OPEN MEETING AGENDA ITEM

EXCEPTION

ORIGINAL

0000108474

BEFORE THE ARIZONA CORPORATION COMMISSION

**COMMISSIONERS**
KRISTIN K. MAYES - CHAIRMAN
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

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

Arizona Corporation Commission
DOCKETED
MAR 18 2010
DOCKETED BY

# UNS GAS, INC.'S EXCEPTIONS TO THE RECOMMENDED OPINION AND ORDER

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2010 MAR 18 P 3: 44
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March 18, 2010

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UNS Gas, Inc. ("UNS Gas" or the "Company"), through undersigned counsel, respectfully submits its Exceptions to the Recommended Opinion and Order ("ROO") issued in this case on March 9, 2010. The Company respectfully requests that the Arizona Corporation Commission ("Commission") issue its Order approving the ROO as amended by these Exceptions. Proposed amendments for each of UNS Gas' Exceptions are included in Attachment A.

## I. **INTRODUCTION.**

Commission approval of the ROO in this matter would result in rates that are inadequate, unjust and unreasonable, and not in the public interest. Specifically, the Company objects to the ROO's recommendations regarding: (1) Fair Value Rate of Return ("FVROR"); (2) Return on Equity ("ROE"); (3) the customer annualization methodology; (4) the exclusion of post-test year plant investments in rate base; and (5) the disallowance of prudently incurred outside legal expenses.[1] Adopting any one of these contested ROO recommendations would impair the Company's financial position; adopting the ROO in its entirety, however, would significantly erode the financial strength and integrity of UNS Gas.

As described below, these ROO recommendations are unsupported by the record in this case, and are contradictory to and inconsistent with prior Commission decisions, including the Commission's decision in the prior UNS Gas rate case. Adopting UNS Gas' Exceptions on these contested recommendations will result in just and reasonable rates, while avoiding the adoption of unprecedented and unsupported rulings.

### A. **The ROO's FVROR methodology is unprecedented and unconstitutional.**

In this case, UNS Gas determined its FVROR using the methodologies expressly approved by the Commission in Decision Nos. 70441 (July 28, 2008) and 71308 (October 21, 2009). Each methodology produces the same FVROR for UNS Gas. In those decisions, the Commission addressed the issue of FVROR carefully after having received some guidance from the courts. The Company justifiably used the Commission's methodology from those cases in this case. The

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[1] The ROO also modified various other components of the Company's rate request. These adjustments are discussed in detail in UNS Gas' post-hearing briefs, which by this reference are incorporated herein. UNS Gas does not waive any of the positions or requests that it has presented in this case.

ROO, however, has introduced a new FVROR method that has never been used by the Commission and that was not supported by any witness in this case. Moreover, the ROO's method has been expressly rejected by the Commission[2] with good reason: it attempts to apply an inflation factor to a portion of fair value rate base (that is, original cost rate base) that by definition does not reflect any inflation. There is no evidence in the record or other justification to support this significant deviation. Further, the ROO's *de minimus* use of fair value does not comport with the Arizona Constitution. Given the foregoing, the ROO's FVROR method is unacceptable; the Commission should simply apply the methodology the Company utilized in accordance with Decision No. 71308.[3]

**B. The ROO recommends an unreasonably low ROE.**

The ROO recommends an unreasonably low ROE of 9.5%. This is 0.5 to 1.5% lower than the ROEs recently awarded to other energy utilities in Arizona, including Arizona Public Service ("APS") and Southwest Gas ("SWG").[4] In addition to not being supported by UNS Gas' size or risk, 9.5% is not supported by the record in this case. There is nothing in the record to demonstrate that UNS Gas is a less risky investment than any of the other energy utilities in Arizona. Conversely, the record fully supports that UNS Gas is a more risky investment than APS or SWG. In fact, Commission Staff's own exhibit shows that the average ROE for utilities that are similar to, but less risky than, UNS Gas is 10.37%.[5] The adoption of a 9.5% ROE for UNS Gas is unsupported by evidence, unjust and unreasonable.

Since the last test year (December 31, 2005) through the end of the test year in this case (June 30, 2008), UNS Gas has invested approximately $54 million in facilities that are used and useful and that have significantly improved the condition, reliability and safety of the gas system. UNS Gas' operating expenses also have increased since the last test year. Given UNS Gas'

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[2] Decision No. 70441 at 36-37.

[3] Ex. UNSG-14 (Grant Rebuttal) at 28-31.

[4] See Decision No. 71448 (December 30, 2009), where APS was awarded an 11% ROE, and Decision No. 70665 (December 24, 2008), where Southwest Gas was awarded a 10% ROE. Both of these cases were decided during similar, if not worse, economic conditions.

[5] Ex. S-1 (Regulatory Focus).

significant investment since the last rate case and its rising expenses for operations, the ROO falls well short of providing the Company with an opportunity to earn a just and reasonable return. The Company will earn a ROE of only 6 to 7% in the first full year under the new rates if the ROO's revenue requirement is adopted.[6] This return on equity capital is substantially below even the unreasonably low ROE of 9.5% recommended by the ROO. The Commission should calculate UNS Gas' rates in this case, using the appropriate ROE of 11%. Even Commission Staff's ROE of 10% is more realistic than the 9.5% of the ROO.

### C. The ROO's rejection of the Commission's traditional customer annualization methodology is improper.

UNS Gas applied the Commission's traditional methodology for customer annualization in this case. UNS Gas' position is consistent with the methodology adopted by the Commission in UNS Gas' prior rate case (Decision No. 70011 (Nov. 27, 2007)). In that Decision, the Commission found that that it should continue to use the traditional method for UNS Gas, noting that: (1) there was no "valid case for departing from the traditional method"; and (2) the "lack of any significant demonstrated seasonality" at UNS Gas.[7] Neither of those conditions has changed here, yet the ROO recommends deviating from the proper and accepted norm. Such a deviation is inappropriate, unsupported by evidence and should not be adopted. The Commission should use the traditional methodology for customer annualization as proposed by the Company.

### D. The ROO, without justification and contrary to accepted Commission practice, inappropriately rejects the inclusion of post-test year plant investments in rate base.

