ORIGINAL

OPEN MEETING ITEM

0000108276

ERNEST G. JOHNSON
Executive Director

ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED
MAR - 9 2010
DOCKETED BY

DATE: MARCH 9, 2010

DOCKET NO.: G-04204A-08-0571

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Dwight D. Nodes. The recommendation has been filed in the form of an Opinion and Order on:

UNS GAS, INC.
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

MARCH 18, 2010

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Open Meeting to be held on:

MARCH 31, 2010 and APRIL 1, 2010

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

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ERNEST G. JOHNSON
EXECUTIVE DIRECTOR

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

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

PUBLIC COMMENTS:	August 3, 2009 (Flagstaff); August 6, 2009 (Prescott); August 17, 2009 (Nogales)
DATES OF HEARING:	August 3, 2009 (Pre-Hearing); August 10, 11, 12, 14, 17, and 18, 2009 (Hearing)
PLACE OF HEARING:	Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Dwight D. Nodes
APPEARANCES:	Mr. Philip J. Dion, III, UNISOURCE ENERGY SERVICES; and Mr. Michael W. Patten ROSHKA, DeWULF & PATTEN, PLC, on behalf of UNS Gas, Inc.; Mr. Nicholas J. Enoch, LUBIN & ENOCH, P.C., on behalf of IBEW Local 1116; Mr. Daniel Pozefsky, on behalf of the Residential Utility Consumer Office; Ms. Cynthia Zwick, in propria persona; Ms. Robin Mitchell and Mr. Kevin Torrey, Staff Attorneys, on behalf of the Utilities Division of the Arizona Corporation Commission.

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BY THE COMMISSION:

On November 7, 2008, UNS Gas, Inc. ("UNS Gas" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for a rate increase.

On December 3, 2008, Local Union 1116, International Brotherhood of Electrical Workers, AFL-CIO ("IBEW") filed an Application to Intervene.

On December 4, 2008, UNS Gas filed a revised H-5 Schedule to its application.

On December 5, 2008, the Company filed a revised H-1 Schedule to its application.

On December 8, 2008, the Commission's Utilities Division ("Staff") filed a Letter of Sufficiency indicating that UNS Gas's application satisfied the requirements of Arizona Administrative Code ("A.A.C.") R14-2-103, and classifying the Company as a Class A utility.

On December 22, 2008, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene.

On January 7, 2009, a Procedural Order was issued scheduling a hearing to commence on August 10, 2009; setting various other procedural deadlines; directing UNS Gas to publish notice of the applications and hearing date; and granting the IBEW and RUCO requests for intervention.

On February 2, 2009, Cynthia Zwick filed a letter requesting permission to intervene "as an individual concerned about the potential impact of a rate increase on low-income and working poor Arizonans."

By Procedural Order issued March 26, 2009, Ms. Zwick's request for intervention was granted.

By Procedural Order issued March 26, 2009, the pre-hearing conference was rescheduled in this matter for August 3, 2009.

With its rate application, UNS Gas filed its required schedules in support of the application, as well as the direct testimony of D. Bentley Erdwurm, David Hutchens, Kentton Grant, Dallas Dukes, Karen Kissinger, Gary Smith, and Denise Smith.

On May 5, 2009, the Company filed Affidavits of Publication and Mailing in accordance with the January 7, 2009, Procedural Order.

On June 8, 2009, Staff filed the direct testimony of Dr. Thomas Fish, David Parcell, Robert

Gray, Rita Beale,[1] Corky Hanson and Juan Manrique; RUCO filed the direct testimony of William Rigsby, Ralph Smith,[2] and Frank Radigan; IBEW filed the direct testimony of Frank Grijalva; and Ms. Zwick filed her direct testimony.

On July 8, 2009, UNS Gas filed the rebuttal testimony of Mr. Erdwurm, Mr. Grant, Mr. Dukes, Ms. Kissinger, and Mr. Hutchens.

By Procedural Order issued July 9, 2009, public comment meetings were scheduled for Flagstaff on August 3, 2009; for Prescott on August 6, 2009; and for Nogales on August 17, 2009. The Company was directed to publish notice of the public comment meetings.

On July 29, 2009, Staff filed the surrebuttal testimony of Dr. Fish, Mr. Parcell, Mr. Gray, and Ms. Beale; and RUCO filed the surrebuttal testimony of Mr. Rigsby, Mr. Smith,[3] and Mr. Radigan.

On August 3, 2009, a prehearing procedural conference was conducted to discuss the order of witnesses and exhibits.

On August 5, 2009, UNS Gas filed the rejoinder testimony of Mr. Hutchens, Mr. Grant, Mr. Dukes, and Mr. Erdwurm.

The evidentiary hearing commenced as scheduled on August 10, 2009, and additional hearing days were held on August, 11, 12, 14, 17, and 18, 2009. Public comment meetings were held, as scheduled, on August 3, 6, and 17, 2009, in Flagstaff, Prescott, and Nogales, respectively.

On September 1, 2009, Chairman Mayes filed a letter in the docket requesting a response from UNS Gas with respect to the Company's plans to expedite refunds of over-collected amounts received through the Purchased Gas Adjustor ("PGA") mechanism.

On September 1, 2009, Staff filed a Late-Filed Exhibit that included Arizona unemployment statistics for 2005-09; July 2009 foreclosure rates for counties in the Company's service area; UNS Gas disconnections from 2006-09; and information regarding a Kansas energy efficiency program and Arizona Energy Office programs.

On September 3, 2009, UNS Gas filed Affidavits of Publication for the public comment meetings, in accordance with the July 9, 2009 Procedural Order.

[1] Ms. Beale submitted separately a confidential version of her direct testimony. (Ex. S-5.)
[2] Mr. Smith submitted separately a confidential version of his direct testimony. (Ex. R-22.)
[3] Mr. Smith submitted separately a confidential version of his surrebuttal testimony. (Ex. R-23.)

On September 8, 2009, UNS Gas filed a letter describing the Company's policies regarding acceptance of payments at local offices and other locations.

Initial briefs were filed on September 18, 2009, by UNS Gas, Staff, RUCO, IBEW, and Ms. Zwick. UNS Gas, Staff, and RUCO also filed their Final Schedules on September 18, 2009, setting forth their respective final revenue requirement and rate design positions.

Reply Briefs were filed on September 29, 2009, by IBEW; on September 30, 2009, by RUCO; and on October 5, 2009, by UNS Gas and Staff.

RATE APPLICATION

According to the Company's application, as modified, in the test year ended June 30, 2008, UNS Gas had adjusted operating income of $11,693,461, on an adjusted Original Cost Rate Base ("OCRB") of $184,379,086, for a 6.34 percent rate of return. The Company's proposed test year Reconstruction Cost New Depreciated ("RCND") rate base is $330,365,912, resulting in a rate of return of 3.54 percent; and its proposed Fair Value Rate Base ("FVRB") is $257,372,499, resulting in a test year rate of return of 4.54 percent on FVRB.

According to the Final Schedules, UNS Gas requests a gross revenue increase of $9,480,875; Staff recommends a gross revenue increase of $3,395,423; and RUCO proposes a gross revenue increase of $1,265,000. A summary of the parties' positions follows.

	Company Proposed	Staff Proposed	RUCO Proposed
ORIGINAL COST			
Adjusted Rate Base	$184,379,086	$178,509,369	$179,884,851
Rate of Return	9.48%	7.59%	7.55%
Req'd Operating Inc.	17,486,492	15,621,857[4]	13,581,275
Op. Income Available	11,693,461	13,544,256	12,831,730
Operating Inc. Def.	5,793,032	2,077,601	749,545
Rev.Conver. Factor	1.6366	1.6343	1.6366
Gross Rev. Increase	$9,480,875	$3,395,423	$1,227,000
FAIR VALUE			
Adjusted Rate Base	$257,372,499	$251,524,153	$252,877,851
Rate of Return	6.79%	6.37%[5]	5.38%

[4] Staff's "alternative" fair value recommendation.
[5] Staff's alternative fair value rate of return recommendation.

Req'd Operating Inc.	17,486,492	15,621,857	13,604,828
Op. Income Available	11,693,461	13,544,256	12,831,730
Operating Inc. Def.	5,793,032	2,077,601	773,098
Rev.Conver. Factor	1.6366	1.6343	1.6366
Gross Rev. Increase	$9,480,875	$3,395,423	$1,265,000[6]

REVENUE REQUIREMENT

Rate Base Issues

As shown above, UNS Gas proposed an OCRB of $184,379,086; Staff recommends an OCRB of $178,509,369; and RUCO proposed an OCRB of $179,884,851. Each of the contested issues regarding rate base items is discussed below.

Post-Test-Year Plant

UNS Gas proposes to include $1,527,588 of post-test-year plant in rate base. The Company claims to have limited its request to plant added after the test year and which is "non-revenue producing." According to Company witness Dukes, the post-test-year plant for which the Company seeks rate base recognition "is plant ... whose primary purpose is to serve existing customers and which would have been replaced regardless of customer growth." (Ex. A-18, at 4.) Mr. Dukes testified that the plant in question includes transportation equipment, general plant, replacement of mains, and relocation of facilities that were placed into service after the end of the test year, but which are now in service. (Ex. A-17, at 4.)

In support of its position, UNS Gas contends that it responded to concerns expressed by the Commission in the Company's last rate case, Decision No. 70011 (November 27, 2007), that the Company's request for post-test-year plant failed to segregate revenue producing plant from non-revenue-producing plant. UNS Gas claims that it "took [the Commission's] criticism to heart" (UNS Gas Reply Brief, at 2) by identifying only the plant that it categorized as "non-revenue-producing" by the Company's plant accounting group and operational personnel.

UNS Gas also cites to prior Commission decisions involving water companies wherein post-test-year plant was included in rate base. For example, in a case involving Bella Vista Water

[6] As discussed below, RUCO also presented several alternative methods for calculating the Fair Value revenue requirement.

Company, Decision No. 65350 (November 1, 2002), the Commission permitted inclusion of post-test-year system improvements on the basis that the record did not reflect a material impact on revenues and expenses. The Company also points to a Chaparral City Water Company case, Decision No. 68176 (September 30, 2004), in which the Commission allowed post-test-year plant in rate base despite the potential mismatch between revenues and expenses.

Staff opposes the Company's request for post-test-year plant on the basis that it would violate principles of ratemaking and would result in a mismatch of such plant with test year revenues, expenses and rate base. Staff witness Dr. Fish stated that the Company's plant investment after the test year could result in efficiencies and lower maintenance costs, thereby resulting in a mismatch with test year revenues and expenses. (Ex. S-12, at 16.)

Staff also argues that, contrary to the Company's claims, the Commission did not indicate in Decision No. 70011 that it would allow post-test-year plant if UNS Gas could segregate "revenue-producing" from "non-revenue-producing" plant added after the test year. Rather, according to Staff, the Commission rejected the Company's request for many of the same reasons it declined to allow recovery of construction work in progress ("CWIP"). In denying the Company's request for CWIP in the prior UNS Gas case, we stated:

> UNS is not faced with an extraordinary situation that would justify inclusion of CWIP in rate base because the plant required to serve new customers will help produce revenues; UNS has a means, through accrual of AFUDC, to mitigate the effect of the CWIP investment; allowance of CWIP would undermine the balancing of test year revenues and expenses; and the regulatory lag inherent in utility regulation may provide benefits to the extent that items such as plant retirements and accumulated depreciation occur between test periods and thereby help to mitigate periods of higher plant investment associated with customer growth.

(Decision No. 70011, at 6-7.)

Staff disputes the Company's interpretation of the cited Chaparral City case (Decision No. 68176), arguing that the Commission's inclusion of post-test-year plant was based on its determination that Chaparral City's plant was placed in service within three months of the end of the test year, and that the additional plant was needed to close a deficiency in available capacity and, as such, was necessary to provide a safe capacity operating margin. With respect to Bella Vista

(Decision No. 65350), Staff claims that the Commission indicated that the inclusion of post-test-year plant is a matter to be determined on a case-by-case basis, and the plant in that case was placed into service one year and three days after the test year.

Staff claims that it traditionally recommends allowance of post-test-year plant only in instances where the magnitude of the investment, relative to the company's total plant investment, is such that non-inclusion could jeopardize the company's financial health; and when other factors are present, such as the cost of the post-test-year plant is significant, the net impact on revenue and expenses for the plant is insignificant or revenue-neutral, and the post-test-year plant is necessary for the provision of safe and reliable service. (Tr. 565-66.) Staff argues that the post-test-year plant proposed by UNS Gas does not meet these criteria and should be denied.

RUCO similarly opposes inclusion of post-test-year plant in this case. RUCO witness Ralph Smith testified that the Company's request for post-test-year plant is a subset of CWIP and raises the same concerns presented with respect to including CWIP in rate base. He stated that the attempt by UNS Gas employees to identify "non-revenue-producing" plant failed to take into consideration whether the plant also was expense-reducing. Mr. Smith explained that even if plant could be identified as non-revenue-producing, the replacement of older mains and service lines with new plant could reduce operating and maintenance expenses associated with aging equipment. Mr. Smith indicated that the Commission has typically not allowed inclusion of post-test-year plant except in rare circumstances involving water companies. He also pointed out that the Commission specifically denied the request by UNS Gas in its last rate case to include such plant in rate base. (Ex. R-21, at 12-20.)

In Decision No. 70011, we denied UNS Gas's proposal for rate base recognition of post-test-year plant. In that Decision, we pointed out that although such plant has previously been allowed in several prior cases involving water companies, those cases provided some assurance that a mismatch of rate base with revenues and expenses did not occur. UNS Gas has not identified any prior Commission decisions that allowed post-year-plant for gas or electric companies. We also indicated that the same reasons for denying recognition of CWIP are applicable to the issue of post-test-year plant, and that there was not a sufficient basis upon which to evaluate whether a mismatch would result. (Decision No. 70011, at 7-8.)

UNS Gas identified portions of its post-test-year plant as "non-revenue-producing" in an attempt to satisfy what it interpreted as the Commission's sole concern in the last case related to such plant. Aside from the subjective nature of the "revenue-producing" versus "non-revenue-producing" inquiry undertaken by the UNS Gas employees, the Company's narrow reading of Decision No. 70011 is misplaced. Although that Decision observed that inclusion of post-test-year plant could result in a mismatch, it also specifically referred to the discussion regarding denial of CWIP as a basis for rejecting post-test-year plant. As set forth in the passage above with respect to denial of CWIP, the mismatch of rate base with revenues and expenses was only one of several concerns expressed in Decision No. 70011, and was not intended as a prescription for UNS Gas to overcome the broader concerns regarding inclusion of CWIP and post-test-year plant in rate base.

We agree with Staff that the decision of whether to allow inclusion of post-test-year plant in rate base should continue to be made on a case-by-case basis. Some of the factors that may be considered in making that determination are: the amount of test year plant relative to overall capitalization; the impa ct on the company's financial health and ability to provide service; the presence of capacity or safety issues that require expedited plant investment for compliance purposes; and whether there is sufficient certainty regarding the revenue neutrality of the post-test-year plant, including consideration of whether the additional plant is non-revenue-producing and non-expense reducing. This list of factors is not intended to be exhaustive, but rather suggestive of the type of issues that may be considered.

For these reasons, we decline to adopt UNS Gas's request for inclusion of post-test-year plant.

<u>Deduction of Customer Advances from Rate Base</u>

Similar to the issue raised in its last rate case, UNS Gas proposes that $589,152 that it holds in customer advances should not be deducted from rate base. The Company contends that these funds should not be treated as a rate base reduction because the funds are tied to plant that is not yet in rate base. According to UNS Gas, adoption of the recommendations of Staff and RUCO to reduce rate base by this amount would improperly reduce the Company's pre-existing rate base.

Although the Company concedes that such advances are typically deducted from rate base because they represent customer-supplied capital, UNS Gas argues that it is inherently unfair to exclude the advances from rate base if the plant associated with those advances is not yet in service and not included in rate base. (Ex. A-17, at 5-6.) UNS Gas claims that the purpose of deducting advances (*i.e.*, recognizing customer-supplied capital) is not furthered when the plant is not in service. The Company also contends that the deduction of advances in this case would discourage utilities from seeking advances to offset infrastructure capital costs. To support its position, UNS Gas cites to Decision No. 69914 (September 27, 2008). The Company claims that in Decision No. 69914 the Commission allowed Arizona-American Water Company ("Arizona-American") to exclude contributions associated with a specific surface water treatment plant for the rate base calculation.

Both Staff and RUCO oppose the Company's recommendation. RUCO witness Ralph Smith stated that because advances represent non-investor-supplied capital, they should be reflected as a deduction to rate base. Mr. Smith also cites to A.A.C. R14-2-103, Appendix B, Schedule B-1, which he claims requires companies to reflect advances as a deduction from rate base. (Ex. R-21, at 20-23). Mr. Smith testified that the treatment of advances accorded in the last UNS Gas rate case should be followed in this case. (*Id.*)

Staff also contends that the Commission rule cited above contemplates that customer contributions and advances are to be reflected as a deduction to rate base, because they represent customer-supplied funds that are available to the Company. Dr. Fish stated that advances represent non-investor-supplied capital, and that the Commission's rule set forth in A.A.C. R14-2-103 requires that such funds be treated as a deduction to rate base. (Ex. S-13, at 3.)

We agree with Staff and RUCO that advances represent customer-supplied funds that are properly deducted from the Company's rate base. Indeed, the Commission's rules contemplate that such a deduction is required, as both the Staff and RUCO witnesses testified. The Company's reliance on Decision No. 69914 to support its position is not pesuasive. In that Decision, the Commission addressed a financing application by Arizona-American and whether the company should be permitted to finance a proposed wastewater treatment plant with hook-up fees, compared to a competing bid by a Maricopa County Municipal Water Conservation District to construct the treatment plant and sell capacity to Arizona-American. That case is clearly distinguishable from the instant case, in which the issue presented is whether customer-provided advances should be treated as deductions from rate base even if the plant built with such funds is not yet part of the Company's rate base. This issue was raised by UNS Gas in its last rate case and denied by the Commission. (Decision No. 70011, at 8-11.) The Commission also subsequently denied UNS Electric Company's arguments on the same issue in Decision No. 70360.[7]

As indicated in the Company's last rate case, regulated utility companies control the timing of their rate case filings and should not be heard to complain when their chosen test periods do not coincide with the completion of plant that may be considered used and useful and therefore properly included in rate base. Further, our conclusion regarding UNS Gas's advances is consistent with the treatment that has been afforded to other utility companies regulated by the Commission, and provides a result that is fair to both the Company and its customers.

