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BEFORE THE ARIZONA CORPORATION COMMISSION

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8 IN THE MATTER OF THE APPLICATION OF
9 UNS ELECTRIC, INC. FOR THE
10 ESTABLISHMENT OF JUST AND
11 REASONABLE RATES AND CHARGES
12 DESIGNED TO REALIZE A REASONABLE
13 RATE OF RETURN ON THE FAIR VALUE
14 OF THE PROPERTIES OF UNS ELECTRIC,
15 INC. DEVOTED TO ITS OPERATIONS
16 THROUGHOUT THE STATE OF ARIZONA.

Docket No. E-04204A-09-0206

Arizona Corporation Commission

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17 **RESIDENTIAL UTILITY CONSUMER OFFICE'S ("RUCO")**
18 **REPLY BRIEF**

19 The Residential Utility Consumer Office ("RUCO") hereby submits its Reply Brief on the
20 matters raised in UNS Electric, Inc.'s ("UNSE" or "Company") recent rate hearing.

21 **I. CONTESTED RATE BASE ISSUES**

22 **Plant-In-Service**

23 **Black Mountain Generation Station ("BMGS")**

24 Staff presents several arguments in support of its recommendation that the Commission should deny the Company's request to include BMGS in rate base. RUCO agrees that BMGS is not owned by UNSE at this time. Staff Brief at 5. This is Staff's main argument and the

1 argument from which all its other arguments flow. It is also a fact that is not disputed.
2 Furthermore, RUCO does not take issue with the fact that neither Staff nor RUCO did a
3 prudency review or that Staff did not do an analysis to determine if BMGS is used and useful.
4 Staff Brief at 6-7. But these facts do not support adoption of Staff's position, because in the
5 absence of Commission approval the Company will not acquire BMGS, the Company will
6 continue to purchase BMSG' entire output, and it will be the ratepayers who will be the losers.
7 UNSE-13 at 5. As discussed in RUCO's Opening Brief, approval of BMGS into UNSE's rate
8 base benefits ratepayers because of stability, diversity and location. RUCO Brief at 5-8.
9 Rate base treatment of BMGS is also revenue neutral. Transcript at 154. Acquisition results
10 in a cost shift. Now, ratepayers pay for the electricity purchased from BMGS in the Company's
11 adjuster mechanism. Upon acquisition, those costs will move over to the non fuel base rates.
12 Id.

13 Commissioner Mundell used to say that the Commission is not a bunch of "bean
14 counters" acting as a rubber stamp. Commissioner Mundell is right and the Commission
15 needs to exercise its discretion here because a strict interpretation to regulatory principles
16 would not only be against the ratepayers best interests but the shareholders also. The
17 Company has made it clear that "Absent a post-test year adjustment to rate base and the
18 proposed revenue-neutral rate reclassification, an acquisition of the BMGS is simply not
19 feasible from a financial perspective." UNSE-13 at 15. The Company's point is well taken and
20 persuasive – as of December 31, 2008, the Company's total capitalization was \$192 million.
21 UNSE-3 at 15. This is what makes this situation unique - the Company is simply not in a
22 position to acquire a \$62 million asset without a "...commensurate increase in earnings and
23 cash flow." Id.

24 Staff next argues that not all of the facts are known regarding the purchase and there is
no guarantee that if the Company gets approval that it will ever purchases BMGS. These
arguments are also unpersuasive. These obstacles served as the basis for denial of the

1 Company's request in the Company's last rate case and have since been cured. There is no
2 dispute that the plant is built and is operational. BMGS entered service on May 30, 2008.
3 UNSE-8 at 13. Both its construction and operational costs are known. Id. at 16. The
4 Company is asking for a post-test adjustment of \$62 million (the cost of the plant) and a
5 reclassification of rates. The \$62 million request, according to the Company represents the
6 original cost of the plant net of depreciation as of the end of the test year. UNSE-12 at 8.

7 Staff further complains that the BMGS was not fully functional at the time of the
8 hearing. Staff Brief at 7. Staff is referring to one of the turbines that was not operational at
9 the time of the hearing. However, the Company, at the hearing avowed that the turbine was
10 being repaired and was due back in service in mid-February. Transcript at 102. The
11 Company, in its Closing Brief, claims that the turbine was placed back in service in mid-
12 February and is fully operational. Company Brief at 13. The Commission has a full record
13 which contains all of the necessary, material and relevant facts to support approval of rate
14 base treatment at this time.

