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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

Arizona Corporation Commission

DOCKETED

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KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE APPLICATION OF
UNS GAS, INC. FOR THE ESTABLISHMENT OF
JUST AND REASONABLE RATES AND
CHARGES DESIGNED TO REALIZE A
REASONABLE RATE OF RETURN ON THE
FAIR VALUE OF THE PROPERTIES OF UNS
GAS, INC. DEVOTED TO ITS OPERATIONS
THROUGHOUT THE STATE OF ARIZONA.

DOCKET NO. G-04204A-08-0571

DECISION NO. 71623OPINION AND ORDER

PUBLIC COMMENTS:

August 3, 2009 (Flagstaff); August 6, 2009 (Prescott);
August 17, 2009 (Nogales)

DATES OF HEARING:

August 3, 2009 (Pre-Hearing); August 10, 11, 12, 14,
17, and 18, 2009 (Hearing)

PLACE OF HEARING:

Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE:

Dwight D. Nodes

APPEARANCES:

Mr. Philip J. Dion, III, UNISOURCE ENERGY
SERVICES; and Mr. Michael W. Patten ROSHKA,
DeWULF & PATTEN, PLC, on behalf of UNS Gas,
Inc.;

Mr. Nicholas J. Enoch, LUBIN & ENOCH, P.C., on
behalf of IBEW Local 1116;

Mr. Daniel Pozefsky, on behalf of the Residential Utility
Consumer Office;

Ms. Cynthia Zwick, in propria persona;

Ms. Robin Mitchell and Mr. Kevin Torrey, Staff
Attorneys, on behalf of the Utilities Division of the
Arizona Corporation Commission.

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1 BY THE COMMISSION:

2 On November 7, 2008, UNS Gas, Inc. ("UNS Gas" or "Company") filed with the Arizona
3 Corporation Commission ("Commission") an application for a rate increase.

4 On December 3, 2008, Local Union 1116, International Brotherhood of Electrical Workers,
5 AFL-CIO ("IBEW") filed an Application to Intervene.

6 On December 4, 2008, UNS Gas filed a revised H-5 Schedule to its application.

7 On December 5, 2008, the Company filed a revised H-1 Schedule to its application.

8 On December 8, 2008, the Commission's Utilities Division ("Staff") filed a Letter of
9 Sufficiency indicating that UNS Gas's application satisfied the requirements of Arizona
10 Administrative Code ("A.A.C.") R14-2-103, and classifying the Company as a Class A utility.

11 On December 22, 2008, the Residential Utility Consumer Office ("RUCO") filed an
12 Application to Intervene.

13 On January 7, 2009, a Procedural Order was issued scheduling a hearing to commence on
14 August 10, 2009; setting various other procedural deadlines; directing UNS Gas to publish notice of
15 the applications and hearing date; and granting the IBEW and RUCO requests for intervention.

16 On February 2, 2009, Cynthia Zwick filed a letter requesting permission to intervene "as an
17 individual concerned about the potential impact of a rate increase on low-income and working poor
18 Arizonans."

19 By Procedural Order issued March 26, 2009, Ms. Zwick's request for intervention was
20 granted.

21 By Procedural Order issued March 26, 2009, the pre-hearing conference was rescheduled in
22 this matter for August 3, 2009.

23 With its rate application, UNS Gas filed its required schedules in support of the application, as
24 well as the direct testimony of D. Bentley Erdwurm, David Hutchens, Kentton Grant, Dallas Dukes,
25 Karen Kissinger, Gary Smith, and Denise Smith.

26 On May 5, 2009, the Company filed Affidavits of Publication and Mailing in accordance with
27 the January 7, 2009, Procedural Order.

28 On June 8, 2009, Staff filed the direct testimony of Dr. Thomas Fish, David Parcell, Robert

1 Gray, Rita Beale,¹ Corky Hanson and Juan Manrique; RUCO filed the direct testimony of William
2 Rigsby, Ralph Smith,² and Frank Radigan; IBEW filed the direct testimony of Frank Grijalva; and
3 Ms. Zwick filed her direct testimony.

4 On July 8, 2009, UNS Gas filed the rebuttal testimony of Mr. Erdwurm, Mr. Grant, Mr.
5 Dukes, Ms. Kissinger, and Mr. Hutchens.

6 By Procedural Order issued July 9, 2009, public comment meetings were scheduled for
7 Flagstaff on August 3, 2009; for Prescott on August 6, 2009; and for Nogales on August 17, 2009.
8 The Company was directed to publish notice of the public comment meetings.

9 On July 29, 2009, Staff filed the surrebuttal testimony of Dr. Fish, Mr. Parcell, Mr. Gray, and
10 Ms. Beale; and RUCO filed the surrebuttal testimony of Mr. Rigsby, Mr. Smith,³ and Mr. Radigan.

11 On August 3, 2009, a prehearing procedural conference was conducted to discuss the order of
12 witnesses and exhibits.

13 On August 5, 2009, UNS Gas filed the rejoinder testimony of Mr. Hutchens, Mr. Grant, Mr.
14 Dukes, and Mr. Erdwurm.

15 The evidentiary hearing commenced as scheduled on August 10, 2009, and additional hearing
16 days were held on August, 11, 12, 14, 17, and 18, 2009. Public comment meetings were held, as
17 scheduled, on August 3, 6, and 17, 2009, in Flagstaff, Prescott, and Nogales, respectively.

18 On September 1, 2009, Chairman Mayes filed a letter in the docket requesting a response
19 from UNS Gas with respect to the Company's plans to expedite refunds of over-collected amounts
20 received through the Purchased Gas Adjustor ("PGA") mechanism.

21 On September 1, 2009, Staff filed a Late-Filed Exhibit that included Arizona unemployment
22 statistics for 2005-09; July 2009 foreclosure rates for counties in the Company's service area; UNS
23 Gas disconnections from 2006-09; and information regarding a Kansas energy efficiency program
24 and Arizona Energy Office programs.

25 On September 3, 2009, UNS Gas filed Affidavits of Publication for the public comment
26 meetings, in accordance with the July 9, 2009 Procedural Order.

27 ¹ Ms. Beale submitted separately a confidential version of her direct testimony. (Ex. S-5.)

28 ² Mr. Smith submitted separately a confidential version of his direct testimony. (Ex. R-22.)

³ Mr. Smith submitted separately a confidential version of his surrebuttal testimony. (Ex. R-23.)

On September 8, 2009, UNS Gas filed a letter describing the Company's policies regarding acceptance of payments at local offices and other locations.

Initial briefs were filed on September 18, 2009, by UNS Gas, Staff, RUCO, IBEW, and Ms. Zwick. UNS Gas, Staff, and RUCO also filed their Final Schedules on September 18, 2009, setting forth their respective final revenue requirement and rate design positions.

Reply Briefs were filed on September 29, 2009, by IBEW; on September 30, 2009, by RUCO; and on October 5, 2009, by UNS Gas and Staff.

RATE APPLICATION

According to the Company's application, as modified, in the test year ended June 30, 2008, UNS Gas had adjusted operating income of \$11,693,461, on an adjusted Original Cost Rate Base ("OCRB") of \$184,379,086, for a 6.34 percent rate of return. The Company's proposed test year Reconstruction Cost New Depreciated ("RCND") rate base is \$330,365,912, resulting in a rate of return of 3.54 percent; and its proposed Fair Value Rate Base ("FVRB") is \$257,372,499, resulting in a test year rate of return of 4.54 percent on FVRB.

According to the Final Schedules, UNS Gas requests a gross revenue increase of \$9,480,875; Staff recommends a gross revenue increase of \$3,395,423; and RUCO proposes a gross revenue increase of \$1,265,000. A summary of the parties' positions follows.

	<u>Company Proposed</u>	<u>Staff Proposed</u>	<u>RUCO Proposed</u>
ORIGINAL COST			
Adjusted Rate Base	\$184,379,086	\$178,509,369	\$179,884,851
Rate of Return	9.48%	7.59%	7.55%
Req'd Operating Inc.	17,486,492	15,621,857 ⁴	13,581,275
Op. Income Available	11,693,461	13,544,256	12,831,730
Operating Inc. Def.	5,793,032	2,077,601	749,545
Rev.Conver. Factor	1.6366	1.6343	1.6366
Gross Rev. Increase	\$9,480,875	\$3,395,423	\$1,227,000
FAIR VALUE			
Adjusted Rate Base	\$257,372,499	\$251,524,153	\$252,877,851
Rate of Return	6.79%	6.37% ⁵	5.38%

⁴ Staff's "alternative" fair value recommendation.

⁵ Staff's alternative fair value rate of return recommendation.

1	Req'd Operating Inc.	17,486,492	15,621,857	13,604,828
	Op. Income Available	11,693,461	13,544,256	12,831,730
2	Operating Inc. Def.	5,793,032	2,077,601	773,098
	Rev.Conver. Factor	1.6366	1.6343	1.6366
3	Gross Rev. Increase	\$9,480,875	\$3,395,423	\$1,265,000 ⁶

REVENUE REQUIREMENT

Rate Base Issues

As shown above, UNS Gas proposed an OCRB of \$184,379,086; Staff recommends an OCRB of \$178,509,369; and RUCO proposed an OCRB of \$179,884,851. Each of the contested issues regarding rate base items is discussed below.

Post-Test-Year Plant

UNS Gas proposes to include \$1,527,588 of post-test-year plant in rate base. The Company claims to have limited its request to plant added after the test year and which is "non-revenue producing." According to Company witness Dukes, the post-test-year plant for which the Company seeks rate base recognition "is plant ... whose primary purpose is to serve existing customers and which would have been replaced regardless of customer growth." (Ex. A-18, at 4.) Mr. Dukes testified that the plant in question includes transportation equipment, general plant, replacement of mains, and relocation of facilities that were placed into service after the end of the test year, but which are now in service. (Ex. A-17, at 4.)

In support of its position, UNS Gas contends that it responded to concerns expressed by the Commission in the Company's last rate case, Decision No. 70011 (November 27, 2007), that the Company's request for post-test-year plant failed to segregate revenue producing plant from non-revenue-producing plant. UNS Gas claims that it "took [the Commission's] criticism to heart" (UNS Gas Reply Brief, at 2) by identifying only the plant that it categorized as "non-revenue-producing" by the Company's plant accounting group and operational personnel.

UNS Gas also cites to prior Commission decisions involving water companies wherein post-test-year plant was included in rate base. For example, in a case involving Bella Vista Water

⁶ As discussed below, RUCO also presented several alternative methods for calculating the Fair Value revenue requirement.

1 Company, Decision No. 65350 (November 1, 2002), the Commission permitted inclusion of post-
2 test-year system improvements on the basis that the record did not reflect a material impact on
3 revenues and expenses. The Company also points to a Chaparral City Water Company case,
4 Decision No. 68176 (September 30, 2004), in which the Commission allowed post-test-year plant in
5 rate base despite the potential mismatch between revenues and expenses.

6 Staff opposes the Company's request for post-test-year plant on the basis that it would violate
7 principles of ratemaking and would result in a mismatch of such plant with test year revenues,
8 expenses and rate base. Staff witness Dr. Fish stated that the Company's plant investment after the
9 test year could result in efficiencies and lower maintenance costs, thereby resulting in a mismatch
10 with test year revenues and expenses. (Ex. S-12, at 16.)

11 Staff also argues that, contrary to the Company's claims, the Commission did not indicate in
12 Decision No. 70011 that it would allow post-test-year plant if UNS Gas could segregate "revenue-
13 producing" from "non-revenue-producing" plant added after the test year. Rather, according to Staff,
14 the Commission rejected the Company's request for many of the same reasons it declined to allow
15 recovery of construction work in progress ("CWIP"). In denying the Company's request for CWIP in
16 the prior UNS Gas case, we stated:

17 UNS is not faced with an extraordinary situation that would justify
18 inclusion of CWIP in rate base because the plant required to serve new
19 customers will help produce revenues; UNS has a means, through accrual
20 of AFUDC, to mitigate the effect of the CWIP investment; allowance of
21 CWIP would undermine the balancing of test year revenues and expenses;
22 and the regulatory lag inherent in utility regulation may provide benefits to
the extent that items such as plant retirements and accumulated
depreciation occur between test periods and thereby help to mitigate
periods of higher plant investment associated with customer growth.

23 (Decision No. 70011, at 6-7.)

24 Staff disputes the Company's interpretation of the cited Chaparral City case (Decision No.
25 68176), arguing that the Commission's inclusion of post-test-year plant was based on its
26 determination that Chaparral City's plant was placed in service within three months of the end of the
27 test year, and that the additional plant was needed to close a deficiency in available capacity and, as
28 such, was necessary to provide a safe capacity operating margin. With respect to Bella Vista

1 (Decision No. 65350), Staff claims that the Commission indicated that the inclusion of post-test-year
2 plant is a matter to be determined on a case-by-case basis, and the plant in that case was placed into
3 service one year and three days after the test year.

4 Staff claims that it traditionally recommends allowance of post-test-year plant only in
5 instances where the magnitude of the investment, relative to the company's total plant investment, is
6 such that non-inclusion could jeopardize the company's financial health; and when other factors are
7 present, such as the cost of the post-test-year plant is significant, the net impact on revenue and
8 expenses for the plant is insignificant or revenue-neutral, and the post-test-year plant is necessary for
9 the provision of safe and reliable service. (Tr. 565-66.) Staff argues that the post-test-year plant
10 proposed by UNS Gas does not meet these criteria and should be denied.

11 RUCO similarly opposes inclusion of post-test-year plant in this case. RUCO witness Ralph
12 Smith testified that the Company's request for post-test-year plant is a subset of CWIP and raises the
13 same concerns presented with respect to including CWIP in rate base. He stated that the attempt by
14 UNS Gas employees to identify "non-revenue-producing" plant failed to take into consideration
15 whether the plant also was expense-reducing. Mr. Smith explained that even if plant could be
16 identified as non-revenue-producing, the replacement of older mains and service lines with new plant
17 could reduce operating and maintenance expenses associated with aging equipment. Mr. Smith
18 indicated that the Commission has typically not allowed inclusion of post-test-year plant except in
19 rare circumstances involving water companies. He also pointed out that the Commission specifically
20 denied the request by UNS Gas in its last rate case to include such plant in rate base. (Ex. R-21, at 12-
21 20.)

22 In Decision No. 70011, we denied UNS Gas's proposal for rate base recognition of post-test-
23 year plant. In that Decision, we pointed out that although such plant has previously been allowed in
24 several prior cases involving water companies, those cases provided some assurance that a mismatch
25 of rate base with revenues and expenses did not occur. UNS Gas has not identified any prior
26 Commission decisions that allowed post-year-plant for gas or electric companies. We also indicated
27 that the same reasons for denying recognition of CWIP are applicable to the issue of post-test-year
28

1 plant, and that there was not a sufficient basis upon which to evaluate whether a mismatch would
2 result. (Decision No. 70011, at 7-8.)

3 UNS Gas identified portions of its post-test-year plant as "non-revenue-producing" in an
4 attempt to satisfy what it interpreted as the Commission's sole concern in the last case related to such
5 plant. Aside from the subjective nature of the "revenue-producing" versus "non-revenue-producing"
6 inquiry undertaken by the UNS Gas employees, the Company's narrow reading of Decision No.
7 70011 is misplaced. Although that Decision observed that inclusion of post-test-year plant could
8 result in a mismatch, it also specifically referred to the discussion regarding denial of CWIP as a
9 basis for rejecting post-test-year plant. As set forth in the passage above with respect to denial of
10 CWIP, the mismatch of rate base with revenues and expenses was only one of several concerns
11 expressed in Decision No. 70011, and was not intended as a prescription for UNS Gas to overcome
12 the broader concerns regarding inclusion of CWIP and post-test-year plant in rate base.

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

22 For these reasons, we decline to adopt UNS Gas's request for inclusion of post-test-year plant.

23 Deduction of Customer Advances from Rate Base

24 Similar to the issue raised in its last rate case, UNS Gas proposes that \$589,152 that it holds in
25 customer advances should not be deducted from rate base. The Company contends that these funds
26 should not be treated as a rate base reduction because the funds are tied to plant that is not yet in rate
27 base. According to UNS Gas, adoption of the recommendations of Staff and RUCO to reduce rate
28 base by this amount would improperly reduce the Company's pre-existing rate base.