The Company's proposed treatment of customer advances is therefore denied.

Working Capital

As described by UNS Gas witness Dallas Dukes, working capital is generally defined as "investor funding in excess of the balance of net utility plant reflected in rate base that is required for the provision of utility service." (Ex. A-16 at 12.) The components of working capital include materials and supplies, prepayments, and cash working capital. The amounts for materials and supplies, and prepayments, are determined based on test year recorded balances, whereas the cash working capital component was determined by UNS Gas based on a lead-lag study. (*Id.* at 13.)

In his direct testimony, Mr. Dukes described the concept of a lead-lag study as follows:

> A lead-lag study is a detailed analysis of the dynamic movement of funds throughout the organization, between the receivable and payable balance sheet accounts and related revenues and expenses that are reflected in the operating income component of revenue requirements. ... The focal point of all lead-lag studies is the 'point of service.' That is the instant in time

[7] See, *UNS Electric Co.*, Decision No. 70360 (May 27, 2008), at 10-11. The Commission recently confirmed the treatment of customer contributions and advances as deductions to rate base in *Arizona-American Water Co.*, Decision No. 71410 (December 8, 2009), at 26-28; and *H2O Water Co.*, Decision No. 71414 (December 8, 2009), at 4-8.

> at which customers receive service and, coincident therewith, the utility incurs the cost of providing that service. A lead-lag study measures the average length of time between the provision of service and the ultimate receipt of payment from the customer ('revenue lag'). The result is compared with the average length of time between the point at which the utility incurs a cost of providing that service and the date upon which it makes the related cash disbursement ('payment lead' if payment precedes the cost benefit, or 'payment lag' if the payment occurs after the cost benefit). Cash working capital reflects the effect on costs of service of the difference between the revenue lag and payment leads or lags.

(*Id.* at 14-15.) RUCO witness Ralph Smith summarized the concept of cash working capital as follows:

> Cash working capital is the cash needed by the Company to cover its day-to-day operations. If the Company's cash expenditures, on an aggregate basis, precede the cash recovery of expenses, investors must provide cash working capital. In that situation, a positive cash working capital requirement exists. On the other hand, if revenues are typically received prior to when expenditures are made, on average, then ratepayers provide the cash working capital to the utility, and the negative cash working capital allowance is reflected as a reduction to rate base. In this case, the cash working capital requirement is a reduction to rate base as ratepayers are essentially supplying these funds.

(Ex. R-20 at 21.) Mr. Smith stated in his direct testimony that, based on the results of the Company's lead-lag study, UNS Gas proposed a cash working capital allowance of approximately $1,568, which RUCO did not oppose. (*Id.*)

Staff witness Dr. Fish indicated in his direct testimony that he believed UNS Gas erred in calculating the lag days for purchased gas. According to Dr. Fish, the Company used 17.83 lag days for the test year months of December 2007, and January and February 2008, instead of the normal 35 lag days, thereby shortening the overall lag period to 27.89 days for gas procurement. Dr. Fish therefore adjusted the lag days back to 35.44 days, and calculated a revised cash working capital requirement of *negative* $1,624,840. (Ex. S-12, at 18.)

In his rebuttal testimony, Company witness Dukes stated that, in preparing his response to Dr. Fish, he discovered that the payment periods for gas purchased from BP Energy were much shorter than the 35 day assumption used by Dr. Fish, and shorter than the original 27.89 lag days included in the Company's original filing. Mr. Dukes indicated that UNS Gas's payment terms were altered during the test year by BP Energy "because of credit limitations," and that BP Energy "now requires the Company to make payments twice a month." (Ex. A-17, at 8.) He testified that, because the new payment requirement is a known and measurable change, it should be recognized in the lead-lag calculation. Mr. Dukes therefore proposed that UNS Gas's working capital requirement be amended to $2,183,948.

In response to the Company's amended position, Staff witness Fish testified that the payment terms agreed to by UNS Gas "are not representative of normal credit terms" and the Company "has the discretion to obtain more favorable terms and conditions from another supplier." (Ex. S-13, at 4.)

RUCO witness Smith also opposed the Company's request to modify its working capital allowance. Mr. Smith testified that the original 27.89 lag day proposal should be adopted because the number is supported by Company workpapers; 27.89 lag days is fairly consistent with the 30.97 lag days used in the Company's last case; the proposed change would reach outside the test year for a single item; the post-test-year change in gas procurement responsibility from BP Energy to Tucson Electric Power ("TEP") was described in Staff's procurement review as a proposed benefit to ratepayers; and UNS Gas has not demonstrated that the change in payment terns is a permanent requirement. (Ex. R-21, at 24-25.)

In his rejoinder testimony, Mr. Dukes responded that the change in payment terms began during the test year and continues to be in effect today. He stated the payment terms will continue during this winter and those terms are "recurring, known and measurable," and should therefore be recognized in the rates set in this case. (Ex. A-18, at 7.)

We agree with Staff and RUCO that the Company's proposed adjustment, that was offered one month before the commencement of the hearing, should be denied. The original 27.89 lag for gas procurement was supported by detailed documentation showing purchases from all of UNS Gas's suppliers, and was the proposal that reflected the Company's position on this issue from the time the application was filed in November 2008 until just before the hearing. It is the Company's responsibility to prepare its application in a manner that reflects an accurate portrayal of its operations, based on facts that are known at the time the application is filed. To be clear, the proposed adjustment was not simply the correction of a clerical error, but rather a substantial change to the calculation of a significant component of the Company's lead-lag study, and the change would cause UNS Gas's working capital requirement to be increased from less than $1,600 to more than $2.18 million.

The burden of proof that rests on the applicant proposing a rate increase includes an obligation to present supporting documentation to other parties in a timely manner, so that such parties are not placed at a disadvantage in responding to substantial changes in position. Moreover, the information that caused the eleventh-hour amendment was at all times within the Company's control and should have been included in the original rate filing.

In addition to the prejudicial effect of the proposed adjustment, RUCO witness Smith indicated that there are other post-test-year cost decreases that the Company has not reflected, such as for labor, meter reading, repairs and maintenance, communications and vehicle depreciation. (Ex. R-21, at 27.) Further, it is not clear that the accelerated payment terms agreed to by UNS Gas will remain on a permanent basis. Mr. Smith indicated that the Company may pay BP Energy on a monthly basis as long as UNS Gas is within its established credit limit. (*Id.* at 30.) To the extent that declining gas prices allow the Company to remain within its credit limit in future periods, the working capital requirement could be reduced significantly during future periods.

Based on the record, we decline to adopt Staff's negative working capital recommendation, and find that RUCO's proposal to adopt the Company's original position, which was maintained by UNS Gas for the first eight months of the pendency of this case (*i.e.*, $1,568), should be adopted as a reasonable reflection of UNS Gas's working capital requirement.

Prepayments

In his direct testimony, RUCO witness Smith proposed that rate base should be reduced by $95,671, to reflect an end-of-test-year balance for prepayments consistent with the treatment of plant-in-service, accumulated depreciation, customer advances, and customer deposits. (Ex. R-20, at 20-21.) RUCO argues on brief that the Company failed to address this issue in its rebuttal testimony and RUCO's position should therefore be adopted. (RUCO Initial Brief, at 7.)

UNS Gas contends in its reply brief that RUCO did not list this issue in the joint issues matrix, and therefore the Company did not address the issue at hearing. (UNS Gas Reply Brief, at 8.) The Company claims that RUCO's proposal should be denied.

We agree with RUCO that, for consistency purposes, the end-of-test-year balance for prepayments should be used. There is no valid reason for treating prepayments in a manner that is different from other rate base balances, including customer deposits.

RUCO's position shall therefore be adopted.[8]

Accumulated Deferred Income Tax

Based on its recommendations in this case, RUCO proposed a reduction to rate base by $271,069 to account for removal of accumulated deferred income tax ("ADIT") related to stock-based compensation and accrued liabilities (Ex. R-21 at 36). RUCO contends in its brief that rate base should be reduced by $196,256.[9]

Although Staff initially recommended an ADIT adjustment for the income tax effects of the proposed adjustment for the Company's Supplemental Executive Retirement Plan ("SERP"), Dr. Fish later agreed with Company witness Karen Kissinger that the Staff adjustment should not be made because it had not been included in UNS Gas's rate base. (Ex. S-13, at 8.)

In its initial brief, UNS Gas did not address the ADIT issue raised by RUCO, except for the statement that the differences between the Company's, Staff's, and RUCO's proposals would result in different ADIT adjustments. (UNS Gas Initial Brief, at 11.) The Company did not address in its reply brief the ADIT issues raised in RUCO's initial brief.

It appears from Ms. Kissinger's testimony that the Company disagrees with RUCO's proposal in this case, based on her claim that "ADIT related to vacation and pension expense were included in rate base in [UNS Gas's] last rate case," and "RUCO's proposed adjustment is another example of

[8] RUCO argues on brief for using end-of-test-year balances for customer deposits, which is consistent with the treatment proposed by UNS Gas and agreed to by Staff. However, RUCO recommended using a 13-month average balance if its position on prepayments is denied. (RUCO Initial Brief, at 9-10.) Given our adoption of RUCO's proposal on prepayments, it appears RUCO is in agreement with the Company's use of an end-of-test-year balance for customer deposits.

[9] It appears that RUCO's position on brief reflects the direct testimony of its witness, Ralph Smith (Ex. R-20, at 24), rather than Mr. Smith's subsequent surrebuttal testimony (Ex. R-21, at 36), which proposed reducing rate base by $271,069 to reflect ADIT on accrued vacation and pension liabilities.

RUCO challenging accepted Commission-approved methods." (Ex. A-12, at 3.) However, the Company's failure to address the issue on brief leaves uncertainty regarding its position on this issue. On the other hand, RUCO did not cross-examine Ms. Kissinger regarding the Company's ADIT position. (Tr. 163.) Nor did the Company question RUCO witness Smith regarding his ADIT testimony. (Tr. 880-98.)

Based on the record before us, we do not believe that RUCO's position should be adopted on this issue because it would represent a departure from the ADIT methodology adopted in prior cases for UNS Gas and its affiliate companies. Therefore, the appropriate reconciliation adjustments should be made to reflect the effect on ADIT and income tax expense in accordance with the prior UNS Gas case in Decision No. 70011. However, the issues raised by Mr. Smith on behalf of RUCO should be addressed more fully in the Company's next rate case in order to assess the merits of RUCO's arguments on this issue.

Summary of Rate Base Adjustments

Based on the foregoing discussion, we adopt an adjusted OCRB of $180,080,695, RCND of 326,067,520, and a FVRB of $253,074,108.[10]

	Commission Approved
ORIGINAL COST RATE BASE:	
Gas Plant in Service	$316,700,036
Less: Accumulated Depreciation	(87,543,544)
Net Plant in Service	229,156,492
Citizens Acquisition Discount	(30,709,738)
Less: Accum. Amort. – Citizens Acq. Disc.	(3,935,647)
Net Citizens Acq. Discount	(26,774,091)
Total Net Utility Plant	202,382,401
Deductions:	
Customer Advances for Construction	(11,825,028)
Customer Deposits	(2,609,271)
Accum. Deferred Income Taxes	(10,606,875)
Total Deductions	(25,041,174)
Allowance for Working Capital	2,269,250
Regulatory Liabilities	(22,372)
Regulatory Assets	492,590

[10] The FVRB is determined by averaging the OCRB and RCND.

Total OCRB	$180,080,695
RCND RATE BASE:	
Gas Plant in Service	$558,511,431
Less: Accumulated Depreciation	(152,278,962)
Net Plant in Service	406,232,469
Less: Accum. Amort. – S. Union Acq. Prem.	(3,553)
Citizens Acquisition Discount	(55,126,579)
Less: Accum. Amort. – Citizens Acq. Disc.	(6,658,438)
Net Citizens Acq. Discount	(48,468,141)
Total Net Utility Plant	357,760,775
Deductions:	
Customer Advances for Construction	(13,348,925)
Customer Deposits	(2,609,271)
Accum. Deferred Income Taxes	(18,474,527)
Total Deductions	(34,432,723)
Allowance for Working Capital	2,269,250
Regulatory Liabilities	(22,372)
Regulatory Assets	492,590
Total RCND	$326,067,520
FAIR VALUE RATE BASE:	$253,074,108

Operating Revenue and Income Issues

In the test year, the Company's reported operating revenues were $51,157,763, with reported adjusted test year operating expenses of $41,209,045, and test year net operating income of $11,693,461. As reported in its Final Schedules, Staff's proposed adjusted test year operating revenues were $52,657,136, with adjusted test year operating expenses of $40,857,623, resulting in test year net operating income of $13,544,256. RUCO's Final Schedules show proposed adjusted test year operating revenues of $53,418,509, with adjusted test year operating expenses of $40,586,779, yielding test year net operating income of $12,831,730. The disputed expense adjustments are discussed below.

Operating Revenues

Customer Annualization

In the last UNS Gas case, the Company proposed to annualize customer revenues based on a cyclical growth pattern, which the Company contended more accurately reflected its actual experience in its service territory. The Commission declined to adopt the Company's proposal in that case, based on "the lack of any significant demonstrated seasonality, the complexity of the formula, lack of transparency, and … that the methodology may actually result in an understatement of revenues." (Decision No. 70011, at 17-19.) Instead, the Commission adopted the so-called "traditional method" of customer annualization, in which the monthly customer count for each of the first eleven months of the test year is brought equal to the customer count in the final month of the test year. (Ex. A-21, at 2.)

In the instant case, UNS Gas recommended that the traditional approach to customer annualization be used in order to be consistent with the Commission's Decision in the last case. Company witness D. Bentley Erdwurm testified that UNS Gas's residential and commercial customer counts exhibit some seasonality, as some customers disconnect service in summer months and then reconnect in the fall and winter. (*Id.*) UNS Gas points out that both Staff and RUCO advocated use of the traditional method in the last case, but have abandoned use of that methodology in this case because the test year in this case ends in the summer and thereby results in a lower number of customers at the end of the test year. The Company contends that it is unfair to abandon the traditional method simply because it would result in a higher revenue requirement for UNS Gas.

Staff witness Dr. Fish recommended an annualization adjustment based on the mid-point of the test year (December 2007), plus a 1.25 percent growth rate. He stated that the growth rate is based on Company witness Hutchens' 2.5 percent growth rate estimate for UNS Gas, adjusted for the mid-point of the test year. Staff's recommended annualization adjustment would result in an increase to test year revenues of $869,221, compared to the Company's proposal to reduce test year revenues downward by $516,003. (Ex. S-12, at 21-22.) Dr. Fish claims that Staff's recommendation reflects a representative level of revenues under normal conditions; is based on historical test year information; employs the growth rate claimed by UNS Gas; and reconciles the counterintuitive result that would occur under the Company's proposal (*i.e.*, that UNS Gas is experiencing declining growth on its system). (Ex. S-13, at 9-13.)

RUCO witness Ralph Smith also opposes the Company's customer annualization proposal in this case. Mr. Smith explained that in situations where a utility is growing and adding plant to serve that growth, a revenue annualization is typically used to reflect the impact on revenue related to customer growth and to better match the test year revenues with test year plant. He indicated that although UNS Gas employed an annualization similar to that used in the last case, that methodology should not be used in this case because it would understate test year revenues, as well as the revenues that are expected to be achieved post-test-year. (Ex. A-21, at 37-38.) Mr. Smith testified that the Company has added residential and commercial customers for the past several years, including in the test year, and it would not make sense to assume UNS Gas is experiencing a decline in customers and revenues at the same time that the Company is adding plant to serve new customers. (*Id.*)

We agree with Staff and RUCO that it is not appropriate to blindly apply the traditional customer annualization methodology if the result achieved by that exercise does not reflect an accurate portrayal of UNS Gas's actual operations. The Company would have the Commission assume that it is losing customers and revenues while, at the same time, requesting that we recognize significant additions to plant in rate base that were needed to serve customer growth.

In support of its position, UNS Gas relies heavily on the fact that the Commission adopted an end of test year annualization methodology in the Company's last rate case. The Company argues that just because the end of the test year in this case happens to fall in the summer, the rationale should not change when the end of the test year coincides with the end of the calendar year, as occurred in the prior case.

We agree with UNS Gas that consistency in Commission Decisions is important. However, the overriding consistency to be achieved on this issue is recognition of the Company's overall operations during the test year. In the prior case, we denied the Company's proposed annualization methodology based not only on the fact that it did not fully recognize customer growth, but also due to the complexity and lack of transparency of the proposed formula. (Decision No. 70011, at 17-19.) In the last case, UNS Gas experienced significant and rapid growth during the test year and it was appropriate to use the end of the test year to reflect that growth. The prior Decision did not state or imply, however, that the "traditional" annualization methodology would be adopted in all cases without consideration of all other facts and circumstances.

We find that adoption of RUCO's position on this issue recognizes that the UNS Gas system continues to grow, albeit at a slower pace than in prior years. Acceptance of the Company's position would produce a counterintuitive result that assumes negative growth, while Staff's recommendation assumes growth that is greater than the level experienced, especially considering current economic conditions. Therefore, in accordance with RUCO's recommended adjustment, we decline to reduce test year revenues by $516,003 as proposed by UNS Gas.

Weather Normalization

In its brief, UNS Gas states that the other parties do not dispute the Company's weather normalization methodology, and any differences are the result of the respective customer annualization positions.

It does not appear that any methodological difference exists between the parties on this issue. However, the weather normalization adjustment should be applied in accordance with the customer annualization method adopted above.

Operating Expenses

Fleet Fuel Expense

UNS Gas witness Dukes proposed that the Company's fleet fuel expense be established based on a three-year average (2006-2008) of gasoline costs incurred, ($3.05 per gallon). (Ex. A-17 at 30-31.) The Company's three-year normalization proposal represents a reduction of $51,285 to its actual test year fleet fuel costs. Mr. Dukes stated that the average fuel price used by UNS Gas reflects the Company's actual costs and that lower cost recommendations made by Staff and RUCO should be rejected. He testified that the Company incurs slightly higher fuel costs than some other utilities because the UNS Gas service area is farther from large metropolitan areas like Phoenix and Tucson and covers a larger number of square miles given its more rural locations. (*Id.*)

Although Staff witness Fish recommended a pro forma adjustment to the Company's test year fleet fuel costs (Ex. S-13, at 18), Staff did not address this issue in either its initial or reply briefs, and therefore presumably is now in agreement with the Company's normalization adjustment.

