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AZ CORP 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

STAFF'S POST-HEARING REPLY BRIEF

I. INTRODUCTION.

Following is Staff's Reply to the Initial Post-Hearing Briefs filed by UNS Electric, Inc. ("UNSE", "UNS Electric" or "Company") and the Residential Utility Consumers' Office ("RUCO").

By far, the most significant issues raised in this case relate to the inclusion of the Black Mountain Generating Station, now owned by Unisource Energy Development ("UED") an affiliate of UNSE, in rate base as a post-test year adjustment, the appropriate Fair Value Rate of Return, and the appropriate Return on Equity for UNS Electric. Commission Staff's position on these issues are reasonable, in the public interest, and protect the interests of ratepayers while appropriately balancing the interests of the Company's shareholders.

II. REVENUE REQUIREMENT - RATE BASE AND OPERATING EXPENSE ADJUSTMENTS.

A. Rate Base Adjustments.

1. The Company's Request to Include Post Test Year Plant In Service in Rate Base Should be Rejected.

The Commission should deny the Company's request to include $7,263,614 of post test year plant items in rate base. A.A.C. R14-2-103(A)(3)(p) requires the Commission to use the one-year historical test period in determining rate base. However, there are of course *exceptions to this* general rule, and at times the Commission will include post-test-year plant in rate base where

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circumstances warrant.[1] But these are the exceptions, and not the rule. Here the Company has failed to provide adequate justification for inclusion of its post-test-year plant items in rate base.

The Company attempts to argue that its post test year plant should be included in rate base because, "the adjustment proposed by the Company in this case seeks only non-revenue producing post-test-year plant."[2] As in the recent UNS Gas case in Docket No. G-04204A-08-0571, the Company argues that because post-test-year plant has been included in rate base in prior Commission decisions involving water companies, it should also be included in this instance.[3] Also, as in the recent UNS Gas case, the Company attempts to argue that the Chaparral City *Decision* No. 68176 supports their argument for inclusion of post-test-year plant.[4] However, as Staff noted previously, the post-test-year plant that was included in Decision No. 68176 was completed within three months of the test year and was needed to serve existing customers.[5]

The Company also cites to Decision No. 65350 involving the Bella Vista Water Company in which post test year plant was included in rate base.[6] However, the Commission also stated in Decision No. 65350 that the Commission evaluates post test year plant inclusion on a case-by-case basis.[7] Additionally, as noted by Dr. Fish:

> Bella Vista Water Company had made a series of capital investments that were in service after the end of the test year but prior to the hearing. The investment at issue amounted to about 24 percent of rate base and was installed to enhance service to existing customers and to increase system reliability. A reason given by the Commission to allow the plant to be included in rate base was that it did not want to discourage companies from proactively addressing system reliability needs and thus incur another rate case expense. In addition, the Commission agreed with Staff that the Company had the burden to demonstrate that the post test-year plant is revenue neutral.[8]

As Dr. Fish explained, in general, where the Commission has previously allowed inclusion of post test year plant in rate base, the plant items "were especially important for the provision of safe

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1 Decision No. 65350 at 10-11.
2 UNSE *Initial Brief* at 17:17-18.
3 UNS Gas ROO Docket No. G-04204A-08-0571 at 5:25-6:5.
4 UNSE Initial Brief at 18:19-21.
5 UNS Gas ROO (Docket No. G-04204A-08-0571) at 6:24-28; Staff Initial Post-Hearing Brief in Docket No. G-04-204A-08-05741 at 3:14-26.
6 UNSE Initial Brief at 18:10-18.
7 Decision No. 65350 at 10.
8 Ex. S-9 (Fish Direct) at 13:20-14:2.

and reliable service, and factors which caused the delay in completion of plant past test year end were extraordinary."[9] In contrast to the plant items included in rate base in previous Commission determinations, the total requested post-test-year items comprise less than 4.2% of the Company's adjusted original cost rate base.[10] The Company's post test year plant items are not extraordinary, and the Company was unable to establish specifically what prevented completion of the projects within the test year.[11] Furthermore, the Company has not provided adequate support for its contention that the plant items are revenue neutral.[12]

UNSE made an almost identical request in its last rate case which the Commission rejected.[13] Its affiliate, UNS Gas ("UNSG") also made this request in its last two rate cases before the Commission and both times the request was denied.[14] The Company has not offered any support why this case is different and why different treatment should be afforded. The Commission should reject the Company's request.

2. The Company Does not Own the Black Mountain Generating Station, Significant Issues Have Not Been Addressed and Its Inclusion In Rate Base Would Once Again Be Premature.

The Company acknowledges that its request in its last rate case to include the Black Mountain Generating Station ("BMGS"), a 90 MW turbine generating facility in northern Arizona, in rate base was rejected by the Commission.[15] In that case, Unisource Energy Development ("UED") (an affiliate of UNSE) had just purchased the turbines, plant construction was not even completed, yet UNSE was asking the Commission to include it in rate base. The Commission understandably denied that request. However, the Commission in that same order took some very important steps to enable the Company to purchase BMGS if it chose to do so.