1 Although the Company concedes that such advances are typically deducted from rate base
2 because they represent customer-supplied capital, UNS Gas argues that it is inherently unfair to
3 exclude the advances from rate base if the plant associated with those advances is not yet in service
4 and not included in rate base. (Ex. A-17, at 5-6.) UNS Gas claims that the purpose of deducting
5 advances (*i.e.*, recognizing customer-supplied capital) is not furthered when the plant is not in
6 service. The Company also contends that the deduction of advances in this case would discourage
7 utilities from seeking advances to offset infrastructure capital costs. To support its position, UNS
8 Gas cites to Decision No. 69914 (September 27, 2008). The Company claims that in Decision No.
9 69914 the Commission allowed Arizona-American Water Company ("Arizona-American") to
10 exclude contributions associated with a specific surface water treatment plant for the rate base
11 calculation.

12 Both Staff and RUCO oppose the Company's recommendation. RUCO witness Ralph Smith
13 stated that because advances represent non-investor-supplied capital, they should be reflected as a
14 deduction to rate base. Mr. Smith also cites to A.A.C. R14-2-103, Appendix B, Schedule B-1, which
15 he claims requires companies to reflect advances as a deduction from rate base. (Ex. R-21, at 20-23).
16 Mr. Smith testified that the treatment of advances accorded in the last UNS Gas rate case should be
17 followed in this case. (*Id.*)

18 Staff also contends that the Commission rule cited above contemplates that customer
19 contributions and advances are to be reflected as a deduction to rate base, because they represent
20 customer-supplied funds that are available to the Company. Dr. Fish stated that advances represent
21 non-investor-supplied capital, and that the Commission's rule set forth in A.A.C. R14-2-103 requires
22 that such funds be treated as a deduction to rate base. (Ex. S-13, at 3.)

23 We agree with Staff and RUCO that advances represent customer-supplied funds that are
24 properly deducted from the Company's rate base. Indeed, the Commission's rules contemplate that
25 such a deduction is required, as both the Staff and RUCO witnesses testified. The Company's
26 reliance on Decision No. 69914 to support its position is not persuasive. In that Decision, the
27 Commission addressed a financing application by Arizona-American and whether the company
28 should be permitted to finance a proposed wastewater treatment plant with hook-up fees, compared to

1 a competing bid by a Maricopa County Municipal Water Conservation District to construct the
2 treatment plant and sell capacity to Arizona-American. That case is clearly distinguishable from the
3 instant case, in which the issue presented is whether customer-provided advances should be treated as
4 deductions from rate base even if the plant built with such funds is not yet part of the Company's rate
5 base. This issue was raised by UNS Gas in its last rate case and denied by the Commission.
6 (Decision No. 70011, at 8-11.) The Commission also subsequently denied UNS Electric Company's
7 arguments on the same issue in Decision No. 70360.⁷

8 As indicated in the Company's last rate case, regulated utility companies control the timing of
9 their rate case filings and should not be heard to complain when their chosen test periods do not
10 coincide with the completion of plant that may be considered used and useful and therefore properly
11 included in rate base. Further, our conclusion regarding UNS Gas's advances is consistent with the
12 treatment that has been afforded to other utility companies regulated by the Commission, and
13 provides a result that is fair to both the Company and its customers.

14 The Company's proposed treatment of customer advances is therefore denied.

15 Working Capital

16 As described by UNS Gas witness Dallas Dukes, working capital is generally defined as
17 "investor funding in excess of the balance of net utility plant reflected in rate base that is required for
18 the provision of utility service." (Ex. A-16 at 12.) The components of working capital include
19 materials and supplies, prepayments, and cash working capital. The amounts for materials and
20 supplies, and prepayments, are determined based on test year recorded balances, whereas the cash
21 working capital component was determined by UNS Gas based on a lead-lag study. (*Id.* at 13.)

22 In his direct testimony, Mr. Dukes described the concept of a lead-lag study as follows:

23 A lead-lag study is a detailed analysis of the dynamic movement of funds
24 throughout the organization, between the receivable and payable balance
25 sheet accounts and related revenues and expenses that are reflected in the
26 operating income component of revenue requirements. ... The focal point
of all lead-lag studies is the 'point of service.' That is the instant in time

27 ⁷ See, *UNS Electric Co.*, Decision No. 70360 (May 27, 2008), at 10-11. The Commission recently confirmed the
28 treatment of customer contributions and advances as deductions to rate base in *Arizona-American Water Co.*, Decision
No. 71410 (December 8, 2009), at 26-28; and *H2O Water Co.*, Decision No. 71414 (December 8, 2009), at 4-8.

1 at which customers receive service and, coincident therewith, the utility
2 incurs the cost of providing that service. A lead-lag study measures the
3 average length of time between the provision of service and the ultimate
4 receipt of payment from the customer ('revenue lag'). The result is
5 compared with the average length of time between the point at which the
6 utility incurs a cost of providing that service and the date upon which it
makes the related cash disbursement ('payment lead' if payment precedes
the cost benefit, or 'payment lag' if the payment occurs after the cost
benefit). Cash working capital reflects the effect on costs of service of the
difference between the revenue lag and payment leads or lags.

7 (*Id.* at 14-15.) RUCO witness Ralph Smith summarized the concept of cash working capital as
8 follows:

9 Cash working capital is the cash needed by the Company to cover its day-
10 to-day operations. If the Company's cash expenditures, on an aggregate
11 basis, precede the cash recovery of expenses, investors must provide cash
12 working capital. In that situation, a positive cash working capital
13 requirement exists. On the other hand, if revenues are typically received
14 prior to when expenditures are made, on average, then ratepayers provide
the cash working capital to the utility, and the negative cash working
capital allowance is reflected as a reduction to rate base. In this case, the
cash working capital requirement is a reduction to rate base as ratepayers
are essentially supplying these funds.

15 (Ex. R-20 at 21.) Mr. Smith stated in his direct testimony that, based on the results of the Company's
16 lead-lag study, UNS Gas proposed a cash working capital allowance of approximately \$1,568, which
17 RUCO did not oppose. (*Id.*)

18 Staff witness Dr. Fish indicated in his direct testimony that he believed UNS Gas erred in
19 calculating the lag days for purchased gas. According to Dr. Fish, the Company used 17.83 lag days
20 for the test year months of December 2007, and January and February 2008, instead of the normal 35
21 lag days, thereby shortening the overall lag period to 27.89 days for gas procurement. Dr. Fish
22 therefore adjusted the lag days back to 35.44 days, and calculated a revised cash working capital
23 requirement of *negative* \$1,624,840. (Ex. S-12, at 18.)

24 In his rebuttal testimony, Company witness Dukes stated that, in preparing his response to Dr.
25 Fish, he discovered that the payment periods for gas purchased from BP Energy were much shorter
26 than the 35 day assumption used by Dr. Fish, and shorter than the original 27.89 lag days included in
27 the Company's original filing. Mr. Dukes indicated that UNS Gas's payment terms were altered
28

1 during the test year by BP Energy "because of credit limitations," and that BP Energy "now requires
2 the Company to make payments twice a month." (Ex. A-17, at 8.) He testified that, because the new
3 payment requirement is a known and measurable change, it should be recognized in the lead-lag
4 calculation. Mr. Dukes therefore proposed that UNS Gas's working capital requirement be amended
5 to \$2,183,948.

6 In response to the Company's amended position, Staff witness Fish testified that the payment
7 terms agreed to by UNS Gas "are not representative of normal credit terms" and the Company "has
8 the discretion to obtain more favorable terms and conditions from another supplier." (Ex. S-13, at 4.)

9 RUCO witness Smith also opposed the Company's request to modify its working capital
10 allowance. Mr. Smith testified that the original 27.89 lag day proposal should be adopted because the
11 number is supported by Company workpapers; 27.89 lag days is fairly consistent with the 30.97 lag
12 days used in the Company's last case; the proposed change would reach outside the test year for a
13 single item; the post-test-year change in gas procurement responsibility from BP Energy to Tucson
14 Electric Power ("TEP") was described in Staff's procurement review as a proposed benefit to
15 ratepayers; and UNS Gas has not demonstrated that the change in payment terms is a permanent
16 requirement. (Ex. R-21, at 24-25.)

17 In his rejoinder testimony, Mr. Dukes responded that the change in payment terms began
18 during the test year and continues to be in effect today. He stated the payment terms will continue
19 during this winter and those terms are "recurring, known and measurable," and should therefore be
20 recognized in the rates set in this case. (Ex. A-18, at 7.)

21 We agree with Staff and RUCO that the Company's proposed adjustment, that was offered
22 one month before the commencement of the hearing, should be denied. The original 27.89 lag for gas
23 procurement was supported by detailed documentation showing purchases from all of UNS Gas's
24 suppliers, and was the proposal that reflected the Company's position on this issue from the time the
25 application was filed in November 2008 until just before the hearing. It is the Company's
26 responsibility to prepare its application in a manner that reflects an accurate portrayal of its
27 operations, based on facts that are known at the time the application is filed. To be clear, the
28 proposed adjustment was not simply the correction of a clerical error, but rather a substantial change

1 to the calculation of a significant component of the Company's lead-lag study, and the change would
2 cause UNS Gas's working capital requirement to be increased from less than \$1,600 to more than
3 \$2.18 million.

4 The burden of proof that rests on the applicant proposing a rate increase includes an obligation
5 to present supporting documentation to other parties in a timely manner, so that such parties are not
6 placed at a disadvantage in responding to substantial changes in position. Moreover, the information
7 that caused the eleventh-hour amendment was at all times within the Company's control and should
8 have been included in the original rate filing.

9 In addition to the prejudicial effect of the proposed adjustment, RUCO witness Smith
10 indicated that there are other post-test-year cost decreases that the Company has not reflected, such as
11 for labor, meter reading, repairs and maintenance, communications and vehicle depreciation. (Ex. R-
12 21, at 27.) Further, it is not clear that the accelerated payment terms agreed to by UNS Gas will
13 remain on a permanent basis. Mr. Smith indicated that the Company may pay BP Energy on a
14 monthly basis as long as UNS Gas is within its established credit limit. (*Id.* at 30.) To the extent that
15 declining gas prices allow the Company to remain within its credit limit in future periods, the
16 working capital requirement could be reduced significantly during future periods.

17 Based on the record, we decline to adopt Staff's negative working capital recommendation,
18 and find that RUCO's proposal to adopt the Company's original position, which was maintained by
19 UNS Gas for the first eight months of the pendency of this case (*i.e.*, \$1,568), should be adopted as a
20 reasonable reflection of UNS Gas's working capital requirement.

21 Prepayments

22 In his direct testimony, RUCO witness Smith proposed that rate base should be reduced by
23 \$95,671, to reflect an end-of-test-year balance for prepayments consistent with the treatment of plant-
24 in-service, accumulated depreciation, customer advances, and customer deposits. (Ex. R-20, at 20-
25 21.) RUCO argues on brief that the Company failed to address this issue in its rebuttal testimony and
26 RUCO's position should therefore be adopted. (RUCO Initial Brief, at 7.)

1 UNS Gas contends in its reply brief that RUCO did not list this issue in the joint issues
2 matrix, and therefore the Company did not address the issue at hearing. (UNS Gas Reply Brief, at 8.)
3 The Company claims that RUCO's proposal should be denied.

4 We agree with RUCO that, for consistency purposes, the end-of-test-year balance for
5 prepayments should be used. There is no valid reason for treating prepayments in a manner that is
6 different from other rate base balances, including customer deposits.

7 RUCO's position shall therefore be adopted.⁸

8 Accumulated Deferred Income Tax

9 Based on its recommendations in this case, RUCO proposed a reduction to rate base
10 by \$25,844 (Ex. R-20, Sched. B-6) to account for removal of accumulated deferred income tax
11 ("ADIT") related to stock-based compensation and accrued liabilities (Ex. R-21 at 36).

12 In its initial brief, UNS Gas did not address the ADIT issue raised by RUCO, except for the
13 statement that the differences between the Company's, Staff's, and RUCO's proposals would result
14 in different ADIT adjustments. (UNS Gas Initial Brief, at 11.) The Company did not address in its
15 reply brief the ADIT issues raised in RUCO's initial brief.

16 It appears from Ms. Kissinger's testimony that the Company disagrees with RUCO's proposal
17 in this case, based on her claim that "ADIT related to vacation and pension expense were included in
18 rate base in [UNS Gas's] last rate case," and "RUCO's proposed adjustment is another example of
19 RUCO challenging accepted Commission-approved methods." (Ex. A-12, at 3.) However, the
20 Company's failure to address the issue on brief leaves uncertainty regarding its position on this issue.
21 On the other hand, RUCO did not cross-examine Ms. Kissinger regarding the Company's ADIT
22 position. (Tr. 163.) Nor did the Company question RUCO witness Smith regarding his ADIT
23 testimony. (Tr. 880-98.)

24
25
26 ⁸ RUCO argues on brief for using end-of-test-year balances for customer deposits, which is consistent with the treatment
27 proposed by UNS Gas and agreed to by Staff. However, RUCO recommended using a 13-month average balance if its
28 position on prepayments is denied. (RUCO Initial Brief, at 9-10.) Given our adoption of RUCO's proposal on
prepayments, it appears RUCO is in agreement with the Company's use of an end-of-test-year balance for customer
deposits.

Consistent with our removal of stock-based compensation and customer advances (see discussion below), we agree that rate base should be reduced by \$25,844 to recognize the ADIT associated with that compensation.

Summary of Rate Base Adjustments

Based on the foregoing discussion, we adopt an adjusted OCRB of \$180,080,695, RCND of 326,067,520, and a FVRB of \$253,074,108.⁹

Commission Approved

ORIGINAL COST RATE BASE:

Gas Plant in Service	\$316,700,036
Less: Accumulated Depreciation	(87,543,544)
Net Plant in Service	229,156,492
Citizens Acquisition Discount	(30,709,738)
Less: Accum. Amort. – Citizens Acq. Disc.	(3,935,647)
Net Citizens Acq. Discount	(26,774,091)
Total Net Utility Plant	202,382,401
<u>Deductions:</u>	
Customer Advances for Construction	(11,825,028)
Customer Deposits	(2,609,271)
Accum. Deferred Income Taxes	(10,632,719)
Total Deductions	(25,067,018)
Allowance for Working Capital	2,269,250
Regulatory Liabilities	(22,372)
Regulatory Assets	492,590
Total OCRB	\$180,054,851

RCND RATE BASE:

Gas Plant in Service	\$558,511,431
Less: Accumulated Depreciation	(152,278,962)
Net Plant in Service	406,232,469
Less: Accum. Amort. – S. Union Acq. Prem.	(3,553)
Citizens Acquisition Discount	(55,126,579)
Less: Accum. Amort. – Citizens Acq. Disc.	(6,658,438)
Net Citizens Acq. Discount	(48,468,141)
Total Net Utility Plant	357,760,775
<u>Deductions:</u>	
Customer Advances for Construction	(13,348,925)
Customer Deposits	(2,609,271)
Accum. Deferred Income Taxes	(18,500,371)

⁹ The FVRB is determined by averaging the OCRB and RCND.

1	Total Deductions	(34,458,567)
2	Allowance for Working Capital	2,269,250
3	Regulatory Liabilities	(22,372)
4	Regulatory Assets	<u>492,590</u>
5	Total RCND	\$326,041,676
6	FAIR VALUE RATE BASE:	\$253,048,264

Operating Revenue and Income Issues

7 In the test year, the Company's reported operating revenues were \$51,157,763, with reported
8 adjusted test year operating expenses of \$41,209,045, and test year net operating income of
9 \$11,693,461. As reported in its Final Schedules, Staff's proposed adjusted test year operating
10 revenues were \$52,657,136, with adjusted test year operating expenses of \$40,857,623, resulting in
11 test year net operating income of \$13,544,256. RUCO's Final Schedules show proposed adjusted test
12 year operating revenues of \$53,418,509, with adjusted test year operating expenses of \$40,586,779,
13 yielding test year net operating income of \$12,831,730. The disputed expense adjustments are
14 discussed below.

Operating Revenues

Customer Annualization

16 In the last UNS Gas case, the Company proposed to annualize customer revenues based on a
17 cyclical growth pattern, which the Company contended more accurately reflected its actual
18 experience in its service territory. The Commission declined to adopt the Company's proposal in that
19 case, based on "the lack of any significant demonstrated seasonality, the complexity of the formula,
20 lack of transparency, and ... that the methodology may actually result in an understatement of
21 revenues." (Decision No. 70011, at 17-19.) Instead, the Commission adopted the so-called
22 "traditional method" of customer annualization, in which the monthly customer count for each of the
23 first eleven months of the test year is brought equal to the customer count in the final month of the
24 test year. (Ex. A-21, at 2.)