RUCO agrees that it is appropriate for UNS Gas to normalize fleet fuel expense to smooth out volatility in gas prices. However, RUCO witness Smith disagrees with using what he calls the Company's "backward-looking" costs of fuel based on 2006-2008 gasoline prices, because prices reached extreme levels in 2008 of over $4.00 per gallon. (Ex. R-21, at 61-62.) Mr. Smith instead proposes use of average fuel prices from 2006 through June 2009. The additional months would cause the normalized fuel price to drop from $3.05 per gallon, as requested by UNS Gas, to $2.95 per gallon. RUCO's recommended adjustment would reduce test year fleet fuel expense by a total of $71,963, an additional $20,705 to the Company's proposed reduction of $51,258. (*Id.* at 63.)

We find that RUCO's fleet fuel expense reduction more accurately reflects the volatility of gasoline prices by incorporating a longer normalization period than that proposed by UNS Gas. We will therefore adopt RUCO's proposal to use a normalized price of $2.95 per gallon resulting in a reduction to test year expenses of $71,963.

<u>Customer Call Center Expenses</u>

UNS Gas included in its application the actual allocated test year costs associated with operations at the call center shared with its affiliate companies, UNS Electric and TEP. Costs are allocated based on talk time for each of the three companies, although in the Kingman, Havasu, and Nogales districts UNS Gas and UNS Electric share talk time, and allocations are based on customer counts. (Ex. A-17, at 24.) During the test year, UNS Gas's allocation of call center expenses totaled $1,399,522, or $116,627 per month. (Ex. S-12, at 26-27.) RUCO does not object to UNS Gas's proposed call center expenses,

Staff witness Dr. Fish testified that the increase in the Company's call center expenses compared to the last case ($76,227) is unjustified because the number of service orders per month decreased from 5,435 in 2006 to 4,656 in 2008. (*Id.*) Dr. Fish recommends that UNS Gas's authorized call center expenses be reduced by $484,798, to the level authorized in the Company's last case (*i.e.*, $76,227).

Company witness Dukes responded that the number of "service orders" is not the proper measurement of call center usage by UNS Gas customers. He claims that the call center has experienced an increase in call volume and call duration of approximately 150 percent over 2005 levels, the test year used for establishing call center expenses in the last rate case. (Ex. A-17, at 21-22.) Mr. Dukes stated that filling service orders is a minor portion of the call center's services, and UNS Gas is using more of the center's capacity than it was in 2005. He indicated that the overall annual operating costs of the call center increased by 22 percent from 2005 to 2008; technology improvements have been made, including implementation of a new billing system in 2007; and the increased call volumes and durations reflect the need to explain bills, make payment arrangements, discuss credit terms, and discuss disconnection and reconnection arrangements. (*Id.* at 24.) Mr. Dukes added that the Company now offers options to pay by credit card or online, which services add to the call center's costs.

We find that UNS Gas has justified the basis for the increased call center costs compared to the Company's last rate case. As the Company's witness pointed out, the expenses authorized in the prior case were based on a 2005 test year, and the call volumes and duration of calls have increased substantially since that time. We do not believe that Staff's justification for decreasing the call center expenses to a 2005 level is supported by the record. Reliance on a single factor (decreased service order volumes) is not a sufficient basis for disallowing almost $500,000 of test year expenses related to providing important services to customers. We also recognize that the Company's closure of a number of local offices since the last case has likely caused an increase in calls, and that the economic downturn has resulted in the need for an increased need for call center time to address payment arrangements and related issues.

We therefore adopt UNS Gas's position on this issue and will allow recovery of the Company's test year call center expenses.

Payroll and Payroll Tax Expense

UNS Gas proposed that the rates adopted in this case should include recognition of increases in payroll and payroll tax expenses ($362,018 and $2,557, respectively) that went into effect January 1, 2010. (Ex. A-16, at 19-20.) Mr. Dukes testified that these known and measurable increases were applied to employee levels at the end of the test year to avoid a mismatch of revenue and expenses. (Ex. A-17, at 10.) Staff does not oppose the Company's proposal on this issue, except to modify the payroll tax adjustment in accordance with Staff's position on incentive compensation (see discussion below).

IBEW witness Frank Grijalva testified in support of the Company's inclusion of 2010 wage increases, based on the fact that UNS Gas and the IBEW have completed contract negotiations and therefore the amount of the wage increases is known and measurable. (Ex. IBEW-1, at 4-5.)

RUCO witness Smith does not oppose the three percent pay increase that went into effect outside the test year on January 1, 2009, but proposes disallowance of the additional three percent wage increase that was effective January 1, 2010. Mr. Smith stated that the 2010 pay increase is too far removed from the test year and other companies are curtailing budgeted pay increases due to the downturn of the economy. (Ex. R-20, at 56.)

We find that the 2010 wage increases should be recognized in the rates approved in this proceeding. Those increases are known and measurable and have been reconciled with end-of-test year employee levels to avoid a mismatch of revenues and expenses. Allowance of the known and measurable wage increases is also consistent with the Commission's treatment of this issue for UNS Electric in Decision No. 70360 (May 27, 2008) and for Southwest Gas Corporation in Decision No. 70665 (December 24, 2008).

Rate Case Expense

UNS Gas initially requested inclusion of $500,000 for rate case expense, normalized over three years ($166,667 per year). In his direct testimony, Staff witness Dr. Fish recommended removal of the test year amortization of rate case expense of $300,000 approved in the Company's last rate case that will be recovered before the new rates in this case become effective. Staff's proposed adjustment would decrease the Company's rate case expense by $58,333 per year, resulting in annual rate case expense of 141,667. (Ex. S-12, at 29.) Company witness Dukes stated in his rebuttal testimony that the Company agrees with Staff's proposed adjustment. (Ex. A-17, at 19.)

RUCO proposes a reduction to UNS Gas's rate case expense beyond the amount recommended by Staff and accepted by the Company. RUCO witness Smith testified that, even with the correction accepted by UNS Gas, the Company should be limited to no more than $300,000 for rate case expense, normalized over three years (*i.e.*, $100,000). With the adjustment recommended by Staff, RUCO proposes a net reduction to the Company's proposed rate case expenses of $158,333. (Ex. R-21, at 64-67.)

Mr. Smith supports his proposal by comparing the rate case expenses allowed in several recent cases. Mr. Smith cites to the allowed rate case expense in the prior UNS Gas case of $300,000, normalized over three years, and to the subsequent UNS Electric case (Decision No.

70360), wherein the Commission also allowed rate case expense of $300,000, normalized over three years. He also pointed to the most recent Southwest Gas case (Decision No. 70665) in which the Commission granted rate case expense of $276,000, normalized over three years. Mr. Smith claims that the instant case presented many of the same types of issues addressed in those prior cases, and that there are actually fewer issues in the current UNS Gas case than the Company's prior case. (*Id.*)

Mr. Dukes contends that RUCO's proposal fails to recognize legitimate expenses incurred by the Company. He indicated that, as of the date of his rebuttal testimony filing, UNS Gas had already incurred more than $400,000 in rate case expenses, and the final cost would be well in excess of the $500,000 original estimate. Mr. Dukes claims that an annual allowance of $100,000 would not allow the Company to cover the cost of even one regulatory attorney, and UNS Gas should not be penalized for "efficiently outsourcing its regulatory needs." (Ex. A-17, at 20.) Mr. Dukes also stated that, if the revenue requirement recommendations advocated by Staff or RUCO are adopted by the Commission, "it is very likely that UNS Gas will need to quickly file another rate case." (*Id.*) Therefore, according to Mr. Dukes, there would be no basis for adopting a three-year normalization of rate case expense.

We agree with RUCO that the Company's proposed rate case expense of $500,000 should be reduced significantly. As RUCO suggests, the recent UNS Gas and UNS Electric cases, as well as the two most recent Southwest Gas cases, presented many of the same issues that were raised in this case, and the Decisions in those cases represent an appropriate measure of comparison for UNS Gas in this case. The number of hearing days in those cases was comparable as well. In fact, the prior UNS Gas case presented more issues than were litigated in this case, given that the prior case was the first one filed and considered following UNS Gas's acquisition of Citizens Utilities' assets. For these reasons, we allow rate case expense of $300,000, normalized over three years. The $58,333 adjustment proposed by Staff and accepted by the Company should also be accounted for in the rate case expense calculation.

<u>Postage Expense</u>

In his direct testimony, Staff witness Dr. Fish stated that the authorized expenses in this case should include recognition of a two-cent increase in first class postage rates after the Company filed its application. (Ex. S-12, at 25.) There is no opposition from the Company or RUCO to recognizing the postage rate increase that occurred in May 2009.

The May 2009 postage rate increase should therefore be included in UNS Gas's expenses in this case, adjusted for the customer annualization finding adopted above.

American Gas Association Dues

The American Gas Association ("AGA") is a national trade association for natural gas distribution and transmission companies. UNS Gas included $45,964 for dues paid to the AGA in the test year. In the direct testimony filed by Gary Smith (adopted by Company witness Hutchens, Tr. 44), UNS Gas describes the benefits received through the AGA's programs, services and advocacy efforts. The Company claims that the AGA conducts hundreds of operating and engineering activities to improve safety, engineering and productivity, and that of the $18 million in dues collected, the AGA provided its member companies "$479 million in outright savings or avoided costs." (Ex. A-8, at 9.)

The Company asserts that its requested AGA dues expense represents a four percent reduction to the actual dues paid, to account for the portion of the AGA's budget that UNS Gas claims is related to lobbying activities. Mr. Dukes indicated that the Company's position is consistent with the Commission's findings in Decision No. 70011, wherein 3.51 percent of the total dues were disallowed to account for the lobbying portion of the AGA's budget. (Ex. A-17, at 21.) Staff accepted the Company's proposed AGA dues expense. (Ex. S-13, at 16.)

RUCO witness Ralph Smith proposed a further reduction to UNS Gas's AGA dues expense. Mr. Smith cites to the finding in the most recent Southwest Gas case, Decision No. 70665, in which the Commission disallowed 40 percent of AGA dues. (Ex. R-21, at 52-55.) In the Southwest Gas Decision, a portion of which was admitted as an exhibit in this proceeding (Ex. R-6), we described the type of activity categories in which the AGA engages on behalf of its members: Advertising; Public Affairs; Corporate Affairs; General Counsel; General & Administrative Expense; Policy, Planning and Regulatory Affairs; Operations & Engineering Management; Policy & Analysis; and Industry Finance & Administrative Programs. (*Id.* at 10-11.) In Decision No. 70665, we noted that although the prior Southwest Gas case (Decision No. 68487) had excluded only 3.64 percent of AGA dues, Southwest Gas was required in its subsequent case to provide 'a clearer picture of AGA functions and how the AGA's activities provide specific benefits to the Company and its Arizona customers.' (*Id.* at 11, quoting Decision No. 68487 at 14.)

In Decision No. 70665, we agreed with the recommendation of Mr. Smith, who was a Staff witness in that case, and who recommended disallowance of 40 percent of AGA dues on the basis that Southwest Gas had not demonstrated how the AGA's activities provide specific benefits to ratepayers. (Ex. R-6, at 12.) Mr. Smith similarly testified in this case that UNS Gas failed to demonstrate why ratepayers should fund activities through membership in an industry organization that would likely be disallowed if they were performed by the Company itself. (Ex. R-21, at 53.) RUCO's 40-percent disallowance recommendation is based on decisions by other state regulatory commissions and audits of the AGA by NARUC. RUCO cites to orders issued by other commissions in which AGA dues were disallowed in the following percentages: Michigan (16.17 percent), California (25 percent), and Florida (40 percent). (Ex. R-20, at 45 -46.) He also cited a 1999 NARUC-sponsored audit of AGA expenditures that stated, "these expense categories may be viewed by some State commissions as potential vehicles for charging ratepayers with such costs as lobbying, advocacy or promotional activities which may not be to their benefit." (*Id.* at 46.)

Consistent with our conclusion in Decision No. 70665, we find that RUCO's recommended disallowance of 40 percent of AGA dues represents a reasonable approximation of the amount for which ratepayers receive no supportable benefit. The documentation offered by the Company to justify the AGA dues, including the alleged monetary savings to members, consists primarily of information provided by the AGA itself and must be viewed in that context. As Mr. Smith indicated, several other states have disallowed AGA dues in substantially higher amounts than the amount proposed by UNS Gas in this case. We therefore adopt RUCO's recommendation to disallow 40 percent of the Company's AGA dues.

<u>Outside Legal Expenses</u>

In addition to the actual test year outside legal expense incurred during the test year ($83,555), UNS Gas proposes to recover an additional $305,984 for outside legal expenses, based on a normalized three-year (2005-2007) average of such costs. (Ex. A-16, at 25.) In the Company's prior case, we allowed $400,000 for outside legal expenses based on an approximation of costs incurred over a three-year period. (Decision No. 70011, at 20.) In that case, we recognized that the test year (2005) legal expenses were higher than normal due to the Company's involvement in a case with El Paso Natural Gas Company ("El Paso") at the Federal Energy Regulatory Commission ("FERC"). Because the El Paso case settled, we agreed with Staff and RUCO that the test year expense level was likely to be non-recurring, and therefore based the legal expense allowance on an approximate average of 2004, 2006, and estimated 2007 costs. (*Id.*)

In this case, the incurred test year legal expense was approximately $84,000 due primarily to UNS Gas's write-off of $310,000 of outside legal costs that were disallowed in the prior case. (Ex. A-16, at 24.) Mr. Dukes stated that an average of approximately $390,000 represents a normal and recurring level of outside legal expenses for UNS Gas. (*Id.* at 25.) He added that the Company continues to monitor interstate pipeline filings made by El Paso and Transwestern Pipeline at the FERC. (Ex. A-17, at 27.)

Staff witness Dr. Fish testified that the Company should be limited to recovery of only the test year expenses actually incurred ($83,555). Dr. Fish stated that the Company failed to offer substantive reasons for the high level of legal expenses and did not offer evidence regarding attempts to mitigate those costs. (Ex. S-13, at 17.) Staff therefore recommends disallowance of the normalized $305,984 sought by UNS Gas for outside legal expense.

RUCO witness Smith recommends that the Company be permitted to recover a normalized level of outside legal costs, excluding expenses in prior years related to the El Paso case at FERC, which was settled. (Ex. R-20, at 48-49.) Mr. Smith stated that, because it appears the Company will continue to incur legal costs with future FERC cases, RUCO agreed that an additional annual allowance over actual test year expense is reasonable. RUCO proposes that the Company be permitted to recover $171,865 in annual outside legal expense, a reduction of $217,674 to UNS Gas's requested amount. (Ex. R-21, at 60-61.)

As we indicated in UNS Gas's last rate case, we believe that the Company's allowable legal expenses should be set at a level that reflects more accurately its actual experience, both historical and anticipated. Staff and RUCO make valid arguments about the non-recurring nature of the outside legal expenses incurred from 2005 through 2007, which were higher than normal due to the Company's participation in the El Paso rate case. However, Staff's recommendation fails to give any recognition to the fact that the Company will continue to incur legal expenses related to FERC cases, and that it is in the best interest of UNS Gas's customers for the Company to monitor and participate as necessary in those proceedings. We believe RUCO's recommendation offers a reasonable allowance for an ongoing level of expenses and we therefore allow outside legal expenses of $171,865 to UNS Gas in this case.

Bad Debt Expense

Staff witness Dr. Fish recommends reducing the Company's proposed bad debt expense by $186,627, to account for what he claims is an overstatement of bad debt expense accruals by UNS Gas. Dr. Fish indicated that bad debt is handled as a two-part process whereby actual losses are reviewed, an estimate of expected losses are recorded as an accrual on the Company's books, and the actual losses are then booked to the accruals. (Ex. S-12, at 23.) Dr. Fish claims that UNS Gas's actual bad debt expense was $972,007 in 2006; $668,482 in 2007; $849,695 in 2008; and $625,168 for the test year. However, according to Dr. Fish, the accruals booked by UNS Gas to Allowance for Doubtful Accounts increased from $(366,736) in 2006, to $(1,010,624) in 2007, to $(1,219,587) at the end of the test year, an increase of more than 300 percent. (*Id.* at 24.) Dr. Fish stated that, as of the end of the test year, the allowance for doubtful accounts represented over 17 percent of the Company's Billed Accounts Receivable. (Ex. S-13, at 18.) He therefore recommended that the Company's Uncollectibles rate be reduced from the current level of 4.87 percent to 3.468 percent, until the accrual of bad debts becomes aligned with the actual bad debt experience. (Ex. S-16, at 24.)

UNS Gas contends that its proposed bad debt expense adjustment is based on a three-year historical average for the percentage of bad debt expense compared to revenue. The Company claims that this adjustment was prepared and calculated in the same manner as was approved in the last rate case. (Ex. A-16, 24.) RUCO does not oppose the Company's request on this issue.

In response to Staff's recommendation, Mr. Dukes explained that the bad debt allowance account is a "contra asset account" that reduces the Accounts Receivable account on the Company's balance sheet, so that the net of the two accounts reflects the reality that not all of the accounts will be collected fully. (Ex. A-17, at 25.) Mr. Dukes stated that the account is reconciled on a quarterly basis by TEP's accounting department and is audited annually by an independent auditing firm. Mr. Dukes suggests that Dr. Fish, who is not a CPA or accountant, was looking at only one side of the equation and came to an incorrect conclusion, because bad debt expense is the accrual-based expense to match expected net write-offs with revenue as it is recorded. (*Id.* at 26.) He contends that, for ratemaking purposes, the appropriate method is to take net write-offs as a percentage of retail revenue over a period of time in order to calculate bad debt expense. Mr. Dukes testified that the Company's calculation of 4.87 percent of pro forma retail revenues, based on historical levels of bad debt expense and net write-off levels, is appropriate and should be adopted.

We agree with the Company's contention that the accounting undertaken for recording bad debt expense is appropriate. As Mr. Dukes indicated, Staff's claim that UNS Gas has substantially overstated its allowance account due to over-expensing of bad debt, is incorrect. Rather, the allowance account is higher to reflect that the Accounts Receivable account has higher uncollectible accounts that have not been written off. (Ex. A-18, at 11-12.) We find that UNS Gas has explained sufficiently the basis of its accounting treatment of bad debt expense and we therefore decline to adopt Staff's recommendation on this issue.