The Commission authorized UNSE to implement an accounting order to record any and all of the Company's financial activities associated with the BMGS, as if the BMGS were in rate base as of June 1, 2008 (the date the plant was expected to be operational). Unless otherwise ordered by the

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9 Ex. S-9 (Fish Direct) at 16:2-4.
10 Ex. S-9 (Fish Direct) at 16:8-9.
11 Ex. S-9 (Fish Direct) at 16:9-12.
12 Ex. S-9 (Fish Direct) at 16:22-23.
13 Decision No. 70360 at 9.
14 UNS Gas ROO (Docket No. G-04204A-08-0574) at 8; also Decision No. 70011 (UNS Gas).
15 UNSE Initial Brief at 7:19-20; Decision No. 70360.

Commission, the accounting order would remain in effect until the conclusion of UNSE's next rate case.

In addition, the Commission granted UNSE's financing request to allow it to issue up to $40 million of new debt securities, and receive up to $40 million of additional equity contributions from UniSource Energy. The Company stated at the time that the requested debt issuance would be in addition to that approved in Decision No. 69395 (March 22, 2007), and that long-term debt would be secured by the BMGS assets or other UNSE assets. The Company's witness also stated that the equity infusion would allow the Company to purchase the BMGS and provide the Company an opportunity to maintain a balanced capital structure.[16] Despite all of this, the record indicates that UNSE essentially took no steps, and has yet to take any steps, to acquire the plant.

In the last case, both RUCO and Staff opposed inclusion of the plant in rate base as premature. While RUCO agrees that it is "not the normal regulatory accounting practice to rate base plant that is not owned by the utility", it believes that an exception is warranted in this case for a number of reasons.[17] First, RUCO argues that most of the issues that were the subject of the last rate case are no longer a concern.[18] The Staff disagrees that there are no outstanding issues that need to be resolved. The capital costs associated with financing the plant are still unknown. There still has been no traditional prudence review undertaken.[19] Staff's engineering witness testified that the traditional prudence review was not possible because UNSE does not own the plant. While a cursory inspection was done, the normal prudency review typically entails much more. Staff's engineering witness Mr. Lewis testified:

> A. ... My review was at best equal to what we would call a reconnaissance mission, to just get a general handle on the level of construction and maintenance. I don't consider that proper due diligence before the purchase.
>
> Q. And what kind of an inspection would you recommend that Staff do?

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[16] Decision No. 69295 at 77.
[17] RUCO Brief at 5.
[18] RUCO Brief at 5.
[19] Tr. at 429:6-430:5.

> A. Well, I would, among other things, I would want to be, I would want to observe a full power of both units for about 24 hours. I would want to make an assessment of the control and monitoring system. I would want to take my own and analyze oil samples from the substation transformers. I would like to revisit the water system and especially the demineralization agency facility as to its reliability and mean time to repair, just in general, what you would characterize a prudence or due diligence evaluation of any power plant before I would recommend to a client that they purchase it."[20]

Normally, the plant records are also examined. In this case, they were not because the plant is still owned by UED.[21] RUCO's witness testified that a prudency review should be undertaken but that RUCO had not performed any such prudency review due to funding issues.[22] In addition, when Staff inspected the plant, Staff discovered that there was a blade failure in one of the turbines which had resulted in the turbine being nonoperational for some period of time. While the turbine is now reported to be operational, the Staff has performed no subsequent inspection to assess its performance.

RUCO is also sympathetic to the Company's argument that it does not have sufficient cash flow to purchase the BMGS, and that it risks a downgrade to noninvestment grade status if it proceeds with the purchase prior to preapproval and the rate reclassification it proposes in this case.[23] With respect to the rate reclassification, the Company has stated that inclusion of BMGS in rate base will be revenue neutral.[24] The Company concedes that because it is revenue neutral that it appears this would not help the Company finance BMGS.[25] The Company then argues that it actually would increase cash flow because that money paid to UED under its 5 year contract with UNSE would no longer have to be paid because UNSE would now own the plant.[26] However, that would be the case anyway if and when UNSE purchases BMGS. UNSE would no longer have to pay UED under the 5 year PPA for power received from BMGS. So, contrary to the Company's argument, the increase in cash flow resulting from UNSE no longer having to make a payment to UED under the PPA does not result from Commission preapproval or reclassification.

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[20] Tr. at 429.
[21] Tr. at 453:13-21.
[22] Tr. at 601:1-7.
[23] RUCO Initial Brief at 6.
[24] RUCO Initial Brief at 7; UNSE Initial Brief at 3:12-13.
[25] UNSE Brief at 9.
[26] *Id.*

Staff recognizes that part of the Company's proposal is to reclassify an amount equivalent to the payment it is passing through the PPFAC for the PPA into the Company's non-fuel base rates. Company witness Grant testified that the two are almost equivalent, and therefore the transaction would be revenue neutral to the customer. This, of course, would result in more revenue to the Company because they would be receiving an amount equivalent to the PPA passthrough without having to make the payment under the PPA anymore. Staff has not done a review of this aspect of the Company's filing (whether the revenue requirement of including the plant in base rates is essentially equivalent to the PPA passthrough) and its appropriateness because it is not recommending inclusion of the facility in base rates at this time.

Second, with respect to the downgrade from investment grade status, it was established at the hearing that these concerns are based solely upon speculation. UNSE could have, but did not, seek an opinion from the bond rating agency, Moody's, what impact the purchase of BMGS would have on the Company's bond rating.[27] A Company witness testified that UNSE could have obtained an opinion from Moody's but did not. Further, the Company could produce no statements, reports or letters by Moody's confirming this concern is actually valid.[28] Company witness DeConnini testified that because UNSE is so small and its debt is privately held, it does not typically receive ratings from Moodys; but rather requests them periodically.[29] Therefore, the Company's testimony and RUCO's regarding a likely downgrade by Moodys is merely speculation at this time.