The test year for this case ended June 30, 2008 – 21 months ago. The Company requests that the Commission allow UNS Gas to include $1,527,588 in non-revenue producing post-test year plant in rate base. This is only 0.8% of UNS Gas' original cost rate base ("OCRB"), and 0.6% of its fair value rate base ("FVRB"). This treatment of post-test year investment is well

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[6] Ex. UNSG-14 (Grant Rebuttal) at 24. The ROO's revenue requirement is slightly lower than Commission Staff's recommended revenue requirement. Therefore, Mr. Grant's testimony on the Commission Staff recommendation is applicable to the ROO's revenue requirement.

[7] Decision No. 70011 (Nov. 27, 2007) at 19.

within accepted Commission practice and meets the ROO's factors for including post-test year plant investments in rate base. There is not a rational basis for excluding the investment.

In disallowing this adjustment, the ROO does not consider or address the effect of the significant regulatory lag in this case and how the Company's proposal is an appropriate means to partially address such a delay. The impact of the ROO's denial of post-test year plant is exacerbated by the passage of time. However, as a result of the schedule of this case, two heating seasons have now passed since UNS Gas' last rate increase. This lag significantly ameliorates the impact of the Company's rate request. Adopting the Company's position is consistent with Commission practice, will provide much needed revenue to off-set the time lag and will help improve UNS Gas' poor financial performance.

**E. The ROO improperly disallows prudently incurred outside legal expenses.**

UNS Gas proposed an outside legal expense based on the three-year historical average methodology used in its prior rate case, Decision No. 70011. The requested expense in this case was lower than the expense allowed in Decision No. 70011, even though UNS Gas will be participating in significant ongoing litigation and future Federal Energy Regulatory Commission ("FERC") matters – including the El Paso Natural Gas rate case and a Transwestern rate case. The ROO acknowledges that UNS Gas' participation in FERC matters is beneficial to ratepayers and that the Commission wants to encourage such participation.[8] However, the ROO then renders that statement moot by proposing to reduce the outside legal expense by excluding the historical legal expenses related to a previous FERC rate case – even though UNS Gas is currently engaged in a similar FERC rate case. Such a reduction is arbitrary, unsupported by the evidence and contrary to the Commission's ruling on outside legal expense in the previous UNS Gas rate case. The Commission should adopt the Company's position in this matter, thereby affirming its prior methodology and its stated position that UNS Gas should participate in FERC cases.

[8] ROO at 27, lines 3-5.

**F. The contested ROO recommendations are inequitable and should be rejected.**

In reaching its result, the ROO basically follows Commission precedent when such precedent results in a reduction of UNS Gas' proposed revenue requirement. However, in several key instances, where the result would support UNS Gas' revenue requirement, the ROO inexplicably deviates from Commission precedent in a manner that is unsubstantiated by the record. In some instances, the ROO treats UNS Gas more poorly than other, more financially healthy energy utilities in Arizona. Those results are inequitable and arbitrary. Utilities and their investors should expect some level of consistency in their regulation. Without such consistency, investment in Arizona utilities will decline or will result in terms less favorable to the utilities, both ultimately increasing utility costs and delaying investment in necessary utility infrastructure.

There are other immediate practical impacts from the ROO's recommendations. UNS Gas recently achieved an investment grade credit rating of Baa3. This rating, the lowest investment grade rating assigned by Moody's, will benefit the Company and customers in the future through better credit terms and a lower cost of debt.[9] However, maintaining this rating requires a financially healthy utility. And maintaining UNS Gas' credit rating is critical because UNS Gas has $50 million in notes maturing in August 2011.[10] UNS Gas' revolving credit facility matures at the same time. Adopting the ROO will jeopardize its already weak credit rating. A lower credit rating means ratepayers will ultimately bear the burden of higher interest rates. Quite simply, adopting the ROO as written will result in unjust and unreasonable rates and will deprive the Company of its Constitutional right to the opportunity to earn a just and reasonable return.

UNS Gas is not seeking special treatment in this case. It is seeking equitable and consistent treatment. It is seeking results based upon the evidence in the record. UNS Gas respectfully requests that the Commission amend the ROO in accordance with these Exceptions and issue a final order in this case that will allow the Company to recover its prudently incurred costs and provide it with an opportunity to earn a reasonable return on its prudent investment.

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[9] Ex. UNSG-13 (Grant Direct) at 6-8, 27-28.

[10] Ex. UNSG-19 (Moody's Report); Tr. (Grant) at 231.

UNS Gas needs adequate rate relief in order to continue to provide safe and reliable gas service to its current and future customers.

### G. Conclusion.

For the forgoing reasons, UNS Gas requests that the Commission amend the ROO to reflect the Company's proposals, as set forth herein. In order to assist the Commission and the parties in this case in the evaluation of the Company's exceptions, the following chart delineates the impact on the Company's revenue requirement and the effect on an average residential ratepayer's monthly bill:

| The Company's Exceptions to the ROO | Increase to the ROO's Revenue Requirement | Increase to an Average Monthly Bill |
|---|---|---|
| FVROR | $4,638,777 | $2.18 |
| ROE | $3,112,496 | $1.47 |
| Customer Annualization | $516,003 | $0.26 |
| Post Test Year Plant | $238,831 | $0.13 |
| Outside Legal Expenses | $217,674 | $0.12 |

## II. THE ROO'S FVROR IS INCONSISTENT WITH EVERY PREVIOUS COMMISSION DECISION ON FVROR, WITH THE ARIZONA CONSTITUTION, AND WITH THE RECORD IN THIS CASE.

### A. Overview.

In this case, UNS Gas calculated the FVROR based on recent Commission precedent – Decision Nos. 70441 and 71308. In those decisions, the Commission, with guidance from the courts, addressed the issue of FVROR carefully and thoroughly. The Company justifiable used the Commission's methodology in those cases in this matter.

