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Tucson Electric Power Company
One South Church Ave., Post Office Box 711
Tucson, Arizona 85702

April 16, 2010

Commissioner Gary Pierce
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Re: Notice of Inquiry Regarding Line Extension Policies of Electric Utilities (Docket No. E-00000J-10-0044)

Dear Commissioner Pierce:

Tucson Electric Power Company and UNS Electric, Inc. hereby file their responses to your inquiry letter dated March 9, 2010 regarding line extension policies of electric utilities.

Sincerely,

Philip J Dion mp

Philip J. Dion

PD:mi
Attachment
cc: Docket Control – Original and 13 copies
Chairman Kristin Mayes
Commissioner Sandra Kennedy
Commissioner Paul Newman
Commissioner Bob Stump
Lyn A. Farmer, Hearing Division
Janice M. Alward, Legal Division
Steve Olea, Utilities Division

RESPONSE TO COMMISSION PIERCE'S
LETTER OF MARCH 9, 2010
April 16, 2010

Tucson Electric Power Company ("TEP") and UNS Electric, Inc. ("UNSE") (collectively, "the Companies"), hereby respond to the questions posed in Commissioner Gary Pierce's letter dated March 9, 2010, as follows:

I. INTRODUCTION.

In Decision No. 70628 (December 1, 2008), the Arizona Corporation Commission ("Commission") approved the TEP Rate Case Settlement Agreement which included a provision that there would be no free footage in connection with requested line extensions.

In Decision No. 70360, the Commission imposed a similar provision to eliminate free footage from requested line extensions for UNSE.

The Commission has also ordered other utilities in Arizona to eliminate free footage provisions from their line extension policies.

The elimination of free footage provisions for utility line extension policies has elicited strong reactions from real estate developers and home builders, among others. This has caused the Commission to initiate an inquiry as to which line extension policies will best serve Arizona in the future.

TEP and UNSE are committed to working with the Commission to review existing policies and develop ones for the future that will fairly treat all affected parties. In the meantime, TEP and UNSE will continue to comply with the line extension policies that have been ordered by the Commission.

II. RESPONSES TO QUESTIONS.

TEP and UNSE provide the following responses to the questions asked in Commissioner Gary Pierce's letter dated March 9, 2010. In so doing, the utilities reserve their rights to supplement the answers and to address the information provided by any other person in connection with utility line extension policies.

1) What factors should the Commission consider when establishing policies governing electric line extensions?

RESPONSE:

Many factors should be considered when establishing policies governing electric line extensions. Three key factors to consider are: 1) whether the extension policy should apply to all extensions or only extensions for new customers; 2) whether the policy should apply to residential customers, commercial customers, or both, and 3) how the policy will address the costs of extensions. Factors to consider when deciding how costs should be addressed include:

- the location of the extension;
- the actual cost per foot or mile of the extension;
- the average cost per foot or mile of other extensions in the immediate area, service territory and state;
- the size of the line;
- the line's proximity to future growth;
- the cash flow impact of the extension on the utility;
- the cash flow impact of the extension on the end-user or developer;
- current cost recovery methods (whether in base rates or through contributions in aid of construction ("CIAC") or a mixture of both);
- whether current costs are recovered based on cost of service ("COS"); and
- whether system improvements could or should be combined with the extension.

2) Should the principles of cost-causation be the predominant consideration (i.e., requiring costs to be borne by the cost-causer)? If not, what should be the predominant consideration?

RESPONSE:

In utility rate design, cost-causation is rarely the driving force. Traditionally, the Commission has favored approaches that focus on limiting customer impacts more than tracking the actual costs associated with serving a customer class. Focusing on limiting customer impacts instead of cost causation reduces shifting costs between classes that would otherwise be justified if rates were based on cost-causation. However, where possible, some form of cost allocation to the cost-causer is still appropriate.

Line extensions are one area where cost-causation has (at least historically) been used, in part, to establish just and reasonable rates. Until recently, customers were allowed some common footage or cost when connecting to the system. In the event the actual cost or footage exceeded the allowable amount, the customer was held fully responsible for the additional cost. New customers that came on to the system after the initial line extension was constructed contributed towards the line extension's cost as well. The contribution made by the new customer was in part, or in whole, given to the original customer as an offset to the original contribution.