<u>Depreciation and Property Tax on Post-Test-Year Plant</u>

RUCO witness Ralph Smith testified that in accordance with RUCO's recommendation to disallow post-test-year plant, test year expenses should be reduced for depreciation ($58,107), operation and maintenance depreciation on transportation equipment ($11,351), and property tax ($25,584). (Ex. R-20, at 28-29.)

Although UNS Gas opposes RUCO's adjustment, the Company's opposition is based on its disagreement regarding inclusion of post-test-year plant. (UNS Gas Initial Brief, at 20.)

Given our rejection of the Company's request for post-test-year plant, we find that RUCO's proposed depreciation and property tax expenses should be adopted.

<u>Property Tax Rate</u>

UNS Gas requested recovery of property tax expense based on its final, adjusted plant-in-service at the end of the test year, using the 2009 statutory assessment rate of 22.0 percent and the most current average property tax rates. (Ex. A-11, at 8.) Although Staff did not oppose the Company's property tax proposal, RUCO recommends setting allowable expenses for property tax based on a rate of 21.0 percent.

RUCO witness Ralph Smith testified that RUCO's recommendation is based on the known and measurable assessment for 2010, pursuant to legislation passed by the Arizona State Legislature (A.R.S. §42-15001) that decreased property tax assessments from the 25 percent rate in effect in 2005, by 0.5 percent in 2006, and by 1.0 percent in each successive year until a rate of 20 percent is achieved in 2011. (Ex. R-20 at 54.) Mr. Smith stated that the Company's proposal fails to recognize the impact of the known tax change.

UNS Gas argues on brief that RUCO's use of a 2010 assessment ratio reaches too far into the future and fails to consider other likely changes to property taxes in 2010. The Company asserts that RUCO's proposal would create a mismatch and an unrealistic property tax allowance. (UNS Gas Initial Brief, at 14.)

We agree with RUCO that the property tax expense allowance in this case should be based on the known and measurable assessment rate currently in effect. The rate for 2010 is 21.0 percent, and the rate will decline again in 2011 to 20.0 percent. These tax rate changes are known and measurable, as set forth in A.R.S. §42-15001. Our adoption of the known property tax rate for 2010, when the rates set in this case will become effective, is consistent with prior cases that addressed this issue, as well as our inclusion of known and measurable wage increases that took effect in 2010. In accordance with RUCO's proposal, property tax expense should be reduced by $230,913.

<u>Incentive Compensation</u>

UNS Gas allows its non-union employees to participate in its parent company's Performance Enhancement Program ("PEP"), which provides eligible employees compensation above their base pay for meeting financial targets (30 percent), cost containment goals (30 percent), and customer service goals (40 percent). (Ex. R-21, at 40.) Company witness Dukes claims that the PEP is a core component of its compensation package for employees and that the program should be viewed as a means of encouraging and enhancing group and individual employee performance. (Ex. A-17, at 13-14.)

Mr. Dukes testified that without the PEP compensation, the Company would face pressure to increase base compensation to compete with other companies for qualified employees. (*Id.*) He also indicated that the goals of the program benefit customers by promoting safety and reducing operating costs, thereby increasing the financial soundness of the Company without exceeding reasonable employee compensation levels. (*Id.*)

In accordance with prior Commission Decisions, Staff and RUCO propose to adjust the PEP expenses by 50 percent, based on the claim that incentive compensation programs benefit both ratepayers and shareholders. (Ex. S-12, at 27-28; Ex. R-20, at 29-35.) Staff and RUCO cite to prior cases involving UNS Gas (Decision No. 70011, at 27), UNS Electric (Decision No. 70360, at 21), and Southwest Gas (Decision Nos. 68487, at 18, and 70665, at 16), to support their recommendations. In those cases, the Commission disallowed 50 percent of the incentive programs costs, based on a finding that the programs benefited both customers and shareholders. RUCO witness Ralph Smith stated that there is no relevant distinction between the incentive programs presented in this case and those for which 50 percent of costs were disallowed. (Ex. R-21 at 44). Mr. Smith also cited to a 2009 PEPCO rate case in Washington D.C., in which the utility company voluntarily excluded expenses related to incentive compensation, executive raises, and other expenses, in recognition of the poor economy. (*Id.*)

In the most recent Southwest Gas case, we disallowed 50 percent of a management incentive compensation program. (Decision No. 70665, at 16.) In *Southwest Gas*, we concluded as follows:

> In the last Southwest Gas rate case, as well as several subsequent cases [footnote omitted], we disallowed 50 percent of management incentive compensation on the basis that such programs provide approximately equal benefits to shareholders and ratepayers because the performance goals relate to financial performance and cost containment goals as well as customer service elements. (Decision No. 68487 at 18.) In that Decision, we stated:
>
> > In Decision No. 64172, the Commission adopted Staff's recommendation regarding MIP expenses based on Staff's claim that two of the five performance goals were tied to return on equity and thus primarily benefited shareholders. We believe that Staff's recommendation for an equal sharing of the costs associated with MIP compensation

> provides an appropriate balance between the benefits attained by both shareholders and ratepayers. Although achievement of the performance goals in the MIP, and the benefits attendant thereto, cannot be precisely quantified there is little doubt that both shareholders and ratepayers derive some benefit from incentive goals. Therefore, the costs of the program should be borne by both groups and we find Staff's equal sharing recommendation to be a reasonable resolution.
>
> (*Id.*) We believe the same rationale exists in this case to adopt the position advocated by Staff and RUCO to disallow 50 percent of the Company's proposed MIP costs. [footnote omitted]

We believe that the Staff and RUCO recommendations, to require a 50/50 sharing of incentive compensation costs, provides a reasonable balancing of the interests between ratepayers and shareholders. The equal sharing of such costs recognizes that the program is comprised of elements that relate to the parent company's financial performance and cost containment goals, matters that primarily benefit shareholders, while at the same time recognizing that approximately 40 percent of the program's incentive compensation is based on meeting customer service goals. This offers the opportunity for the Company's customers to benefit from improved performance in that area.

Therefore, consistent with the recent cases cited above, we will adopt the recommendation of Staff and RUCO on this issue.

<u>Stock-Based Compensation</u>

UNS Gas included in test year expenses stock-based compensation provided to Company employees under the following programs: Stock Options; Dividend Equivalents on Stock Units; Performance Stock Award; Dividend Equivalent on Stock Options; and Directors Stock Awards. (Ex. R-21, at 46.) Company witness Dukes testified that inclusion of the expenses related to this compensation is appropriate because a portion of employee pay is put at risk and stock-based pay benefits customers because it promotes long-term planning goals and employee retention. (Ex. A-17, at 17.) Staff did not take a position on this issue.

RUCO opposes inclusion of any amount of stock-based compensation based on prior Commission Decisions that excluded such expenses.[11] RUCO witness Smith testified that

[11] *Arizona Public Service*, Decision No. 69663, at 36; *UNS Electric*, Decision No. 70360, at 22.

"[r]atepayers should not be required to pay executive compensation that is based on the performance of the Company's (or its parent company's) stock price." (Ex. R-20, at 39.) He added that prior to being required to report stock options as expenses under SFAS 123R, the cost of stock options were treated as a dilution of shareholders' investments (*i.e.*, a cost borne by shareholders). Mr. Smith contends that the requirement for companies under SFAS 123R to expense stock options on financial statements should not be used as a basis for shifting the cost responsibility for stock options from shareholders to ratepayers. (*Id.*)

We agree with RUCO that UNS Gas's proposal to include the costs of stock-based compensation should be denied. In Decision No. 69663, we agreed with Staff's recommendation to exclude stock-based incentive compensation, finding that ratepayers should not be required to fund the costs of a program that is based on the company's, or its parent company's, stock price. On page 36 of that Decision, we stated:

> To the extent that Pinnacle West shareholders wish to compensate APS management for its enhanced earnings, they may do so, but it is not appropriate for the utility's ratepayers to provide such incentive and compensation.

Similarly, in the last UNS Electric case, we agreed with Staff that "test year expenses should be reduced to remove stock-based compensation to officers and employees." (Decision No. 70360, at 22.)

We agree with RUCO's recommendation to exclude stock-based compensation for UNS Gas's test year expenses. As we have indicated in prior cases, tying employee compensation to a company's stock price has the potential to "negatively affect the Company's provisions of safe, reliable utility service at a reasonable rate" because management decisions (*e.g.*, delaying maintenance costs) could be influenced by the effect on earnings. (Decision No. 69663, at 36.) Further, as RUCO's witness pointed out, current economic conditions should cause utility companies to reconsider whether it is appropriate to seek recovery from captive ratepayers of incentive programs, such as providing stock options to management and employees.

In accordance with RUCO's recommendation, $266,399 should be excluded from test year expenses related to stock-based compensation.

Supplemental Executive Retirement Plan

UNS Gas allows select executives to participate in a Supplemental Executive Retirement Plan ("SERP"). The SERP provides to eligible executives retirement benefits in excess of the limits allowed under Internal Revenue Service ("IRS") regulations for salaries in excess of specified amounts.

UNS Gas contends that the SERP costs are reasonable and that neither Staff nor RUCO have shown that the Company's overall executive compensation costs are excessive or out of line with industry standards. The Company claims that SERP costs do not represent an excess benefit, but are necessary to keep management benefits equal as a percentage of compensation to the eligible employees. (Ex. A-17, at 18.) UNS Gas argues that SERP expenses are normal, reasonable and recurring compensation costs that are incurred in the provision of service, and the costs should therefore be recoverable.

Staff and RUCO recommend disallowance of the SERP costs ($101,021), in accordance with the Commission's Decisions in several recent cases.

In a prior Southwest Gas case (Decision No. 68487, at 18-19), we disallowed SERP costs, finding:

> [T]he provision of additional compensation to Southwest Gas' highest paid employees to remedy a perceived deficiency in retirement benefits relative to the Company's other employees is not a reasonable expense that should be recovered in rates. Without the SERP, the Company's officers still enjoy the same retirement benefits available to any other Southwest Gas employee and the attempt to make these executives "whole" in the sense of allowing a greater percentage of retirement benefits does not meet the test of reasonableness. If the Company wishes to provide additional retirement benefits above the level permitted by IRS regulations applicable to all other employees it may do so at the expense of its shareholders.

We reached the same conclusion regarding SERP expenses in the last UNS Gas case (Decision No. 70011, at 27-29), stating:

> [T]he issue is not whether UNS may provide compensation to select executives in excess of the retirement limits allowed by the IRS, but whether ratepayers should be saddled with the costs of executive benefits that exceed the treatment allowed for all other employees. If the Company

> chooses to do so, shareholders rather than ratepayers should be responsible for the retirement benefits afforded only to those executives.

More recent Commission Orders have consistently denied recovery of SERP expenses in rates. For example, in Decision No. 69663, we disallowed SERP expenses for APS based on the finding made in the earlier Southwest Gas proceeding. (Decision No. 69663, at 26-27.) In the prior UNS Electric case (Decision No. 70360, at 22), we also excluded SERP costs stating "[w]e see no reason to depart from the rationale on this issue in the most recent UNS Gas rate case…" In the most recent Southwest Gas case (Decision No. 70665, at 17-18), we again found that SERP expenses should not be recoverable from ratepayers.

We see no reason to depart from the rationale on this issue in all of the recent cases cited above, that ratepayers should not be required to fund the retirement benefits of a few select executives whose salaries exceed current IRS limits (currently $240,000). As has been stated in prior cases, the Company's shareholders may provide these additional retirement benefits but ratepayers should not be subject to this additional burden.

We therefore adopt the recommendations of Staff and RUCO and disallow $101,021 in SERP expenses proposed by UNS Gas.

Interest Synchronization

There does not appear to be any dispute that an interest synchronization adjustment is necessary to coordinate the income tax calculation with rate base and cost of capital. As described in RUCO witness Smith's testimony, this adjustment decreases income tax expense and increases the Company's achieved operating income by a similar amount. (Ex. R-20, at 53, Attach. Sched. C-10.)

Net Operating Income

Consistent with the foregoing discussion, we will allow adjusted test year operating expenses of $40,849,910, which based on test year revenues of $53,418,509, results in test year adjusted operating income of $12,568,599.

COST OF CAPITAL

UNS Gas recommends that the Commission determine the Company's cost of common equity to be 11.0 percent, with an overall weighted average cost of capital ("WACC") recommendation of

8.75 percent. Staff recommends a cost of common equity of 10.0 percent, with an overall weighted cost of capital determination of 8.24 percent. RUCO proposes adoption of a cost of common equity of 8.61 percent, with an overall weighted cost of capital of 7.55 percent.

Capital Structure

At the end of the test year, UNS Gas had a capital structure consisting of 50.01 percent long-term debt and 49.99 percent equity. (Ex. A-13 at 8.) The Company proposes using its actual capital structure as of the end of the test year. Both Staff and RUCO agreed that it is appropriate to use the Company's actual capital structure. (Ex. S-14, at 3; Ex. R-13, at 50.) We agree that it is appropriate to use UNS Gas's actual test year capital structure for the purpose of determining the Company's cost of capital in this proceeding.

Cost of Debt

All parties in the case agreed that the Company's cost of debt was 6.49 percent during the test year. (Ex. A-13, at 26; Ex. S-14, at 2; Ex. R-13, at 3.) Since there is no dispute regarding this issue, we will adopt a cost of debt of 6.49 percent for purposes of establishing UNS Gas's weighted cost of capital in this proceeding.

Cost of Common Equity

Determining a company's cost of common equity for purposes of setting its overall cost of capital requires an estimate based on a number of factors. There is no fool-proof methodology for making this determination, and the expert witnesses rely on various analyses to support their respective recommendations.

UNS Gas

UNS Gas witness Kentton Grant based his common equity cost recommendation of 11.0 percent on the results of his common equity models, namely a multi-stage Discounted Cash Flow ("DCF"), Capital Asset Pricing Model ("CAPM"), and risk premium ("RP"). Mr. Grant examined the risk profile of UNS Gas relative to a comparable company group to determine a point in the range produced by those models. The estimated cost of equity produced by this analysis was then compared to the allowed returns for other gas local distribution companies ("LDCs") in the United States to confirm the reasonableness of the Company's estimate. Mr. Grant indicated that he relied on capital markets data primarily from August 2008, in order to avoid the volatility experienced in the markets shortly after. (Ex. A-13, at 9-11.) Mr. Grant also examined the financial impact of the recommended return on equity ("ROE") and the overall rate request to assess the Company's ability to attract capital on reasonable terms. (Ex. A-14 at 2.)

Mr. Grant claims that it was appropriate to use a comparable group of LDCs in his analysis because the cost of equity capital for UNS Gas's parent company, UniSource Energy, which is heavily weighted toward the electric industry, may not be representative of the cost of equity capital for UNS Gas. Mr. Grant's comparable group was based on all LDCs evaluated by *Value Line Investment Survey* ("*Value Line*"), from which 10 companies were selected based on several criteria that Mr. Grant believes make them comparable to UNS Gas. (Ex. A-13, at 11.)

Mr. Grant explained that the DCF methodology is based on the theory that the price of a share of stock is equal to the present value of all future dividends. As described by Mr. Grant, the constant growth form of the DCF model recognizes that the return to shareholders consists of both dividend yield and growth. He stated that the constant growth form of the model should not be used for companies with near-term growth rates that are significantly higher or lower than their long-term growth potential. For such companies, Mr. Grant claims that a multi-stage DCF model should be used to incorporate the various growth rates that are expected over time. (*Id.* at 12-13.)

According to Mr. Grant, an annual long-term growth rate of 6.3 percent represents a reasonable estimate of long-term investor expectations for earnings and dividends, which he claims is consistent with the 5.3 to 7.0 percent median growth rate in earnings per share ("EPS") for his comparable company group's published point estimates for 2011 through 2013 by *Value Line*, as well as a five-year estimate of EPS growth reported by *Zacks Investment Research* ("*Zacks*") and *SNL Financial* ("*SNL*"). Based on his application of a multi-stage DCF model, the estimated cost of equity for the sample companies produced a range of 9.5 percent to 11.2 percent, with an average value of 10.1 percent. (*Id.* at 14-18.)

Mr. Grant stated that use of the CAPM is premised on the assumption that capital markets are highly efficient and that investors attempt to optimize their risk/return profiles through diversification. He indicated that the CAPM assumes that risk is comprised of systematic risk (which is unavoidable) and unsystematic risk (which is company-specific and can theoretically be eliminated through portfolio diversification). As a result, Mr. Grant explained that the CAPM is based on the theory that investors should be compensated only for systematic risk. (*Id.*) Applying the CAPM produced a result of 10.2 percent to 11.3 percent, with an average value of 10.7 percent. (*Id.* at 20.)

Mr. Grant next discussed his RP analysis, which relies on the relationship between risk and required rates of return. He stated that rational investors demand higher expected returns on investments that present a greater potential for loss, as observed in the bond markets in which investors accept lower yields on U.S. Treasury bonds relative to corporate bonds. (*Id.*) Mr. Grant indicated that investments in common stocks, which are inherently riskier than bonds, require an incremental risk premium compared to observed bond yields. He testified that the RP analysis is appropriate to use during periods of high volatility in the financial markets, as a means of validating the results achieved from the traditional DCF and CAPM methodologies. (*Id.* at 20-21.) Mr. Grant's RP analysis resulted in an estimated cost of equity of 10.2 to 11.5 percent for the comparable companies. (*Id.* at 23.)

Based on his comparison of the DCF, CAPM and RP results, Mr. Grant observed a range of overlapping values of 10.2 percent to 11.2 percent, which range he determined as the Company's estimate of the cost of equity for the comparable company group. (*Id.* at 24.)

The next step in the Company's analysis was to determine the appropriate ROE in this proceeding for UNS Gas, based on a comparison of the "risk profiles" of UNS Gas and the comparable companies. Mr. Grant asserts that an equity investment in UNS Gas is "decidedly riskier" than an equity investment in the comparable companies due to several factors, including UNS Gas's smaller size, its inability to pay dividends, and lower credit ratings for UNS Gas than for most of the comparable companies. Based on these relative risk factors, Mr. Grant proposes that the ROE for UNS Gas be set at the top of the range for the comparable companies and that the Commission award a ROE of 11.0 percent in this proceeding. (*Id.* at 24-25.)