Despite Commission precedent, the ROO has proposed a FVROR based on a methodology that the Commission has never adopted and that is inconsistent with prior Commission decisions. The ROOs primary justification for the substantial deviation from precedent is absent from the record. The ROO states that its approach is necessary because "reconstruction cost estimates likely exceed the rate of inflation based on the factors above."[11] However, there is no evidence in the record to support that statement or the "factors." In fact, the factors in the Chaparral City decisions led the Commission to apply only half of the rate of inflation to the cost of capital. For example, in Decision No. 71308, the Commission stated that "[b]ecause one half of the FVRB includes OCRB, which does not include inflation, Commission Staff adjusted the 2.4% inflation rate factor by one-half, resulting in an inflation adjustment to the WACC of 1.2%."[12] The Commission went on to explain that the methodology it was adopting – the methodology used by UNS Gas in this case – "is a reasoned and sound approach to determining a FVROR that equitably balances the needs of the Company and it ratepayers, and results in the setting of just and reasonable rates."[13]

The methodology proposed by the ROO would apply the entire inflation rate to the FVRB, not just the Reconstruction Costs Net Depreciation ("RCND") portion of the FVRB. Thus, the ROO applies the inflation factor to Original Cost Rate Base ("OCRB"), which includes no inflation by definition. The Resident Utility Consumer Office ("RUCO") had proposed this approach in the Chaparral City Remand docket (reducing the overall weighted average cost of capital by the entire inflation rate), but the Commission expressly rejected RUCO's position – and modified the methodology to apply the inflation rate only to the cost of equity.[14] The ROO's rejection of Commission precedent significantly impacts the Company's FVROR and related revenue requirement, as shown by the table below. The following table shows what the FVROR would be under Decision No. 70441, under Decision No. 71308 and under the ROO:

[11] ROO at 50, lines 23-24.
[12] Decision No. 71308 at 43.
[13] Decision No. 71308 at 49.
[14] Decision No. 70441 at 36-37.

Calculation of FVROR Using Method Adopted in Decision No. 70441

| | Cost | Inflation Adjustment | Adjusted Cost | % of Capital Structure | FVROR |
|---|---|---|---|---|---|
| Common Equity | 9.50% | -2.25% | 7.25% | 49.99% | 3.62% |
| Long-Term Debt | 6.49% | | 6.49% | 50.01% | 3.25% |
| Total | | | | 100.00% | 6.87% |

Calculation of FVROR Using Method Adopted in Decision No. 71308

| | Cost | Inflation Adjustment | Adjusted Cost | % of Capital Structure | FVROR |
|---|---|---|---|---|---|
| Common Equity | 9.50% | -1.125% | 8.375% | 49.99% | 4.19% |
| Long-Term Debt | 6.49% | -1.125% | 5.365% | 50.01% | 2.68% |
| Total | | | | 100.00% | 6.87% |

Which is the same as:

| | |
|---|---|
| Weighted Average Cost of Capital | 8.00% |
| (Less) Inflation Adjustment | 1.125% |
| Fair Value Rate of Return | 6.87% |

Calculation of FVROR Using Method Recommended in the ROO

| | Cost | Inflation Adjustment | Adjusted Cost | % of Capital Structure | FVROR |
|---|---|---|---|---|---|
| Common Equity | 9.50% | -2.25% | 7.25% | 49.99% | 3.63% |
| Long-Term Debt | 6.49% | -2.25% | 4.24% | 50.01% | 2.12% |
| Total | | | | 100.00% | 5.75% |

Which is the same as:

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

### B. The Arizona Constitution requires the Commission to use fair value in calculating rates.

The requirement to use fair value in calculating rates comes directly from the Arizona Constitution. The Commission has established methodologies for calculating fair value in Decision Nos. 70441 and 71308. In this case, rather than relying on the expert testimony in the record, or on prior Commission decisions, the ROO proposes a new method for setting rates that is unsupported by the record or Commission precedent. This deviation from precedent must be rejected because it does not use fair value, as required by the Arizona Constitution. Indeed, the ROO's purported "use" of fair value is simply negligible, providing a return of only 0.2% (or $146,000) on a $73 million fair value increment of rate base (i.e. the difference between fair value rate base and original cost rate base identified in the ROO). Under the ROO, fair value has only a *de minimus* impact on the Company's rates, with an end result that is nearly the same as that derived from the "backing-in" method based solely on original cost rate base – a method that all parties acknowledged is illegal.

The Arizona Constitution states that "[t]he Commission shall, **to aid it in the proper discharge of its duties**, ascertain the fair value of the property in the state of every public service corporation doing business therein."[15] The framers of Arizona's Constitution placed great importance on ratemaking[16] and made it a separate Article of the Constitution. They could not have intended that the fair value finding would be an empty gesture.

Because fair value must "aid in the proper discharge of [the Commission's] duties," fair value cannot be ignored, and it must have a material impact on rates. In other words, the Commission must use fair value. As the Arizona Court of Appeals held, "the Commission must first determine the "fair value" of a utility's property and **use** this fair value as the utility's rate

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[15] Arizona Const. Article XV Section 14 (emphasis added).

[16] *See Ariz. Corp. Comm'n v. State ex rel. Woods,* 171 Ariz. 286, 290-91; 830 P.2d 807, 811-12 (1992); John D. Leshy, *The Making of the Arizona Constitution*, 20 Ariz. St. L.J. 1, 88-91 (1988).

base."[17] Or as the Arizona Supreme Court stated, the "reasonableness and justness of the rates must be related to this finding of fair value."[18]

Since the Court of Appeals decision in *Chaparral City Water*, the Commission has carefully followed this constitutional requirement. In the Chaparral City Remand Order, the Commission found that "[a]s interpreted by Arizona courts, the Arizona Constitution requires that when setting rates, the Commission must find the fair value of a public service corporation's property and **use** that value to set just and reasonable rates."[19] Thus, in a number of recent orders, the Commission has used fair value by ensuring that fair value has a meaningful impact on rates through a variety of methods. Unfortunately, the ROO rejects all of these past methods, and makes no meaningful use of fair value. Instead the ROO adopts a method that gives no substantive effect to fair value, treating it as an empty formality to be honored in name only. That is not what Arizona's Constitution, and the courts, require.

### C. The ROO uses a fair value method unsupported by the evidence or prior Commission decisions.

The FVROR method proposed in the ROO is a substantial deviation from Commission accepted FVROR methods; the Commission has never used it and it is not supported by evidence in this case. Selection of this untried method is especially odd because it was recently considered and rejected by the Commission in Decision No. 70441. The ROO's method was not supported by any parties' expert witnesses, thus the Company did not have an opportunity to rebut the ROO's method by submitting testimony or cross-examination regarding the overstatement of inflation described above. This lack of fair process is another reason why the Commission should reject the ROO's untried and unsupported recommendation regarding FVROR.