RUCO also echoes the Company's concern that in 2008 it had completed a private placement financing transaction, had another \$40 million in debt, and \$60 million in notes all coming due.[30] However, these refinancings were all completed in August 2008.[31] The Company could have subsequently proceeded with issuing equity and/or placement of debt, or the Company could have received the same terms from its parent that UED received to finance the plant.[32] As Mr. Parcell noted, UED used credit facilities and internal cash generation of UniSource Energy and/or other

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27 Tr. at 494; 18-495:7.
28 *Id.*
29 Tr. at 52-54.
30 Tr. at 151.
31 Tr. at 161:7-17.
32 Tr. at 490:23-491:6.

affiliated companies to finance this plant.[33] The parent of UED also guaranteed these obligations. Similar terms offered to UNSE would have made the financing less risky and more palatable to investors.[34] Staff is not sure why the Company did not consider these options or why it did not consider any of the options discussed in Staff witness Parcell's testimony. For instance, Mr. Parcell also stated in addition to other options, "a potential interim source of financing the facility would be the transfer of the assets and liabilities within the UniSource framework to UNS Electric."[35]

In addition, with this case, the Company will now have received two rate increases. Certainly with this additional cash flow, the deferred accounting treatment, and the 2008 refinancings having been completed, the Company could proceed with the purchase and seek rate recognition in its next case. A significant portion of the cash flow associated with the sale will occur whether or not the Commission rate bases the BMGS in this case. The Company will no longer be paying under the PPA for purchased power.

The Company also expressed a concern at the hearing that absent preapproval it has no assurance that the Commission will authorize the sale in a subsequent case.[36] It also suggests that this would be of great concern to investors.[37] But, the Commission in its last rate order for this Company, gave the Company every incentive to purchase the plant. The Commission should continue to encourage the Company to buy the plant but[38] it should be handled in the normal fashion to permit the necessary reviews to be made.

In sum, the Company's request for rate base treatment of the BMGS is premature. Staff does not, and has never, disputed that there are benefits to ownership of BMGS by UNSE. The Commission has taken, in rare circumstances, extraordinary measures when warranted, but, in this case, the Company's bond rating concerns are based upon speculation and not evidence in the record. It is true that the Commission has allowed large post test year plant adjustments where extraordinary circumstances were present in the past. But, what the Company is asking for goes well beyond these

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[33] Ex. S-14 (Parcell Direct) at 19.
[34] Tr. at 491:15-492:13.
[35] Ex. S-14 (Parcell Direct) at 20:9-12; Tr. at 797-798 and 813.
[36] Tr. at 145:24-146:8.
[37] Tr. at 160:7-21.
[38] Ex. UNSE-12 (Grant Direct) at 10:5-8.

cases. In this case, what UNSE is seeking goes beyond even the extraordinary step of post test year plant in rate base. UNSE is seeking Commission authorization to include $62,000,000 in post test year plant that it does not even own yet. Staff recommends that the Commission not approve the Company's request at this time, but instead encourage the Company to fully explore a combination of internal and external financing options to allow UNSE to purchase this plant and include it in rate base in its next rate case.

B. Operating Expense Adjustments.

1. Rate Case Expense.

UNSE requests $500,000 in rate case expense, amortized over three years.[39] Both Staff and RUCO have recommended $300,000 amortized over three years. UNSE argues that it must use TEP employees because it would not be as cost effective for UNS Electric to have its own parallel staff.[40] But the Company's use of TEP personnel does not alone support its need for such a high level of rate case expense. Nor would it be appropriate for the Commission to simply "pass-through" excessive costs associated with the use of TEP personnel.

The Company also supports its request by stating that it responded to numerous Commission Staff and RUCO data requests and that it had to comply with the Commission's procedural order.[41] But this is not adequate justification to support its request to recover additional rate case expense of this magnitude.[42]

In its last case, UNSE requested inclusion of $600,000 amortized over three years.[43] The Company raised many of the same arguments that it raises in this case. Staff had recommended $265,000 in rate case expense amortized over three years in that case, while RUCO had recommended $251,000, allocated over three years. The Commission found that the Company's request was excessive and that $300,000 amortized over three years was appropriate.[44]

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39 UNSE Initial Brief at 24.
40 UNSE Initial Brief at 24.
41 *Id.*
42 Ex. S-11 (Fish Surrebuttal) at 10:20-11:2.
43 Decision No. 70360 at 23.
44 *Id.* at 24.

Both Staff and RUCO are recommending the same $300,000 for this case to be amortized over three years as allowed in the Company's last rate case. Virtually the same issues that were raised by the Company in the last case were raised in this case. There is absolutely no support for giving the Company an additional $200,000 in rate case expense. For the reasons given, the Company's request should be denied.

