UTIL- 16369

E-04204A-09-0206 VOL. V

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BEFORE THE ARIZONA CORPORAT[illegible]

IN THE MATTER OF THE APPLICATION OF UNS ELECTRIC, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS ELECTRIC, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. E-04204A-09-0206

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BE IT REMEMBERED that the above-entitled and numbered matter came on regularly to be heard before the Arizona Corporation Commission, in Hearing Room 1 of said Commission, 1200 West Washington Street, Phoenix, Arizona, commencing at 9:00 a.m. on the 11th of February, 2010.

BEFORE: LYN A. FARMER, Chief Administrative Law Judge

APPEARANCES:

For the Applicant:

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and

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For the Residential Utility Consumer Office:

RUCO
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For the Arizona Corporation Commission Staff:

Ms. Maureen A. Scott and Mr. Wesley C. Van Cleve
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MICHELE E. BALMER
Certified Reporter
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CALJ FARMER: Let's go ahead and go back on the record. Good morning, welcome back to the Commission.

Good morning, Mr. Dukes.

MR. DUKES: Good morning.

CALJ FARMER: Any procedural issues or housekeeping items anybody has before we start?

MR. PATTEN: Your Honor, I do have one. We have marked as Exhibit UNSE-30 several revised rules and regs pages that were docketed on February 9. And these revised pages reflect the recommendations of Mr. Rozen in his surrebuttal. It basically has the itemized issue in for estimates, and it also deleted some hangover language that we meant to take out regarding the facilities charge but for some reason it didn't get taken out.

So if you combine these revised pages with the revised TSM-5 pages, I think we have provided all of the revisions to the rules and regs that comport with our proposals, as modified by Mr. Rozen.

CALJ FARMER: Okay. What was that marked again?

MR. PATTEN: UNSE-30.

CALJ FARMER: 30, okay. Are there any objections to the admission of UNSE-30?

Hearing none, it's admitted.

(Exhibit UNSE-30 was admitted into evidence.)

CALJ FARMER: Okay. Is the company ready to call your next witness?

MR. PATTEN: We are, Your Honor. We would recall Mr. Dallas Dukes.

CALJ FARMER: Mr. Dukes, just remember you're still under oath from your previous testimony.

MR. DUKES: I do.

DALLAS DUKES,

called as a witness on behalf of the Applicant, having been previously duly sworn by the Certified Reporter to speak the truth and nothing but the truth, was examined and testified as follows:

DIRECT EXAMINATION

Q. (BY MR. PATTEN) Good morning, Mr. Dukes.

A. Good morning.

Q. You should have two exhibits in front of you. There is a chart marked as UNSE-31, which is entitled UNS Electric base power supply and PPFAC components comparisons. Do you have that?

A. I do.

Q. And then UNSE-32 is entitled UNS Electric bill impacts. Do you have that?

A. I do as well.

Q. Let's start with UNSE-31. There was some discussion earlier in the hearing about how the PPFAC forward component would change when new rates went into effect and whether or not it would be zeroed out or whether we would sort of let the PPFAC operate.

Do you recall that discussion?

A. I do.

Q. And subsequent to that discussion, did we meet with Commission Staff to discuss the issue?

A. Yes, we did.

Q. And could you -- and did we come up with sort of a proposal on how the relationship between the new base power rate and the PPFAC forward component would be determined?

A. Yes, and we attempted to put together an exhibit here to kind of lay that out.

Q. Can you explain UNSE-31?

A. I'll give it a shot. Column A represents the present rate structure. You can see that the average base power supply rate that's presently built into retail customers' rates is 7.12 cents. Right now, we have a forward component that's about three-tenths of a cent reduction, and we have a true-up component that's almost eight-tenths of a cent as a reduction. So presently, customers are paying both base power supply and PPFAC components at a combined rate of about 6 cents, 6.1 cents, approximately.

The concern that's been raised in the hearing is just understanding exactly how all of these moving parts will work, depending on when the rate order is issued. Just to be complete, we would put information with regards to if the rate order is issued prior to June 1 when the next PPFAC cycle takes place and the new PPFAC rates are set, what we would propose is that essentially we accelerate the PPFAC process, and simultaneously with the rate case we'll reset the PPFAC rate and we'll reset the base rates with this filing, and that's what Column B reflects there. It reflects in this filing presently we have 6.77 average base power supply rate for retail customers. And that's built into all of the rate structures, and that's -- right now, that's not opposed by RUCO or Staff. So those numbers will not move or should not move, I guess.

Q. That's the base power supply rate as opposed to the non-fuel base rate, correct?

A. Correct. And that's all these numbers represent is the PPFAC and the base power supply rates. And as of December, we filed what we believe to be the estimate for next year, the next PPFAC cycle, of what our average system supply costs will be, and that's that 7.11 cents.

And that could change slightly in April.

What we will do in April is we'll file our updated estimates on both the forward components and the true-up components. We anticipate that what we will do is we will file that both in this docket as well as the PPFAC docket, and we will file it with the present base power supply rate, what the rates would be using the present base power supply rate, and we'll file it using what base power supply rates will be set in this, what we assume will be set in this docket as well, so that you have all of the information you need to know which PPFAC forward component should apply.

So prior to June 1, like I said, we're proposing that to the extent, say, rates went -- these rates went into effect May 1, so that the customers would only see one change, they would see the new rates go into effect, the new base power supply be set, and the new PPFAC be set all at the same time. Because otherwise, they would have that change in May, and then June 1st they would see their PPFAC change again with the normal PPFAC process. We were trying to limit the times their bills will change.

Q. Let me just ask you, Mr. Dukes, even though all of the parties agree on the base power supply rate, the proposed forward component is at this point an estimate and Staff still has the opportunity to review and agree with that rate, correct?

A. Yeah. Essentially, what Staff will be reviewing is our estimate of the actual forward costs, that 7.11 cents, and that will drive what the forward component is. But at this time, Staff has not agreed to the numbers themselves, just to the -- they're in agreement with this proposed process.

Q. Okay.

A. So that would be prior to June 1. Now, if the rates set in this case were to happen after June 1, let's just use August as an example, then what we would propose on June 1 is to let the normal PPFAC process take place. The primary reason there would be to get that large true-up component fall off and kind of get rates close to what they should be so we don't, through the summer months, accrue a very large undercollection, which could then impact the customers very negatively the next year when we anticipate both power supply costs would go up, and we would have this fairly large undercollection that would cause a large true-up next year in June of 2011.

So what would happen in that, at June 1 is we would continue to use the present base power supply rate, the 7.12, and then we would have our estimate of 7.11, and then we would have just a slight negative forward component adjustment. And then we're anticipating a true-up of just under seven-tenths of a cent, or actually seven-hundredths of a cent. So essentially, we're almost at what our present base costs are.

Now, when rates go into effect, if they were to go into effect, say, August 1, what we're proposing is that we would then reset the forward component of the PPFAC to match up with the new base power supply rates being set in this case, average base power supply rates, and essentially that gets you back to the 7.11 cents.

So in total the customers won't see any change, and it will all take place with the rate increase at the same time. And we'll do our best to work with Staff to come up with some kind of an insert to explain the changes and the moving numbers as well.

Q. So the total energy cost will be 7.18 cents. It's just the amount of the base power charge will be changed and then the PPFAC will be changed --

A. Correct.

Q. -- at the time that the new rates go into effect?

A. Correct.

MR. PATTEN: I think that's all I have on that particular exhibit, Judge Farmer. If there are questions on this one now, perhaps we could get those and then move on to the bill estimate.

CALJ FARMER: RUCO, do you have questions about this exhibit?

MR. POZEFSKY: I don't.

CALJ FARMER: Staff?

MS. SCOTT: Just two.

CROSS-EXAMINATION

Q. (BY MS. SCOTT) Good morning, Mr. Dukes.

A. Good morning.

Q. Column C, is it correct that that's the scenario if the rates go into effect at June 1, 2010?

A. That would be if the rates went into effect after June 1. That's just assuming business as usual. In other words, that's our present rates, and then we don't get the rates set in this case until, like, July 1 or August 1.

Q. And that's Column C?

A. Yes.

Q. Okay.

A. Column D could happen on June 1 itself.

Q. All right. I understand.

And then it is the company's understanding that while Staff may agree with this methodology, it hasn't had a chance or opportunity to review the numbers yet and would need to review the numbers on this chart, correct?

A. Yes, with the exception being the base power supply, average base power supply rate, the 6.77. That's already built into Staff's filing in this proceeding as well. That's the same number they have.

MS. SCOTT: Okay, thank you.

EXAMINATION

Q. (BY CALJ FARMER) Good morning. I do have some questions about it.

Where is the scenario if the new rates go into effect on June 1?

A. That would be Column D. Actually, we even spoke about that and probably should have changed that. That's on or after June 1, is what that should say.

Q. Okay. Let me ask you, then, why is there a forward component? Why isn't the 34 cents shown as an addition up to the average base power supply rate?

A. It's just a matter of timing. When we filed our case last year with the cost estimates we believed to be -- what we believed to be the proper cost levels built into the case, I mean, that's been, you know, over almost a year now. And we have better estimates going into this next PPFAC, but we haven't proposed resetting the base rates again in this case or changing our estimates in this case.

Q. So the 34 cent number is what could change based upon what you file in April?

A. Correct. I mean, there is the possibility that it could even go down some. Ultimately, we're estimating 7.11 cents as our average system supply cost. To the extent, you know, there's some market changes, that could go up or down to some degree.

Q. And could also-- that 7 cent number also change based upon what you update in April? That's with the true-up component?

A. Yes, it could. It could.

Q. Although is that closed out at the end of December, so is that a little bit more certain?

A. I think it's closed out at the end of February, so it's pretty close to certain at this point. This is based on what we filed in December. So there are going to be a couple of months it may change, but that's a pretty small number anyway. That's, like I say, seven one-hundredths of a cent, so that's a pretty small number as it is.

Q. So basically what you're saying is that the average base power supply rate of 6.77 was the amount you originally proposed back when you filed the case, and you haven't updated it since then.

A. Correct.

Q. And that's why the forward component is going to be an adder to that?

A. Correct. We did not file within this docket an attempt to reset the base power supply rate again within this docket.

CALJ FARMER: Okay, thank you.

MR. PATTEN: Your Honor, I would move admission of Exhibit UNSE-31.

CALJ FARMER: Any objections to that?

MS. SCOTT: No.

CALJ FARMER: UNSE-31 is admitted.

(Exhibit UNSE-31 was admitted into evidence.)

FURTHER DIRECT EXAMINATION

Q. (BY MR. PATTEN) Mr. Dukes, could you turn to Exhibit UNSE-32.

A. I have it.

MR. PATTEN: Judge Farmer, you should have a copy.

Q. (BY MR. PATTEN) And this is intended to represent bill impacts on the average monthly bill for three different classes of customers?

A. Yes, it's the average annual monthly usage for three different classes, and this just reflects our rate proposal. It doesn't reflect the questions that were asked yesterday with regards to REST and other options, so we don't have that worked up yet.

Q. Right. And this reflects the company's revenue requirement, correct?

A. Yes, it does.

Q. And the three classes are the residential bill, the CARES residential bill, and the small commercial bill, correct?

A. Yes. That's the vast majority of the customers of UNS Electric. I apologize I don't have that full percentage, but that's the vast majority of customers at UNS Electric.

Q. For each customer class we've provided the bill impact for a small, median, average, and large customer within that class, correct?

A. Yes, we did.

Q. And for -- let's just look at the residential bill impact. The median customer is the customer that's sort of the 50th percentile; is that correct?

A. That's correct. 50 percent of customers would use less and 50 percent of the customers would use more. That's just the flat middle.

Q. And the large and small are just intended to give a perspective of someone who is a low user or an above-

average user, correct?
A. Yes.
Q. And that helps understand the impact of the proposed tiers, correct?
A. Yes. That's why we include that, because we do have a tiered rate structure.
Q. All right. And you have done the small, median, average, and large for all three classes, correct?
A. Yes, I have.
Q. Let's walk through one of the columns. And is it fair to say all of the other columns could be interpreted in the same way as one of these columns? And I'll walk you through the average user for residential. Okay?
A. Okay.
Q. And let's start with the first. This does not include the demand-side management charge or the REST surcharge, correct?
A. Correct.
Q. Okay. Let's look at the average residential user, and that indicates they use on average per month 874 kilowatt hours, correct?
A. Yes.
Q. All right. And then the next line down where it indicates $103.14, that would have been their average monthly bill based on the company's rates at the time of

filing this application on April 30, correct?

A. Yes.

Q. All right. And the next, on June 1, 2009, there was a PPFAC change, correct?

A. Yes, there was.

Q. And that was a fairly significant decrease, correct?

A. Yes.

Q. And so their average monthly bill dropped to $81.02, correct?

A. Yes.

Q. And the percentage difference between the $103 and the $81 is shown a couple of lines below where it says percentage change, 4/30/09 to 6/1/09?

A. Yes. For that average residential customer, they saw a 21.4 percent decrease in their bill from the April 30 level.

Q. The way we have this laid out is showing the next PPFAC change going into effect, and then the impact of our rate increase, so that you could clearly see the cost impact of the proposed increased revenue requirement, correct?

A. Yes. The June 1, 2010, you can see that the bill changes on the average to $90.79. What that is reflective of is on the previous exhibit, that Column C, that's our current estimate of what that PPFAC change will be June 1, 2010.

Q. And a lot of that -- so it's basically the -- when the new PPFAC rates go into effect as we've currently estimated, it will be approximately a $9 per month impact, correct?

A. Yes.

Q. And much of that is the falling off of the true-up component?

A. It's primarily the falling off of the true-up component.

Q. So that PPFAC adjustor would result in a 12.1 percent increase in the average monthly bill, looking at the line -- the percent change from 6/1/09 to 6/1/10?

A. Correct.

Q. And now we're going to get to the potential bill impact of our rate request in this docket, correct?

A. Yes.

Q. And that would be the change from the $90.79 to the $99.26; is that correct?

A. Yes.

Q. And based on -- for the average residential customer, that would result in a 9.3 percent increase in their bill, total bill, correct?

A. Yes. If rates went into effect after that PPFAC change, they would see a 9.3 percent change from that bill at that time.

Q. And the 9.3 percent is effectively the bill impacts of our requested revenue requirement in this docket?

A. Correct. Essentially, it's called a "D" in the former exhibit. It reflects, again, the same PPFAC charges that would be in effect as June as far as the same estimated average cost with our non-fuel rate changes that we've requested, our request of 13.5 million.

Q. Okay. And then looking at the overall change from the time we filed through all of the PPFAC adjustments, both that have occurred and that we anticipate to occur, plus the requested rate increase, that would be a change from April 30 of $103 down to $99, correct?

A. Correct.

Q. And that would -- so the customers effectively would see a negative 3.8 percent change in their bill if you compare it back to April 30 when we filed, but the rate increase in this particular case is going to be approximately a 9.3 percent impact?

A. If it goes into effect after June, yes.

Q. Let me just have you look at the CARES bill impacts. And I want to focus your attention on the last -- or the line that indicates percent change 6/1/10 to proposed rates. Do you see that?

A. Yes, I do.

Q. And again, let's go over to the average CARES customer, and it indicates a negative 11.6 percent bill impact; is that right?

A. Yes.

Q. And so the effect of our rate design in this case with respect to our revenue requirement would be to decrease the CARES bill by 11 percent?

A. Yes. What we essentially have done -- and Mr. Erdwurm explained it earlier -- is we reset the CARES customers' billing structure, their rate structure, so that they would essentially be held harmless to the rate increase. But not only held harmless to the rate increase from April, but held harmless from -- allowed to keep the rate decrease that happened in June of last year. Essentially, we reset their tariff so that they would stay at that June level.

Q. Okay.

A. June of '09 level.

Q. So it basically wipes out the PPFAC impact that's going to happen this summer?

A. Correct.

Q. And so overall, CARES customers will -- their bills will be approximately 22 percent less after the end of this rate case than they were back in April of 2009?

A. For an average CARES customer, yes.

Q. Okay. And Mr. Dukes, out to the side of each column it has some information about the charge levels. Could you just briefly describe what that information is?

A. We thought it would just be useful to have all of the different -- differing pieces of the rate structures for each of the time frames that were being discussed; therefore, someone could recalculate the information.

So, for example, you can see on the residential rates that we've shown the customer charge and the tiered energy charges and the base power supply rates that are in effect for those customers for each of those time frames, as well as the PPFAC component, which is a combination of the true-up and the forward component. The customer on the bill only sees the net of those two. They don't get -- we don't show or we don't have on the bill two parts of a PPFAC. It just comes across as a net number.

MR. PATTEN: Okay. Your Honor, that's all I have for Mr. Dukes on this exhibit.

CALJ FARMER: RUCO, do you have questions?

MR. POZEFSKY: I think just one.

CROSS-EXAMINATION

Q. (BY MR. POZEFSKY) Good morning, Mr. Dukes.
A. Good morning.
Q. And again, if Black Mountain were to be approved and put into rate base after the company acquires it, none of these bill impacts would change, correct?
A. Correct.
MR. POZEFSKY: That's it. Thank you.
CALJ FARMER: Staff?
MS. SCOTT: No, I don't have any questions, Your Honor. Thank you.
CALJ FARMER: I've got a couple of questions.

FURTHER EXAMINATION

Q. (BY CALJ FARMER) Let's look at the residential bill impact to the average user that you were going through with your Counsel.
A. Correct. I have it, Your Honor.
Q. The current bill today for an average user would be the $81.02?
A. That is correct.
Q. And the bill after your -- if your proposed revenue requirement is adopted and the PPFAC is modified

as you request, the dollar amount, that would be $99.26; is that correct?

A. The $99.26 would represent both our rate request for non-fuel rates and the PPFAC as we currently estimate that it will be.