This was a sound method for handling line extensions because additional load does in fact benefit the system as a whole. To determine how much the additional load benefits the system, the Commission could review (e.g., during a rate case or annually) whether the free footage or dollar allowance should be changed. In the past, "free allowance" represented the contribution new customers made with existing rates toward the cost of the extension. It was equivalent to how much the utility could recover from that new customer (assuming average usage) over a determined period of time. Since "free allowance" is based on the new customer's assumed incremental contribution, there were no inherent inequities related to the customer specific line extension.

With no free footage, however, substantial inequities result. Customers under this model pay more than their fair share because they pay not only for their line extension (what was formerly free footage), but also for the costs of all previous line extensions because these costs were included in base rates. After paying the full cost of the line extension, that same customer contributes toward the recovery of every preceding customer's free footage amount.

The predominant consideration here should be what is best for society as a whole. Because of the inequities discussed above, the policy that will likely benefit society the most will be some variation of the free footage or dollar allowance mechanism. The Companies believe a dollar allowance would be the most equitable, but are not opposed to a free footage standard. Building the average allowance into general rates (determined by an individual customer's marginal contribution over some predetermined period of time) will allow more customers to connect to the system at a lower cost. This will ultimately allow fixed costs to be recovered more fairly over a larger customer base.

3) Is it possible for the Commission to devise line extension policies that will result in existing customers subsidizing growth? If so, please provide an example.

RESPONSE:

Growth can both drive increased or decreased cost for existing customers. It depends upon the current available capacity and at what point additional capacity must be added. Growth will reduce cost for existing customers up to the point where large investments have to be made for additional systems and generation to support both new and existing customers. However, those sales increases allow those large fixed cost investments to be spread over a larger customer base and more sales, which results in benefits to all customers on the utility's system. Because of these benefits, nothing should be done to discourage the addition of new customers.

4) Is it possible for the Commission to devise line extension policies that will result in growth subsidizing existing customers? If so, please provide an example.

RESPONSE:

Yes. The current policies, without free footage, result in growth subsidizing existing customers. New customers not only pay for all costs associated with their own line extension, but they also pay for all costs associated with free allowances from the past.

5) Should growth pay for growth or should it be subsidized by existing customers? If you believe growth should be subsidized by existing customers, in what amount and by what mechanism? Should growth costs be included in base rates and allocated to all customers or should they be allocated to specific customer classes?

RESPONSE:

Please see the Companies' response to question 3. The Companies prefer a marginal revenue based dollar allowance, where costs of new construction in excess of that allowance are paid for by the customer requesting a line extension, with follow-up refunds to that customer if additional load is added to the extension.

6) Should growth be required to pay for more than growth? If not, why not? Does APS' existing line extension policy require growth to pay for more than growth?

RESPONSE:

Given the benefit that all rate payers experience from growth, and the inequity of doing otherwise, growth should not be required to pay for more than growth. A growing system is a healthy system. All customers benefit from a healthy utility system. Having a reasonable marginal revenue based allowance, where costs of new construction in excess of that allowance are paid for by that new customer (with follow-up refunds if additional load is added to the extension), is an equitable way to handle growth on a system.

7) Should certain customer groups (such as low income customers, Native Americans on Native American lands, rural customers, etc.) be exempted from an otherwise generally applicable line extension policy? If so, what groups should be exempted and why?

RESPONSE:

A fair cost recovery system would consider the marginal contribution that will be provided by the new customers and to the extent the necessary, "new" cost will not be recovered in a reasonable period of time - then those new customers, despite their sub grouping, should be required to provide the shortfall. However, the Companies recognize that handling of cost recovery from certain sub-groupings of customers maybe appropriate and is ultimately a policy decision of the Commission.

8) **Should new line extensions have excess capacity? If so, should new customers be required to pay for that excess capacity? Is there a minimum level of electric capacity that all new customers should be required to have irrespective of their own electric demand? If so, what is that minimum electric capacity and what is the potential incremental cost of installing electric lines at the minimum electric capacity versus the customer's actual electric demand? What percentage of line extensions are single-customer installations, versus those that 'grow the grid' to further extend company service capability?**

RESPONSE:

Line extensions should be built to system standards so that they adequately serve existing customers while providing a means to serve future customers in the immediate area. The Companies design their distribution systems to provide service for customers' load plans, not for excess capacity. Some line extensions are feeder line extensions that will provide reliable service to an area, not just the customer requesting service. These installations are typically required for subdivisions, large commercial and industrial developments. It is difficult to quantify the percentage of those feeder line installations, as the Companies require property owners to provide line extensions to the boundary of their property in order to extend service to adjacent property owners. It would be unfair to charge an individual customer for a facility that is more than they need for their own load requirement, especially since the enhancements would be designed to benefit the entire system.