25 In the instant case, UNS Gas recommended that the traditional approach to customer
26 annualization be used in order to be consistent with the Commission's Decision in the last case.
27 Company witness D. Bentley Erdworm testified that UNS Gas's residential and commercial customer
28

1 counts exhibit some seasonality, as some customers disconnect service in summer months and then
2 reconnect in the fall and winter. (*Id.*) UNS Gas points out that both Staff and RUCO advocated use
3 of the traditional method in the last case, but have abandoned use of that methodology in this case
4 because the test year in this case ends in the summer and thereby results in a lower number of
5 customers at the end of the test year. The Company contends that it is unfair to abandon the
6 traditional method simply because it would result in a higher revenue requirement for UNS Gas.

7 Staff witness Dr. Fish recommended an annualization adjustment based on the mid-point of
8 the test year (December 2007), plus a 1.25 percent growth rate. He stated that the growth rate is
9 based on Company witness Hutchens' 2.5 percent growth rate estimate for UNS Gas, adjusted for the
10 mid-point of the test year. Staff's recommended annualization adjustment would result in an increase
11 to test year revenues of \$869,221, compared to the Company's proposal to reduce test year revenues
12 downward by \$516,003. (Ex. S-12, at 21-22.) Dr. Fish claims that Staff's recommendation reflects a
13 representative level of revenues under normal conditions; is based on historical test year information;
14 employs the growth rate claimed by UNS Gas; and reconciles the counterintuitive result that would
15 occur under the Company's proposal (*i.e.*, that UNS Gas is experiencing declining growth on its
16 system). (Ex. S-13, at 9-13.)

17 RUCO witness Ralph Smith also opposes the Company's customer annualization proposal in
18 this case. Mr. Smith explained that in situations where a utility is growing and adding plant to serve
19 that growth, a revenue annualization is typically used to reflect the impact on revenue related to
20 customer growth and to better match the test year revenues with test year plant. He indicated that
21 although UNS Gas employed an annualization similar to that used in the last case, that methodology
22 should not be used in this case because it would understate test year revenues, as well as the revenues
23 that are expected to be achieved post-test-year. (Ex. A-21, at 37-38.) Mr. Smith testified that the
24 Company has added residential and commercial customers for the past several years, including in the
25 test year, and it would not make sense to assume UNS Gas is experiencing a decline in customers and
26 revenues at the same time that the Company is adding plant to serve new customers. (*Id.*)

27 We agree with Staff and RUCO that it is not appropriate to blindly apply the traditional
28 customer annualization methodology if the result achieved by that exercise does not reflect an

1 accurate portrayal of UNS Gas's actual operations. The Company would have the Commission
2 assume that it is losing customers and revenues while, at the same time, requesting that we recognize
3 significant additions to plant in rate base that were needed to serve customer growth.

4 In support of its position, UNS Gas relies heavily on the fact that the Commission adopted an
5 end of test year annualization methodology in the Company's last rate case. The Company argues
6 that just because the end of the test year in this case happens to fall in the summer, the rationale
7 should not change when the end of the test year coincides with the end of the calendar year, as
8 occurred in the prior case.

9 We agree with UNS Gas that consistency in Commission Decisions is important. However,
10 the overriding consistency to be achieved on this issue is recognition of the Company's overall
11 operations during the test year. In the prior case, we denied the Company's proposed annualization
12 methodology based not only on the fact that it did not fully recognize customer growth, but also due
13 to the complexity and lack of transparency of the proposed formula. (Decision No. 70011, at 17-19.)
14 In the last case, UNS Gas experienced significant and rapid growth during the test year and it was
15 appropriate to use the end of the test year to reflect that growth. The prior Decision did not state or
16 imply, however, that the "traditional" annualization methodology would be adopted in all cases
17 without consideration of all other facts and circumstances.

18 We find that adoption of RUCO's position on this issue recognizes that the UNS Gas system
19 continues to grow, albeit at a slower pace than in prior years. Acceptance of the Company's position
20 would produce a counterintuitive result that assumes negative growth, while Staff's recommendation
21 assumes growth that is greater than the level experienced, especially considering current economic
22 conditions. Therefore, in accordance with RUCO's recommended adjustment, we decline to reduce
23 test year revenues by \$516,003 as proposed by UNS Gas.

24 Weather Normalization

25 In its brief, UNS Gas states that the other parties do not dispute the Company's weather
26 normalization methodology, and any differences are the result of the respective customer
27 annualization positions.
28

1 It does not appear that any methodological difference exists between the parties on this issue.
2 However, the weather normalization adjustment should be applied in accordance with the customer
3 annualization method adopted above.

4 **Operating Expenses**

5 **Fleet Fuel Expense**

6 UNS Gas witness Dukes proposed that the Company's fleet fuel expense be established based
7 on a three-year average (2006-2008) of gasoline costs incurred, (\$3.05 per gallon). (Ex. A-17 at 30-
8 31.) The Company's three-year normalization proposal represents a reduction of \$51,285 to its actual
9 test year fleet fuel costs. Mr. Dukes stated that the average fuel price used by UNS Gas reflects the
10 Company's actual costs and that lower cost recommendations made by Staff and RUCO should be
11 rejected. He testified that the Company incurs slightly higher fuel costs than some other utilities
12 because the UNS Gas service area is farther from large metropolitan areas like Phoenix and Tucson
13 and covers a larger number of square miles given its more rural locations. (*Id.*)

14 Although Staff witness Fish recommended a pro forma adjustment to the Company's test year
15 fleet fuel costs (Ex. S-13; at 18), Staff did not address this issue in either its initial or reply briefs, and
16 therefore presumably is now in agreement with the Company's normalization adjustment.

17 RUCO agrees that it is appropriate for UNS Gas to normalize fleet fuel expense to smooth out
18 volatility in gas prices. However, RUCO witness Smith disagrees with using what he calls the
19 Company's "backward-looking" costs of fuel based on 2006-2008 gasoline prices, because prices
20 reached extreme levels in 2008 of over \$4.00 per gallon. (Ex. R-21, at 61-62.) Mr. Smith instead
21 proposes use of average fuel prices from 2006 through June 2009. The additional months would
22 cause the normalized fuel price to drop from \$3.05 per gallon, as requested by UNS Gas, to \$2.95 per
23 gallon. RUCO's recommended adjustment would reduce test year fleet fuel expense by a total of
24 \$71,963, an additional \$20,705 to the Company's proposed reduction of \$51,258. (*Id.* at 63.)

25 We find that RUCO's fleet fuel expense reduction more accurately reflects the volatility of
26 gasoline prices by incorporating a longer normalization period than that proposed by UNS Gas. We
27 will therefore adopt RUCO's proposal to use a normalized price of \$2.95 per gallon resulting in a
28 reduction to test year expenses of \$71,963.

1 Customer Call Center Expenses

2 UNS Gas included in its application the actual allocated test year costs associated with
3 operations at the call center shared with its affiliate companies, UNS Electric and TEP. Costs are
4 allocated based on talk time for each of the three companies, although in the Kingman, Havasu, and
5 Nogales districts UNS Gas and UNS Electric share talk time, and allocations are based on customer
6 counts. (Ex. A-17, at 24.) During the test year, UNS Gas's allocation of call center expenses totaled
7 \$1,399,522, or \$116,627 per month. (Ex. S-12, at 26-27.) RUCO does not object to UNS Gas's
8 proposed call center expenses,

9 Staff witness Dr. Fish testified that the increase in the Company's call center expenses
10 compared to the last case (\$76,227) is unjustified because the number of service orders per month
11 decreased from 5,435 in 2006 to 4,656 in 2008. (*Id.*) Dr. Fish recommends that UNS Gas's
12 authorized call center expenses be reduced by \$484,798, to the level authorized in the Company's last
13 case (*i.e.*, \$76,227).

14 Company witness Dukes responded that the number of "service orders" is not the proper
15 measurement of call center usage by UNS Gas customers. He claims that the call center has
16 experienced an increase in call volume and call duration of approximately 150 percent over 2005
17 levels, the test year used for establishing call center expenses in the last rate case. (Ex. A-17, at 21-
18 22.) Mr. Dukes stated that filling service orders is a minor portion of the call center's services, and
19 UNS Gas is using more of the center's capacity than it was in 2005. He indicated that the overall
20 annual operating costs of the call center increased by 22 percent from 2005 to 2008; technology
21 improvements have been made, including implementation of a new billing system in 2007; and the
22 increased call volumes and durations reflect the need to explain bills, make payment arrangements,
23 discuss credit terms, and discuss disconnection and reconnection arrangements. (*Id.* at 24.) Mr.
24 Dukes added that the Company now offers options to pay by credit card or online, which services add
25 to the call center's costs.

26 We find that UNS Gas has justified the basis for the increased call center costs compared to
27 the Company's last rate case. As the Company's witness pointed out, the expenses authorized in the
28 prior case were based on a 2005 test year, and the call volumes and duration of calls have increased

1 substantially since that time. We do not believe that Staff's justification for decreasing the call center
2 expenses to a 2005 level is supported by the record. Reliance on a single factor (decreased service
3 order volumes) is not a sufficient basis for disallowing almost \$500,000 of test year expenses related
4 to providing important services to customers. We also recognize that the Company's closure of a
5 number of local offices since the last case has likely caused an increase in calls, and that the
6 economic downturn has resulted in the need for an increased need for call center time to address
7 payment arrangements and related issues.

8 We therefore adopt UNS Gas's position on this issue and will allow recovery of the
9 Company's test year call center expenses.

10 Payroll and Payroll Tax Expense

11 UNS Gas proposed that the rates adopted in this case should include recognition of increases
12 in payroll and payroll tax expenses (\$362,018 and \$2,557, respectively) that went into effect January
13 1, 2010. (Ex. A-16, at 19-20.) Mr. Dukes testified that these known and measurable increases were
14 applied to employee levels at the end of the test year to avoid a mismatch of revenue and expenses.
15 (Ex. A-17, at 10.) Staff does not oppose the Company's proposal on this issue, except to modify the
16 payroll tax adjustment in accordance with Staff's position on incentive compensation (see discussion
17 below).

18 IBEW witness Frank Grijalva testified in support of the Company's inclusion of 2010 wage
19 increases, based on the fact that UNS Gas and the IBEW have completed contract negotiations and
20 therefore the amount of the wage increases is known and measurable. (Ex. IBEW-1, at 4-5.)

21 RUCO witness Smith does not oppose the three percent pay increase that went into effect
22 outside the test year on January 1, 2009, but proposes disallowance of the additional three percent
23 wage increase that was effective January 1, 2010. Mr. Smith stated that the 2010 pay increase is too
24 far removed from the test year and other companies are curtailing budgeted pay increases due to the
25 downturn of the economy. (Ex. R-20, at 56.)

26 We find that the 2010 wage increases should be recognized in the rates approved in this
27 proceeding. Those increases are known and measurable and have been reconciled with end-of-test
28 year employee levels to avoid a mismatch of revenues and expenses. Allowance of the known and

measurable wage increases is also consistent with the Commission's treatment of this issue for UNS Electric in Decision No. 70360 (May 27, 2008) and for Southwest Gas Corporation in Decision No. 70665 (December 24, 2008).

Rate Case Expense

UNS Gas initially requested inclusion of \$500,000 for rate case expense, normalized over three years (\$166,667 per year). In his direct testimony, Staff witness Dr. Fish recommended removal of the test year amortization of rate case expense of \$300,000 approved in the Company's last rate case that will be recovered before the new rates in this case become effective. Staff's proposed adjustment would decrease the Company's rate case expense by \$58,333 per year, resulting in annual rate case expense of 141,667. (Ex. S-12, at 29.) Company witness Dukes stated in his rebuttal testimony that the Company agrees with Staff's proposed adjustment. (Ex. A-17, at 19.)

RUCO proposes a reduction to UNS Gas's rate case expense beyond the amount recommended by Staff and accepted by the Company. RUCO witness Smith testified that, even with the correction accepted by UNS Gas, the Company should be limited to no more than \$300,000 for rate case expense, normalized over three years (*i.e.*, \$100,000). With the adjustment recommended by Staff, RUCO proposes a net reduction to the Company's proposed rate case expenses of \$158,333. (Ex. R-21, at 64-67.)

Mr. Smith supports his proposal by comparing the rate case expenses allowed in several recent cases. Mr. Smith cites to the allowed rate case expense in the prior UNS Gas case of \$300,000, normalized over three years, and to the subsequent UNS Electric case (Decision No. 70360), wherein the Commission also allowed rate case expense of \$300,000, normalized over three years. He also pointed to the most recent Southwest Gas case (Decision No. 70665) in which the Commission granted rate case expense of \$276,000, normalized over three years. Mr. Smith claims that the instant case presented many of the same types of issues addressed in those prior cases, and that there are actually fewer issues in the current UNS Gas case than the Company's prior case. (*Id.*)

Mr. Dukes contends that RUCO's proposal fails to recognize legitimate expenses incurred by the Company. He indicated that, as of the date of his rebuttal testimony filing, UNS Gas had already incurred more than \$400,000 in rate case expenses, and the final cost would be well in excess of the

1 \$500,000 original estimate. Mr. Dukes claims that an annual allowance of \$100,000 would not allow
2 the Company to cover the cost of even one regulatory attorney, and UNS Gas should not be penalized
3 for "efficiently outsourcing its regulatory needs." (Ex. A-17, at 20.) Mr. Dukes also stated that, if the
4 revenue requirement recommendations advocated by Staff or RUCO are adopted by the Commission,
5 "it is very likely that UNS Gas will need to quickly file another rate case." (*Id.*) Therefore, according
6 to Mr. Dukes, there would be no basis for adopting a three-year normalization of rate case expense.

7 We agree with RUCO that the Company's proposed rate case expense of \$500,000 should be
8 reduced significantly. As RUCO suggests, the recent UNS Gas and UNS Electric cases, as well as
9 the two most recent Southwest Gas cases, presented many of the same issues that were raised in this
10 case, and the Decisions in those cases represent an appropriate measure of comparison for UNS Gas
11 in this case. The number of hearing days in those cases was comparable as well. In fact, the prior
12 UNS Gas case presented more issues than were litigated in this case, given that the prior case was the
13 first one filed and considered following UNS Gas's acquisition of Citizens Utilities' assets. For these
14 reasons, we allow rate case expense of \$300,000, normalized over three years. The \$58,333
15 adjustment proposed by Staff and accepted by the Company should also be accounted for in the rate
16 case expense calculation.

17 Postage Expense

18 In his direct testimony, Staff witness Dr. Fish stated that the authorized expenses in this case
19 should include recognition of a two-cent increase in first class postage rates after the Company filed
20 its application. (Ex. S-12, at 25.) There is no opposition from the Company or RUCO to recognizing
21 the postage rate increase that occurred in May 2009.

22 The May 2009 postage rate increase should therefore be included in UNS Gas's expenses in
23 this case, adjusted for the customer annualization finding adopted above.

24 American Gas Association Dues

25 The American Gas Association ("AGA") is a national trade association for natural gas
26 distribution and transmission companies. UNS Gas included \$45,964 for dues paid to the AGA in the
27 test year. In the direct testimony filed by Gary Smith (adopted by Company witness Hutchens, Tr.
28 44), UNS Gas describes the benefits received through the AGA's programs, services and advocacy

1 efforts. The Company claims that the AGA conducts hundreds of operating and engineering
2 activities to improve safety, engineering and productivity, and that of the \$18 million in dues
3 collected, the AGA provided its member companies "\$479 million in outright savings or avoided
4 costs." (Ex. A-8, at 9.)

5 The Company asserts that its requested AGA dues expense represents a four percent reduction
6 to the actual dues paid, to account for the portion of the AGA's budget that UNS Gas claims is
7 related to lobbying activities. Mr. Dukes indicated that the Company's position is consistent with the
8 Commission's findings in Decision No. 70011, wherein 3.51 percent of the total dues were
9 disallowed to account for the lobbying portion of the AGA's budget. (Ex. A-17, at 21.) Staff
10 accepted the Company's proposed AGA dues expense. (Ex. S-13, at 16.)