UNS Gas is critical of the ROE recommendations of both Staff and RUCO based on the Company's claim that Staff and RUCO's results fail a basic test of reasonableness. Mr. Grant claims that all of Staff witness Parcell's analyses (DCF, CAPM, and CE) contain significant flaws that result in understating the Company's cost of equity capital. According to Mr. Grant, Staff's use of the CAPM is flawed because Mr. Parcell's use of a historical market risk premium does not reflect the current risk-averse nature of investments in debt and equity securities in the capital markets. (Ex. A-14, at 4-7.) Mr. Grant claims that Mr. Parcell's CAPM results (7.3 to 7.7 percent) would not even cover the cost of debt for most of the companies in his comparable group. Mr. Grant is also critical of Staff's use of a geometric mean return[12] in its CAPM analysis, which he claims is contrary to sound financial theories. UNS Gas argues that the use of an arithmetic mean return[13] in determining the market risk premium is supported by academics and financial professionals. With respect to Staff's DCF model, Mr. Grant asserts that the constant growth version, which assumes that dividends and earnings of a company grow at a constant rate over an infinite period, fails to reflect that investors expect non-constant short-term growth, as well as constant long-term growth. (*Id.* at 12.) Finally, Mr. Grant stated that Staff's CE analysis should be accorded little weight because it assumes that investors use historical accounting returns on book equity to determine required future returns on stock investments. Mr. Grant also claims that Mr. Parcell's conclusions were influenced by earned returns for electric utilities, which companies have experienced earnings impacted by restructuring and other factors not relevant to the gas utility industry. (*Id.* at 14.)

The Company contends that RUCO's ROE recommendation (8.61 percent) is well below the cost of equity determined for any gas utility since at least 1990. Mr. Grant indicated that although RUCO witness Rigsby's DCF analysis supports the Company's ROE proposal, the averaging of his DCF and CAPM results produces a flawed recommendation. Mr. Grant claims that, similar to the problems he identified with Staff's CAPM method, RUCO failed to adjust its historical market risk premiums to reflect investors' "flight to quality," and therefore underestimated significantly the cost of equity for the comparable companies analyzed by Mr. Rigsby. (*Id.* at 17-18.)

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[12] Mr. Grant states that the "geometric mean return" reflects "the compound average return earned over a multi-year period…[which] serves to inappropriately understate the cost of equity capital." (*Id.* at 9.)

[13] Mr. Grant defined the "arithmetic mean return" as "the mathematical average of historical returns realized over each discrete 12 month period." (*Id.*)

<u>RUCO</u>

RUCO witness William Rigsby proposes adoption of a ROE of 8.61 percent based on his analysis using DCF and CAPM methodologies. As noted above, Mr. Rigsby employed a single-stage DCF analysis, as opposed to the multi-stage version used by UNS Gas. RUCO contends that Mr. Rigsby's DCF analysis is appropriate because it is based on five-year growth rates specific to the LDCs used in Mr. Rigsby's proxy group, whereas Mr. Grant's DCF model assumes a long-term growth rate for LDCs that would be comparable to an inflation-adjusted growth rate for all goods and services produced by labor and property in the United States in perpetuity. (Ex. R-13, at 55.) According to Mr. Rigsby, the multi-stage DCF used by the FERC requires more weight to be given to short-term growth expectations, which is similar to the one-to-five-year projections used in his DCF analysis. (Ex. R-14, at 8.) Mr. Rigsby pointed out that if the Company's DCF inputs were applied to RUCO's single-stage DCF model, the resulting mean average would be significantly less than even Mr. Rigsby's DCF estimate. (Ex. R-13, at 56.)

With respect to its CAPM analysis, RUCO asserts that the use of both geometric and arithmetic means of historical returns is more reasonable than the Company's exclusive reliance on arithmetic returns. (*Id.* at 28.) Similar to the arguments made by Staff (see below), RUCO contends that it is appropriate to use both means in the CAPM analysis, because investors have access to both forms of information regarding historical returns. Mr. Rigsby added that he believes the geometric mean provides "a truer picture of the effects of compounding on the value of an investment when return variability exists." (Ex. R-14, at 9.)

Mr. Rigsby also testified that it should not be surprising that his CAPM analysis produced the results reflected in his testimony considering the effect of lower interest rates on low-risk investments such as U.S. Treasury bonds and certificates of deposit. Based on the low returns on these safe investments, and his claim that utility stocks have traditionally been considered as safe investments, Mr. Rigsby indicated that the Company's proposed 11.0 percent ROE is unreasonable. (*Id.* at 16.) Although Mr. Rigsby conceded that common stock shareholders bear a higher risk than bondholders, he asserts that Mr. Grant overstates the risk premium that should be assigned to a relatively low risk utility monopoly such as UNS Gas. (*Id.*)

Staff

Staff witness David Parcell presented Staff's ROE recommendation in this case. In developing his recommendation, Mr. Parcell utilized DCF, CAPM, and CE analyses. He indicated that because UNS Gas is not publicly traded, it is not possible to directly apply cost of equity models. In his analysis, Mr. Parcell employed two comparable groups of companies as a proxy for UNS Gas and UniSource. (Ex. S-14, at 23-24.) The first sample group was comprised of a group of seven combination gas and electric companies and the second group consisted of the same ten natural gas companies used by the Company's witness.

Mr. Parcell's DCF analysis produced a range of 9.5 percent to 10.5 percent for the proxy groups' cost of equity. His CAPM model produced a cost of equity range of 7.3 percent to 7.7 percent for the sample groups. (*Id.* at 29-32.) Mr. Parcell also utilized a CE analysis, which he described as a method designed to measure the returns expected to be earned on the original cost book value of similar risk companies. According to Mr. Parceli, his CE analysis was based on market data using market-to-book ratios, and is therefore a market test that should not be subject to criticisms leveled at other analyses that are based on past earned returns. He also claims that the CE uses prospective returns and is therefore not backward-looking. (*Id.* at 32-34.) Based on his CE analysis, Mr. Parcell concluded that the cost of equity for the proxy companies is "no more than 9.5 percent to 10.5 percent." (*Id.* at 36.)

Based on the results of the three methodologies, Mr. Parcell found an overall range of 7.3 percent to 10.5 percent ROE for the proxy companies, and concluded that the appropriate cost of equity rate for UNS Gas is in the range of 9.5 percent to 10.5 percent. He recommended that the Commission adopt the mid-point of the range (10.0 percent) as the ROE in this case. (*Id.* at 38.)

Mr. Parcell also addressed how he believes the current financial crisis impacts the cost of equity for UNS Gas. He stated that because the economic conditions affect almost all segments of the economy, and UNS Gas is a regulated utility that sells a relatively inelastic product, the Company is largely insulated from the adverse economic conditions. Mr. Parcel added that: (1) there is no justification for increasing returns awarded to regulated utilities at the same time that other businesses are experiencing lower profits; (2) unlike unregulated firms, UNS Gas has the opportunity to pass on higher costs to customers in its next rate case; (3) there is no indication that UNS Gas's risks have increased since its last case; and (4) a number of measures are being undertaken by the United States and other governments to make credit more accessible and restore confidence in financial markets. (*Id.* at 38-39.)

With respect to the arguments raised by the Company, Mr. Parcel responded that the events of the past two years have affected virtually all aspects of the economy and society, and not just utilities or UNS Gas in particular. He stated that the Company's customers have been impacted adversely by the same economic conditions, by virtue of high unemployment rates, diminished real estate values, and reduced values of retirement savings. (Ex. S-15, at 2-3.) With respect to criticism of his cost of capital methodologies, Mr. Parcell indicated that the Commission has accepted the same recommendations in prior cases. In response to his CAPM results specifically, Mr. Parcell testified that the reason the CAPM results are lower than normal is due to current lower Treasury bond yields and a lower risk premium reflective of the decline in stock prices in 2008. He pointed out, however, that the DCF results tend to be higher than normal due to higher yields based on stock price declines, and that "[i]t would not be proper to disregard the lower CAPM results while not discounting the higher DCF results." (*Id.* at 2-3.)

Regarding the Company's criticism of the use of geometric means in the CAPM, Staff cites to Mr. Parcell's surrebuttal testimony, wherein he indicated that investors have access to both arithmetic and geometric returns in making investment decisions, and that many mutual fund investors rely on geometric returns in evaluating historic and prospective returns of funds. (*Id.* at 3.) Staff also points to Mr. Parcell's testimony indicating that the Commission found it appropriate in the last UNS Electric case to use a geometric or compound growth rate in using the CAPM model. (*Id.* at 4-5.)

<u>Conclusion on Cost of Equity</u>

Based on the competing positions presented through the testimony, exhibits, and arguments, we believe that Staff's recommended cost of equity capital range of 9.5 percent to 10.5 percent is appropriate. We agree with Staff that the CAPM results are reflective of the combination of lower bond yields and a lower risk premium associated with a decline in stock prices, and that the same stock market decline tends to produce higher DCF results. We also continue to believe, consistent with our findings in several prior cases, 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.

As noted above, Mr. Parcell's DCF analysis produced a range of 9.5 percent to 10.5 percent for the proxy groups' cost of equity, his CAPM model produced a cost of equity range of 7.3 percent to 7.7 percent for the sample groups, and his CE analysis produced a result for the proxy companies of no more than 9.5 to 10.5 percent. Based on his conclusion that UNS Gas has an estimated ROE of 9.5 to 10.5 percent, Mr. Parcell recommended setting the Company's ROE at the mid-point of the range, or 10.0 percent.

In his testimony, Mr. Parcell raises valid arguments with respect to the effect of current economic conditions on all aspects of the economy, and on society in general. Although Mr. Parcell recommended adoption of the 10.0 percent midpoint in his cost of equity range, he testified that it is "appropriate for the Commission should they choose to do so, to go to the low end of the range to reflect economic conditions," and that setting the ROE at 9.5 percent "would be proper and supportable." (Tr. 844.)

We do not believe UNS Gas has demonstrated that its risk is significantly greater compared to other comparable companies; nor has it shown that its risks have increased substantially since its last rate case. The Company cannot pretend that it operates in a vacuum or that the challenges it faces are unique. Indeed, relative to a number of unregulated industries, the utility industry is insulated from the vagaries of the marketplace to the extent that it does not face direct competition for its product and there is a high degree of inelasticity in the need for utility services.

We believe that adoption of an estimated ROE of 9.50 percent will allow the Company to attract capital at a reasonable rate, and strikes a reasonable balance between its proposal for an estimated ROE near the top of the range produced by its own analysis and the results achieved through the methodologies employed by Staff and RUCO. We also believe that adoption of an estimated cost of equity at the low point of Staff's ROE range, 9.50 percent, provides at least some minimal recognition of the devastating effects of current economic conditions on UNS Gas's customers, as established in the record of this case.[14]

Accordingly, we adopt a 9.50 percent ROE in this proceeding for UNS Gas, which results in an overall weighted average cost of capital of 8.00 percent.

	Percentage	Cost	Weighted Avg. Cost
Common Equity	49.9%	9.50%	4.75%
Total Debt	50.1%	6.49%	3.25%
			8.00%

Fair Value Rate of Return

FVRB in Decision No. 70011

In its last rate case, UNS Gas proposed, as an amendment to its application, that the WACC should be applied directly to its fair value rate base. The Company based its proposal on a Memorandum Decision issued by the Arizona Court of Appeals in *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, 1 CA-CC 05-0002 (Ariz. App. Feb. 13, 2007) ("*Chaparral City*").

UNS Gas argued in its prior case that the Commission's Decision in the underlying Chaparral City case adopted Staff's recommendation to calculate the revenue requirement by multiplying OCRB by the cost of capital. (Decision No. 68179, at 26-28.) In its previous case, the Company claimed that, only after the OCRB revenue requirement was completed did Staff calculate the FVRB for Chaparral City, which resulted in what UNS Gas asserted was a "backing-in" approach that was mathematically equivalent to the methodology rejected by the Court of Appeals in *Chaparral City*. In support of its argument, UNS Gas cited to Article 15, §14 of the Arizona Constitution, which states in part that "[t]he Corporation Commission shall, to aid it in the proper discharge of its duties, ascertain the fair value of the property within the State of every public service corporation doing business therein…"

[14] We note that, as discussed in the Fair Value Rate of Return ("FVROR") section below, UNS Gas initially proposed to "voluntarily" accept a lower FVROR than it claimed could be supported, in order to mitigate the rate impact on customers "in these challenging economic times." (Ex. A-13, at 30.) However, the Company subsequently withdrew that recommendation, opting instead for the higher FVROR that it claimed could be justified. (Ex. A-14, at 32.)

In the last UNS Gas case, we rejected the Company's arguments on this issue, in part, because the Company had not raised its FVRB recommendation in a timely manner. We indicated that UNS Gas's attempt to modify its position on this issue, just days before the Staff and RUCO surrebuttal testimony was due, was prejudicial to opposing parties, because those parties did not have adequate time to pursue discovery and prepare testimony on the Company's amended proposal. (Decision No. 70011, at 48-49.)

We indicated further that no party disputed that the Commission is required to consider the Company's FVRB in determining rates. However, we disagreed with UNS Gas's reliance on *Chaparral City* to support its position, on the basis that we have broad discretion in determining how FVRB is to be used in the ratemaking exercise. In the prior case, we stated:

> Mr. Grant's proposal ignores the explicit language of the Court's decision, which states: 'the Commission asserts that it was not bound to use the weighted average cost of capital as the rate of return to be applied to the FVRB. The Commission is correct....[t]he Commission has the discretion to determine the appropriate methodology.' (*Chaparral City, supra,* at p. 13, ¶17). Despite this unambiguous explanation, UNS would have us employ the very methodology the Court of Appeals specifically stated the Commission was not required to apply in setting rates.

(*Id.* at 49-50.) We also pointed out that the *Chaparral City* case was on remand at that point and the Commission had not yet conducted a hearing or issued a further order regarding the Court of Appeals' decision. (*Id.*)

Finally, we raised concerns with respect to UNS Gas's attempt to apply the WACC to FVRB without modification, citing to Staff's testimony which claimed that "there is no logical basis for applying such a methodology because investors have no expectation that they will earn a return on the excess between OCRB, which represents investor supplied funds, and FVRB, which represents unrealized paper profits." (*Id.* at 50.)

<u>Chaparral City Remand Decision and Subsequent Chaparral City Rate Decision</u>

In Decision No. 70441 (July 28, 2008) ("Decision No. 70441" or "Chaparral City Remand Case"), we addressed the issue that was remanded by the Court of Appeals in *Chaparral City*. Decision No. 70441 did not adopt the company's proposal to determine a FVROR by applying the

WACC directly to the FVRB, but revised the method used in Decision No. 68176 (the prior Chaparral City Decision) to calculate operating income. We found that applying the WACC directly to the FVRB would over-compensate Chaparral City Water Company ("Chaparral City") for inflation, and therefore calculated the FVROR by adjusting the WACC to reflect an inflation adjustment that reduced the cost of equity. The FVROR was then applied to the FVRB to determine operating income. (Decision No. 70441, at 41.)[15]

In its recent rate case ("Decision No. 71308" or "Chaparral City Rate Case"), Chaparral City raised many of the same arguments addressed by the Commission in Decision No. 70441, including the proposal that the WACC should be applied directly to Chaparral City's FVRB without an inflation adjustment. (Decision No. 71308, October 21, 2009.) We rejected Chaparral City's arguments and adopted Staff's recommendation that the FVROR should be calculated by subtracting an inflation factor from both the debt and equity components of the WACC. In reaching that conclusion, we reiterated the findings set forth in Decision No. 70441, stating that:

> [Chaparral City] is advocating for a rate of return methodology which would produce comparably higher rates, which conflicts with the most basic tenet of rate regulation, which is that a utility should be provided with rates that will allow it an opportunity to earn a return that is comparable to those of similarly situated enterprises.

(*Id.* at 48.) We concluded that "using [Chaparral City's] proposed methodology would produce excessive returns." (*Id.* at 48-49.) Accordingly, we adopted Staff's recommendation to apply an inflation adjustment to the WACC to determine the FVROR.[16]

<u>UNS Gas' Position</u>

In its application, as detailed in Mr. Grant's direct testimony, UNS Gas proposed that a FVROR of 6.80 percent should be applied to the Company's FVRB in this proceeding. Mr. Grant stated that, although UNS Gas could justify a FVROR of 7.30 percent[17] using the same methodology

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[15] Chaparral City has appealed Decision No. 70441 to the Court of Appeals.

[16] Chaparral City has also appealed Decision No. 71308 to the Court of Appeals.

[17] Mr. Grant calculated the 7.30 percent FVROR by subtracting a 2.9 percent inflation factor from the Company's proposed 11.0 percent cost of equity, and applying the remainder (8.1 percent) to the equity component of the capital structure (*i.e.*, 49.99% equity x 8.1% =4.05% plus 3.25% debt component = 7.30%. (*Id.* at 31.)

adopted in Decision No. 70441, the Company agreed to forego the full 7.30 percent "to mitigate the rate impact on our customers in these challenging economic times." (Ex. A-13, at 30.)

In his rebuttal testimony, however, Mr. Grant withdrew the Company's "voluntary measure" of recommending a 6.80 percent FVROR due to "substantial cuts to the revenue requirement proposed by Staff and RUCO, and the possibility that those adjustments could be adopted by the Commission." (Ex. A-14, at 32.) Mr. Grant stated that, given the recommendations included in Staff's and RUCO's direct testimony, the Company now insists that the FVROR should be based on the method approved in Decision No. 70441 or, in the alternative, on the method proposed by Staff in the most recent Chaparral City case (since adopted in Decision No. 71308), both of which produce a FVROR of 7.30 percent (assuming acceptance of the Company's 11.0 percent cost of equity). (*Id.*) Mr. Grant also indicated that a FVROR of 7.25 percent would result from using the Chaparral City formula, if applied to Staff's proposed 10.0 percent cost of equity and the 2.0 percent inflation factor referenced in Staff witness Parcell's testimony. (*Id.*)

<u>Staff's Position</u>

Staff witness Parcell testified that the concept of cost of capital is designed to apply to an original cost rate base rather than a fair value rate base. (Ex. S-14, at 46.) He explained that when the concept of fair value is incorporated, the link between rate base and capital structure is broken because the increment between OCRB and FVRB represents an amount that is not financed with investor-supplied capital. According to Mr. Parcell, financial theory dictates that investors should be provided an opportunity to earn a return on the capital they provided to the utility, and therefore the only appropriate method is to assign a zero cost to the increment of FVRB over OCRB. (*Id.* at 47.) The result of this calculation is a FVROR of 6.03 percent. (*Id.* at 48.)