9) **Explain how any applicable line extension charges should be calculated. Under what circumstances and on what basis, are customer refunds of customer-financed line extensions appropriate? Should the initial applicant be required to pay the total cost with a refunding mechanism if subsequent applicants use any common facility paid for by the original applicant or should the initial customer only be required to pay for the common plant constructed on a pro rata basis?**

RESPONSE:

Under the present policies of no free footage, line extension charges generally should be calculated on a per foot basis, with additional charges for large equipment such as transformers and pad-mounted switches. Customers should be responsible for all construction, including trenching and conduit. Refunds may be appropriate where subsequent applicants use any common facility paid for by the original applicant. The current rules, however, do not allow the Companies to make such collections from the subsequent customer and provide refunds. Current rules require that customer contributions be treated as contributions rather than deposits subject to refund ability for some defined period of time.

10) Should line extension policies vary depending on the type of customer? In other words should line extension policies vary among the following types of customers:

- **an individual owner, or a small group of owners, of land who will not subdivide their respective properties and are seeking service exclusively for a future residence and not for a development;**
- **larger developments, residential subdivisions, or master-planned communities; and**
- **commercial and/or industrial customers?**

RESPONSE:

To the extent that line extension policies apply to a customer group, they should be designed with the same general guidelines applicable to all customers. To the extent an individual or group of customers provides appropriate marginal contribution to support the extension of a new line, it should be provided. Conversely, to the extent any individual or group of customers does not provide appropriate marginal contribution, that group should be required to pay the differential. Where analysis shows that cost recovery is contingent upon the future addition of new customers or the ramping up of load, then the payment should be treated as an advance or deposit. In that case, the advance should convert to a contribution within a set time period if the necessary growth does not materialize.

11) What were the original considerations for establishing a 1,000 foot line extension policy for APS, and why wasn't the same line extension policy adopted for the other electric utilities?

RESPONSE:

The general reason for setting such an allowance at TEP and UNS Electric was that system wide average base rates included (and still do include) a level of cost recovery for existing customer service and distribution lines. The allowance was meant to give new customers credit for their extra contribution toward the requested line extension while not burdening existing customers with additional cost recovery.

12) Has the changed character of APS' service territory, i.e. rural/urban mix, removed the need for a line extension subsidy? Given the fact that APS' line extension policy was in place for 50+ years prior to 2006, has the original purpose of this subsidy been served?

RESPONSE:

The Companies will defer to APS' response.

13) What is the appropriate time interval for examining subsidy costs? I.e., should subsidies be re-examined every 50 years, 10 years, 5 years or less? Should subsidies be set on a downward glide path or is it appropriate for customers to expect their perpetual existence?

RESPONSE:

The allowance process could include a formulaic approach that would reset with each set of new rates approved by the Commission. A properly designed allowance policy should not create an inequitable rate outcome, thus the allowance should be examined in each rate proceeding. For example, suppose new rates established that the average residential customer used 10,000 kWh annually, and that a marginal contribution of $.07 per kWh reasonable. Under this formula, new customers would add $700 in new margin annually. Assuming a formula with a three year cycle, new customers would get credit for $2,100 towards their line extension and would be required to pay the remaining cost. By the time rates are set in the next case, the new customer will have paid $2,100 through existing rates, and the remainder as a contribution. This protects existing customers from subsidizing the growth cost specific to the line extension.

14) Is it inconsistent for the Commission to establish some subsidies that decline over time and some subsidies that do not decline over time? Should the Commission pursue an across-the-board phase out of all subsidies?

RESPONSE:

Subsidies raise significant policy questions that must ultimately be addressed by the Commission on a case-by-case basis.

15) Should line extension policies for electric utilities be uniform across the state and established via rulemaking or should they be decided on a case by case basis? Should electric cooperatives be treated differently than investor-owned electric utilities? If so, how and why or why not?

RESPONSE:

A uniform policy could be applied across the state if the dollar allowance method was used and based on the anticipated margin revenue recovery for each utility. A similar model could be used for all electric utilities regardless of whether they are a cooperative or investor-owned.