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[17] *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (App. 1978)(emphasis added).
[18] *Simms v. Round Valley*, 80 Ariz. 145, 151, 294 P.d 378, 382 (1956).
[19] Decision No. 70441 (July 28, 2008) at 20 (emphasis added).

### D. The ROO's method is logically flawed because it applies an inflation adjustment to part of the rate base that does not include inflation.

The ROO makes a serious conceptual error by applying 100% of the inflation rate to the entire fair value rate base. The only component of the fair value rate base impacted by inflation is the RCND. RCND is only half of the fair value rate base calculation; applying inflation to the entire fair value rate base is improper because it double counts inflation.

It is a basic concept of ratemaking that inflation applies only to the RCND rate base, as recognized by the Commission in its 2009 rate order for Chaparral City Water Company:

> The Company provided no study or other evidence that controverts the existence of an inflation component in RCND rate base. We note that the Company used the Handy-Whitman Index and the Consumer Price Index to trend its OCRB to a RCND value. Both of these indices are measures of inflation. Clearly, the RCND value proposed by the Company includes inflation, and that inflation component carries into the FVRB.[20]

Because the OCRB does not contain inflation, it is incorrect to apply inflation to the portion of the fair value rate base derived from the OCRB. The two Chaparral City orders avoided the ROO's mistake. In those cases, the Commission did apply an inflation adjustment to the entire fair value rate base – but only partially. In the most recent case, the Commission only applied 50% of the inflation rate – matching the percentage of RCND in fair value rate base.

### E. Fair value conclusion and recommendation.

The ROO's unsupported fair value method should be rejected because it has no basis in the record, is inconsistent with recent Commission decisions on fair value, and because it penalizes the Company by double counting inflation. The Commission can correct these errors by adopting UNS Gas' position on fair value.

Adopting the Commission's FVROR methodology as set forth in Decision No. 71308 would result in a $2.8 million increase in required operating income and a $4.6 million increase in the Company's revenue requirement over the ROO's proposal; this represents an additional 2.8% increase over test year revenues and would result in an additional increase of approximately $2.18

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[20] Decision No. 71308 (October 21, 2009) at 41.

for the average residential customer's monthly bill.[21]

## III. THE RECORD DOES NOT SUPPORT UNS GAS EARNING A LOWER RETURN, ESPECIALLY WHEN COMPARED TO OTHER ARIZONA ENERGY UTILITIES.

UNS Gas proposed a ROE of 11.0%. Commission Staff recommended a cost of equity of 10.0%. The ROO adopts a ROE of 9.5%, noting that the rate "provides some minimal recognition of the devastating effects of the current economic conditions on UNS Gas' customers." However, the 9.5% is **substantially** lower than the ROEs that the Commission has recently approved for other energy utilities under the same or worse economic conditions. In particular, APS was awarded 11.0% in 2009 (Decision No. 71448 (December 30, 2009)) and SWG was awarded 10.0% in 2008 (Decision No. 70665 (December 24, 2008). Commission Staff's own exhibit shows that similar gas companies have recently been granted an average ROE of 10.37%.[22] Further, Commission Staff's witness, Mr. Parcell, reports that comparable gas utilities earn between 11 and 12%.[23] This proves that the ROO's 9.5% recommended ROE is unreasonable.

The record shows that UNS Gas is not less risky than APS, SWG, or any other comparable gas utility that was awarded a higher cost of equity. To the contrary, UNS Gas is more risky than these utilities. Moreover, the rationale of using poor economic conditions as an adjustment to ROE is counterintuitive and sets a dangerous precedent in light of the cyclical nature of the economy. For example, when the economy improves utilities will logically be entitled to a higher cost of equity. Using current economic conditions to set artificially low rates only means that greater compensation must come later; the Commission would then risk setting artificially high rates. And contrary to the ROO's contention, current economic conditions have resulted in tighter capital markets offering much less favorable terms.[24] This also supports UNS Gas' position for a higher ROE.

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[21] Applying the fair value methodology in Decision No. 70441 would have the same result.

[22] Ex. S-1 (Regulatory Focus).

[23] Ex. S-14 (Parcell Direct) at Schedule 10, Page 1, Average and Median ROEs for Grant Comparable Company Group.

[24] Ex. UNSG-14 (Grant Rebuttal) at 6-7.

The ROO suggests that UNS Gas has not demonstrated that its risk is significantly greater compared to other comparable companies. This is an error because the evidence in the record clearly demonstrates that UNS Gas is a risky utility. Moreover, there is no evidence in the record that UNS Gas' risk is *less* than the comparable companies. In fact, Commission Staff's witness, Mr. Parcell, acknowledged a myriad of factors indicating UNS Gas is more risky than the sample group. He acknowledged that UNS Gas is smaller than any of the companies in either of his sample groups.[25] Additionally, Mr. Parcell acknowledged that only two of the 17 sample group companies he used have a credit rating as low as UNS Gas.[26] A lower credit rating, of course, indicates higher risk.[27] Further, UNS Gas has not earned its authorized ROE. As Company witness Mr. Grant noted, both *Value Line* and Mr. Parcell's own comparable earnings analysis show that the comparable gas utilities are earning actual returns of 11 to 12%.[28] Lastly, Mr. Parcell stated that the comparable group companies pay dividends, while UNS Gas has never paid a dividend.[29] In all of these ways, UNS Gas is riskier and less attractive to investors than the companies in the sample groups, and it should therefore be granted a higher ROE.

Although UNS Gas' credit rating and equity ratio have increased, its ROE should not be decreased. While UNS Gas has made improvement, it remains far riskier than comparable utilities. And, UNS Gas' improvement would not have occurred without strong backing from UNS Gas' management and board, who improved the capital structure by reinvesting $16 million of additional equity capital into UNS Gas.[30] These improvements will help the Company to save money on its borrowing costs which are ultimately passed on to UNS Gas' customers. If the ROO's recommended cost of equity is adopted, it will effectively penalize UNS Gas' for the prudent and disciplined actions taken by the Company.

