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BEFORE THE ARIZONA CORPORATION COMMISSION

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

INITIAL POST-HEARING BRIEF

OF UNS ELECTRIC, INC.

Arizona Corporation Commission
DOCKETED
MAR 23 2010
DOCKETED BY

March 23, 2010

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UNS Electric, Inc. ("UNS Electric" or "Company"), through undersigned counsel, respectfully submits its Initial Post-Hearing Brief[1] in this matter. As set forth herein, the evidence presented in this case fully justifies the Company's requested rate relief. Many aspects of UNS Electric's request in this case were undisputed[2] because in many instances, the Company simply applied the Arizona Corporation Commission's ("Commission") analyses and conclusions from the most recent UNS Electric rate case order (Decision No. 70360 (May 27, 2008)). For several of the issues that remain in dispute, UNS Electric adhered to Commission precedent, but Commission Staff or RUCO have deviated therefrom and now advocate a new approach. All of UNS Electric's positions are supported by the record in this case. Adopting UNS Electric's positions in this case will result in just and reasonable rates. In support of the Company's requested rate relief, UNS Electric states as follows:

I. INTRODUCTION.

On April 30, 2009, UNS Electric filed its Application for the establishment of just and reasonable rates and charges. UNS Electric is requesting Commission approval of: (1) a base rate increase of $13.5 million; (2) rate base treatment of the Black Mountain Generating Station ("BMGS"), which has been in service since May 30, 2008; (3) an authorized Return on Equity ("ROE") of 11.4%; (4) approval of UNS Electric's rate design to allow the Company to recover more of its fixed costs through a modestly higher monthly customer charge while offering new and enhanced time-of-use ("TOU") options for customers; (5) a rate design that will hold eligible low-income customers harmless from the proposed rate increase; (6) minor revisions to its Rules and Regulations; and (7) modifications to its Purchased Power and Fuel Adjustment Clause ("PPFAC"). The evidence in the record of this case fully supports UNS Electric's request.

[1] UNS Electric reserves the right to address, in its Reply Post-Hearing Brief, any argument or evidence raised by any other Party in their respective briefs that are not addressed here.

[2] Attached as Appendix A is the final Joint Matrix docketed January 29, 2010. The Joint Matrix identifies the issues that are contested or uncontested.

A. UNS Electric's rates are unjust and unreasonable because they do not allow the Company to recover its actual operating expenses and its substantial capital investment.

The evidence in the record demonstrates that the costs UNS Electric incurs in providing electric service in a safe and reliable manner have increased well beyond the amount the Company receives in rates. This is because UNS Electric has experienced significant increases in expenses since 2005 and 2006, which is the level that current rates are based on. For example, UNS Electric has experienced the following cost increases: labor has increased 3% to 4%; transformers have increased 5 to 10%; primary and secondary cable has increased 2 to 5%; wood and steel poles have increased 8 to 10%; and pole line hardware, connectors and rubber goods have increased 2 to 5%.[3]

Between June 30, 2006 (the end of the test year used in Decision No. 70360) and December 31, 2008, UNS Electric invested approximately $86 million in capital improvements. It is undisputed that the Company prudently invested that capital to improve the system it took over from Citizens Utilities Company and to meet the demands of the rapid growth that had occurred prior to the economic downturn. The evidence is clear that those improvements to UNS Electric's system are used and useful and providing benefits to customers. Notably, UNS Electric met its significant infrastructure demands through prudent management including reinvesting **all** of its income back into its system.

UNS Electric is entitled to a just and reasonable return on those investments as well as recovery of the costs necessary to operate a safe and reliable system. However, UNS Electric's current rates do not allow the Company to recover its prudently incurred costs nor the opportunity to earn a reasonable rate of return. Therefore, UNS Electric's current rates are unjust and unreasonable and detrimental to the financial health of the Company. All of the parties in this matter agree that UNS Electric deserves a rate increase, the evidence in the record justifies the Company's full request for a rate increase of $13,500,000, or approximately 7.5% above test year revenues.

[3] Ex. UNSE-8 (McKenna Direct) at 3.

B. BMGS should be placed into rate-base because it provides proven and significant operational and financial benefits to the Company and its ratepayers, and can be acquired in a rate neutral transaction.

BMGS has been in commercial operation since May 30, 2008.[4] All parties agree on the substantial operational and financial benefits that having BMGS in rate base will provide, both to the Company and its customers. RUCO agrees with the Company's proposal to rate base BMGS and understands the necessity of rate reclassification approval in order for the Company to buy the facility. On this issue, Commission Staff is the sole dissenter; its objection is merely that UNS Electric did not own BMGS during the test year. Commission Staff's position is unreasonable because it is based on a procedural timing technicality, and does not outweigh the overwhelming amount of evidence in this case recognizing that it is in the public interest to place BMGS into rate base.

In this case and in the prior UNS Electric rate case, the Company offered to purchase BMGS in a way that would result in a revenue neutral rate reclassification. Customers will see no net change in their electric bills attributable to the acquisition on rate-basing of BMGS. UNS Electric's acquisition of BMGS, tied to its inclusion in rate base, is in the public interest because it will not increase customers' bills, and allows the Company to own needed generation.

C. The Company's positions on operating expenses should be adopted as they follow Commission precedent.

For several of the contested issues, UNS Electric applied the Commission's analyses and conclusions from the prior UNS Electric rate case, Decision No. 70360. Despite Commission precedence, Commission Staff and RUCO have suddenly deviated from Decision No. 70360 without justification. Several of those deviations significantly reduce the Company's requested revenue requirement, in particular Commission Staff's unprecedented Income Tax calculation and Commission Staff's proposals on Fleet Fuel, Call Center, Bad Debt and Outside Legal Expenses.

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[4] Ex. UNSE-8 (McKenna Direct) at 13.

Based on the record in this case, the Commission should continue its prior treatment of these ratemaking components as proposed UNS Electric.

D. UNS Electric's risk profile justifies the Company's requested increase in its ROE.

The Commission, in Decision No. 70360, authorized a ROE of 10.0% for UNS Electric. Although the Company was authorized to earn 10.0%, UNSE only realized a return of 4.6% for the test-year ending December 31, 2008.[5] For the year ending September 30, 2009 (reflecting a full year under the new rates approved in Decision No. 70360), UNS Electric's earned ROE was only 6.9%.[6] This is unreasonable because it is 310 basis points below UNS Electric's authorized ROE and below the Company's cost of debt. Even if the Commission grants UNS Electric's requested rate increase of $13.5 million by June 1, 2010, the Company will only have the opportunity to earn a ROE of 9.5% for 2010.

Commission Staff and RUCO recommend ROEs of 10.0% and 9.25% respectively. These recommendations are inadequate, inequitable, unsupported by the record and substantially below the Company's recommendation of 11.4%. Commission Staff's and RUCO's recommended ROEs are unjust, especially when UNS Electric's risk profile is compared to other similar utilities. Further, Commission Staff and RUCO's recommendations are significantly below the 11.0% ROE that was recently authorized for Arizona Public Service Company ("APS").[7] It is contrary to the facts and illogical to argue that UNS Electric is less risky than APS and that the Company's investors would accept a ROE of 100 to 175 basis points lower than that of APS.

Given the Company's significant investments since the last rate case and its rising expenses for operations, the ROE recommendations of Commission Staff and RUCO fall well short of providing the Company with an opportunity to earn a just and reasonable return. The Company estimates it will earn an ROE of only 7.9% in the first full year under new rates if Commission Staff's revenue requirement is adopted – and only 6.0% if RUCO's revenue

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[5] Ex. UNSE-12 (Grant Direct) at 17.
[6] Ex. UNSE-13 (Grant Rebuttal) at 22.
[7] See Decision No. 71448 (December 30, 2009) at 8-9.

requirement is adopted.[8] UNS Electric's unchallenged projections are based on a rigorous analysis performed by experienced and qualified financial professionals. Neither RUCO nor Commission Staff disputes those numbers, nor did they examine whether the Company will have an opportunity to earn its rate of return under their respective revenue requirements recommendations. The evidence shows that Commission Staff's and RUCO's recommendations would deny UNS Electric any real opportunity to earn its ROE and therefore, would produce rates that are unjust and unreasonable and should be rejected in favor of the Company's recommended ROE of 11.4%.

E. The Company's Fair Value Rate of Return ("FVROR") methodologies should be adopted as they mirror the methodologies and analysis of the Commission in its most recent rate cases.

In this case, UNS Electric initially requested a FVROR that utilized the methodologies expressly approved by the Commission in Decision No. 70441 (July 28, 2008). The Company also analyzed what was necessary to give it an opportunity to earn its requested ROE, which resulted in a FVROR of 6.88%. However, should Commission Staff's or RUCO's adjustments be adopted, the FVROR should be based on either of the methodologies in Decision Nos. 70441 and 71308 (October 21, 2009). In those decisions, the Commission addressed the issue of fair value carefully after having received some guidance from the courts. The Company justifiably used the Commission's methodology from those cases in this case. The Company's request amounts to the bare minimum necessary to ensure financial health.

Commission Staff and RUCO recommend entirely different methods than the ones approved in Decision Nos. 70441 and 71308, yet neither can provide sufficient justification for doing so. Notably, Commission Staff's recommendations here are inconsistent with its prior position in the Chaparral City 2009 rate case.[9] Moreover, RUCO's proposed method has been expressly rejected by the Commission[10] 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

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[8] Ex. UNSE-13 (Grant Rebuttal) at 22, 25-26.
[9] See Decision No. 71308 at 39.
[10] Decision No. 70441 at 36-37.

any inflation. The use of Commission Staff's and RUCO's alternative proposals would result in a revenue requirement too low to support UNS Electric's financial integrity.[11] More importantly, the methods proposed by Commission Staff and RUCO give too little weight to fair value, which is unconstitutional. The Commission can prevent these errors by adopting UNS Electric's position on fair value.

F. The Company's rate design proposals are in the public interest.

The Company proposes a modest increase to the residential monthly customer charge - balancing the Company's need for revenue stability with gradualism, affordability and all other important rate design factors. Further, UNS Electric offers to enhance its TOU options through: (1) increasing the price differentials between on-peak, off-peak and shoulder peak energy charges; and (2) adding a summer "super-peak" options where one peak hour would be price significantly higher than the remaining hours of the day. Both options will provide increased opportunity for customers to save money by shifting usage from peak times. The Company also proposes that all of its Customer Assistance Residential Energy Support ("CARES") program customers be held harmless from the proposed rate.

G. Conclusion.

The Company's requested rate relief is critical in magnitude and timing in order for UNS Electric to maintain its financial integrity. This is because UNS Electric, regardless of growth, needs to upgrade and maintain its system which requires raising capital. It must also be able to procure fuel and purchased power on reasonable terms. In 2008, the Company was assigned the lowest level investment grade rating of Baa3 assigned by Moody's. Maintaining an investment grade and the potential benefits is an utmost priority, and it requires a financially healthy utility. The Company can neither maintain its tenuous financial integrity nor provide safe and reliable service without an investment grade rating. The Company's requested revenue requirement is reasonable, fully supported by the record, results in just and reasonable rates and should be approved by the Commission. UNS Electric believes that it will be able to maintain an investment

[11] Ex. UNSE-13 (Grant Rebuttal) at 12.

grade rating if its rate request is granted. Moreover, these proposals are timely because virtually all customers will see a net decrease in their overall bills – from April 30, 2009 (when the Company filed this request) to June 1, 2010 when the Company has requested the proposed rates should take effect.[12]

II. BLACK MOUNTAIN GENERATING STATION.

BMGS presents a unique and important opportunity for UNS Electric to diversify its power supply portfolio. Currently, UNS Electric receives power from BMGS through a five-year purchase power agreement ("PPA") with UniSource Energy Development ("UED"). UNS Electric is almost entirely reliant on PPAs and the wholesale energy market to meet its customers' demands for electricity. Ownership of BMGS would help diversify UNS Electric's resource mix by reducing its reliance on PPAs, while also providing substantial operational and financial benefits to the Company and its ratepayers. In order to acquire BMGS, however, the Company must have rate base treatment for the facility. Therefore, the Company proposes a rate reclassification that will allow UNS Electric to finance acquisition of BMGS with no net change in the price paid by customers for electric service on the date of the reclassification.[13]

In UNS Electric's last rate case, Commission Staff and RUCO opposed the Company's proposed reclassification and inclusion of BMGS in rate base. Both Parties opposed it because BMGS was not in commercial operation at the time, thus exact costs were not known and measurable. The Commission agreed with Commission Staff and RUCO, and rejected the Company's proposal in Decision No. 70360. The Commission did allow UNS Electric to implement an accounting order deferring the costs associated with BMGS, and approved the Company's financing request (up to $40 million of debt and up to $40 million of equity).[14] As is explained in more detail below, without the accompanying rate base treatment, it would have been

[12] Ex. UNSE-32 (Residential Bill Impacts).
[13] Ex. UNSE-12 (Grant Direct) at 3.
[14] See Decision No. 70360 at 76-78.

financially imprudent for UNS Electric to absorb the cost of the facility, even with an accounting order.

In this case, UNS Electric renews its proposal from its last rate case since many, if not all, of the concerns cited by Commission Staff and RUCO no longer exist. For example, the cost of BMGS is known and measurable and it is in commercial operation. Due to these changed circumstances, RUCO now supports the Company's proposal – recognizing the benefits BMGS will provide to ratepayers and realizing UNS Electric needs the proposed rate treatment in order to prudently finance the acquisition. On this issue, Commission Staff is the sole dissenter; their objection is merely that UNS Electric did not own BMGS during the test year. Commission Staff's position is unreasonable because it is based on a technicality, and is contrary to the overwhelming amount of evidence in this case that demonstrates that BMGS should be placed into ratebase as it is in the public interest. For the reasons stated in the record, placing BMGS in ratebase as proposed by the Company in the public interest and the Commission should approve the Company's proposal.

A. The rate base treatment for BMGS is in the public interest as it is a revenue neutral reclassification of rates.

UNS Electric proposes a post-test year adjustment to rate base of $62 million and a corresponding reclassification of rates. That amount reflects the original cost for BMGS net of depreciation as of December 31, 2008.[15] In order to fund the proposed purchase, UNS Electric would need to raise additional debt and equity capital under the financing authority approved in Decision No. 70360.[16] To raise that capital, UNS Electric's proposed rate reclassification is necessary.

The rate reclassification UNS Electric proposes would increase the Company's non-fuel base rates by approximately 0.7 cents per kWh.[17] Mr. D. Bentley Erdwurm illustrates the

[15] Ex. UNSE-12 (Grant Direct) at 8.
[16] Ex. UNSE-12 (Grant Direct) at 3.
[17] Ex. UNSE-12 (Grant Direct) at 11-12; Ex. UNSE-18 (Erdwurm Direct) at 28 (the 0.7 cents is rounded up from approximately 6.7 mills).

mechanics behind the rate reclassification in his Direct Testimony. Using the Company's revenue requirement proposal (including weighted average cost of capital), Mr. Erdwurm illustrates how base power supply charge would decrease to $0.0611 per kWh from $0.0678 per kWh once BMGS is rate-based, but the non-fuel charge would increase from $0.0384 per kWh to $0.0451 per kWh. The average retail rate, however, remains at $0.1062 per kWh.[18] Therefore, customers would see no net change in their electric service bills on the date of the rate reclassification.[19]

Exhibit UNSE-26 shows that for the average residential summer bill, the base power supply charge decreases by $6.55 while the non-fuel base rates increases by $6.55.[20] It may appear that because it is revenue neutral reclassification that it would not help the Company finance BMGS. This is not the case. The cash that would leave the Company in the form of payments to UED will cease because the BMGS PPA with UED will be cancelled, thereby saving the Company money.[21] In other words, money that would have been paid to UED for energy produced by BMGS will now remain with UNS Electric. Consequently, the Company will immediately begin to realize an increase to its earnings and cash flow.[22] This increase in earnings and cash flow will allow UNS Electric to raise the additional capital needed to purchase BMGS.

Without the proposed rate reclassification, UNS Electric simply cannot finance BMGS. UNS Electric has a total capitalization of only $192 million as of December 31, 2008.[23] Financing $62 million of additional capital (equivalent to a 32% increase to the Company's test-year capitalization) will result in a substantial decline of UNS Electric's operating cash flow and key credit metrics – which would be too expensive for both the Company and its customers.[24] Commission Staff states UNS Electric could simply use the accounting order approved in Decision No. 70360. However, Commission Staff's proposal is flawed as it does not address the very

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[18] Ex. UNSE-18 (Erdwurm Direct) at 27-28.
[19] Ex. UNSE-12 (Grant Direct) at 3.
[20] See also Hearing Transcript ("Tr.") (Erdwurm) at 268-270.
[21] Ex. UNSE-14 (Grant Rejoinder) at 2.
[22] Ex. UNSE-12 (Grant Direct) at 12 and Ex. KCG-2.
[23] Ex. UNSE-12 (Grant Direct) at 9.
[24] Ex. UNSE-12 (Grant Direct) at 10-11.

important cash flow issue; indeed, it does not provide any cash rate relief.[25] In short, the Company must have BMGS included in rate base along with the proposed rate reclassification to be able to finance the acquisition.

Finally, if the Company's proposal to rate base BMGS is accepted in full, the Company will pursue Federal Energy Regulatory Commission ("FERC") approval to purchase BMGS from UED. Upon completion of the purchase, UNS Electric would promptly notify Commission Staff regarding the transfer of ownership and reclassification of rate – which could take place within 15 days of the purchase date.[26] In short, the requested rate base treatment and rate reclassification will not occur until *after* UNS Electric acquires BMGS. Therefore, there is no risk to ratepayers.