Mr. Parcell indicated that, if the Commission is inclined to adopt a return greater than zero for the fair value increment, an alternative methodology could be considered based on a "nominal risk-free rate" of 4.5 percent, less an inflation factor of 2.0 percent, for a net "real risk-free rate" of 2.5 percent. He indicated that the 2.5 percent risk-free rate was a maximum amount, but that it would be appropriate to use any percentage between zero and 2.5 percent. Mr. Parcell chose the mid-point of that range, or 1.25 percent, to be applied to the fair value increment, resulting in an alternative FVROR recommendation by Staff of 6.37 percent. (*Id.* at 50-51.)

<u>RUCO's Position</u>

RUCO witness Ralph Smith evaluated four separate methodologies to determine RUCO's FVROR recommendation of 5.38 percent, resulting in an overall revenue requirement that is $38,000 higher than RUCO's OCRB recommendation. The four options considered by Mr. Smith were: (1) adjusting the recommended OCRB-based ROE for estimated inflation; (2) adjusting the recommended OCRB-based overall rate of return for estimated inflation; (3) applying a zero cost to the fair value increment; and (4) applying a factor of 1.25 percent to the fair value increment. (Ex. R-20, Sched. A.) RUCO discarded methods one and four as producing results ($4,649,000 and $2,290,000 revenue increases, respectively) that were "too high." RUCO concluded that methods two and three produced results ($524,000 revenue reduction and $800,000 revenue increase, respectively) that were "too low." (*Id.*) RUCO's final recommendation settled on a FVROR of 5.38 percent, which produces a revenue increase of $841,000. (*Id.*)

Mr. Smith explained that the criteria used in these methodologies were based on "informed judgment" and an attempt to comply with the *Chaparral City* decision by the Court of Appeals, as well as Commission Decision No. 70441. He stated that the "determination of FVROR is at best an estimation and not an exact science," and the goal of the exercise is to afford the Company a reasonable return without providing excessive rates or windfall profits. (Ex. R-21, at 10.) RUCO contends that its recommendation satisfies the requirements of those prior decisions and achieves a reasonable rate of return for UNS Gas "when all relevant and appropriate factors are considered." (*Id.*)

<u>Conclusion on FVROR</u>

As is clearly delineated in the Arizona Constitution, the Commission is obligated to establish rates and charges that are "just and reasonable" (Article 15, §3), and to "ascertain the fair value of the [utility's] property" (Article 15, §14). Arizona courts have interpreted the constitution's "fair value" language as requiring fair value to be used in setting rates.[18] In Decision No. 70441, we recognized the fair value requirement for one component of the rate setting exercise (*i.e.*, rate base), but observed that:

> The Constitution is silent as to how the Commission is to determine the rate of return, thereby leaving that duty to the Commission and allowing it to use its knowledge and expertise, with the caveat that resulting rates and charges must be just and reasonable.[19]

In that Decision, we discussed the history of utility regulation and the evolution of ratemaking in conjunction with standardized accounting procedures and economic and financial theory. We noted that the testimony of RUCO's witness:

> ...included a history of 'fair value' in the context of rate regulation with an explanation of how in the early 1900s, a distrust of the book cost information provided by the utilities due to the practice of trading utility properties back and forth at escalating 'values,' recording 'cost' that included the profit of an affiliate, and the lack of standardized accounting methods led state commissions to favor 'fair value' over 'original cost' rate base determinations.[20]

We also observed that, although the fair value ratemaking method was prominent in the first half of the twentieth century, regulators began to use original cost information due to its greater reliability, ease of interpretation, and being less susceptible to abuses. In the Chaparral City Remand Case, we cited to the landmark United States Supreme Court case, *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281 (1944), which freed most regulatory commissions from fair value ratemaking requirements. (Decision No. 70441, at 21.) In that context, we indicated that "[o]nce regulators had the appropriate controls in place to regulate accounting and the double dealing transactions, the original cost was given more weight because it was a more reliable and trustworthy number." (*Id.*)

With respect to Arizona specifically, we pointed out that, at the time Arizona's constitutional framers adopted Article 15, §14, the NARUC Uniform System of Accounts did not exist and there

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[18] *See*, e.g., *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 294 P.2d 378 (1956). "While our constitution does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates. The reasonableness and justness of the rates must be related to this finding of fair value."
[19] Decision No. 70441, at 20.
[20] Decision No. 70441, at 21, footnote 56.

were no modern financial models for estimating cost of equity. (*Id.*) The Arizona Supreme Court, in *Arizona Corp. Com'n v. State ex rel. Woods*, 171 Ariz. 286, 830 P.2d 807 (1992), discussed the genesis of the Commission's constitutional powers and observed that at the time the Arizona Constitution was drafted, progressive and labor forces shared a distrust of corporate powers and combined to grant to the Commission broad authority to regulate public service corporations. The court stated that, "[t]he founders expected the Commission to provide both effective regulation of public service corporations and consumer protection against overreaching by those corporations."[21] In the Chaparral City Remand Case, we observed that "Arizona is apparently the only remaining state that continues to have a fair value requirement." (Decision No. 70441, at 33.)

With this historical framework in mind, we must analyze the constitutional requirement to ascertain the Company's fair value rate base with our concurrent constitutional obligation to set just and reasonable rates. In both of the Chaparral City cases cited above, we attempted to reconcile the direction from the Court of Appeals regarding fair value rate of return with the obligation to protect utility customers from excessive rates that could result from inflated returns. In doing so, however, we emphasized that "there are many ways to analyze and calculate an appropriate rate of return on FVRB." (*Id.*) As stated in Decision No. 71308, the FVROR is intended to allow a utility to attract capital on reasonable terms; maintain the utility's financial integrity; and permit the utility an opportunity to realize a return that is commensurate with the returns earned by enterprises with commensurate risks. (*Id.* at 47.) At the same time, the FVROR must produce a result that does not over-compensate the utility for the fair value of its property through rates and charges that are not just and reasonable. (Decision No. 70441, at 33.)

In *Chaparral City*, the Commission was criticized for adopting a methodology that allegedly "backed-in" to a revenue requirement that was comparable for both OCRB and FVRB. In this case, UNS Gas is proposing what is effectively a "reverse backing-in" approach to produce its desired revenue requirement. As RUCO witness Ralph Smith testified, using the Company's "voluntary" 6.80 percent FVROR would, if applied to its proposed OCRB, result in an implicit ROE of 12.58

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[21] *Id.* at 290, 830 P.2d 807, at 811. *See, also*, Deborah Scott Engelby, Comment, *The Corporation Commission: Preserving its Independence*, 20 Ariz. St. L. J. 241 (1988); Kris Mayes, *Encouraging Conservation by Arizona's Private Water Companies: A New Era of Regulation by the Arizona Corporation Commission*, 49 Ariz. L. R. 297 (2007).

percent. (Ex. R-20, at 10.) Indeed, the Company's proposed revenue increase in this case (approximately \$9.5 million) is more than three times the amount that would be realized under a typical cost of capital analysis based on the OCRB, operating expenses, and ROE determined above. We do not believe rates that are set at a level more than 100 percent above the increase that would be calculated under the OCRB/ROE methodology, and which methodology is employed in virtually every other state in the nation, can be considered "just and reasonable" under any logical definition of that term. It is therefore necessary to employ an analysis in this case that balances the Commission's fair value and just and reasonable obligations under the Arizona Constitution.

In the Chaparral City Rate Case, we found that an inflation element exists in both the debt and equity components of the capital structure and, accordingly, the inflation adjustment should be made to the entire cost of capital. (Decision No. 71308, at 45.) In that Decision, we reiterated that "the most basic tenet of rate regulation...is that a utility should be provided with rates that will allow it an opportunity to earn a return that is comparable to those of similarly situated enterprises."[22] However, we do not believe the inflation factor should be reduced by 50 percent, as was done in that case, because such a methodology would fail to recognize that RCND estimations are based on estimates of the cost to reconstruct the entirety of the Company's system at current prices, and do not take into account in the RCND estimation efficiencies and cost savings that may exist due to factors such as technological advances. We note that the Chaparral City Remand Decision did not apply a 50 percent weighting factor to the inflation estimate, although inflation was calculated only on the equity component in that case due to a lack of sufficient evidence in the record concerning inflation in the cost of debt. (Decision No. 70441, at 36-37.) In this proceeding, we find that an unadjusted inflation factor should be subtracted from the entire WACC, to afford appropriate recognition to the fact that inflation exists in both the debt and equity components of the Company's capital structure, and that reconstruction cost estimates likely exceed the rate of inflation based on the factors cited above.

We turn next to the appropriate inflation rate to be applied to UNS Gas's WACC. In his direct testimony, Company witness Grant indicated that an inflation factor of 2.9 percent was

[22] *Id.* at 48, citing *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591, 64 S.Ct. 281 (1944).

appropriate for purposes of supporting a justification of a 7.30 percent FVROR. (Ex. A-13, at 30-31.) In his direct testimony, RUCO witness William Rigsby calculated an average inflation factor of 2.5 percent for the years 2001 through 2008, a level of inflation that RUCO witness Smith found to be "a very conservative estimate of inflation." (Ex. R-13, Sched. WAR-1, p.4; Ex. R-21, at 10.) Staff witness David Parcell suggested that an inflation factor of 2.0 percent should be used for calculating the FVROR, if Staff's alternative recommendation is adopted by the Commission. (Ex. S-14, at 50.)

Although we believe it would be reasonable to assume an inflation factor as high as 2.9 percent, as suggested in the Company's direct testimony, for purposes of determining an appropriate FVROR in this case we will adopt a lower inflation rate based on an average of the Staff and RUCO inflation rates. The average of the Staff and RUCO rates of 2.0 and 2.5 percent, respectively, results in a rate of 2.25 percent, which we believe is a conservative estimate of the inflation factor that should be applied to the WACC in order to remove from it the effects of inflation. Subtracting the 2.25 percent inflation factor from the 8.0 percent WACC, results in a FVROR of 5.75 percent, which we find to be reasonable under the facts and circumstances of this case. Applying the FVROR to the FVRB determined herein, produces an overall revenue increase of $3,245,607.

As this case makes clear, the substantial difference between UNS Gas's OCRB and estimated RCND produces a FVRB that is far in excess of the OCRB. The large gap between UNS Gas's OCRB and FVRB underscores the inherent flaw in attempting to apply a weighted average cost of capital directly to the FVRB, even with the modifications employed in the Chaparral City cases and herein for UNS Gas. Although historically the FVRB has been calculated by averaging the OCRB and RCND, the issue of whether a given company's estimated RCND is accurate, or whether it is appropriate to determine the FVRB by taking a simple average of OCRB and RCND, are matters that have not heretofore been analyzed in any substantial detail because, prior to the Court of Appeals' *Chaparral City* decision, the methodology employed by the Commission did not typically result in significant differences.

We believe that future cases should include a more detailed and comprehensive evaluation of how fair value rate base is determined, including a determination of the accuracy of the RCND estimation process; whether it is appropriate to average OCRB and RCND to calculate FVRB; and how, or whether, the Commission should use cost of capital models as part of the determination of fair value rate of return.

As we have stated in prior cases, the Constitution does not prescribe the methodology to be used by the Commission in ascertaining the fair value of a utility company's property, and it is undisputed that the Commission has broad discretion in making fair value determinations.[23] Even the Court of Appeals' decision in *Chaparral City* recognized the Commission's authority to craft appropriate methodologies for determining fair value. We indicated previously that there are a number of methods that may be appropriate for determining FVRB and FVROR and, as the facts of this case make clear, a one size fits all approach may not enable the Commission to satisfy its obligation to establish just and reasonable rates without the ability to tailor a remedy that balances the Commission's concurrent constitutional obligations.

As a final matter, it is noteworthy that UNS Gas initially proposed a FVROR of 6.80 percent, based on its concern for its customers "in these challenging economic times." (Ex. A-13, at 30.) However, the Company later withdrew its "voluntary" offer after reading Staff's and RUCO's direct testimony, and realizing that those parties recommended a revenue requirement that was less than the amount requested by the Company. Staff and RUCO's adjustments to parts of the Company's rate application should not have been a surprise, unless the Company somehow believes the economic challenges faced by its customers are no longer as daunting as they were previously; or the Company's concern for customers only applies to the extent it is assured of receiving the full revenue increase requested in its application.

Fair Value Rate of Return Summary

Weighted Average Cost of Capital	8.00%
(Less) Inflation Adjustment	2.25%
Fair Value Rate of Return	5.75%

AUTHORIZED INCREASE

Based on our findings herein, we determine that UNS Gas is entitled to a gross revenue

[23] *See*, e.g., *Simms v. Round Valley Light & Power Co.* (1956), 80 Ariz. 145, 294 P.2d 378; *Consolidated Water Utilities, Ltd. v. Arizona Corp. Com'n* (App. Div.1 1993), 173 Ariz. 478, 875 P.2d 137; *Scates v. Arizona Corp. Com'n* (Div.1 1978), 118 Ariz. 532, 578 P.2d 612.

increase of $3,245,608.

Fair Value Rate Base	$253,074,108
Required Rate of Return	5.75%
Required Operating Income	14,551,761
Operating Income Available	12,568,599
Operating Income Deficiency	1,983,162
Gross Revenue Conversion Factor	1.636582
Gross Revenue Increase	$3,245,608

RATE DESIGN ISSUES

Monthly Customer Charge

UNS Gas

In its application, UNS Gas proposed increases to the fixed monthly charge for all customer classes, except residential customers served under the CARES[24] program. Under the Company's proposal, the residential customer charge would be increased from $8.50 per month to $14.00 per month, in three phased steps. The first step would increase the charge to $10.00 when the rates in this case go into effect, with an increase to $12.00 per month one year later, and an additional increase to $14.00 per month two years following the effective date. The Company's recommendation would result in a corresponding reduction in the non-commodity volumetric charges, such that the automatic adjustments would be revenue neutral for an average usage customer. (Ex. A-20, at 14-15.)

UNS Gas claims that its customer charge proposal would better align rates with its cost of service, as detailed in its class cost-of-service study. (Ex. A-22, at 6.) Mr. Erdwurm explained that although the vast majority of the Company's costs are fixed, the recovery of those fixed costs is heavily dependent on revenues received through the volumetric charges. The Company's recommendation in this case seeks to recover an increasingly greater percentage of fixed costs by imposing higher monthly customer charges while reducing non-commodity volumetric charges by a corresponding amount. Company witness Erdwurm described the Company's plan to phase-in automatic increases in the monthly fixed charge as "an initial and gradual move towards de-coupling." (*Id.*)

24 "CARES" is the Customer Assistance Residential Energy Support program that offers low-income customers discounted rates on the monthly service charge and a portion of non-commodity volumetric charges. (Ex. A-20, at 22.)

According to UNS Gas, its cost-of-service study indicates that the "bare bones" monthly customer charges needed to recover its fixed costs would be $18.15 for residential service, $19.00 for small commercial/industrial customers, and approximately $220.00 for large commercial/industrial customers. (Ex. A-20, at 14.) Mr. Erdwurm indicated that the fixed monthly costs include metering, meter reading, the service drop to customers, and customer service and billing. (*Id.*) The Company claims that moving towards a rate structure that more closely matches fixed customer charges to fixed costs provides benefits, such as allowing customers to make better decisions regarding the use of resources; allowing the Company to receive revenues more in line with incurrence of costs; and serving an important policy goal of lessening reliance on volumetric charges to recover fixed costs.

UNS Gas also contends that its proposed rate design would reduce existing subsidies from its customers in colder climates to those in warmer areas. As an example, Mr. Erdwurm claims that the average Flagstaff residential customer pays $145 more in annual margin than an average customer in Lake Havasu City, for the same fixed costs. He stated that if the Company's customer charge were to be capped at $10 per month, rather than allowing the additional proposed adjustments, that subsidy would increase to $173 annually. However, according to Mr. Erdwurm, if the Company's recommended rate design is approved, the alleged cross-subsidy would be reduced to $134 per year. (*Id.* at 17-18.)

In response to the objections of Staff and RUCO, the Company argues that increasing the monthly customer charge from $8.50 to $14.00 would not result in "rate shock" because the increase would be phased in over three steps, and because the customer charge represents a relatively small portion of the overall bill. In addition, UNS Gas claims that the customer charge increases would be partially offset by reductions to the non-fuel volumetric charges under the Company's proposal. The Company also disputes the contention that its proposed rate design would result in customer confusion, arguing that the Commission has approved phased-in rates in the past. Finally, UNS Gas asserts that its rate design would not eliminate the incentive to conserve. Mr. Erdwurm stated that the average residential customer's bill is composed of approximately 60 percent related to commodity use that is passed through the Purchased Gas Adjustor ("PGA"), and only 40 percent related to the margin portion. He indicated that the substantial portion of customer bills related to the cost of gas "will continue to provide customers a strong incentive to conserve." (*Id.* at 21.)

RUCO

RUCO witness Frank Radigan testified that the Company's proposed rate design would increase the residential monthly customer charge by 65 percent, which he considers excessive given that the Company's overall revenue increase is approximately 6 percent, and RUCO's recommended revenue increase is only 1.6 percent. (Ex. R-12, at 2.) RUCO proposes an increase in the residential customer charge from the current $8.50 per month to $10.00 per month; an increase from $13.50 to $15.50 per month for small commercial, industrial, and irrigation customers; and an increase for large commercial and industrial customers from $100.00 to $105.00 per month. (Ex. R-11, at 8.)

Mr. Radigan contends that the Company's proposal ignores the rate design principle of "rate stability," claiming that "automatic rate increases are generally not appreciated by customers." (*Id.* at 6.) He stated that the automatic increases proposed by UNS Gas would increase a small customer's bill by 40 percent in the second and third years, which he claims "will undoubtedly cause an increase in customer complaints." (*Id.*)

In response to the Company's inter-class subsidization claims, RUCO asserts that customers in the higher usage in cold weather areas may contribute more to the Company's peak, indicating that it costs more to serve those customers. Mr. Radigan suggests that if the Company believes district-specific rates should be adopted, it should present a study regarding the cost differences to serve customers in colder climates versus warmer areas. (*Id.* at 7.)

Staff

Staff witness Dr. Fish advocates a rate design that would increase the residential customer charge from $8.50 to $9.50 per month; the small commercial and industrial customer charge from $13.50 to $15.50 per month; and the large commercial industrial charge from $100.00 to $105.00 per month. (Ex. S-12, Sched. THF-RD6.) Dr. Fish expressed opposition to the Company's attempt to recover a substantially greater percentage of its fixed costs through the customer charge, stating that the Company's proposal would shift more of its cost recovery to residential customers, who have the greatest inelasticity of demand (*i.e.*, the least ability to lower usage in response to price increases). (*Id.* at 30.)