16) Should line extension policies for electric utilities be uniform with line extension policies for telecommunications, gas, water and sewer utilities?

RESPONSE:

A similar theory could be applied to all utilities, but some differences may be justified. A marginal revenue based free allowance theory could certainly be used for both gas and electric utilities. While the theory should be reasonable for other utilities, there may be circumstances that exist which could require some variation of the method being proposed.

17) If the Commission reinstates a free footage allowance for utilities, should the Commission make the new policy retroactive? Should existing customers be compensated who were previously negatively affected by the "no free allowance" policy? If so, how? If one is opposed to retroactive application, is that opposition based in law, policy or both?

RESPONSE:

No, it would be extremely difficult, if not impossible, to track customers, cost and an appropriate amount to retroactively refund.

18) What costs should be captured in line extension policies? In other words, should line extension policies consider the costs of local facilities, system or backbone facilities, and upgrades to existing facilities?

RESPONSE:

Only local facilities costs should be captured in line extension policies. Feeder ties, backbone facilities and upgrades to existing facilities (including pole replacements and conductor replacements or upgrades) should be recovered in system wide rates. The line extension itself is for the benefit of the new customer, but the other improvements are primarily done for the benefit of the system as a whole.

19) What are the comparative advantages and disadvantages of free footage allowance versus a dollar allowance policies? What would be the cost to ratepayers if the policy were changed to include an "equipment allowance" of a specified amount for only individual residential homeowners?

RESPONSE:

There are many advantages to using a dollar allowance as long as it is based on a customer's marginal contribution to the system (or the average for the class where appropriate). This means a customer can apply the allowance towards cost per foot and/or large equipment. The free footage design will limit their allowance to a specified number of feet meaning any customer with a shorter than average line extension will not benefit from the allowance to the level of other customers. For example, a customer may need a 250' line extension instead of the normal 500' normally allowed, but also need a large transformer. With free footage, they would have to pay the full cost of the transformer even though their extension is one-half as long as the amount allowed. Under the dollar allowance method some of the transformer cost would be offset. The cost to extend lines can vary based on terrain and equipment required, so the dollar allowance policy would be equitable for all customers.

20) If you are an electric utility, what is your current line extension policy and how has your line extension policy changed over the last fifty years? For APS, what percent of line extensions are installed inside Maricopa County versus outside of Maricopa County? What percentage of line extensions are for residential service versus commercial and industrial service? How many residential line extension estimates has APS provided since 2007 that did not result in a subsequent payment and request for a line extension and service?

RESPONSE:

TEP currently has a "no free allowance" line extension policy that was approved in Decision No. 70628 (December 01, 2008). UNS Electric ("UNS Electric") eliminated free footage in Decision No. 70360 (May 27, 2008). A revised UNS Electric line extension tariff was approved in Decision No. 71285 (October 7, 2009).

For 2009, approximately 30% of line extensions installed by TEP were for commercial/industrial customers. The remaining 70% were for residential customers. TEP has provided 226 line extension estimates for a total of approximately $1.2 million between June 2009 and March 2010 that have not yet resulted in a subsequent payment and request for a line extension and service.

21) Please describe the optimal line extension policy that, in your view, best balances the interests of existing and future customers. If you believe that a historical line extension policy (e.g., APS' 1000 free feet line extension policy) is the best, please explain why you believe it is better than alternative proposals (e.g., why is 1000 free feet better than 500 free feet, why is 1000 free feet better than 2000 free feet, etc.)

RESPONSE:

Please see the Companies' response to question number 2, wherein the Companies state their preference for some level of dollar allowance (not a specific footage allowance), as this method will produce the most societal benefit. Building the averaged allowance into general rates (determined by an individual customer's marginal contribution over some predetermined period of time) will allow more customers to connect to the system, allow them to connect at a lower cost, and will ultimately allow the utilities fixed costs to be recovered over a larger customer base.

22) If the optimal line extension policy is different than existing and/or historical line extension policies, should the Commission transition to the optimal policy? If so, how?

RESPONSE:

Yes, a transition period is appropriate for any significant policy change. The transition period should allow for utilities to adjust their processes and budgets, allow rule makers to adjust the rates, and allow developers and customers to evaluate their costs.

23) Please estimate the impact on the economy and new construction from the current line extension policies. What is the impact on land values?