1. Operational benefits.

The Company has set forth numerous operational benefits of owning BMGS. No party has refuted these benefits, which include having:

- full operational flexibility, with the capability to meet required reserves and ancillary services and allow for full, unlimited and economic dispatch in any market, which will optimize the Company's portfolio;
- full control over maintenance and operations of the plant to ensure high standards of reliability and safety;
- owned generation that allows UNS Electric to meet the exact peaking capacity and reserve needs for its supply portfolio, including renewable resources; and
- generation at a location where transmission costs can be minimized, reducing overall delivery costs, providing necessary must-run energy and allowing for connection to dual pipeline systems for fuel redundancy.[27]

BMGS uses LM 6000 turbines; these are quick start units that allow for compliance with several reliability criteria, especially within the load area. Specifically, LM 6000 turbines within the load area reduce the likelihood of transmission interruptions and restoring and/or supplying

[25] Ex. UNSE-12 (Grant Direct) at 10-11.
[26] Ex. UNSE-12 (Grant Direct) at 12.
[27] Ex. UNSE-8 (McKenna Direct) at 17-18.

load during transmission contingencies – as well as potentially providing alternatives to transmission expansion.[28] Moreover, BMGS' location within the Mohave County load pocket increases its ability to address intermittency issues, which can enhance the development renewable resources in that area.[29] There are few, if any, market alternatives to BMGS where reliable reserves could be purchased.[30] Finally, Commission Staff's engineering witness, W. Michael Lewis, agreed that BMGS would provide operational benefits to UNS Electric if it was in the Company's control and ownership.[31] In short, both UNS Electric and its customers will secure a long-term source of necessary and economical peaking capacity.

2. Financial benefits.

Ownership of BMGS will provide substantial financial benefits to UNS Electric's customers, especially when compared to the long-term costs of acquiring similar capacity in the wholesale market. Similarly, the cumulative effects of depreciation expense and deferred income taxes on rate base will reduce the Company's revenue requirement for owned generation capacity. This provides additional long-term cost advantages over a purchase power contract or lease agreement,[32] especially since the Company's non-fuel revenue requirement is projected to decrease from approximately $11 million to approximately $9 million per year over the first 10 years – and to $7 million by 2025.[33] By contrast, relying on the wholesale market or PPAs does not provide any of these benefits. Moreover, PPAs often contain margin or collateral posting requirements that can affect utility's credit needs and financial profile – requiring a cash deposit or letter of credit; and minimum monthly demand charges often included result in ratings agencies imputing a debt obligation that has further adverse impact.[34] In short, purchased power and long-term lease agreements have specific financial and credit accounting implications that adversely impact UNS Electric's credit profile if relied upon too heavily. Acquiring BMGS preserves a sufficient supply-

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[28] Ex. UNSE-8 (McKenna Direct) at 19.
[29] Ex. UNSE-8 (McKenna Direct) at 19.
[30] Ex. UNSE-8 (McKenna Direct) at 20.
[31] Tr. (Lewis) at 424.
[32] Ex. UNSE-12 (Grant Direct) at 5-6.
[33] Ex. UNSE-12 (Grant Direct) at 5, Ex. KCG-1.
[34] Ex. UNSE-12 (Grant Direct) at 6-7.

side-resource portfolio of owned generation and PPAs.[35]

Further, if the purchase is financed at a cost comparable to the Company's overall cost of capital, net income at UNS Electric is expected to increase by $3 million per year (net of additional interest expense) – and net operating cash flow is expected to increase by $6 million per year.[36] These increases in earnings and cash flow will improve UNS Electric's creditworthiness, which will consequently facilitate the funding of capital expenditures and procurement of energy resources needed to meet future customer demand. In short, BMGS offers financial benefits to the Company (in addition to operational benefits) that will also benefit customers.

B. RUCO supports the Company's proposal to acquire BMGS.

RUCO's witness, Dr. Ben Johnson, supports the Company's BMGS proposal for several reasons: (1) acquiring BMGS will improve UNS Electric's resource mix; (2) the two LM6000 combustion turbines were purchased at reasonable cost; (3) given its limited financial strength and small size, the Company's request is reasonable and avoids a potentially serious problem with regulatory lag (particularly given that the cost of BMGS is substantial relative to UNS Electric's total capitalization); and (4) adding BMGS to UNS Electric's rate base will not harm and could improve the Company's credit metrics – including increasing funds from operations.[37] Further, the issues and concerns regarding cost and operations no longer exist.[38] Finally, Dr. Johnson agrees that the cost for BMGS is reasonable and that UNS Electric "was not overpaying for this plant".[39] As a result, RUCO supports the proposed rate base treatment for BMGS.

C. Commission Staff's opposition to the Company's proposal is unfounded.

Commission Staff remains the lone Party opposing the Company's proposal to rate base BMGS and rate reclassification. Commission Staff witness, Dr. Thomas H. Fish, appears to advocate two arguments against the Company's proposal: (1) he suggests that all the facts about the purchase of BMGS are not known; and (2) the Company had adequate support to acquire

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[35] Ex. UNSE-12 (Grant Direct) at 6.
[36] Ex. UNSE-12 (Grant Direct) at 4.
[37] See Ex. RUCO-6 (Johnson Direct) at 18-21.
[38] Tr. (Johnson) at 590.
[39] Tr. (Johnson) at 597-98.

BMGS and should purchased BMGS during or before the test year before seeking rate base.[40] Commission Staff witness, David C. Parcell, implies that the Company could finance BMGS through its shared revolving credit facility or simply "the transfer of the assets and liabilities within the UniSource framework to UNS Electric."[41] The evidence in the record contradicts both Dr. Fish's and Mr. Parcell's testimony. First, all the material facts about BMGS are known. Second, both Dr. Fish and Mr. Parcell do not address the adverse impacts of UNS Electric acquiring BMGS absent the Company's requested treatment.

1. All of the material facts about BMGS are known.

BMGS will cost UNS Electric approximately $62 million (its original cost net depreciation).[42] BMGS is a facility that has been in commercial operation since May 30, 2008.[43] The two LM6000 turbines that are part of BMGS are 2003 vintage units that were unused prior to being placed in to service at BMGS. By acquiring these units, UED paid 50% less than they would have had the same turbines been purchased from the manufacturer (General Electric).[44] As Mr. McKenna stated "these are very, very durable engines."[45] These facts are undisputed.

W. Michael Lewis, who is an engineer and Commission Staff' technical and operational expert, testified that BMGS was well-constructed.[46] Mr. Lewis confirmed that, from his perspective, the plant would be used and useful if included in rate base.[47] However, Dr. Fish, Commission Staff's rates expert, noted that one of turbines was not operational at the time of the hearing.[48] During the hearing Mr. McKenna testified that the turbine was being repaired and was due back at BMGS in mid-February, and that the other turbine was operating properly.[49] The turbine at BMGS was placed back into service in Mid-February and is fully operational. The

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[40] Ex. S-11 (Fish Surrebuttal) at 2; Tr. (Fish) at 482-484.
[41] Ex. S-14 (Parcell Direct) at 20.
[42] Ex. UNSE-12 (Grant Direct) at 8.
[43] Ex. UNSE-8 (McKenna Direct) at 13-14; Tr. (McKenna) at 103-04.
[44] Ex. UNSE-8 (McKenna Direct) at 14.
[45] Tr. (McKenna) at 105.
[46] Ex. S-7 (Lewis Direct) at 26; Tr. (Lewis) at 423.
[47] Tr. (Lewis) at 418.
[48] Ex. S-9 (Fish Direct – Public Version) at 54
[49] Tr. (McKenna) at 102.

turbine has had no other issues. Since BMGS is under warranty, there was no cost to UNS Electric (or UED for that matter) for the repair.[50]

While Dr. Fish implies that all the facts regarding the purchase may not be known, the cost to acquire is known (it is $62 million as explained previously). Further, Dr. Fish admits that several other facts are known about BMGS, including that: (1) BMGS would give UNS Electric a resource mix it does not have;[51] (2) the acquisition of BMGS could improve the Company's financial metrics;[52] (3) the Company's exposure to the open market would be reduced;[53] (4) the proposed rate base adjustment would only occur after the actual acquisition occurs;[54] and (5) the additional cash flow available to the Company (with the rate base treatment and rate reclassification) would cover the cost of financing the acquisition.[55] In fact, Dr. Fish does not deny the many operational and financial benefits that UNS Electric and its customers would receive if BMGS was put in rate base. In conclusion, all the material facts (the costs and benefits of BMGS) are known and are part of the evidentiary record in this case.

2. Acquiring BMGS absent rate base treatment would be impractical and imprudent for UNS Electric.

Absent the proposed rate base treatment, UNS Electric could not acquire BMGS without significantly adversely affecting its financial integrity. The Company appreciates the Commission's approval of its requested financing authority (to issue up to $40 million of debt and $40 million equity) in its last rate order. Unfortunately, neither this authority nor the accounting order approving deferral of costs provides the necessary cash flow to finance the BMGS and maintain its investment-grade rating.

Given the size of UNS Electric (having a total capitalization of about $192 million as of December 31, 2008), acquiring BMGS will result in an approximate 32% increase to the

[50] Ex. UNSE (McKenna Rebuttal) at 5.
[51] Tr. (Fish) at 445-46.
[52] Tr. (Fish) at 446.
[53] Tr. (Fish) at 448.
[54] Tr. (Fish) at 480.
[55] Tr. (Fish) at 481.

Company's test-year capitalization.[56] This is a significant investment for UNS Electric relative to rate base.[57] In contrast, without having BMGS in rates as proposed, the Company would incur almost $5 million of cash expenses without any revenue streams from the facility.[58] Further, under those circumstances, it would be hard for UNS Electric to either maintain an investment grade rating or to avoid considerably higher interest rates.[59] These concerns underlie UNS Electric's well-founded belief that acquiring the plant absent the Company's proposed rate base treatment would be imprudent.

In addition, neither the financing approval nor the accounting order approved in Decision No. 70360 solves the situation of providing the Company with both adequate earnings *and* cash flow to support acquiring BMGS. As Mr. Grant explains, having the *authority* to raise capital is different than having the *capability* to do so.[60] Commission Staff does not provide any explanation as to how the financing authority alone addresses these issues. Also, the accounting order, as explained above, does not give UNS Electric sufficient cash flow (even with its requested rate increase) to service the additional capital required to purchase BMGS.[61] In short, the Company likely cannot secure the necessary capital to finance BMGS absent its request.

Further, unlike UED, UNS Electric would have to wait until the conclusion of a subsequent rate case if it were to first purchase BMGS and then seek rate base treatment in order to begin to recover its investment (as Commission Staff suggests the Company do). On the contrary, UED could start charging the price for capacity from BMGS fairly quickly versus the 18-to-24-month lag it would take for UNS Electric to receive rate relief.[62]

Commission Staff suggests that the Company should have sought an opinion from Moody's as to whether financing BMGS would lead to a downgrade.[63] However, as RUCO's

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[56] Ex. UNSE-12 (Grant Direct) at 9, 11.
[57] Tr. (DeConcini) at 77.
[58] Ex. UNSE-12 (Grant Direct) at Ex. KCG-2; Tr. (Grant) at 233-34.
[59] Tr. (Grant) at 159, 161-62, 237.
[60] Ex. UNSE-13 (Grant Rebuttal) at 5.
[61] See Ex. UNSE-12 (Grant Direct) at 10-11; Ex. UNSE-13 (Grant Rebuttal) at 5.
[62] Tr. (Grant) at 236.
[63] Tr. (Fish) at 494-95.

expert, Dr. Johnson testified, it would not have been prudent for UNS Electric to ask Moody's about whether acquiring BMGS would have resulted in a downgrade – stating "I wouldn't if I were them."[64] And doing so would not change the uncontroverted evidence in this case about the impact to the Company's financial metrics, which makes the transaction unduly burdensome if not impossible.

Finally, neither of Mr. Parcell's suggested "interim" financing options are practical. First, using the revolving credit facility would prevent both UNS Electric and UNS Gas from using that facility for other needs (*e.g.*, seasonal working capital requirements), without any increase in cash flow.[65] Even Mr. Parcell appeared hesitant to endorse this as a viable method of financing BMGS for UNS Electric.[66] Indeed, Mr. Parcell admits he did not address the purpose of UNS Electric's revolving credit facility;[67] therefore, he cannot provide any basis to justify this as a viable means to finance BMGS. Second, a transfer as Mr. Parcell suggests eliminates any fixed cost recovery from BMGS and the earned ROE for UNS Electric would be even less than current levels.[68] Thus, neither option addresses the problems that UNS Electric's request for rate base treatment of BMGS will resolve.

D. UNS Electric's request is in the best interests of both the Company and its customers.

In Decision No. 67744 (April 7, 2005), the Commission approved a settlement agreement and a rate increase for Arizona Public Service Company. That settlement allowed APS to rate base five generation units formerly owned by its affiliate ("Pinnacle West Energy Corporation" or "PWEC"). While the facts and circumstances in that case are distinguishable from this case, that decision shows that the Commission allowed for the rate basing of assets not yet owned by a utility. For different, but equally compelling reasons, UNS Electric is seeking rate base treatment for BMGS. Doing so will help the Company diversify its portfolio and lessen its dependence on

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[64] Tr. (Johnson) at 589.
[65] Ex. UNSE-13 (Grant Rebuttal) at 7.
[66] Tr. (Parcell) at 798-99.
[67] See Ex. UNSE-33 (Staff Response to UNSE 3.57)
[68] Ex. UNSE-13 (Grant Rebuttal) at 7-8.

the wholesale market for power. The benefits are numerous and uncontroverted. The cost is known, measurable and very reasonable when compared to equivalent alternatives. RUCO recognizes the benefit and the Company's need to have rate base treatment (including the rate reclassification) in order to finance the acquisition. Even Commission Staff witnesses recognize the benefits – but they have chosen ignore the imprudence of UNS Electric acquiring BMGS without rate base treatment. Simply put, it would be detrimental to the Company and its customers for UNS Electric to acquire the facility– absent the rate base treatment requested here. For all of the reasons stated above, the Company's proposal to place BMGS in ratebase, including the revenue neutral reclassification, should be approved.

III. RATE BASE.

The one rate base adjustment being contested in this matter is Post-Test Year Non-Revenue Plant Adjustment.

A. Post-Test Year Non-Revenue Plant in Service.

The Company proposes an adjustment to include $7,263,614 of Post-Test Year Non-Revenue Plant in rate base.[69] In Decision No. 70360, the Commission rejected UNS Electric's request for post-test year plant, noting that there was no segregation of revenue-producing plant from non-revenue producing plant. To comport with that ruling, the adjustment proposed by the Company in this case seeks only non-revenue producing post-test-year plant. The Company has identified specific post-test-year plant that is non-revenue producing.[70] It is undisputed that these post-test-year plant additions are already in service or will be in service prior to new rates going into effect.[71] Moreover, no party has claimed that these plant additions are imprudent.[72]

Commission Staff and RUCO oppose UNS Electric's prudent post-test year plant additions because they allege such additions could result in a mismatch between post-test year revenue and costs. Commission Staff and RUCO also argue that any investment in plant would result in

[69] See UNSE's Final Schedules (March 1, 2010) at Schedule B-2, Page 1.
[70] Ex. UNSE-16 (Dukes Rebuttal) at 10-11.
[71] Ex. UNSE-16 (Dukes Rebuttal) at 10.
[72] See Ex. UNSE-27 (Staff Response to UNSE 3.8).

reduced expenses, without providing or citing any empirical evidence to support that assertion.[73] But neither Commission Staff nor RUCO disputed that the post-test year plant in question will improve system reliability and improve service to existing customers. Neither disputed that the investments are necessary to avoid system interruptions and failures.[74] Indeed, these investments would be necessary regardless of customer growth at UNS Electric.

Under Commission Staff's analysis, it appears that non-revenue producing Post Test Year Plant would only be included in rate base when a Company is in serious financial straits, for extraordinary circumstances, or when the amount of post-test-year plant is a large percentage of the Company's total rate base. But there is no requirement that any of those situations be present. For example, in Decision No. 65350 (November 1, 2002), the 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."[75] The Commission rejected Commission Staff and RUCO's argument, noted 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.[76] 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."[77]

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."[78] 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

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[73] See Ex. UNSE-27 (Staff Response to UNSE 3.7.g).
[74] Ex. UNSE-16 (Dukes Rebuttal) at 10.
[75] Decision No. 65350 at 9.
[76] Decision No. 65350 at 10.
[77] Decision No. 65350 at 11.
[78] Decision No. 68176 at 5.

revenue or expenses."[79] In that case, 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."[80] Finally, in Decision No. 66849 (March 19, 2004) the Commission approved post-test-year plant up to 12 months after the end of the test year because it was in service a reasonable time before the hearing so it could be inspected.[81] Commission Staff witness, Dr. Fish, conceded that there is no requirement that post-test-year plant must be either: (1) a certain percentage of rate base; or (2) an extraordinary or unusual project.[82]

RUCO witness, Dr. Johnson, states that the Company's proposed post-test-plant adjustment should not be granted as the Commission should strictly adhere to the historical test year. But Commission rules and regulations allow for pro forma adjustments "to obtain a normal or more realistic relationship between revenues, expenses and rate base."[83] Indeed, RUCO has advocated *for* pro forma adjustments in past cases (*e.g.* property taxes).[84] As discussed in the preceding paragraphs, the Commission has approved including post-test-year plant in rate base in several previous rate cases.

Here, the record confirms that UNS Electric reviewed the projects and indentified those investments that: (1) are replacing distribution system assets to maintain system reliability and service levels; (2) are needed regardless of customer growth; and (3) will be in operation and providing service to the customer when this rate case concludes.[85] If this plant is not included in rate base, then UNS Electric will not begin recovering its investment for over three-and-one-half years after the investments were made; this is significant considering the plant in question serves

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[79] Decision No. 67279 at 7.
[80] Decision No. 67279 at 6.
[81] Decision No. 66849 at 4-5.
[82] See Ex. UNSE-27 (Staff Response to UNSE 3.5 and 3.6).
[83] See A.A.C R14-2-103.A.3.i.
[84] Ex. UNSE-16 (Dukes Rebuttal) at 7.
[85] Ex. UNSE-16 (Dukes Rebuttal) at 10.

existing customers.[86] The record supports UNS Electric's position that there is no material mismatch between revenues and expenses. The evidence and prior Commission orders rebut the position of Commission Staff and RUCO on this issue.

UNS Electric has met the standard for including post-test year plant in rate base and the Commission should allow UNS Electric to recover its investment in this prudent plant needed to serve existing customers.

B. BMGS Working Capital.

UNS Electric proposes an adjustment for BMGS Working Capital equaling ($587,494).[87] RUCO proposes a slightly different adjustment of ($580,420).[88] The slight difference is due to a modification for property tax.[89] Commission Staff does not propose any adjustment for BMGS Working Capital because it is opposed to rate base treatment for BMGS for UNS Electric. Therefore, the Company's position should be accepted.