11 RUCO witness Ralph Smith proposed a further reduction to UNS Gas's AGA dues expense.
12 Mr. Smith cites to the finding in the most recent Southwest Gas case, Decision No. 70665, in which
13 the Commission disallowed 40 percent of AGA dues. (Ex. R-21, at 52-55.) In the Southwest Gas
14 Decision, a portion of which was admitted as an exhibit in this proceeding (Ex. R-6), we described
15 the type of activity categories in which the AGA engages on behalf of its members: Advertising;
16 Public Affairs; Corporate Affairs; General Counsel; General & Administrative Expense; Policy,
17 Planning and Regulatory Affairs; Operations & Engineering Management; Policy & Analysis; and
18 Industry Finance & Administrative Programs. (*Id.* at 10-11.) In Decision No. 70665, we noted that
19 although the prior Southwest Gas case (Decision No. 68487) had excluded only 3.64 percent of AGA
20 dues, Southwest Gas was required in its subsequent case to provide 'a clearer picture of AGA
21 functions and how the AGA's activities provide specific benefits to the Company and its Arizona
22 customers.' (*Id.* at 11, quoting Decision No. 68487 at 14.)

23 In Decision No. 70665, we agreed with the recommendation of Mr. Smith, who was a Staff
24 witness in that case, and who recommended disallowance of 40 percent of AGA dues on the basis
25 that Southwest Gas had not demonstrated how the AGA's activities provide specific benefits to
26 ratepayers. (Ex. R-6, at 12.) Mr. Smith similarly testified in this case that UNS Gas failed to
27 demonstrate why ratepayers should fund activities through membership in an industry organization
28 that would likely be disallowed if they were performed by the Company itself. (Ex. R-21, at 53.)

1 RUCO's 40-percent disallowance recommendation is based on decisions by other state regulatory
2 commissions and audits of the AGA by NARUC. RUCO cites to orders issued by other commissions
3 in which AGA dues were disallowed in the following percentages: Michigan (16.17 percent),
4 California (25 percent), and Florida (40 percent). (Ex. R-20, at 45 -46.) He also cited a 1999
5 NARUC-sponsored audit of AGA expenditures that stated, "these expense categories may be viewed
6 by some State commissions as potential vehicles for charging ratepayers with such costs as lobbying,
7 advocacy or promotional activities which may not be to their benefit." (*Id.* at 46.)

8 Consistent with our conclusion in Decision No. 70665, we find that RUCO's recommended
9 disallowance of 40 percent of AGA dues represents a reasonable approximation of the amount for
10 which ratepayers receive no supportable benefit. The documentation offered by the Company to
11 justify the AGA dues, including the alleged monetary savings to members, consists primarily of
12 information provided by the AGA itself and must be viewed in that context. As Mr. Smith indicated,
13 several other states have disallowed AGA dues in substantially higher amounts than the amount
14 proposed by UNS Gas in this case. We therefore adopt RUCO's recommendation to disallow 40
15 percent of the Company's AGA dues.

16 Outside Legal Expenses

17 In addition to the actual test year outside legal expense incurred during the test year
18 (\$83,555), UNS Gas proposes to recover an additional \$305,984 for outside legal expenses, based on
19 a normalized three-year (2005-2007) average of such costs. (Ex. A-16, at 25.) In the Company's
20 prior case, we allowed \$400,000 for outside legal expenses based on an approximation of costs
21 incurred over a three-year period. (Decision No. 70011, at 20.) In that case, we recognized that the
22 test year (2005) legal expenses were higher than normal due to the Company's involvement in a case
23 with El Paso Natural Gas Company ("El Paso") at the Federal Energy Regulatory Commission
24 ("FERC"). Because the El Paso case settled, we agreed with Staff and RUCO that the test year
25 expense level was likely to be non-recurring, and therefore based the legal expense allowance on an
26 approximate average of 2004, 2006, and estimated 2007 costs. (*Id.*)

27 In this case, the incurred test year legal expense was approximately \$84,000 due primarily to
28 UNS Gas's write-off of \$310,000 of outside legal costs that were disallowed in the prior case. (Ex. A-

1 16, at 24.) Mr. Dukes stated that an average of approximately \$390,000 represents a normal and
2 recurring level of outside legal expenses for UNS Gas. (*Id.* at 25.) He added that the Company
3 continues to monitor interstate pipeline filings made by El Paso and Transwestern Pipeline at the
4 FERC. (Ex. A-17, at 27.)

5 Staff witness Dr. Fish testified that the Company should be limited to recovery of only the test
6 year expenses actually incurred (\$83,555). Dr. Fish stated that the Company failed to offer
7 substantive reasons for the high level of legal expenses and did not offer evidence regarding attempts
8 to mitigate those costs. (Ex. S-13, at 17.) Staff therefore recommends disallowance of the normalized
9 \$305,984 sought by UNS Gas for outside legal expense.

10 RUCO witness Smith recommends that the Company be permitted to recover a normalized
11 level of outside legal costs, excluding expenses in prior years related to the El Paso case at FERC,
12 which was settled. (Ex. R-20, at 48-49.) Mr. Smith stated that, because it appears the Company will
13 continue to incur legal costs with future FERC cases, RUCO agreed that an additional annual
14 allowance over actual test year expense is reasonable. RUCO proposes that the Company be
15 permitted to recover \$171,865 in annual outside legal expense, a reduction of \$217,674 to UNS Gas's
16 requested amount. (Ex. R-21, at 60-61.)

17 As we indicated in UNS Gas's last rate case, we believe that the Company's allowable legal
18 expenses should be set at a level that reflects more accurately its actual experience, both historical
19 and anticipated. The Company will continue to incur legal expenses related to FERC cases, and it is
20 in the best interest of UNS Gas's customers for the Company to monitor and participate as necessary
21 in those proceedings. Therefore, we agree with UNS Gas that this is a variable expense and should
22 be normalized. We used a three year average to normalize outside legal expenses in the last UNS
23 Gas rate case, and we see no reason to depart from this practice in this case. We will allow an
24 adjustment of \$305,984 to test year outside legal expenses in this case.

25 Bad Debt Expense

26 Staff witness Dr. Fish recommends reducing the Company's proposed bad debt expense by
27 \$186,627, to account for what he claims is an overstatement of bad debt expense accruals by UNS
28 Gas. Dr. Fish indicated that bad debt is handled as a two-part process whereby actual losses are

1 reviewed, an estimate of expected losses are recorded as an accrual on the Company's books, and the
2 actual losses are then booked to the accruals. (Ex. S-12, at 23.) Dr. Fish claims that UNS Gas's
3 actual bad debt expense was \$972,007 in 2006; \$668,482 in 2007; \$849,695 in 2008; and \$625,168
4 for the test year. However, according to Dr. Fish, the accruals booked by UNS Gas to Allowance for
5 Doubtful Accounts increased from \$(366,736) in 2006, to \$(1,010,624) in 2007, to \$(1,219,587) at
6 the end of the test year, an increase of more than 300 percent. (*Id.* at 24.) Dr. Fish stated that, as of
7 the end of the test year, the allowance for doubtful accounts represented over 17 percent of the
8 Company's Billed Accounts Receivable. (Ex. S-13, at 18.) He therefore recommended that the
9 Company's Uncollectibles rate be reduced from the current level of 4.87 percent to 3.468 percent,
10 until the accrual of bad debts becomes aligned with the actual bad debt experience. (Ex. S-16, at 24.)

11 UNS Gas contends that its proposed bad debt expense adjustment is based on a three-year
12 historical average for the percentage of bad debt expense compared to revenue. The Company claims
13 that this adjustment was prepared and calculated in the same manner as was approved in the last rate
14 case. (Ex. A-16, 24.) RUCO does not oppose the Company's request on this issue.

15 In response to Staff's recommendation, Mr. Dukes explained that the bad debt allowance
16 account is a "contra asset account" that reduces the Accounts Receivable account on the Company's
17 balance sheet, so that the net of the two accounts reflects the reality that not all of the accounts will be
18 collected fully. (Ex. A-17, at 25.) Mr. Dukes stated that the account is reconciled on a quarterly basis
19 by TEP's accounting department and is audited annually by an independent auditing firm. Mr. Dukes
20 suggests that Dr. Fish, who is not a CPA or accountant, was looking at only one side of the equation
21 and came to an incorrect conclusion, because bad debt expense is the accrual-based expense to match
22 expected net write-offs with revenue as it is recorded. (*Id.* at 26.) He contends that, for ratemaking
23 purposes, the appropriate method is to take net write-offs as a percentage of retail revenue over a
24 period of time in order to calculate bad debt expense. Mr. Dukes testified that the Company's
25 calculation of 4.87 percent of pro forma retail revenues, based on historical levels of bad debt
26 expense and net write-off levels, is appropriate and should be adopted.

27 We agree with the Company's contention that the accounting undertaken for recording bad
28 debt expense is appropriate. As Mr. Dukes indicated, Staff's claim that UNS Gas has substantially

1 overstated its allowance account due to over-expensing of bad debt, is incorrect. Rather, the
2 allowance account is higher to reflect that the Accounts Receivable account has higher uncollectible
3 accounts that have not been written off. (Ex. A-18, at 11-12.) We find that UNS Gas has explained
4 sufficiently the basis of its accounting treatment of bad debt expense and we therefore decline to
5 adopt Staff's recommendation on this issue.

6 Depreciation and Property Tax on Post-Test-Year Plant

7 RUCO witness Ralph Smith testified that in accordance with RUCO's recommendation to
8 disallow post-test-year plant, test year expenses should be reduced for depreciation (\$58,107),
9 operation and maintenance depreciation on transportation equipment (\$11,351), and property tax
10 (\$25,584). (Ex. R-20, at 28-29.)

11 Although UNS Gas opposes RUCO's adjustment, the Company's opposition is based on its
12 disagreement regarding inclusion of post-test-year plant. (UNS Gas Initial Brief, at 20.)

13 Given our rejection of the Company's request for post-test-year plant, we find that RUCO's
14 proposed depreciation and property tax expenses should be adopted.

15 Property Tax Rate

16 UNS Gas requested recovery of property tax expense based on its final, adjusted plant-in-
17 service at the end of the test year, using the 2009 statutory assessment rate of 22.0 percent and the
18 most current average property tax rates. (Ex. A-11, at 8.) Although Staff did not oppose the
19 Company's property tax proposal, RUCO recommends setting allowable expenses for property tax
20 based on a rate of 21.0 percent.

21 RUCO witness Ralph Smith testified that RUCO's recommendation is based on the known
22 and measurable assessment for 2010, pursuant to legislation passed by the Arizona State Legislature
23 (A.R.S. §42-15001) that decreased property tax assessments from the 25 percent rate in effect in
24 2005, by 0.5 percent in 2006, and by 1.0 percent in each successive year until a rate of 20 percent is
25 achieved in 2011. (Ex. R-20 at 54.) Mr. Smith stated that the Company's proposal fails to recognize
26 the impact of the known tax change.

27 UNS Gas argues on brief that RUCO's use of a 2010 assessment ratio reaches too far into the
28 future and fails to consider other likely changes to property taxes in 2010. The Company asserts that

1 RUCO's proposal would create a mismatch and an unrealistic property tax allowance. (UNS Gas
2 Initial Brief, at 14.)

3 We agree with RUCO that the property tax expense allowance in this case should be based on
4 the known and measurable assessment rate currently in effect. The rate for 2010 is 21.0 percent, and
5 the rate will decline again in 2011 to 20.0 percent. These tax rate changes are known and
6 measurable, as set forth in A.R.S. §42-15001. Our adoption of the known property tax rate for 2010,
7 when the rates set in this case will become effective, is consistent with prior cases that addressed this
8 issue, as well as our inclusion of known and measurable wage increases that took effect in 2010. In
9 accordance with RUCO's proposal, property tax expense should be reduced by \$230,913.

10 Incentive Compensation

11 UNS Gas allows its non-union employees to participate in its parent company's Performance
12 Enhancement Program ("PEP"), which provides eligible employees compensation above their base
13 pay for meeting financial targets (30 percent), cost containment goals (30 percent), and customer
14 service goals (40 percent). (Ex. R-21, at 40.) Company witness Dukes claims that the PEP is a core
15 component of its compensation package for employees and that the program should be viewed as a
16 means of encouraging and enhancing group and individual employee performance. (Ex. A-17, at 13-
17 14.)

18 Mr. Dukes testified that without the PEP compensation, the Company would face pressure to
19 increase base compensation to compete with other companies for qualified employees. (*Id.*) He also
20 indicated that the goals of the program benefit customers by promoting safety and reducing operating
21 costs, thereby increasing the financial soundness of the Company without exceeding reasonable
22 employee compensation levels. (*Id.*)

23 In accordance with prior Commission Decisions, Staff and RUCO propose to adjust the PEP
24 expenses by 50 percent, based on the claim that incentive compensation programs benefit both
25 ratepayers and shareholders. (Ex. S-12, at 27-28; Ex. R-20, at 29-35.) Staff and RUCO cite to prior
26 cases involving UNS Gas (Decision No. 70011, at 27), UNS Electric (Decision No. 70360, at 21),
27 and Southwest Gas (Decision Nos. 68487, at 18, and 70665, at 16), to support their
28 recommendations. In those cases, the Commission disallowed 50 percent of the incentive programs

1 costs, based on a finding that the programs benefited both customers and shareholders. RUCO
2 witness Ralph Smith stated that there is no relevant distinction between the incentive programs
3 presented in this case and those for which 50 percent of costs were disallowed. (Ex. R-21 at 44). Mr.
4 Smith also cited to a 2009 PEPCO rate case in Washington D.C., in which the utility company
5 voluntarily excluded expenses related to incentive compensation, executive raises, and other
6 expenses, in recognition of the poor economy. (*Id.*)

7 In the most recent Southwest Gas case, we disallowed 50 percent of a management incentive
8 compensation program. (Decision No. 70665, at 16.) In *Southwest Gas*, we concluded as follows:

9 In the last Southwest Gas rate case, as well as several subsequent cases
10 [footnote omitted], we disallowed 50 percent of management incentive
11 compensation on the basis that such programs provide approximately
12 equal benefits to shareholders and ratepayers because the performance
13 goals relate to financial performance and cost containment goals as well as
customer service elements. (Decision No. 68487 at 18.) In that Decision,
we stated:

14 In Decision No. 64172, the Commission adopted Staff's
15 recommendation regarding MIP expenses based on Staff's
16 claim that two of the five performance goals were tied to
17 return on equity and thus primarily benefited shareholders.
18 We believe that Staff's recommendation for an equal
19 sharing of the costs associated with MIP compensation
20 provides an appropriate balance between the benefits
21 attained by both shareholders and ratepayers. Although
22 achievement of the performance goals in the MIP, and the
benefits attendant thereto, cannot be precisely quantified
there is little doubt that both shareholders and ratepayers
derive some benefit from incentive goals. Therefore, the
costs of the program should be borne by both groups and
we find Staff's equal sharing recommendation to be a
reasonable resolution.

23 (*Id.*) We believe the same rationale exists in this case to adopt the position
24 advocated by Staff and RUCO to disallow 50 percent of the Company's
proposed MIP costs. [footnote omitted]

25 We believe that the Staff and RUCO recommendations, to require a 50/50 sharing of incentive
26 compensation costs, provides a reasonable balancing of the interests between ratepayers and
27 shareholders. The equal sharing of such costs recognizes that the program is comprised of elements
28

1 that relate to the parent company's financial performance and cost containment goals, matters that
2 primarily benefit shareholders, while at the same time recognizing that approximately 40 percent of
3 the program's incentive compensation is based on meeting customer service goals. This offers the
4 opportunity for the Company's customers to benefit from improved performance in that area.

5 Therefore, consistent with the recent cases cited above, we will adopt the recommendation of
6 Staff and RUCO on this issue.

7 Stock-Based Compensation

8 UNS Gas included in test year expenses stock-based compensation provided to Company
9 employees under the following programs: Stock Options; Dividend Equivalents on Stock Units;
10 Performance Stock Award; Dividend Equivalent on Stock Options; and Directors Stock Awards. (Ex.
11 R-21, at 46.) Company witness Dukes testified that inclusion of the expenses related to this
12 compensation is appropriate because a portion of employee pay is put at risk and stock-based pay
13 benefits customers because it promotes long-term planning goals and employee retention. (Ex. A-17,
14 at 17.) Staff did not take a position on this issue.