RESPONSE:

It is difficult to estimate the current policies' impact on the economy and new construction, but the chart on the following page shows a dramatic decline in extension activity since 2007 in TEP's service territory:

Commercial Line Extensions		**Total Costs**	**Money Received (CIAC)**
	2007	$8,791,324	($2,977,061)
	2008	$8,100,063	($1,616,577)
	2009	$4,506,793	($1,445,075)
Services		**Total Costs**	**Money Received (CIAC)**
	2007	$4,971,529	($73,195)
	2008	$5,929,830	($79,033)
	2009	$5,441,989	($895,252)
Residential Line Extensions		**Total Costs**	**Money Received (CIAC)**
	2007	$9,682,955	($296,449)
	2008	$6,870,861	($347,358)
	2009	$4,380,299	($163,199)
Feeder Extensions		**Total Costs**	**Money Received (CIAC)**
	2007	$4,359,349	($1,290,047)
	2008	$4,274,599	($1,291,220)
	2009	$2,009,580	($1,062,663)
Summary		**Total Costs**	**Money Received (CIAC)**
	2007	$27,805,157	($4,636,752)
	2008	$25,175,353	($3,334,188)
	2009	$16,338,661	($3,566,189)

24) Should the Commission be concerned about the potential for new line extensions becoming idle (i.e., "building a line to nowhere")? If so, what provisions should be made to protect against such contingencies?

RESPONSE:

If allowances are based on marginal revenue, and appropriate due diligence is preformed on any proposed project involving a substantial number of services, idle service line extensions should not be a problem. Utilities do and should have the right to delay extension of facilities until site improvements have reached an appropriate stage, as determined by the company. Additionally, there are many ways to address the issue of idle line extension. Where multiple extensions are being considered, such as in a new subdivision, one possible solution is to do the calculations in phases and require a smaller payment to initiate the subdivision. That way if full development is successful, further phases could be addressed in a like manner. If the initial line is sized such that a substantial payment is required of the developer in the early phase, refunds should be granted to the original developer if new phases are added and offset the original cost of the line. Long term contracts and payment plans could be a consideration, but would require substantial review to assure all parties are protected. Limiting refund mechanisms to a 5-year period should help as well.

25) Should an economic model be used to determine the benefits of new customers versus the costs associated with providing line extensions?

RESPONSE:

An economic model could be considered, but if the original free footage or marginal revenue based allowance is based on near term marginal revenues (e.g., 2 or 3 years worth of margin), a complex model would not be needed to justify the original free allowance. This is because a new customer's ongoing contribution to existing and future fixed costs would most likely be in place for 50+ years; by design this would result in an incremental reduction in rates to all customers. If the original extension cost exceeds that initial allowance, the benefiting customer will have already paid for those costs.

26) What prompted the changes to line extension policies that go beyond the elimination of free footage allowances? For example, what prompted the change in categorizing line extensions associated with subdivisions from "advances in aid of construction" to "contributions in aid of construction"? If the policy was changed back to an "advance" what would be the impact on electric utility rates? What would be the impact on electric utilities' financial condition?

RESPONSE:

A customer advance is when the customer provides the construction funds necessary when the construction cost of a line extension is only cost justified (existing customers held harmless) after a certain customer and sales levels is obtained. Once enough customers are added to insure existing customers will be held harmless for the line extension cost - the funds would then be returned to the customer.

When the policy was changed to "no" free footage – it required that the entire extension be paid for by the developer up front. This eliminates the need to hold any of the funds as an "advance" because there is no consideration of marginal contribution associated with the new customer load. The whole purpose of the advance process was to protect existing customers if the load did not materialize – so they did not have to pay for extensions and equipment that was underutilized. For the categorization to go back to an advance there has to be a free footage or dollar allowance established for each customer – so as to make it necessary to require an advance.

27) How much, if any, additional funding has the change in line extension policies brought to electric utilities?

RESPONSE:

TEP collected approximately $2.5 million that would not have otherwise been collected. While the current method does result in more timely recovery of cost offsets, those same levels of recovery would have been realized over time (under the old method) once the plant was placed in rate base. Other than timing benefits and any associated time value of money, there has been no additional funding realized. In theory, the new method might have discouraged new additions, which actually could lead to reduced revenue.

28) Is it possible to change line extension policies without affecting rates? If so, how?