C. Accumulated Deferred Income Taxes.

UNS Electric, Commission Staff and RUCO all propose some adjustment for accumulated deferred income taxes. The differences in those adjustments are the result of other proposed adjustments.

D. Working Capital (non-BMGS)

UNS Electric, Commission Staff and RUCO all propose some adjustment for working capital. Commission Staff proposes a different adjustment that is the result of other proposed adjustments. RUCO includes the Company's proposed adjustment.[90]

E. Acquisition Discount Adjustment.

UNS Electric proposes an Acquisition Discount Adjustment of $8,355,383.[91] Neither Commission Staff nor RUCO dispute that adjustment,[92] thus the Commission should adopt this adjustment.

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[86] Ex. UNSE-15 (Dukes Direct) at 12.
[87] See UNSE's Final Schedules at BMGS B-2, Page 1.
[88] See RUCO Final Schedules (March 1, 2010) at BJ-2.
[89] See Appendix A.
[90] See Ex. RUCO-6 (Johnson Direct) at 27.

F. Reconstruction Cost New Less Depreciation.

The Company proposes a Reconstruction Cost New Less Depreciation ("RCND") of $418,548,539, including BMGS.[93] Commission Staff proposes an RCND of $347,241,128.[94] RUCO proposes an RCND of $411,422,319.[95] These figures are different based on the respective adjustments each Party has made and whether or not BMGS is included in rate base (both RUCO and the Company include BMGS).

G. Fair Value Rate Base.

UNS Electric, Commission Staff and RUCO agree that fair value rate base ("FVRB") should be calculated by averaging original cost rate base ("OCRB") and RCND. Thus, the Commission should approve this traditional method.

IV. OPERATING REVENUE.

There are no contested items regarding adjustments to operating revenue. The evidence fully supports the Company's following undisputed adjustments: (1) Retail Revenue & Purchased Power Annualization; (2) Wholesale Revenue & Purchased Power; (3) Weather Normalization; (4) Customer Energy & Demand Normalization; (5) Fuel and PPFAC Revenue & Expense Normalization; and (6) Demand Side Management ("DSM") and Renewables Revenue & Expense.[96] Commission Staff originally disputed the CARES discounts adjustment, but no longer opposes that adjustment.[97] Thus, the Commission should approve Company's adjustments.

V. OPERATING EXPENSES.

A. Legal Standard for Recovery of Expenses.

The Commission is required "to allow a recovery for all reasonable expenses." *Tucson Electric Power Co. v. Arizona Corp. Comm'n,* 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982). In other words, the Commission must provide sufficient income to permit full recovery of "operating

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[91] See UNSE's Final Schedules at B-2, Page 1.
[92] See Appendix A.
[93] Company Final Schedules at BMGS A-1.
[94] See Staff Final Schedules (March 12, 2010) at THF A-1.
[95] RUCO Final Schedules at BJ-1.
[96] See Appendix A at 3.
[97] Tr. (Erdwurm) at 297; Tr. (Fish) at 657.

costs" in addition to the return on rate base. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978). In addition, the Commission "must consider" any "expenditures made in compliance with the Commission's decision[s]." *Arizona Corp. Comm'n v. Palm Springs Utility Co.*, 24 Ariz. App. 124, 536 P.2d 245 (1975).

B. Fleet Fuel Expense.

In its Rebuttal filing, UNS Electric updated the data related to its original request of fleet fuel test-year expense. Due to this new information, UNS Electric reduced its original request by $56,333 to reflect the average fuel and cost data from 2007 through September 2009 – approximately $3.00 per gallon.[98] Commission Staff proposed reducing test-year expense by $75,798 and relied on AAA's annual average price per gallon figure for the entire state of Arizona.[99] This is not an accurate reflection of actual fleet fuel expenses because UNS Electric largely serves rural areas; and Commission Staff's proposed adjustment does not reflect the real costs UNS Electric incurs.[100] Staff's expert, Dr. Fish, admits that fuel expense in rural areas is higher than in urban areas.[101] As a result, Commission Staff's adjustment is simply a statewide estimate that does not accurately reflect the costs that the Company incurs for fleet fuel expense. UNS Electric's proposed adjustment is superior as it reflects the average cost actually incurred over the last three years, a cost that is known and measureable. Therefore, its, adjustment should be adopted in this case.

C. Call Center Expense.

For UNS Electric, the Call Center Expense equaled $880,553. This is the actual amount the Company incurred during the test year and UNS Electric seeks only to recover its actual costs during the test year.[102] RUCO did not contest this expense. Commission Staff originally proposed a negative adjustment of approximately $281,582, but amended its adjustment in its Surrebuttal

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[98] Ex. UNSE-16 (Dukes Rebuttal) at 31; Company Final Schedules at C-2, Page 4.
[99] Staff Final Schedules at THF C-2, Page 2.
[100] Ex. UNSE-16 (Dukes Rebuttal) at 31.
[101] Tr. (Fish) at 477.
[102] Ex. UNSE-17 (Dukes Rejoinder) at 4.

filing to negative $99,456.[103] Commission Staff argues that the increase in the expense level being allocated to UNS Electric is not commensurate with an increase in call volume. Commission Staff's narrow focus ignores the reality of the Call Center operations.

Since the last rate case, the Call Center has received increased investment, which has resulted in a 4% annual increase from what was approved in the prior rate case.[104] Dr. Fish does not dispute that the Call Center consolidates a lot of functions and having UNS Electric share the Call Center with UNS Gas and Tucson Electric Power Company ("TEP") is more efficient versus each utility having its own.[105] There is no evidence that the Call Center is over-staffed; rather, the Call Center has been successful in reducing duration times because of measures like the virtual hold program.[106] It would not be prudent for the Company to reduce system capacity.[107]

In short, the costs incurred by UNS Electric for the Call Center are prudent and appropriate. Yet Commission Staff argues that these costs should be reduced to the level of expense UNS Electric incurred in 2005. That is unreasonable and unsupported by the record. The Commission should allow UNS Electric to recover the actual test year costs for its Call Center.

D. Payroll and Payroll Tax Expenses.

The Company proposes adjustments that include certain upcoming known and measurable payroll (increase of $220,252) and payroll tax expenses (increase of $55,054) that have gone into effect January 1, 2010.[108] This treatment is consistent with the last UNS Electric rate case, Decision No. 70360, and the last three Southwest Gas Corporation ("SWG") rate filings.[109] Commission Staff did not contest this payroll adjustment and modified the payroll tax adjustment to reflect its position on incentive compensation.

RUCO agrees with an adjustment that includes the January 1, 2009 payroll, but argues that the January 1, 2010 payroll is too far from the test year and is not presently known. However, the

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[103] Ex. S-11 (Fish Surrebuttal) at 13; see also Staff Final Schedules at THF C-2, page 1.
[104] Ex. UNSE-16 (Dukes Rebuttal) at 25.
[105] Tr. (Fish) at 472-73.
[106] See Ex. UNSE-8 (McKenna Direct) at 8.
[107] Tr. (Fish) at 474-75.
[108] Company Final Schedules at C-2, Page 2.
[109] Ex. UNSE-16 (Dukes Rebuttal) at 14; see also Decision No. 70665 (December 24, 2008) at 10.

rates in this case will not go into effect until well into the 2010 calendar year – after the 2010 payroll increase goes into effect. The increased wages are being applied to employee levels as of the end of test year; therefore, there is no mismatch of revenue and expenses.[110]

Further, RUCO witness Dr. Johnson's discussion about strict adherence to a historical test year contradicts RUCO's support of using a reduced assessment ratio for 2010 property taxes. Dr. Johnson supports that adjustment but disputes the adjustment for test-year-level employees that is also known and measurable.[111]

Based upon the evidence presented by UNS Electric and Commission Staff, the Commission should allow the adjustment to reflect the upcoming wage increases that will be in place when new rates go into effect.

E. Rate Case Expense.

The Company is requesting $500,000 amortized over three years. This is less than what the Company will actually incur.[112] TEP employees provide much of the rate case support for UNS Electric, because it would not be as cost effective for UNS Electric to have its own parallel staff.[113] UNS Electric uses TEP personnel and it must compensate TEP to avoid any subsidization.[114] UNS Electric had already incurred $436,000 by December 2009 in this case – for responding to numerous Commission Staff and RUCO data requests and complying with the procedural order issued in this case.[115]

Both Commission Staff and RUCO propose adjustments taking out $200,000 – leaving UNS Electric with just $300,000 in rate case expense. That does not cover the amount UNS Electric actually incurred before the evidentiary hearings started. Neither Commission Staff nor RUCO explains how UNS Electric can adequately prepare its case, respond to data requests, and present testimony, in addition to doing all the things necessary to run a public utility. Neither

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[110] Ex. UNSE-16 (Dukes Rebuttal) at 14.
[111] Ex. UNSE-17 (Dukes Rejoinder) at 12.
[112] Ex. UNSE-17 (Dukes Rejoinder) at 5.
[113] Ex. UNSE-16 (Dukes Rebuttal) at 22-23.
[114] Ex. UNSE-16 (Dukes Rebuttal) at 22-23.
[115] Ex. UNSE-16 (Dukes Rebuttal) at 22.

RUCO nor Commission Staff has suggested that the Company has incurred exorbitant or imprudent expenses in the preparation of its case. Finally, the evidence is undisputed that it is more cost-effective to use external resources (as UNS Electric has done) than to hire a full-time staff and provide them with the resources and equipment necessary to process a rate case.[116] The Commission should allow the Company's proposed level of rate case expense because it is both reflective of the actual costs that UNS Electric will incur and is a reasonable level of expense.

F. Edison Electrical Institute ("EEI") Membership Dues.

The Company increased test-year expense by $11,172 for EEI membership dues. These costs should be allowable; the adjustment corrects a posting error where dues were not included in the Company's test-year expense.[117] Commission Staff had incorrectly proposed reducing this amount by $40,792. This was because Dr. Fish had applied his adjustment to all industry dues – including for the Western Electric Coordinating Council ("WECC"). WECC dues, however, are mandatory costs UNS Electric must incur.[118]

Commission Staff amended its adjustment to remove $4,763 from the Company's adjustment – reflecting a disallowance of 49.93% of EEI dues.[119] RUCO's adjustment is similar – removing 40% from total EEI dues (or about $4,492 from the Company's adjustment).[120] The Company stands by its adjustment as a reasonable level of expense incurred for customer benefit.

G. Outside Legal Expense.

The Company proposes outside legal expense of $138,890 – or an adjustment of positive $109,434 from test-year levels. This includes legal costs other than those incurred for the rate case. The Company determined this adjustment by averaging legal expense from 2005 to 2007. UNS Electric incurred approximately $128,000, $106,000 and $181,000 in 2005, 2006, and 2007 respectively.[121] There is no real dispute of the benefits of UNS Electric's participation in such

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[116] Ex. UNSE-17 (Dukes Rejoinder) at 5.
[117] Ex. UNSE-16 (Dukes Rebuttal) at 24.
[118] Ex. UNSE-16 (Dukes Rebuttal) at 24.
[119] Staff Final Schedules at THF C-2, page 1.
[120] See Appendix A at 6; Staff Final Schedules at THF C-2, page 1.
[121] Ex. UNSE-15 (Dukes Direct) at 25.

matters. The Company's adjusted test-year expense was prepared and calculated in the same manner approved in UNS Gas' last rate case – Decision No. 70011 (November 27, 2007).[122] Commission Staff and RUCO, however, propose different adjustments. First, Commission Staff witness Dr. Fish advocated reducing the Company's adjustment by $58,722.[123] In Surrebuttal Testimony, Dr. Fish appeared to be advocating for a four-year normalization including all values from 2005 to 2008.[124] Yet in Commission Staff's Final Schedules, it appears Dr. Fish is maintaining a reduction based on a three-year average – using 2005, 2006 and 2008.[125] RUCO witness Dr. Johnson recommends using an average of the Company's 2006, 2007 and 2008 legal expenses (excluding costs associated with the prior rate case)[126] or an outside legal expense amount equaling approximately $105,333. Even so, the record reflects that the Company has met its burden and proven that its three-year average is appropriate and provides a reasonable level of recurring cost recovery.

H. Bad Debt Expense.

The Company has proposed a Bad Debt expense adjustment of ($436,441) to reduce unadjusted test-year levels based on the same method the Commission approved in UNS Electric's last rate case.[127] In addition, the Company used the method that the Commission approved for both UNS Gas and TEP in their latest respective rate orders.[128] This approach allows for a smoothing and normalization of the pro forma bad debt expense, which can fluctuate due to unusual events such as a large customer going bankrupt or economic conditions causing defaults to significantly increase. RUCO does not dispute this adjustment.

Commission Staff witness Dr. Fish contends that test-year bad debt expense is overstated – because the average retail expense rate is applied to adjusted test-year expense. Commission Staff's assertion is simply wrong. For ratemaking purposes the preferred method is to take net

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[122] Ex. UNSE-16 (Dukes Rebuttal) at 29.
[123] Ex. S-11 (Fish Direct) at 28-29.
[124] Ex. S-12 (Fish Surrebuttal) at 15.
[125] Ex. S-12 (Fish Surrebuttal) at 14; Staff Final Schedules at THF C-2, Page 1.
[126] Ex. RUCO-6 (Johnson Direct) at 40.
[127] Ex. UNSE-15 (Dukes Direct) at 23; Company Final Schedules at C-2, Page 3.
[128] Ex. UNSE-16 (Dukes Rebuttal) at 26-27.

write offs (or bad debt expense) as a percentage of retail revenue over a long period of time and use that normalized relationship to apply to pro forma retail revenue to calculate pro forma bad debt expense.[129] The expense level being requested by the Company is reflective of anticipated levels of net write-offs, is reasonable and should be adopted here.

I. Postage Expense.

The Company included an increase to test-year postage expense to reflect the postage rate increases that went into effect on May 12, 2008 and May 11, 2009.[130] Commission Staff does not dispute the adjustment. RUCO disputes the 2009 adjustment as being too far outside the test year.[131] But similar to the Company's proposed adjustment for payroll and payroll tax expense, this adjustment is a known and measurable adjustment to test-year levels. The Commission's rules allow for pro form adjustments when reflecting a more realistic relationship between revenues, expenses and rate base. This is such an adjustment. It is reasonable and therefore should be adopted.

J. Depreciation and Property Tax.

Commission Staff and RUCO propose an adjustment to depreciation and property tax expenses that is related to their positions on the Company's Post-Test Year Plant adjustment.[132] The Company opposes this adjustment because the Post-Test Year Plant adjustment is appropriate. The Commission should adopt the Company's position.

K. Incentive Compensation.

The Company proposes to include its cash-based incentive paid to non-union employees under its Performance Enhancement Program ("PEP") as a test year expense. Commission Staff and RUCO, however, recommend that the pro forma level of PEP expense be reduced by 50% (*i.e.*, by $132,159) because, they argue, the program benefits both ratepayers and shareholders.[133]

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[129] Ex. UNSE-16 (Dukes Rebuttal) at 26-27.
[130] Ex. UNSE-15 (Dukes Direct) at 24-25.
[131] See Ex. RUCO-6 (Johnson Direct) at 40.
[132] Company Final Schedules at C-2, Page 3.
[133] See Appendix A at 7.

UNS Electric opposes this reduction and the reduction to payroll tax expense by $10,110 related to incentive compensation.

The Company's PEP is a core component of its employees' compensation – promoting cost containment and customer service. PEP puts a portion of an employee's total compensation at risk and should be seen as a means to encourage and enhance group and individual performance. It provides an additional tool for the Company to encourage cost savings and incentivize employees to impact goals.[134] Without the PEP, the pressure to increase base compensation would become considerable because UNS Electric would have to compete with other companies to attract and retain a skilled workforce.[135] The Company would have to increase its base compensation so that its total compensation would be equivalent to what other utilities provide. Further, offering the PEP provides cost savings to customers versus paying median market wages as base compensation. Employee costs including vacation pay, sick leave, long-term disability, 401K matching and other post-retirement benefits are reduced.[136] No party disputes that the PEP program reduces the ultimate cost passed onto customers in the form of reduced payroll and benefit costs.

Although they do not challenge the prudence or reasonableness of the total cash compensation paid to the non-union employees, both Commission Staff and RUCO propose reducing the incentive compensation expense by 50%. Commission Staff and RUCO both argue that incentive compensation benefits both shareholders and customers and thus should be shared equally. They argue that this is consistent with the prior UNS Electric rate order and thus appropriate treatment in this case.

UNS Electric acknowledges that Decision No. 70360 allowed UNS Electric to recover only 50% of PEP expense. However, the Commission's prior UNS Electric order did not address Decision No. 69663 (June 28, 2007), which allowed APS full recovery of its cash-based incentive compensation expense for a program very similar to the PEP. There, the Commission noted that

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[134] Ex. UNSE-16 (Dukes Rebuttal) at 17.
[135] Ex. UNSE-16 (Dukes Rebuttal) at 18.
[136] Ex. UNSE-16 (Dukes Rebuttal) at 19.

APS' variable incentive program rewards employees for performance measures primarily for the benefit of customers:

> APS' variable incentive program is an "at risk" pay program where a part of an employee's annual cash compensation is put at risk and expectations are established for the employee at the start of the year. If certain performance results are achieved, a predictable award will be earned based upon objective criteria. The actual amount of the award depends upon the achieved results. The intent of the plan is to: link pay with business performance and personal contributions to results; motivate participants to achieve higher levels of performance; communicate and focus on critical success measures; reinforce desired business behaviors, as well as results; and to reinforce an employee ownership culture. (APS Exhibit No. 51, Gordon Rebuttal, p. 8) Staff did not oppose inclusion of the TY variable incentive expense in cost of service, noting that although corporate earnings serve as a threshold or precondition to the payout, the TY level of expense is tied primarily to performance measures that directly benefit APS customers. (Staff Exhibit No. 43, Dittmer Direct, p. 110)[137]

Commission Staff and RUCO also do not address Decision No. 69663. Like APS' variable incentive program, UNS Electric's PEP rewards employees for performance that directly benefits customers.