15 RUCO opposes inclusion of any amount of stock-based compensation based on prior
16 Commission Decisions that excluded such expenses.¹⁰ RUCO witness Smith testified that
17 "[r]atepayers should not be required to pay executive compensation that is based on the performance
18 of the Company's (or its parent company's) stock price." (Ex. R-20, at 39.) He added that prior to
19 being required to report stock options as expenses under SFAS 123R, the cost of stock options were
20 treated as a dilution of shareholders' investments (*i.e.*, a cost borne by shareholders). Mr. Smith
21 contends that the requirement for companies under SFAS 123R to expense stock options on financial
22 statements should not be used as a basis for shifting the cost responsibility for stock options from
23 shareholders to ratepayers. (*Id.*)

24 We agree with RUCO that UNS Gas's proposal to include the costs of stock-based
25 compensation should be denied. In Decision No. 69663, we agreed with Staff's recommendation to
26 exclude stock-based incentive compensation, finding that ratepayers should not be required to fund
27

28 ¹⁰ *Arizona Public Service*, Decision No. 69663, at 36; *UNS Electric*, Decision No. 70360, at 22.

1 the costs of a program that is based on the company's, or its parent company's, stock price. On page
2 36 of that Decision, we stated:

3 To the extent that Pinnacle West shareholders wish to compensate APS
4 management for its enhanced earnings, they may do so, but it is not
5 appropriate for the utility's ratepayers to provide such incentive and
6 compensation.

7 Similarly, in the last UNS Electric case, we agreed with Staff that "test year expenses should be
8 reduced to remove stock-based compensation to officers and employees." (Decision No. 70360, at
9 22.)

10 We agree with RUCO's recommendation to exclude stock-based compensation for UNS
11 Gas's test year expenses. As we have indicated in prior cases, tying employee compensation to a
12 company's stock price has the potential to "negatively affect the Company's provisions of safe,
13 reliable utility service at a reasonable rate" because management decisions (e.g., delaying
14 maintenance costs) could be influenced by the effect on earnings. (Decision No. 69663, at 36.)
15 Further, as RUCO's witness pointed out, current economic conditions should cause utility companies
16 to reconsider whether it is appropriate to seek recovery from captive ratepayers of incentive
17 programs, such as providing stock options to management and employees.

18 In accordance with RUCO's recommendation, \$266,399 should be excluded from test year
19 expenses related to stock-based compensation.

20 Supplemental Executive Retirement Plan

21 UNS Gas allows select executives to participate in a Supplemental Executive Retirement Plan
22 ("SERP"). The SERP provides to eligible executives retirement benefits in excess of the limits
23 allowed under Internal Revenue Service ("IRS") regulations for salaries in excess of specified
24 amounts.

25 UNS Gas contends that the SERP costs are reasonable and that neither Staff nor RUCO have
26 shown that the Company's overall executive compensation costs are excessive or out of line with
27 industry standards. The Company claims that SERP costs do not represent an excess benefit, but are
28 necessary to keep management benefits equal as a percentage of compensation to the eligible
employees. (Ex. A-17, at 18.) UNS Gas argues that SERP expenses are normal, reasonable and

1 recurring compensation costs that are incurred in the provision of service, and the costs should
2 therefore be recoverable.

3 Staff and RUCO recommend disallowance of the SERP costs (\$101,021), in accordance with
4 the Commission's Decisions in several recent cases.

5 In a prior Southwest Gas case (Decision No. 68487, at 18-19), we disallowed SERP costs,
6 finding:

7 [T]he provision of additional compensation to Southwest Gas' highest
8 paid employees to remedy a perceived deficiency in retirement benefits
9 relative to the Company's other employees is not a reasonable expense
10 that should be recovered in rates. Without the SERP, the Company's
11 officers still enjoy the same retirement benefits available to any other
12 Southwest Gas employee and the attempt to make these executives
13 "whole" in the sense of allowing a greater percentage of retirement
benefits does not meet the test of reasonableness. 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.

14 We reached the same conclusion regarding SERP expenses in the last UNS Gas case
15 (Decision No. 70011, at 27-29), stating:

16 [T]he issue is not whether UNS may provide compensation to select
17 executives in excess of the retirement limits allowed by the IRS, but
18 whether ratepayers should be saddled with the costs of executive benefits
19 that exceed the treatment allowed for all other employees. If the Company
chooses to do so, shareholders rather than ratepayers should be responsible
for the retirement benefits afforded only to those executives.

20 More recent Commission Orders have consistently denied recovery of SERP expenses in
21 rates. For example, in Decision No. 69663, we disallowed SERP expenses for APS based on the
22 finding made in the earlier Southwest Gas proceeding. (Decision No. 69663, at 26-27.) In the prior
23 UNS Electric case (Decision No. 70360, at 22), we also excluded SERP costs stating "[w]e see no
24 reason to depart from the rationale on this issue in the most recent UNS Gas rate case..." In the most
25 recent Southwest Gas case (Decision No. 70665, at 17-18), we again found that SERP expenses
26 should not be recoverable from ratepayers.
27
28

1 We see no reason to depart from the rationale on this issue in all of the recent cases cited
2 above, that ratepayers should not be required to fund the retirement benefits of a few select executives
3 whose salaries exceed current IRS limits (currently \$240,000). As has been stated in prior cases, the
4 Company's shareholders may provide these additional retirement benefits but ratepayers should not
5 be subject to this additional burden.

6 We therefore adopt the recommendations of Staff and RUCO and disallow \$101,021 in SERP
7 expenses proposed by UNS Gas.

8 Interest Synchronization

9 There does not appear to be any dispute that an interest synchronization adjustment is
10 necessary to coordinate the income tax calculation with rate base and cost of capital. As described in
11 RUCO witness Smith's testimony, this adjustment decreases income tax expense and increases the
12 Company's achieved operating income by a similar amount. (Ex. R-20, at 53, Attach. Sched. C-10.)

13 Net Operating Income

14 Consistent with the foregoing discussion, we will allow adjusted test year operating expenses
15 of \$40,983,890, which based on test year revenues of \$53,418,509, results in test year adjusted
16 operating income of \$12,434,619.

17 COST OF CAPITAL

18 UNS Gas recommends that the Commission determine the Company's cost of common equity
19 to be 11.0 percent, with an overall weighted average cost of capital ("WACC") recommendation of
20 8.75 percent. Staff recommends a cost of common equity of 10.0 percent, with an overall weighted
21 cost of capital determination of 8.24 percent. RUCO proposes adoption of a cost of common equity
22 of 8.61 percent, with an overall weighted cost of capital of 7.55 percent.

23 Capital Structure

24 At the end of the test year, UNS Gas had a capital structure consisting of 50.01 percent long-
25 term debt and 49.99 percent equity. (Ex. A-13 at 8.) The Company proposes using its actual capital
26 structure as of the end of the test year. Both Staff and RUCO agreed that it is appropriate to use the
27 Company's actual capital structure. (Ex. S-14, at 3; Ex. R-13, at 50.) We agree that it is appropriate
28

1 to use UNS Gas's actual test year capital structure for the purpose of determining the Company's cost
2 of capital in this proceeding.

3 Cost of Debt

4 All parties in the case agreed that the Company's cost of debt was 6.49 percent during the test
5 year. (Ex. A-13, at 26; Ex. S-14, at 2; Ex. R-13, at 3.) Since there is no dispute regarding this issue,
6 we will adopt a cost of debt of 6.49 percent for purposes of establishing UNS Gas's weighted cost of
7 capital in this proceeding.

8 Cost of Common Equity

9 Determining a company's cost of common equity for purposes of setting its overall cost of
10 capital requires an estimate based on a number of factors. There is no fool-proof methodology for
11 making this determination, and the expert witnesses rely on various analyses to support their
12 respective recommendations.

13 UNS Gas

14 UNS Gas witness Kentton Grant based his common equity cost recommendation of 11.0
15 percent on the results of his common equity models, namely a multi-stage Discounted Cash Flow
16 ("DCF"), Capital Asset Pricing Model ("CAPM"), and risk premium ("RP"). Mr. Grant examined
17 the risk profile of UNS Gas relative to a comparable company group to determine a point in the range
18 produced by those models. The estimated cost of equity produced by this analysis was then
19 compared to the allowed returns for other gas local distribution companies ("LDCs") in the United
20 States to confirm the reasonableness of the Company's estimate. Mr. Grant indicated that he relied
21 on capital markets data primarily from August 2008, in order to avoid the volatility experienced in
22 the markets shortly after. (Ex. A-13, at 9-11.) Mr. Grant also examined the financial impact of the
23 recommended return on equity ("ROE") and the overall rate request to assess the Company's ability
24 to attract capital on reasonable terms. (Ex. A-14 at 2.)

25 Mr. Grant claims that it was appropriate to use a comparable group of LDCs in his analysis
26 because the cost of equity capital for UNS Gas's parent company, UniSource Energy, which is
27 heavily weighted toward the electric industry, may not be representative of the cost of equity capital
28 for UNS Gas. Mr. Grant's comparable group was based on all LDCs evaluated by *Value Line*

1 *Investment Survey* ("*Value Line*"), from which 10 companies were selected based on several criteria
2 that Mr. Grant believes make them comparable to UNS Gas. (Ex. A-13, at 11.)

3 Mr. Grant explained that the DCF methodology is based on the theory that the price of a share
4 of stock is equal to the present value of all future dividends. As described by Mr. Grant, the constant
5 growth form of the DCF model recognizes that the return to shareholders consists of both dividend
6 yield and growth. He stated that the constant growth form of the model should not be used for
7 companies with near-term growth rates that are significantly higher or lower than their long-term
8 growth potential. For such companies, Mr. Grant claims that a multi-stage DCF model should be
9 used to incorporate the various growth rates that are expected over time. (*Id.* at 12-13.)

10 According to Mr. Grant, an annual long-term growth rate of 6.3 percent represents a
11 reasonable estimate of long-term investor expectations for earnings and dividends, which he claims is
12 consistent with the 5.3 to 7.0 percent median growth rate in earnings per share ("EPS") for his
13 comparable company group's published point estimates for 2011 through 2013 by *Value Line*, as
14 well as a five-year estimate of EPS growth reported by *Zacks Investment Research* ("*Zacks*") and
15 *SNL Financial* ("*SNL*"). Based on his application of a multi-stage DCF model, the estimated cost of
16 equity for the sample companies produced a range of 9.5 percent to 11.2 percent, with an average
17 value of 10.1 percent. (*Id.* at 14-18.)

18 Mr. Grant stated that use of the CAPM is premised on the assumption that capital markets are
19 highly efficient and that investors attempt to optimize their risk/return profiles through
20 diversification. He indicated that the CAPM assumes that risk is comprised of systematic risk (which
21 is unavoidable) and unsystematic risk (which is company-specific and can theoretically be eliminated
22 through portfolio diversification). As a result, Mr. Grant explained that the CAPM is based on the
23 theory that investors should be compensated only for systematic risk. (*Id.*) Applying the CAPM
24 produced a result of 10.2 percent to 11.3 percent, with an average value of 10.7 percent. (*Id.* at 20.)

25 Mr. Grant next discussed his RP analysis, which relies on the relationship between risk and
26 required rates of return. He stated that rational investors demand higher expected returns on
27 investments that present a greater potential for loss, as observed in the bond markets in which
28 investors accept lower yields on U.S. Treasury bonds relative to corporate bonds. (*Id.*) Mr. Grant

1 indicated that investments in common stocks, which are inherently riskier than bonds, require an
2 incremental risk premium compared to observed bond yields. He testified that the RP analysis is
3 appropriate to use during periods of high volatility in the financial markets, as a means of validating
4 the results achieved from the traditional DCF and CAPM methodologies. (*Id.* at 20-21.) Mr. Grant's
5 RP analysis resulted in an estimated cost of equity of 10.2 to 11.5 percent for the comparable
6 companies. (*Id.* at 23.)

7 Based on his comparison of the DCF, CAPM and RP results, Mr. Grant observed a range of
8 overlapping values of 10.2 percent to 11.2 percent, which range he determined as the Company's
9 estimate of the cost of equity for the comparable company group. (*Id.* at 24.)

10 The next step in the Company's analysis was to determine the appropriate ROE in this
11 proceeding for UNS Gas, based on a comparison of the "risk profiles" of UNS Gas and the
12 comparable companies. Mr. Grant asserts that an equity investment in UNS Gas is "decidedly
13 riskier" than an equity investment in the comparable companies due to several factors, including UNS
14 Gas's smaller size, its inability to pay dividends, and lower credit ratings for UNS Gas than for most
15 of the comparable companies. Based on these relative risk factors, Mr. Grant proposes that the ROE
16 for UNS Gas be set at the top of the range for the comparable companies and that the Commission
17 award a ROE of 11.0 percent in this proceeding. (*Id.* at 24-25.)

18 UNS Gas is critical of the ROE recommendations of both Staff and RUCO based on the
19 Company's claim that Staff and RUCO's results fail a basic test of reasonableness. Mr. Grant claims
20 that all of Staff witness Parcell's analyses (DCF, CAPM, and CE) contain significant flaws that result
21 in understating the Company's cost of equity capital. According to Mr. Grant, Staff's use of the
22 CAPM is flawed because Mr. Parcell's use of a historical market risk premium does not reflect the
23 current risk-averse nature of investments in debt and equity securities in the capital markets. (Ex. A-
24 14, at 4-7.) Mr. Grant claims that Mr. Parcell's CAPM results (7.3 to 7.7 percent) would not even
25 cover the cost of debt for most of the companies in his comparable group. Mr. Grant is also critical
26 of Staff's use of a geometric mean return¹¹ in its CAPM analysis, which he claims is contrary to

27 _____
28 ¹¹ Mr. Grant states that the "geometric mean return" reflects "the compound average return earned over a multi-year period...[which] serves to inappropriately understate the cost of equity capital." (*Id.* at 9.)

1 sound financial theories. UNS Gas argues that the use of an arithmetic mean return¹² in determining
2 the market risk premium is supported by academics and financial professionals. With respect to
3 Staff's DCF model, Mr. Grant asserts that the constant growth version, which assumes that dividends
4 and earnings of a company grow at a constant rate over an infinite period, fails to reflect that
5 investors expect non-constant short-term growth, as well as constant long-term growth. (*Id.* at 12.)
6 Finally, Mr. Grant stated that Staff's CE analysis should be accorded little weight because it assumes
7 that investors use historical accounting returns on book equity to determine required future returns on
8 stock investments. Mr. Grant also claims that Mr. Parcell's conclusions were influenced by earned
9 returns for electric utilities, which companies have experienced earnings impacted by restructuring
10 and other factors not relevant to the gas utility industry. (*Id.* at 14.)

11 The Company contends that RUCO's ROE recommendation (8.61 percent) is well below the
12 cost of equity determined for any gas utility since at least 1990. Mr. Grant indicated that although
13 RUCO witness Rigsby's DCF analysis supports the Company's ROE proposal, the averaging of his
14 DCF and CAPM results produces a flawed recommendation. Mr. Grant claims that, similar to the
15 problems he identified with Staff's CAPM method, RUCO failed to adjust its historical market risk
16 premiums to reflect investors' "flight to quality," and therefore underestimated significantly the cost
17 of equity for the comparable companies analyzed by Mr. Rigsby. (*Id.* at 17-18.)

18 RUCO

19 RUCO witness William Rigsby proposes adoption of a ROE of 8.61 percent based on his
20 analysis using DCF and CAPM methodologies. As noted above, Mr. Rigsby employed a single-stage
21 DCF analysis, as opposed to the multi-stage version used by UNS Gas. RUCO contends that Mr.
22 Rigsby's DCF analysis is appropriate because it is based on five-year growth rates specific to the
23 LDCs used in Mr. Rigsby's proxy group, whereas Mr. Grant's DCF model assumes a long-term
24 growth rate for LDCs that would be comparable to an inflation-adjusted growth rate for all goods and
25 services produced by labor and property in the United States in perpetuity. (Ex. R-13, at 55.)
26 According to Mr. Rigsby, the multi-stage DCF used by the FERC requires more weight to be given to
27

28 ¹² Mr. Grant defined the "arithmetic mean return" as "the mathematical average of historical returns realized over each discrete 12 month period." (*Id.*)

1 short-term growth expectations, which is similar to the one-to-five-year projections used in his DCF
2 analysis. (Ex. R-14, at 8.) Mr. Rigsby pointed out that if the Company's DCF inputs were applied to
3 RUCO's single-stage DCF model, the resulting mean average would be significantly less than even
4 Mr. Rigsby's DCF estimate. (Ex. R-13, at 56.)

5 With respect to its CAPM analysis, RUCO asserts that the use of both geometric and
6 arithmetic means of historical returns is more reasonable than the Company's exclusive reliance on
7 arithmetic returns. (*Id.* at 28.) Similar to the arguments made by Staff (see below), RUCO contends
8 that it is appropriate to use both means in the CAPM analysis, because investors have access to both
9 forms of information regarding historical returns. Mr. Rigsby added that he believes the geometric
10 mean provides "a truer picture of the effects of compounding on the value of an investment when
11 return variability exists." (Ex. R-14, at 9.)