Q. Okay. So what would be the percentage increase if those -- I think your counsel said the difference was 9.3 percent. But when I look at it, it looks like the dollar amount is about $18, and that's more than 9 percent.

MR. PATTEN: Your Honor, I think my question was what the impact of the revenue requirement was. I don't think I asked the question that you're asking, so it's a good question.

Q. (BY CALJ FARMER) Well, what is the percentage change between the current rates and the rates that the company wants, including the PPFAC? Where can I find that number?

A. It's essentially those two numbers added together. There's a compounding effect there. But, for example, we're going to -- it will go up about 12 percent from the June -- the present rate to as of June 2010, and then it's going to go up the additional $9 when the new rates are put into effect based on our request. That total impact, like you said, the $18 is about 22 percent.

Q. So the customers would actually see, if the PPFAC was reset at the same time new base rates are put into effect, the customers would see a bill impact of 22 percent?

A. Well, when that true-up falls off, they're going to see essentially that 12 percent change. Unfortunately, because of that large true-up, that's driving that big difference.

Q. Would you repeat that again?

A. To answer your question, yes. But what is rolling off is that big true-up, and that's going to happen regardless of the rate increase or not. They're going to go up 12 percent just because of the change in the fuel cost, regardless of our rate increase.

Q. So does the company have a preference of whether all of the rates change in the same bill or if it's staggered?

A. The only concern I would have with any kind of a staggering would be -- I would have to look at the magnitude, but a lot of your fuel costs are very tied to the summer. You know, the majority of the dollars collected for fuel are tied to the summer sales, because this is a very residential heavy system.

So it would take some heavy winter -- if I understand you right, what you would have to do is you would have to really come up with a very high winter rate to kind of compensate for not putting it in effect during the summer months to keep from building too large of a true-up balance.

Q. Okay. Well, I wasn't necessarily talking about waiting until winter. I just meant -- because you have different, prior to June, after June, whether the company preferred that it all happened at the same time, or whether a month or two difference was your preference.

A. Well, we would obviously prefer to have rates -- our rate increase put into effect as soon as possible. From a customer impact standpoint, to the extent that this can be done at one time and explained at one time, that would probably avoid a lot of confusion.

CALJ FARMER: Okay, thank you.

Any further questions concerning this exhibit?

MR. PATTEN: Just one clarification or just follow up on your last question.

REDIRECT EXAMINATION

Q. (BY MR. PATTEN) Mr. Dukes, in terms of the energy portion of the bill, the intent is to have, as shown on the PPFAC thing, the PPFAC exhibit UNSE-31, the estimated cost of $7.11 would be reflected. It may just be reflected differently between the base cost of power and the PPFAC rate, correct?

A. I couldn't follow you.

MR. PATTEN: I'm sorry. That's not a good question. I'll withdraw the question.

Can I move Exhibit UNSE-32?

CALJ FARMER: Are there any objections to its admission?

MS. SCOTT: No, Your Honor.

CALJ FARMER: Hearing none, UNSE-32 is admitted.

(Exhibit UNSE-32 was admitted into evidence.)

MR. PATTEN: I think that's all we have for Mr. Dukes, Your Honor.

CALJ FARMER: Okay. Thank you, sir, for your testimony today.

THE WITNESS: Thank you.

CALJ FARMER: Okay. Let's move on to our next witness. Do you want to start with the company's cost of capital witness?

MR. DION: Sure, Your Honor. I call to the stand Martha Pritz, please.

MARTHA B. PRITZ,

called as a witness on behalf of the Applicant, having been first duly sworn by the Certified Reporter to speak the truth and nothing but the truth, was examined and testified as follows:

DIRECT EXAMINATION

Q. (BY MR. DION) Good morning. Please state your name for the record.
A. Good morning. My name is Martha Pritz.
Q. And where are you employed?
A. I'm employed by Tucson Electric Power, a subsidiary of UniSource Energy. In my position as director of financial planning for Tucson Electric Power, I provide financial analysis and forecasting services for all of UniSource Energy's subsidiaries, including UNS Electric.
Q. And could you tell me your business address, please.
A. My business address is One South Church Avenue.
Q. And you have in front of you what has been marked as UNSE-22, 23, and 24?
A. Yes, I do.
Q. UNSE-22 is your direct testimony, which was filed

on April 30, 2009; UNSE-23 is your rebuttal testimony, which was filed on December 11, 2009; and then Exhibit 24 is your rejoinder testimony filed on January 25, 2010.

Was that testimony from those three exhibits prepared by you or under your direction and supervision?

A. Yes, it was.

Q. Do you have any corrections or additions you want to make to that testimony today?

A. No, I do not.

Q. And are you adopting UNSE-22, 23, and 24 as your sworn testimony in this case?

A. Yes.

MR. DION: Your Honor, at this time I would move for the admission of UNSE-22, 23, and 24.

CALJ FARMER: Exhibits UNSE-22, 23, and 24 were prefiled. No objections were received; they are admitted.

(Exhibits UNSE-22, UNSE-23, and UNSE-24 were admitted into evidence.)

MR. DION: Thank you, Your Honor.

Q. (BY MR. DION) Can you briefly summarize your testimony?

A. Yes. I filed direct, rebuttal, and rejoinder testimony in this case. In my direct testimony, I provide an estimate of the cost of capital for UNS Electric based on a capital structure of 45.76 percent equity and

54.24 percent long-term debt, an 11.4 percent return on equity, and a 7.05 percent cost of long-term debt. I recommend a weighted average cost of capital of 9.04 percent.

I established the 11.4 percent return on equity recommendation using discounted cash flow, capital asset pricing model, and bond yield plus risk premium analyses.

The DCF and CAPM models are familiar to the Commission. The bond yield plus risk premium analysis is useful because it is based on the fundamental premise that investors require a higher return for taking on greater investment risk.

Since UNS Electric is not a publicly traded company, data from a proxy group of companies is used in the DCF and CAPM models. I point out that as a group, the proxy companies used in the models are less risky than UNS Electric; therefore, returns on equity indicated by DCF and CAPM models are on the conservative side for UNS Electric.

In my rebuttal testimony, I focus on the cost of equity because the company's proposals regarding the cost of long-term debt and capital structure are not disputed by the Arizona Corporation Commission Staff or the Residential Utility Consumer Office.

I note that the cost of equity recommendations provided by Staff and RUCO are much lower than mine. I provide testimony critical of the analyses of the other cost of capital witnesses, and I also provide additional support for the analyses detailed in my direct testimony.

The purpose of my rejoinder testimony was to further address my concerns about the return on equity recommendations made by Staff and RUCO in light of data on allowed returns for electric utilities, earned returns on comparable companies, and expected premiums over cost of debt.

I note that when I consider my original analyses, updated analyses, and the outlook for the financial markets, my recommendation of the 11.4 percent return on equity remains reasonable for UNS Electric.

MR. DION: Thank you, Your Honor. Ms. Pritz is available for cross-examination.

CALJ FARMER: RUCO.

MR. POZEFSKY: Thank you, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. POZEFSKY) Good morning, Ms. Pritz. How are you?

A. Good morning. I'm fine, thank you.

Q. Let's see. Let's start with the cost of equity.

The company is recommending a cost of common equity of 11.40 percent?

A. That's right.

Q. Ms. Pritz, are you aware of the Commission approving a cost of equity award that high within the last year or so for a Class A utility?

A. No, I am not.

Q. How does your recommendation factor in the current state of the economy?

A. My recommendation is based on economic information. Inputs from the current state of the economy are reflect in those inputs. I would note that the resulting recommendation appears in line when compared to allowed returns in other jurisdictions.

Q. As a general proposition, Ms. Pritz, as the economy worsens over time, do you think that cost of equity awards should also fall over time to reflect the decline in the economy?

A. Mr. Pozefsky, I am not aware of a legal precedent, a legal standard that directs that a fair rate of return be established and then adjusted to be higher or lower based on economic circumstances faced by ratepayers, nor do I see evidence of such a thing when I consider allowed returns in other jurisdictions for the year 2009. Because in a review of those returns for companies that got rate orders in 2009, in comparison of those rate orders to their prior rate orders, shows a majority of the companies' rates were increased, the cost of capital of increased.

And so it's possible that buried in those increases is an increase in the allowed cost of equity, but an offset on behalf of ratepayers, but I can't see that clearly. So either the cost of capital has increased more than any offsetting factor that was considered, or that isn't in there at all.

Q. So you don't believe it would be appropriate for the Commission to adjust or consider the current economy in ascertaining what would be an appropriate cost of equity?

A. I believe the standards for ratemaking call on the Commission to determine fair rates at all times.

Q. Okay. And wouldn't it be fair to say that the Commission has the discretion to consider the economy in ascertaining what would be a fair cost of capital?

A. Certainly, the economy impacts all of our recommendations and impacts the Commission's final determination.

Q. Ms. Pritz, do you believe that RUCO's recommendation to allow the company to acquire the rate base -- to rate base the Black Mountain generation station, in other words, to give it preapproval, will help the company's future financial position?

A. I expect that over time it will help the company's financial position, because it does provide -- I believe Mr. Grant's testimony cites approximately $6 million a year of additional cash for the company.

Q. And if approved for the full amount and the company makes the acquisition, it will increase the company's rate base by $62 million?

A. That's right.

Q. Whatever the allowed return is once that plant is put into rate base, the company will be able to earn a return off of that additional rate base, correct?

A. The company would earn a return on that amount in rate base, and that would, as Mr. Grant addressed in terms of the ratepayers' rates, that would move the portion of the bill from the PPFAC line to the non-fuel base rate line.

Q. Let me talk to you a little bit about the DCF analysis that the company made, or that you made in this case. Do you have your testimony before you, Ms. Pritz?

A. I do.

Q. If you would, would you go to Exhibit MBP-7 in your direct testimony.

A. I'm there.

Q. And this exhibit appears to establish or show different estimated cost of equities for the proxy companies you used in your analysis; is that correct?

A. That's correct.

Q. In your DCF analysis here, the range resulted in costs -- resulted in a range of 10.6 percent, 14.7 percent. I'm sorry if that wasn't as articulate as I wanted it to be.

A. Yes, I do see those data points.

Q. Okay. And neither Staff nor RUCO is recommending that the cost of equities are in this range; correct?

A. That's correct.

Q. And the average value for your sample group you used was 12.1 percent, correct?

A. Yes.

Q. So why are you recommending a cost of equity lower than the average of your proxies?

A. Because this is one of several analyses I completed in considering an overall recommendation.

Q. And this one analysis, the DCF analysis, is an analysis that the Commission has historically used in the past; is that correct?

A. Perhaps not in the identical form as a multistage model, but yes, they have often used DCF analysis.

Q. And you would agree with me that the DCF analysis is an accepted methodology in the industry?

A. It is a frequently used model.

Q. Okay. And you used the non-constant growth multistage DCF model?

A. That's right.

Q. That's also referred to as the multistage DCF model, correct?

A. Yes.

Q. And in the multistage model that you use, there's two stages, correct?

A. That's right.

Q. In the first stage you determine the growth in the short-term, correct?

A. Yes.

Q. And in looking at the short-term growth, Ms. Pritz, isn't it true that you look at the future dividends, or you looked at the future dividends and earnings growth published by Value Line, Zacks, and SNL for the companies in your proxy?

A. That's correct.

Q. And what is SNL?

A. SNL is a financial data publishing company. They acquired RRA, Regulatory Research Associates, several years ago.

Q. And looking at your Exhibit MBP-7, you looked at the projected dividends in the short-term over the next five years, correct?

A. That's right.

Q. In the second stage of the multistage you look at long-term growth, correct?

A. Yes.

Q. Now, the period that you look at in the long-term, is that different than the time period that you used in the short-term?

A. The period represented in the model for the long-term would be the period from basically six years to infinity. The model covers the first five years using the short-term projections.

Q. And do you give the same amount of weight to the long-term projections that you do to the short-term projections?

A. I use -- the model specifies that there be an input for short-term growth to determine the first five years' dividends, and that I have done.

There is a second factor used for the long-term portion of the model, and I will point out that that long-term factor, that single long-term factor was based upon three data points, two of which were three- to five-year projections, first for the proxy group, second for the industry, and the third data point was an estimate of GDP growth.

Q. So would your answer to my question be you do use the same amount of weight overall for the long-term as you do for the short-term?

A. In arriving at a long-term factor, I use two short-term and one long-term point estimates. So I'm not sure how to answer you mathematically, but I do have a short-term, a long-term input, and the long-term input considers both short- and long-term projections.

Q. Now, you said that the long-term growth in the U.S. economy as you used it was measured by the GDP, correct?

A. Yes.

Q. And that's trued up for expected inflation?

A. That's right.

Q. So you would agree with me that that measure is not company or industry specific, correct?

A. It's intended to represent the U.S. economy, the outlook for the U.S. economy as a whole.

Q. Okay. Now, you also, I believe, stated in the long-term, you determine that long-term growth by averaging two figures to arrive at an estimate, correct?

A. The long-term growth in my DCF model?

Q. Yes.

A. I started with three figures. I used the three-to five-year expected earnings growth for the proxy group of companies, three- to five-year earnings growth for the utility industry, and GDP growth. And when I evaluated those three factors, the average with -- the average of the three figures I used was 6.8. And because the outlook for utility growth was a bit on the high side, I discounted that and I settled on 6.5 percent as the recommended long-term growth rate.

Q. Well, let me back into -- look at it from the way I read your testimony and see if I can get to that 6.5, because I am looking for an explanation.

So those three figures you used, let's start with the first figure. That's an average adjusted implied inflation rate for the period January 2007 through August 2008; isn't that correct? I'm getting this out of your direct testimony.

A. Okay. Say that again for me, please.

Q. The first figure that you use is an average adjusted implied inflation rate for the period of January 2007 through August 2008, correct?

A. Yes.

Q. And that figure was 2.68 percent, correct?

A. Let's see. May I go to the page in my direct testimony?

Q. Yes, please. I think it's going to be on Page 11 or thereabouts.

A. The 2.68 percent is the implied inflation rate from January of 2007 to August of 2008, as you stated, but I also considered a second figure, the implied inflation rate from February of 2009 based on 20-year treasuries, and then I averaged those two figures to arrive at an implied -- an expected inflation rate of 2.1 percent. And I did that because of the upheaval in the financial markets. I wanted to consider both the current data point as well as an average from prior to the market turmoil.

Q. And so from there you added the 3.3 percent real GDP figure to that 2.1 percent to get a total of 5.4 percent, correct?

A. That's correct.

Q. But you used 6.5 percent for your long-term growth estimate for all of your proxy companies, correct?

A. That's right.

Q. So how do you explain the difference of the 1.1 percent?

A. The long-term growth rate that I used in the model, I started by averaging the 5.4 percent expected GDP growth for the U.S. economy, 6.5 percent earnings, 35 years earnings growth for the proxy group of companies, and 8.6 percent for the electric utility industry. There was expected growth published by Zacks. I averaged those three. The average is 6.8.

And because the figure for electric utility industry appeared high, I chose to discount that figure, and so I settled on 6.5 percent, a slightly lower figure for the long-term growth.

Q. Even at 6.5 percent, isn't that inconsistent with the way the current economy is going now? How do you explain that?

A. I don't believe that that's inconsistent. One of the factors is the GDP growth. And I considered data back to 1926, so that I was considering a very, very long time period that included economic cycles, contraction and expansions, both modest and more extreme.

So I believe that 5.4 percent figure for the U.S. economy is a strong figure. And keep in mind, this portion of the model is very long-term. It's intended to represent the expected growth rate out to an infinite number of years.

So I'm using a very long-term GDP growth figure. I'm averaging near-term growth for the proxy group of companies and the electric utility industry. So I think that the combination of those three outlooks provides a strong estimate of long-term growth.

Q. With regard to the short-term growth, Ms. Pritz, you calculated for your first year the short-term dividends or projected dividends. They were calculated on the most recent quarterly payments, correct?

A. The most recent quarterly payments were the basis for the dividend projections. And then I'm going to the applicable exhibit, if that's all right.

Q. Please.

A. As seen on Exhibit MBP-7, I started with recent share price and then used projected dividends. The projected dividends are based on the growth rate and the past dividends for these companies.

Q. Okay. Well, the years two through five they were calculated a little differently, weren't they? Weren't they calculated by applying near-term growth rate for each company to its expected first-year dividend?

A. Yes. The near-term growth rate was applied to determine projected dividends.

Q. So these short-term projections, you would agree, are based on recent data and near-term expectations, correct?

A. Yes.

Q. And isn't it reasonable, would you agree with me, Ms. Pritz, to believe that estimates of short-term growth are more reliable than estimates of long-term growth?

A. I believe it depends a bit on the time frame. I believe that for short-term growth, analysts have the ability to look at recent history and expected changes. For very, very long-term growth like that represented in the long-term growth portion of the model by the GDP calculation, I think that looking to the long-term GDP historical data is a stronger indicator.

Q. Okay. Let me hand out an exhibit.

CALJ FARMER: Mr. Pozefsky, we're going to have to stop. Do you want to pass this exhibit out before we take the break here?

MR. POZEFSKY: Why don't I wait.

CALJ FARMER: Okay. We're going to come back here at 11:00 a.m. Thank you.

(A recess was taken from 9:58 a.m. to 11:04 a.m.)

CALJ FARMER: Let's go back on the record.

Mr. Pozefsky, you may continue.

MR. POZEFSKY: Thank you, Your Honor.

Q. (BY MR. POZEFSKY) All right. Let's pick up where I left off. I have handed you what's marked RUCO's Exhibit No. 9. Do you have that before you?