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[25] Tr. (Parcell) at 860; *see* Decision No. 57944 (July 6, 1992) at 16 (agreeing with Commission Staff's recommendation to increase ROE for sewer division over average of sample group due to small size risk).
[26] Tr. (Parcell) at 861.
[27] Ex. UNSG-13 (Grant Direct) at 25.
[28] Tr. (Grant) at 223.
[29] Tr. (Parcell) at 862.
[30] Ex. UNSG-13 (Grant Direct) at 4.

The ROO uses the low end, specifically 9.5%, of Commission Staff's proposed Cost of Equity. By way of contrast, if the ROO had adopted the top range of Commission Staff's proposed Cost of Equity, specifically 10.5%, it would result in a $2.1 million increase in revenue requirement over the ROO's proposal, which is an additional 1.3% increase over test year revenues and which would result in an additional increase of approximately $1.00 for the average residential customer's monthly bill.

The Commission should amend the ROO to adopt the Company's 11.0% cost of equity as it is just and reasonable and supported by the record in this case. Adopting the Company's proposed Cost of Equity of 11.0% would result in a $3.1 million increase in revenue requirement over the ROO's proposal, which is an additional 1.9% increase over test year revenues and which would result in an additional increase of approximately $1.47 for the average residential customer's monthly bill.

## IV. THE COMMISSION SHOULD REJECT THE ROO'S INEQUITABLE DEPARTURE FROM THE TRADITIONAL CUSTOMER ANNUALIZATION METHODOLOGY.

The ROO deviates from the Commission's traditional method for customer annualization. This deviation from prior Commission decisions, results in a lower revenue requirement for UNS Gas.

UNS Gas applied the traditional methodology for customer annualization in this case.[31] The record fully supports UNS Gas' position that the traditional method of annualization should be used by the Commission in this case. Further, UNS Gas' position is consistent with the traditional methodology adopted by the Commission in UNS Gas' prior rate case (Decision No. 70011). In that case, Commission Staff's witness Mr. Ralph Smith (RUCO's witness in this case) testified that the "traditional method of customer annualization has been effective in appropriately coordinating the revenue element of the ratemaking formula with the other components, such as

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

rate base."[32] Likewise, RUCO's witness in the prior case stated that UNS Gas does not experience "extreme seasonality" and that there is no "reason to depart from the 'traditional' or Commission-accepted methodology of revenue annualization."[33] The Commission agreed that it should use the traditional method for UNS Gas, noting that there is no "valid case for departing from the traditional method" and that there was a "lack of any significant demonstrated seasonality" at UNS Gas.[34]

The ROO rejects the traditional customer annualization methodology because it believes it produces a "counterintuitive" result that assumes negative growth.[35] But in Decision No. 70011, the Commission was fully aware of the possibility of a counterintuitive result under the traditional method.[36] In fact, given economic conditions in much of UNS Gas' service area, slightly negative customer growth is wholly possible and is borne out using the traditional methodology. Picking and choosing among methodologies to reduce revenue requirement is inequitable and arbitrary.

The Commission should amend the ROO to adopt the traditional method of customer annualization because there is no sound basis for departing from the traditional methodology, particularly given the Commission's express findings in the prior UNS Gas rate order.

Adopting the traditional customer annualization would result in a $516,003 increase in revenue requirement over the ROO's proposal, which is an additional 0.3% increase over test year revenues and which would result in an additional increase of approximately $0.26 for the average residential customer's monthly bill.

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[32] Ex. UNSG-21 (Erdwurm Rebuttal) at 3, quoting Surrebuttal Testimony of Ralph C. Smith, Docket No. G-04204A-06-0463, at 21, lines 16-18.

[33] Ex. UNSG-21 (Erdwurm Rebuttal) at 3, quoting Surrebuttal Testimony of Marylee Diaz-Cortez, Docket No. G-04204A-06-0463, at 12, lines 20-23.

[34] Decision No. 70011 (Nov. 27, 2007) at 19.

[35] ROO at 18-19.

[36] Decision No. 70011 at 18.

## V. RATE BASE SHOULD BE MODESTLY ADJUSTED THROUGH POST TEST YEAR PLANT TO REFLECT THE SIGNIFICANT REGULATORY LAG IN THIS CASE.

### A. UNS Gas requests a limited amount of post-test year plant be included in rate base.

The test year for this case ended in June 30, 2008 – 21 months ago. UNS Gas requests that the Commission allow $1,527,588 of non-revenue producing post-test year plant be included in rate base. This is only 0.8% of UNS Gas' original cost rate base, and 0.6% of its fair value rate base. While the amount is modest in comparison to UNS Gas' rate base, it will provide needed revenue to off-set regulatory lag and improve UNS Gas' poor financial performance.

Based on guidance in the prior UNS Gas rate order, UNS Gas strictly limited its request for post-test year plant. It included only non-revenue producing plant.[37] It did this by identifying plant that was intended to serve existing customers – plant it would have invested in even without growth.[38] Commission Staff's witness, Dr. Fish, testified that "I have no reason to say that it isn't nonrevenue producing."[39] In addition, no party disputed the prudence of this plant.[40] UNS Gas also limited the post-test year plant to plant that was in-service by June 30, 2009 – nine months ago.[41] The cut-off date was one year after the end of the test year. In contrast, the Commission recently granted APS post-test year plant for 18 months after then end of its test year.[42]

Despite this limited request, the ROO applied an unduly stringent test in this case that is inconsistent with many other Commission decisions by declining to include the post-test year plant in rate base, thereby exacerbating the harmful effect of regulatory lag.

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[37] Ex. UNSG-42 (Response to RUCO 1.88); Tr. (Dukes) at 908, 916-918.
[38] Ex. UNSG-17 (Dukes Rebuttal) at 5.
[39] Tr. (Fish) at 628.
[40] Ex. UNSG-24 (Commission Staff Response to UNSG 3.9); Ex. UNSG-41 (RUCO Response to UNSG 3.2).
[41] Ex. UNSG-42 (Response to RUCO 1.88).
[42] Decision No. 71448 (December 30, 2009), attached Settlement Agreement at 12, Section 3.4; *but see* Dissenting Opinion of Commissioner Pierce at 1.