2. Outside Legal Expenses.

The Company calculated its outside legal expense by averaging legal costs incurred from 2005 to 2007, or approximately $128,000, $106,000 and $181,000 respectively.[45] Not even the Company, however, disputes the fact that 2007 legal expense were higher than normal. Its use, therefore, cause the Company's three-year average to be overstated. For this reason, Staff initially averaged the Company's legal expense for the years 2005, 2006 and 2008 to get a more representative level. However, the Company pointed out in its Rebuttal Testimony that the 2008 expense Staff used was actually lower than normal, which resulted in an understatement of average outside legal expense. Accordingly, Staff in Surrebuttal Testimony used a four-year average to get a more representative level of legal expense for inclusion in this case.[46] By using the four-year average, the two unrepresentative amounts essentially cancelled each other out.[47]

Staff witness Fish proposed using 2005, 2006, 2007 and 2008 which resulted in an outside legal expense adjustment of $27,359.00 for purposes of this case.[48]

The Company agreed at the evidentiary hearing that it had no problem with Dr. Fish's use of the four-year average in this case.[49]

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45 UNSE Initial Brief at 25.
46 Ex. S-11 (Fish Surrebuttal) at 15:1-4.
47 Ex. S-11 (Fish Surrebuttal) at 15:4-6.
48 The Company's 3-year average legal expense of $138,263.69, Staff's 3-year average legal expense was $87,552.94, and Staff's 4-year average legal expense was $110,905. Staff's pro forma adjustment outside legal expense based on 3-year average was $58,722 so Staff reduced the Company's pro forma adjustment by the difference, or $50,962. The difference between Staff's original adjustment and the 4-year adjustment reflects the increase in revenue requirement that is used to update Exhibit S-16. Staff's pro forma adjustment outside legal expenses based on the 4-year average was $27,359.
49 Tr. at 329:22-330-8; Tr. at 352:25-353:23.

The Company notes that this four-year average is not reflected in Staff's final schedule THF C-8.[50] This was an oversight on Staff's part. Staff has attached a revision to its final schedules which includes the four-year average proposed by Dr. Fish in Surrebuttal.

3. Wholesale Credit Support.

The Company proposed to recover wholesale credit support costs through its PPFAC.[51] This is contrary to prior Commission decisions on this issue.[52] Further, Staff has always opposed the inclusion of wholesale credit support costs through its PPFAC. Staff believes that this is contrary to the purpose of the PPFAC and other similar mechanisms which are intended as a vehicle to allow pass-through of increased fuel costs.[53] To the extent that the Company did not include these costs in base rates, Staff agrees that an adjustment as proposed by the Company would be necessary.

4. Fleet Fuel Expense.

In its direct case, the Company based its test year fleet fuel expense on actual expense incurred during the test year. Based upon the test year, the Company proposed for purposes of this case an average price per gallon for gasoline of $3.32 and for diesel of $3.82 during the test period. In his Direct Testimony, Staff witness Fish pointed out that fuel costs for the test year were at a historic high and have not continued at that level, and therefore, the Company's use of actual test expense levels in this case overstated the price on a going forward basis. To obtain a more reasonable level for this case Staff witness Fish obtained fuel cost information from AAA. Fish then calculated the average of 2009 actual monthly prices plus the projected average monthly price for the remainder of 2009 which resulted in an average gasoline price per gallon of $2.52 and an average diesel price per gallon of $2.65 for 2009.[54]

The Company came back in Rebuttal and proposed the use of a three-year period of 2007 through September 2009 to determine an average fuel price of approximately $3.00 per gallon.[55] But, this average fuel price is also higher than the actual fuel prices in 2009 when testimony was filed in

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[50] UNSE Initial Brief at 26.
[51] Ex. UNSE-12 (Grant Direct) at 24:4-6.
[52] Decision No. 70360 (UNSE).
[53] Decision No. 69663 (APS).
[54] Ex. S-9 (Fish Direct) at 30.
[55] UNSE Initial Brief at 22

this case.[56] The Company claims that its proposed adjustment more accurately reflects the Company's actual fuel costs because it is based on fuel costs in rural areas.[57] However, there is no support in the record that the cost of gasoline in the Company's service areas is higher than other portions of the State.

Staff's proposal of average fuel prices for 2009 provides a more reasonable and more accurate representation of the actual current fuel prices.

5. Incentive Compensation – Performance Enhancement Program.

The Commission should allow only 50% of the Company's Performance Enhancement Program ("PEP") expense.[58] This is consistent with the Commission's order in Decision No. 70360, the Company's last rate case. The Company argues that because the PEP expense is reasonable, 100% of the program should be funded by its customers.[59] However, as Dr. Fish stated in Surrebuttal Testimony:

> Incentive pay, of course, is distinctively different compared to payroll expense. Incentive pay is earned over and above base pay, and its purpose is to induce greater efficiency and productivity from employees than payroll expense alone. This extra reward for above normal productivity makes this cost unique and subject to special treatment. Normal payroll expenses are a normal and ongoing cost of providing service. Incentive pay is designed as a reward for extraordinary and above normal service and benefit to the Company and as such its cost should be borne by the parties that enjoy the above normal service and benefit, the Company's owners and ratepayers.[60]

The Company argues that Decision No. 69663 (the APS 2007 rate case) supports its request to include 100% of its Performance Enhancement Program expenses.[61] But this is not clear. UNSE has not established that the incentive compensation plans of APS and UNSE are at all similar. APS had both a stock-based incentive compensation plan and a cash-based incentive based compensation plan. There was a large adjustment made to the test year costs of APS' stock-based incentive based compensation to be included in rate base because the stock based incentive compensation plan was

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[56] Ex. S-9 (Fish Direct) at 30:1-10.
[57] UNSE Initial Brief at 22:6-18.
[58] Decision No. 70360 at 20:10-21:11.
[59] UNSE Initial Brief at 29.
[60] Ex. S-11 (Fish Surrebuttal) at 9:15-23.
[61] UNSE Initial Brief at 27-29.

driven by the financial performance of Pinnacle West Capital Corporation (Pinnacle West"), rather than the operational performance of APS as a public utility.[62] While APS also had a cash based incentive compensation plan, there is no indication that it was structured in the same manner as UNSE's plan.