A. Yes, I do.

Q. Does it appear to be an excerpt of the "Cost of Service Rates Manual" for FERC?

A. Yes, based on the title page, it does.

Q. And why don't you take a second to look -- really what I would like you to concentrate on is the last page,

Page No. 17. There's some brackets in there. And rather than have you read them into the record, I would just like you to take a look at it and then I'll ask you some questions.

A. Okay.

Q. Have you had an opportunity to size it up? And as you can see, just to be fair, this relates to natural gas companies in that context, but I think the concept is the same.

Ms. Pritz, do you have any reason to disagree that FERC recognizes that the short-term return projections are more reliable than the long-term projections?

A. While I don't see the exact form of their model because there's no example provided, it does appear that they intend to weight short-term estimates more heavily than long-term estimates.

Q. Okay. In fact, twice as heavily as the long-term estimates?

A. Yes.

MR. POZEFSKY: Your Honor, at this time I would move for the admission of RUCO Exhibit No. 9.

CALJ FARMER: Are there any objections to RUCO-9?

MR. DION: Judge, just a clarification that this is the most recent cost of service manual from FERC.

MR. POZEFSKY: Yeah. Mr. Rigsby had vouched for it, so I'm going under the assumption that it is from my expert.

CALJ FARMER: Is there an objection or --

MR. DION: No, I don't have an objection. I just wanted to make sure that that was the most current version, as avowed to by RUCO.

CALJ FARMER: You can ask Mr. Rigsby about that. RUCO Exhibit 9 is admitted.

(Exhibit RUCO-9 was admitted into evidence.)

Q. (BY MR. POZEFSKY) Let's move on to the CAPM, the capital asset pricing model. You would agree with me, wouldn't you, Ms. Pritz, that one of the inputs that's used in the CAPM model is the market rate of return; is that correct?

A. If by that you mean the risk-free rate of return, yes.

Q. And in your analysis you relied on the arithmetic mean using historical data from Morningstar's 2009 yearbook for the period of 1926 to 2008?

A. Yes. Perhaps you were referring to the market risk premium. And for the market risk premium, I did look to the Ibbotson yearbook.

Q. I'm sorry. You're correct. That's correct.

And in your rebuttal, you rely on Roger Morin's

"New Regulatory Finance," textbook for your contention that the arithmetic average is the appropriate average to be used?

A. Would you mind giving me the page reference? I just want to be sure I'm looking at the same thing.

Q. I wouldn't mind, but I didn't mark it down. Let me see if I can find it. Hold on.

It looks like on Page 14.

A. Page 14 in my direct testimony. And then I believe you were referring to my rebuttal testimony?

Q. That's correct. I'm on Page 14 also in your rebuttal testimony. It looks like the last Q and A.

A. Okay, I'm there.

Q. Would you agree, Ms. Pritz, that the market has access to data using both geometric and arithmetic means?

A. I would agree with that, but I would say that the publishers of that data don't intend that it all be used for the same purposes.

Q. Since the mean is based on historical data, isn't the use of an arithmetic mean going to result in a higher risk premium than the use of a geometric mean?

A. While that is the case mathematically, geometric means are generally regarded as being appropriate for stating historical results over a certain period of time, while arithmetic means are regarded as being appropriate for future projections.

Q. You're aware that Mr. Rigsby has recommended the use of both arithmetic and geometric mean, correct?

A. I am aware of that.

Q. Do you have before you a copy of the Commission's decision in the last UNS Gas case? It should be marked RUCO's Exhibit No. 2. You may not. It's probably been moved since then, but let me -- I have another copy.

A. I do not.

Q. Here it is. I'm going to give you this open to the page.

A. All right.

Q. Again, I've handed you a copy of what has been marked RUCO's Exhibit No. 2, which should be a copy of the opinion and order in the company's sister's company, UNS Gas, last rate case.

Does that appear to be what that is?

A. Yes, that does appear to be what it is.

Q. Could you turn to Page 44 of that decision.

A. Okay.

Q. There's just two sentences that -- or just a sentence that I would like you to read. On Line 27 under the conclusion of cost of equity, will you read that sentence? It continues onto the next page.

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

Q. Do you disagree with the Commission's findings in that case?

A. Mr. Pozefsky, as a cost of capital witness in this case, I feel it's outside of my purview to comment on previous decisions. However, when in my research I find support for the arithmetic rather than geometric, or rather than an average, I present that information in this case, as I did in my testimony.

Q. And why do you think that the Commission should change its position there and go to an arithmetic mean?

A. One minute, please.

Mr. Pozefsky, my research on the matter shows that there is support for the use of historical data -- or I'm sorry -- geometric means in explaining historical period results, but that the preponderance of the literature supports the use of the arithmetic mean for forward-looking models, so that's why I presented that.

Q. So the Commission's decision there is not supported by the preponderance of the data that's out there. Is that what you're saying?

A. Based on my research, that would be the case.
Q. Okay. Let's go to your direct testimony and Exhibit MBP-8.
A. Okay.
Q. And there you list the range of CAPM estimated cost of equities for your proxy groups; is that correct?
A. I show results for each company and average values for the group, yes.
Q. And that range goes from 9.5 percent to 10.4 percent?
A. Yes. Well, there's one data point at 9.5 and three data points at 10.4, but those are the boundaries, yes.
Q. And the average value of the group was 10.1 percent?
A. That's correct.
Q. And this 10.1 percent average is definitely closer to the lower end of your range that you found in your DCF analysis than the average or the higher end of the DCF analysis, correct?
A. I did not determine a range in my DCF analysis. I arrived at an estimate of 12.1 percent.
Q. I'm sorry. I thought we went through that, and I thought you had a range from 10.6 to 14-point something in your proxy groups in the DCF.

A. I'm sorry. I was referring to the single resulting recommendation.

Q. Okay. So let me repeat my question then. So the average of your cost of equity proxy group of 10.1 percent is closer to the lower end of your range in your DCF analysis, which was 10.6 percent, than the average or the higher end of your DCF analysis. Is that a fair statement?

A. Yes, it is.

Q. In your opinion, Ms. Pritz, should the DCF and the CAPM be given the same or different weight in a cost of capital analysis?

A. In this case, at the time when I prepared these analyses, the results of my CAPM model without a risk premium adjustment appeared unusually low. I made an adjustment and then gave them equal weight along with the bond yield plus risk premium method. So I weighted the three methods evenly.

Q. Okay. And the reason you made an adjustment -- well, I'm going to get there, so let me continue on.

If the Commission were to just consider your DCF and your CAPM analysis alone, would you agree that a cost of equity somewhere in the 10 percent range would have been appropriate?

A. Had I not included a bond yield plus risk premium, I would have averaged these two and arrived at an 11.1 percent figure.

Q. Ms. Pritz, would you agree that the capital markets resurged in September 2008 and basically lessened investors' appetites for risks?

A. I agree that investors had less appetite for risk in the fall of 2008.

Q. And with less tolerance for risk, shouldn't we expect to see lower systematic risk and, hence, lower betas than before?

A. Would you repeat that question for me?

Q. Sure. And if investors had less tolerance for risk, shouldn't we expect to see lower systematic risk and, hence, lower betas than before?

A. I think the lower tolerance for risk is visible in expected premiums. The betas for the companies are not -- are determined on historical price fluctuations with respect to the whole market.

Q. So seeing -- or having investors' tolerance for risk being lessened shouldn't equate to necessarily a lower cost of equity as far as the CAPM is concerned. Is that your testimony?

A. I would expect that if investors' appetite for risk decreases, the premium required would increase. That would tend to drive results higher on the CAPM model.

Q. Okay. You made an adjustment for the risk premium; is that correct?
A. Yes, I did.
Q. And without that adjustment to the risk premium, the cost of equity result from the CAPM would have been 8.4 percent?
A. That's right. Really low relative to the company's cost of debt.
Q. And that isn't consistent with the investors having less tolerance for risk?
A. The CAPM model also includes a risk-free rate as one component. The risk-free rate at the time that I did this analysis was 3.83 percent. So that played a part in the resulting 10.1 percent recommendation.
Q. Let's get back to that 8.4 percent recommendation. With that level of risk, you would have given that recommendation little or no weight at all; is that correct?
A. That's right, consistent with the decision by the other cost of capital witnesses.
Q. And again, how much was the adjustment that you made to the risk premium?
A. That was 229 basis points.
Q. And what was that based on?
A. Let me get to the spot in my testimony so that I

don't misstate my answer.

I based that adjustment on the change in yield spreads between 30-year treasury bonds and Baa-rated bonds from the period just before the financial markets began to deteriorate, until January of 2009 when I was preparing my testimony.

Q. So in the end, was that adjustment based on an actual formula, or was it based on a judgment?

A. That was based on an observed change in the yield spread which reflects the investors' increased return requirement.

Q. And was that yield spread 229 points?

A. The change in the yield spread from the beginning of that period from August of 2008 until January of 2009 was an increase of 229 basis points.

Q. And the objective of that adjustment was to attain a higher CAPM estimate?

A. I'm sorry?

Q. The objective of that adjustment was to obtain a higher CAPM estimate?

A. Yes, it was. I was trying to adjust the CAPM estimate so that I could include it in order to provide three estimates of the cost of equity. And had I, instead of adjusting it, just excluded it, I would have averaged just the bond yield plus risk premium and DCF models, and that would have indicated an ROE of 12 percent or just over.

Q. And Ms. Pritz, in your experience, do you typically represent companies, utilities, when you do cost of capital analyses?

A. I have done cost of capital analyses for UNS Electric. I have not represented other organizations.

Q. Let me ask you, have you ever made a recommendation when times were good where you had to actually make a downward adjustment to the risk premium and the CAPM analysis?

A. I have not.

Q. Do you believe that the Commission should give the results of your CAPM analysis little or no weight in this case?

A. I believe that, as adjusted, it is appropriate to include the result in looking at the overall recommendation of 11.4. I did do an update of my analyses, and in my update, without adjusting CAPM, again, it was unreasonably low as a recommendation on return on equity with respect to the company's cost of debt. So as I stated in my rejoinder testimony, at that point I did not include it in the average for my final recommendation or my final indication at that point in time.

Q. In addition to the DCF and the CAPM models, Ms. Pritz, did I hear you say that you also used the bond yield and risk premium approach in estimating your cost of equity?

A. That's correct.

Q. Would you agree with me that the Commission traditionally assigns more weight to the DCF and CAPM models than it does to the bond yield and risk premium approaches?

A. I am not able to cite percentage of times the Commission in the past has relied on the respective models. I do see that in the recent discussion for UNS Electric and UNS Gas that bond yield plus risk premium was used by prior company witnesses, but not by the Commission Staff.

Q. But in this case you're requesting that the Commission give the same weight to all three, correct?

A. I am. I think the bond yield plus risk premium method provides important insights.

Q. Let me ask you, with regard to all three of these methods, do the current economic factors or conditions factor into one method more than any of the other methods in your opinion?

A. I think it's always best to use several models, because that provides more information. And as I have found and the other cost of capital witnesses have found, in the current economic environment, the returns indicated by the CAPM model appear unreasonably low. So at this point in time I would not give that particular model as much weight, but I do think it's important to do that analysis every time.

Q. So is that model the one that's most affected by the current economic conditions?

A. Sir, I would expect to find all of the models affected by the economic conditions. There are inputs to each of the models that vary as economic conditions change.

Q. But you can't say one is more affected by the economy than the other?

A. I would not make that statement, no.

MR. POZEFSKY: Thank you, Ms. Pritz. That's all I have.

CALJ FARMER: Thank you.

Staff?

MR. VAN CLEVE: Thank you, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. VAN CLEVE) Good morning, Ms. Pritz.

A. Good morning.

Q. I guess the first point I would like to address is -- and I think this was in your opening summary -- you had mentioned that, correct me if I'm wrong, but something along the lines that the proxy group or the sample group was less risky than UNS Electric. And was that the reason that you included the bond yield risk premium method in your analysis?

A. That was not the reason that I included it. I did indeed make that statement, but I included the bond yield plus risk premium just because I believe it provides additional insight.

Q. Did you say something else? And again, I just don't recall what you said exactly, but you said something in relation to the fact that the sample group or proxy group was less risky than UNS, and it seemed like you mentioned you had taken something into consideration because of that.

A. I would be happy to repeat what I said in my summary.

Q. And if you don't mind, just related to that, though.

A. Okay. I said that -- I point out that as a group, the proxy companies used in the models are less risky than UNS Electric; therefore, returns on equity indicated by the DCF and CAPM models are on the conservative side for UNS Electric.

Q. Okay. And by including the bond yield or risk premium method or model, does that, I guess from the company's standpoint, correct that risk?

A. No, sir. The inclusion of that model does not correct that risk because, again, that's an even broader group of companies and would include companies that are far less risky than UniSource Electric.

Q. And why is UniSource Electric more risky than what this proxy group is?

A. The company is smaller in size and has been unable to pay a dividend. The rest of the companies are able to pay a regular dividend. So that's something that a potential investor would look to and expect a higher premium because of that factor.

Q. And do you believe that a regulated utility such as UNS Electric should be entitled to a higher cost of equity than nonregulated monopolies would be able to earn in the market today?

A. In preparing my analyses, I tried to pick regulated electric utility companies that were as comparable as possible. So I do not -- and in the bond yield plus risk premium method, while I have expanded the group of utility companies used, that is still limited to companies with a Baa investment grade rating. And I do not consider any comparisons to nonregulated companies in other industries.

Q. And then I think it was Mr. Pozefsky had asked you some questions that -- I don't recall this being in your testimony, but regarding the inclusion of Black Mountain generating station, if that were -- if the Commission adopted the company's position, allowed it to, I guess, purchase that and include it in rates, that that would benefit the company, and I think you said in the long-term.

A. Yes, I would expect in the long-term. First of all, the cost of capital is applied to rate base, and rate base would be decreasing over time as accumulated depreciation and accumulated deferred income taxes build on this asset. So with respect just to this asset, the rate base upon which cost of capital -- to which cost of capital is applied would be getting smaller.

As far as the cost of debt and cost of equity, the cash flows, the incremental cash flows to the company are small. It would take a while to make a difference. I would expect 6 million a year, I believe, is the cash figure that Mr. Grant cited in his testimony as incremental to the company with Black Mountain. That would go first to reducing reliance on the revolver.

To the extent that the cash builds over time, the company would be able to cover more of its capital expenditures using operating cash, and it's possible that a rating agency would get to the point where they felt comfortable with upgrading the outlook for the company.

Q. Were you here for the testimony of Dr. Johnson?

A. No, I was not.

Q. And what you had just said about the inclusion of Black Mountain, wouldn't that hold true whether or not there was preapproval by the Commission?

A. It would push all of the benefits back several years. No benefit would start to accrue until such time as the plant were accepted in rate base by the Commission.

Q. But once that happened, your previous statement would hold true even if it wasn't based on -- inclusion wasn't based on a preapproval by the Commission?

Stated another way, there would still be long-term benefits to the company owning the generating station even if it was purchased without preapproval by the Commission?

A. Well, if it were purchased without preapproval, I guess it's a question of are you then assuming approval in a later rate case? Is that the assumption under which I should be answering the question?

Q. Yes, assuming the Commission in the next rate case allows it into rate base.

A. Then yes, I would expect benefits to begin to accrue. It would put a bit of a lag, because you wouldn't be collecting the rate revenues as quickly, but that's -- it would not be a lag that would last longer than just until the next rate case, assuming it were approved then.

Q. And then I think you -- how long have you worked for -- is it Tucson Electric that you work for?

A. That's correct.

Q. How long have you been employed there?

A. 10 years.

Q. And have you always held your current position that you currently hold there for that period of time?

A. I have been in the finance department the entire time.

Q. Okay. And so you were in that position, then, when UniSource purchased Citizens' natural gas and electric operations in Arizona?

A. Yes, I was.

Q. And when those operations were purchased, is it correct to say that separate subsidiaries were set up for both UNS Gas and UNS Electric?

A. That's correct, with a holding company above them.

Q. And in both cases were they initially capitalized with 35 percent equity and 65 percent debt, to the best of your knowledge?

A. I would have to check that.
Q. Subject to check?
A. Perhaps we could check that at a break and follow up on that later?
Q. Okay. And do you know how UNS Gas and UNS Electric were initially financed?
A. They were financed in part with private placement debt and in part with a capital infusion from UniSource Energy Corporation.
Q. And so is it correct to say that the debt portion of it was from loans from insurance companies?
A. That is my recollection.
Q. Okay. And do you know if that initial debt was rated by, I guess, Moody's or Standard & Poor's?
A. It was not. It did have an insurance company rating, but it was not rated by one of the major rating agencies.
Q. Do you recall the terms of that initial debt, the time frame and the interest rate, or the rate?
MR. DION: Judge, I am just wondering where we're going with this. Our witness is for cost of capital, and I'm wondering what her -- the relevance of -- and I'm wondering about the scope of this questioning about a transaction, a financial transaction of a purchase of two utilities four and five years ago.

CALJ FARMER: So is that a relevance objection?

MR. DION: Relevance and scope, Judge, both.

MR. VAN CLEVE: Your Honor, it does lead into the cost of capital question. It's just a little background.

CALJ FARMER: Okay. I'll allow the questions.

THE WITNESS: Okay. Yes, the debt initially issued matured in 2008 and was at a rate of 7.61 percent.

Q. (BY MR. VAN CLEVE) And then you had mentioned it matured in 2008. How was that initial debt refinanced, or was it refinanced?

A. The company was able to refinance. The original amount, I believe, was $60 million. The company increased the debt to $100 million, a portion of which is due in 2015, and a portion of which is due in 2025.

Q. And if you need to refer to it, it's on Page 2, Line 21 and 22 of your direct testimony. But in your direct testimony, don't you indicate that the refinancing of UNS Electric's debt resulted in lowering the cost rate from 7.61 percent to 6.8 percent?

