCO relies exclusively on "5-year growth projections."[76] Such analyst projections are notoriously inaccurate. Still, they are probably the best that can be done for estimating short-term growth. But there is no reason to project those short-term growth projections into infinity. That is why UNS Gas used stable, consistent historical data on long-term growth to estimate future long-term growth in its multi-stage DCF. And that is why the Commission has used the multi-stage DCF in so many cases.

RUCO also suggests that UNS Gas' data was too old.[77] UNS Gas made a conscious choice not to use suspect data from the financial crisis. Staff's witness, Mr. Parcell, also recognized the problem, giving little weight to his CAPM analysis based on crisis-era data. RUCO argues that its

[76] RUCO Br. at 27:4.
[77] RUCO Br. at 27:21 to 28:4.

CAPM model, using inputs from the crisis, should be used. RUCO concedes "there is a certain sense of logic to Mr. Parcell's dismissal of the CAPM now, it begs the question what is a normal economy."[78] While UNS Gas will not attempt to define normal, certainly a financial crisis widely described as the worst since the Great Depression is not normal.

VI. FINANCIAL INTEGRITY.

Staff's and RUCO's briefs have little to say about UNS Gas' financial integrity. Staff and RUCO both note that UNS Gas has achieved a Baa3 rating (the lowest investment grade rating). But Staff and RUCO offer no assurances in their briefs that UNS Gas will be able to maintain that rating under their proposed rates. Indeed, they make no projections at all as to what UNS Gas' actual financial results will be under their recommendations. Yet debt and equity investors pay close attention to actual reported financial results. And maintaining UNS Gas' credit rating is critical because UNS Gas has $50 million in notes maturing in August 2011.[79] UNS Gas' revolving credit facility matures at the same time. A lower credit rating means higher interest rates. Failing to consider financial integrity would be the proverbial "penny wise, pound foolish" approach.

VII. FAIR VALUE.

A. Response to Staff.

Staff, in its initial post-hearing brief, does not discuss UNS Gas' fair value proposal at all. That is odd because UNS Gas' proposal is based on the Commission's own approach in the "Chaparral City remand" case. If Staff has concerns or objections to the Commission's approach in that case, they have not shared them in their brief. UNS Gas cannot respond to non-existent criticism.

In addition, it is difficult to respond to Staff's position on this issue because many of Staff's citations have no connection to the statements they are supposed to support. For example, Staff cites the gas procurement testimony of Mr. Gray and Ms. Beale, and UNS Gas' price

[78] RUCO Br. at 29.
[79] Ex. UNSG-19 (Moody's Report); Tr. (Grant) at 231.

stabilization policy.[80] UNS Gas has been unable to discern any connection to fair value in those materials.

Staff repeatedly emphasizes the concept of "investor-supplied capital", for example stating that its proposal "provides for a return on all investor-supplied funds."[81] Staff's focus on investor-supplied funds is called the "prudent investor theory", and it is forbidden by the Arizona Constitution as interpreted by the Arizona Supreme Court.[82]

In other words, Staff advocates determining rates based entirely on original cost, with fair value being simply a meaningless exercise. Staff admits that its position is based on its belief the "fair value increment" has "no financing cost".[83] However, Staff also claims that it "specifically recognizes and utilizes the FVRB in establishing rates."[84] Staff's recognition and utilization is nothing more than a charade. By assigning a return of zero to the fair value increment, the fair value rate base has no impact at all on rates. This method must be rejected as the Commission must use fair value in setting rates.

Staff also describes its alternative fair value recommendation. However, Staff does not address any of the criticism of this alternative recommendation raised in testimony and summarized on page 18 of UNS Gas Initial Post-Hearing Brief. For the reasons cited in that brief, Staff's alternative proposal should also be rejected.

B. Response to RUCO.

RUCO claims its fair value rate of return ("FVROR") is based on a "range" of four methods.[85] RUCO does not explain how it selected its recommendation other than to say it used its "discretion." The Commission should adopt a principled and consistent approach, rather than relying on RUCO's subjective judgment. Moreover, RUCO concedes that its approach provides a

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[80] Staff Br. at 17-18, at footnotes 119, 120, and 122.
[81] Staff Br. at 17.
[82] *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959)(holding that the "Commission cannot be guided by the prudent investment theory"); *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).
[83] Staff Br. at 17.
[84] Staff Br. at 18.
[85] RUCO Br. at 32.

trivial increase in revenue as compared to the original cost revenue requirement. Because RUCO's approach gives no material effect to fair value, it does not comply with the Arizona Constitution's requirement that the Commission use fair value. Moreover, RUCO's position is inconsistent with every recent Commission decision on fair value, especially the "Chaparral City remand" case. Therefore, RUCO's proposal should be rejected.

VIII. RATE DESIGN.

The only rate design issue addressed by Staff and RUCO is the proposal by UNS Gas to phase-in an increase to the monthly customer charge. Both Staff and RUCO assert that the increase of $1.50 to $2.00 per month on an average monthly bill of $60 constitutes "rate shock." However, neither party disputes that: (i) it is appropriate to increase the customer charge so that it covers a larger portion of the fixed cost of service; (ii) cold-weather customers are subsidizing the warm-weather customers; and (iii) the Company's rate design will mitigate that subsidy. With respect to their claims of rate shock, neither party addresses the fact the Company's proposed rate design also includes a reduction in the non-gas volumetric rate. That reduction results in a revenue-neutral impact of the rate design for the average customer. Moreover, even putting aside the revenue neutral volumetric rate reduction and the phased-in approach, the proposed increase in the monthly charge is a relatively small portion of the overall bill. Given that the average customer bill is almost $60,[86] the total proposed monthly charge increase of $5.50 over three years is less than 10%, not the 65% increase claimed by RUCO and Staff. Once the volumetric charge reduction is factored in, the impact is well below 10%. And the phase-in proposal reduces the impact even more.