RESPONSE:

Any change in the way a company recovers revenues will have some impact on rates if those changes are addressed in an equitable manner. Due to regulatory lag, any change in rates because of line extension policies maybe slow. During these interim periods, rates will not be changed without some unique intervention by the Commission. Also, in the case of TEP, a rate moratorium is in place; thus rates cannot be changed until that moratorium expires.

29) **How do the costs of construction of electric lines compare today with the costs of construction in 2006? How are adjustments made to the costs of construction? Are adjustments made to these costs pursuant to a tariff?**

RESPONSE:

Material and labor costs have increased since 2006. Any charges for these costs are made pursuant to the tariff on file with the Commission

30) **If the actual costs associated with construction are less than the amounts paid in advance by the developer, are those overages refunded? Can ratepayers obtain the actual costs for materials and the actual labor costs? What is the linear cost difference between buried electric line extensions and overhead, pole-attached line extensions?**

RESPONSE:

TEP only evaluates actual costs compared to customer contributions for Large Light and Power ("LLP") line extensions; any difference is refunded or charged to the customer. Since customers provide the civil system (trenching, conduit, risers, et cetera), there is a minimal difference in linear costs for single-phase and three-phase overhead and underground line extensions. Underground feeder line extensions are at least 24% more expensive. UNS Electric does refund any difference from actual cost.

31) **Should the Commission adopt a separate line extension policy for "extraordinary" customers, waiving costs or the like for developer commitments such as, all electric subdivisions, Energy Star homes, or solar installation programs, etc. If so, what should be the criteria for establishing such waivers?**

RESPONSE:

This is certainly something the Commission should consider. However, any special treatment should be justified economically, or have enough social benefit to justify the exceptions. The precise criteria that should be used to design any proposed waiver or exception would likely need to be discussed as part of a workshop or joint project team to assure uniform understanding and implementation between the utilities.

32) What flexibility does a utility or cooperative have in interpreting and implementing line extension policies? What flexibility *should* they have?

RESPONSE:

Utilities should have some flexibility to interpret and implement line extension policies as needed on a case-by-case basis, as long as they are consistently applied in like circumstances. Currently there is very little flexibility for utilities in this area.

33) What changes in line extension policies can occur in a generic docket? What changes must occur in a rate case?

RESPONSE:

The Companies believe that, subject to any Commission Order to the contrary, any change in line extension policies could be addressed in a generic docket. The Commission has full latitude to order the investigation and ultimately the implementation of policies established in a generic docket. What must be considered is the timing of implementing these decisions.

34) Would a change in the line extension policy be detrimental to energy efficiency or DSM goals?

RESPONSE:

There would be no detrimental effect if the change meant that the "no free allowance" policy would be eliminated. Some level of free allowance will promote growth; building new, high-efficiency buildings and homes is more economical than retro fitting with the high-efficiency equipment. As more demand-side management ("DSM") and energy efficiency programs are designed, and as building codes are updated to require more efficiency, some free allowance will give customers a greater ability to take advantage of these projects as they will not spend as much getting connected to the system. More new customers mean that DSM related funding will be spread over a larger customer base, thereby reducing the per-unit cost to all customers.

Conversely, the "no free allowance" policy may not benefit energy efficiency or DSM goals because it could take more money out of a new customer's initial construction fund, leaving them with less money to use on energy efficiency improvements.

35) **Would a change in the line extension policy provide an economic incentive to build homes in Arizona? If so, does the benefit of increased construction outweigh the costs of increased rates for all ratepayers? Can any increase in new home construction be quantified?**

RESPONSE:

Eliminating the "no free allowance" policy should incent building homes in Arizona, especially when a dollar allowance and refunding mechanism are used. Based on the Companies' communications with developers, they believe that the benefits of increased construction outweigh the cost of increased rates. The Companies cannot quantify the increase in new home construction because there are many other economic factors that affect the level of building activity.

<u>Accounting Treatment of Line Extension Proceeds</u>:

36) **Are the funds associated with line extensions treated as contributions in aid of construction (CIAC) or as revenue in your electric utility?**

RESPONSE:

The funds are treated as contributions in aid of construction ("CIAC") by both TEP and UNS Electric.

37) **Should the accounting treatment for any funds collected for line extensions be treated as revenues, as contributions-in-aid of construction, or determined on a case-by-case basis?**

RESPONSE:

Pursuant to the existing policies for TEP and UNSE, the funds collected for line extensions should be treated as CIAC on a consistent basis. When the funds are treated as CIAC, the funds collected offset the capital cost of the asset constructed, and there is a zero addition to rate base, so no further recovery of the asset is required.