A. Yes. The company was able to get a lower interest rate when we refinanced.

Q. Doesn't this indicate that UNS's cost of debt in the current case is less than it was in that case?

A. The cost of debt as reflected in the cost of capital testimony I filed, yes.

Q. Okay. And you had indicated earlier that this debt had not been rated by Moody's or Standard & Poor's.
Has UNS Electric's debt now been rated by Standard & Poor's?
A. No, it has not, but it has been rated by Moody's.
Q. And what is it rated at by Moody's?
A. The lowest investment grade rating, Baa3.
Q. And how does that compare to Tucson Electric's senior unsecured debt? And this is, I think --
A. Well, that is what I was speaking of.
Q. Okay. Do you know what the cost of equity the company -- that was sought in the UNS Gas case in the 2006 UNS Gas case?
A. In the UNS Gas, 2006, no, I do not.
Q. Subject to check, would you agree that it's 11 percent?
A. Again, getting back to you after the break, sure.
Q. Okay. And are you aware -- well, are you aware of what the Commission's decision was in that case as far as what the cost of equity that the Commission approved?
A. For the UNS Gas case?
Q. Yes.
A. I would prefer to confirm after the break. I believe it was 10 percent, but I need to confirm that after the break.

Q. Okay. And then in UNS Electric's last case, were you involved in the preparation of that case?
A. Mr. Grant was the cost of capital witness for that case.
Q. Do you recall what the company was asking for as a cost of equity in that case?
A. I believe that was 11.8 percent.
Q. Which is higher than, again subject to check, what was being sought in the UNS Gas case?
A. Subject to check, yes.
Q. And do you recall what the Commission approved as a cost of equity in that case?
A. The cost of equity approved in that case was 10 percent.
Q. And then there's -- isn't there also a UNS Gas case that's still pending before the Commission?
A. That's right. I believe there's a recommended opinion and order expected sometime in the near future.
Q. And do you recall what UNS Gas requested as a return on equity in that case?
A. I would prefer to follow up on that on the break. I don't want to misspeak.
Q. There should be an exhibit up there marked RUCO Exhibit No. 2. It's the opinion and order from the prior UNS Gas case.

A. Okay. Yes, I do still have that here.

Q. And if you need a moment to -- actually, I think it's on Page 44. If you could confirm at least the UNS Gas numbers we were talking about.

MR. DION: Your Honor, sorry to interrupt. This is the gas order or the electric order?

MR. VAN CLEVE: This is the gas order.

MR. DION: Thank you.

THE WITNESS: Are you waiting for me to --

Q. (BY MR. VAN CLEVE) Yes. I guess could you confirm what the company was seeking in that case and what the Commission ultimately awarded or adopted?

A. Let's see. I see in the middle of Page 45 that the Commission ordered 10 percent as the cost of equity.

Q. And do you know, again, can you find a reference to what the company was seeking in that case?

A. I'm looking back through pages of the testimony, or of the order.

On Page 39, it indicates UNS witness Kentton Grant based his common equity cost recommendation of 11 percent, dot, dot, dot.

Q. And then also, I think this is also RUCO Exhibit No. 1, this is the decision in the UNS -- the 2006 UNS Electric case. If you, instead of waiting until the break, could confirm what the company was seeking and what the Commission adopted.

A. What did you say the exhibit is marked?

Q. RUCO No. 1.

A. I don't have a RUCO No. 1.

Q. There you go.

A. Thank you. Is there a page number that I should look at?

Q. Around Page 38, I think will be in the ballpark.

A. Yes, I see on Page 38 that Mr. Grant recommended 11.8 percent. And I see on Page 43 that the conclusion was 10.0, 10 percent.

Q. And again, in this case the company is recommending 11.4 cost of equity?

A. I believe that's 11.8.

Q. But in the current case, in this case.

A. Oh, in the current case, yes. In the current case, the recommendation is 11.4.

Q. And you would agree that that's less than the 11.8 that was requested in the prior case?

A. Yes, 11.4 is less than 11.8, I agree.

Q. And sort of moving on to a slightly different area, and Mr. Pozefsky touched upon this, too, but -- and this is regarding the changes in economics and financial condition since the current case was filed.

And do you recall -- or actually, is it correct that your direct testimony in this case was filed on April 30, 2009?

A. Yes, that's correct.

Q. And what was the time period of data that you used in your direct testimony? And if you need a reference, I think you can look at MBP-8.

A. MBP-8 is an exhibit showing the CAPM model. And on that page, it's noted that the risk-free rate that I selected for input in the model was from February of 2009.

Q. And then if I can have you turn to MBP-9, does this exhibit show the spread between the Baa-rated public utility bonds and 30-year U.S. treasury bonds?

A. Yes, it does.

Q. And what was the spread between these two types of debt at the time that you filed or prepared your direct testimony?

A. Let me look for another source that shows that rather than relying on just the graph.

As of January of 2009, there was a spread of 477 basis points for Baa-rated public utility bonds relative to the 30-year treasuries.

Q. And would you agree with me that the spread between these two types of debt as of the time of your direct testimony was at a high point, a relative high point?

A. Yes. That was the basis of my recommendation for the addition of the change in spreads from before the market crisis to that time period as an adjustment to the CAPM risk premium.

Q. I'm sorry. And then looking back at MBP-9, would you agree that this exhibit indicates that that spread had just begun to turn when your direct testimony was prepared?

A. At the time, the yield had narrowed just slightly from previous months. It was -- one could not predict what would happen with the yield spread in the coming months, but at that point it had narrowed just slightly from the wider spread observed just a couple of months earlier, yes.

Q. And you had mentioned just a minute ago about the 477 basis point spread. Do you, in fact, use that differential as a component of one of your three cost of equity models?

A. In determining a risk premium for my CAPM model, I looked at the increase in the spread relative to August of 2008 before the market turmoil began as an indication of the increase required by investors.

Q. And your rebuttal testimony in this case was filed on December 11; is that correct?

A. That's correct.

Q. And hopefully it's still up there, but you should have an exhibit that's marked as S-17 for identification.
A. Yes, I do.
Q. It should be excerpts of two data requests that Staff had issued?
A. Yes.
Q. Turning first to the second page of that document, is that Staff's data request 24.6?
A. Yes, it is.
Q. And were you responsible for responding to that data request?
A. Yes. At that point I had not updated the analyses, although I had done some preliminary work.
Q. And when was your rejoinder testimony filed in this case?
A. My rejoinder testimony was filed on January 25.
Q. And did you provide any updates to your cost of equity analysis in your rejoinder testimony?
A. Yes, I did.
Q. You did. Could you refer me to those pages?
A. Yes. On Page 6 of my rejoinder testimony, starting -- my answer starting on Line 10.
Q. And what does that update reflect? A lower cost of capital?
A. Yes, based on the three -- initial use of the

three models and the determination that the CAPM result was too low to be meaningful, I averaged the results from the other two methods and arrived at a 10.8 percent cost of equity indicated by the models as of that point in time.

Q. But the company didn't change its recommendation in rejoinder testimony, or you didn't change your recommendation?

A. That's correct. As I went on to explain in my rejoinder testimony, I was comfortable with the 11.4 percent based on the two sets of analyses and the financial market outlook, and particularly when compared to other recent allowed ROEs.

Q. So touching upon that subject, would you agree with me, then, that as far as cost of capital goes, when dealing with cost of equity, that there is a factor of judgment involved in that? Stated another way, there's some art and some science to developing a cost of equity?

A. Sir, I don't believe I would refer to it as art, but there is professional judgment. And when a CAPM analysis indicates a return that is not higher than the company's cost of debt with respect to historical risk premiums, then I do think a judgment is called for.

Q. That's the judgment call that you made in this case?

A. Yes, consistent with the judgment calls of the other cost of capital witnesses with respect to the CAPM models at this time.

Q. If I could have you turn back to your direct testimony, Exhibit MBP-9 again.

A. Okay, I'm there.

Q. Do you happen to know what the current yield on Baa-rated bonds is?

A. Give me just a minute.

Q. Sure.

A. I can't provide an up-to-the-minute number, but as of November of 2009, the yield was 6.18 percent.

Q. If I were to hand you a document, and I think it's an excerpt, would you -- I mean, I guess I'll hand it to you and see if you recognize it.

Do you recognize that source of information?

A. I recognize this as being from the merchant bond record publication.

Q. Okay. And what, according to that document, does it reflect the --

MR. DION: Your Honor, before we go forward, I think we need to establish the date of this document. I don't have a copy, so I don't have a date on it. I have heard from the witness the source, but I think we need some more information for the foundation of the record.

CALJ FARMER: Okay. I believe he showed you a copy of it, but you just don't have one right now.

MR. DION: He did show me a copy and said he was going to ask my witness if she recognized it. If we're going to talk about it, I think we need to know when it was published. Is this December 2009? December 2008? Some other foundational questions would just be my objection.

CALJ FARMER: Okay.

MR. VAN CLEVE: We can certainly provide a copy at the break or after the break. If she recognizes the document, I don't see the harm in going forward with the question. My understanding is that it's a January 2010 excerpt from the merchant bond records.

CALJ FARMER: Does the document have a date on it?

THE WITNESS: I don't see a date, but it provides information as of December of 2009, so it's been published since December.

CALJ FARMER: Okay. Mr. Dion, do you still have an objection to him asking questions at this point?

MR. DION: I guess if I do, I will make them, Judge. But the basic understanding is this would be published sometime after December 2009, I guess would be where I sit on this right now. So if I do have those objections, I'll make them.

CALJ FARMER: Okay, thank you.

Q. (BY MR. VAN CLEVE) So on that document, do you see a reference as to what the yield would be on the Baa-rated utility bond as of December 2009?

A. Yes. It's come up slightly from the figure I cited for November. It's shown at 6.26 percent.

Q. And do you, if you know, what the current yield is as of December 2009 on a 30-year treasury bond?

A. I do know it was 4.49 percent.

Q. And so is it accurate to say that the differential between those two is 177 basis points?

A. One minute. And the figure you stated again?

Q. 177 basis points.

A. Yes, I agree.

Q. And that's compared to the 477 basis points that you have in your direct testimony when it was prepared?

A. That's correct. And as you'll see, that spread had narrowed. I did not include that as an adjustment to the CAPM model in the update.

Q. On Page 16 of your direct testimony on Lines 10 through 12, you indicate that you used a 7.9 percent yield on Baa-rated utility bonds in your bond yield risk premium method; is that correct?

A. That is correct.

Q. And how does this 7.9 percent yield compare to the current yield on Baa-rated utility bonds?
A. It was higher at that time.
Q. And, in fact, would you agree with me that as of -- between your direct testimony and the current yield, there's actually been a decline of 1.64 percent?
A. Yes, I agree.
Q. Now, turning to the area of compound growth rates and risk premium, if I could have you turn to Page 8 of your rebuttal testimony.
A. I'm there.
Q. And this is -- I think it goes along the lines of some questions that Mr. Pozefsky asked you, but on Page 8 of your rebuttal testimony, is it fair to say that you criticize Mr. Parcell's use of the geometric mean in developing the risk premium component of the CAPM analysis?
A. Yes. Because he is arriving at a forward-looking projection, arithmetic means are more appropriate.
Q. Okay. And if I could have you turn to what had been marked as Exhibit S-17.
A. I have that.
Q. And this time it's the first page of that document. Is that a data request that Staff issued to the company?

A. Yes, it is.
Q. And did you prepare the response to that data request?
A. Yes, I did.
Q. If I could have you -- well, in your response, you cite or quote from the Decision No. 70360 where the Commission indicated and agreed with Staff that it's appropriate to consider the geometric returns in calculating comparable company CAPM, because to do so -- to do otherwise would fail to give recognition to the fact that many investors have access to such information for purposes of making investment decisions, correct?
A. That's correct.
Q. And you go on to state that, as stated in your rebuttal testimony, investors also have access to financial literature that would lead them to use arithmetic averages rather than geometric averages, correct?
A. Correct.
Q. So do you take issue with the Commission's decision to adopt Staff's position to use geometric means?
A. In my position as the cost of capital witness for this case, I present information that shows that investors would see information supporting the use of an arithmetic average rather than geometric, and, therefore, that is

what I used in my testimony, and, therefore, I was critical of that in the other cost of capital witness analyses.

MR. VAN CLEVE: Thank you, Ms. Pritz.

No further questions, Your Honor.

CALJ FARMER: Okay. I have a few questions for you, and then we can take a break and you can come back. And we can have some redirect now if you want to.

EXAMINATION

Q. (BY CALJ FARMER) On Page 17 of your direct testimony, you discuss what you recommend as the appropriate return on equity, and I believe the way that you derived your recommendation was to take the average of those three returns from the models; is that correct?

A. That is correct.

Q. Okay. And then in your rejoinder testimony, you updated those analyses. And I think that for the DCF you had originally found a 12.1 percent, and that changed to 11.2 percent; is that correct?

A. That's right.

Q. And then for the CAPM you had found 10.1 percent, and that changed to 8.9 percent?

A. That's right.

Q. And then for the risk premium method you had a 12 percent which changed to a 10.3 percent; is that correct?

A. That's correct. I will point out that in my original analysis, I included the CAPM results as I had adjusted them to get to the 10.1 you just cited. And that in my rejoinder testimony, rather than make an adjustment to the CAPM model so that it was reasonable or in line with an expected return relative to cost of debt, I chose to exclude that. So I averaged the result of the bond yield plus risk premium and DCF models when I did the update.

Q. So you averaged those two in your rebuttal or your rejoinder, did you say?

A. In the rejoinder. I'm sorry.

Q. Okay. So when you averaged the 11.2 and the 10.3, that's what you say you did?

A. That's right.

Q. Okay. Then what was your recommendation when you averaged those two?

A. Well, 10.8 is the indication at that point in time. Again, I went on in my rejoinder testimony to point out that I still feel the 11.4 from my original set of analyses is a stronger number, and that's still my recommendation.

Q. Yeah, and I wondered about that, because if all of the analyses have changed, why wouldn't the recommendation also change?

A. Well, at each point in time that one does an analysis, one would expect to have the results move a bit. And so the 11.4 and 10.8 were both valid at different points in time. Neither of them includes a premium based on the increased riskiness of UNS Electric.

And at the time that I updated my analyses, the financial press is showing a great deal of concern about the potential for increasing inflation, which would increase the risk-free rate and drive up cost of capital.

And lastly, a review of recent rate orders show companies with less risk than UNS Electric having rate orders 10.7 to 11 percent.

Q. Did you say the first reason was the increased riskiness of UNSE?

A. Relative to the comparable companies that were used in arriving at these base recommendations, yes.

Q. So between the time you made your initial recommendation and this updated one, UNS has become more risky?

A. No, ma'am. What I mean to say is that at each point in time, UNS Electric would be regarded by investors as a riskier investment than investment in the proxy group of companies that I used. So in each case, the recommended ROE is quite conservative; therefore, when I updated my analyses, I felt comfortable staying with the 11.4 percent recommendation.

Q. But wasn't that also true at the time that you made the initial recommendation?

A. That was true, and I did note at the time in my direct testimony that I regarded that as a conservative estimate.

Q. Okay. I guess I'm just having trouble seeing why that's a reason you wouldn't modify your recommendation, because it was also in existence at the time that you did the initial recommendation.

A. Your Honor, keeping the initial 11.4 percent recommendation, I'm looking at the updated analysis that shows 10.8, which does not reflect a premium with respect to other companies' rate orders, companies that would be considered less risky.

And since the time of my initial recommendation, there has been increasing concern about the possibility of inflation increasing, and that was not a factor that I had initially considered.

Q. Okay. What would be the average if you did include the CAPM results in the updated analysis?

A. May I ask for another pen? Thank you.

Had I included the CAPM result, the overall average would have been just above 10 percent, 10.1. And again, I note that I excluded that, as did the other cost of capital witnesses.

Q. Thank you. On page -- I think your rebuttal testimony, please, on Page 2, there you're discussing a disagreement that you have with Mr. Parcell, and you're talking about why you consider some of the sets of data to be weak.

Did Mr. Parcell respond to your statement that the inclusion of historical data again as a separate data source is redundant and produces a downward biased estimate of growth for the groups of companies that he examined?

A. I do not have his surrebuttal testimony in front of me, but I believe that he felt -- continued to feel that because the information is observable by investors, it should be considered.

CALJ FARMER: Those are all of the questions that I have.

Do you want to do redirect now?

MR. DION: I just want to find out if you had any other questions. I don't have any questions for this witness.

MR. VAN CLEVE: Your Honor, I don't have any questions, but I forgot to move for the admission of S-17.

CALJ FARMER: S-17 is the data responses of -- from Staff?

MR. VAN CLEVE: Yes, Your Honor.

MR. POZEFSKY: I did have a few questions, Your Honor.

CALJ FARMER: Are there any objections to the admission of Exhibit S-17?

MR. DION: None Your Honor.

CALJ FARMER: Hearing none, they're admitted.

(Exhibit S-17 was admitted into evidence.)

CALJ FARMER: Okay. You have a few?

MR. POZEFSKY: Just a few. I'll make them quick.

FURTHER CROSS-EXAMINATION

Q. (BY MR. POZEFSKY) Ms. Pritz, I heard you saying a few times that your unadjusted CAPM results were too low to be meaningful, correct?

A. Yes, that's correct.

Q. Couldn't the meaning be that a lower cost of equity is appropriate?

A. While I would expect the results of the various analyses to go up and down over time as a result of changing economic factors, I would expect that investors continue to require premium above less risky investments. And the premium that would be offered in this case above the company's cost of debt is below what investors have typically expected.

Q. Ms. Pritz, wouldn't a low CAPM normally indicate a low level of risk?

A. It can be an indication of a lower level of risk if the level of risk is still appropriate with respect to debt and is still within reason based on findings produced by other analyses.