12 Mr. Rigsby also testified that it should not be surprising that his CAPM analysis produced the
13 results reflected in his testimony considering the effect of lower interest rates on low-risk investments
14 such as U.S. Treasury bonds and certificates of deposit. Based on the low returns on these safe
15 investments, and his claim that utility stocks have traditionally been considered as safe investments,
16 Mr. Rigsby indicated that the Company's proposed 11.0 percent ROE is unreasonable. (*Id.* at 16.)
17 Although Mr. Rigsby conceded that common stock shareholders bear a higher risk than bondholders,
18 he asserts that Mr. Grant overstates the risk premium that should be assigned to a relatively low risk
19 utility monopoly such as UNS Gas. (*Id.*)

20 Staff

21 Staff witness David Parcell presented Staff's ROE recommendation in this case. In
22 developing his recommendation, Mr. Parcell utilized DCF, CAPM, and CE analyses. He indicated
23 that because UNS Gas is not publicly traded, it is not possible to directly apply cost of equity models.
24 In his analysis, Mr. Parcell employed two comparable groups of companies as a proxy for UNS Gas
25 and UniSource. (Ex. S-14, at 23-24.) The first sample group was comprised of a group of seven
26 combination gas and electric companies and the second group consisted of the same ten natural gas
27 companies used by the Company's witness.

1 Mr. Parcell's DCF analysis produced a range of 9.5 percent to 10.5 percent for the proxy
2 groups' cost of equity. His CAPM model produced a cost of equity range of 7.3 percent to 7.7
3 percent for the sample groups. (*Id.* at 29-32.) Mr. Parcell also utilized a CE analysis, which he
4 described as a method designed to measure the returns expected to be earned on the original cost
5 book value of similar risk companies. According to Mr. Parcell, his CE analysis was based on
6 market data using market-to-book ratios, and is therefore a market test that should not be subject to
7 criticisms leveled at other analyses that are based on past earned returns. He also claims that the CE
8 uses prospective returns and is therefore not backward-looking. (*Id.* at 32-34.) Based on his CE
9 analysis, Mr. Parcell concluded that the cost of equity for the proxy companies is "no more than 9.5
10 percent to 10.5 percent." (*Id.* at 36.)

11 Based on the results of the three methodologies, Mr. Parcell found an overall range of 7.3
12 percent to 10.5 percent ROE for the proxy companies, and concluded that the appropriate cost of
13 equity rate for UNS Gas is in the range of 9.5 percent to 10.5 percent. He recommended that the
14 Commission adopt the mid-point of the range (10.0 percent) as the ROE in this case. (*Id.* at 38.)

15 Mr. Parcell also addressed how he believes the current financial crisis impacts the cost of
16 equity for UNS Gas. He stated that because the economic conditions affect almost all segments of
17 the economy, and UNS Gas is a regulated utility that sells a relatively inelastic product, the Company
18 is largely insulated from the adverse economic conditions. Mr. Parcel added that: (1) there is no
19 justification for increasing returns awarded to regulated utilities at the same time that other businesses
20 are experiencing lower profits; (2) unlike unregulated firms, UNS Gas has the opportunity to pass on
21 higher costs to customers in its next rate case; (3) there is no indication that UNS Gas's risks have
22 increased since its last case; and (4) a number of measures are being undertaken by the United States
23 and other governments to make credit more accessible and restore confidence in financial markets.
24 (*Id.* at 38-39.)

25 With respect to the arguments raised by the Company, Mr. Parcel responded that the events of
26 the past two years have affected virtually all aspects of the economy and society, and not just utilities
27 or UNS Gas in particular. He stated that the Company's customers have been impacted adversely by
28 the same economic conditions, by virtue of high unemployment rates, diminished real estate values,

1 and reduced values of retirement savings. (Ex. S-15, at 2-3.) With respect to criticism of his cost of
2 capital methodologies, Mr. Parcell indicated that the Commission has accepted the same
3 recommendations in prior cases. In response to his CAPM results specifically, Mr. Parcell testified
4 that the reason the CAPM results are lower than normal is due to current lower Treasury bond yields
5 and a lower risk premium reflective of the decline in stock prices in 2008. He pointed out, however,
6 that the DCF results tend to be higher than normal due to higher yields based on stock price declines,
7 and that “[i]t would not be proper to disregard the lower CAPM results while not discounting the
8 higher DCF results.” (*Id.* at 2-3.)

9 Regarding the Company’s criticism of the use of geometric means in the CAPM, Staff cites to
10 Mr. Parcell’s surrebuttal testimony, wherein he indicated that investors have access to both arithmetic
11 and geometric returns in making investment decisions, and that many mutual fund investors rely on
12 geometric returns in evaluating historic and prospective returns of funds. (*Id.* at 3.) Staff also points
13 to Mr. Parcell’s testimony indicating that the Commission found it appropriate in the last UNS
14 Electric case to use a geometric or compound growth rate in using the CAPM model. (*Id.* at 4-5.)

15 Conclusion on Cost of Equity

16 Based on the competing positions presented through the testimony, exhibits, and arguments,
17 we believe that Staff’s recommended cost of equity capital range of 9.5 percent to 10.5 percent is
18 appropriate. We agree with Staff that the CAPM results are reflective of the combination of lower
19 bond yields and a lower risk premium associated with a decline in stock prices, and that the same
20 stock market decline tends to produce higher DCF results. We also continue to believe, consistent
21 with our findings in several prior cases, that it is appropriate to consider the geometric returns in
22 calculating a comparable company CAPM because to do otherwise would fail to give recognition to
23 the fact that many investors have access to such information for purposes of making investment
24 decisions.

25 As noted above, Mr. Parcell’s DCF analysis produced a range of 9.5 percent to 10.5 percent
26 for the proxy groups’ cost of equity, his CAPM model produced a cost of equity range of 7.3 percent
27 to 7.7 percent for the sample groups, and his CE analysis produced a result for the proxy companies
28 of no more than 9.5 to 10.5 percent. Based on his conclusion that UNS Gas has an estimated ROE of

1 9.5 to 10.5 percent, Mr. Parcell recommended setting the Company's ROE at the mid-point of the
2 range, or 10.0 percent.

3 In his testimony, Mr. Parcell raises valid arguments with respect to the effect of current
4 economic conditions on all aspects of the economy, and on society in general. Although Mr. Parcell
5 recommended adoption of the 10.0 percent midpoint in his cost of equity range, he testified that it is
6 "appropriate for the Commission should they choose to do so, to go to the low end of the range to
7 reflect economic conditions," and that setting the ROE at 9.5 percent "would be proper and
8 supportable." (Tr. 844.)

9 We do not believe UNS Gas has demonstrated that its risk is significantly greater compared to
10 other comparable companies; nor has it shown that its risks have increased substantially since its last
11 rate case. The Company cannot pretend that it operates in a vacuum or that the challenges it faces are
12 unique. Indeed, relative to a number of unregulated industries, the utility industry is insulated from
13 the vagaries of the marketplace to the extent that it does not face direct competition for its product
14 and there is a high degree of inelasticity in the need for utility services.

15 We believe that adoption of an estimated ROE of 9.50 percent will allow the Company to
16 attract capital at a reasonable rate, and strikes a reasonable balance between its proposal for an
17 estimated ROE near the top of the range produced by its own analysis and the results achieved
18 through the methodologies employed by Staff and RUCO. We also believe that adoption of an
19 estimated cost of equity at the low point of Staff's ROE range, 9.50 percent, provides at least some
20 minimal recognition of the devastating effects of current economic conditions on UNS Gas's
21 customers, as established in the record of this case.¹³

22 Accordingly, we adopt a 9.50 percent ROE in this proceeding for UNS Gas, which results in
23 an overall weighted average cost of capital of 8.00 percent.

24 ...

25 ...

26 _____
27 ¹³ We note that, as discussed in the Fair Value Rate of Return ("FVROR") section below, UNS Gas initially proposed to
28 "voluntarily" accept a lower FVROR than it claimed could be supported, in order to mitigate the rate impact on customers
"in these challenging economic times." (Ex. A-13, at 30.) However, the Company subsequently withdrew that
recommendation, opting instead for the higher FVROR that it claimed could be justified. (Ex. A-14, at 32.)

	<u>Percentage</u>	<u>Cost</u>	<u>Weighted Avg. Cost</u>
Common Equity	49.9%	9.50%	4.75%
Total Debt	50.1%	6.49%	<u>3.25%</u>
			8.00%

Fair Value Rate of Return

FVRB in Decision No. 70011

In its last rate case, UNS Gas proposed, as an amendment to its application, that the WACC should be applied directly to its fair value rate base. The Company based its proposal on a Memorandum Decision issued by the Arizona Court of Appeals in *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, 1 CA-CC 05-0002 (Ariz. App. Feb. 13, 2007) ("*Chaparral City*").

UNS Gas argued in its prior case that the Commission's Decision in the underlying Chaparral City case adopted Staff's recommendation to calculate the revenue requirement by multiplying OCRB by the cost of capital. (Decision No. 68179, at 26-28.) In its previous case, the Company claimed that, only after the OCRB revenue requirement was completed did Staff calculate the FVRB for Chaparral City, which resulted in what UNS Gas asserted was a "backing-in" approach that was mathematically equivalent to the methodology rejected by the Court of Appeals in *Chaparral City*. In support of its argument, UNS Gas cited to Article 15, §14 of the Arizona Constitution, which states in part that "[t]he Corporation Commission shall, to aid it in the proper discharge of its duties, ascertain the fair value of the property within the State of every public service corporation doing business therein..."

In the last UNS Gas case, we rejected the Company's arguments on this issue, in part, because the Company had not raised its FVRB recommendation in a timely manner. We indicated that UNS Gas's attempt to modify its position on this issue, just days before the Staff and RUCO surrebuttal testimony was due, was prejudicial to opposing parties, because those parties did not have adequate time to pursue discovery and prepare testimony on the Company's amended proposal. (Decision No. 70011, at 48-49.)

We indicated further that no party disputed that the Commission is required to consider the Company's FVRB in determining rates. However, we disagreed with UNS Gas's reliance on

1 *Chaparral City* to support its position, on the basis that we have broad discretion in determining how
 2 FVRB is to be used in the ratemaking exercise. In the prior case, we stated:

3 Mr. Grant's proposal ignores the explicit language of the Court's decision,
 4 which states: 'the Commission asserts that it was not bound to use the
 5 weighted average cost of capital as the rate of return to be applied to the
 6 FVRB. The Commission is correct....[t]he Commission has the discretion
 7 to determine the appropriate methodology.' (*Chaparral City, supra*, at p.
 8 13, ¶17). Despite this unambiguous explanation, UNS would have us
 9 employ the very methodology the Court of Appeals specifically stated the
 10 Commission was not required to apply in setting rates.

11 (*Id.* at 49-50.) We also pointed out that the *Chaparral City* case was on remand at that point and the
 12 Commission had not yet conducted a hearing or issued a further order regarding the Court of
 13 Appeals' decision. (*Id.*)

14 Finally, we raised concerns with respect to UNS Gas's attempt to apply the WACC to FVRB
 15 without modification, citing to Staff's testimony which claimed that "there is no logical basis for
 16 applying such a methodology because investors have no expectation that they will earn a return on
 17 the excess between OCRB, which represents investor supplied funds, and FVRB, which represents
 18 unrealized paper profits." (*Id.* at 50.)

19 Chaparral City Remand Decision and Subsequent Chaparral City Rate Decision

20 In Decision No. 70441 (July 28, 2008) ("Decision No. 70441" or "Chaparral City Remand
 21 Case"), we addressed the issue that was remanded by the Court of Appeals in *Chaparral City*.
 22 Decision No. 70441 did not adopt the company's proposal to determine a FVROR by applying the
 23 WACC directly to the FVRB, but revised the method used in Decision No. 68176 (the prior
 24 Chaparral City Decision) to calculate operating income. We found that applying the WACC directly
 25 to the FVRB would over-compensate Chaparral City Water Company ("Chaparral City") for
 26 inflation, and therefore calculated the FVROR by adjusting the WACC to reflect an inflation
 27 adjustment that reduced the cost of equity. The FVROR was then applied to the FVRB to determine
 28 operating income. (Decision No. 70441, at 41.)¹⁴

¹⁴ Chaparral City has appealed Decision No. 70441 to the Court of Appeals.

1 In its recent rate case ("Decision No. 71308" or "Chaparral City Rate Case"), Chaparral City
 2 raised many of the same arguments addressed by the Commission in Decision No. 70441, including
 3 the proposal that the WACC should be applied directly to Chaparral City's FVRB without an
 4 inflation adjustment. (Decision No. 71308, October 21, 2009.) We rejected Chaparral City's
 5 arguments and adopted Staff's recommendation that the FVROR should be calculated by subtracting
 6 an inflation factor from both the debt and equity components of the WACC. In reaching that
 7 conclusion, we reiterated the findings set forth in Decision No. 70441, stating that:

8 [Chaparral City] is advocating for a rate of return methodology which
 9 would produce comparably higher rates, which conflicts with the most
 10 basic tenet of rate regulation, which is that a utility should be provided
 11 with rates that will allow it an opportunity to earn a return that is
 12 comparable to those of similarly situated enterprises.

13 (*Id.* at 48.) We concluded that "using [Chaparral City's] proposed methodology would produce
 14 excessive returns." (*Id.* at 48-49.) Accordingly, we adopted Staff's recommendation to apply an
 15 inflation adjustment to the WACC to determine the FVROR.¹⁵

16 UNS Gas' Position

17 In its application, as detailed in Mr. Grant's direct testimony, UNS Gas proposed that a
 18 FVROR of 6.80 percent should be applied to the Company's FVRB in this proceeding. Mr. Grant
 19 stated that, although UNS Gas could justify a FVROR of 7.30 percent¹⁶ using the same methodology
 20 adopted in Decision No. 70441, the Company agreed to forego the full 7.30 percent "to mitigate the
 21 rate impact on our customers in these challenging economic times." (Ex. A-13, at 30.)

22 In his rebuttal testimony, however, Mr. Grant withdrew the Company's "voluntary measure"
 23 of recommending a 6.80 percent FVROR due to "substantial cuts to the revenue requirement
 24 proposed by Staff and RUCO, and the possibility that those adjustments could be adopted by the
 25 Commission." (Ex. A-14, at 32.) Mr. Grant stated that, given the recommendations included in
 26 Staff's and RUCO's direct testimony, the Company now insists that the FVROR should be based on
 27 the method approved in Decision No. 70441 or, in the alternative, on the method proposed by Staff in

28 ¹⁵ Chaparral City has also appealed Decision No. 71308 to the Court of Appeals.

¹⁶ Mr. Grant calculated the 7.30 percent FVROR by subtracting a 2.9 percent inflation factor from the Company's proposed 11.0 percent cost of equity, and applying the remainder (8.1 percent) to the equity component of the capital structure (*i.e.*, 49.99% equity x 8.1% = 4.05% plus 3.25% debt component = 7.30%. (*Id.* at 31.)

1 the most recent Chaparral City case (since adopted in Decision No. 71308), both of which produce a
2 FVROR of 7.30 percent (assuming acceptance of the Company's 11.0 percent cost of equity). (*Id.*)
3 Mr. Grant also indicated that a FVROR of 7.25 percent would result from using the Chaparral City
4 formula, if applied to Staff's proposed 10.0 percent cost of equity and the 2.0 percent inflation factor
5 referenced in Staff witness Parcell's testimony. (*Id.*)

6 Staff's Position

7 Staff witness Parcell testified that the concept of cost of capital is designed to apply to an
8 original cost rate base rather than a fair value rate base. (Ex. S-14, at 46.) He explained that when the
9 concept of fair value is incorporated, the link between rate base and capital structure is broken
10 because the increment between OCRB and FVRB represents an amount that is not financed with
11 investor-supplied capital. According to Mr. Parcell, financial theory dictates that investors should be
12 provided an opportunity to earn a return on the capital they provided to the utility, and therefore the
13 only appropriate method is to assign a zero cost to the increment of FVRB over OCRB. (*Id.* at 47.)
14 The result of this calculation is a FVROR of 6.03 percent. (*Id.* at 48.)