15 The argument that the Company may not purchase BMSG if given pre-approval
16 treatment is a red herring. The Company acknowledges that "the requested rate base
17 treatment and rate reclassification will not occur until *after* UNS Electric acquires BMGS."
18 Company Brief at 10. This is RUCO's understanding of how it will work. Therefore, if the
19 Company does not purchase BMGS as is Staff's concern, it will not be able to rate base it.
20 While that would be unfortunate for ratepayers, the plant would not be in rate base and the
21 Company would not be earning a return on the plant. Again, these arguments are not
22 persuasive and should not serve as the basis for denying a great opportunity for ratepayers.
23 The Company still needs to get FERC approval to purchase BMSG. UNSE-12 at 12.

24

1 Furthermore, after the Company gets FERC approval, and upon completion of the purchase,
2 the Company will contact Staff. Id.

3 Finally, Staff concludes that the financial circumstances do not preclude the Company
4 from purchasing BMGS based on several comments of Dr. Parcell which by no means indicate
5 that the Company is in the financial position to acquire BMGS. Staff Brief at 6. The fact is that
6 Commission's prior rate case decision allowing the Company to defer its costs, while
7 generous, has done nothing to provide the Company with sufficient cash flow relief to cover the
8 interim cash costs that the Company would incur to finance the BMGS acquisition. UNSE-13
9 at 5. Neither the financing approval nor the accounting order the Commission granted in the
10 Company's last rate case (Decision No. 70360) will allow the Company the ability to operate
11 and cover its interim cash costs that the Company would incur to finance the BMGS
12 acquisition. UNSE-3 at 15. Like it or not, this is the financial reality the Company faces and
13 the reason why the Company has not acquired BMGS since the last rate case. The reason for
14 the favorable treatment in the last case was to encourage the Company to acquire the plant. If
15 the Commission is serious about encouraging the Company to acquire the plant it needs to be
16 realistic and pre-approve the rate base treatment because of the circumstances of UNSE's
situation.

17 **Post-Test-Year Non-Revenue Plant in Service**

18 The Company's notion of revenue neutrality as it applies to other post-test-year plant in
19 service beyond BMGS escapes RUCO. If approved, these investments will go into rate base
20 and increase the Company's revenues. RUCO-6 at 24. The Company has not shown, as
21 even Staff points out, how these investments, which total over \$7 million, are revenue neutral.
22 Staff Brief at 3. Unlike the Company's revenue neutral proposal for BMGS, these post-test-
23 year additions add costs – they do not merely shift costs.

1 Furthermore, the Company has not reflected in its adjustment the operating efficiencies
2 or reductions to expenses that will undoubtedly occur as a result of these post-test-year
3 investments. Transcript at 313. For example, even if the plant and improvements could
4 actually be shown to be revenue neutral, the replacement of older equipment with new plant
5 could reduce the operating and maintenance expenses associated with the older equipment.

6 The Company's request here is similar to its sister company, UNS Gas, in its pending
7 rate case¹. In that case, UNS Gas proposed to include \$1,527,588 of post-test year plant in
8 rate base. UNS Gas ROO at 5. Granted the plant and improvements were different in that
9 case, Judge Node's observations on this issue are applicable:

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

22 Staff's witness, Dr. Fish, recommended that the Commission deny these post-test-year
23 additions in the subject case because of the "...small size of the investments relative to the
24 Company's rate base, the relatively non-essential, or on-going, nature of the investments, and
the lack of support for the revenue neutrality contention." Staff Brief at 3, S-9 at 12-16. The
Commission should deny the Company's request to include this post-test-year plant for all of
the above stated reasons.

¹ The UNS Gas case was decided on March 31, 2010. The Commission passed the ROO and none of the references or passages in the ROO mentioned in this Brief were changed or modified by the Commission.

1 **III. CONTESTED INCOME ADJUSTMENTS**

2 **Payroll Expense and Payroll Tax Expense**

3 RUCO incorporates its position set forth in its Closing Brief². RUCO Brief at 10-11.

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5 **Property Tax Adjustment**

6 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 11.