It is undisputed that at-risk compensation is paid to all non-union employees. The PEP provides a portion of employees' overall compensation based on whether individual employee performance helps the Company meet its objectives. Employees whose individual goals are met as part of the PEP are likely to receive more compensation. In turn, customers benefit from the improved performance of employees whose jobs directly relate to serving the customer. Therefore, UNS Electric's PEP Expense provides direct customer benefits and is reasonable. Lastly, the Commission is required "to allow a recovery for all reasonable expenses." *Tucson Electric Power Co. v. Arizona Corp. Comm'n,* 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982). Commission Staff and RUCO have not argued that incentive compensation is not a reasonable expense. The Company's proposed prudent and beneficial incentive compensation expense should be allowed.

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[137] Decision No. 69663 at 37.

L. Stock-Based Compensation.

The Company proposes to include its stock-based incentive compensation as an expense. Commission Staff did not contest this adjustment. RUCO opposes the inclusion of stock-based compensation and proposes to remove test year Officers' compensation properly allocated to UNS Electric from TEP. RUCO bases this exclusion on the recent APS Decision No. 69663 and the UNS Electric Decision No. 70360.

In the UNS Gas Rate Case (Docket No. G-04204A-08-0571), UNS Gas opposed RUCO's adjustment because the stock-based compensation is primarily awarded in the form of stock options, which vest over a period of years making the value dependent on the Company's future strength and performance.[138] For the same reasons, UNS Electric opposes RUCO's proposed adjustment in this case.[139] The stock-based compensation at issue here is tied to long-term benefits and long-term incentives, is reasonable, and should be allowed in rates.

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

The Company proposes to include this element of executive compensation as an expense. UNS Electric believes the test-year expense for SERP, $102,042, is reasonable and appropriate and should be recoverable in rates.

Commission Staff and RUCO, however, both proposed adjustments that disallow UNS Electric's test-year SERP expense.[140] Commission Staff and RUCO believe SERP expense as an excess benefit provided to select executives. The Company strongly opposes this representation as misleading and incorrect. SERP is not an "excess" benefit or cost but rather is required to keep retirement benefits "equal" as a percentage of compensation for eligible employees.[141] No Party disputes that SERP is a typical cost for electric utilities. Because the expense is a normal, reasonable and recurring expense associated with compensation of employees, and is incurred to provide service to customers, it should be fully recoverable.

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[138] See Initial Post-Hearing Brief of UNS Gas, Inc. (Docket No. G-04204A-08-0571) at 23.
[139] Tr. (Dukes) at 335-37.
[140] Staff Final Schedules at THF C-2, page 1.
[141] Ex. UNSE-16 (Dukes Rebuttal) at 20.

N. Property Tax.

UNS Electric proposed a Property Tax expense adjustment of $105,181,[142] to reflect the 2010 statutory assessment ratio of 21% and the most currently known average property tax rates.[143] Neither Commission Staff nor RUCO revised property tax expense in their respective Surrebuttal filings. The Company believes its proposal is consistent with prior Commission orders on the issue and should be adopted.

O. Wholesale Credit Support

In its Rebuttal filing, the Company proposed an adjustment of positive $195,500. This figure was calculated by multiplying the weekly average balance of wholesale credit support from August 10, 2008 through April 12, 2009 ($17 million) by 1.15%.[144] The Company proposed this adjustment in response to Commission Staff's recommendation that the Company request such costs through base rates instead of through the PFFAC. These costs were not included in the Company's revenue requirements calculation in its Application.[145] Commission Staff witness Dr. Fish does not dispute the necessity or the reasonableness of such costs.[146] Therefore, these wholesale credit support costs, if not allowed to flow through the PPFAC, should be recovered in base rates. The Company's proposed adjustment is reasonable and should be approved.

P. Income Tax

UNS Electric proposes an Income Tax expense of $2,026,033, which reflects an adjustment of ($55,652) from the test year income taxes.[147] The adjustment results from other pro forma adjustments.[148] The calculation of UNS Electric's Income Tax expense includes synchronization of interest in order to coordinate the income tax calculation with the rate base and cost of capital. This is consistent with the Commission's long-standing method, and is the same

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[142] Company Final Schedules at C-2, Page 4.
[143] Ex. UNSE-6 (Kissinger Direct) at 8; Ex. UNSE-7 (Kissinger Rebuttal) at 1-2.
[144] Ex. UNSE-13 (Grant Rebuttal) at 28; Company Final Schedules at C-2, Page 4.
[145] Tr. (Grant) at 202-03.
[146] Ex. S-6 (Fish Direct) at 48-49.
[147] See Company Final Schedules, Schedule C-1, page 1, line 9.
[148] See Ex. UNSE-16 (Dukes Rebuttal) at 2.

method adopted in the prior UNS Electric Rate Case.[149] RUCO used the same methodology to determine Income Tax expense, including synchronizing interest.[150] However, Commission Staff did not follow the long-standing Arizona practice of synchronizing interest. The Commission should confirm that interest must be synchronized in determining Income Tax expense.

It is difficult to directly compare the actual Income Tax expense proposed by each Party because Income Tax expense is greatly affected by other pro forma adjustments. The more critical comparison is the manner in which the Income Tax expense is calculated. To determine a normalized income tax expense, the adjusted pro forma operating income is first calculated using the various operating income adjustments. Then, the interest expense is subtracted from the pro forma operating income to provide the taxable pro forma income. That taxable income is then multiplied by the applicable tax rate to determine the Income Tax expense. The long-accepted method of determining the interest expense to be deducted from pro forma operating income is to synchronize interest expense with rate base.[151] Synchronization is done by multiplying the pro forma rate base by the weighted average cost of debt in the capital structure.[152] Synchronizing the interest recovered with the rate base is necessary to avoid providing a return of interest cost on capital not used to serve present customers.[153]

As noted above, both UNS Electric and RUCO synchronized interest in determining Income Tax expense. In his Direct Testimony, Commission Staff witness Dr. Fish also used interest synchronization in his Income Tax calculation.[154] However, in his Surrebuttal, Dr. Fish deviated from the Commission approved method and modified his Income Tax expense calculation by not synchronizing interest.[155] Dr. Fish acknowledged that interest synchronization is the standard process in Arizona and that it is done to coordinate the income tax calculation with

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[149] See Decision No. 70360 at 37; UNSE-17 (Dukes Rejoinder) at 8-9.
[150] Tr. (Johnson) at 614-15.
[151] See Ex. UNSE-17 (Dukes Rejoinder) at 8.
[152] See Ex. UNSE-17 (Dukes Rejoinder) at 8.
[153] See Ex. UNSE-17 (Dukes Rejoinder) at 10.
[154] See Ex. UNSE-17 (Dukes Rejoinder) at 8;
[155] Tr. (Fish) at 460, 656; Ex. UNSE-17 (Dukes Rejoinder) at 8-9.

the rate base [156]and the cost of capital. He also acknowledged that this method was used in last UNS Electric Rate Case[157] and that *his* method could include interest related to items that are not in rate base.[158]

In addressing the proper methodology for calculating Income Tax expense in this case, the Commission should affirm that interest must be synchronized. Commission Staff's proposal is contrary to well established Commission practices and would result in an inaccurate Income Tax expense calculation, thus it should be rejected.[159] Finally, with respect to the Income Tax expense, UNS Electric understands that Commission Staff has withdrawn its Surrebuttal proposal to include $195,000 of short-term interest related to wholesale credit support as part of its interest calculation. UNS Electric agrees that the wholesale credit support should not be included as part of this expense.

Q. Uncontested Operating Expenses.

The Commission should approve the following uncontested expense adjustments: (1) Retail Revenue & Purchased Power Annualization; (2) Wholesale Revenue & Purchased Power; (3) Weather Normalization; (4) Customer Energy & Demand Normalization; (5) Fuel & PPFAC Revenue & Expense Normalization; (6) DSM & Renewables Revenue & Expense; (7) Pension & Benefits; (8) Post-Retirement Medical; (9) Interest on Customer Deposits; (10) Workers Compensation; (11) A&G Expense Capitalized; and (12) Depreciation & Amortization Expense.[160]

R. Operating Expense Adjustments Related to BMGS.

UNS Electric proposes the following adjustments go into effect when the proposed rate base treatment is approved allowing the Company to acquire BMGS: (1) BMGS purchase power agreement adjustment (negative $10,960,779); (2) BMGS Operations & Maintenance Expense (positive $1,158,464); (3) BMGS Depreciation & Amortization Annualization Expense (positive

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[156] Tr. (Fish) at 459-60; see Ex. S-16.
[157] Tr. (Fish) at 460-62; see Decision No. 70360 at 37.
[158] Tr. (Fish) at 461.
[159] See Ex. UNSE-17 (Dukes Rejoinder) at 8-9.
[160] See Appendix A at 4, 5 and 7.

$1,649,496; (4) BMGS Property Tax Expense (positive $434,148); and (5) BMGS Income Tax Expense (positive $2,074,196).[161] Regarding the last two adjustments, the Company revised these figures to account for a revision in the assessment ratio.[162] RUCO does not dispute the adjustments but its figures for both BMGS Property Tax Expense and BMGS Income Tax Expense are slightly different in its Surrebuttal filing. Commission Staff disallows all the above adjustments due to it opposing the Company's rate base treatment proposal for BMGS. As described in Section II of this Brief, ample evidence supports rate base treatment for BMGS and the rate reclassification the Company proposes. The Commission should approve these adjustments as reasonable and appropriate.

S. Depreciation Rates.

As part of its Application, UNS Electric provided 2009 technical updates of depreciation rates for the Company. Dr. Ronald E. White prepared two updates for the Company: (1) one that excludes BMGS; and (2) one that includes BMGS using an estimated year of final retirement.[163] Dr. White's testimony was stipulated to by the Parties.[164] No party objects to the Company's proposed updates and therefore they should be deemed to accept the Company's position. Therefore, the Company recommends the Commission adopt the proposed depreciation rates and updates as put forth in Dr. White's Direct Testimony.

VI. COST OF CAPITAL.

A. Overview.

It is frequently remarked that determining the cost of capital, especially the ROE, is more than just a mathematical exercise and involves a great deal of professional judgment. However, that does not mean that basic financial principles or guidelines can be ignored. As Commission Staff's witness Mr. Parcell testified, a core principle is that the "return to the equity owner should

[161] Ex. UNSE-15 (Dukes Direct) at 31-33; Company Final Schedules at BMGS C-2.
[162] See Appendix A at 8-9.
[163] Ex. UNSE-25 (White Direct) at Attachment REW-2.
[164] Tr. at 32.

be commensurate with returns on investments in other enterprises having corresponding risks."[165] UNS Electric's expert, Ms Martha B. Pritz, selected a sample group of other electric utilities, and then compared UNS Electric's risk to those utilities. Ms. Pritz demonstrated how UNS Electric is riskier than the sample group of utilities.[166] While RUCO and Commission Staff also used sample groups of other utilities, they did not adjust their results to reflect the fact that UNS Electric is riskier than the sample group – they simply ignored that critical fact.

B. Capital Structure.

Ms. Pritz testified that the appropriate capital structure to use for UNS Electric consists of 54.24% long-term debt and 45.76% equity.[167] No party disputes this recommendation and it should be adopted.

C. Cost of Debt.

Ms. Pritz also testified that UNS Electric's actual, test year cost of debt was 7.05%, and that this actual cost should be used to set rates in this case.[168] Again, no party disputes this recommendation and it should be adopted.

D. Return on Equity.

1. UNS Electric's ROE Recommendation.

Ms. Pritz prepared a comprehensive analysis of UNS Electric's cost of equity. She used the Capital Asset Pricing Model ("CAPM"), the multi-stage Discounted Cash Flow ("DCF") model and the bond yield plus risk premium ("BYRP") model. The CAPM and multi-stage DCF models are Commission accepted, having been used in several prior decisions. The Company's BYRP approach is based on the fundamental concept that equity is more costly than debt. Ms. Pritz computed the historical "spread" or risk premium between utility bond yields and ROEs allowed by utility commissions as reported by SNL Financial.[169] The Company then added this

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[165] Ex. Staff-14 (Parcell Direct) at 6, quoting *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1942).
[166] Ex. UNSE-22 (Pritz Direct) at 17.
[167] Ex. UNSE-22 (Pritz Direct) at 5.
[168] Ex. UNSE-22 (Pritz Direct) at 17.
[169] Ex. UNSE-22 (Pritz Direct) at Ex. MBP-11.

risk premium to the current yield to maturity of Baa-rated utility bonds to derive an estimated cost of equity.[170]

Using the DCF, CAPM and BYRP models, the Company determined the following range of ROEs for the sample group of electric companies:[171]

DCF	12.1%
CAPM	10.1%
BYRP	12.0%

The average ROE indicated by the three models equals 11.4%. Because UNS Electric is riskier than the sample group of companies (due in large part to its small size and inability to pay dividend), Ms. Pritz's ROE recommendation of 11.4% is a conservative recommendation.[172] Because it is a conservative recommendation, the Company maintained that position through subsequent rounds of testimony.[173]

Ms. Pritz further explained that investors would require an allowed ROE greater than the 10.0% recommended by Commission Staff's expert, Mr. Parcell.[174] UNS Electric's current ROE is 10.0% was authorized in its last rate case. But due primarily to regulatory lag, UNS Electric earned an ROE of only 6.9% for the first twelve months under current rates. That was *with an allowed* ROE of 10.0%.[175] Data provided by Commission Staff's own witness, Mr. Parcell, shows a range of projected earned returns of 8.6% to 10.4%, thus an allowed ROE of only 10% nearly guarantees that UNS Electric will under-earn by a wide margin when compared to comparable utilities.[176] For example, APS was recently granted a ROE of 11.0%.[177] It is incomprehensible how UNS Electric can be considered less risky than APS by a magnitude of 100 basis points.

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[170] Ex. UNSE-22 (Pritz Direct) at 16 and at Ex. MBP-12.
[171] Ex. UNSE-22 (Pritz Direct) at 17.
[172] Ex. UNSE-22 (Pritz Direct) at 17; Tr. (Pritz) at 719-20.
[173] Tr. (Pritz) at 692-93, 733.
[174] Ex. S-14 (Parcell Direct) at 2.
[175] Ex. UNSE-24 (Pritz Rejoinder) at 2.
[176] Ex. UNSE-24 (Pritz Rejoinder) at 2.
[177] Decision No. 71448 at 8-9.

2. UNS Electric is riskier than the sample group.

A key flaw in Commission Staff's and RUCO's analyses is that they do not adjust their ROEs to recognize that UNS Electric is riskier than the sample groups. Commission Staff's expert Mr. Parcell testified that the ROE should reflect the returns earned by companies "having corresponding risks."[178] Mr. Parcell admits that the utilities in his proxy group are: (1) much larger than UNS Electric; (2) have a Moody's bond rating higher than UNS Electric; and (3) pay dividends, unlike UNS Electric.[179] So, Mr. Parcell undermines his argument by not adjusting his ROE to reflect the fact that UNS Electric is riskier than the sample group. This is even more puzzling given that Mr. Parcell recommended such an adjustment in his testimony in the most recent TEP rate case.[180] In the TEP case, Mr. Parcell recommended an ROE for TEP above the midpoint of his range, because TEP had a higher risk that the sample group.[181] The higher risk was due to "[l]ower bond ratings... verses the bond ratings of the proxy companies" and a "[l]ower equity ratio... versus the proxy companies."[182] Although UNS Electric now has an equity ratio that is consistent with industry norms, the Company's credit rating is below average for the sample groups of companies used by both Ms. Pritz and Mr. Parcell.[183] Moreover, not one of the 17 sample companies used by Mr. Parcell has a credit rating as low as UNS Electric.[184] A lower credit rating indicates higher risk, as does the inability to pay a dividend. Mr. Parcell confirmed that the comparable group companies pay dividends, while UNS Electric has never paid a dividend.[185]

Finally, APS is much larger than UNS Electric and it was recently authorized an 11.0% ROE.[186] TEP (also significantly larger) recently received a ROE of 10.25%.[187] Ms. Pritz testified

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[178] Ex. S-14 (Parcell Direct) at 6, quoting *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1942).
[179] Tr. (Parcell) at 794-96.
[180] Tr. (Parcell) at 790.
[181] Ex. UNSE-35 (Excerpt from Parcell Feb. 29, 2008 testimony).
[182] Ex. UNSE-35 (Excerpt from Parcell Feb. 29, 2008 testimony).
[183] Ex. UNSE-22 (Pritz Direct) at 17.
[184] See Ex. S-14 (Parcell Direct) at Ex. DCP-1, Schedule 6.
[185] See Tr. (Parcell) at 796.
[186] Decision No. 71448 at 8-9, 55.
[187] Decision No. 70628 (Dec. 1, 2008) at 9, 19, 44-45.

that the average allowed return awarded to utilities in 2009 was 10.52%.[188] Alternatively, UNS Electric's earned ROE was just 6.9% for the twelve months after current rates were in effect; that is equivalent to 310 basis points below what was authorized for the Company.[189]

The evidence demonstrates that UNS Electric is riskier and less attractive to investors than the companies in the sample groups; UNS Electric is smaller, has not paid a dividend, and has the lowest investment-grade debt rating. The evidence also shows that less risky companies in Arizona have been given higher ROEs than proposed by RUCO or Commission Staff here. Given the circumstances, UNS Electric should have a higher ROE than the 10.0% ROE previously approved in its last rate case.

3. Importance of dividends to equity investors.

UNS Electric's inability to pay a dividend – *ever* – puts it at a great disadvantage compared to other electric utilities seeking capital. Mr. Parcell emphasized the importance of dividends, noting that he would not include a company in his sample group if it did not pay dividends.[190] Adopting either Commission Staff's or RUCO's recommendations will ensure UNS Electric will have a competitive disadvantage in the marketplace and it will be unable to attract the income investors extolled by Mr. Rigsby. To compensate, the Company would have to offer higher returns than dividend-paying utilities else the Company could not entice investors. By adopting the Company's ROE, the Commission can help UNS Electric avoid this disadvantaged position.