**B. Prior Commission decisions support including post-test year plant.**

The ROO appears to endorse a highly stringent test for post-test year plant, possibly requiring the existence of an "extraordinary situation" and imposing an extremely tough matching requirement.[43] That approach runs counter to numerous Commission decisions. For example, in 2002, the Commission stated that "We do not agree with Commission Staff and RUCO that the Commission has always required extraordinary circumstances to allow post test year plant."[44] In another order, the Commission summarized its past cases as follows: "In the past, the Commission has allowed the inclusion of post test year plant in circumstances where the new plant is **revenue neutral** and there is no evidence of a **material mismatch** between revenue and expenses and where the post test year plant is required for system reliability or to provide adequate service."[45] Thus a slight or theoretical mismatch is not enough; the mismatch must be material. The ROO does not include a finding of a material mismatch, and no party offered testimony that there was a material mismatch – only unquantified speculative or theoretical mismatches. Thus, there is no material mismatch. Commission Staff and RUCO conceded that UNS Gas' post-test year plant will improve system reliability and improve service to existing customers.[46]

UNS Gas' post-test year plant fits squarely within the parameters established by prior Commission decisions. For example, in Decision No. 65350 (November 1, 2002), Bella Vista Water Company requested inclusion of numerous system improvement projects into rate base as post-test year plant. In that case, Commission Staff and RUCO argued that the plant should be excluded, because the plant "may improve system reliability resulting in lower expenses and increased revenues."[47] The Commission rejected Commission Staff and RUCO's argument, noting that while plant constructed to serve existing customers could have some impact on revenues or expenses, the evidence did not show a **material impact** on revenues and expenses.[48]

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[43] ROO at 6-8; "extraordinary situation" at 6, line 17.
[44] Decision No. 65350 (Nov. 1, 2002) at 11.
[45] Decision No. 67279 (Oct. 5, 2004) at 6 (emphasis added).
[46] Tr. (Fish) at 591-593; Tr. (R. Smith) at 882.
[47] Decision No. 65350 (Nov. 1, 2002) at 9.
[48] Decision No. 65350 (Nov. 1, 2002) at 10 (emphasis added).

Along similar lines, in Decision No. 68176 (September 30, 2004) the Commission explained that "inclusion of post test year plant **always causes some mismatch** between revenues and expenses, even if the post test year plant is revenue neutral."[49] The Commission nevertheless included the post test year plant in rate base. The Commission emphasized materiality again in Decision No. 67279 (October 5, 2004) noting that "there would not be a material impact on revenue or expenses."[50]

### C. The ROO's distinction between water utilities and gas and electric utilities is without merit.

The ROO points out that "UNS Gas has not identified any prior Commission decisions that allowed post-year plant for gas or electric companies."[51] But prior to the ROO being issued, the Commission approved the APS settlement agreement, which included 18 months of post-test year plant.[52] Thus, there is precedent for including post-test year plant for gas and electric companies.

Moreover, there is no principled reason for limiting post-test year plant to water utilities. Water, gas and electric utilities all operate under the same ratemaking methods at the ACC. Both water and gas utility systems are comprised of buried pipes. The ROO identifies no relevant difference between water utilities and gas utilities.

### D. UNS Gas satisfies the factors proposed by the ROO.

As described above, UNS Gas' post-test year plant satisfies the standards described in prior Commission decisions. The ROO creates its own list of "factors" to consider, without specifying a source or authority supporting these factors. More remarkably, the ROO does not contain an analysis of whether UNS Gas meets these factors, but instead simply concludes "[f]or these reasons, we decline" to approve post-test year plant.[53] In fact, these factors support including post-test year plant:

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[49] Decision No. 68176 (Sept. 30, 2004) at 5 (emphasis added).
[50] Decision No. 67279 (Oct. 5, 2004) at 7.
[51] ROO at 7, lines 25-26.
[52] Decision No. 71448 (December 30, 2009), attached Settlement Agreement at 12, Section 3.4; *but see* Dissenting Opinion of Commissioner Pierce at 1.
[53] ROO at 8, lines 13-22.

**Factor One:** "the amount of test year plant relative to overall capitalization."[54] As described above, the post-test year plant is less than 1% of rate base; thus approving it will have a relatively small impact on rates.

**Factor Two:** "the impact on the company's financial health and ability to provide service."[55] UNS Gas has never earned the rate of return authorized in its last rate order, and it has never paid a dividend.[56] UNS Gas' financial performance falls significantly behind other gas utilities.[57] While approving post-test year plant will not be a cure-all, it will provide a modest step towards addressing these issues.

**Factor Three:** "the presence of capacity or safety issues that required expedited plant investment for compliance purposes."[58] Commission Staff and RUCO agreed that the post-test year plant will improve system reliability and improve service to existing customers.[59]

**Factor Four:** "whether there is sufficient certainty regarding the revenue neutrality of the post-test year plant, including whether the additional plant is non-revenue producing and non-expense reducing."[60] As noted above, this factor is more stringent than prior Commission orders, which looked to whether the plant was revenue-neutral and whether there was a material mismatch with expenses. But even if this more stringent standard is adopted, UNS Gas meets this criteria. While Commission Staff speculated that there may be some impact on expenses, they provided no data to support their speculation.[61] Commission Staff's speculation centered on the possibility that replacement plant to serve existing customers may have lower operating and maintenance costs. But Commission Staff's witness conceded that operating and maintenance costs are ongoing.[62] For example, he agreed that UNS Gas would still have to perform the same leak surveys if it

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[54] ROO at 8, lines 15-16

[55] ROO at 8, line 16.

[56] Tr. (Parcell) at 862-63; Ex. UNSG-13 (Grant Direct) at 5; Ex. UNSG-14 (Grant Rebuttal) at 23.

[57] Ex. S-14 (Parcell Direct) at Schedule 10, Page 1, Average and Median ROES for Giant Comparable Company Group.

[58] ROO at 8, lines 16-17.

[59] Tr. (Fish) at 591-593; Tr. (R. Smith) at 882.

[60] ROO at 8, lines 18-20.

[61] Ex. UNSG-24 (Commission Staff Response to UNSG 3.7.g).