According to Dr. Fish, rates should be "efficient, equitable, and result in providing the Company the opportunity to recover its cost of providing service." (*Id.* at 29.) He also indicated that rates should be non-discriminatory; easily understood; should have minimal revenue fluctuations; and should discourage wasteful production and consumption. Dr. Fish stated that although cost-based rates are important, the concept of gradualism is also an important factor in setting just and reasonable rates. With respect to the monthly customer charge, he claims that the movement to cost-based rates "should not be so abrupt as to cause rate shock." (*Id.* at 30.)

<u>Conclusion on Customer Charge</u>

As discussed by Staff's witness, movement towards cost-based rates is just one of the many factors that must be considered in designing rates. The goal of moving closer to cost-based rates must be balanced with competing principles such as gradualism, fairness, and encouragement of conservation.

In accordance with these rate design principles, we believe that an increase in the monthly customer charge to $10.00 for residential customers will make significant movement towards cost-based rates and provide a reasonable level of protection for the customers who are affected by this base rate increase. For the remainder of the customer classes, we believe it is appropriate to adopt Staff's and RUCO's recommended customer charges as set forth in the testimony of Dr. Fish and Mr. Smith. (Sched. THF-RD4.) The non-fuel volumetric charges will be adjusted to recover the balance of the revenue requirement established in this Order based on an even percentage allocation to each class, except that the volumetric charge for the residential class will remain at its current rate.

For a residential customer on Rate R10, the fixed monthly customer charge would increase from $8.50 to $10.00, and the volumetric charge would remain at its current rate of $0.3270 per therm. Based on these rates, a residential customer with 20 therms of usage would experience an increase in monthly base rates of 10 percent (from $15.04 to $16.54) and an overall monthly increase (including the cost of gas) from $28.60 to $30.10 (5.2 percent). The same Rate R10 customer with consumption of 100 therms would see an increase in base rates of 3.7 percent (from $40.20 to $42.70) and an overall increase (including the cost of gas) from $109.02 to $110.52 (1.4 percent).

Low-Income Customer Programs

UNS Gas currently offers several low-income assistance programs. The CARES program provides a discounted monthly customer charge of $7.00 throughout the year, as well as a $0.015 per therm discount on the first 100 therms used in the winter billing months of November through April. To qualify for CARES, customers must have a combined household income of no more 150 percent of the federal poverty level. (Ex. S-12, at 31-32.) The Company also offers a Warm Spirits program through which emergency bill assistance program is offered to eligible low-income customers.

Intervenor Cynthia Zwick submitted testimony regarding low-income customer issues and recommended several modifications to the Company's proposal. Ms. Zwick proposed that CARES customers should be held harmless from the rate increase in this case, for both base rate and any increases to the PGA. Additional measures proposed by Ms. Zwick are: (1) that language in the CARES, Warm Spirits, and weatherization programs should track federal LIHEAP[25] and weatherization eligibility language; (2) the Company should be required to increase outreach and enrollment efforts in the low-income discount program, including automatically enrolling eligible customers in CARES; (3) CARES customers should be exempted from the security deposit requirements in UNS Gas's tariffs; (4) the Company should increase its level of support for the Warm Spirits and Low-Income Weatherization programs; and (5) the Company should be directed to cease the referral of customers to payday lending institutions. (Ex. Z-1, at 2.)

CARES Program

For CARES customers, UNS Gas proposed maintaining the current monthly charge of $7.00 and keeping the current non-fuel volumetric charge at $0.1770 per therm for the first 100 therms per month from November through April. (Ex. A-5, at 11.) For usage in excess of 100 therms in the winter billing period, the applicable non-fuel volumetric charge would remain $0.3270 per therm. (*Id.*)

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[25] "LIHEAP" is the Low Income Home Energy Assistance Program.

Company witness Erdwurm testified that the Company supported a collaborative effort of stakeholders to examine the possibility of providing a discount in gas commodity costs for CARES customers, with the lost commodity revenues being recovered through the PGA mechanism from other customers. (Ex. A-20, at 22.) However, no stakeholder meetings were apparently held regarding this issue, and the Company does not favor excluding CARES customers from the PGA or otherwise discounting the PGA rate for low-income customers. Company witness Hutchens testified that the PGA adjustor fluctuates based on the gas market and, during periods of downward movement, CARES customers would not receive that benefit if they were not subject to the PGA. (Tr. 82-83.) He indicated, however, that the Company has typically not passed through PGA surcharges to low-income customers. (*Id.* at 83.) UNS Gas argues that the accounting treatment of Ms. Zwick's proposal regarding the PGA, including how to allocate the impact to other customers, would be difficult to administer.

Ms. Zwick continues to advocate holding CARES customers harmless from increases in base rates as well as PGA commodity increases. She contends that more middle and low-income families are unable to pay their utility bills and any increases will result in additional disconnections. She points to a 2008 survey presented at the hearing that indicates of the households unable to pay their bills, 93 percent had at least one vulnerable household member, 29 percent were unemployed at some point during the year, 70 percent had a serious medical problem, 28 percent kept their homes at unsafe temperatures, 33 percent used a kitchen stove to provide heat, 47 percent paid less than the full bill, 32 percent went without food for at least one day, 42 percent went without medical or dental care, and 24 percent had someone in their home who became sick because the home was kept too cold. (Ex. Z-3.) She argues that the presence of these factors supports her recommendation to not impose any increases, including commodity rate adjustments, on CARES customers.

Staff witness Fish stated that Staff agreed the CARES monthly customer charge and winter month volumetric charge should be maintained at current levels. (Ex. S-12, at 31-32.) However, Staff witness Robert Gray testified that the PGA should continue to reflect only the cost of the natural gas commodity and interstate transportation, plus an interest rate component. Mr. Gray concluded that "Staff does not believe that proposals which would alter the way the PGA mechanism operates are the right venue to pursue additional low income customer relief." (Ex. S-9, at 8.)

RUCO witness Radigan also agreed with the Company's recommendation to maintain the current CARES discounted rates, but he did not take a position with respect to discounted PGA rates for low-income customers. (Ex. R-11, at 10.)

We agree with UNS Gas, Staff, and RUCO, that keeping the current customer charge in effect for CARES customers at $7.00 per month, and retaining the current winter month volumetric discount for the first 100 therms, will protect those customers from the effects of the rate increase approved in this case, and will continue to provide a rate structure for the low-income customers enrolled in the program that allows an opportunity to reduce their overall bills through conservation efforts. Although we are sympathetic to Ms. Zwick's position regarding the provision of a discounted PGA rate for CARES customers, the record in this case is not developed sufficiently to adopt that proposal. For such a recommendation to be considered, a number of issues would need to be addressed including, but not necessarily limited to, whether low-income customers would be excluded from the PGA entirely, the level of a PGA discount, and the mechanism for allocating the unrecovered revenues. Moreover, we are concerned with imposing significant additional costs on non-CARES-eligible customers who may also happen to be experiencing financial difficulties due to the current economic climate.

<u>CARES Eligibility</u>

Currently, customers are eligible for enrollment in the CARES program based on a household income of 150 percent of the federal poverty level or below. In her testimony, Ms. Zwick stated that Arizona received a total of $6.1 million in LIHEAP funding in federal fiscal year 2008, and that she was informed in November 2008 that the state would be receiving $31 million in federal LIHEAP. (Ex. Z-1, at 5.) Although this represents a significant funding increase, Ms. Zwick testified that, on a per capita basis, Arizona receives the lowest amount of LIHEAP funds of any state in the country. She indicated that even with the additional funding, assistance agencies will be able to serve only 78,000 of approximately 500,000 eligible households in Arizona. (*Id.*)

Ms. Zwick stated that in exchange for receiving the increased LIHEAP funds, community action agencies and the Arizona Department of Economic Security staff agreed to increase eligibility for those funds to households with income up to 200 percent of the federal poverty level. (*Id.*) Because of the increased eligibility level, she requested that UNS Gas be required to track the LIHEAP eligibility standard for purposes of enrolling customers in its CARES program. Ms. Zwick further requested that UNS Gas expand its outreach efforts by including flyers in customer bills between November and April, and that the Company automatically enroll customers in CARES that are determined to be LIHEAP eligible. (*Id.* at 6-7.)

At the hearing, UNS Gas witness Hutchens testified that the Company has begun enrolling customers in the CARES program who have qualified and are receiving LIHEAP funds based on the 200 percent of poverty level standard. (Tr. 80-81.) Other customers are enrolled on a self-certified basis, but only at the 150 percent standard. (*Id.*; Tr. 717.) Mr. Hutchens stated that the Company "is already doing some auto enrollment from customers that come to us from those agencies" (*i.e.*, customers determined to be LIHEAP-eligible by community assistance agencies in Arizona). (Tr. 717.)

In its brief, UNS Gas claims that the Company remains open to discussing eligibility beyond the 150 percent poverty level, but does not believe any such requirement should be adopted in this rate case given the potential impact on other customers. (UNS Gas Initial Brief, at 45.) In support of its argument, the Company cites to an exhibit it prepared showing approximately 8,000 of its 132,000 residential customers are currently enrolled in the CARES program, and 35,640 customers (27 percent) would currently meet the 150 percent eligibility standard. (Ex. A-44.) The exhibit also indicates that an additional 15,840 customers (12 percent) would qualify under the 200 percent of federal poverty level standard. UNS Gas estimates that if the CARES program is expanded to include customers between the 150 and 200 percent standards, an additional 3,556 customers would likely be enrolled in CARES. (*Id.*) The Company stated that the current rate impact on non-CARES customers is approximately $4.00 per year, and that expansion of the program to 200 percent of the poverty level would result in an additional $2.00 annually being borne by non-CARES customers. (*Id.*)

We are encouraged that UNS Gas is currently enrolling automatically into CARES the customers that are already qualified under the federal LIHEAP program at the 200 percent poverty level. However, we believe that the Company should undertake additional efforts to investigate whether its current policy for enrolling non-LIHEAP-qualified customers at the 150 percent standard should be expanded to include customers that fall within the 150 percent to 200 percent increment. We will therefore direct UNS Gas to convene a meeting within 60 days with the parties to this case, and any other interested stakeholders, to address this issue and submit its recommendations within 120 days of the effective date of this Decision.

CARES Customer Deposits

In her testimony, Ms. Zwick also requested that UNS Gas be required to waive any applicable deposit requirements for customers in the CARES program. She indicated that many families are incurring significant past-due unpaid amounts on their bills, and an additional requirement for a customer deposit to prevent disconnection, or for reconnection of service, would exacerbate the burden on such customers. (Ex. Z-1, at 7-8.)

UNS Gas opposes Ms. Zwick's deposit waiver proposal on the basis that it would impose an unfair burden on other customers. Company witness Hutchens stated that "we're stewards of our entire customer base." (Tr. 85-86.) However, Mr. Hutchens was not aware of the number of CARES customers disconnected during a given year, or the cost to the Company in making such disconnections, that would justify the level of customer deposits currently allowed under the Company's tariffs. (Tr. 708-09.)

Although we will not direct that the Company make any specific changes to its deposit policies at this time, we believe that it is in the public interest to require UNS Gas to undertake a further investigation of this issue. Therefore, the Company should include this issue in the discussions it is required to conduct with interested stakeholders regarding the CARES eligibility issue, and submit its recommendations within 120 days of the effective date of this Decision.

Warm Spirits Program

Warm Spirits is a program funded by customer contributions that provides emergency bill payment assistance to low-income customers, for purposes of avoiding disconnection or reconnection of service. UNS Gas matches aggregate customer contributions up to $25,000 annually. Currently, customers contribute through a fixed-amount pledge that is added to their bills each month, or they make random contributions through payment of their monthly bills. (Ex. A-8, at 3.) UNS Gas is proposing to offer an additional option, called "round-up," that would allow customers to contribute the difference between the actual bill amount and the amount rounded to the next even dollar as a Warm Spirits contribution. (*Id.*) UNS Gas administers the Warm Spirits program in coordination with the Arizona Community Action Association ("ACAA"). The Company disburses the collected funds quarterly to the ACAA, which distributes the funds to assistance agencies within the communities from which the funds were received. (*Id.* at 4.)

Ms. Zwick proposed that the Company be directed to increase its matching funding to the Warm Spirits program up to $50,000 annually, in recognition of the growth in number of customers requiring assistance since the last rate case and expected customer growth. (Ex. Z-1, at 8.)

Staff agrees with the Company's Warm Spirits proposal, including creation of the round-up option. RUCO did not take a position on the Company's Warm Spirits proposal.

UNS Gas agreed with Ms. Zwick's recommendation to increase its matching funding of Warm Spirits, up to $50,000 annually. (UNS Gas Initial Brief, at 45.)

We believe that the Company's agreement to increase its matching contributions to the Warm Spirits program to $50,000 annually, from the current level of $25,000 per year, is a reasonable commitment at this time. We encourage the Company to continue to promote the existence of the Warm Spirits program and to strive to find additional ways that give customers the ability to make voluntary contributions to this program.

<u>Low-Income Weatherization Program</u>

UNS Gas has four demand-side management ("DSM") programs approved by the Commission, including a low-income weatherization ("LIW") program. Company witness Denise Smith testified that the LIW program has a budget of approximately $100,000 per year, with an ability to increase that amount by up to an additional 25 percent. (Tr. 635-38.) Ms. Smith stated that the DSM funds for this program are distributed to community action agencies, including the Northern Arizona Council of Governments ("NACOG"), and those agencies administer the LIW program. She also indicated that NACOG requested additional funding for the program and that UNS Gas was discussing the request. (*Id.* at 638.) Ms. Smith testified that 52 homes in the UNS Gas service area were weatherized under the LIW program in 2008; and that an additional 27 homes had received LIW funding as of the date of the hearing in August 2009. (Tr. 646.)

Ms. Zwick recommended that the Company be required to increase its funding for the LIW program to $200,000 per year, and that the household funding level be increased from $2,000 to 3,000 per weatherization. (Ex. Z-1, at 8-9.) She compared the spending levels of Southwest Gas and UNS Gas, and asserted that Southwest Gas spends more on a per customer basis than UNS Gas for this program. (*Id.*) However, at the hearing, Company witness Smith stated that UNS Gas spends approximately $0.68 per customer for LIW, compared to Southwest Gas's $0.46 per customer level. (Tr. 635.)

We find that the Company's current level of spending on the LIW program is reasonable. However, we encourage the Company to continue to evaluate the appropriate level of funding for the LIW program, as well as its other programs. UNS Gas should be prepared to support its LIW budget in the next case.

<u>Payments at Payday Loan Stores</u>

In the Company's last rate case, we addressed the issue of whether it was appropriate for UNS Gas to refer customers to "payday loan stores" for making cash payments. In that case, we stated as follows:

> In 2006, UNS closed local offices in Prescott, Cottonwood, Flagstaff, and Show Low [but continues to operate local offices in Kingman, Lake Havasu, and Nogales]. These closings coincided with the Company's consolidation of its Tucson call center operations for all of the UniSource operating affiliates, which UNS claims was intended to improve customer service while at the same time cutting the Company's operating costs. At the time these offices were being closed, customers were notified that future payments could be made at various ACE Cash Express locations and other specified "cash only" stores. For payments made at these so-called "payday loan" stores in areas where UNS does not have a local office, UNS pays the fee charged by the payday loan stores, but customers who pay at such stores in an area that has a local office (*i.e.*, Kingman, Lake Havasu, and Nogales) must pay a $1 fee in order to make a payment at the payday loan stores.

(Decision No. 70011, at 68-70, footnotes and citations omitted.) Due to the allegations raised in that case regarding the predatory lending practices of payday loan stores, we directed the Company to "make every reasonable effort to determine whether other payment locations may be utilized." (*Id.* at 69.) As a result, UNS Gas entered into an agreement in 2009 that allows customers to make payments at WalMart stores in the Company's service area. (Ex. Z-1, at 9.)

In her testimony, Ms. Zwick expressed appreciation for the WalMart solution, but indicated that the Company continued to refer customers to a payday loan store through its website. She requested that the Company be directed to delete any reference or link to ACE Cash Express from the Company's website. (*Id.*) At the hearing, Company witness Hutchens testified that UNS Gas removed the link to ACE Cash Express from the Company's website in response to Ms. Zwick's request. (Tr. 718.) Ms. Zwick stated that she was satisfied that the website reference has been removed. (Tr. 494.)

On September 8, 2009, a letter from Paul Bonavia, the Chairman, President and Chief Executive Officer of UniSource Energy, was filed in the docket addressing the issue of payments at local offices. The letter confirmed that UNS Gas, as well as TEP and UNS Electric, now allow bills to be paid at WalMart stores, but not at local Company offices (with the exception of Lake Havasu, Kingman, and Nogales). However, effective October 1, 2009, the Company no longer accepts payments at those three remaining local offices[26] but instead, offers a phone link and dedicated computer kiosk in each local Company office.

UNS Gas should file, within 30 days of the effective date of this Decision, a statement regarding the current status of payment options available at the Nogales office, the current status of the phone links and computer kiosks in all local offices, and any other relevant information related to customer options for bill payments. If, prior to UNS Gas's next rate case Decision, any substantive changes are made to the Company's bill payment options or availability of customer contacts at local offices, UNS Gas shall file in this docket a statement regarding those changes.

. . .

[26] Mr. Bonavia indicated that, in response to concerns expressed at the August 17, 2009, public comment meeting in Nogales, the Company would continue to accept customer payments at the Nogales office until an acceptable alternative could be determined.

Proposed Changes to Rules and Regulations

UNS Gas proposed several changes to its existing Rules and Regulations governing service. The proposed changes are summarized below.

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

(Ex. A-8, at 5.) The Company's proposed changes to its Rules and Regulations were not opposed by any party in the proceeding. We find the changes to be reasonable and they shall be adopted.

Revised Fees for Additional Charges

UNS Gas also proposed revisions to various fees in its Statement of Additional Charges. The Company claims that the proposed changes reflect rising costs associated with the provision of the services. The proposed changes are summarized below.