4. Impact of Economy.

UNS Electric is aware of the current economic situation and its effect on its ratepayers and employees. In response, the Company has proposed: (1) to lower the monthly customer charge for CARES customers to $3.50 from $7.50; (2) reduce the base power supply charge for CARES customers; (3) set the PPFAC forward and true-up components to zero and freeze them; and (4) continue to offer volumetric discounts.[191] The Company also proposed a modest increase to the

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[188] Ex. UNSE-24 (Pritz Rejoinder) at 3.
[189] Ex. UNSE-13 (Grant Rebuttal) at 22.
[190] Tr. (Parcell) at 796.
[191] Ex. UNSE-3 (DeConcini Direct) at 8.

monthly customer charge for its non-CARES residential customers, and proposes enhanced and expanded TOU options to give customers more control over their energy usage and more ability to save money.[192]

Though the Company considered the economic downturn in proposing increased rates, Commission precedent does not call for adjustments to cost of equity based on the economy. It is improper to give artificially low returns in difficult times, just as it is improper to give inflated returns in good times. Setting such a precedent would be shortsighted and the Commission has yet to do so. In fact, most rate orders in 2009 resulted in higher ROEs despite the recession.[193] Further, the record in this case shows that it is illogical to artificially depress a Company's ROE during this economic period because the credit markets have tightened. Thus, the financial markets are demanding additional returns in exchange for lending others funds. Additionally, "cost of capital is forward-looking in nature."[194] Still, it makes sense to reexamine the results from the models used to determine ROE and make adjustments when results are irrational or illogical. This is what Ms. Pritz did with her CAPM method.

The CAPM is particularly impacted by the current economic conditions. Ms. Pritz testified that to accurately reflect the increased risk premiums required by investors in the current economic environment, she adjusted the 6.5% historical market risk premium upward by an additional 2.29%. The adjustment is based on the spreads between 30-year treasury yields and Baa-rated public utility bond yields to ascertain a conservative estimate of the additional amount an equity investor would require.[195] This was necessary because of the illogical results from the CAPM model without the adjustment. Without the adjustment, the indicated ROE would be only 8.4% - far too low to attract rational investors because that is barely above average bonds yield for Baa-rated bonds, and would not adequately compensate equity investors for the increased risk they bear. [196] Her adjustment resulted in a CAPM result of 10.1% - still significantly below her results

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[192] Ex. UNSE-3 (DeConcini Direct) at 6-7.
[193] Ex. UNSE-24 (Pritz Rejoinder) at 3.
[194] Decision No. 64727 (April 17, 2002) at 14.
[195] Ex. UNSE-23 (Pritz Rebuttal) at 11; Tr. (Pritz) at 715.
[196] Ex. UNSE-22 (Pritz Direct) at 14-15; Ex. UNSE-23 (Pritz Rebuttal) at 11; Tr. (Pritz) at 714, 745-46.

from using the DCF and BYRP models. But instead of ignoring the model completely, or using completely irrational results, Ms. Pritz incorporated the modified CAPM results in her analysis, lowering her final ROE Recommendation.

5. RUCO's aberrant ROE must be rejected.

RUCO's proposed ROE of 9.25% is outside the range of equity returns ordered by utility commissions. Ms. Pritz testified that with the exception of one outlier, for the 44 rate orders issued from 2009 through January 2010, the allowed ROEs ranged from 10.0% to 11.5%.[197] RUCO's proposed ROE lies significantly outside this range, is unreasonably low, and unsupported by any rational approach.

Further, RUCO's ROE recommendation is nonsensical when considering the current economic environment. In UNS Electric's last rate case, Mr. Rigsby proposed a ROE of 9.30%.[198] Yet now, in a period of greater aversion to risk, Mr. Rigsby is proposing an ROE of 9.25%. In other words, while investors are more risk-adverse today, Mr. Rigsby apparently believes those same investors will accept a return lower than his previous recommendation, and 75 basis points lower than approved by the Commission in UNS Electric's last rate case. Mr. Rigsby's analysis does not withstand scrutiny.

Mr. Rigsby's ROE recommendation is also difficult to understand in light of the importance of dividends to utility investors. UNS Electric has never been able to pay a dividend. Mr. Rigsby would have the Commission believe that investors would be interested in UNS Electric, with his proposed ROE of 9.25%, over utilities which pay dividends and have authorized ROEs of 10% to 11.5% (including APS, which has an authorized ROE of 11.0%). RUCO's recommendation must be rejected as it is not realistic, would place UNS Electric at a severe disadvantage in the marketplace and it would ultimately harm ratepayers as it would unnecessarily raise UNS Electric's financing costs.

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[197] Ex. UNSE-24 (Pritz Rejoinder) at 3.
[198] Decision No. 70360 at 41.

On a more technical level, Mr. Rigsby goes astray by overly relying on his CAPM model, without making any adjustment for the current economic environment. As already explained, an unmodified CAPM analysis leads to illogical and irrational results; that is why Mr. Parcell placed little weight on his CAPM, and why Ms. Pritz adjusted the historical market risk premium. Mr. Rigsby, however, used a CAPM result of an ROE between 5.33% and 6.79% in his analysis.[199] Mr. Rigsby's CAPM results are *below* UNS Electric's cost of debt of 7.05%.[200] Mr. Rigsby's CAPM result is wholly implausible and should be given no weight.

Mr. Rigsby's DCF analysis also suffers from some fatal flaws. Aside from using only a single-stage DCF analysis, Mr. Rigsby assumes that a company's market-to-book ratio will move toward a value of 1. This is in direct contrast to observed market-to-book ratios for comparable companies that have averaged well above 1.0.[201] In short, Mr. Rigsby makes assumptions contrary to fact.

Mr. Rigsby would have the Commission believe that UNS Electric's cost of equity is 175 basis points below that of APS. And given RUCO's other revenue requirement recommendations in this case, UNS Electric would likely only earn an ROE of 6.0%.[202] RUCO's ROE recommendation is confiscatory and will not allow UNS Electric any opportunity to earn its allowed ROE. For all of the above reasons, RUCO's ROE recommendation should be rejected.

6. Commission Staff's ROE should also be rejected.

Commission Staff's ROE is also flawed. Most significantly, as already noted, Commission Staff fails to recognize that UNS Electric is riskier than the sample group it references. Simply stated, UNS Electric, a smaller company with a lower credit rating, no dividends, and lower earned returns has more risk than the sample group.

Moreover, Mr. Parcell uses only the single-stage version of the DCF. But investors do not expect a single, uniform growth rate. The multi-stage DCF recognizes this and is therefore

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[199] Ex. RUCO-11 (Rigsby Surrebuttal) at 14 (updated from his Direct Testimony).
[200] Ex. UNSE-24 (Pritz Rejoinder) at 4.
[201] Ex. UNSE-24 (Pritz Rejoinder) at 4-5.
[202] Ex. UNSE-13 (Grant Rebuttal) at 25-26.

superior. As the Commission explained, the multi-stage DCF "properly recognizes that investors expect both non-constant short-term growth as well as constant long term growth."[203] The Commission has considered both types of DCF model, and often averages the results of the two to produce an overall DCF estimate. Commission Staff has proposed, and the Commission has approved, that approach to the DCF in many orders.[204] Mr. Parcell does not explain why the Commission should now exclusively rely on a single-stage DCF model.

Mr. Parcell also incorporates two growth rates in his DCF analysis based solely on historical data. As Ms. Pritz explains, Mr. Parcell ignores the fact that analysts would have taken historical data into account when developing the forward-looking estimates – making the inclusion of historical data redundant.[205] Mr. Parcell's retention growth figures also are unreasonably low when compared to real domestic product growth from 1929 to 2008 (1.8% to 2.8% compared to 3.3%).[206] Finally, by using a single-stage DCF analysis, Mr. Parcell simply assumes these unreasonably low growth figures will continue in perpetuity. As a result, his DCF result should be rejected in favor of the more accurate and realistic multi-stage DCF proposed by the Company.

Further, Mr. Parcell's Comparable Earnings method is significantly flawed. Mr. Parcell uses historical accounting returns – but those do not reflect the always-changing market-based returns investors seek based on alternative investment opportunities.[207] Mr. Parcell states that an earned return of 9.5 to 10.5% should result in a market to book ratio above 1.0. But, if UNS Electric were to earn 9.5 to 10.5% (and even if that resulted in a market to book ratio of slightly above 1.0,) UNS Electric would still be at a significant disadvantage when compared to Mr. Parcell's comparable companies. This is because three out of four had average market-to-book

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[203] Decision No. 66849 at 22.

[204] See, e.g., Decision No. 68176 at 21 (stating Staff's approach) and 26 (agreeing with Staff); Decision No. 68858 (July 28, 2006) at 25, 28; Decision No. 69164 (December 5, 2006), at 23, 26; Decision No. 69440 (May 1, 2007) at 18, 20; Decision No. 70209 (March 20, 2008) at 27, 30.

[205] Ex. UNSE-23 (Pritz Rebuttal) at 2-3.

[206] Ex. UNSE-23 (Pritz Rebuttal) at 3.

[207] Ex. UNSE-23 (Pritz Rebuttal) at 6.

ratios above 1.5.[208] Further, Mr. Parcell ignores and does not contest that an allowed return of 10.0% for UNS Electric will likely only result in an earned ROE of 7.9%.[209]

Finally, Mr. Parcell apparently believes that UNS Electric – despite its small size, lower credit rating and inability to pay a dividend – is *less* risky than a large utility like APS. Mr. Parcell's recommendation is inconsistent with his recommendation of an 11.0% ROE for APS. Mr. Parcell downplays his recommendation as reflecting "a policy determination" made by Commission Staff.[210] But his APS testimony expressly stated "I recommend an 11.0 percent level..."[211] Further, Mr. Parcell's recommendation of 10.0% for UNS Electric is at the very bottom of the range when compared to other authorized ROEs that the Commission awarded to 44 utilities from 2009 through January 2010 – even though UNS Electric has never paid a dividend and the record is clear that it is decidedly riskier than the average utility. Under Commission Staff's revenue requirement recommendations, the Company will only likely earn an ROE of only 7.9% - 210 basis points below Mr. Parcell's ROE recommendation. In other words, the Company would be precluded from the opportunity to earn its authorized ROE. For all of these reasons, Mr. Parcell's ROE recommendation is unreasonably low and should be rejected.

VII. FINANCIAL INTEGRITY.

Mr. Parcell testified that the return must "be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[212] Unfortunately, Commission Staff's recommendation (and RUCO's much lower recommendation) fails to meet this standard. Mr. Parcell did not address whether UNS Electric would actually be able to earn the ROE that he recommends.[213] In contrast, Mr. Grant explained that UNS Electric has historically

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[208] Ex. UNSE-23 (Pritz Rebuttal) at 6.
[209] Ex. UNSE-14 (Grant Rebuttal) at 22.
[210] Tr. (Parcell) at 789.
[211] Ex. UNSE-34 (Parcell APS excerpt) at 32.
[212] Ex. S-14 (Parcell Direct) at 6-7 (quoting *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1942)).
[213] Ex. UNSE-33 (Staff Response to UNSE 3.40.a.).

not earned its authorized ROE.[214] Mr. Grant also projected UNS Electric's future earnings under UNS Electric's, Commission Staff's and RUCO's proposed revenue requirements:[215]

	Allowed ROE	Projected Earned ROE
UNS Electric	11.4%	9.5% (2010); 11.4% (2011)
Commission Staff	10.0%	7.9%
RUCO	9.25%	6.0%

As Mr. Grant explains, these calculations are straightforward.[216] Yet these calculations (and the financial forecasts in Mr. Grant's pre-filed testimonies) are based on rigorous analysis by a highly qualified staff of financial professionals.[217] It is not "mere speculation" as Mr. Rigsby suggests.[218] To the contrary, the mere speculation here is Commission Staff's and RUCO's suggestions that the Company will simply earn its allowed ROE when the evidence is completely the opposite. The projected earned ROE under Commission Staff's and RUCO's recommendations will not preserve the financial integrity of UNS Electric. That is not a sustainable situation for UNS Electric.

The Arizona Court of Appeals has held that the "rates established by the Commission should meet the overall operating costs of the utility and produce a reasonable rate of return. It is equally clear that rates cannot be considered just and reasonable if they fail to produce a reasonable return, or if they produce revenue which exceeds a reasonable rate of return." *Consolidated Water Utilities, Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 141, 875 P.2d 137, 482 (App. 1994). Thus, the rate of return actually produced or earned is at the core of ratemaking.

A utility is, of course, not guaranteed its authorized return – only the opportunity to earn it. But historical and projected information shows that UNS Electric will not have that opportunity. No one has suggested – much less testified – that there are sufficient measures that UNS Electric could take that would allow it to earn its authorized return. And UNS Electric's actual earned

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[214] Ex. UNSE-12 (Grant Direct) at 17.
[215] Ex. UNSE-12 (Grant Direct) at 18; UNSE-13 (Grant Rebuttal) at 22-26.
[216] Ex. UNSE-13 (Grant Rebuttal) at 23.
[217] Ex. UNSE-14 (Grant Rejoinder) at 10.
[218] Ex. RUCO-11 (Rigsby Surrebuttal) at 6.

returns on average common equity in 2007 (6.6%) and 2008 (4.6%) significantly lag behind the actual average earned returns of comparable groups of companies. For 2007, the earned ROEs of the two comparable groups of companies shown on Mr. Parcell's Schedule 10 were 8.7% and 10.2%. For 2008, the earned ROE's for that same group of companies averaged 7.9% and 9.4%.[219]

As discussed above, Commission Staff's and RUCO's revenue requirement and ROE recommendations will not allow UNS Electric to earn its allowed ROE or maintain its financial integrity. It is critical that the Commission not reduce the Company's rate request in a manner that will impair UNS Electric's financial integrity. UNS Electric has been able to steadily improve its equity ratio over time and has managed to obtain an investment grade debt rating. It would be poor public policy to now erode the tenuously positive position of the Company. Ultimately, ratepayers pay the price for a financially challenged utility – they are penalized with increased debt and equity costs, reduced trade credit from wholesale energy providers, and third-rate services.

UNS Electric recently obtained the lowest possible investment grade debt rating of Baa3 from Moody's.[220] That was not an easy feat; it took hard work and prudent decision making. Keeping or improving that rating is of critical importance to both UNS Electric and its ratepayers. A lower credit rating will result in a higher debt cost than would otherwise be the case.

Mr. Rigsby provides no analysis that UNS Electric will have any opportunity to earn a ROE even close to what he is recommending. Instead, Mr. Rigsby simply states that "RUCO believes that the rates it is recommending in this case will provide the Company with the opportunity to recover its operating expenses and provide *a* return on its invested capital" (emphasis added).[221] The actual evidence shows that UNS Electric's earned ROE under RUCO's revenue requirements recommendations will be 6.0% or 105 basis points below its cost of debt.[222]

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[219] S-15 (Parcell Surrebuttal) at Ex. DCP-1 (Schedule 10).
[220] Ex. UNSE-22 (Pritz Direct) at 3.
[221] Ex. RUCO-11 (Rigsby Surrebuttal) at 6.
[222] Ex. UNSE-13 (Grant Rebuttal) at 25-26.

This is not mere speculation as Mr. Rigsby would have everyone believe; it is the result of rigorous analysis conducted by financial professionals.[223]

Mr. Parcell's analyses are also absent from the record. For example, he states that "the pre-tax coverage that *would* result *if* UNS Electric earned [his] cost of capital recommendation" (emphasis added) would be above the "benchmark" range for a BBB rated utility.[224] This assertion is without support, however, and merely assumes that his cost of capital will actually be earned. Indeed, Mr. Parcell specifically denied making any prediction that his assumption will actually occur.[225] As shown above, there is no evidence that the earned ROE will come even close to the authorized ROE. Quite simply, UNS Electric's credit rating will be seriously endangered under Commission Staff's and RUCO's revenue requirements. Therefore, the Commission should reject their recommendations and approve the Company's requested revenue requirement.

VIII. FAIR VALUE.

A. The Arizona Constitution requires use of fair value in setting rates.

The Arizona Constitution, in Article XV § 14, requires that the Commission use fair value in setting rates. That requirement has been enforced in numerous court cases. *See e.g. Phelps Dodge Corp. v. Arizona Electric Power Co-op,* 207 Ariz. 95 ¶ 38, 83 P.3d 573, 578 (App. 2004); *Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994). The Arizona Supreme Court requires that the "reasonableness and justness of the rates must be related to this finding of fair value." *Simms v. Round Valley*, 80 Ariz. 145, 151, 294 P.d 378, 382 (1956). In other words, "the Commission must first determine the "fair value" of a utility's property and use this fair value as the utility's rate base." *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (App. 1978).

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[223] Ex. UNSE-14 (Grant Rejoinder) at 10.
[224] Ex. S-14 (Parcell Direct) at 41.
[225] Ex. UNSE-33 (Staff Responses to UNSE 3.40.a.).

B. UNS Electric's method follows the Arizona Constitution and Commission decisions.

Implementing the fair value requirement has been controversial in recent times. Seeking to minimize contested issues in this case, UNS Electric proposed a Fair Value Rate of Return ("FVROR") of 6.88%, which is based upon the method adopted by the Commission in the Chaparral City Remand Order, Decision No. 70441. That method results in a FVROR of 8.08%.[226] The Company, however, analyzed what was necessary to give it an opportunity to earn its requested ROE. Based on that analysis, the Company only requested a FVROR of 6.88% (less than what the method in Decision No. 70441 produces). The Company-proposed FVROR (from its Direct Testimony) is also lower than what it would have been under the method the Commission adopted in the Chaparral City 2009 Rate Order, Decision No. 71308. That method produces a FVROR of 7.99%.[227]

Despite the higher FVROR that the Company could realize under the methods approved in Decision Nos. 70441 and 71308, the Company proposes a FVROR of 6.88% because it is just and reasonable, and produces an increase in revenues that will allow it a reasonable opportunity to earn its ROE.[228] Even RUCO's witness, Dr. Johnson, who opposes the Company's proposed FVROR, gives the Company credit for not asking for a higher FVROR than necessary.[229]

Further, even using Commission Staff's proposed Cost of Capital ("COC"), UNS Electric would realize a FVROR of 7.48% using the method approved in the Chaparral City Remand Order (Decision No. 70441). Using the method approved in the Chaparral City 2009 Rate Order (Decision No. 71308), the FVROR equals 7.40%.[230] No party disputes that the Company accurately reflected both methodologies. Further, while Commission Staff and RUCO advocate different methods here than were adopted by the Commission in Decision Nos. 70441 and 71308,

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[226] Ex. UNSE-12 (Grant Direct) at 14.

[227] Ex. UNSE-12 (Grant Direct) at 14. Decision No. 71308, issued after the Company's Direct Filing, approved Staff's methodology in what Mr. Grant then referred to as the "current Chaparral rate proceeding."

[228] See Ex. UNSE-12 (Grant Direct) at 13.