What is clear is that the Commission disallowed 50% of UNSE incentive-based compensation because the plan is designed to benefit both shareholders and ratepayers. Because it benefits shareholders, ratepayers should not bear the full costs of the plan. Because there is nothing in the record which indicates that the plan's objectives have changed, the 50% disallowance continues to be appropriate.

6. Supplemental Executive Retirement Plan.

As in the recent Recommended Opinion and Order issued in the recent UNS Gas Case Docket No. G-04204A-08-0571, Decision No. 68487, Decision No. 70011, and the Company's last rate case (Decision No. 70360), the Commission should also deny 100% of the Company's requested Supplemental Executive Retirement Plan ("SERP") expenses. The Company argues that the "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."[63] However, as stated in Decision No. 68487, "If the Company wishes to provide additional retirement benefits above the level permitted by IRS regulations applicable to all other employees it may do so at the expense of its shareholders."[64] Ratepayers should not be responsible for the additional burden of paying for retirement benefits afforded to only a select group of high paid executives whose salaries exceed the IRS limits of $240,000.[65]

7. Income Tax Expense.

As noted in Staff's Initial Brief, in its direct case Staff had proposed interest synchronization. The Staff does not dispute that interest synchronization is something that is generally appropriate. Indeed, Staff typically recommends interest synchronization. Interest synchronization allows the

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62 *Id.*
63 UNSE Initial Brief at 30:20-21.
64 Decision No. 68487 at 18-19.
65 Decision No. 70011 at 27-29; ROO in Docket No. G-04204A-08-0571 at 34:10-14.

capital structure percentages to be inferred to original cost rate base so that the utility does not incur a reduction in its weighted cost of capital in the event its original cost rate base is less than its capital structure.[66]

However, in Surrebuttal Testimony, Dr. Fish changed his recommendation based upon the unique facts in this case. The Company's long-term debt as of June 30, 2009 was $100,000,000 with a cost of 7.05%.[67] The actual interest cost is $7,050,000. Using interest synchronization, however, the imputed interest cost would be $6,441,144 for rate making purposes. This reduction in imputed interest as a result of interest synchronization increases the Company's revenue requirement by almost $300,000.[68] Since the Company is requesting a fair value cost of capital revenue requirement in excess of $2,355,000,[69] the use of interest synchronization in this case would simply enable the Company to inappropriately obtain a windfall at the expense of rate payers.[70]

III. COST OF CAPITAL

A. Cost of Equity.

Staff has proposed a return on equity of 10.00% in this case based upon its use of three well-known measures for determining rate of return on equity including the Discounted Cash Flow Model ("DCF"), the Capital Asset Pricing Model ("CAPM") and the Comparable Earnings ("CE") analysis. The Company is proposing 11.4% and RUCO is proposing 9.25%.[71]

UNSE faults Staff for proposing a return on equity for UNSE that is lower than the return on equity approved by the Commission for APS (11%).[72] UNSE states that it is "incomprehensible how UNS Electric can be considered less risky than APS by a magnitude of 100 basis points."[73] However, in addition to the fact that the 11% rate of return for APS was part of a comprehensive settlement package, the Company's position ignores the fact that APS and UNSE are very different companies. Importing the rate of return from one company to another, without analysis of the facts and

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66 Tr. at 654:14-21.
67 *Staff Final Schedule* DCP Schedule 4 at 1.
68 Tr. at 654:22-655:15.
69 UNSE Final Schedule A-1.
70 Staff has attached a revised Ex. S-16 to include its correction for outside legal expense.
71 UNSE Opening Brief at 36; RUCO Opening Brief at 24.
72 UNSE Opening Brief at 36.
73 *Id.*

circumstances relative to each company, would be inappropriate. Staff does an independent analysis for the particular company at issue. Its analysis in this case indicates that a 10% return on equity is fair and adequate.

1. DCF.

The Company argues that because the Commission often averages the multi-stage DCF and the single-stage DCF, the Commission should do so in this instance.[74] The Company's witness Ms. Pritz's "second-stage" or "long-term-stage" growth rate relies exclusively on the 6.5 gross domestic product ("GDP") growth which represents the real GDP growth since 1992 plus implied inflation.[75] However, as Mr. Parcell noted:

> All of Ms. Pritz's other growth rates in her short-term DCF analyses (i.e., DPS and EPS growth) reflect projections of future growth. On the other hand, Ms. Pritz only uses historic rates in her GDP growth input. Apparently, she believes it is not proper to use historic growth rates of financial indicators (i.e., EPS growth), but it is proper to use only historic growth rates in her GDP input.[76]

Two sources of projected GDP growth, the Social Security Administration and the Energy Information Administration gave growth projections of 4.4% and 4.8%, respectively, during the time period that Ms. Pritz prepared her testimony.[77] It would be unreasonable for investors to expect GDP growth to be 6.5% when U.S. government agency forecasts are much lower.[78] Furthermore, the only regulatory agency known to Staff that formally applies GDP growth in its DCF analysis is the Federal Energy Regulatory Commission.[79] However, FERC only gives the GDP growth rate a 33% weight in its two-stage DCF model.[80] Therefore the Company's DCF analysis is deficient and should be rejected because it focuses too much on only historic GDP growth.