Q. You'll agree with me that CAPM measures risk, correct?

A. The CAPM is a measure of riskiness. Beta in particular, as an input to the company, is a measure of the company's relative risk.

Q. Ms. Pritz, what is so risky about this company that an adjustment is necessary?

A. Mr. Pozefsky, are you referring now to my direct testimony? To the adjustment made in the --

Q. Yes.

A. Let me get to the right section, please.

As I pointed out in my direct testimony, had I not included a risk premium adjustment, the model would have indicated an 8.4 percent return on equity, while the average bond yield for Baa-rated bonds was 7.9 percent.

That would have been a premium of only .5 percent in return for the increased risk borne by an equity investor.

Q. You will agree with me, won't you, that this is a regulated company?

A. That is correct.

Q. It has a defined service territory?

A. Yes, it does.

Q. It has captive ratepayers?

A. Yes, it does.

Q. Wouldn't you also agree with me that given that the economy is declining, investors are looking for safer investments?

A. Yes, and certainly that increases the company's cost of equity. It's hard to attract investors in equity when they are risk averse.

Q. Wouldn't you agree with me that utilities are known for being the safer investments?

A. Safer than?

Q. Unregulated companies such as AIG or Ford.

A. I think it would depend greatly on the company.

Q. But in general, aren't utilities, being that they are regulated, have captive ratepayers, tend to have a defined service territory, aren't they usually considered safer investments by investors than unregulated utilities that are subject to competition?

A. Particularly if they're able to pay a dividend.

MR. POZEFSKY: Thank you. That's all I have.

CALJ FARMER: Okay. She requested to come back after the break, so do we want to do that now so she'll be --

MR. DION: Your Honor, I could stand corrected by Staff, but I believe that on Staff's cross those questions were answered.

MR. VAN CLEVE: That's correct.

CALJ FARMER: So you don't need to check anything and then report back whether you agreed?

THE WITNESS: No, because they were able to provide the rate orders that had the requested information.

CALJ FARMER: So any further questions for this witness?

MR. POZEFSKY: None.

CALJ FARMER: Thank you very much for your testimony.

Let's go ahead and take our lunch break and return at 1:30.

(A recess was taken from 12:22 p.m. to 1:51 p.m.)

CALJ FARMER: Let's go back on the record.

I believe that concludes the company's witnesses; is that correct?

MR. PATTEN: It does, Your Honor.

CALJ FARMER: Okay. Now let's move on to RUCO's witness.

MR. POZEFSKY: Okay. At this time, Your Honor, RUCO would call Bill Rigsby.

WILLIAM A. RIGSBY,

called as a witness on behalf of RUCO, having been first duly sworn by the Certified Reporter to speak the truth and nothing but the truth, was examined and testified as follows:

DIRECT EXAMINATION

Q. (BY MR. POZEFSKY) Good afternoon, Mr. Rigsby. Would you please state your name for the record.

A. William A. Rigsby.

Q. Where are you currently employed, Mr. Rigsby?

A. I'm employed as a public utilities analyst with the Residential Utility Consumer Office.

Q. And Mr. Rigsby, did you prepare testimony in this matter?

A. Yes, I did.

Q. Before you should be what is marked as RUCO's Exhibit No. 10 and RUCO Exhibit No. 11?

A. Yes.
Q. And RUCO Exhibit No. 10 should be your direct testimony and RUCO Exhibit No. 11 your surrebuttal testimony; is that correct?
A. Yes.
Q. And was that testimony prepared by or under your direction?
A. Yes.
Q. At this time do you have any additions or corrections to that testimony?
A. No, none that I'm aware of.
MR. POZEFSKY: Your Honor, at this time I move for the admission of RUCO Exhibit 10 and 11.
CALJ FARMER: RUCO Exhibits 10 and 11 were prefiled, and no objections have been received, so they are admitted.
(Exhibits RUCO-10 and RUCO-11 were admitted into evidence.)
Q. (BY MR. POZEFSKY) Mr. Rigsby, would you please give a brief summary of your testimony.
A. Sure. RUCO in this case is recommending a 9.25 percent original cost of equity capital for UniSource -- or UNSE Electric. This 9.25 percent original cost figure falls on the high side of a range of results that I obtained in a cost of equity analysis that employed

both the discounted cash flow and the capital asset pricing model methodologies. My recommended 9.25 percent figure is 215 basis points lower than the company proposed cost of equity capital of 11.4 percent.

On the cost of debt, based on a review of the costs associated with UNS Electric's various debt instruments, RUCO is recommending that the company proposed 7.05 percent cost of debt be adopted by the Arizona Corporation Commission.

Capital structure, RUCO is recommending that the company proposed capital structure, which is comprised of 54.24 percent long-term debt and 45.76 percent common equity, be adopted by the Commission.

Based on the results of my recommended capital structure, original cost of equity capital, and the debt analysis that I just spoke of, RUCO is recommending an 8.06 percent original cost rate of return for UNS Electric. The figure represents the weighted average cost of RUCO's recommended 9.25 percent original cost of equity capital and RUCO's 7.05 percent recommended cost of debt.

And my recommended 8.06 percent original cost rate of return is 98 basis points lower than the company proposed unadjusted 9.04 percent weighted average cost of capital.

I did not specifically address the fair value rate of return. Our witness, Dr. Ben Johnson, handled that part of the case. But just for everyone's information, RUCO is recommending a 5.96 percent fair value rate of return, which is 210 basis points lower than RUCO's recommended 8.06 percent original cost rate of return.

And the method that RUCO used to arrive at its recommended 5.96 percent fair value rate of return comports with the provisions of Decision No. 70441, dated July 28, 2008. And that resulted from a prior remand proceeding that involved Chaparral City Water Company. And again, as I mentioned, Dr. Johnson explained how he arrived at that fair value rate of return in his prefiled testimony.

MR. POZEFSKY: Thank you, Mr. Rigsby.

At this time, Your Honor, I would tender Mr. Rigsby for cross-examination.

CALJ FARMER: Thank you.

Staff?

MR. VAN CLEVE: Just a few questions, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. VAN CLEVE) Good afternoon, Mr. Rigsby.

A. Good afternoon.

Q. You had mentioned that it sounds like RUCO is in agreement with regard to the capital structure that the company is recommending in this case, correct?
A. Yes.
Q. Is it your understanding that Staff is recommending the same capital structure as well?
A. That's my understanding.
Q. And similarly with the cost of debt, you had indicated that RUCO is recommending approval of what the company is seeking in this case, correct?
A. Yes.
Q. Is it your understanding that Staff is also in agreement with that?
A. Yes. I believe that's what I testified to in my surrebuttal testimony.
Q. And so with regard to the cost of capital, is really the only issue of contention the cost of equity?
A. Yes.
Q. Okay. And what is the company -- or RUCO recommending in this case?
A. We're recommending 9.25.
Q. 9.25. And what is your understanding of what the company -- what the Staff is recommending in this case?
A. I believe Staff is recommending 10 percent.
Q. And has RUCO ever recommended a 10 percent cost

of equity in a case?
A. We may -- I may have earlier when cost of equity figures were running higher than -- or cost of equity estimates were a little higher than what we're getting now.
Q. And to the best of your knowledge, how long ago was that?
A. Gee, offhand, I couldn't -- I really couldn't tell you right off the top of my head.
Q. Do you have sort of a time frame at all?
A. Let me think about that. If I did, I think it probably would have been sometime within the last three years. I think I may have recommended a level that high in one of the Arizona-American cases, if I'm not mistaken.
Q. And between what the company is seeking in this case for the cost of equity and what Staff is recommending for cost of equity, which of those two figures would RUCO more likely support?
A. Well, RUCO would like to support its 9.25 figure but -- I mean, naturally, of course. The Commission has been, over the past couple of years, has been adopting rates of return of around 10 percent. I think two of the last cases that I have seen decisions on, they dropped it down to 9.9. So we would feel comfortable with anything within that range of 9.25 to 10 percent.

Q. So just to answer my question, then --
A. I'm sorry.
Q. -- between the two, would you be more likely to support what Staff is recommending in this case than what the company is?
A. Well, that's closer to our number, so, you know, it's closer.
MR. VAN CLEVE: Thank you, Mr. Rigsby.
No further questions, Your Honor.
CALJ FARMER: Thank you.
Mr. Patten?
MR. PATTEN: Thank you, Your Honor. We don't have any questions for Mr. Rigsby.
CALJ FARMER: I do have a couple for you, I think.

EXAMINATION

Q. (BY CALJ FARMER) Your direct testimony was filed in November of last year, correct?
A. Yes.
Q. Have you looked at any more current data to update your recommendation?
A. I've gone over the Value Line updates on the electrics as they come out. The problem is Value Line does their electrics on a regional basis, so you don't

always see all of the -- you don't -- you may not necessarily see all of the companies that are included in this, my sample, because they're in different regions.

But I think that the number that I'm recommending at this point, I think it would hold up even though it's been a couple of months now since I filed my direct. The reason for that was when I made the estimate, I made the estimate on the high side of the range that I came up with. And that was in anticipation of the Federal Reserve, anticipated Federal Reserve actions as far as raising interest rates and, as Ms. Pritz had noted, expectations of higher inflation.

So as far as the number, the estimate itself that I'm putting out there, I feel comfortable with it. That at this point in time, I really don't think I need to make a revision to it.

Q. What are the current expectations about higher inflation?

A. Well, inflation right now is fairly low, but there's some concern out there regarding some actions that the Federal Reserve may take. Actually, some actions that they already have taken regarding their purchase of mortgage instruments, that there's quite a bit of liquidity out there. And as the economy improves, there's this fear that could stoke higher rates of inflation.

Typically, the Federal Reserve deals with inflation by raising interest rates, and there's been some articles in The Wall Street Journal just within the last couple of days where they have speculated on this. And then Chairman Bernanke of the Federal Reserve Board actually had a speech prepared, I think he was going to give yesterday, I think it was in Washington, but with the snow situation back there I guess he wasn't able to give it. But the Fed did release the text of his prepared remarks, and basically he outlined some plans on how the Fed could deal with this problem.

But the possibility of higher interest rates is looming, and, of course, that's one of the reasons why I deviated on my estimate at this time from going with a straight average of my CAPM and DCF results to an estimate that falls, as I say, on the high end of the range. I guess you could say I'm trying to be proactive.

CALJ FARMER: Okay. Those are the only questions I have.

Is there any redirect?

MR. POZEFSKY: Just a little.

REDIRECT EXAMINATION

Q. (BY MR. POZEFSKY) Mr. Rigsby, as between the two numbers, the 10 percent and the 11.4, you believe that the 10 percent is better, though, correct?

A. Well, as I stated, I mean, certainly, you know, we -- if the Commission, you know, I mean, the Commission is allowed discretion as far as where they -- what they award in the way of rate of return. But certainly, you know, we would like to see them go with the figure that's closer to ours.

Q. But RUCO is recommending the 9.25?

A. Yes.

Q. So under the circumstances of this case, RUCO believes that the 9.25 is the most appropriate of the three numbers, correct?

A. Well, and that's how I responded to Mr. Van Cleve's question.

Q. Mr. Rigsby, one other question. With regard to the use of the CAPM in determining cost of equity, given the testimony we've read and heard, what is your response?

A. In regard to the CAPM?

Q. Yes, and use of it.

A. Well, yeah, I think we've raised this point in other proceedings, you know, where we don't try to make adjustments to CAPM results in good economic times; we don't tend to ignore the results in good economic times.

As I say, I think I've said this before, I think, yeah, it may be true the model is producing low results right now, but, you know, I think that's reflective of the economy, and I think it's reflective of the current interest rate situation.

I mean, the risk-free rate of return that I used -- I mean, let me check. I know right now that five-year instrument is at 2.4 percent. I think the one -- just to check to see.

Okay, yeah. It hasn't changed. I used an eight-week average back in November and I came up with 2.41 percent then. And right now, as of the 3rd of February, that five-year yield was at 2.4 percent. So it hasn't changed much. But it's low and so it's going to produce low results, and that's just the nature of the beast.

Q. And given the current state of the economy, should the Commission consider it in its determination of cost of equity, and to what extent and how?

A. Well, yeah, I think they should. You know, a utility files during a certain period of time, and I guess when you file you sort of take your chances as far as what the current economic environment is at that time. So certainly we think that a rate of return, a return on equity should reflect current economic conditions.

In this case, as I was explaining to Judge

Farmer, I think what we've done in this case is try to be proactive in that, you know, as I say, if I had averaged the results of my two models, I would have gotten a much lower result, but we've come up. I've gone ahead and made a recommendation that -- a recommendation for an estimate that's actually a little on the high side of the range of estimates that I came up with.

As I say, you know, that's in anticipation of an improving economy and, you know, the possibility of increased inflation and higher interest rates and so forth.

Q. Given the current state of the economy, Mr. Rigsby, are investors seeking out safer investments?

A. Well, for quite a while there -- and Mr. Parcell can probably testify to this better than I could -- but yeah, there was this flight to quality where investors were worried about where they were going to put their money. So they were putting them into, you know, U.S. treasury instruments where they were getting next to nothing on their money, but they knew that they would be able to get their money out of those investments. In other words, there wouldn't be any loss of it, you know, because they were U.S.-backed treasury instruments and so forth.

And, of course, they were also seeking out safer investments, and I think, you know, during that period of time, utilities would have been a fairly attractive investment, in my opinion, because they've always been attractive for income-oriented investors, mainly because of their higher dividend yields.

And as you were discussing with Ms. Pritz, they're relatively safe because they're regulated. And so an investor could probably put money into, you know, energy stocks, the regulated energy stocks and so forth, natural gas companies, water companies, and at least have some assurance that he wasn't going to lose his money. That he could, you know, at least park his funds in those investments, either the treasury securities that I mentioned or public utilities, and, you know, still be able to get his capital -- his or her capital out of that investment without taking a major loss.

Q. And just one more question. Every party has presented a range, a low range to a high range, and all of these different results from the DCF and the CAPM.

Given the current state of the economy and where cost of equity figures are going these days, should the Commission be leaning towards the lower end of these ranges, the higher end of these ranges, or towards the average?

A. Again, as I say, you know, the Commission is allowed discretion as far as what it wants to do. You know, certainly, as I say, we're putting the 9.25 estimate out there, you know. The best thing I could tell you is that certainly if they were to adopt the -- the cost of common equity that they would adopt, we would certainly hope it would be somewhere very close to what we're recommending in this case.

MR. POZEFSKY: Okay, good enough. Thank you Mr. Rigsby. That's all I have.

THE WITNESS: Sure.

CALJ FARMER: Anything further for the witness?

MR. PATTEN: Just one question.

CROSS-EXAMINATION

Q. (BY MR. PATTEN) Mr. Rigsby, you understand that UNS Electric has not paid a dividend since its inception?

A. That's my understanding.

MR. PATTEN: Thanks.

CALJ FARMER: Thank you, sir, for your testimony.

Is Staff ready to call your witness?

MR. VAN CLEVE: Yes, Your Honor. Staff calls David Parcell.

DAVID C. PARCELL,

called as a witness on behalf of ACC Staff, having been first duly sworn by the Certified Reporter to speak the truth and nothing but the truth, was examined and testified as follows:

DIRECT EXAMINATION

Q. (BY MR. VAN CLEVE) Good afternoon, Mr. Parcell.
A. Good afternoon.
Q. Would you please state your full name for the record.
A. Sure. My name is David C. Parcell, P-a-r-c-e-l-l. My address is 1051 East Cary Street, Suite 601, Richmond, Virginia 23219.
Q. And by whom are you employed and in what capacity?
A. I'm employed by Technical Associates, Incorporated, where I've been since 1970, and the last couple of years I've been the president.
Q. And you were retained by Commission Staff in this case to provide testimony; is that correct?
A. That is correct.
Q. And what is the scope of your testimony in this case?

A. There are two aspects of my testimony. One is the cost of capital, and one is the fair value rate of return.

Q. And did you prepare and prefile direct and surrebuttal testimony in this case?

A. I did indeed.

Q. And you should have in front of you, with any luck, two documents, one that's been marked as Exhibit S-14 for identification.

A. That's my direct testimony, correct.

Q. And the other document being Exhibit S-15?

A. And that is my surrebuttal testimony, correct.

Q. And were both S-14 and S-15 prepared by you or under your direction and supervision?

A. Yes.

Q. And do you have any corrections, clarifications, or modifications to make to either S-14 or S-15 today on the stand?

A. None that -- I had some changes to S-14, but they were done in the process of preparing S-15, so I have no further corrections or additions.

Q. So if I were to ask you the same questions contained in S-14 and S-15 today on the stand, would your answers to those questions be similar or substantially similar to what is contained in those documents?

A. The same except for those corrections, yes.

MR. VAN CLEVE: Your Honor, I move for the admission of S-14 and S-15.

CALJ FARMER: Exhibits S-14 and 15 were prefiled, and no objections have been received, and they are admitted.

(Exhibits S-14 and S-15 were admitted into evidence.)

Q. (BY MR. VAN CLEVE) Mr. Parcell, if you could provide a brief summary of your testimony in this case.

A. Certainly, and it will be brief. I am recommending an overall cost of capital of 8.40 percent. As the prior two witnesses indicated, there's no dispute between the three of us as to the capital structure and the cost of long-term debt.

My recommendation for the cost of equity is in dispute as it is different from the other is two. I am proposing a cost of equity of 9.5 to 10.5 percent, and I focused on the midpoint of that range or 10.0 percent. 10.0 percent ROE in the capital structure with a 7.05 percent cost of debt produces an 8.40 percent cost of capital.

I used three methods to determine my cost of equity: DCF, which is discounted cash flow, where my range is 9.4 percent to 10.1 percent; capital asset pricing model or CAPM, range is 7.6 to 8.3; and comparable earnings or CEM, 9.5 to 10.5.