[229] Tr. (Johnson) at 623.

[230] See Ex. UNSE-13 (Grant Rebuttal) at 14.

both Commission Staff and RUCO must acknowledge that the methods approved in those decisions are reasonable. Indeed, Commission Staff recommended the method approved in Chaparral City's most recent rate filing, Decision No. 71308.[231] And in that case, RUCO recommended the method that had been approved in Decision No. 70441.[232]

C. Commission Staff's methods are unconstitutional and unjustified.

Commission Staff's witness, Mr. Parcell, proposes two methods in this case, both of which are fatally flawed and should be rejected. Mr. Parcell's primary proposal is to apply a 0% return on the "fair value increment," i.e. the portion of Fair Value Rate Base ("FVRB") that exceeds the Original Cost Rate Base ("OCRB"). Under this method, only OCRB impacts revenue requirement; that is the mathematical equivalent of assigning a zero weighting to FVRB for rate setting purposes. This method's failure to use fair value is unconstitutional and the Commission has rejected it at least twice.[233] The Commission is required to use, not ignore, fair value, thus Mr. Parcell's primary method cannot be used.

Mr. Parcell's alternative proposal – applying a "risk-free rate" to the fair value increment – appears to be based on the recent SWG decision.[234] But the SWG decision lacked the extensive analysis of fair value that was set forth in the Chaparral City Remand Order and in the Chaparral City 2009 Rate Order. In the SWG decision, the Commission stated that it did not adopt the method approved in the Chaparral City Remand Order because: (1) that order had not been issued by the time of the hearing, and therefore was not analyzed on the record by the experts in that case; (2) no party presented a method similar to the method approved in the Chaparral remand case; and (3) the utility agreed to the basics of Mr. Parcell's approach, disputing only the method of determining the risk-free rate.[235]

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[231] See Decision No. 71308 at 39; See also UNSE-33 (Staff Responses to UNSE 3.36 and 3.37).
[232] See Decision No. 71308 at 39.
[233] See Decision No. 70441 (July 28, 2008) at 34-38; and Decision No. 70665 (December 24, 2008) at 31-33 (SWG Rate Case).
[234] Decision No. 70665 at 31-32.
[235] See Decision No. 70665 at 32-33.

Those three reasons do not apply to this case because: (1) both the Chaparral City Remand Order and the Chaparral City 2009 Rate Order are available for guidance; (2) UNS Electric presented both methods from those cases in this case; and (3) UNS Electric does not concede the appropriateness of Mr. Parcell's alternative recommendation. Thus, the Southwest Gas decision does not support ignoring the methods approved in Decision Nos. 70441 and 71308; to the contrary, either method is reasonable and appropriate for use in this case. The Company supports using either method if its revenue requirement recommendations are not adopted.[236]

Moreover, Commission Staff's recommended FVROR is mathematically equivalent to the now discredited "backing-in" method. Mr. Parcell, in his Surrebuttal Testimony, re-calculates Commission Staff's FVROR to equal 6.01%. In doing so, Mr. Parcell applies a 1.50% cost of capital for the "Fair Value Increment" (the difference between FVRB and OCRB), but only a 2.50% cost of debt to the "fair value" debt component and 2.99% cost of common equity to the "fair value" equity component.[237] This is a change from how Mr. Parcell developed his debt and equity components from his Direct Testimony (where he used 2.57% for the "fair value" debt component and 3.08% for the "fair value" equity component). Under Mr. Parcell's new arbitrary and unsupported method, the "fair value" for the debt and equity components totals 5.49% - less than the 5.65% FVROR from Mr. Parcell's primary recommendation.[238] This is an incomprehensible result.

Mr. Parcell's alternative proposal is flawed as well because: (1) a FVROR of 5.49% would be obtained if a zero COC is applied to the "fair value increment";[239] and (2) the FVROR of 5.49% would be obtained if Commission Staff's required operating income is divided by Commission Staff's FVRB.[240] As Mr. Grant further explains, this is mathematically equivalent to Mr. Parcell's

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[236] Ex. UNSE-13 (Grant Rebuttal) at 15.
[237] See Ex. S-15 (Parcell Surrebuttal) at Ex. DCP-1, Schedule 15.
[238] See Ex. S-14 (Parcell Direct) at 54.
[239] Ex. UNSE-14 (Grant Rejoinder) at 5.
[240] Ex. UNSE-14 (Grant Rejoinder) at 5.

primary recommendation in this case.[241] So, Commission Staff's FVROR recommendation (based on Mr. Parcell's alternative proposal) is also unconstitutional and cannot be adopted.

Finally, the record contains no support for why Mr. Parcell's proposal is superior to either of the methods approved in Decision Nos. 70441 and 71308. To the contrary, he simply stated that he believes this proposal is "reasonable."[242] Similarly, Mr. Parcell provides no justification for use of his alternative proposal over the methods approved in Decision Nos. 70441 and 71308. He offers no explanation for his deviation from the method Commission Staff supported in the Chaparral City's 2009 rate case.[243] In short, the record is devoid of any reason to use Mr. Parcell's methods. Additionally, use of Mr. Parcell's alternative proposal results in a revenue requirement too low to support UNS Electric's financial integrity.[244] Most importantly, both of Mr. Parcell's proposals give de minimus effect to fair value, which is unconstitutional. The Commission should reject Mr. Parcell's proposals.

D. RUCO's fair value method is arbitrary and unconstitutional.

RUCO's witness, Dr. Johnson, recommends subtracting the full rate of inflation from both the cost of debt and ROE.[245] This method (which he refers to as Method 1) results in a FVROR recommendation of 5.96% - using Mr. Rigsby's flawed recommended weighted average COC. Dr. Johnson also provides a range of values for FVROR based on the five methods he evaluated (including those methods approved in Decision Nos. 70441 and 71308) – resulting in a range from 5.39% to 7.01% - also using Mr. Rigsby's unreasonable recommended weighted average COC.[246] Only two of those methods, however, reflect the methods approved in Decision Nos. 70441 and 71308.[247] Even so, RUCO uses the 5.96% FVROR to determine its recommended revenue requirement increase. But that FVROR recommendation is problematic on multiple fronts.

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[241] Ex. UNSE-14 (Grant Rejoinder) at 5.
[242] Ex. UNSG-33 (Staff Response to UNSE 3.36 and 3.37).
[243] See Decision No. 71308 at 39.
[244] Ex. UNSE-13 (Grant Rebuttal) at 12.
[245] Ex. RUCO-6 (Johnson Direct) at 58.
[246] Ex. RUCO-6 (Johnson Direct) at 58.
[247] Ex. UNSE-13 (Grant Rebuttal) at 19.

First, Dr. Johnson fails to explain why his Method 1 is superior to the methods approved in either the Chaparral City Remand Order or the Chaparral City 2009 Rate Order. In fact, the Commission expressly rejected Dr. Johnson's Method 1 approach in Decision No. 70441.[248] RUCO did not recommend Dr. Johnson's approach in Chaparral City's most recent rate case – instead choosing to advocate for the method approved in Decision No. 70441 (subtracting the rate of inflation only from the cost of equity, not the cost of debt).[249]

Second, Dr. Johnson's recommendation to subtract the full rate of inflation from the cost of capital ignores the fact that only 50% of FVRB is impacted by inflation. This is because OCRB is stated in original nominal dollar terms.[250] Dr. Johnson's method overstates the impact of inflation on capital costs by applying the inflation rate to an element ("OCRB") that does not include inflation, thus artificially lowering the FVROR. In Decision No. 71308, the Commission recognized that one-half of FVRB includes OCRB and that OCRB does not include inflation. Therefore, the Commission approved an inflation component adjusted by one-half.[251]

Finally, a 5.96% FVROR is simply too low to support the financial integrity of UNS Electric. This will only allow UNS Electric – with RUCO's revenue requirement recommendations – to earn an ROE of 6.0%.[252] That is 105 basis points below its cost of debt. This result does not allow UNS Electric the opportunity to earn its COC or to attract new capital on reasonable terms.[253] UNS Electric cannot support an investment grade credit rating with a ROE that low. For these reasons, RUCO's FVROR is unreasonable and should be rejected.

E. The FVROR for BMGS should be the weighted average Cost Of Capital.

The evidence is undisputed that the OCRB and replacement cost for BMGS are nearly identical. The OCRB for BMGS equals approximately $62 million as of December 31, 2008 –

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[248] See Ex. UNSE-13 (Grant Rebuttal) at 16.
[249] Decision No. 71308 at 39.
[250] Ex. UNSE-13 (Grant Rebuttal) at 16.
[251] See Decision No. 71308 at 43-44.
[252] See Ex. UNSE-13 (Grant Rebuttal) at 25-26.
[253] Ex. UNSE-13 (Grant Rebuttal) at 18.

while the replacement cost equals approximately $64.7 million.[254] Further, the weighted average COC (9.04% as determined by Ms. Pritz) is the proxy cost UNS Electric used for the financing costs for BMGS.[255] As Mr. Grant explains, applying the weighted average COC to BMGS does not make the Company more profitable; to the contrary, it merely fills the need for UNS Electric to cover the financing costs for BMGS.[256] In other words, the return is the amount needed to service the additional debt and equity for BMGS.[257]

Further, the concern regarding inflation (when determining a FVROR) does not apply to BMGS. This is because the plant is almost brand new making the replacement cost nearly identical to original cost.[258]

While supporting the Company's proposed rate base treatment for BMGS, RUCO opposes applying the weighted average COC to BMGS. A FVROR of 5.96%, however, is too low relative to the COC needed support UNS Electric's financing of BMGS. As Mr. Grant indicated in his pre-filed testimony, UNS Electric will have to raise new capital to finance the acquisition of BMGS.[259] Even so, this would result in an overall FVROR of 7.29% - below what the Company would receive under the methods approved in the Chaparral City Remand Order and the Chaparral City 2009 Rate Order under the Company's proposal.[260] The evidence supports the Company's request to apply a FVROR to BMGS equal to the Company's weighted average COC.

IX. RATE DESIGN.

A. UNS Electric Rate Design Proposals.

UNS Electric proposes to increase monthly customer charges for all classes of customers except CARES customers. The proposed increase is modest – from $7.50 to $8.00 for residential customers. This small, gradual step is closer to the cost-based levels indicated in the Company's

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[254] See Company Final Schedules at BMGS B-2, page 1, and BMGS B-3, page 1; see also Ex. UNSE-1 at Schedules BMGS B-2, page 1 and BMGS B-3, page 1.
[255] Tr. (Grant) at 195.
[256] Tr. (Grant) at 207.
[257] Tr. (Grant) at 224.
[258] Tr. (Grant) at 245-46.
[259] Ex. UNSE-12 (Grant Direct) at 15-16.
[260] Ex. UNSE-12 (Grant Direct) at 14, 16.

Class Cost of Service Study ("CCOSS").[261] Though modest, this increase will allow the Company to recover the actual costs for providing metering, meter-reading, billing and customer service – charges the Company incurs regardless of how much electricity customers use.[262] The proposed residential monthly customer charge is also in line with what other Arizona utilities charge.[263] The Company proposes that all customer classes receive an equal percentage increase of approximately 9.21% - except CARES customers, who would receive a decrease of approximately 9.41%.

The Company also proposes to redesign its time-of-use ("TOU") options to expand the price differentials between on-peak, off-peak and (for the summer) shoulder-peak hours. In other words, the difference in base power supply charges between on-peak, off-peak and shoulder-peak would be greater under the Company's proposal. As proposed, the off-peak base power supply charge would average 34% of on-peak; off-peak is currently 84% of on-peak.[264] This will make UNS Electric's pricing differentials consistent with those of TEP.[265]

The Company's intention in expanding TOU differentials is to provide a more accurate and pronounced price signal to customers that using energy during peak times is substantially more expensive than during other periods of the day.[266] The proposed differentials help customers save money by providing incentives to shift load to off-peak.[267] This will also provide a long-term benefit to the Company in curbing peak usage, which in turn can defer capacity additions.[268]

In addition to expanding the TOU pricing differentials, UNS Electric also proposes a Super-Peak option – an expansion of the existing TOU options to include a single "super-peak" summer hour for residential customers and general service customers with loads under 3 MW. For that "super-peak" hour, the base power supply charge will be significantly higher than for any other hour in the day.[269] A customer's peak hour will be based on the objective, non-changing

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[261] Ex. UNSE-18 (Erdwurm Direct) at 18.
[262] Ex. UNSE-19 (Erdwurm Rebuttal) at 5.
[263] Ex. UNSE-19 (Erdwurm Rebuttal) at 4; Tr. (Erdwurm) at 294.
[264] Ex. UNSE-18 (Erdwurm Direct) at 21-22.
[265] Ex. UNSE-18 (Erdwurm Direct) at 24.
[266] Ex. UNSE-18 (Erdwurm Direct) at 21.
[267] Ex. UNSE-18 (Erdwurm Direct) at 23.
[268] Ex. UNSE-18 (Erdwurm Direct) at 24.
[269] Ex. UNSE-18 (Erdwurm Direct) at 25.

metric of the last digits of the street address.[270] This "super-peak" option will allow a customer to conveniently but significantly reduce usage during the peak hour – leading to considerable savings for the customer.[271] This option is easy for UNS Electric to implement and easy for customers to understand.[272]

The Company's rate design proposals also includes the rate reclassification proposal for rate-basing BMGS described in Section II of this Brief. The specific adjustments associated with that rate reclassification are shown in the "H" schedules and tariffs that accompanied the Company's Direct filing.[273]

B. Commission Staff supports the Company's rate design proposals.

Commission Staff's rate design witness, William C. Stewart, supports most of the Company's rate design proposals. For instance, he agrees with a constant percentage increase (to test-year adjusted revenues) across all customer classes and a decrease for CARES customers,[274] save for small differences presumably due to Commission Staff's revenue requirements recommendations. Mr. Stewart supports the Company's proposed increase in the monthly customer charges including the amount of those increases.[275] Finally, Commission Staff supports the Company's TOU proposals mentioned above.[276] Commission Staff's only material opposition to the Company's rate design arises with respect to the application of the PPFAC to CARES customers – that issue is addressed in the section of the Brief on Low Income and CARES programs.

C. RUCO's proposal to lower the monthly customer charge is unreasonable.

RUCO witness Dr. Johnson proposes that the monthly customer charge for residential customers be lowered to $5.00. He bases his decision on marginal cost principles that do not realistically reflect what UNS Electric actually incurs to provide services to customers. His

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[270] Ex. UNSE-19 (Erdwurm Rebuttal) at 18.
[271] Ex. UNSE-18 (Erdwurm Direct) at 25.
[272] Ex. UNSE-19 (Erdwurm Rebuttal) at 17.
[273] See Company Final Schedules at H-3 and BMGS H-3; Ex. UNSE-18 (Erdwurm Direct) at 28.
[274] Ex. S-12 (Stewart Direct) at Schedule WCS H-1.
[275] Ex. S-12 (Stewart Direct) at 8-9.
[276] Ex. S-12 (Stewart Direct) at 9-11.

recommended decrease also will increase volatility, decreases revenue stability, and result in a mismatch between revenue collection and cost causation.[277] Dr. Johnson's proposal is an unprecedented and radical departure from the average embedded cost study that the Commission has approved for use by electric utilities for the past 20-plus years.[278] Even Dr. Johnson admits he does not know of any case where his method was adopted by the Commission.[279]

Dr. Johnson also implies that the Company's proposed rate design does not promote conservation because the total cost per kWh goes down. To the contrary, the Company's rate design, by allocating the correct level of fixed cost recovery, moves profitability away from consumption. Because energy charges still increase with increased usage, the Company's rate design still promotes conservation.[280] In fact, it is Dr. Johnson's rate design that would work against the goals of conservation and efficient use of energy. His design makes the Company's ability to recover its costs becomes *more* dependent on consumption and sales of energy because the monthly customer charge is lowered.[281] The Company's proposed customer charge is based on the actual amount necessary for cost recovery, which will allow the Company to pursue creative and effective conservation without damaging its ability to recover costs.[282]

In addition to decreasing the monthly customer charge, Dr. Johnson proposes adding a third tier energy charge – in excess of 800 kWh per month. Together with his proposed monthly customer charges, UNS Electric would have no opportunity to achieve its revenue requirement.[283] Most fundamentally, rate design is an exercise in balancing many different factors – from affordability, conservation and gradualism to revenue stability and cost of service. The Company's rate design promotes conservation while gradually increasing monthly customer charges. Commission Staff supports the Company's rate design. By contrast, Dr. Johnson's rate design proposal de-stabilizes revenue recovery and makes the Company significantly more

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[277] Ex. UNSE-19 (Erdwurm Rebuttal) at 6; Tr. (Erdwurm) at 299.
[278] Ex. UNSE-20 (Erdwurm Rejoinder) at 5.
[279] Ex. UNSE-29 (RUCO response to UNSE 2.10).
[280] Ex. UNSE-19 (Erdwurm Rebuttal) at 10.
[281] Ex. UNSE-19 (Erdwurm Rebuttal) at 8.
[282] Tr. (Erdwurm) at 267.
[283] Ex. UNSE-19 (Erdwurm Rebuttal) at 7.

dependent on energy consumption. That works against the goals of energy efficiency and conservation. For these reasons, the Commission should approve the Company's monthly customer charge and volumetric charges, and reject those proposed by RUCO.

D. UNS Electric's proposed "super-peak" option can and should be implemented in this case.

UNS Electric seeks to implement its proposed "super-peak" option now so it can gather more information about the elasticity of energy at the most critical peak periods. Only through implementation of this option will the Company get truly meaningful results. These results are necessary so that the Company can continue to enhance and improve existing programs and develop new programs.[284] Dr. Johnson seems to discourage the super-peak option in favor of a real-time pricing option. But a real-time option is more costly to implement and is harder for the customer to understand.[285] The Company could not implement a real-time pricing option in this case, but may consider real-time pricing rate as part of its DSM programs.[286] And implementing the "super-peak" option now does not foreclose a real-time pricing option in the future.

X. CARES AND LOW-INCOME ISSUES.

A. CARES adjustment.

UNS Electric proposes a normalization adjustment of $61,797 for the CARES program in order to better reflect the discounts that will prevail when the new rates are in effect.[287] RUCO does not oppose the CARES-related expense adjustment. Commission Staff initially opposed the $61,797 adjustment to CARES expense. However, UNS Electric understands that Commission Staff has withdrawn its opposition.[288] Therefore, the Parties now agree on the Company's CARES expense and the Commission should adopt the Company's position.