The Utilities Division Staff in this case, as in many cases, sponsors a witness on the issue of cost of capital. Staff witnesses, like other witnesses (including utility witnesses, such as UNSG witness Grant and UNSE witness Pritz) are sponsored based upon their own models and analyses.

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74 UNSE Initial Brief at 42.
75 Ex. S-14 (Parcell Direct) at 45:6-12.
76 Ex. S-14 (Parcell Direct) at 45:16-20.
77 Ex. S-14 (Parcell Direct) at 46:5-12.
78 Ex. S-14 (Parcell Direct) at 46:20-23.
79 Ex. S-14 (Parcell Direct) at 47:1-8.
80 Ex. S-14 (Parcell Direct) at 47:10-12.

Likewise, the Commission has the discretion to use whatever analyses and results that it deems appropriate in making its decisions.

The Company argues again that "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."[81] However, as Mr. Parcell explained, "no single indicator of growth is always used by all investors."[82] Furthermore, because investors have access to all growth indicators used by Mr. Parcell, historic data should not be ignored.[83]

2. CAPM.

In UNSE's previous rate case, the Commission agreed with Staff "that it is appropriate to consider the geometric returns in calculating a comparable company CAPM because to do otherwise would fail to give recognition to the fact that many investors have access to such information for purposes of making investment decisions."[84] The Commission should reject Ms. Pritz's upward risk premium adjustment in its CAPM analysis because as Mr. Parcell explained, "the 'flight to safety' during the timeframe of her January 2009 focal point should not be used as a standard for cost of capital determination. In addition, it is clear that the circumstance she cited no longer is in effect."[85]

As both the Company and RUCO note, the CAPM is particularly influenced by the current economic conditions.[86] Mr. Parcell specifically noted that recent CAPM results are downwardly influenced by the impacts of the recent recession, (i.e., "flight to safety" wherein investors moved investment dollars from more risky common stocks and corporate bonds to less risky US securities, which drove US Treasury yields down to unprecedented low levels). As a result, Mr. Parcell did not give specific weight to his CAPM results in this proceeding.

3. CE.

The Company argues that Staff's CE analysis is "significantly flawed" because Staff uses historical accounting returns.[87] However, UNSE's capital book value (including common equity) is

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81 UNSE Initial Brief at 42.
82 Ex. S-14 (Parcell Direct) at 27.
83 Ex. S-14 (Parcell Direct) at 28:6-11.
84 Decision No. 70360 at 43:25-27.
85 Ex. S-14 (Parcell Direct) at 49.
86 UNSE Initial Brief at 39; RUCO Initial Brief at 26-27.
87 UNSE Initial Brief at 42.

used to determine the Company's cost of capital. Therefore, as Mr. Parcell stated, "[*i*]*t is only natural* that the returns on book value of equity (i.e., comparable earnings analyses) is an appropriate mechanism for estimating the cost of equity."[88]

4. Risk.

The Company argues that it is riskier than the sample group used by Staff, and because of this a higher return on equity should be authorized.[89] However, UNSE is not riskier than the sample group.[90] The following passage from Docket No. G-04204A-08-0571 Recommended Opinion and Order regarding UNS Gas applies equally to UNS Electric in this case:

> The Company cannot pretend that it operates in a vacuum or that the challenges it faces are unique. Indeed, relative to a number of unregulated industries, the utility industry is insulated from the vagaries of the marketplace to the extent that it does not face direct competition for its product and there is a high degree of inelasticity in the need for utility services.[91]

Staff's well reasoned cost of equity recommendation of 10.0% should be adopted.

IV. FAIR VALUE RATE OF RETURN.

A. Staff's Proposal Falls Within The Range of Reasonableness and Should Be Adopted.

The Company argues that Staff's proposed methods for utilizing fair value of rate base are unconstitutional and unjustified. The Company states that Staff's proposal to apply a 0% return on the fair value increment has been rejected twice.[92] While Staff disagrees, this is only one of the Staff recommendations in this case and essentially establishes the floor of the range produced when Staff's second recommendation is factored into the analysis. The other alternative recommendation by Mr. Parcell is to assign the fair value increment a cost using the risk free return, or the return on an investment that carries little to no risk.[93] As noted by Mr. Parcell, "[r]isk-free investments are universally defined as U.S. Treasury Securities, with short-term maturities usually being used as the

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[88] Ex. S-15 (Parcell Surrebuttal) at 5:23-26.
[89] UNSE Initial Brief at 41.
[90] Ex. S-14 (Parcell Direct) at 34-36.
[91] ROO Docket No. G-04204A-08-0571 at 42:19-22.
[92] UNSE Initial Brief at 48.
[93] Parcell Direct at 56.

risk-free rate."[94] "The concept of real rates involves the removal of the rate of inflation from the nominal risk-free rate."[95] The upper end of the range produced by the two alternative methods Mr. Parcell proposes would be the value produced by this second method.[96] The alternative methods proposed by Mr. Parcell produce a zone of reasonable rates from which the Commission could choose depending upon the facts and circumstances of the case.[97] In this case, Mr. Parcell has proposed the mid-point of the range, 0 to 3%.[98] This produces a fair value rate of return of 6.01%.