38) **To what extent is the accounting treatment of line extension proceeds relevant to the over-arching policy discussion regarding who pays for the cost of the line extension and whether growth pays for growth?**

RESPONSE:

If the funds collected for line extensions are treated as CIAC, there is a clear one-to-one matching of cost incurrence and cost recovery. If the desire is to have the party causing the additional cost pay for the additional cost, there is complete clarity as to how growth paid for itself; the party requesting the line extension paid the CIAC that offset that particular capital cost.

If there is no separate charge for line extensions, all customers share all costs. The relevant consideration would be the appropriate time period for recognition of the revenue and the related costs.

39) **Does the shift in accounting treatment from CIAC *to* revenue result in growth subsidizing existing customers? In answering this question please respond to the following scenarios.**

The Commission recently authorized Arizona Public Service Company (APS) to treat all Schedule 3 proceeds as revenue instead of CIAC. Under the settlement agreement approved by the Commission, APS will be allowed to treat as revenue all line extension funds collected during January 1, 2010 and the earlier of December 31, 2012 or the conclusion of its next general rate case. Thereafter, Schedule 3 proceeds will be recorded as CIAC unless otherwise ordered by the Commission. APS' next base rate change from its next rate case will be effective no sooner than July 1, 2012. Assuming that the test year of APS' next general rate case ends on December 31, 2011 and that the Commission allows Schedule 3 proceeds to revert back to CIAC, please answer the following:

A. **A hypothetical new customer pays APS $25,000 to extend a line 1000 feet to his new home in 2011. Would such a customer be better off having his $25,000 treated as revenue instead of CIAC? Will such a customer begin to pay for his line "again" once it is placed into rate base and put into APS' rates on July 1, 2012? To what extent, can it be said that existing customers have been insulated from the costs of growth, if the $25,000 paid by the new customer, is still placed into APS' rates on July 1, 2012? To what extent, if any, has this new customer benefitted by having his $25,000 treated as revenue instead of CIAC? Will this new customer receive any benefits under a revenue approach if he first begins taking service from APS on December 31, 2011? What if he first begins taking service from APS on June 30, 2012, the day before the next APS rate case is decided? To the extent that this new customer is not benefitted by treating his $25,000 as revenue instead of CIAC, are there other customers who are benefitted? Who are these**

customers and how have they benefitted? Has the change in accounting treatment resulted in this new customer subsidizing these other customers? Does the shift in accounting treatment result in growth subsidizing existing customers?

RESPONSE:

The Companies would defer to APS response. However, if the test year is calendar 2011, the revenue requirement shortfall will be smaller because line extension funds are treated as revenue; therefore, all customers will benefit ratably from that revenue until the next rate case. However, the $25,000 asset will be added to rate base, the utility will earn a return on the un-depreciated asset, and depreciation expense and return for that asset will be charged to the ratepayers for the entire remaining life of that asset. It would seem that the new customer pays 100% for the asset up front, and then pays for a portion of it again over the life of the asset, ratably with the rest of the customer base. To the extent the new customer paid rates in the first year after the test year (2012), he would also benefit ratably with all customers from the lower rates provided to all customers as a result of his line extension fee treated as revenue. One would have to know the consistency of the amount of line extension revenue over the life of the asset and when the test years occur to know whether customers overall benefit from revenue treatment. This scenario highlights the advantage of CIAC treatment, which provides certainty that the line extension cost is paid for but once.

B. A hypothetical developer is developing a new community along the East Verde River, ten miles west of Payson and is paying the full cost (approximately $6 million) for extending electric services from Payson to the new community. The developer pays the full $6 million to APS in 2011 and the lines are constructed, and become used and useful to the new community by December, 2011. Are the developer and the residents of this new community better off having the $6 million treated as CIAC or revenue? Will existing customers have to pay for the $6 million "again" after it is put into rate base and APS' new rates become effective on July 1, 2012? Once APS' new rates go into effect will APS begin to earn a rate of return on the $6 million that was paid by the developer?