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[284] Ex. UNSE-19 (Erdwurm Rebuttal) at 17.
[285] Ex. UNSE-19 (Erdwurm Rebuttal) at 17.
[286] Ex. UNSE-19 (Erdwurm Rebuttal) at 18.
[287] Ex. UNSE-18 (Erdwurm Direct) at 18; Ex. UNSE-19 (Erdwurm Rebuttal) at 13.
[288] Tr. (Fish) at 462-63.

B. CARES rate design.

UNS Electric proposes to hold most CARES customers harmless from the proposed rate increase. The Company actually proposes lowering the CARES customer charge (before any applicable percentage discount) to $3.50 per month from the current level of $7.50 per month.[289] Additionally, CARES customers will pay a reduced base power supply rate, and the PPFAC forward and true-up components will be set to zero and frozen for CARES customers upon implementation of new rates.[290] CARES customers also will receive the *additional* percentage discounts (30% for 0-300 kWh; 20% for 301-600 kWh, and 10% for 601-1000 kWh) and the flat $8.00 per month discount for customers with monthly usage in excess of 1,000 kWh.[291] As a result of these proposals, CARES customers will actually see decreases of 9.41% on average in their bills after rate implementation.[292]

Commission Staff does not oppose the CARES rate design with the exception of the PPFAC proposal.[293] The PPFAC issue is addressed below. RUCO agrees in general with the goals of the Company's CARES rate design, but proposes a further reduction of the monthly customer charge to $2.50 and unspecified increased usage-based discounts.[294] RUCO noted that other Company proposals were unnecessarily complicated and proposed resolving those issues through the unspecified increased usage-based discounts.[295]

UNS Electric believes that its CARES proposal presents the appropriate relief for CARES customers. Commission Staff appears to agree with the Company's proposal, other than the PPFAC issue. The structure of the discounts is similar to the discount structure currently in place. RUCO did not provide any specifics about its modified usage-based discounts. The Commission should approve the Company's CARES rate design.

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[289] Ex. UNSE-18 (Erdwurm Direct) at 28.
[290] Ex. UNSE-18 (Erdwurm Direct) at 28.
[291] Ex. UNSE-18 (Erdwurm Direct) at 28.
[292] See Ex. UNSE-18 (Erdwurm Direct) at 28 and Exhibit DBE-2 page 2, line 18 thereto; Ex. UNSE-19 (Erdwurm Rebuttal) at 11.
[293] See Ex. S-12 (Stewart Direct) at 7
[294] Ex. RUCO-7 (Johnson Rate Design) at 31.
[295] Ex. RUCO-7 (Johnson Rate Design) at 31.

C. CARES PPFAC rate.

As noted above, the Company proposes to freeze the PPFAC forward and true-up components at zero upon implementation of new rates.[296] Commission Staff proposes that CARES customers be subject only to PPFAC rate decreases, but not increases.[297] Given that CARES customers already enjoy a discount in base rates, such a proposal seems overly complicated and unfair to regular residential customers.[298] CARES customers cannot incur all of the benefit and none of the risk because other customers (mostly middle class customers) bear the entire burden with none of the reward.[299] Commission Staff's proposal could force non-CARES customers to subsidize significantly increased PPFAC charges depending on changes in the wholesale electric rates, although Commission Staff has not addressed this potential impact.[300] Indeed, Commission Staff's Rate Design witness, Mr. Stewart, was unaware of even the number of CARES customers, let alone the impact of his proposal on non-CARES customers.[301]

UNS Electric maintains its proposal to freeze the PPFAC rate at zero for CARES customers when new rates become effective. This result is the most equitable to all customers.

D. Low Income Program expansion.

In its Application and supporting testimony, UNS Electric indicated that it supported expansion of the Low-Income programs from 150% to 200% of poverty level, provided that any expansion of the program was contingent on full recovery of any revenue shortfall from other retail customers.[302] RUCO does not support this expansion.[303] Commission Staff also ultimately concluded that, although it is not opposed to expansion of the program, the structure of any program changes should be determined on the basis of consultation of interested parties.[304]

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[296] Ex. UNSE-18 (Erdwurm Direct) at28; Ex. UNSE-20 (Erdwurm Rejoinder) at 8.
[297] Ex. S-12 (Stewart Direct) at 7. During the hearing, Commission Staff Witness Stewart suggested that the Staff proposal may be that the CARES PPFAC rate would be subject to decreases, but that any increases would be capped back at the zero PPFAC rate. See Tr. (Stewart) at 504-05.
[298] Ex. UNSE-19 (Erdwurm Rebuttal) at 12.
[299] Ex. UNSE-19 (Erdwurm Rebuttal) at 12.
[300] Ex. UNSE-20 (Erdwurm Rejoinder) at 8.
[301] Tr. (Stewart) at 505.
[302] Ex. UNSE-1 (Application) at 5-6; Ex. UNSE-18 (Erdwurm Direct) at 29.
[303] Ex. RUCO-7 (Johnson Rate Design) at 31-32.
[304] Ex. S-13 (Stewart Surrebuttal) at 2.

Therefore, there does not seem to be support for any expansion of the low-income programs at this time.[305]

XI. PURCHASED POWER AND FUEL ADJUSTOR CLAUSE.

UNS Electric originally proposed two changes to the Company's PPFAC: (1) to apply the appropriate carrying cost to under- and over-recoveries of fuel and purchased power costs; and (2) to recover credit support costs UNS Electric incurs when procuring wholesale electricity and gas. The Company maintains both proposals, although it proposed in its Rebuttal filing to recover $195,500 of credit support costs through base rates as an alternative to recovery through the PPFAC. The Company opposes RUCO's proposal to implement a 90/10 sharing mechanism for the PPFAC.

A. The Interest Rate for the Company's PPFAC should reflect its actual carrying costs.

UNS Electric requests changing the carrying cost applicable to its PPFAC from the one-year Nominal U.S. Treasury Constant Maturities rate ("constant maturities rate") to the 3-month LIBOR rate (published by both the British Bankers Association and Wall Street Journal) plus 1.0%. The LIBOR rate much more accurately reflects the interest rates that UNS Electric must bear when it borrows from the joint revolving credit facility. That rate is LIBOR plus 1.0%.[306] Since the middle of 2007, the LIBOR interest rates have been significantly higher than the interest rates on one-year Treasury bills. Keeping the carrying costs applicable to the PPFAC at the one-year constant maturities rate is artificially low; it does not accurately reflect the cost UNS Electric incurs for any under-collected balance on the PPFAC.[307] Consequently, with the higher LIBOR rate, customers would get a greater benefit for any over-collected balance. For these reasons, the Commission should approve the Company's proposal to use the 3-month LIBOR rate plus 1.0%, and to reset the rate monthly.

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[305] Ex. UNSE-19 (Erdwurm Rebuttal) at 11; Ex. UNSE-20 (Erdwurm Rejoinder) at 8.
[306] Ex. UNSE-12 (Grant Direct) at 21.
[307] Ex. UNSE-12 (Grant Direct) at 21.

B. Wholesale Credit Support Costs are necessary costs that should be recovered through the PPFAC or base rates.

UNS Electric originally requested recovery of these costs through the PPFAC.[308] The Company still believes that due to the highly-variable nature of these costs the best place to recover them is through the PPFAC.[309] As an alternative, however, the Company proposed an adjustment to its test-year level of operating expenses to recover $195,500 of these costs through base rates.[310] Recovering these costs through base rates is in accordance with what Commission Staff witness Dr. Fish suggested in his Direct Testimony.[311]

No Party disputes that wholesale credit support costs are necessary costs to finance under-collections of fuel and purchased power.[312] Commission Staff implies, however, that these costs are already included in the Company's Direct filing. But this is not the case. As Mr. Grant explained during the evidentiary hearing, these costs would be recorded as letters of credit or short-term borrowing costs that would be in the interest expense section of the Company's income statement.[313] Interest expense is typically recovered through the weighted cost of debt – but it was not included in UNS Electric's cost of debt here. To the contrary, only the costs related to long-term debt and perhaps some revolving credit facility commitment costs were included.[314] If the Commission determines that these costs should not be recovered through the PPFAC, an adjustment of $195,500 to recover these necessary costs through base rates is appropriate.

C. RUCO's 90/10 sharing mechanism should be rejected.

RUCO proposed a 90/10 sharing mechanism for the PPFAC, but provided no detail on how the mechanism would operate.[315] And even though the Commission rejected such a proposal in

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[308] Ex. UNSE-12 (Grant Direct) at 24.
[309] Ex. UNSE-12 (Grant Direct) at 24; Tr. (Grant) at 201.
[310] Ex. UNSE-13 (Grant Rebuttal) at 26-28.
[311] Ex. S-9 (Fish Direct) at 48-49.
[312] See Ex. UNSE-12 (Grant Direct) at 22 and Ex. KCG-4.
[313] Tr. (Grant) at 202.
[314] Tr. (Grant) at 203.
[315] See Ex. RUCO-6 (Johnson Direct) at 44.

the previous UNS Electric rate case,[316] RUCO failed to provide a rationale for why the mechanism would now be appropriate.

The sharing mechanism is problematic because it can act adversely to customers' interests. For example, on June 1, 2009, UNS Electric's PPFAC rate decreased by about 22% - this is due to the significantly lower fuel and purchased power costs that UNS Electric was able to procure. If a 90/10 sharing mechanism were in place, customers would have received less of a decrease than was actually obtained. Preventing customers from sharing in decreases like the one described above can be harmful because the Company has every incentive to procure the most economical sources of fuel and purchased power available regardless of sharing mechanisms. The presence of a sharing mechanism does not enable the Company to obtain cheaper fuel or purchased power, but it can prevent the customer from sharing in a good deal. For the same reasons that the 90/10 sharing mechanism was rejected in UNS Electric's last rate case, RUCO's proposal should be rejected in this case.

XII. MISCELLANEOUS ISSUES.

A. Rules and Regulations.

In its Direct filing, the Company proposed several minor revisions to its Rules and Regulations. These included formal approval of the Company's updated line extension policies, which were submitted in compliance with Decision No. 70360. On October 7, 2009, the Commission approved the updated line extension policy in Decision No. 71285. That updated policy eliminated the free footage allowance for distribution line extensions and required the customer to pay for all construction costs as contributions in aid of construction.[317]

Most of the changes the Company proposed in its Direct filing were non-substantive. There were, however, a few that were substantive. While Commission Staff had no issues with, for example, adding language to Subsection 11.E. to clarify its meter error corrections policy, Commission Staff did express concerns about other proposed changes from the Company. Upon

[316] Decision No. 70360 at 72.
[317] Ex. UNSE-8 (McKenna Direct) at 11.

further review, and through subsequent filings, the Company withdrew all of the proposals Commission Staff expressed concerns about. In short, the Company accepted all of Commission Staff's recommendations and withdrew the proposed changes that Commission Staff opposed. With regards to the Rules and Regulations, there are no remaining disputes between the Parties.

B. Engineering issues.

In his Direct Testimony, Commission Staff witness Lewis set forth six engineering recommendations.[318] UNS Electric has agreed to four of the recommendations and is in general agreement with another. The disputed recommendation (Commission Staff's first recommendation) involves preparing a list of worst performing circuits, which would require the Company to incur significant expense to develop the necessary underlying information on circuits in Mohave County. As Mr. McKenna testified, the Company believes this is too costly to implement and unnecessary given other reliability reporting.[319]

Commission Staff's second recommendation is that the Company include in rate base all completed and used and useful plant at the end of the test year.[320] UNS Electric has done so in this case.

Commission Staff's third recommendation simply indicates that Mr. Lewis believes that BMGS will be back to full operational levels once the repairs are made.[321] As mentioned previously, BMGS is operating at full capacity.

Commission Staff's fourth recommendation is that if and when UNS Electric acquires BMGS, any repair costs not covered by warranty should be borne by UED.[322] UNS Electric agrees with that recommendation.

Commission Staff's fifth recommendation is that UNS Electric should demonstrate sufficient water availability for the operations of BMGS.[323] UNS Electric did provide information

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[318] Ex. S-7 (Lewis Direct) at 31-32.
[319] Tr. (McKenna) at 110-12; Ex. UNSE-10 (McKenna Rejoinder) at 4.
[320] Ex. S-7 (Lewis Direct) at 32.
[321] Ex. S-7 (Lewis Direct) at 32.
[322] Ex. S-7 (Lewis Direct) at 32.
[323] Ex. S-7 (Lewis Direct) at 32.

on water availability in its Rebuttal filing,[324] and Commission Staff is satisfied with that information with respect to raw water availability.[325]

Commission Staff's sixth recommendation is that UNS Electric should include thermal scanning of the BMGS substation and connected lines on a regular basis if UNS Electric acquires BMGS.[326] UNS Electric agrees to appropriate thermal scanning of the BMGS substation.[327] However, thermal scanning is a costly procedure that requires specially trained personnel and the Company should be allowed to determine the appropriate timing of the thermal scans consistent with sound operational practices.[328]

Finally, Commission Staff recommends that the Company submit an annual list of worst performing circuits.[329] As explained by Mr. McKenna, such a requirement is unnecessary given the Company's current system reliability monitoring and maintenance.[330] Listing "worst performing circuits" effectively duplicates the Company's current reliability monitoring and really does not incorporate other important reliability considerations such as the number of customers affected or the cost of maintenance, repair or upgrade for a particular circuit.[331] UNS Electric already tracks and reviews circuit and lateral performance through its daily Trouble Tickets and Outage Reports, which not only identify outages and the number of outages, but is also used to identify voltage issues, equipment or facility problems.[332] The Company also collects System Average Interruption Frequency Index ("SAIFI") data and Customer Average Interruption Duration Index ("CAIDI") data on a regular basis.[333] That data is reviewed for operational and reliability issues and is submitted to the Commission.[334] These indices provide additional data

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[324] Ex. UNSE-9 (McKenna Rebuttal) at 6 and Ex. TAM-4 thereto.
[325] Tr. (Lewis) at 433.
[326] Ex. S-7 (Lewis Direct) at 32; Tr. (Lewis) at 433.
[327] Ex. UNSE-10 (McKenna Rejoinder) at 3.
[328] Ex. UNSE-10 (McKenna Rejoinder) at 3-4; Tr. (McKenna) at 124.
[329] Ex. S-7 (Lewis Direct) at 31.
[330] Ex. UNSE-10 (McKenna Rejoinder) at 4.
[331] Ex. UNSE-10 (McKenna Rejoinder) at 4.
[332] Ex. UNSE-10 (McKenna Rejoinder) at 4.
[333] Ex. UNSE-10 (McKenna Rejoinder) at 4.
[334] Ex. UNSE-10 (McKenna Rejoinder) at 4.

regarding the reliability of the UNS Electric distribution system, and are used in evaluations of needed repairs and upgrades.[335]

Not only is the "worst circuit" report unnecessary and potentially ineffective for cost-effective system reliability, the Company would have to incur significant upfront costs to develop a circuit data base for Mohave County.[336] The prior owner of the system did not keep detailed records on its distribution network and developing the detailed records on such elements as number of customers per feeder would be costly.[337] Moreover, some of the potential circuit problems are directly affected by the Western Area Power Association ("WAPA") system causing disturbances in the UNS Electric distribution; this would not be alleviated by upgrading the physical UNS Electric circuit.[338]

UNS Electric believes that current reliability reporting is the most cost-effective and efficient approach for evaluating system reliability. An annual "worst circuit" report would be costly, unnecessary and potentially unhelpful in improving reliability. Therefore, the Commission should not adopt Commission Staff's "worst circuit" report recommendation.

C. Power and fuel procurement issues.

Commission Staff consultants conducted a prudence review of UNS Electric's Fuel and Purchased Power policies.[339] Commission Staff's consultant, Dr. Fish, concluded that the organization, staffing and controls function of the Company's PPFAC policy are reasonable and operate as intended.[340] Dr. Fish also found that the Company's Fuel and Purchased Power policies were sound.[341] However, Dr. Fish did make four recommendations regarding those policies.[342]

Dr. Fish's first recommendation was "to strengthen the relationship between fuel contract management and procurement." However, Dr. Fish does not set forth any particular guidance on

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[335] Ex. UNSE-10 (McKenna Rejoinder) at 4.
[336] Tr. (McKenna) at 110-11.
[337] Tr. (McKenna) at 110-11.
[338] Tr. (McKenna) at 111-12.
[339] Ex. S-9 (Fish Direct) at 56.
[340] Ex. S-9 (Fish Direct) at 60.
[341] See Ex. S-9 (Fish Direct) at 68-69.
[342] Ex. S-9 (Fish Direct) at 69.

what should be strengthened. Indeed, Dr. Fish noted in his Surrebuttal Testimony that he had not identified "any specific problems as a result of [his] analysis" but that a periodic connection of the procurement process and the source agreement could strengthen this area.[343] Without having any specific problems to address, it is difficult to know what should be done and whether it would be beneficial or cost-effective.

Dr. Fish's second recommendation was to create internal auditing procedures for contract management and procurement. Although UNS Electric's internal audit department did not perform such an audit for the test-year period, the Company employs other auditing procedures to ensure appropriate oversight of the power and fuel procurement processes.[344] Again, without having specific problems identified, it is difficult to determine what needs to be audited. It is also difficult to tell if Dr. Fish's audit procedure would be an improvement on current audit practices or whether such audits would be cost-effective.

Dr. Fish's third recommendation was to potentially extend the interstate pipeline capacity optimization done by UNS Gas to UNS Electric. However, UNS Electric does not have any interstate pipeline capacity and therefore could not engage in such an optimization.[345]

Dr. Fish's fourth recommendation was that hedging for gas procurement for August, September and October (hurricane season) should be considered but not required. In fact, Section 2.2.3 of UNS Electric's hedging policy specifically states that hedging is not required but should be considered during these three months[346] – which comports with Dr. Fish's recommendation.