[62] Tr. (Fish) at 591.

replaces a section of main.[63] Perhaps Commission Staff's speculation would have some merit if UNS Gas had allowed its system to deteriorate to a dilapidated state, resulting in a measurable difference in expenses. But UNS Gas has not done so; Commission Staff's safety expert complimented the good state of UNS Gas' system.[64]

Thus, whether using the Commission's traditional standard of post-test year plant (revenue-neutral and no material mismatch) or the ROO's new four factors, the Commission should approve the inclusion of UNS Gas' post-test year plant in rate base as requested in this case.

### E. The Commission should consider the considerable regulatory lag that has occurred.

In disallowing this adjustment, the ROO does not even consider the effect of the significant regulatory lag in this case and how the Company's proposal is an equitable means to partially address such a delay. UNS Gas understands the difficult circumstances facing the Commission. However, as a result of the schedule of this case, two heating seasons have now passed since UNS Gas' last rate increase. This regulatory lag significantly ameliorates the impact of the Company's rate request. Adopting the Company's position is consistent with Commission practice, will provide much needed revenue to off-set regulatory lag and will help improve UNS Gas' poor financial performance.

Adopting the Company's proposal to include post-test year plant in rate base would result in a $238,831 increase in revenue requirement over the ROO's proposal, which is an additional 0.2% increase over test year revenues and which would result in an additional increase of approximately $0.13 for the average residential customer's monthly bill.

[63] Id.
[64] Tr. (Hanson) at 543-544.

## VI. THE ROO IGNORES COMMISSION PRECEDENT AND THE RECORD AS IT DOES NOT PROVIDE FOR ADEQUATE RECOVERY OF OUTSIDE LEGAL EXPENSES.

UNS Gas is entitled to recover its prudently incurred outside legal expenses, particularly when those expenses can result in cost savings that are passed on directly to customers. In the prior UNS Gas rate case, the Commission allowed outside legal expenses that included the costs of participating in FERC rate proceedings. In this case, UNS Gas proposed an outside legal expense adjustment of $305,984, based on a three-year historical average of legal costs.[65] This approach was based on a similar three-year historical average methodology used in its prior rate case, Decision No. 70011. The requested expense is lower than the expense allowed in Decision No. 70011, even though UNS Gas will still be participating in significant ongoing litigation and FERC matters – including an El Paso Natural Gas rate case and a Transwestern rate case. There is no real dispute of the benefits of UNS Gas' participation in such matters or the benefits that its customers derive from keeping gas transportation rates as low as possible.[66] Indeed, the ROO acknowledges that the Company will continue to incur legal expenses related to FERC cases and that "it is in the best interest of UNS Gas' customers for the Company to monitor and participate as necessary in those proceedings."[67]

Although the ROO states that legal expenses "should be set at a level that reflects more accurately its actual experience, both historical and anticipated,"[68] the ROO then adopts a reduced legal expense ($171,865 – which is $217,674 less than UNS Gas' requested adjusted expense) based on a RUCO recommendation that admittedly *excluded* legal expenses from previous years that were related to an El Paso Natural Gas rate case at FERC that had finally settled.[69] That reduction both ignores historical *and* anticipated experience.

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[65] Ex. UNSG-16 (Dukes Direct) at 25. The Company's test year legal expense totaled approximately $84,000 ($394,000 of actual legal expenses less a $310,000 write off of legal expenses that were disallowed in the prior UNS Gas rate case). Id. at 24.

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

[67] ROO at 28, lines 4-5.

[68] ROO at 26, lines 27-28.

[69] ROO at 26, lines 20-21.

During the hearing, none of the parties challenged the actual amount of UNS Gas' historic legal expenses. Moreover, there was no basis in the record to reduce historic legal expenses, particularly given the Company's current and anticipated participation in FERC cases. It was undisputed that UNS Gas faces a current El Paso Natural Gas rate case, as well as an upcoming Transwestern rate case.[70] Pipeline rate cases at FERC are a recurring fact of life for gas utilities. The Commission should encourage UNS Gas' participation in those cases by granting recovery of outside legal costs because it will result in lower gas costs for its customers. The ROO's position discourages participation by arbitrarily reducing the Company's legitimate outside legal expenses. Therefore, the Commission should adopt the Company's proposed outside legal expense.

Adopting the Company's proposed outside legal expense would result in a $217,674 increase in revenue requirement over the ROO's proposal, which is an additional 0.1% increase over test year revenues and which would result in an additional increase of approximately $0.12 for the average residential customer's monthly bill.

## VII. CONCLUSION.

Adopting UNS Gas' Exceptions to the ROO's contested recommendations will result in rates that are just and reasonable and in the public interest. Further, it will prevent the Commission from having to adopt recommendations that are unsupported by the record, and contradictory to prior Commission decisions, including the decision in the prior UNS Gas rate case. Adopting the Company's Exceptions will also afford UNS Gas a reasonable opportunity to recover its costs of providing utility service and earn a reasonable return on its investment devoted to public service. Finally, it will treat UNS Gas in an equitable manner that is consistent with Commission precedent, applicable legal standards, and the Arizona Constitution.

Proposed language for the amendments relating to each specific argument are included in Attachment A as follows:

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

| **Amendment** | **Issue** |
|---|---|
| 1. | FVROR |
| 2. | Return on Equity |
| 3. | Post Test Year Plant |
| 4. | Customer Annualization |
| 5. | Outside Legal Expense |

RESPECTFULLY SUBMITTED this 18th day of March 2010.

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# ATTACHMENT

# "A"

# UNS Gas Proposed Amendment No. 1

## <u>ACC Chaparral City Method</u>

**DELETE:**

Page 49, line 22 to Page 50, line 24.

**INSERT:**

At Page 49, line 22:

"Based on the record of this case, we find it appropriate to continue to use the FVROR method we developed for Chaparral City Water Company in Decision No. 70441, as further refined in Decision No. 71308. These decisions represent our most comprehensive analysis of FVROR to date, and it is reasonable to continue to use this approach at this time.

This method reasonably accounts for the impact of inflation on the fair value rate base, without overstating its impact. The RCND rate base includes inflation; the OCRB rate base does not. Thus, applying 50% of the inflation adjustment is appropriate because RCND represents only one-half of the fair value rate base calculation. Therefore, consistent with Decision No. 71308, we will deduct 50% of the inflation adjustment to calculate the FVROR."

**DELETE:**

The sentence beginning on Page 51, line 11 (starting at "which we believe") and ending on Page 52, line 2.