7 **Rate Case Expense**

8 The Company complains that RUCO and Staff's recommendations do not cover the
9 Company's actual costs or provide the Company with the ability to present its case. Company
10 Brief at 24. The standard of recovery is reasonable expense, not actual expense or the
11 amount of expense that it takes this Company to prepare its case. Moreover, where is it
12 written or said that ratepayers should bear the full cost of the Company's rate case expense?
13 RUCO is still at a loss to understand how ratepayers benefit by paying for a Company's rate
14 case expense which has at its core the sole purpose of raising ratepayer's rates. RUCO and
15 Staff's recommendations which would have the result of "leaving UNS electric with just
16 \$300,000 in rate case expense"³ are generous and the Company should not complain. Id.

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18 **Miscellaneous Expenses**

19 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 13.

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22 _____
23 ² Where RUCO's Closing Brief replies to the arguments raised in the Company's Closing Brief and RUCO has
nothing more to add or where the Company has not addressed an issue in its Closing Brief, RUCO will simply
incorporate the argument that it made in its Closing Brief as its reply.

24 ³ Emphasis added.

1 **Depreciation and Property Tax for Post-test-year non-revenue producing plant in**
2 **service.**

3 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 14.

4 **Incentive Compensation-Performance Enhancement Program ("PEP"), SERP, and**
5 **income tax related to disallowed incentive compensation.**

6 The Company claims that Staff and RUCO have not argued that incentive
7 compensation is an unreasonable or imprudent expense. Company Brief at 28. At least from
8 RUCO's perspective this is a true statement. RUCO does not argue that the expense itself is
9 unreasonable; RUCO argues that it is unreasonable for ratepayers to pay the full amount of
10 the expense. Ratepayers do derive a benefit from the expense. Likewise, shareholders
11 benefit from the incentive compensation plan. A 50/50 sharing of the incentive compensation
12 provides a balancing of the interests between ratepayers and shareholders. RUCO Brief at
13 14.

14 The Company relies on Decision No. 69663 (APS - June 28, 2007) to support its
15 position. In Decision No. 69663 the Commission allowed full recovery of the cash-based
16 incentive compensation expense for a program similar to the Company's. Company Brief at
17 28-29. The Commission, however, has decided several other cases since Decision No.
18 69663 where it has disallowed 50% of incentive pay including the Company's last rate case.
19 See Decision No. 70360 at 21 (May 27, 2008), Decision No. 70665, Southwest Gas
20 (December 24, 2008) at 16.

21 One of those Decisions included the Company's last rate case - Decision No. 70360.
22 In the Company's last rate case, the Commission made the exact same award (splitting the
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1 incentive program expense 50/50 between ratepayers and shareholders) and applied the exact
2 same reasoning (citing a prior UNS Gas rate case) regarding the incentive programs⁴.

3 Decision No. 70360 at 21. The Commission further noted "Given that the arguments
4 raised in the UNS Gas case are virtually identical to those presented in this case; we see no
5 reason to deviate from that recent Decision." *Id.* The same should hold true here.

6 This issue of incentive compensation, similar to the stock based compensation and the
7 SERP issues, has been raised by numerous utilities before this Commission for a long time.
8 As in the case here, there really are no new arguments, just a rehash of the same old
9 arguments. The Company continues to disagree in its evaluation as to who benefits from
10 incentive compensation. In the last UNS Gas rate case, the Commission determined that a 50
11 percent sharing in a similar program (the Company's Performance Enhancement Program)
12 provides a rebalancing of the interests between ratepayers and shareholders by requiring each
13 group to bear half the costs of the incentive program. Decision No. 70011 at 27.

14 Like incentive compensation, RUCO and the Company propose fundamentally different
15 approaches to determining whether the costs for stock based compensation and the
16 Company's Supplemental Executive Retirement Plan ("SERP") should be recovered from
17 customers. With stock based compensation, RUCO agrees with the logic of the Commission
18 in UNS Electric (Decision No. 70360 (May 27 2008) at 22) that the expense of providing stock
19 options and other stock based compensation beyond the normal levels of compensation
20 should be the expense of the shareholder and not the ratepayer. The Commission's logic has
21 particular application in the present economy where unemployment is high and money is tight

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23 ⁴ Presently, UNS Gas has a pending rate application. The matter is presently scheduled for the March Open
24 Meeting and a Recommended Opinion and Order ("ROO") has been issued. The ROO recommends
disallowance of UNS Gas' Officer's Long-Term Incentive Program and 100 percent of the SERP costs. UNS Gas
ROO at 20-22.