D. ASBA and AASBO issues.

The Arizona School Board Association ("ASBA") and the Arizona Association of School Business Officials ("AASBO") submitted testimony in this case regarding potential school-specific renewable programs, energy efficiency programs and TOU rates. During the hearing, the ASBA/AASBO clarified that they would like to see: (1) UNS Electric develop a schools program

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[343] Ex. S-11 (Fish Surrebuttal) at 6-7.
[344] Ex. UNSE-4 (DeConcini Rebuttal) at 12.
[345] See Ex. UNSE-4 (DeConcini Rebuttal) at 12; Tr. (DeConcini) at 72-73.
[346] Ex. UNSE-4 (DeConcini Rebuttal) at 12.

for inclusion in UNS Electric's Renewable Energy Implementation Plan; (2) UNS Electric develop a school-specific energy efficiency program for filing in the Company's DSM docket; and (3) UNS Electric work with the school districts to develop a Time-of-Use rate for filing either later or in connection with the next rate case.[347]

UNS Electric has worked with the schools in its service area and remains committed to working with the schools on the issues identified by ASBA/AASBO.[348] UNS Electric does not believe there is sufficient information in the record to allow the Commission to adopt any specific programs for the schools in this docket. However, UNS Electric will continue to work with the schools to: (1) develop a school-specific renewable program for its next Renewable Energy Implementation Plan; (2) develop a school-specific energy efficiency plan; and (3) discuss a school-specific TOU tariff that could be included in UNS Electric's next rate case.

XIII. INVESTMENT RECOVERY MECHANISM PROPOSALS.

A. Renewable generation ownership plan.

During the hearing in this docket, UNS Electric was requested to present a proposal for the recovery of utility investment in renewable generation resources. In response, UNS Electric submitted a "Renewable Generation Ownership Plan" (the "Plan").[349] Under the Plan, the Company would be authorized to: (1) invest up to $5 million of capital each year to develop Renewable Technologies (as defined in the Renewable Energy Standard Tariff ("REST")) and (2) recover the revenue requirement resulting from the Renewable Generation Ownership Plan through the REST adjustor mechanism.[350] The revenue requirement includes depreciation, property taxes, income taxes, operating and maintenance expense and carrying costs using the authorized weighted average cost of capital, and would be recovered through the REST adjustor mechanism until the investment is included in base rates in the Company's next rate case.[351] The Company is not requesting funding for Plan projects in this case. Rather, specific projects

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[347] Tr. at 406-07.
[348] Ex. UNSE-5 (DeConcini Rejoinder) at 4.
[349] Ex. UNSE-28 (Renewable Generation Ownership Plan).
[350] Ex. UNSE-28 at 1.
[351] Ex. UNSE-28 at 1.

pursuant to this Plan will be identified and presented in the UNS Electric 2011 REST Implementation Plan and will be integrated with the Company's "Community Renewable Program."[352] This Plan will aid the Company in its efforts to diversify its renewable portfolio and meet the REST requirements of 15% retail sales from renewable resources by 2025.

UNS Electric requests that the Commission approve the Renewable Generation Ownership Plan in this case. The Plan will increase both the pace and the viability of cost-effective renewable energy development in Arizona.[353] The Plan acts as a financial bridge to allow the Company to recover costs until it can include projects in rate base, at which time the costs will be recovered through rates and not the REST adjustor. This approach allows REST funds to be used more efficiently for utility-scale projects because the full cost of the projects would not be recovered from the REST, just the carrying costs until the next rate case.[354] The proposed recovery mechanism – through the REST adjustor – is similar to the recovery mechanism that was recently approved for Arizona Public Service's AZ Sun Program.[355]

B. Demand side management and energy efficiency ownership.

During the hearing, UNS Electric was also requested to propose a mechanism to recover utility investment in demand side management and energy efficiency projects. At the hearing, UNS Electric committed to submit a plan whereby the Company's demand side management and energy efficiency investments will be recovered in a form similar to its Renewable Generation Ownership Plan.[356] The Company intends to file its Demand Side Management and Energy Efficiency Ownership Plan as part of its Energy Efficiency Implementation Plan, which will be filed in connection with the Commission's Energy Efficiency Rules.[357]

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[352] Ex. UNSE-28 at 1.
[353] Tr. (Hutchens) at 522.
[354] Tr. (Hutchens) at 544.
[355] Decision No. 71502 (March 17, 2010); see Tr. (Hutchens) at 530.
[356] Ex. UNSE-28 at 2.
[357] Ex. UNSE-28 at 2.

XIV. CONCLUSION.

UNS Electric respectfully requests that the Commission issue a final order:

(1) granting the Company the permanent rate increase sought herein;

(2) approving the new or modified rate and service schedules with an effective date no later than June 1, 2010;

(3) approving the proposed rate design;

(4) authorizing UNS Electric's depreciation rate update;

(5) approving UNS Electric's revised Rules and Regulations;

(6) approving the requested modifications to the PPFAC effective as of June 1, 2010;

(7) approving UNS Electric's proposed rate base adjustment and rate reclassification with respect to the proposed acquisition of the Black Mountain Generating Station;

(8) approving the proposed Renewable Generation Ownership Plan; and

(9) granting the Company such additional relief as the Commission deems just and proper.

RESPECTFULLY SUBMITTED this 23rd day of March 2010.

UNS Electric, Inc.

By _____

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APPENDIX

"A"

MATRIX OF MAJOR ISSUES
UNS ELECTRIC, INC.
RATE CASE – DOCKET NO. E-04204A-09-0206

ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
SUMMARY[2]				
Adjusted Original Cost Rate Base	$237,071,572	$168,494,274	$229,945,361	
Weighted Average Cost of Capital	9.04%	8.40%	8.06%	
Required Operating Income	$23,741,671	$15,503,769	$19,112,757	
Adjusted Operating Income	$15,491,350	$10,871,910	$16,297,948	
Fair Value Operating Income Deficiency	$8,250,321	$4,631,859	$2,814,809	
Gross Revenue Conversion Factor	1.6363	1.6363	1.6363	
Increase in Gross Revenue Requirement	$13,500,000	$7,579,110	$4,605,871	
COST OF CAPITAL				
Capital Structure	Debt 54.24% Equity 45.76%	No Dispute	No Dispute	
Cost of Equity	11.40%	10.0%	9.25%	
Cost of Debt	7.05%	No Dispute	No Dispute	

[1] Each of the adjustments are adjustments to the Company's unadjusted test year levels.
[2] Adjusted OCRB, Required Operating Income and Adjusted Operating Income figures include Black Mountain Generating Station ("BMGS").

MATRIX OF MAJOR ISSUES
UNS ELECTRIC, INC.
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ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
Fair Value Rate of Return	6.83% excluding BMGS & 7.24% *including BMGS* With Staff and/or RUCO adjustments – a FV ROR as determined using the method the Commission approved in Decision No. 71308 (October 21, 2009) or the method the Commission approved in Decision No. 70441 (July 28, 2008).	6.01%	5.39% to 7.01% with a *midpoint of 6.20% and an* average of 6.25%. RUCO's Method 1 FVROR equals 5.96%.	
RATE BASE				
Original Cost Rate Base-Unadjusted	$164,679,539	$164,679,539	$164,679,539	
RATE BASE ADJUSTMENTS				
Acquisition Discount Adjustment (UNSE)	$8,355,383	No Dispute	No Dispute	
Post-Test Year Non-Revenue Plant in Service (UNSE)	$7,263,614	Disallowed	Disallowed	
Accumulated Deferred Income Taxes (UNSE)	($684,777)	No Dispute	No Dispute	
Working Capital (UNSE)	($3,925,045)	($3,733,821) Related to other adjustments.	No Dispute. Not revised from direct testimony for surrebuttal *pro forma* changes	
BMGS Plant in Service (UNSE)	$61,970,352	Disallowed	No Dispute	

MATRIX OF MAJOR ISSUES
UNS ELECTRIC, INC.
RATE CASE – DOCKET NO. E-04204A-09-0206

ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
BMGS Working Capital (UNSE)	($587,494)	Disallowed	($580,420). RUCO did not *know about the BMGS* property tax pro forma omitted from UNSE rebuttal but included in rejoinder and so did not revise BMGS cash working capital for surrebuttal.	
RCND - Adjusted	$418,548,539	$347,282,633	$411,422,319	
OPERATING INCOME				
Original Operating Income - Unadjusted	$9,786,382	$9,786,382	$9,786,382	
Operating Revenue Adjustments				
Retail Revenue & Purchased Power Annualization (UNSE)	$10,733,456	No Dispute	No Dispute	
Wholesale Revenue & Purchased Power (UNSE)	($10,168,115)	No Dispute	No Dispute	
Weather Normalization (UNSE)	($1,017,300)	No Dispute	No Dispute	
Customer Energy & Demand Normalization (UNSE)	($2,820,565)	No Dispute	No Dispute	
Fuel & PPFAC Revenue & Expense Normalization (UNSE)	($29,192,263)	No Dispute	No Dispute	
CARES Discounts (UNSE)	($61,797)	Disallowed	No Dispute	
DSM & Renewables Revenue & Expense (UNSE)	($1,458,039)	No Dispute	No Dispute	

MATRIX OF MAJOR ISSUES
UNS ELECTRIC, INC.
RATE CASE – DOCKET NO. E-04204A-09-0206

ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
Operating Expense Adjustments				
Retail Revenue & Purchased Power Annualization (UNSE)	($956,469)	No Dispute	No Dispute	
Wholesale Revenue & Purchased Power (UNSE)	($10,168,115)	No Dispute	No Dispute	
Weather Normalization (UNSE)	($830,613)	No Dispute	No Dispute	
Customer Energy & Demand Normalization (UNSE)	($1,079,814)	No Dispute	No Dispute	
Fuel & PPFAC Revenue & Expense Normalization (UNSE)	($19,024,147)	No Dispute	No Dispute	
DSM & Renewables Revenue & Expense (UNSE)	($1,626,826)	No Dispute	No Dispute	
Payroll Expense (UNSE)	$220,252	No Dispute	$79,628 RUCO disallowed the increase for the expected 3% wage increase for 2010.	
Payroll Tax Expense (UNSE)	$55,054	No Dispute	$35,430 RUCO adjusted payroll tax expense related to the disallowed 2010 payroll expense increase.	
Pension and Benefits (UNSE)	$210,866	No Dispute	No Dispute	
Post Retirement Medical (UNSE)	$161,929	No Dispute	No Dispute	
Rate Case Expense (UNSE)	$138,890	$72,223 Staff disallowed $200,000 of the $500,000 proposed test year rate case expense.	$72,223 RUCO disallowed $200,000 of the $500,000 proposed test year rate case expense.	

MATRIX OF MAJOR ISSUES
UNS ELECTRIC, INC.
RATE CASE – DOCKET NO. E-04204A-09-0206

ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
Bad Debt Expense (UNSE)	($436,441)	($330,954) Advocates that 3-year bad debt ratio should be multiplied by gross retail revenues and that value subtracted from actual bad debt expense to derive normalized bad debt pro forma adjustment. States that adjustment equals $105,487. Disputes Company characterization. Staff corrected what it believe to be was the Company's mismatch of gross and net revenue and proposing an increase rather than the incorrect decrease in revenue requirement associated with bad debt expense.	No Dispute	
Interest on Customer Deposits (UNSE)	($145,701)	No Dispute	No Dispute	
Workers Compensation (UNSE)	($115,528)	No Dispute	No Dispute	

MATRIX OF MAJOR ISSUES
UNS ELECTRIC, INC.
RATE CASE – DOCKET NO. E-04204A-09-0206

ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
Miscellaneous Expenses – Other including Industry Association Dues (UNSE, Staff & RUCO)	($451,888) Believes Staff applied the percentage to total dues per FERC Form 1 and incorrectly did not include amounts for the EEI dues expense that UNSE added to test year expense (in addition to the FERC Form 1 amount). Further believes that Staff Surrebuttal corrected industry association dues as filed in their direct testimony based on UNSE rebuttal. Still disputes Staff adjustment of $4,763.	($456,651) Staff reduced industry association dues by 49.93% as approved by the ACC in Decision No. 70360 in the prior rate case. Staff adjustment was reduced to $4,763 in Surrebuttal. Staff believes that, subsequent to the filing of the Surrebuttal testimony, the Company announced that it had erred and had not actually incurred any EEI expenses	($484,460) RUCO disallowed 40% of the $12,800 of the total EEI dues as presented in the original UNSE pro forma adjustment (UNSE added $11,172 of the EEI dues to the test year). RUCO also reduced the UNSE pro forma for postage expense by disallowing the May 2009 postage increase as being too far outside of the test year.	
Miscellaneous Expenses – Outside Legal (UNSE, Staff & RUCO)	$109,434	$82,075 In Direct, Staff reduced outside legal expenses. Staff removed $180,906 for 2007 from the calculation and used $28,830 from 2008 to calculate its 3-year average. In Surrebuttal, recommended that Commission consider a four-year normalization period including all values from 2005 through 2008. Reduced adjustment from $58,722 to $27,359.	$76,503 RUCO reduced outside legal expense to reflect a 3-year average expense based on 2006, 2007 and 2008.	

MATRIX OF MAJOR ISSUES
UNS ELECTRIC, INC.
RATE CASE – DOCKET NO. E-04204A-09-0206

ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
A&G Expense Capitalized (UNSE)	($229,429)	No Dispute	No Dispute	
Depreciation & Property Tax - Post Test Year Non-Rev Plant in Service(UNSE)	$442,526	Disallowed	Disallowed	
Depreciation & Amortization Expense Annualization (UNSE)	($507,792)	No Dispute	No Dispute	
Property Tax Expense (UNSE & Staff)	$105,181	($7,358). Staff did not revise property tax expense to follow UNSE rebuttal testimony.	($7,358). RUCO revised property tax expense to follow UNSE direct testimony.	
Wholesale Credit Support (UNSE)	$195,500	Not Addressed	Not Addressed	
Fleet Fuel Expense (UNSE & Staff)	($56,333) UNSE added a pro forma adjustment to reduce test year expense to reflect the average fuel cost based on data from 2007 through October 2009.	($75,798) Staff reduced test year expense for lower average gasoline & diesel fuel prices based on 2009 fuel price data.	Not Addressed	
Incentive Compensation - PEP (Staff)		($132,159) Staff disallowed 50% of incentive compensation expense in accordance with ACC Decision No. 70360 in the prior UNSE rate case.	RUCO disallowed 100% of stock-based compensation and disallowed 50% of incentive compensation expenses.	
Payroll Tax Expense: Incentive Compensation - PEP (Staff)		($10,110) Staff reduced payroll tax expense related to the disallowed incentive compensation expense.	RUCO reduced payroll tax expense related to the disallowed incentive compensation expense.	

MATRIX OF MAJOR ISSUES
UNS ELECTRIC, INC.
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ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
Incentive Compensation - SERP (Staff)		($102,142) Staff disallowed 100% of SERP expense in accordance with ACC Decision No. 70360 in the prior UNSE rate case.	($102,142) RUCO disallowed 100% of SERP expense in accordance with Decision No. 70360 in the prior UNSE rate case.	
Call Center Expense (Staff)		($99,476) Staff disallowed the increase in call center expense over the amount presented in the UNSE prior rate case, citing a decrease in call center call volume. Staff further adjusted their pro forma adjustment in Surrebuttal.	Not Addressed	
Synchronized Interest (RUCO)	Included with current income tax adjustment.	Included with current income tax adjustment	$52,172	
BMGS PPA Adjustment (UNSE)	($10,960,779)	Disallowed	No dispute	
BMGS O&M Expense (UNSE)	$1,158,464	Disallowed	No dispute	
BMGS Depreciation & Amortization Annualization Expense (UNSE)	$1,649,496	Disallowed	No dispute	
BMGS Property Tax Expense (UNSE & Staff)	$434,148 In rejoinder, UNSE revised BMGS property tax expense for a revision in the assessment ratio that was omitted from rebuttal.	Disallowed	$419,305 In rejoinder, UNSE revised BMGS property tax expense for a revision in the assessment ratio that was omitted from rebuttal. Surrebuttal - RUCO agreed with UNSE rebuttal testimony and revised their pro forma to match UNSE rebuttal for the base case, but not for BMGS due to timing.	

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UNS ELECTRIC, INC.
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ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
Income Tax - Base Case (UNSE, Staff & RUCO)	($55,652) Related to other adjustments.	$88,329 Related to other adjustments.	$39,582 Related to other adjustments.	
Income Tax - BMGS (UNSE & Staff)	$2,074,196	Disallowed	$2,079,821. RUCO did not know about the BMGS property tax pro forma omitted from UNSE rebuttal but included in rejoinder and so did not revise BMGS income tax expense for surrebuttal.	
RATE DESIGN				
Monthly Customer Charge	$8.00 per month per residential customer (standard and TOU)	No Dispute	$5.00 per month per residential customer	N/A
Allocation of Revenue Increase	Equal percentage increase (9.21%) except CARES customers (9.41% decrease)	Agree with constant increase per customer class (5.13%) except for CARES (5.19% decrease).	Varying percentage increases by rate class (Company does not oppose so long as maximum is no more than 200% of system average percentage increase)	N/A
OTHER ISSUES				
PPFAC – 90/10 sharing mechanism.	Opposes 90/10 sharing mechanism.		Recommends 90/10 sharing mechanism as an incentive for aggressive controlling of fuel and purchased power costs / manage it power and fuel acquisition process as efficiently as possible.	

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ISSUE[1]	UNS ELECTRIC	STAFF	RUCO	AZ SCHOOL BDS
Rules & Regulations (UNSE)	No opposition to Staff recommendations	Recommends (1) itemization of line extension costs; (2) clarification of language in Subsection 9.D.; (3) waiver of A.A.C. R14-2-207 (Rozen).	N/A	N/A
Proposed Additional Charges in Rules and Regulations	None	No Dispute	No Dispute	N/A
Independent Fuel and Purchase Power Audit	Unclear as to what specific problems warrant an audit.	Proposes Audit	N/A	N/A
Listing Worst Performing Distribution Circuits in Annual Report	Requirement for listing is unnecessary given UNS Electric's current system reliability monitoring and maintenance.	Recommends Listing (Lewis)	N/A	N/A
Thermal Scanning	No opposition to scanning. The Company should be allowed to determine appropriate timing of any scans.	Recommends Scanning (Lewis)	N/A	N/A
School Programs for Energy Efficiency, TOU, Renewables.	Willing to work with ASBA and AASBO to discuss and develop programs but notes different circumstances than with the APS rate settlement.	N/A	N/A	Recommends (1) proposal before UNS Electric 2011 REST Plan is due; (2) Energy Efficiency for Schools including financing; (3) School TOU rate within 60 days of effective date of an order.