15 Mr. Parcell indicated that, if the Commission is inclined to adopt a return greater than zero for
16 the fair value increment, an alternative methodology could be considered based on a "nominal risk-
17 free rate" of 4.5 percent, less an inflation factor of 2.0 percent, for a net "real risk-free rate" of 2.5
18 percent. He indicated that the 2.5 percent risk-free rate was a maximum amount, but that it would be
19 appropriate to use any percentage between zero and 2.5 percent. Mr. Parcell chose the mid-point of
20 that range, or 1.25 percent, to be applied to the fair value increment, resulting in an alternative
21 FVROR recommendation by Staff of 6.37 percent. (*Id.* at 50-51.)

22 RUCO's Position

23 RUCO witness Ralph Smith evaluated four separate methodologies to determine RUCO's
24 FVROR recommendation of 5.38 percent, resulting in an overall revenue requirement that is \$38,000
25 higher than RUCO's OCRB recommendation. The four options considered by Mr. Smith were: (1)
26 adjusting the recommended OCRB-based ROE for estimated inflation; (2) adjusting the
27 recommended OCRB-based overall rate of return for estimated inflation; (3) applying a zero cost to
28 the fair value increment; and (4) applying a factor of 1.25 percent to the fair value increment. (Ex. R-

20, Sched. A.) RUCO discarded methods one and four as producing results (\$4,649,000 and \$2,290,000 revenue increases, respectively) that were "too high." RUCO concluded that methods two and three produced results (\$524,000 revenue reduction and \$800,000 revenue increase, respectively) that were "too low." (*Id.*) RUCO's final recommendation settled on a FVROR of 5.38 percent, which produces a revenue increase of \$841,000. (*Id.*)

Mr. Smith explained that the criteria used in these methodologies were based on "informed judgment" and an attempt to comply with the *Chaparral City* decision by the Court of Appeals, as well as Commission Decision No. 70441. He stated that the "determination of FVROR is at best an estimation and not an exact science," and the goal of the exercise is to afford the Company a reasonable return without providing excessive rates or windfall profits. (Ex. R-21, at 10.) RUCO contends that its recommendation satisfies the requirements of those prior decisions and achieves a reasonable rate of return for UNS Gas "when all relevant and appropriate factors are considered." (*Id.*)

Conclusion on FVROR

As is clearly delineated in the Arizona Constitution, the Commission is obligated to establish rates and charges that are "just and reasonable" (Article 15, §3), and to "ascertain the fair value of the [utility's] property" (Article 15, §14). Arizona courts have interpreted the constitution's "fair value" language as requiring fair value to be used in setting rates.¹⁷ In Decision No. 70441, we recognized the fair value requirement for one component of the rate setting exercise (*i.e.*, rate base), but observed that:

The Constitution is silent as to how the Commission is to determine the rate of return, thereby leaving that duty to the Commission and allowing it to use its knowledge and expertise, with the caveat that resulting rates and charges must be just and reasonable.¹⁸

¹⁷ See, e.g., *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 294 P.2d 378 (1956). "While our constitution does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates. The reasonableness and justness of the rates must be related to this finding of fair value."

¹⁸ Decision No. 70441, at 20.

1 In that Decision, we discussed the history of utility regulation and the evolution of ratemaking
2 in conjunction with standardized accounting procedures and economic and financial theory. We
3 noted that the testimony of RUCO's witness:

4 ...included a history of 'fair value' in the context of rate regulation with
5 an explanation of how in the early 1900s, a distrust of the book cost
6 information provided by the utilities due to the practice of trading utility
7 properties back and forth at escalating 'values,' recording 'cost' that
8 included the profit of an affiliate, and the lack of standardized accounting
9 methods led state commissions to favor 'fair value' over 'original cost'
10 rate base determinations.¹⁹

11 We also observed that, although the fair value ratemaking method was prominent in the first
12 half of the twentieth century, regulators began to use original cost information due to its greater
13 reliability, ease of interpretation, and being less susceptible to abuses. In the Chaparral City Remand
14 Case, we cited to the landmark United States Supreme Court case, *Federal Power Comm'n v. Hope*
15 *Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281 (1944), which freed most regulatory commissions from
16 fair value ratemaking requirements. (Decision No. 70441, at 21.) In that context, we indicated that
17 "[o]nce regulators had the appropriate controls in place to regulate accounting and the double dealing
18 transactions, the original cost was given more weight because it was a more reliable and trustworthy
19 number." (*Id.*)

20 With respect to Arizona specifically, we pointed out that, at the time Arizona's constitutional
21 framers adopted Article 15, §14, the NARUC Uniform System of Accounts did not exist and there
22 were no modern financial models for estimating cost of equity. (*Id.*) The Arizona Supreme Court, in
23 *Arizona Corp. Com'n v. State ex rel. Woods*, 171 Ariz. 286, 830 P.2d 807 (1992), discussed the
24 genesis of the Commission's constitutional powers and observed that at the time the Arizona
25 Constitution was drafted, progressive and labor forces shared a distrust of corporate powers and
26 combined to grant to the Commission broad authority to regulate public service corporations. The
27 court stated that, "[t]he founders expected the Commission to provide both effective regulation of
28

¹⁹ Decision No. 70441, at 21, footnote 56.

1 public service corporations and consumer protection against overreaching by those corporations.”²⁰
 2 In the Chaparral City Remand Case, we observed that “Arizona is apparently the only remaining state
 3 that continues to have a fair value requirement.” (Decision No. 70441, at 33.)

4 With this historical framework in mind, we must analyze the constitutional requirement to
 5 ascertain the Company’s fair value rate base with our concurrent constitutional obligation to set just
 6 and reasonable rates. In both of the Chaparral City cases cited above, we attempted to reconcile the
 7 direction from the Court of Appeals regarding fair value rate of return with the obligation to protect
 8 utility customers from excessive rates that could result from inflated returns. In doing so, however,
 9 we emphasized that “there are many ways to analyze and calculate an appropriate rate of return on
 10 FVRB.” (*Id.*) As stated in Decision No. 71308, the FVROR is intended to allow a utility to attract
 11 capital on reasonable terms; maintain the utility’s financial integrity; and permit the utility an
 12 opportunity to realize a return that is commensurate with the returns earned by enterprises with
 13 commensurate risks. (*Id.* at 47.) At the same time, the FVROR must produce a result that does not
 14 over-compensate the utility for the fair value of its property through rates and charges that are not just
 15 and reasonable. (Decision No. 70441, at 33.)

16 In *Chaparral City*, the Commission was criticized for adopting a methodology that allegedly
 17 “backed-in” to a revenue requirement that was comparable for both OCRB and FVRB. In this case,
 18 UNS Gas is proposing what is effectively a “reverse backing-in” approach to produce its desired
 19 revenue requirement. As RUCO witness Ralph Smith testified, using the Company’s “voluntary”
 20 6.80 percent FVROR would, if applied to its proposed OCRB, result in an implicit ROE of 12.58
 21 percent. (Ex. R-20, at 10.) Indeed, the Company’s proposed revenue increase in this case
 22 (approximately \$9.5 million) is more than three times the amount that would be realized under a
 23 typical cost of capital analysis based on the OCRB, operating expenses, and ROE determined above.
 24 We do not believe rates that are set at a level more than 100 percent above the increase that would be
 25 calculated under the OCRB/ROE methodology, and which methodology is employed in virtually
 26 every other state in the nation, can be considered “just and reasonable” under any logical definition of

27 ²⁰ *Id.* at 290, 830 P.2d 807, at 811. See, also, Deborah Scott Engelby, Comment, *The Corporation Commission:*
 28 *Preserving its Independence*, 20 Ariz. St. L. J. 241 (1988); Kris Mayes, *Encouraging Conservation by Arizona’s Private*
Water Companies: A New Era of Regulation by the Arizona Corporation Commission, 49 Ariz. L. R. 297 (2007).

1 that term. It is therefore necessary to employ an analysis in this case that balances the Commission's
2 fair value and just and reasonable obligations under the Arizona Constitution.

3 In the Chaparral City Rate Case, we found that an inflation element exists in both the debt and
4 equity components of the capital structure and, accordingly, the inflation adjustment should be made
5 to the entire cost of capital. (Decision No. 71308, at 45.) In that Decision, we reiterated that "the
6 most basic tenet of rate regulation...is that a utility should be provided with rates that will allow it an
7 opportunity to earn a return that is comparable to those of similarly situated enterprises."²¹ However,
8 we do not believe the inflation factor should be reduced by 50 percent, as was done in that case,
9 because such a methodology would fail to recognize that RCND estimations are based on estimates
10 of the cost to reconstruct the entirety of the Company's system at current prices, and do not take into
11 account in the RCND estimation efficiencies and cost savings that may exist due to factors such as
12 technological advances. We note that the Chaparral City Remand Decision did not apply a 50
13 percent weighting factor to the inflation estimate, although inflation was calculated only on the equity
14 component in that case due to a lack of sufficient evidence in the record concerning inflation in the
15 cost of debt. (Decision No. 70441, at 36-37.) In this proceeding, we find that an unadjusted inflation
16 factor should be subtracted from the entire WACC, to afford appropriate recognition to the fact that
17 inflation exists in both the debt and equity components of the Company's capital structure, and that
18 reconstruction cost estimates likely exceed the rate of inflation based on the factors cited above.

19 We turn next to the appropriate inflation rate to be applied to UNS Gas's WACC. In his
20 direct testimony, Company witness Grant indicated that an inflation factor of 2.9 percent was
21 appropriate for purposes of supporting a justification of a 7.30 percent FVROR. (Ex. A-13, at 30-31.)
22 In his direct testimony, RUCO witness William Rigsby calculated an average inflation factor of 2.5
23 percent for the years 2001 through 2008, a level of inflation that RUCO witness Smith found to be "a
24 very conservative estimate of inflation." (Ex. R-13, Sched. WAR-1, p.4; Ex. R-21, at 10.) Staff
25 witness David Parcell suggested that an inflation factor of 2.0 percent should be used for calculating
26 the FVROR, if Staff's alternative recommendation is adopted by the Commission. (Ex. S-14, at 50.)
27

28 ²¹ *Id.* at 48, citing *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591, 64 S.Ct. 281 (1944).

1 Although we believe it would be reasonable to assume an inflation factor as high as 2.9
2 percent, as suggested in the Company's direct testimony, for purposes of determining an appropriate
3 FVROR in this case we will adopt a lower inflation rate based on an average of the Staff and RUCO
4 inflation rates. The average of the Staff and RUCO rates of 2.0 and 2.5 percent, respectively, results
5 in a rate of 2.25 percent, which we believe is a conservative estimate of the inflation factor that
6 should be applied to the WACC in order to remove from it the effects of inflation. Subtracting the
7 2.25 percent inflation factor from the 8.0 percent WACC, results in a FVROR of 5.75 percent.

8 We find that a FVROR of 5.75 percent is also within the wide range of values found in the
9 record as a result of the various methodologies used by the parties' expert witnesses in their
10 calculations of FVROR. RUCO's witness testified that RUCO's final recommendation was 5.38
11 percent. Staff's recommendation is a FVROR of 6.03 percent, with an alternative methodology
12 calculation of 6.37 percent. The Company offered two different recommendations, originally
13 requesting a 6.80 FVROR which it later increased to 7.25 percent.

14 We concur with Mr. Smith's testimony that the "determination of FVROR is at best and
15 estimation and not an exact science," and that the goal of the exercise is to afford the Company a
16 reasonable return without providing excessive rates or windfall profits. Using our informed judgment
17 concerning the record's range of values for calculation and determination of FVROR, we find that a
18 FVROR of 5.38 percent is on the low side of the range and that both 6.80 percent and 7.25 percent
19 are too high. In the determination of an appropriate FVROR, we are accorded substantial discretion
20 and may reasonably draw on our expertise in our consideration of the record. In this instance, we
21 find that a FVROR of 5.75 percent strikes the appropriate balance on the implicated ratemaking
22 issues, within the range of values in the record. Therefore, we find that a FVROR of 5.75 is
23 reasonable under the facts and circumstances of this case, when all the relevant factors are
24 considered. Applying the FVROR to the FVRB determined herein produces an overall revenue
25 increase of \$3,245,607.

26 As this case makes clear, the substantial difference between UNS Gas's OCRB and estimated
27 RCND produces a FVRB that is far in excess of the OCRB. The large gap between UNS Gas's
28 OCRB and FVRB underscores the inherent flaw in attempting to apply a weighted average cost of

1 capital directly to the FVRB, even with the modifications employed in the Chaparral City cases and
2 herein for UNS Gas. Although historically the FVRB has been calculated by averaging the OCRB
3 and RCND, the issue of whether a given company's estimated RCND is accurate, or whether it is
4 appropriate to determine the FVRB by taking a simple average of OCRB and RCND, are matters that
5 have not heretofore been analyzed in any substantial detail because, prior to the Court of Appeals'
6 *Chaparral City* decision, the methodology employed by the Commission did not typically result in
7 significant differences.

8 We believe that future cases should include a more detailed and comprehensive evaluation of
9 how fair value rate base is determined, including a determination of the accuracy of the RCND
10 estimation process; whether it is appropriate to average OCRB and RCND to calculate FVRB; and
11 how, or whether, the Commission should use cost of capital models as part of the determination of
12 fair value rate of return.

13 As we have stated in prior cases, the Constitution does not prescribe the methodology to be
14 used by the Commission in ascertaining the fair value of a utility company's property, and it is
15 undisputed that the Commission has broad discretion in making fair value determinations.²² Even the
16 Court of Appeals' decision in *Chaparral City* recognized the Commission's authority to craft
17 appropriate methodologies for determining fair value. We indicated previously that there are a
18 number of methods that may be appropriate for determining FVRB and FVROR and, as the facts of
19 this case make clear, a one size fits all approach may not enable the Commission to satisfy its
20 obligation to establish just and reasonable rates without the ability to tailor a remedy that balances the
21 Commission's concurrent constitutional obligations.

22 As a final matter, it is noteworthy that UNS Gas initially proposed a FVROR of 6.80 percent,
23 based on its concern for its customers "in these challenging economic times." (Ex. A-13, at 30.)
24 However, the Company later withdrew its "voluntary" offer after reading Staff's and RUCO's direct
25 testimony, and realizing that those parties recommended a revenue requirement that was less than the
26 amount requested by the Company. Staff and RUCO's adjustments to parts of the Company's rate

27 ²² See, e.g., *Simms v. Round Valley Light & Power Co.* (1956), 80 Ariz. 145, 294 P.2d 378; *Consolidated Water Utilities,*
28 *Ltd. v. Arizona Corp. Com'n* (App. Div.1 1993), 173 Ariz. 478, 875 P.2d 137; *Scates v. Arizona Corp. Com'n* (Div.1
1978), 118 Ariz. 532, 578 P.2d 612.

1 application should not have been a surprise, unless the Company somehow believes the economic
 2 challenges faced by its customers are no longer as daunting as they were previously; or the
 3 Company's concern for customers only applies to the extent it is assured of receiving the full revenue
 4 increase requested in its application.

5 Fair Value Rate of Return Summary

6	Weighted Average Cost of Capital	8.00%
7	(Less) Inflation Adjustment	<u>2.25%</u>
8	Fair Value Rate of Return	5.75%

9 AUTHORIZED INCREASE

10 Based on our findings herein, we determine that UNS Gas is entitled to a gross revenue
 11 increase of \$3,245,608.

12	Fair Value Rate Base	\$253,048,264
13	Required Rate of Return	5.75%
14	Required Operating Income	14,550,275
15	Operating Income Available	12,434,619
16	Operating Income Deficiency	2,115,656
17	Gross Revenue Conversion Factor	<u>1.636582</u>
18	Gross Revenue Increase	\$3,462,445

19 RATE DESIGN ISSUES

20 Monthly Customer Charge

21 UNS Gas

22 In its application, UNS Gas proposed increases to the fixed monthly charge for all customer
 23 classes, except residential customers served under the CARES²³ program. Under the Company's
 24 proposal, the residential customer charge would be increased from \$8.50 per month to \$14.00 per
 25 month, in three phased steps. The first step would increase the charge to \$10.00 when the rates in
 26 this case go into effect, with an increase to \$12.00 per month one year later, and an additional
 27 increase to \$14.00 per month two years following the effective date. The Company's
 28 recommendation would result in a corresponding reduction in the non-commodity volumetric

²³ "CARES" is the Customer Assistance Residential Energy Support program that offers low-income customers discounted rates on the monthly service charge and a portion of non-commodity volumetric charges. (Ex. A-20, at 22.)