In my surrebuttal testimony, in addition to commenting on the rebuttal testimony of Ms. Pritz, I also update my cost of capital, cost of equity analysis, my DCF and CAPM. And on a particular page, which is Page 11 of my surrebuttal testimony or S-15, I show an internal table that compares my DCF and CAPM results in my original analyses from direct testimony and updated analysis from surrebuttal, but my conclusion is the same. I remain focused on the 10 percent as the cost of equity for this company.

The second aspect of my testimony focuses on the fair value rate of return. And in this I'm using the same type of analysis that I have presented in a number of cases before this Commission over the last three years, I guess, including the Chaparral case, the prior two UNS Electric and Gas cases, as well as the Southwest Gas case, whereupon I look at the dollars of capital pertaining to original cost rate base, add to that the dollars of increment, the cost of capital between the original cost and fair value rate base, to determine a fair value capitalization. And I assigned the same cost of debt and equity as in my cost of capital, but for the fair value increment I propose a return of 1.5 percent.

And that completes my summary.

MR. VAN CLEVE: Thank you, Mr. Parcell.

And Mr. Parcell is available for cross.

CALJ FARMER: Thank you.

RUCO?

MR. POZEFSKY: Thank you.

CROSS-EXAMINATION

Q. (BY MR. POZEFSKY) Good afternoon, Mr. Parcell. How are you?

A. Good afternoon. How are you today?

Q. Let me ask you, before I ask you some questions specific to this proceeding, you're recommending a 10 percent cost of equity, correct?

A. Yes.

Q. And I know you have testified before this Commission for years. Can you tell me when was the last time you made a recommendation on cost of equity other than 10 percent?

A. Where? Anywhere?

Q. No, no. Here in Arizona.

A. I was in a Southwest Gas case a couple of years ago. And my final number was 9.9, but I added 10 basis points to that to have a reflection of a lower equity ratio. So that was really 10 percent, too.

I would say in all of my testimonies in the last two or three years, the midpoint of my range would have been 10, but the range itself was not always the same. But the midpoint has been 10.

Q. Don't you think it's a little unusual that in all of those cases -- I know there's been a lot of them -- that this is the same recommendation case after case?

A. I would say it was. In fact, when I was cross-examined in the UNS Gas case by Mr. Patten, right? He pointed out -- when I was preparing this testimony, I was very careful. I said, what do I -- am I still at 10 percent? And I looked at the numbers, and that's what it was.

My DCF was prepared exactly the same way, the 9.4 to 10.1. My CAPM was lower, and my comparable earnings 9.5 to 10.5. So the 10 percent or range of 9.5 to 10.5 is what the numbers show. I've been in cases in other states recently where my number was different.

Q. Is there anything in particular to Arizona that would result in the numbers being pretty consistent the way they have been?

A. No. I would say on most of my cases that the range tends to center on about 10 percent. Not necessarily 10.0 percent, but in that neighborhood, yes.

And, in fact, if you look at Commission decisions over the past several years, they have not jumped or fell a lot. The average return on equity nationwide, it's hard to average cases nationwide because you may get two from Arizona in one year and none the next, and three from Texas the next year, and four from Washington state the next. So it's hard to compare the averages.

But if you look at those, it's been -- the average authorized has been around between 10 and a quarter and 10.4 over the last several years, the average authorized by all of the commissions in the U.S.

Q. Does it matter whether or not times are good or times are bad? I mean, it seems not to matter if you're consistently getting 10 percent. And as we all know, economic factors are definitely part of the equation.

Does it matter whether times are good or times are bad?

A. It does and it doesn't. Here is how it does. Insofar as current economic conditions impact models such as DCF and CAPM, it matters. Insofar as whether there is a moral or practical reason for deviating from what the models show for the purpose of a Commission authorizing a return, that doesn't matter to me. That's something that the Commission would consider, but not a witness.

Now, in this particular case, if you look at the results of the capital asset pricing model, it's well below the other models. When I did a UNS Electric case here three years ago, my recollection is my CAPM was the highest result at that time, but within the range, and that was the lowest.

And one reason I like to use three models, if I get three different results and two are closer together and one is not, then I can ask why is the one different and then make a determination as to whether I should give it less weight or not. If I only used two models, it would be more difficult because I would have to determine which model is the outlier.

So the short answer to your question, it does matter and it doesn't matter depending upon whether you focus strictly on my results, or on the issue of what should the Commission do to balance the interests of ratepayers and stockholders. In the latter, it probably does matter.

Q. Now, in your analysis here, would that be -- would your analysis be affected if the Commission were to approve the rate basing of this Black Mountain plant and the company were eventually to acquire it in its rate base?

A. I don't believe it would. I don't see why that would change the cost of equity. And, in fact, I'm not aware of anyone else suggesting in this case that it would change the cost of equity.

Now, 30 years ago when I was doing this kind of work, if a company would build a new power plant, that would impact it, but I don't know that -- I don't think it impacts this company. Because the power for now is being purchased or -- UNS Electric is going to be selling power to customers, generated in part by Black Mountain, regardless of whether its owned by the company or an affiliate company. So I don't see that as an impact on the cost of equity.

Q. Well, I don't want to get into a debate with you here, but theoretically, one of the arguments that has been made is that if, in fact, it's rate based and they acquire it, the company would get a better generation mix, it would have its own generation, and it wouldn't be subject to the market and, therefore, it could become less risky, which it would necessarily follow could possibly result in a lower CAPM or a lower cost of equity.

I mean, do you subscribe to that at all, or is that even possible?

A. Well, there's also two sides to that question, though. Since the -- over the last decade or so, a number of United States electric utilities have sold or otherwise disposed of their generation assets which made them so-called wires companies. And by wires I mean distribution and transmission. And that distinguishes them from an integrated company, which in addition to being the wires operation has the generation.

When this first happened, Standard & Poor's came out and resultingly created its matrix system where it assigned a business position to various utilities. And based upon this, Standard & Poor's had lower requirements for a wires company in terms of coverage, et cetera, than it did for a generation company that had the same ratings. So Standard & Poor's was, in essence, saying that a wires company was less risky. That's the one hand.

As economists say, on the other hand, on the other hand, if you have got a company that has to buy power in the market, there is some rationale for having some of your own generation because it's, say, a productive asset.

To give you a specific example, when Sierra Pacific Power Company and Nevada Power Company decided to combine operations and merge roughly in 1999, under the umbrella of Sierra Pacific Resources, one of the aspects to that merger was that both companies would divest themselves of their generation capacity. And they're in the process of doing that, and, in fact, one of the two, I think Nevada Power, but I might be wrong on that, but one of the two actually had some signed contracts to transfer ownership of its self-generation to another entity, not affiliated.

And then the so-called western energy crisis occurred, and it became very apparent that the most valuable asset that Nevada Power had was its generating assets, and the Nevada legislature passed a law saying you will not divest. So that's a situation where the generation assets was deemed important.

So there's two ways to look at it, and probably the best mix is to have some generation assets so you have some control, control of the costs. If your plant doesn't work, you have to go out and buy it anyway.

That was a speech, but like I say, there's two ways to look at, and there's two aspects that seem to give different results.

Q. Okay. Well, another way to look at it -- and I don't want to get too far into this -- but is it could also help the company financially, its financial metrics, its earnings, things of this nature, which would make the company, again, more stable, which necessarily could even further lower the cost of equity?

A. Could. Yes, could. I don't think it necessarily would, but it certainly could.

Q. Let me go to Page 38 of your direct testimony.

What I'm going to ask you you testified, it sounds like, in your summary, but you went kind of fast and I want to go a little slower on it.

You list your results for your three different analyses that you did. And your results I see for the discounted cash flow were 9.4 to 10.1; the CAPM, 7.6 to 8.3; and then your comparable earnings, 9.5 to 10.5. And then on Line 17 on Page 38, you recommend a cost of equity of 9.5 percent to 10.5 percent, correct?

A. Correct.

Q. And I know you updated in your rebuttal a little bit. But in that range there, obviously, you didn't consider the CAPM results, the 7.6 to 8.3, because that's not in that range, correct?

A. I did not average them in, but I gave consideration to them as part of the reason not going to -- not using the highest DCF results, and the highest DCF results, obviously, are the 10.1.

But back in my DCF section where I showed the highest growth rates and highest DCF cost, I used the CAPM results to indicate that it would not be appropriate to go to the high end of the DCF results. So in that regard I used it, but not in terms of averaging the three methodologies' results.

Q. Okay. And I recall -- and I know we've had this discussion in the UNS Gas case. I recall you testifying that you considered it -- this is the CAPM -- that it was not reflected in your recommended range in that case either; is that correct?

A. Yes, that's correct.

Q. I'm going to hand out a copy of that transcript, because I'm going to refer to it. So give me a second here.

A. Thank you.

Q. And in that case, UNS Gas case, Mr. Parcell, your recommended rage was also 9.5 to 10.5 percent; is that correct?

A. That is correct.

Q. And your CAPM range in that case was 7.3 percent to 7.7 percent, correct?

A. That is correct.

Q. So as you did in that case -- well, in this case you also disregarded the low CAPM results from your range in your final recommendation, right?

A. Well, look on the transcript 832, Lines 18 and 19. I said, "Well, I considered it, but it's not reflected in my 9.5 to 10.5," which is the same answer I gave you a few minutes ago. I used it in my considerations, but I did not average the results in.

Q. You would agree with me that the CAPM is

frequently used as a check for the DCF analysis?
A. Yes.
Q. In this company's last rate case, you also made a recommendation, or your DCF produced a range of 9.5 to 10.5 percent? I should -- I have a copy of that.
A. I do, too. My UNS Electric case?
Q. Yeah. It's Decision 70360, RUCO-1. It's on Page 42, and it's Line 11 through 12.
A. All right. I have my own testimony, but I can look at whatever version you would prefer me to. RUCO-1?
Q. Yeah. Page 42.
A. 42, sure. Okay. And lines again? I see. 11, 12?
Q. Yes.
A. Yes. My DCF result produced a range of 9.5 to 10.5.
Q. And that was a couple of years ago, correct?
A. That was -- that particular sentence was DCF only. That relates to my 9.4 to 10.1 in this case DCF.
Q. And in that case, the last case, your CAPM analysis produced an equity range of 10 to 10.5 percent, correct?
A. I believe that's correct.
Q. And in that case you also recommended a cost of equity of 10 percent, correct?

A. Yes. A range of 9.5 to 10.5, I believe.

Q. But in that case you actually considered the midpoint of the CAPM and used it to support your final recommendation, correct?

A. That's correct, because the CAPM fell within the same general range as my comparable earnings and DCF, unlike this case.

Q. With regard to the economic conditions, you have agreed with me, haven't you, in the past that these are factors that are considered or should be considered when determining cost of capital?

A. Yes, I did. I gave you two aspects of that, yes.

Q. And economic conditions influence the CAPM input of the risk-free rate? I'm at your transcript at 834, Line 6.

A. I would agree with that, yes.

Q. And they influence the CAPM input for market risk premium?

A. Yes.

Q. And from a public policy perspective, economic conditions could also be a factor in determining an appropriate cost of equity?

A. Yes, and in the beta as well.

Q. And you're aware that the Commission has made it known that it's very concerned with the current state of the economy and how it affects and -- well, and how it should affect the Commission in considering appropriate rates?

A. Yeah, I agree fully. In fact, when I gave you the two aspects, when I said it matters and it doesn't matter, that's exactly what I was referring to when I said it does matter.

Q. And you would agree with me that there's been a significant downturn in the economy in the last couple of years, correct?

A. Well, there was a very significant downturn in between the end of 2007 and probably the beginning of the third -- well, the middle of the third quarter of 2009. So not only is it a significant downturn in terms of the decline, but also how long it has lasted.

Q. And with regard to this particular company, I know we've gone through this in UNS Gas, but with this particular company, how has its financial condition changed since the last rate case? Has its credit ratio improved? Has it become more financially sound? How would you describe that?

A. Well, I would say that the company is marginally better off financially than it was in its last rate case for probably three reasons. First of all, its cost of debt has come down as it has refinanced some debt. Second of all, it's sold debt in the public market, so to speak, now and has bond ratings by Moody's. And third, unlike the last case, it has come off the rate freeze where it had not been able to change its rates for -- I think four years the rate freeze lasted. And that went through a -- I'll use the term "cycle" where it had its second rate increase request for like a three-year period. So it's able to do things now it could not have done prior to the last case.

Q. And again, given all of these answers, Mr. Parcell, would it be unreasonable for the Commission to award a cost of equity in this case similar to what RUCO is recommending?

A. Unreasonable? I would not -- you know, witnesses love double negatives. I would not describe it as unreasonable, no. I mean, it's a little below my range. My range starts at 9.5. If you would ask me 9.5, I would be more inclined to go along with that.

But I did not add an increment in my recommendation in the last case because of the fact that the company had a four-year freeze, et cetera, because that's what they had agreed to and that was a rule of the game at that time. So that's a risk factor that probably did not create an increment to my return at that point in time.

Q. By the way, Mr. Parcell, when you testified earlier that you had a case a couple of years ago where the CAPM was actually the highest, did you take out the range in your consideration of cost of equity like you did in this case?

A. No. In fact, what I was referring to is this case that you and I just are discussing now, the UNS Electric case in RUCO-1. Because my -- I think we read together a few moments ago my CAPM result was 10 to 10.5. And that was within the same range as my DCF and comparable earnings, so I did not take it out. If I had, it would not have changed anything because it was within the same range as the other models.

Q. Mr. Parcell, is it only really reasonable to take out or to use the CAPM results when the times are good?

A. Say it again.

Q. Is it only reasonable to use the CAPM range when the times are good?

A. I'm having a hard time with "times are good." I'm inclined to consider not using any models' results when those results are what I deem to be outliers in comparison to other results, and whether times are good or times are bad are not a factor. What matters is that the results are substantially different, and the question is do they deserve equal weight at this time. And to me, that's what is important.

Q. Mr. Parcell, in the UNS case, you were asked by Judge Nodes, if the Commission were to take into account both national and local economic indicators, whether it would be more appropriate to factor that into the cost of capital determination or the revenue requirement. And your answer was the cost of capital because it was very specific.

Do you still believe that?

A. I'm sorry. I missed a word there. The result was?

Q. Your answer was that the cost of capital -- it would be better to take it off the cost of capital because it is very specific. And I'm at Page 842, 843 of your transcript.

A. Okay.

Q. I don't want to misquote you.

A. Part of the -- when I said better off, obviously there was a second option on the table, and I don't recall what the second option was, at least I presume there was a second option on the table.

Yes. On Page 842 on the -- the question was on Lines 6 through 15, the question was should it be taken -- if the Commission determined -- well, maybe I shouldn't paraphrase the Commission. I will just say, read Lines 6 through 15.

But the issue was whether any Commission modification should come from the cost of capital or the overall -- yes, Lines 12 through -- should these considerations more appropriately be factored into establishing an appropriate cost of capital, or should they be taken into consideration in establishing the overall revenue requirement in a more general sense as far as the impact on ratepayers?

So those are two options in the answer that I gave that you just cited.

Q. I'm sorry. And the answer you gave was cost of capital, correct?

A. Yes. Like the last sentence, it says: Well, it's a cost of capital guide.

Q. And you still believe that, correct?

A. Sorry?

Q. And you still believe that, correct?

A. Yes, I do.

Q. A better way to take it is off the cost of capital than the revenue requirement?

A. I would say so, because you know it's measurable that way. You can say we did this in this case. If things change, we can modify this in another case.

Q. Going down to the next question on 843, you were also asked in that case that among the three witnesses providing the cost of capital recommendations in that case, that the Commission should give more weight to a lower in the range set recommended by the witnesses as opposed to the higher in the range. And you said that it would be appropriate to go to the low end of the range to reflect the economic conditions.

Is that true, and would that be applicable in this case?

A. Well, see, if you look at Page 844, I used language there that I used in answer to your question 15 minutes ago. That is, from a strict cost of capital standpoint, you look at the models. As the cost of capital guy, I look at the models.

But a Commission would go beyond the model results, if they wanted to, in making a determination, and that's the public policy aspect. And that's what I said on Page 844 of that transcript, and that's what I think I told you earlier this afternoon about whether it matters or doesn't matter when we first started off.

Q. Right. But you did say that from the public policy perspective, should the Commission choose to do so, to go to the low end of the range to reflect the economic conditions, correct?

A. That is correct.

Q. Finally, Mr. Parcell, the judge in that case asked you if the CAPM methodology was more influenced by the current economic conditions in the other methodologies and not as influential in an analyst's overall evaluation as the other methodologies. And you stated that, in general terms, yes; is that correct?

A. That is correct.

Q. And can you explain that?

A. Yes. Because the CAPM uses a current level of interest rates as a major input in the formula. So if interest rates change a lot, the CAPM will change a lot, quickly.

Whereas a DCF, for example, the impact of changed conditions in the short-term is in stock prices. And stock prices factor into the yield, but in the last decade or so the yield is the minor component of the DCF. The growth rate is what's rising. It was true 34 years ago, and it's true now.

So the impact of economic or financial conditions on the CAPM is more immediate and dramatic than it is on the DCF, because interest rates play a bigger role in CAPM than stock prices do in DCF.

Q. Which is why, Mr. Parcell, I really don't understand. If it's an outlier, we've heard that it has no meaning.

A. It has no meaning?
Q. It's unmeaningful without some sort of adjustment. If it is an outlier and you're getting results that are that low, don't you think that it's time for the Commission to start reconsidering the 10 percent cost of equity that seems to be -- has been going on for the last couple of years and to actually go lower on the cost of equity?
A. Maybe. However, since I prepared my surrebuttal testimony in this case and updated my CAPM, I now have access to the Morningstar results, or what we used to called Ibbotson results through 2009.
You see, the results in my analysis in this case used for my risk premium component date to 2008, which is the worst ending time period since the 1930s. So the risk premiums were quite low in 2008. And because of the flight to safety, the risk-free rate was quite low. So when you've got two or three components that are abnormally low, you're going to get low capital results.
Now that the 2009 results can be factored in, the risk premium is higher, 25 or 30 basis points than it was in my analysis here. And there would be an expectation over time that long-term corporate bond rates would go up a little, too. I'm sorry, long-term U.S. Government rates, if for no other reason than the deficits that we're

running right now. They have to be financed.