1 for most ratepayers. Ratepayers should not be shouldering extras like stock based incentives
2 beyond what is the norm.

3 Likewise, ratepayers should not be shouldering the burden of excess retirement
4 benefits to a select group of high-ranking officers in the Company. It is remarkable that the
5 Company would even request this given the current economy which shows the Company's
6 insensitivity to the current economy and its customer's needs. While SERP may be a
7 recurring expense for the Company, it is by no means a reasonable expense for ratepayer's to
8 have to pay. These same executives already have a regular retirement plan and any
9 retirement benefits beyond that should be funded by the Company's shareholders.

10 **90/10 sharing of the costs associated with purchased power and fuel**

11 The Company argues that RUCO's 90/10 sharing recommendation should be rejected
12 because it "...can act adversely to customers' interests." Company Brief at 62. RUCO
13 appreciates the Company's concerns regarding the ratepayer's best interests but respectfully
14 believes RUCO's constituency would be better served with a sharing mechanism. RUCO
15 believes that the reasons for a 90/10 mechanism for APS' Power Supply Adjuster apply
16 equally well here.

17 We believe that maintaining an incentive mechanism with the
18 opportunity for some "sharing" of the savings or costs of the purchased
19 power and fuel costs is appropriate. Although the 90/10 sharing may be
20 a "blunt instrument," apparently it did hit the mark and has worked to
21 insure that APS is diligent in its fuel procurement. "As pointed out by
RUCO, it is not a "penalty provision" but an incentive mechanism to
align APS' interest in acquiring fuel with the interests of APS' customers
who pay the costs that APS incurs.

22 Decision No. 69663 at 106-107.

1 The reality is that over time, fuel and purchased power costs tend to trend upward, not
2 downward and there is a need for the Commission to incent the Company to minimize these
3 costs.

4 **Synchronized Interest**

5 This is a corresponding adjustment to income tax to synchronize interest.

6 **IV. RATE DESIGN**

7 The Company claims that RUCO's proposed rate design, and not the Company's, works
8 against the goals of conservation and efficient use of energy. Company Brief at 55.
9 Apparently, the Company is not familiar with its own expert's testimony on the issue. By
10 comparison, a lower monthly service charge will promote greater conservation than a greater
11 monthly charge. Why? Because there is less of an incentive to conserve if one is going to pay
12 a higher amount for the same amount of service. This concept is elementary. The Company's
13 rate design expert, Bentley Erdwurm admitted as much – although noting that the difference in
14 this case is going to be "fairly trivial." Transcript at 300, RUCO-8 at 10. The Commission
15 should adopt RUCO's proposed rate design which provides for a smaller monthly service
16 charge and promotes greater conservation and energy efficiency.

17 **V. FAIR VALUE RATE OF RETURN**

18 The Company is critical of RUCO's FVROR recommendation citing as its support the
19 Commission's Decisions in the Chaparral Remand proceeding (Decision No. 70441) and the
20 recent Chaparral rate case (Decision No. 71308). Company Brief at 51. In the Chaparral
21 Remand hearing the Company claims that the Commission "expressly rejected Dr. Johnson's
22 Method 1 approach." Id. at 51. The Company is playing fast and loose with what the
23 Commission decided. First of all, the Commission in the remand proceeding determined:
24

1 Accordingly, while we find that either Staffs or RUCO's method would
2 result in a fair rate of return on FVRB, in this case we will use RUCO's
3 method, with modifications as discussed below, to reduce the inflation
4 embedded in the cost of capital in order to determine a fair return on
5 FVRB.