RESPONSE:

Based upon this hypothetical situation, it would appear that the $6 million of construction cost to build the line extension asset will be added to rate base, earn a return, and will be depreciated. The depreciation expense and return will enter into cost of service ratably for all customers. One would have to know the consistency of the amount of line extension revenue over the life of the asset and when the test years occur on an on-going basis to know whether customers benefit from revenue treatment. It would seem that, if the reimbursement for the line extension is treated as revenue when paid by the developer, the developer pays 100% for the constructed asset up front, and then pays for a portion of it again over the life of the asset, ratably with the rest of the customer base. To the extent the developer paid rates in the first year after the test year (2012), he would also benefit ratably with all customers from the lower rates provided to all customers as a result of his payment of the line extension fee.

Third Party Vendors:

40) Should third-party contractors or vendors be allowed to install electric line extensions? If so, under what circumstances and conditions?

RESPONSE:

No. For clarification purposes, it is assumed that this question refers to third-party contractors or vendors that are not contracted by the utility directly, but rather, contracted by a developer or land owner. Both UNS Electric and TEP have used third-party contractors to fill resource gaps as needed, while maintaining the responsibility and ownership of the material used, quality of work and scheduling. UNS Electric and TEP plan to continue to operate in this manner, using third-party contractors as needed. Neither company supports third-party contractors installing electric line extensions, unless they are directly contracted by the utility.

41) What are the potential cost-savings of third-party vendors?

RESPONSE:

There is no significant construction cost savings potential expected from use of third-party contractors or vendors compared to construction by utility company forces. Third-party vendors would pay the same or more for material, since UNS Electric and TEP negotiate long-term large volume discounts. The Companies' experience in the market has shown that qualified third party construction man-hour costs are comparable to internal costs. Additional costs would be incurred for the required oversight by the utility.

42) What should be the scope of third-party involvement? (e.g., design; construction; right-of-way acquisition; licenses and permits, etc.)

RESPONSE:

In some cases, both UNS Electric and TEP contract with third parties to acquire rights-of-way, licenses and permits, design and install electric facilities under the direction and control of the utility. That should be the limit of third-party involvement.

Utilities design new installations to serve the immediate development need, as well as the reliability of the electric system as a whole, and for future expansion. We believe that independent third-party contractors would only design for the immediate development, because they would not have the appropriate information to design for the system as a whole or for future expansion.

43) How should the host utility ensure quality control? How should warranty, insurance and liability issues be resolved? Who would bear responsibility for accidents, injuries, and fatalities among patrons and workers resulting from substandard work from third-party contractors?

RESPONSE:

Material specifications would be provided by UNS Electric and TEP and verified prior to third party acquisition and installation. The Companies' inspectors would be on-site through 100% of the construction process to ensure quality control of third party installation. Third parties would be required to provide a bond for all work performed as a means to warranty their craftsmanship. Third parties would be responsible for accidents, injuries, and fatalities among patrons and workers resulting from substandard work from third-party contractors.

44) Can we be certain that any benefits from a third-party contractor option will not be offset by safety and reliability issues?

RESPONSE:

UNS Electric and TEP believe that use of third-party contractors could diminish safety and decrease reliability, which would outweigh any benefits.

45) Would the inclusion of a third-party option generally promote the "convenience, comfort, and safety, and the preservation of the health, of the employees and patrons" of electric utilities?

RESPONSE:

No. UNS Electric and TEP have been in the utility construction business for over 100 years. Our safety performance, and the rest of the industry, has consistently performed at a much higher level of than that of the general electrical contracting industry. An appropriate level of staffing is required to maintain a safe and reliable system to the benefit of both our customers and employees. Perhaps even more important than new construction is system restoration which requires qualified employees to be available at all times. The skill level needed to perform system restoration is acquired through the career of a craftsman. In order to develop well-rounded craftsmen, they must be exposed to all types of work: system reinforcement, maintenance, emergency repairs, and new installations.

46) **Have other jurisdictions permitted third-party contractors to construct line extensions? If so, what has been their experience? Have there been any "hidden costs" (e.g., design, inspection, and repair costs borne by utilities and ratepayers, but not captured in contractors' prices), delays, and complaints associated with such work?**

RESPONSE:

The Companies are aware of third-party contractors constructing line extensions in California. A cursory search showed some issues with costs not being captured in contractors' prices and incremental costs of utility inspections being borne by rate payers. The Companies are not aware what, if any, conclusions have been reached in California to resolve these issues.

Catch-all Question:

47) **What other questions or issues should be answered or addressed in connection with this inquiry?**

RESPONSE:

The Companies are not aware of any other questions or issues that should be addressed in connection with this inquiry. The Companies reserve their rights to supplement this response.