**INSERT:**

At Page 51, line 11:

"..., which we then divide in half to determine the inflation factor that should be applied to the WACC in order to remove from it the effects of inflation. Deducting this inflation factor of 1.125 percent from the WACC of 8.0 percent results in a FVROR of 6.87 percent."

**DELETE** Page 51, lines 12-20.

**DELETE** 2.25% on Page 51, line 23 and **INSERT** 1.125%.

**DELETE** 5.75% on Page 51, line 34 and **INSERT** 6.87%.

**MAKE ALL CONFORMING CHANGES**

# UNS Gas Proposed Amendment No. 2

## Return on Equity – 11%

**DELETE**

From Page 42, line 11 to Page 43, line 8.

**INSERT**

At Page 42, line 11:

"RUCO's estimate is far below any energy return on equity we have approved in recent times. Moreover, RUCO's CAPM analysis appears to be based on skewed data from the peak of the 2008 financial crisis. In addition, RUCO's single-stage DCF is less accurate than the multi-stage DCF method that we have used for some time. As we have noted in the past, it is not reasonable to believe that investors expect a constant rate of growth in perpetuity, as assumed in the single-stage DCF.

Staff's range of 9.5% to 10.5% overlaps with UNS Gas's range of 10.2% to 11.2%. We find that it is reasonable to believe that the return on equity of the sample companies is within the overlapping portion of these ranges. However, we do not believe that UNS Gas's return on equity is identical to that of the sample group. UNS Gas is smaller than the sample group companies and it has a lower credit rating than all but two of the 17 sample companies. UNS Gas has never been able to declare a dividend, while Mr. Parcell testified that the comparable group companies pay dividends. (Tr. at 862). Both Mr. Grant and Mr. Parcell observed that comparable gas utilities earn actual returns of 11 to 12%, while UNS Gas's actual returns have consistently fallen short of the 10% return on equity from its last rate case. These factors justify UNS Gas having a higher return on equity than the sample group.

We also note that we recently awarded APS an 11% return on equity. (Decision No. 71448 (December 30, 2009)).

Accordingly, we find UNS Gas's return on equity to be 11%, which results in an overall weighted cost of capital of 8.74%.

| | Percentage | Cost | Weighted Avg. Cost |
|---|---|---|---|
| Common Equity | 49.9% | 11% | 5.49% |
| Total Debt | 50.1% | 6.49% | 3.25% |
| | | | 8.74%" |

**MAKE ALL CONFORMING CHANGES**

# UNS Gas Proposed Amendment No. 3

## Customer Annualization

**DELETE**

Page 18, from line 8 to line 12.

**DELETE**

On Page 18, line 18, the word "However,".

**DELETE**

From Page 18, line 19 to Page 19, line 4.

**INSERT**

At Page 18, line 19:

"In Decision No. 70011, we did not find "any significant demonstrated seasonality" that would justify a departure from the well-established traditional method. No party presented evidence that the UNS Gas's customer seasonality changed from the last rate case. Accordingly, we will continue to use the traditional method and approve UNS Gas's request and reduce test year revenues by $516,003."

**MAKE ALL CONFORMING CHANGES**

## UNS Gas Proposed Amendment No. 4

## <u>Post-Test Year Plant</u>

**DELETE**

From Page 7, line 22 to Page 8, line 22.

**INSERT**

At Page 7, line 22:

"As we have explained in the past, we do not require "extraordinary circumstances" to approve post-test year plant. (Decision No. 65350 (Nov. 1, 2002) at 11). We will not approve post-test year plant in every case, but if the utility demonstrates that the post-test year plant is non-revenue producing and that there will be no material mismatch, inclusion is appropriate. (See Decision No. 67279 (Oct. 5, 2004) at 6, summarizing prior decisions).

We do not agree with Staff and RUCO that the theoretical possibility of new plant having lower expenses is sufficient to demonstrate a material mismatch. Staff and RUCO made the same argument in the Bella Vista case, arguing that post-test year plant "may improve system reliability resulting in lower expenses and increased revenues." (Decision No. 65350 (Nov. 1, 2002) at 9-10). We rejected that argument, explaining that while post-test year plant constructed to serve existing customers could have some impact on revenues or expenses, the evidence did not show a material impact on revenues and expenses. (Id.) Or as we explained in another order, the "inclusion of post test year plant always causes some mismatch between revenues and expenses, even if the post test year plant is revenue neutral." (Decision No. 68176 (Sept. 30, 2004) at 5). Nevertheless, we approved the post-test year plant, because the mismatch was not material. (Id.).

In Decision No. 70011, we rejected UNS Gas's request for post-test year plant because, among other things, UNS Gas had not limited its request to non-revenue producing plant. Here, UNS Gas demonstrated that the post-test year plant was non-revenue producing because it was constructed to serve existing customers. No party has provided data showing that maintenance or operating expenses will decrease. Indeed, Staff's witness testified that many of the maintenance activities will be the same, such as leak surveys. (Tr. 591). Thus, we do not find a material mismatch in this case.

We note that we recently approved 18 months of post-test year plant for APS. (Decision No. 71448 (December 30, 2009)). Here, UNS Gas limited its request to 12 months of post-test year plant. The post-test year plant to plant was all in-service by June 30, 2009. Under the circumstances of this case, we will approve UNS Gas's request to include $1,527,588 in rate base; this amount represents a *de minimus* portion of the Company's FVRB."

**MAKE ALL CONFORMING CHANGES**

# UNS Gas Proposed Amendment No. 5

## Outside Legal Expense

**DELETE**

The sentence beginning on Page 26, line 28 (starting with "Staff and RUCO") and ending on Page 27, line 2.

**DELETE**

The sentence beginning on Page 27, line 5 (starting with "We believe") and ending on Page 27, line 7.

**INSERT**

At Page 25, line 5:

"Naturally, outside legal expense will fluctuate – it will be low when no rate case is pending, and high during peak periods of rate cases. We agree with UNS Gas that this variable expense should be normalized. We used a three-year average to normalize outside legal expenses in the last UNS Gas rate case, and we see no reason to depart from this practice in this case. Therefore, we agree with UNS Gas and approve an adjustment of $305,984 to test year outside legal expenses, to reflect the three year average."

**MAKE ALL CONFORMING CHANGES**