RUCO is recommending a fair value rate of return of 5.96%. In coming up with its return, RUCO considered several methods including those proposed by Staff witness Parcell.[99] The range produced by the five methods considered by RUCO produced a range of 5.39% to 7.01%.[100] Staff's proposed FVROR of 6.01% falls well within this range.

Moreover, the Commission has expressly recognized that the Staff's approach would produce an appropriate result. As Mr. Parcell noted in Surrebuttal Testimony, the Commission stated in the *Chaparral City* Remand Proceeding (Docket No. W-02113A-04-0616:

> "...we also believe that Staff's method is an appropriate way to adjust the Weighted Average cost of Capital associated with the Original Cost Rate Base ("OCRB") for use with the FVRB, as it is based on sound economic and financial theory."[101]

On the other hand, the FVROR of UNS Gas and UNS Electric in their 2007 rate proceedings was the same as Chaparral City, namely to simply use the original cost rate of return ("OCROR") applied to the level of FVRB. In all of these cases, the Commission rejected this position since it would result in an excessive rate of return on fair value rate base.

In the recent UNS Gas case, which the Commission just voted on, the Commission found that an unadjusted inflation factor should be subtracted from the entire WACC, to afford appropriate

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94 *Id.*
95 *Id.*
96 Parcell Direct at 57.
97 *Id.*
98 *Id.*
99 RUCO noted in its Brief that it considered a third proposal that had been made by Staff in the Chapparal City Rate Case and adopted by the Commission in Decision 71308, which was that the FVROR should be calculated by subtracting an inflation factor from both the debt and equity components of the WACC. RUCO Brief at 19-20.
100 RUCO Brief at 20.
101 Decision No. 70441 at 37.

recognition to the fact that inflation exists in both the debt and equity components of the Company's capital structure.[102] The Commission adopted an inflation factor based upon the average of the inflation rates proposed by RUCO and Staff in that case, or 2.25%. The Commission then subtracted that from the weighted average cost of capital of 8.0% to derive a Fair Value Rate of Return of 5.75%. RUCO witness Johnson's recommendation in this case appears to be similar.

While Staff certainly would not oppose adoption of this approach in this case, Staff continues to believe that its recommendation of 6.01% total Fair Value Rate of Return for investor supplied capital is also reasonable.

B. The Company's Proposal for A Separate FVROR for BMGS Should be Denied.

The Company argues that, should BMGS be included in rate base, a separate FVROR be applied to this portion of rate base. Specifically, UNSE proposes that the overall cost of capital be applied to the fair value rate base of BMGS, in contrast to the FVROR be applied to the fair value rate base of the remaining rate base. Staff opposes this proposal. Applying the cost of capital to the fair value rate base of BMGS amounts to the very proposal made by Chaparral City in its Remand Case. This proposal was rejected by the Commission.

V. PURCHASED POWER AND FUEL ADJUSTOR CLAUSE.

A. Rate Design – PPFAC – CARES.

Staff continues to recommend that the PPFAC rate for CARES customers be set at zero unless fuel and purchased power costs reduce and result in a negative PPFAC rate.[103] The Company objects to Staff's recommendation stating that "Commission Staff's proposal could force non-CARES customers to subsidize significantly increased PPFAC charges depending on changes in the wholesale electric rates[.]"[104] However, as Mr. Erdwurm admitted, if the Company's recommendation is adopted and PPFAC costs decreased, the Company's CARES customers would be paying a higher PPFAC charge than customers who were not low income CARES customers.[105] Therefore, Staff's recommendation should be adopted by the Commission because it ensures that the

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102 UNS Gas ROO (Docket No. G-04204A-08-0571) at 50.
103 Ex. S-13 (Stewart Surrebuttal) at 2:15-21.
104 UNSE Initial Brief at 59.
105 Tr. at 284:21-285:1.

Company's lowest income customers will not be paying a higher PPFAC charge than the Company's other customers.

VI. MISCELLANEOUS.

The Company opposes Staff's recommendation that the Company be ordered to submit a list of worst performing circuits because the Company believes it would be too costly and unnecessary.[106] Specifically, the Company states that its Mohave County circuit will be particularly costly because "[t]he prior owner of the system did not keep detailed records on its distribution network."[107] Lastly, the Company states that it believes some of its circuit problems are caused by the Western Area Power Association ("WAPA") system and would not be alleviated by upgrading the UNS Electric circuit.[108] However, Staff continues to recommend that UNSE provide a listing of the worst performing circuits in an annual report of the distribution indices, including the Mohave County circuit because the average performance in an affected service area can be misleading if in fact some customers are experiencing worse outages, in frequency or duration than other customers in the same service area.[109] The Company is able to note and then exclude from the indices calculation outage effects caused by the WAPA. Furthermore, the worst performing circuits list will provide additional incentive to UNSE to address them in a timely manner.[110]

At the hearing, the Company's witness McKenna indicted that such a list could be developed in a different mode, without the same degree of detail now provided by TEP in its reports.[111] It is only if the Commission orders the list to be developed comparable to what TEP now provides in a computerized system that the cost would be significant.[112]