6 Decision No. 70441 at 34. In the remand case the Commission adopted RUCO's
7 methodology with certain modifications.

8 Second, as concerns the modifications, the Commission determined:

9 We find that the Company's proposed method inappropriately
10 allows inflation to be reflected in both the WACC and in the FVRB,
11 and that while the inflation is not necessarily "doubled," it is
12 overstated. Although we believe that the cost of debt may reflect the
13 effects of inflation, we are not convinced that the evidence presented
14 in this proceeding is developed sufficiently to make that
15 determination with certainty. Accordingly, while we agree with RUCO
16 that the WACC should be adjusted to remove the inflation
17 component, we believe that the appropriate adjustment in this case
18 is to adjust only the cost of equity component of the WACC. We also
19 believe that Staff's method is an appropriate way to adjust the
20 WACC associated with the OCRB for use with the FVRB, as it is
21 based upon sound economic and financial theory. Staffs method
22 also supports the return that we adopt.

23 Id. at 36 – 37. In other words, the Commission did not "expressly reject" RUCO's approach,
24 rather the Commission said there was not enough evidence in that record to support its full
application. Id.

Incredibly, the Company argues RUCO did not make the same recommendation in the
most recent Chaparral Decision (Decision No. 71308) and this somehow supports the
Company's position in this case. Company Brief at 51. RUCO's recommendation in the more
recent Chaparral case followed the modified version of RUCO's methodology adopted by the
Commission in the remand case. Company Brief at 51. In the more recent Chaparral case the
Commission determined:

1 Because there is an inflation component in the Company's FVRB, all
2 inflation must be removed from the rate of return, whether in debt or
3 equity.

4 Decision No. 71308 at 49. In the Chaparral case the Commission decided to apply an inflation
5 adjustment to both the debt and equity component of the WACC – exactly what RUCO is
6 recommending in the subject case! *Id.* The Commission's Decision in the more recent
7 Chaparral case supports RUCO's position in this case, not the Company's.

8 **VI. COST OF CAPITAL**

9 **Cost of Equity**

10 The Company argues that RUCO's recommended 9.25 percent cost of equity is
11 "nonsensical" when considering the current economic environment. Company Brief at 40.
12 The Company apparently believes its 11.40 percent cost of equity, a recommendation that
13 even its own witness cannot remember being equaled or exceeded by any decision of the
14 Commission in the recent past, makes sense in the current environment. Company Brief at
15 40. Again, the Company's argument defies RUCO and does not appropriately reflect the
16 current state of the economy.

17 The Company criticizes RUCO's cost of equity results for being lower than RUCO's
18 recommendation in the Company's last case, given RUCO's admission that investors are
19 becoming more risk adverse. Further, the Company, as well as Staff discounts the CAPM
20 model as being unsuited for the present financial situation. UNSE-22 at 15, S-14 at 38.

21 It is no secret or great revelation that investors are more risk adverse in a down
22 economy. As a result investors seek safer investments. Electric utilities, like UNSE
23 represent a safe investment which explains why on the whole these utilities are doing
24 relatively well. RUCO-10 at 46. The average DCF cost of equity capital of the proxy of the

1 energy utilities that RUCO's witness, William Rigsby used was 9.55%. RUCO-10, Schedule
2 WAR-2. By comparison, Mr. Rigsby's 9.25% recommendation for this Company is
3 reasonable.

4 The technical analysis that the Commission has historically followed when determining
5 cost of equity further supports Mr. Rigsby analysis and not the Company's or Staff's. Both the
6 Company and Staff want to discount heavily the CAPM results because it provides low
7 returns. With all due respect, this makes little sense. The Commission has historically relied
8 on the CAPM as it is an economic model that factors in the present state of the economy. The
9 fact that results in low returns now is indicative of the present state of the economy and should
10 not be discounted. The Commission has not disregarded the CAPM results in good times.
11 The CAPM is saying loud and clear that the Commission should reconsider what is normal
12 given the present state of the economy and adjust its cost of equity awards accordingly.

13 **VIII. CONCLUSION**

14 RUCO recommends that the Commission approve a revenue increase of no more than
15 \$4,604,908, based on the above discussion and as reflected in its final schedules. The
16 Commission should adopt RUCO's 9.25 percent return on equity and 5.96 percent FVROR.
17 Further, RUCO recommends that the Commission adopt RUCO's rate design that will reduce
18 the residential ratepayer's basic service charge from \$7.50 per month to \$5.00 per month.
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1 RESPECTFULLY SUBMITTED this 2nd day of April, 2010.

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5 Daniel W. Pozefsky
6 Chief Counsel

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