So there's an expectation on my part that the CAPM results will move back up over the next couple of years, probably into the same general area as the DCF is now or will be at that time. That's a supposition on my part, but I anticipate that happening. So I'm not willing to throw the company in front of the bus right now.

Q. So for the next couple of years, to sort of mediate what has been going on now, would it be fair to keep the cost of equity at 10 percent?

A. I think it's the safe thing to do. I'm not saying it's the only thing to do, but I think it's the safe thing to do.

MR. POZEFSKY: Thank you, sir.

Your Honor, at this time I would move for the admission of RUCO Exhibit No. 12.

CALJ FARMER: Are there any objections to RUCO-12?

MR. PATTEN: No.

CALJ FARMER: Hearing none, it's admitted.

(Exhibit RUCO-12 was admitted into evidence.)

MR. POZEFSKY: That's all I have, Your Honor. Can we just take a five-minute break to use the restroom?

CALJ FARMER: Sure. Let's just come back at 3:00.

(A recess was taken from 2:48 p.m. to 3:00 p.m.)

CALJ FARMER: Let's go back on the record.

Is the company ready to cross-examine this witness?

MR. PATTEN: Yes, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. PATTEN) Good afternoon, Mr. Parcell.

A. Good afternoon.

Q. Déjà vu five months later here.

A. That's right. As Yogi would say.

Q. Mr. Parcell, you should have three exhibits in front of you, and I'm going to ask you first about Exhibit UNSE-33, which is a packet of data request responses. Do you have that?

A. I do.

Q. And if you could flip through those responses and confirm that you were the respondent and witness on all of those?

A. I am respondent on all of them, yes.

MR. PATTEN: Your Honor, I would move admission of Exhibit UNSE-33.

CALJ FARMER: Are there any objections to the admission of Exhibit UNSE-33?

(No response.)

CALJ FARMER: Hearing none, it's admitted.

(Exhibit UNSE-33 was admitted into evidence.)

THE WITNESS: I need to admit an error on one of these, though.

Q. (BY MR. PATTEN) Okay.

A. On the last page of 33, which is UNSE 3-72, I answered the questions backwards. The question you asked, "Please indicate whether Staff disagrees." Upon reading my answers, I answered as though the question was, "Please indicate whether Staff agrees."

So I need to change the answer. I don't get to change the question. That's your question. If I change the question to agree, my answers are then proper. But the way it is now, my answers are backwards.

Q. Okay. Actually, I read it the same way you did, I think. So let's change the word "disagree" --

A. On the second --

Q. -- on the second line to "agree."

A. Yes. May I do this on this copy here? Just mark through this?

CALJ FARMER: Yes, that's fine.

THE WITNESS: Otherwise, it was some pretty bizarre answers. I was reading my answers, and I said, wait a minute. I just answered wrong.

MR. PATTEN: Okay. Thank you, Mr. Parcell.
THE WITNESS: Thank you.
MR. PATTEN: Your Honor, with that slight modification to UNSE-33, we would move admission.
CALJ FARMER: Any objections?
(No response.)
CALJ FARMER: UNSE-33, as corrected, is admitted.
(Exhibit UNSE-33 was admitted into evidence.)
Q. (BY MR. PATTEN) Mr. Parcell, could you turn to Exhibit UNSE-34.
A. Sure.
Q. And you submitted direct testimony in the recently concluded APS rate case, didn't you?
A. I did.
Q. And what has been marked as UNSE-34 was your direct testimony, dated December 19, 2008, correct?
A. Or at least three pages of it, yes.
Q. It's an excerpt of it.
A. Yes.
Q. And that testimony was submitted prior to the settlement negotiations that took place, correct?
A. That is correct.
Q. And so this testimony would have been your litigation position in that case, correct?
A. Yes.

Q. And if you could turn to Page 32 of the excerpt.
A. Yes.
Q. And down at Line 25 of Page 32, you recommend a return on equity of 11 percent, correct?
A. Yes, for the reasons stated on the top of Page 33.
Q. Okay. And you explained that your 11 percent recommendation was at the top of your 9 to 11 percent range, right?
A. Right. To reflect a policy determination made by the Commission Staff, yes.
Q. And that policy determination was a desire to aid APS in its efforts to attract capital investment, correct?
A. That's correct. Although I see the word "capital" is misspelled on Line 1, but we can fix that one.
Q. I won't hold you responsible for that one.
And does Staff desire to aid UNS Electric in its efforts to attract capital investment?
A. Say it again, please.
Q. Does Staff desire to aid UNS Electric in its efforts to attract capital investment?
A. I would certainly think so. But I don't think that Staff believes and I know I don't believe that UNS Electric is in the same situation today that APS was at

that time.

Q. Mr. Parcell, could you turn to Exhibit UNSE-35.

A. Certainly. I'm there.

Q. And this is an excerpt from your direct testimony filed in the 2007 TEP rate case, correct?

A. Yes.

Q. And that was filed on February 29, 2008?

A. That is correct.

Q. And again, this was your litigation position prior to settlement?

A. That is correct.

Q. All right. On Page 36 of that testimony, you recommend or you state that the midpoint range of your range of 9.5 to 10.5 percent was 10 percent, correct?

A. Yes.

Q. But further down on the page at Line 22, you recommend a cost of equity at the upper end of that range, or 10.25 percent, correct?

A. That's correct.

Q. And that was because TEP was more risky than your proxy companies?

A. That's correct. My recollection is TEP had a common equity ratio of under 40 percent.

Q. Okay. UNS Electric has an equity ratio of under 40 percent, too, doesn't it?

A. No. It's about 45 percent.
Q. If you could turn to, I think, your Schedule 6.
A. Well, my Page 2, the cost of -- the common equity ratio is 45.76. That's what we used for the cost of capital purposes. In the case of TEP, it was like 39 something, if I recall correctly.
Q. Okay. And TEP also had a lower bond rating than most of its proxy companies, too, correct?
A. That's correct, yes.
Q. All right. UNS Electric is at least as risky an investment as TEP, isn't it?
A. I would say not, and I think that the Moody's report on UNS Electric agrees with that. And the major reason not is that it's substantially different capital structures. UNS Electric has got like a 45, 46 percent common equity ratio, and TEP is down around 40 or less. So for a company that size, that's a pretty low equity ratio. So I think that's a factor that would distinguish between the two.
Q. UNS Electric has the lowest investment grade rating by Moody's, doesn't it?
A. That's correct. And it's also the same one Moody's assigns to TEP.
Q. So UNS Electric may be as risky as TEP?
A. It may be. But if you read the Moody's reports,

they say that UNS Electric has metrics that are normally associated with the higher end of the BBB range as opposed to the lower end. And they don't come out and exactly say it, but you get the impression that the Moody's was not -- Moody's was reluctant to give UNS Electric a different bond rating than TEP's is the way I read that.

Q. And UNS Electric also has never paid a dividend, has it?

A. No. But again, we all know that when UniSource bought these operations, they didn't buy a company. They bought operations and created subsidiaries to operate them. And they began with a quite low equity ratio of 35 percent, and the plan was -- and this came up a couple of cases back -- the plan was to not pay dividends but use the retained earnings to build the equity ratio up of the companies, and that's what they have done. Also, there have been some cash infusion or some equity infusions from the parent.

But they've used the not paying dividends to get the equity ratio from 35 percent to 45 percent. And that, as I understand, was the plan.

Q. So in effect, UNS Electric is being penalized on its cost of equity because it reinvested all of its income, net income, back into the company?

A. I wouldn't call it penalizing it at all. I'm just saying that that's -- not paying dividends, I'm not saying there's anything negative about that judgment, and I see no penalty associated with that.

MR. PATTEN: Your Honor, I move admission of UNSE-34 and 35.

CALJ FARMER: Are there any objections to UNSE Exhibits 34 and 35?

(No response.)

CALJ FARMER: Hearing none, they are admitted.

(Exhibits UNSE-34 and UNSE-35 were admitted into evidence.)

Q. (BY MR. PATTEN) Mr. Parcell, you would agree that a proxy group should have similar risk and, therefore, a similar expected cost of capital to the subject company, wouldn't you?

A. That's certainly the objective of selecting a proxy group, yes.

Q. Could you turn to Schedule 6 of your direct testimony?

A. Sure.

Q. I noticed that you attached a Schedule 6 to your surrebuttal, too, but I couldn't tell that it had been -- excuse me -- that had been changed.

A. If it does not say "updated," there was no change. If I made any change in my schedule, I attached the word "updated."

Q. It doesn't say updated.

A. I'm sorry?

Q. It does not say updated.

A. It's the same schedule then. So I'm on Schedule 6, yes.

Q. And on Schedule 6, that shows the proxy groups used in the determination of cost of equity, correct?

A. Yes, but both proxy groups, mine and Ms. Pritz.

Q. Each of the utilities shown in the Parcell proxy group are much larger than UNS Electric, aren't they?

A. Yes.

Q. And APS is much larger than UNS Electric, isn't it?

A. Yes.

Q. UNS Electric is rated by Moody's as Baa3, correct?

A. Yes.

Q. All right. And if you look at your Schedule 6, that has a column labeled Moody's bond rating, does it not?

A. That is correct.

Q. And none of the proxy companies in your group have a rating as low as Baa3, do they?

A. That is correct. This particular source takes the -- presents the highest bond rating out of any company when it presents this. So, for example, on Page 16 of my direct testimony, I show Tucson Electric has different ratings for senior secured debt and senior unsecured debt.

The source of the column on Schedule 6 is AUS Utility Reports, and they always present the highest bond rating of any company in this. So a company with dual ratings like Tucson, for example, they would be shown as the highest.

Q. The highest rating for UNS Electric, though, is Baa3, correct?

A. It's the only rating.

Q. Right. And if you look at the Pritz comparable company group below, none of those companies have as low a Moody's bond rating as UNS Electric, do they?

A. That is correct.

Q. All right. All other things being equal, would investors require a higher return on the utility with a lower bond rating as opposed to a higher rated utility?

A. All other things equal, there would be some aspect to that. If you take a notch, for example, from Baa2 to Baa3, I don't know that it's measurable, the difference between those two. Between a single and a triple B, there may be some measurement that you could do for the difference in the cost of equity, but a notch within a single rating -- a singular rating like BBB, it would not be a lot of difference, I don't think.

Q. But you would anticipate some?

A. Could be some, yes. I would anticipate there could be some.

Q. All right. Again, on Schedule 6, do all of the companies identified in your proxy group pay dividends?

A. Yes. Otherwise, I would not have selected them, because I could not have used them in the DCF. So that was one of the criteria that you pay dividends.

Q. And again, UNS Electric has not paid a dividend since its inception?

A. Right. But UNS Electric is not even publicly traded, so I could not have chosen them as a proxy company anyway.

Q. Could you turn to your direct testimony at Page 20?

A. Sure. I have that.

Q. And looking at pages -- or Lines 10 to 12 there, you suggest that an interim source of financing would be to simply transfer the Black Mountain station from UED to UNS Electric, correct?

A. Yes. Assets and liabilities, yes.

Q. Isn't that the equivalent of a $62 million equity contribution from UniSource Energy to UNS Electric?

A. Unless they did part of it in debt, it would be some kind of contribution, yes, because it's a movement of assets within the corporate umbrella.

Q. Under your proposed interim financing proposal here, how would any rate of return be earned on the equity investment prior to including Black Mountain in rate base?

A. Well, I'm not an accountant, but based upon what I have learned through osmosis over the last 40 years, the only two ways to do it is put it in rate base or set up some kind of a deferral account and defer costs and revenues until it's treated for ratemaking purposes and recovered then. So that would be the two ways you could do it.

Q. You would still have to carry any deferred costs for the period of time until it got into rate base, wouldn't you?

A. Right. But once it was in the rate base, then you would rate base -- the deferrals would make the rate base bigger. So it's a timing thing.

Q. In that interim period, it may be difficult to carry the costs if the cash flow is not adequate, wouldn't it?

A. Well, at this point in time, though, the costs would be carried by the parent. I'm saying it's an option. I'm not proposing it. I'm saying it's an option.

Q. And there would be no return on those carrying costs during that two- or three-year period?

A. Not during that period. But again, it's a timing thing. At least the recovery would be made.

Q. And under your proposed --

A. It's the same principle as building a plant and not having a return on CWIP. When the plant is finished, the plant is bigger than it would be otherwise, but you get return over the life of the plant. So it's the same principle as CWIP.

Q. Under your proposal, how long a time period would constitute the interim period?

A. Until it was refinanced.

Q. How long -- and by refinanced, what do you mean by that?

A. They're raising it. If the company chose to finance it with permanent capital, debt and equity, until that permanent capital was raised.

Q. So you don't really have an idea of how long that would be?

A. That would be both a management decision and whether they wanted to do it and whether they felt they could do it.

Q. And it may depend on getting the asset into rate base before being able to achieve reasonable financing terms, wouldn't it?

A. It certainly could be a consideration. It would be a consideration, yes.

Q. Do you believe it would be prudent for UniSource or UNS Electric to exhaust all of its revolving credit capacity for that period of time?

A. I would not think so to exhaust all of it, no. But for interim purposes, it could be done for a portion of it for a portion of the time, but not all of the time, no. I'm not proposing that.

Q. Okay. So you're not saying that they could just take their 35 million revolver and use that to bridge the time between acquisition and put it into rate base?

A. I don't really know that they could or could not. I'm not proposing that. I'm just saying that I can think of two examples of interim or bridge financing. That's what I'm proposing here.

In fact, Mr. Grant said in his rebuttal testimony that they could do this, but they won't do it. That's the company's question, do they want to? But Mr. Grant stated, as I read his rebuttal testimony, that they could do these things.

Q. But they can't do it because of the timing and recovery aspect?

A. They wouldn't want to, is what he said.

Q. Turn to Page 7 of your direct testimony.
A. Sure. I have that.
Q. And I'm looking at Lines 4 to 6.
A. Yes.
Q. And you state there that the Hope case is credited with establishing the end result doctrine which maintains that the methods utilized to develop a fair return are not important as long as the end result is reasonable. Do you see that?
A. Yes, I do.
Q. Would a reasonable result be one where the company is able to earn its authorized cost of capital?
A. Well, that would be one aspect of it, but that's not the point I'm making here. The point I'm making here is that, for example, it doesn't matter what methodology you use to determine the cost of equity, for example, as long as they produce reasonable results. It's not the methodology that counts. It's the result that counts.
Now, one result could be what you suggested, the earnings cost of capital, but that wouldn't be the only result. But you see, the end result here in the Hope case was a question of how rates were established. This particular case had to be whether they use a fair value rate base or original cost rate base. But it's been interpreted by people like me for the last 40 or 50 years,

it does not matter what methodology you use for cost of equity as long as you produce reasonable results.

Q. It wouldn't be a reasonable result if the rate relief was such that the company simply would be unable to achieve its authorized return on equity given, you know, management efficiencies and -- or efficient management, would it?

A. No, I disagree with that. I have never seen any representation that regulation owed any regulated company a guarantee that it would earn its authorized cost of capital.

Q. I'm not saying it would be a guarantee that they would earn it. It would be a certainty that they could not earn it, so there would be no opportunity to earn its authorized return on equity. That wouldn't be a reasonable result, would it?

A. Well, you can't say that, because when you're using model results that use the DCF and CAPM methodologies for similar risk utilities, there's no assumption that these similar risk regulated utilities are going to earn their authorized return on equity. So therefore, that could be a risk going into the cost of capital for those companies that would transfer into the subject company that you're using the proxy companies for. So even those companies don't guarantee and, therefore, no expectations that they will always earn the authorized return. So any risk for the subject company would also be reflected in those risks.

Q. So to your knowledge, has the company been able to earn its authorized cost of capital since its last rate order?

A. I missed your second word.

Q. To your knowledge.

A. Oh, to my knowledge. According to Mr. Grant, they have not. I'm going on his representation, his testimony.

Q. And you have no reason to dispute Mr. Grant's statement, do you?

A. I haven't reviewed his numbers, but I would have no reason to dispute him.

Q. Do you think that regulatory lag has had an impact on the company's ability to earn its authorized cost of capital?

A. Well, insofar as one aspect of regulatory lag here is the rate freeze that was voluntarily agreed to to purchase the assets.

Q. I'm talking since the last rate order.

A. Well, but again, that's a factor that was represented of the company at that time, and that's also a factor that kind of still has some ongoing aspects here.

But the fact that they have not earned their authorized rate of return either says that the company is not being efficient, which I'm not proposing at all, or that the growth that has occurred since that point in time is not reflected in rates.

But here we are in a rate case again now, so I'm not sure you would expect the company to totally catch up in one rate case after a rate freeze like that.

Q. Could you turn to Page 41 of your direct testimony?

A. Sure. I have that.

Q. I'm looking at the question posed at Lines 9 through 11 there.

A. Yes.

Q. And you use the terms: A sufficient level of earnings to maintain its financial integrity. Do you see that?

A. I do.

Q. Does that sufficient level of earnings include the opportunity to earn its authorized return on equity?

A. It does, but without implying necessarily a floor of it, but it does in general, yes.

Q. And you believe that return on equity should be 10 percent, correct?

A. I think the opportunity should be 10 percent, yes.

Q. Have you conducted any analysis to determine whether the company will actually have an opportunity to earn a 10 percent return on equity based on Staff's revenue requirement?