Staff also asserts that the Company's proposed rate design is decoupling. However, the purpose of the rate design is not to completely decouple volumetric costs from fixed costs of service. Indeed, even at the end of the three-year phase-in period, the fixed monthly charge still covers only a portion of the fixed costs for service. For example, for residential service, the monthly charge will reach $14.00 at the end of the phase-in. However, under the class cost-of-

[86] Tr. (Radigan) at 749.

service study, the "basic" monthly residential customer costs are calculated to be $18.15.[87] The proposed rate design is another step towards better matching of the monthly charge to fixed costs to UNS Gas and its customers, which was started in the prior UNS Gas rate case.[88]

Staff also appears to misunderstand the impact of the parallel revenue-neutral volumetric rate reduction. Staff asserts that "in order for a customer to reduce the impact of the proposed customer charge, a customer would have to reduce usage by 25%."[89] That is incorrect and the cited portion of the transcript does not support the assertion. Rather, under the Company's proposed rate design, the monthly charge increase is offset by the volumetric reduction if the average customer's usage *stays the same*.[90] The transcript reference discusses the impact on the average residential customer if that customer reduced usage by 25%.[91] There is no need for a "substantial life style change" to realize the revenue-neutral impact of the Company's proposal.

The Company submits that its proposed rate design using small phased-in increases to the monthly customer charge is a reasonable approach to address better matching of rates to fixed costs of service and to mitigate the existing. The Commission should adopt the Company's rate design proposal.

IX. PGA.

Contrary to Staff's assertion, the Company has set forth a clear reason for modifying the interest rate on PGA bank balances – recovery of actual carrying costs of the bank balances.[92] This proposed rate would apply to both over-collected and under-collected balances. Indeed, given the current over-collected bank balance, the Company's proposal would benefit the customers. UNS Gas believes that its proposal is reasonable, comports with the regulatory concept of recovery of actual, prudently-incurred costs and should be adopted by the Commission.

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[87] Ex. UNSG-20 (Erdwurm Direct) at 14.
[88] See Decision No. 70011 at 56.
[89] Staff Br. at 10.
[90] Ex. UNSG-20 (Erdwurm Direct) at 14-15.
[91] Tr. (Erdwurm) at 421-423.
[92] Ex. UNSG-13 (Grant Direct) at 33.

X. LOW INCOME ISSUES.

Neither Staff nor RUCO addressed any low income issues. Ms. Cynthia Zwick did not raise any additional issues in her initial post-hearing brief beyond those set for in her Direct Testimony. Although the Company has set forth its position on Ms. Zwick's issues in its Initial Post-Hearing Brief, it believes some additional response is necessary on certain issues.

First, with respect to holding CARES customers harmless from increases in the PGA, the Company continues to believe that is not appropriate or in the public interest. If CARES customers will continue to enjoy decreases in the PGA, but not the PGA increases, other customers must step forward to foot the bill for the difference. UNS Gas does not profit from the PGA's operation and UNS Gas is entitled to recover the actual cost of gas provided to customers. The PGA acts simply as a pass-through mechanism to achieve this goal. Even if CARES customers are not subject to any change in the PGA rate, determining a "fixed" PGA rate for CARES would be difficult. CARES customers would also not benefit when gas prices drop. And other customers would still have to cover any difference between the cost of the CARES gas and the CARES commodity revenues.

Second, Ms. Zwick requests that CARES be expanded to apply to all customers at the 200% poverty level. Although the Company is auto-enrolling LIHEAP-qualified customers in its CARES program, expanding eligibility could significantly impact other customers' bills.[93] UNS Gas believes that it is more appropriate to involve all stakeholders in addressing this issue and its impact on all UNS Gas customers, and that this issue could be brought to the Commission in the next UNS Gas rate case.

Third, Ms. Zwick seeks additional outreach for low income programs. The Company believes that the funding levels for its low income outreach programs are appropriate but it remains willing to coordinate with the community action agencies to improve those outreach programs' effectiveness.

[93] See Ex. UNSG-44 (CARES Customer Analysis).

XI. WAIVER REQUEST.

The Company believes that granting the waiver requested in Docket No. G-04204A-08-0050 will reduce expenses, is in the public interest and should be done in this docket. Although Staff agrees that the waiver is appropriate, Staff believes that this is not the proper docket to grant the waiver. Should the Commission agree with Staff's procedural position, the Company requests that the decision in this docket direct that the waiver be timely considered in Docket No. G-04204A-08-0050.

XII. CONCLUSION.

Throughout this case, UNS Gas has presented evidence to support its requested rate increase and to expose the inappropriateness of the positions of those who seek to diminish the rates ultimately ordered by the Commission. UNS Gas' Initial Post-Hearing Brief and this Reply Brief adequately summarize the evidence that fully demonstrates that the Company's requested rate relief should be granted.

RESPECTFULLY SUBMITTED this 5th day of October 2009.

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