VII. RENEWABLE ENERGY ADJUSTOR MECHANISM.

As the Company notes in its Reply Brief, at the hearing, it was requested to present a proposal on renewable energy generation resources. The Company submitted its "Renewable Generation Ownership Plan" in which it proposed to (1) invest up to $5 million of capital each year to develop

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106 UNSE Initial Brief at 63:8-11 and 64:9-65:14.
107 UNSE Initial Brief at 65:3-10.
108 UNSE Initial Brief at 65:3-10.
109 Ex. S-8 (Lewis Surrebuttal) at 3:13-17.
110 Ex. S-8 (Lewis Surrebuttal) at 3:21-24.
111 Tr. at 112:10-25.
112 Tr. at 111:6-25.

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. The "revenue requirement" would include 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 rate base in the Company's next rate case. The Company is not requesting funding for the Plan projects but would seek that approval through its REST Implementation Plan filings.

With respect to the surcharge proposal, the Company agreed in cross-examination that its proposal was very similar to what had been approved by the Commission for APS, as part of the APS Settlement Agreement in Decision No. 71448, at least with respect to the type costs to be included in the surcharge until the Company's next rate case. (See APS Settlement Agreement, p. 33, Section 15.7). Since then, the Staff has recommended a similar approach for UNSE's affiliate, TEP.[112] Thus, Staff does not oppose the Company's surcharge proposal and its approval in this case.

VIII. CONCLUSION.

Staff's positions in this case represent a reasonable balance between the interests of ratepayers and the Company's shareholders and should be adopted.

RESPECTFULLY SUBMITTED this 2nd day of April, 2010.

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[112] Docket No. E-01933A-09-0340, filed on March 30, 2010.

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ATTACHMENT 1

Schedule THF C-8

UNS Electric, Inc.
Docket No. E-04204A-09-0206
Legal Expenses
Test Year Ended December 31, 2008

Schedule THF C-8
Page 1

Line No.	Year	Total Amount	Excluded	Allowable Amount	Staff Adj	Reference
1	2005	127,621.78	0.00	127,621.78	127,621.78	
2	2006	106,263.16	0.00	106,263.16	106,263.16	
3	2007	452,227.78	271,321.65	180,906.13	0.00	A
4						
5		686,112.72	271,321.65	414,791.07	233,884.94	
6						
7		Prior 3 year Avg.		138263.69	$87,552.00	B
8						
9	TY 2008	170,623.45	141,793.56	28,829.89	$28,830.00	
0						
10			Proforma	109,433.80	$58,722.00	C
11		4-year average			$110,905.00	
12						
13	A: Staff Removed as non-normal					
14	B: 3 year Average Allowable Amount 2005, 2006, 2008 TY				27359 d	
	C: Company 3 Year Average less Staff 3 Year Average					
	d Co 3 year average less staff four year adjustment (138,264 - 110,905)					

ATTACHMENT 2

Exhibit S-16

Correction for Outside Legal

Exhibit S-16 corrected for outside legal

	Co. review of Staff calculations/interest synchronization(1)	Readjustment of Staff calculations Excluding Credit support & CARES
Staff OCRB ROR	8.40%	8.40%
Staff's proposed return OCRB	$14,163,717.00	$14,163,717.00
Staff's fair value return(2)	$1,339,997.00	$1,339,997.00
Staff's proposed return tot	$15,503,714.00	$15,503,714.00
Company's proposed operating expeses before taxes	($146,801,451.00)	($146,801,451.00)
Staff's proposed operating expenses before taxes	($147,945,938.00)	($147,945,938.00)
Staff's pro forma operatring income before inc. taxes	$13,041,924.00	$12,946,804.00
Less interest-synchronized per Co. review*	($6,441,144.00)	
Less actual interest L-T debt**		($7,050,000.00)
Less actual interest credit support costs***		
Pro forma taxable income	$6,600,780.00	$5,896,804.00
Tax rate	38.5980%	38.5980%
Income Tax Expense	$2,547,769.06	$2,276,048.41
Company adjusted income tax	$2,121,267.00	$2,121,267.00
Income Tax Increase over Co. Filing	$426,502.06	$154,781.41
Pro forma Oper income after taxes	$10,494,154.94	$10,670,755.59
Revenue Shortfall	$3,669,562.06	$3,492,961.41
Fair Value Increment	$1,339,997.00	$1,339,997.00
Deficiency	$5,009,559.06	$4,832,958.41
Tax gross-up	1.6363	1.6363
Staff's corrected increase	$8,197,141.50	$7,908,169.84
Staff's surrebuttal corrected increase		$7,579,110.00
Change in Staff's increase		$329,059.84

(1) Interest synchronization was traditionally used to insure that capital structure was forced to the size of OCRB. Otherwise, the Co. could be in a situation of not being given the opportunity to recover its capital cost.

(2) Staff is proposing a fair value (before gross-up) adjustment of $1.34M. This amount is not associated with capital costs or pro forma adjustments but is associated with fair value public interest. The amount is about 10% of cost of capital as related to OCRB, therefore the Company's capital cost is assured and the public interest is being served.

*OCRB *weighted average cost of debt
**L-T debt times cost of debt
***Actual annual cost as per Grant rebuttal testi