A. No, and I could not, because if you do it based upon Staff or any other revenue requirement, you would need to do the measurement based upon the factors that are implicit in the revenue requirement and not necessarily the book figures.

Because if the Staff or any other party makes a ratemaking adjustment that the company -- that the Commission agrees with and it's a down adjustment, that's a level of revenues and return that the company is deemed they should not recover for whatever reasons.

So on an after-the-fact basis, if you try to determine if the company actually earned its authorized return, it would be inappropriate to consider those expenses, those particular disallowed expenses, for example, and say that the fact that they didn't earn those means that they did not earn their authorized return, because that would be an improper comparison.

MR. PATTEN: Thank you, Mr. Parcell. I'm glad we could get you out of Virginia for a week.

THE WITNESS: The problem is I've got to go back.

MR. PATTEN: We can't do anything about that.

CALJ FARMER: I do have a few questions for you.

EXAMINATION

Q. (BY CALJ FARMER) Do you have your rebuttal testimony with you? Could you turn to Page 11, please?

A. Certainly. I have that.

Q. There you show the comparison of your original analysis on the DCF and also your updated analysis.

And comparing your proxy group original versus updated, it almost looks like the mean and the median have flipped. Is there any significance to that, or does it say anything to you?

A. I had not noticed that. And I also observed that from my proxy group, at least, exactly half of these DCF results go up and half go down.

And the medians -- let's see, the means, no. Well, to answer your question, I do not know if there is any significance to that.

Q. Okay.

A. But if the mean moved more than the median, what that would tell us is that there would be more change at the top or bottom of the range as opposed to within the range. In other words, a couple of companies had a relatively large change in the cost of capital. That's what would make the median -- that would make the mean change more than the median. Because the median is a central number, whereas the mean or a mean is the average number.

Q. Okay. Did you testify in the UNS Gas rate proceeding that's pending in front of the Commission now?

A. I did.

Q. What was your cost of equity recommendation in that case?

A. I think that was dated June 9, 2009. My testimony, my cost of equity is 9.5 to 10.5 with an 8.24 percent midpoint total cost of capital, as opposed to 8.4 in this case. Their cost of debt was 6.49, whereas this company's cost of debt is 7.05. But the cost of equity is the same.

Q. Is there any reason why the two companies' cost of capital should not be the same?

A. Well, the cost of capital, they probably should be different, even with the same cost of equity, because the capital structure is a little bit different and their cost of debt were different. But I don't see any obvious reason why their cost of equity would be different. Should be different, I should say.

Q. Did you use a different set of proxy groups? Was your proxy group the same utilities that you used in this case?

A. I think that's going to be a yes and a no question. My proxy group was -- the one that I chose is the same in both cases. But I also do my analyses on the proxy group used by the company's witness, and those were different.

So in the gas case I used Mr. Grant's proxy group, which is basically the gas companies, and in this case I'm using Ms. Pritz's proxy group, which are electric companies. So one of the two is the same, one is different.

Q. Can you explain why all of the results from the CAPM are so low?

A. Sure. There really are two reasons. If we were to look at my S-15, which is my surrebuttal testimony, and go to my Schedule 2, Page 3. And on that page look at the column that says U.S. treasury T-bonds, 10 years. Now, I used 20-year T-bond yields in my CAPM, but the source I use only shows 10, so I'm going to use this schedule for demonstrative purposes.

If you look at the period from 1995 to 2000, you saw the yield on treasury bonds at 6 percent. And then from 2000 down to 2007, they're in the lower to mid 4 percent range. Yet in 2008, they're 3.66. And in 2009, which is not shown there, they're going to be about 3.0 percent. So over the last couple of years, the yields on treasury bonds has been very low. And that's really an anomaly, if you will. It's not necessarily a market return as we view that over the last 40, 50 years.

The reason that treasury bonds have yielded so low is that people, investors in 2008 and early 2009, were being clobbered so much, first on common stocks and then on corporate bonds, that they were afraid to leave their money in there and lose even more. So they sold those securities, which made them go down even more. And where are you going to put your money? The obvious place to put money is in U.S. bonds, which are safe.

So money flowed out of the stock market as the Dow dropped from 14,000 to 8- or 9,000. And at the same time it went into U.S. government bonds, which all of that money going in drove the price up and the yield down. So the corporate -- the yield on U.S. treasuries went way down, and that is a direct input to the CAPM.

At the same time, for any CAPM analyses done during 2009, the end point of the risk premium studies like the Ibbotson or Morningstar would have ended with the year 2008, and that was the group almost at the bottom of the slide of the stock market. So that meant that the returns on those was very low for that ending period, so your risk premium was also down for one year.

Now, in 2009 the stock market came back somewhat. And as a result, using the ending period of 2009, the return, market return on stocks is higher for the period ending 2009 than it was in 2008. So that already has had an effect of moving the risk premium levels up somewhat. I said earlier about 25 to 40 percentage points or basis points.

So two of the direct influences or two of the inputs of CAPM, the risk-free rate and the risk premium, were adversely affected by that stock market slide of late 2008 and 2009. And that is largely why the CAPM results are so low for the past two years or the past 18 months. Long answer, but that's --

Q. Okay.

A. -- that's what is going on here, in my humble view.

Q. Do you believe that UNS Electric's risks have increased since its last rate proceeding?

A. I do not believe they have.

Q. Okay. And so according to your testimony, since they have not, then there's no justification for increasing their cost of equity?

A. That's correct. But a part of that rationale is that capital costs also have not increased. What I'm really saying is if capital costs have not gone up, then the only potential justification for having a higher return for UNS Electric would be an increase in the risk, but I'm saying that also has not occurred.

So neither of the factors that influence cost of capital, that is, risk and opportunity cost of capital, neither of those have increased. Therefore, this company's cost of capital has not increased between the two rate cases. And, in fact, their requested return has come down between the two.

CALJ FARMER: Okay. Those are the questions that I have.

Is there any redirect?

MR. VAN CLEVE: I just have one question.

CALJ FARMER: Okay. RUCO, do you want to ask -- do you have a question, too?

MR. POZEFSKY: I do. Do you want me to wait?

CALJ FARMER: He may want to do a follow-up after, so why don't you go ahead.

MR. POZEFSKY: Thank you.

FURTHER CROSS-EXAMINATION

Q. (BY MR. POZEFSKY) Mr. Parcell, just in response to what the Judge asked you, that largely the CAPM results were so low because of changes in the risk-free rate and market risk premium, which were largely affected by a slide in the stock market.

So that's what it kind of comes down to on the CAPM, that there was a slide in the stock market which caused really these low rates?

A. Yes, both. Both the risk-free rate and the risk premium, yes.

Q. Well, when you kind of consider that or consider that an anomaly, maybe the stock market was an anomaly before the slide being that it was so high? How do you define what constitutes an anomaly or not?

A. In this case, if you used three methodologies and two of them stay the same over a three- or four-year period and one of them takes a dramatic shift, that to me is a red flag for an anomaly. That doesn't necessarily indicate an anomaly, but that gives you reason to look for one.

Q. But the two that stayed the same are less focused on the economy, so they would have been less affected by that change or slide, correct?

A. Right. But the DCF has been upwardly influenced somewhat because of the stock prices going down and the yields going up. We may have a similar anomaly in the next few years if you start looking at DCF growth rates going from a depressed beginning point. And it may be that those growth rates that we observe two or three years from now are an anomaly because the beginning point was the beginning of the -- was during the recession. The DCF can experience anomalies, too, and it may well be so. Whether I'm still around doing these cases or not at that point in time is a different story, but it could happen.

Q. Here is the connection. The economy, for the most part, has declined, arguably, because of the slide in the stock market. If you eliminate the results of your CAPM, which are basically caused as a result of the slide in the stock market, isn't the Commission then really not considering the major cause behind the current economy when it makes its -- when it's considering cost of equity? See the connection?

A. Vaguely.

MR. POZEFSKY: It's pretty clear to me, but okay. I don't know a better way to ask it. Thank you, Mr. Parcell.

CALJ FARMER: Staff?

MR. VAN CLEVE: Thank you, Your Honor.

REDIRECT EXAMINATION

Q. (BY MR. VAN CLEVE) Mr. Parcell, you didn't eliminate the CAPM in this case, though, did you?

A. No.

Q. Okay. And then this is, I guess, addressing the Black Mountain generating station. You were asked some questions by the company's counsel regarding, I guess, the possibilities or ways of purchasing that that you addressed in your testimony. Do you recall those?

A. In an interim fashion, yes.

Q. Interim fashion. Would another possibility be for the company to -- well, is it your understanding that in the last rate case the company was authorized financing of 40 million of debt and 40 million in equity?

A. That's correct. In fact, I so state that in my testimony.

Q. Would another possibility for the purchase in the interim be to utilize some combination of debt and equity?

A. Well, for example, if the parent company of UNS Electric chose to buy $30 million of equity of UNS Electric and sell or buy $30 million of bonds from UNS Electric, then the subsidiary would have the funds from the parent to buy the plant.

Again, the question is, would they want to? Because you still have the timing thing as to whether the -- when would the parent get a return on it. But that's an interim step, too, yes.

MR. VAN CLEVE: Thank you, Mr. Parcell.
No further questions, Your Honor.
CALJ FARMER: Any further questions for this witness?
(No response.)
CALJ FARMER: Okay. Thank you, sir, for your testimony.
THE WITNESS: Thank you.
CALJ FARMER: Okay. That concludes the testimony in this case. Let's talk for a minute about briefing schedules.
Let's go off the record for a moment.
(A brief off-the-record discussion ensued.)
CALJ FARMER: Back on the record. The transcript should be ready sometime in the week of February 22nd or thereabouts.
Do the parties have any proposals for when you would like the initial brief to come in?
MR. PATTEN: Your Honor, we did talk. I think we proposed opening briefs March 12 and reply briefs March 26, although we would be amenable to doing it a week before that on both ends.
CALJ FARMER: March 12 and 26. Is that what --
MR. PATTEN: Yeah.
MR. POZEFSKY: That works for RUCO, Your Honor.

CALJ FARMER: Is that okay for Staff?

MS. SCOTT: Yes.

MR. PATTEN: And again, part of it depends on Your Honor's needs for the briefs at a certain time and trying to hit a time clock.

CALJ FARMER: Well, one thing that I do want is for the parties to file their final schedules that show all of your adjustments with your final position, and including rate design.

And I'm probably going to need to have -- at some point there may be somebody from the A-team contacting you asking you for an electronic version of the schedules and probably also rate design. So I don't want you to file those, but if you get contacted by somebody from the A-team, then that helps a lot in getting the orders out as soon as --

MR. PATTEN: When would you like the final schedules filed?

CALJ FARMER: Well, I think I'm -- here is the thing. I want your briefs to cite to those final schedules. So you're going to need to have them filed before you file your briefs. So why don't we say the final schedules by March 1. Is that doable for everyone? I don't hear any --

MR. POZEFSKY: I'm trying to follow your logic.

Could we file the final schedules with the opening brief? Would that -- that's what we've done in other cases.

CALJ FARMER: You can if you want. The problem -- actually, I think I would prefer you didn't. Because if the final schedules are docketed before your brief, the other parties will know your final position and they can reference that in their opening brief. And I think it will help maybe shorten the reply briefs a bit. We'll have a round of -- there's nothing worse than getting an opening brief and you don't know what the other party's position is, so you don't respond to it, and then it's too late after you find it out.

So let's put the final schedules to be docketed March 1, opening briefs March 12, closing March 26. And in your briefs, I want you to brief all of the issues, and I want you to state what your final position is on each issue, cite to the testimony, the exhibit, whatever witness, the transcript page, and also to the final schedule.

And don't just say that if you haven't addressed something you're not waiving it, because I want a position on all of the issues. So even if there's an issue and you agree with, you know, the other parties, put that in the brief so that I know we don't have issues dangling out there.

MR. DION: Your Honor, just quickly, I understand that. That's clear. Is it acceptable to the Judge to say something like cost of debt -- cost of debt would be the company's proposed da-da-da-da. And then if Staff and RUCO have agreed, that's enough to state that, or would you like something more? There are a number of items that we have agreed to, and I'm just wondering how long of a position you want for things that we have agreed to. That's all I'm requesting of the Judge.

CALJ FARMER: It would be helpful if you would cite to either the testimony or the transcript when you have agreed to something so I can verify it and put it in the order, so in the future it will all be there in the order to find.

MS. SCOTT: Judge Farmer, there's also the bill impact analysis that Chairman Mayes requested. And if I understood the company correctly, that may take them a while to do. We were also going to file one, as well as a written response to some of the questions she asked yesterday regarding the benefits associated with either including the costs of, for instance, renewables in rate base versus through the surcharge mechanism.

Do you want dates for those items?

CALJ FARMER: Yes. I think we have got our -- and I think I'm looking at maybe March 1 for those also.

MR. DION: Yeah, that's fine.

Your Honor, just so the record is clear, I have as my homework assignments there were bill impacts that were requested for the renewables to be moved into rate base from the REST at the 50 percent, 75 percent, and 100 percent levels, exclusive of DG. So the utility scale, if you will.

And then there was a request to do, I believe 100 percent, including DG. We'll probably just do a similar 50, 75, 100 percent, inclusive of all costs, including DG. There was also a second request to do something similar for energy efficiency.

And then there were two other requests. One was by Staff regarding the cost of renewables if it was placed into service with the ITC and the revenue being essentially -- the revenue being acquired at that time, and then without the ITC and the revenue would be picked up such as in a subsequent rate case.

And then, finally, I believe RUCO requested to know how many kilowatt hours would be produced if the company invested $5 million. And my understanding is we would give them those figures in PV and what would be a large wind project, not necessarily a small wind project we would build, and then perhaps CSP technologies. And my understanding is that those four items are still outstanding and that the Judge would like those filed by March 1.

CALJ FARMER: That's correct. Okay. And I'm going to put a date for an objection, if anybody objects to something that is in any of these late-filed documents.

Let's just go ahead and we'll make these exhibits. The company's late-filed March 1 will be UNSE-36. And Staff's late filed will be --

MR. DION: Your Honor, just so the record is clear, I've got four different exhibits.

CALJ FARMER: Just put them all into one packet.

MR. DION: Just in one packet, UNSE-36?

CALJ FARMER: Yes.

MR. DION: Absolutely.

CALJ FARMER: Make it easier.

MR. DION: Thank you very much.

CALJ FARMER: Let's go off the record for a minute.

(A brief off-the-record discussion ensued.)

CALJ FARMER: All right. Back on the record.

And the Staff exhibit will be S-18.

File those by March 1. Any objections to anything contained in those will be due, let's put it a week later, March 8.

MS. SCOTT: Judge Farmer, could I just clarify what the Staff request was?

CALJ FARMER: Sure.

MS. SCOTT: What we had asked for was the company to do a comparison on the ultimate impact to the customer of putting it into rate base versus putting the costs through the surcharge. So ultimately what would be the difference between those two methods to the customer.

CALJ FARMER: Does the company understand that?

MR. DION: Absolutely. I was talking in code with ITC, but I do understand what Staff is looking for. Thank you.

CALJ FARMER: Okay.

MR. POZEFSKY: Your Honor, is that what is due March 1, what you were talking about earlier as far as the energy efficiency and the rate basing of the renewables? Is that what we were talking about, those schedules that Staff and the company were going to file? I just want to make sure. You talked about that earlier, the final schedules are due March 1, and --

CALJ FARMER: Oh, no, the final schedules, I was referring to your adjustments and also any kind of rate design that -- if it's been modified.

MR. POZEFSKY: No, that I understand. But you also asked that on March 1, the issues or the filings that were going to be made for the energy and renewables, I just want to make sure that that's -- what that is exactly.

CALJ FARMER: Okay, that would be -- that's the Staff Exhibit 18, and I believe was this a request by the Chairman for you to put together the information?

MS. SCOTT: Yes. But when we talked yesterday amongst ourselves, we also agreed that we would respond in writing to her questions, too, regarding what would be the most appropriate method for collection of these costs, and I think RUCO had wanted an opportunity to respond in writing as well.

MR. POZEFSKY: See, that's kind of what I was getting at is that -- so the schedules would be filed on March 1, but we would have nothing to respond to, because we won't have seen them until March 1.

And what I'm talking about is the difference between what these impacts are going to look like if they're put into base rates as opposed to the adjustor. That was the issue she was talking about.

CALJ FARMER: Okay. So I'm not sure if I'm understanding this. Right now they're scheduled to -- the company and Staff are supposed to have late-filed exhibits on March 1, and I had said any objections to that would be March 8. Would you like to have a response time of March 8 to anything within those exhibits? Is that what you're saying?

MR. POZEFSKY: Yeah, that's what it comes down to.

CALJ FARMER: Does that sound okay?

MR. POZEFSKY: That would be great.

CALJ FARMER: So response and/or objections to any of the late-filed exhibits will be due March 8.

MR. POZEFSKY: Thank you.

CALJ FARMER: Okay. Is there anything else that we need to get on the record now?

(No response.)

CALJ FARMER: Okay. Well, I thank you all for your participation in this hearing, and I think that you all did a very good job of getting the evidence into the record and making it understandable for me and for the Commission, and so I thank you.

(The hearing concluded at 3:56 p.m.)

STATE OF ARIZONA)
) ss.
COUNTY OF MARICOPA)

I, MICHELE E. BALMER, Certified Reporter No. 50489 for the State of Arizona, do hereby certify that the foregoing printed pages constitute a full, true and accurate transcript of the proceedings had in the foregoing matter, all done to the best of my skill and ability.

WITNESS my hand this 18th day of February, 2010.

Michele E. Balmer
MICHELE E. BALMER
Certified Reporter
Certificate No. 50489