	Current	Proposed
Service Transfer	$15.00	$20.00
Collection Fee	$20.00	$20.00
Customer Req. Meter Re-Reads	$15.00	$20.00
Mult. Attempts to Connect	$15.00	$20.00
Service Estab. & Reestablishment During Working Hours	$25.00	$35.00
Reestablishment of Service Due to Non-Payment – Working Hours	$45.00	$35.00
Service Estab. & Reestablishment		

Outside Working Hours	$35.00	$50.00
Reestablishment of Service Due to Non-Payment – O/S Working Hours	$55.00	$50.00
Customer Requested Meter Test	$65.00	$90.00
Insufficient Funds	$15.00	$10.00
Interest on Customer Deposits	One-Year Treasury Rate	

(Ex. A-8, at 7.) The Company's proposed changes to its Statement of Additional Charges were not opposed by any party in the proceeding. Staff witness Dr. Fish stated that UNS Gas conducted incremental cost studies for most of the charges, and the proposed rates are in line with the results of those studies. We find the changes to be reasonable and they shall be adopted.

<u>Gas Procurement Practices and Policies</u>

For purposes of evaluating the prudence and reasonableness of UNS Gas's gas procurement practices, Staff retained an outside consultant, Ms. Rita Beale of Energy Ventures Analysis, Inc. (Ex. S-6.) Ms. Beale conducted a prudence review of the Company's practices for the period January 2006 to June 2008, resulting in the following ten recommendations:

(1) UNS Gas should conduct a thorough analysis of excess interstate pipeline capacity that could be optimized through Asset Management Arrangements ("AMA");

(2) If excess pipeline capacity is available, UNS Gas should have TEP seek potential counterparties on UNS Gas's behalf, at least annually, to optimize all of its excess capacity on both the Transwestern and El Paso pipelines, although not at the expense of incurring a net increase in charges and penalties by El Paso;

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

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

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

(6) To increase its hedge documentation, UNS Gas should create a record indicating the months that management decides to deviate

from a ratable purchasing pattern, even if it is as simple as using a checklist denoting "management decided not to hedge;"

(7) The UNS Gas Inc. Price Stabilization Policy should also be amended for any strategy changes effective September 2008, when TEP took over gas procurement;

(8) The UNS Gas Inc. Price Stabilization Policy must be updated at least annually to reflect the current practices and procedures before being approved by the Corporate Risk Management Committee;

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

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

(*Id.* at 4-5.) UNS Gas witness Hutchens testified that the Company accepts all of Staff's gas procurement recommendations, as discussed in the testimony of Ms. Beale and described above. (Ex. A-6, at 8-12; Tr. 48.)

There is no dispute on the issue of prudence during the identified audit period. We therefore agree that the Company's natural gas procurement practices and policies during the audit period of January 2006 through June 2008 are deemed prudent, subject to implementation of and compliance with Staff's recommendations.

Purchased Gas Adjustor

In his direct testimony, Staff witness Robert Gray explained that UNS Gas's PGA mechanism was evaluated in its last rate case, and a number of changes were made to the PGA. The changes included setting the base cost of gas to zero, expanding the bandwidth on the monthly PGA rate, eliminating the bank balance threshold on undercollections, increasing the bank balance threshold on overcollections, and retaining the existing interest rate for the PGA bank balance. (Ex. S-9, at 3, referencing Decision No. 70011, at 77-82.) Mr. Gray testified that Staff is not proposing any further changes to the current PGA mechanism because additional time is needed to evaluate the impact of the changes made in the last case. He stated that Staff did not see any compelling evidence to support changes to UNS Gas's PGA, at this time. (*Id.*)

In its application, UNS Gas proposed only one change to its current PGA mechanism, to increase the interest rate applied to its PGA bank balance.

PGA Bank Interest Rate

In its application, UNS Gas proposed that the interest rate applicable to its PGA bank balance should be based on the three-month London Interbank Offered Rate ("LIBOR"), plus an additional 1.0 percent. (Ex. A-13, at 32-33.) Mr. Grant stated that the interest rate it pays on short-term credit, pursuant to a revolving credit facility shared with UNS Electric, is LIBOR plus 1.0 percent. He indicated that the current interest rate is tied to three-month commercial paper rates, but that rate is inadequate to cover the Company's short-term borrowing needs. (*Id.*) In his rebuttal testimony, Mr. Grant testified that the Company would accept use of the current three-month commercial paper rate, as long as an additional 1.0 percent increment is added to cover its costs under the revolving credit facility. (Ex. A-14, at 35-36.)

In his direct testimony, Staff witness Gray discussed the Commission's rejection of a nearly identical argument in the last case, and recounted the history of how the PGA bank balance interest rate was established. (Ex. S-9, at 4-5.) Mr. Gray testified that interest rates for PGA bank balances were originally set in a generic docket (Decision No. 61225, issued October 30, 1998) and applied uniformly to all Arizona LDCs as a result of the consensus of a working group that included LDCs, Staff, and RUCO. (*Id.*). He indicated that the uniform interest rate established in that generic docket was the monthly three-month commercial *non-financial* paper rate, as set by the Federal Reserve (*Id.*). Mr. Gray stated that the interest rate was later changed in a subsequent generic proceeding (Decision No. 68600, issued March 23, 2006), only because the Federal Reserve was no longer publishing the previously established rate. Therefore, the current generic interest rate for PGA bank balances is the monthly three-month commercial *financial* paper rate published by the Federal Reserve. (*Id.*).

In response to UNS Gas's proposal in this case, Mr. Gray pointed out that the Federal Reserve does not publish a three-month LIBOR rate. He indicated that the rate intended by the Company was apparently based on rates on a British Bankers Association website and in the *Wall Street Journal*, both of which are set on a daily basis. (*Id.* at 5.) Mr. Gray stated that the interest rate employed currently, and in the past arising out of the generic dockets, is not intended to equal the LDC's cost of borrowing. According to Mr. Gray, the Company's cost of borrowing is likely to change over time, and it is therefore unlikely there is a simple way to set an interest rate that specifically tracks UNS Gas's cost of borrowing. He reiterated the concern expressed in the last UNS Gas case that an interest rate that allows full recovery of borrowing costs could cause the Company to become less concerned with reducing the PGA bank balance, and ultimately the overall cost of gas procured for its customers. (*Id.* at 6.) Mr. Gray concluded that the continued use of the three-month commercial financial paper rate for UNS Gas's PGA bank balance is reasonable, and should not be changed absent compelling reasons. (*Id.* at 7.)

Consistent with our findings in the last UNS Gas rate case, we agree with Staff that the Company has not presented a sufficient basis for altering the PGA bank balance interest rate that currently exists. Mr. Gray points out that a similar rate is in effect for Southwest Gas and APS, and we see no reason why UNS Gas should be treated differently from those companies. We also agree with Staff's concern that granting a higher interest rate could provide a disincentive for the Company to reduce bank balances and could cause it to become less focused on taking all possible measures to reduce the cost of gas for its customers. We therefore adopt Staff's recommendation to retain the current interest rate for UNS Gas's PGA bank balances.

Waiver Request

On January 25, 2008, UNS Gas filed a Request for Waiver in Docket No. G-04204A-08-0050 ("Waiver Docket"). In that filing, the Company requested that the Commission issue an order waiving certain requirements imposed in Decision No. 66028 (July 3, 2003). (Ex. A-9.) Decision No. 66028 required UniSource Energy, and subsequently UNS Gas, to, among other things: refrain from using contract personnel for the performance of operation and maintenance functions, such as leak surveys and valve maintenance; and independently inspect all new construction work performed by contractor personnel regarding the installation of new service lines and main extensions. (*Id.* at 22; IBEW-2.)

On February 14, 2008, Staff issued a Response in the Waiver Docket, recommending that the waiver request be approved. (Ex. A-10.) Staff stated that UNS Gas's safety record is excellent, and the Company is well beyond the transitional phase of operations for which the restrictions were intended to cover following UniSource's acquisition of the former Citizens Utilities' assets. Staff concluded that neither safety nor service would be jeopardized if the condition is waived. (*Id.* at 2.)

In his rebuttal testimony, Company witness Hutchens requested that the Commission approve in this case the application submitted in the Waiver Docket, on the same grounds identified in that case. (Ex. A-6, at 15-16.) In its reply brief, UNS Gas requests that if the Commission agrees with Staff's procedural deficiency arguments (see below), the Waiver Docket application should be considered in a timely manner. (UNS Gas Reply Brief, at 24.)

Staff contends that although its position regarding the requested waiver has not changed, it does not believe the waiver should be approved in this rate case because the request is not properly before the Commission. Staff contends that UNS Gas did not seek to consolidate the instant case with the Waiver Docket, and did not seek reconsideration of the requirements established in Decision No. 66028 pursuant to A.R.S. §40-252.

IBEW also opposes approval of the waiver request in this docket. IBEW argues that the Company did not seek approval of the waiver in its rate application and did not request that the two dockets be consolidated. IBEW contends approval of the request in this case "would constitute a serious procedural error." (IBEW Initial Brief, at 3.) IBEW further claims that even if the procedural defects were resolved, approval of the waiver is not in the public interest as evidenced by the exemplary service record attained by having operation and maintenance functions performed by Company personnel. (*Id.*)

We agree with Staff and IBEW that UNS Gas's request to shift consideration of the waiver request into this rate case was untimely and procedurally deficient. We reach no conclusion, at this time, regarding the merits of the Company's waiver request, but observe that the Waiver Docket appears to seek amendment of a prior Commission Order (Decision No. 66028).

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

. . .

FINDINGS OF FACT

1. On November 7, 2008, UNS Gas filed an application with the Commission (Docket No. G-04204A-08-0571) for an increase in its rates throughout the State of Arizona.

2. On December 8, 2008, Staff filed a Letter of Sufficiency indicating that the Company's application met the sufficiency requirements outlined in A.A.C. R14-2-103 and classifying the Company as a Class A utility.

3. On January 7, 2009, a Procedural Order was issued scheduling a hearing to commence August 10, 2009; directing UNS Gas to publish notice of the application and hearing date; and setting various other procedural deadlines.

4. Intervention was granted to RUCO, IBEW, and Cynthia Zwick.

5. With its application, UNS Gas filed its required schedules in support of the application, and the direct testimony of various witnesses.

6. On June 8, 2009, Staff, RUCO, IBEW, and Ms. Zwick filed direct testimony in accordance with the previously established procedural schedule.

7. On July 8, 2009, UNS Gas filed the rebuttal testimony of various witnesses in response to Staff and intervenor testimony.

8. By Procedural Order issued July 9, 2009, public comment meetings were scheduled for Flagstaff on August 3, 2009; for Prescott on August 6, 2009; and for Nogales on August 17, 2009; and the Company was directed to publish notice of the public comment meetings.

9. Surrebuttal testimony was filed on July 29, 2009, by Staff and RUCO.

10. On August 3, 2009, the prehearing procedural conference was conducted to address the order of witnesses and exhibits.

11. On August 5, 2009, UNS Gas filed the rejoinder testimony of several witnesses in response to Staff and intervenor testimony.

12. The evidentiary hearing commenced as scheduled on August 10, 2009, and additional hearing days were held on August, 11, 12, 14, 17, and 18, 2009.

13. Public comment meetings were held, as scheduled, on August 3, 6, and 17, 2009, in Flagstaff, Prescott, and Nogales, respectively.

14. On September 1, 2009, Chairman Mayes filed a letter in the docket requesting a response from UNS Gas with respect to the Company's plans to expedite refunds of over-collected amounts received through the PGA mechanism.[27]

15. On September 1, 2009, Staff filed a Late-Filed Exhibit that included Arizona unemployment statistics for 2005-09; July 2009 foreclosure rates for counties in the Company's service area; UNS Gas disconnections from 2006-09; and information regarding a Kansas energy efficiency program and Arizona Energy Office programs.

16. On September 3, 2009, UNS Gas filed Affidavits of Publication for the public comment meetings, in accordance with the July 9, 2009 Procedural Order.

17. On September 8, 2009, UNS Gas filed a letter regarding the Company's policies for acceptance of payments at local offices and other locations.

18. Initial briefs were filed on September 18, 2009, by UNS Gas, Staff, RUCO, IBEW, and Ms. Zwick. UNS Gas, Staff, and RUCO also filed their Final Schedules on September 18, 2009, setting forth their respective final revenue requirement and rate design positions.

19. Reply Briefs were filed on September 29, 2009, by IBEW; on September 30, 2009, by RUCO; and on October 5, 2009, by UNS Gas and Staff.

20. According to the Company's application, as modified, in the test year ended June 30, 2008, UNS Gas had adjusted operating income of $11,693,461 on an adjusted OCRB of $184,379,086, for a 6.34 percent rate of return. The Company's proposed RCND is $330,365,912, resulting in a rate of return on RCND of 3.54 percent; and its proposed FVRB is $257,372,499, resulting in a test year rate of return of 4.54 percent on FVRB.

21. UNS Gas requests a gross revenue increase of $9,480,875; Staff recommends a revenue increase of $3,395,423, and RUCO recommends a revenue increase of $1,265,000.

22. For purposes of this proceeding, we determine that UNS Gas has an OCRB of $180,080,695, RCND of $326,067,520 and a FVRB of $253,074,108.

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[27] In response, UNS Gas filed on September 22, 2009, an application for approval of a temporary customer credit, or surcredit, of up to $0.08 per therm for the period November 2009 through October 2010. The Company's application was approved, and the $0.08 per therm surcredit was adopted for the 12-month period beginning November 1, 2009, or until the PGA bank balance reaches zero, whichever occurs first. (Decision No. 71316, October 30, 2009.)

23. UNS Gas's test year revenues are determined to be 53,418,509.

24. UNS Gas's test year expenses are determined to be 40,849,910.

25. The Company's cost of common equity is determined to be 9.50 percent; its cost of debt is 6.49 percent; its capital structure is comprised of 49.9 percent equity and 50.1 percent debt; and the Company's overall weighted average cost of capital is determined to be 8.00 percent.

26. Under the facts of this case, it is appropriate to apply an inflation factor of 2.25 percent to UNS Gas's WACC of 8.00 percent, resulting in a fair value rate of return of 5.75 percent.

27. UNS Gas is entitled to a gross revenue increase of $3,245,607.

28. For residential customers under Schedule R10, the basic monthly customer charge should be increased from $8.50 to $10.00, with the non-fuel volumetric charge remaining at the current rate of $0.3270 per therm.

29. For CARES customers (Schedule R12), the current customer charge of $7.00 should remain in place, and the non-fuel volumetric charge shall also be maintained at its current level of $0.3270 per therm, with a discounted rate of $0.1770 for the first 100 therms during the months of November through April.

30. The customer charges for the non-residential classes will be established at the levels recommended by Staff and RUCO, with the applicable non-fuel volumetric charges for the non-residential classes based on an even percentage allocation to each class.

31. The billing determinants proposed by the Company should be employed for setting rates in this proceeding.

32. The Company's natural gas procurement practices and policies during the audit period of January 2006 through June 2008 are deemed prudent, subject to the Company's implementation of, and compliance with, Staff's recommendations.

33. UNS Gas should convene a meeting within 60 days with the parties to this case, and any other interested stakeholders, to address CARES eligibility issues and deposit policies for CARES customers, and should submit its recommendations within 120 days of the effective date of this Decision.

34. UNS Gas's agreement to increase its matching contributions to the Warm Spirits

program to $50,000 annually, from the current level of $25,000 per year, is a reasonable commitment at this time, but the Company should continue to promote the existence of the Warm Spirits program and strive to find additional ways that give customers the ability to make voluntary contributions to the program.

35. UNS Gas's current level of spending on the LIW program is reasonable, but the Company should continue to evaluate the appropriate level of funding for the LIW program, as well as its other programs.

36. The interest rate for the Company's PGA bank balance should remain in place (monthly three-month commercial financial paper rate published by the Federal Reserve), in accordance with Staff's recommendation.

37. UNS Gas should file within 30 days of the effective date of this Decision, with Docket Control as a compliance item in this docket, a statement regarding the current status of payment options available at the Nogales office, the current status of the phone links and computer kiosks in all local offices, and any other relevant information related to customer options for bill payments.

38. UNS Gas's proposed revisions to its Statement of Additional Charges are reasonable and are adopted.

39. UNS Gas's request to consider the Waiver Docket application in this case was untimely and procedurally deficient and will therefore not be adopted in this proceeding, but will instead be addressed in the waiver docket or pursuant to a request for modification of a prior Commission Order pursuant to A.R.S. §40-252.

CONCLUSIONS OF LAW

1. UNS Gas is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§40-250, 40-251, and 40-367.

2. The Commission has jurisdiction over UNS Gas and the subject matter of the above-captioned case.

3. The fair value of UNS Gas's rate base is $253,074,108, and applying a 5.75 percent rate of return on this fair value rate base produces rates and charges that are just and reasonable.

4. The rates, charges, approvals, and conditions of service established herein are just and

reasonable and in the public interest.

ORDER

IT IS THEREFORE ORDERED that UNS Gas, Inc., is hereby authorized and directed to file with the Commission, on or before April 30, 2010, revised schedules of rates and charges consistent with the discussion herein and a proof of revenues showing that, based on the adjusted test year level of sales, the revised rates will produce no more than the authorized increase in gross revenues.

IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective for all service rendered on and after April 1, 2010.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall notify its customers of the revised schedules of rates and charges authorized herein by means of an insert, in a form acceptable to Staff, included in its next regularly scheduled billing.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall convene a meeting within 60 days with the parties to this case, and any other interested stakeholders, to address CARES eligibility issues and deposit policies for CARES customers, and shall file its recommendations with Docket Control as a compliance item in this docket, within 120 days of the effective date of this Decision.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall continue to promote the existence of the Warm Spirits program and strive to find additional ways that give customers the ability to make voluntary contributions to the program.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall continue to evaluate the appropriate level of funding for the LIW program, as well as its other programs.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall file with Docket Control as a compliance item in this docket, within 30 days of the effective date of this Decision, a statement regarding the current status of payment options available at the Nogales office, the current status of the phone links and computer kiosks in all local offices, and any other relevant information related to customer options for bill payments.

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IT IS FURTHER ORDERED that UNS Gas's request to consider the Waiver Docket application in this case was untimely and procedurally deficient and will therefore not be adopted in this proceeding, but will instead be addressed in the Waiver Docket or pursuant to a request for modification of a prior Commission Order pursuant to A.R.S. §40-252.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN		COMMISSIONER
COMMISSIONER	COMMISSIONER	COMMISSIONER

IN WITNESS WHEREOF, I, ERNEST G. JOHNSON, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _______ day of ____________, 2010.

____
ERNEST G. JOHNSON
EXECUTIVE DIRECTOR

DISSENT ___________________________

DISSENT ___________________________

SERVICE LIST FOR: UNS GAS, INC.

DOCKET NO.: G-04204A-08-0571

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