1 charges, such that the automatic adjustments would be revenue neutral for an average usage
2 customer. (Ex. A-20, at 14-15.)

3 UNS Gas claims that its customer charge proposal would better align rates with its cost of
4 service, as detailed in its class cost-of-service study. (Ex. A-22, at 6.) Mr. Erdworm explained that
5 although the vast majority of the Company's costs are fixed, the recovery of those fixed costs is
6 heavily dependent on revenues received through the volumetric charges. The Company's
7 recommendation in this case seeks to recover an increasingly greater percentage of fixed costs by
8 imposing higher monthly customer charges while reducing non-commodity volumetric charges by a
9 corresponding amount. Company witness Erdworm described the Company's plan to phase-in
10 automatic increases in the monthly fixed charge as "an initial and gradual move towards de-
11 coupling." (*Id.*)

12 According to UNS Gas, its cost-of-service study indicates that the "bare bones" monthly
13 customer charges needed to recover its fixed costs would be \$18.15 for residential service, \$19.00 for
14 small commercial/industrial customers, and approximately \$220.00 for large commercial/industrial
15 customers. (Ex. A-20, at 14.) Mr. Erdworm indicated that the fixed monthly costs include metering,
16 meter reading, the service drop to customers, and customer service and billing. (*Id.*) The Company
17 claims that moving towards a rate structure that more closely matches fixed customer charges to fixed
18 costs provides benefits, such as allowing customers to make better decisions regarding the use of
19 resources; allowing the Company to receive revenues more in line with incurrence of costs; and
20 serving an important policy goal of lessening reliance on volumetric charges to recover fixed costs.

21 UNS Gas also contends that its proposed rate design would reduce existing subsidies from its
22 customers in colder climates to those in warmer areas. As an example, Mr. Erdworm claims that the
23 average Flagstaff residential customer pays \$145 more in annual margin than an average customer in
24 Lake Havasu City, for the same fixed costs. He stated that if the Company's customer charge were to
25 be capped at \$10 per month, rather than allowing the additional proposed adjustments, that subsidy
26 would increase to \$173 annually. However, according to Mr. Erdworm, if the Company's
27 recommended rate design is approved, the alleged cross-subsidy would be reduced to \$134 per year.
28 (*Id.* at 17-18.)

1 In response to the objections of Staff and RUCO, the Company argues that increasing the
2 monthly customer charge from \$8.50 to \$14.00 would not result in "rate shock" because the increase
3 would be phased in over three steps, and because the customer charge represents a relatively small
4 portion of the overall bill. In addition, UNS Gas claims that the customer charge increases would be
5 partially offset by reductions to the non-fuel volumetric charges under the Company's proposal. The
6 Company also disputes the contention that its proposed rate design would result in customer
7 confusion, arguing that the Commission has approved phased-in rates in the past. Finally, UNS Gas
8 asserts that its rate design would not eliminate the incentive to conserve. Mr. Erdwurm stated that the
9 average residential customer's bill is composed of approximately 60 percent related to commodity
10 use that is passed through the Purchased Gas Adjustor ("PGA"), and only 40 percent related to the
11 margin portion. He indicated that the substantial portion of customer bills related to the cost of gas
12 "will continue to provide customers a strong incentive to conserve." (*Id.* at 21.)

13 RUCO

14 RUCO witness Frank Radigan testified that the Company's proposed rate design would
15 increase the residential monthly customer charge by 65 percent, which he considers excessive given
16 that the Company's overall revenue increase is approximately 6 percent, and RUCO's recommended
17 revenue increase is only 1.6 percent. (Ex. R-12, at 2.) RUCO proposes an increase in the residential
18 customer charge from the current \$8.50 per month to \$10.00 per month; an increase from \$13.50 to
19 \$15.50 per month for small commercial, industrial, and irrigation customers; and an increase for large
20 commercial and industrial customers from \$100.00 to \$105.00 per month. (Ex. R-11, at 8.)

21 Mr. Radigan contends that the Company's proposal ignores the rate design principle of "rate
22 stability," claiming that "automatic rate increases are generally not appreciated by customers." (*Id.* at
23 6.) He stated that the automatic increases proposed by UNS Gas would increase a small customer's
24 bill by 40 percent in the second and third years, which he claims "will undoubtedly cause an increase
25 in customer complaints." (*Id.*)

26 In response to the Company's inter-class subsidization claims, RUCO asserts that customers
27 in the higher usage in cold weather areas may contribute more to the Company's peak, indicating that
28 it costs more to serve those customers. Mr. Radigan suggests that if the Company believes district-

1 specific rates should be adopted, it should present a study regarding the cost differences to serve
2 customers in colder climates versus warmer areas. (*Id.* at 7.)

3 Staff

4 Staff witness Dr. Fish advocates a rate design that would increase the residential customer
5 charge from \$8.50 to \$9.50 per month; the small commercial and industrial customer charge from
6 \$13.50 to \$15.50 per month; and the large commercial industrial charge from \$100.00 to \$105.00 per
7 month. (Ex. S-12, Sched. THF-RD6.) Dr. Fish expressed opposition to the Company's attempt to
8 recover a substantially greater percentage of its fixed costs through the customer charge, stating that
9 the Company's proposal would shift more of its cost recovery to residential customers, who have the
10 greatest inelasticity of demand (*i.e.*, the least ability to lower usage in response to price increases).
11 (*Id.* at 30.)

12 According to Dr. Fish, rates should be "efficient, equitable, and result in providing the
13 Company the opportunity to recover its cost of providing service." (*Id.* at 29.) He also indicated that
14 rates should be non-discriminatory; easily understood; should have minimal revenue fluctuations; and
15 should discourage wasteful production and consumption. Dr. Fish stated that although cost-based
16 rates are important, the concept of gradualism is also an important factor in setting just and
17 reasonable rates. With respect to the monthly customer charge, he claims that the movement to cost-
18 based rates "should not be so abrupt as to cause rate shock." (*Id.* at 30.)

19 Conclusion on Customer Charge

20 As discussed by Staff's witness, movement towards cost-based rates is just one of the many
21 factors that must be considered in designing rates. The goal of moving closer to cost-based rates
22 must be balanced with competing principles such as gradualism, fairness, and encouragement of
23 conservation.

24 In accordance with these rate design principles, we believe that an increase in the monthly
25 customer charge to \$10.00 for residential customers will make significant movement towards cost-
26 based rates and provide a reasonable level of protection for the customers who are affected by this
27 base rate increase. For the remainder of the customer classes, we believe it is appropriate to adopt
28 Staff's and RUCO's recommended customer charges as set forth in the testimony of Dr. Fish and Mr.

Smith. (Sched. THF-RD4.) The non-fuel volumetric charges will be adjusted to recover the balance of the revenue requirement established in this Order based on an even percentage allocation to each class, except that the volumetric charge for the residential class will remain at its current rate.

For a residential customer on Rate R10, the fixed monthly customer charge would increase from \$8.50 to \$10.00, and the volumetric charge would remain at its current rate of \$0.3270 per therm. Based on these rates, a residential customer with 20 therms of usage would experience an increase in monthly base rates of 10 percent (from \$15.04 to \$16.54) and an overall monthly increase (including the cost of gas) from \$28.60 to \$30.10 (5.2 percent). The same Rate R10 customer with consumption of 100 therms would see an increase in base rates of 3.7 percent (from \$40.20 to \$42.70) and an overall increase (including the cost of gas) from \$109.02 to \$110.52 (1.4 percent).

Low-Income Customer Programs

UNS Gas currently offers several low-income assistance programs. The CARES program provides a discounted monthly customer charge of \$7.00 throughout the year, as well as a \$0.015 per therm discount on the first 100 therms used in the winter billing months of November through April. To qualify for CARES, customers must have a combined household income of no more 150 percent of the federal poverty level. (Ex. S-12, at 31-32.) The Company also offers a Warm Spirits program through which emergency bill assistance program is offered to eligible low-income customers.

Intervenor Cynthia Zwick submitted testimony regarding low-income customer issues and recommended several modifications to the Company's proposal. Ms. Zwick proposed that CARES customers should be held harmless from the rate increase in this case, for both base rate and any increases to the PGA. Additional measures proposed by Ms. Zwick are: (1) that language in the CARES, Warm Spirits, and weatherization programs should track federal LIHEAP²⁴ and weatherization eligibility language; (2) the Company should be required to increase outreach and enrollment efforts in the low-income discount program, including automatically enrolling eligible customers in CARES; (3) CARES customers should be exempted from the security deposit requirements in UNS Gas's tariffs; (4) the Company should increase its level of support for the Warm

²⁴ "LIHEAP" is the Low Income Home Energy Assistance Program.

1 Spirits and Low-Income Weatherization programs; and (5) the Company should be directed to cease
2 the referral of customers to payday lending institutions. (Ex. Z-1, at 2.)

3 CARES Program

4 For CARES customers, UNS Gas proposed maintaining the current monthly charge of \$7.00
5 and keeping the current non-fuel volumetric charge at \$0.1770 per therm for the first 100 therms per
6 month from November through April. (Ex. A-5, at 11.) For usage in excess of 100 therms in the
7 winter billing period, the applicable non-fuel volumetric charge would remain \$0.3270 per therm.
8 (*Id.*)

9 Company witness Erdworm testified that the Company supported a collaborative effort of
10 stakeholders to examine the possibility of providing a discount in gas commodity costs for CARES
11 customers, with the lost commodity revenues being recovered through the PGA mechanism from
12 other customers. (Ex. A-20, at 22.) However, no stakeholder meetings were apparently held
13 regarding this issue, and the Company does not favor excluding CARES customers from the PGA or
14 otherwise discounting the PGA rate for low-income customers. Company witness Hutchens testified
15 that the PGA adjustor fluctuates based on the gas market and, during periods of downward
16 movement, CARES customers would not receive that benefit if they were not subject to the PGA.
17 (Tr. 82-83.) He indicated, however, that the Company has typically not passed through PGA
18 surcharges to low-income customers. (*Id.* at 83.) UNS Gas argues that the accounting treatment of
19 Ms. Zwick's proposal regarding the PGA, including how to allocate the impact to other customers,
20 would be difficult to administer.

21 Ms. Zwick continues to advocate holding CARES customers harmless from increases in base
22 rates as well as PGA commodity increases. She contends that more middle and low-income families
23 are unable to pay their utility bills and any increases will result in additional disconnections. She
24 points to a 2008 survey presented at the hearing that indicates of the households unable to pay their
25 bills, 93 percent had at least one vulnerable household member, 29 percent were unemployed at some
26 point during the year, 70 percent had a serious medical problem, 28 percent kept their homes at
27 unsafe temperatures, 33 percent used a kitchen stove to provide heat, 47 percent paid less than the full
28 bill, 32 percent went without food for at least one day, 42 percent went without medical or dental

1 care, and 24 percent had someone in their home who became sick because the home was kept too
2 cold. (Ex. Z-3.) She argues that the presence of these factors supports her recommendation to not
3 impose any increases, including commodity rate adjustments, on CARES customers.

4 Staff witness Fish stated that Staff agreed the CARES monthly customer charge and winter
5 month volumetric charge should be maintained at current levels. (Ex. S-12, at 31-32.) However,
6 Staff witness Robert Gray testified that the PGA should continue to reflect only the cost of the natural
7 gas commodity and interstate transportation, plus an interest rate component. Mr. Gray concluded
8 that "Staff does not believe that proposals which would alter the way the PGA mechanism operates
9 are the right venue to pursue additional low income customer relief." (Ex. S-9, at 8.)

10 RUCO witness Radigan also agreed with the Company's recommendation to maintain the
11 current CARES discounted rates, but he did not take a position with respect to discounted PGA rates
12 for low-income customers. (Ex. R-11, at 10.)

13 We agree with UNS Gas, Staff, and RUCO, that keeping the current customer charge in effect
14 for CARES customers at \$7.00 per month, and retaining the current winter month volumetric
15 discount for the first 100 therms, will protect those customers from the effects of the rate increase
16 approved in this case, and will continue to provide a rate structure for the low-income customers
17 enrolled in the program that allows an opportunity to reduce their overall bills through conservation
18 efforts. Although we are sympathetic to Ms. Zwick's position regarding the provision of a
19 discounted PGA rate for CARES customers, the record in this case is not developed sufficiently to
20 adopt that proposal. For such a recommendation to be considered, a number of issues would need to
21 be addressed including, but not necessarily limited to, whether low-income customers would be
22 excluded from the PGA entirely, the level of a PGA discount, and the mechanism for allocating the
23 unrecovered revenues. Moreover, we are concerned with imposing significant additional costs on
24 non-CARES-eligible customers who may also happen to be experiencing financial difficulties due to
25 the current economic climate.

26 CARES Eligibility

27 Currently, customers are eligible for enrollment in the CARES program based on a household
28 income of 150 percent of the federal poverty level or below. In her testimony, Ms. Zwick stated that

1 Arizona received a total of \$6.1 million in LIHEAP funding in federal fiscal year 2008, and that she
2 was informed in November 2008 that the state would be receiving \$31 million in federal LIHEAP.
3 (Ex. Z-1, at 5.) Although this represents a significant funding increase, Ms. Zwick testified that, on a
4 per capita basis, Arizona receives the lowest amount of LIHEAP funds of any state in the country.
5 She indicated that even with the additional funding, assistance agencies will be able to serve only
6 78,000 of approximately 500,000 eligible households in Arizona. (*Id.*)

7 Ms. Zwick stated that in exchange for receiving the increased LIHEAP funds, community
8 action agencies and the Arizona Department of Economic Security staff agreed to increase eligibility
9 for those funds to households with income up to 200 percent of the federal poverty level. (*Id.*)
10 Because of the increased eligibility level, she requested that UNS Gas be required to track the
11 LIHEAP eligibility standard for purposes of enrolling customers in its CARES program. Ms. Zwick
12 further requested that UNS Gas expand its outreach efforts by including flyers in customer bills
13 between November and April, and that the Company automatically enroll customers in CARES that
14 are determined to be LIHEAP eligible. (*Id.* at 6-7.)

15 At the hearing, UNS Gas witness Hutchens testified that the Company has begun enrolling
16 customers in the CARES program who have qualified and are receiving LIHEAP funds based on the
17 200 percent of poverty level standard. (Tr. 80-81.) Other customers are enrolled on a self-certified
18 basis, but only at the 150 percent standard. (*Id.*; Tr. 717.) Mr. Hutchens stated that the Company "is
19 already doing some auto enrollment from customers that come to us from those agencies" (*i.e.*,
20 customers determined to be LIHEAP-eligible by community assistance agencies in Arizona). (Tr.
21 717.)

22 In its brief, UNS Gas claims that the Company remains open to discussing eligibility beyond
23 the 150 percent poverty level, but does not believe any such requirement should be adopted in this
24 rate case given the potential impact on other customers. (UNS Gas Initial Brief, at 45.) In support of
25 its argument, the Company cites to an exhibit it prepared showing approximately 8,000 of its 132,000
26 residential customers are currently enrolled in the CARES program, and 35,640 customers (27
27 percent) would currently meet the 150 percent eligibility standard. (Ex. A-44.) The exhibit also
28 indicates that an additional 15,840 customers (12 percent) would qualify under the 200 percent of

1 federal poverty level standard. UNS Gas estimates that if the CARES program is expanded to
2 include customers between the 150 and 200 percent standards, an additional 3,556 customers would
3 likely be enrolled in CARES. (*Id.*) The Company stated that the current rate impact on non-CARES
4 customers is approximately \$4.00 per year, and that expansion of the program to 200 percent of the
5 poverty level would result in an additional \$2.00 annually being borne by non-CARES customers.
6 (*Id.*)

7 We are encouraged that UNS Gas is currently enrolling automatically into CARES the
8 customers that are already qualified under the federal LIHEAP program at the 200 percent poverty
9 level. However, we believe that the Company should undertake additional efforts to investigate
10 whether its current policy for enrolling non-LIHEAP-qualified customers at the 150 percent standard
11 should be expanded to include customers that fall within the 150 percent to 200 percent increment.
12 We will therefore direct UNS Gas to convene a meeting within 60 days with the parties to this case,
13 and any other interested stakeholders, to address this issue and submit its recommendations within
14 120 days of the effective date of this Decision.

15 CARES Customer Deposits

16 In her testimony, Ms. Zwick also requested that UNS Gas be required to waive any applicable
17 deposit requirements for customers in the CARES program. She indicated that many families are
18 incurring significant past-due unpaid amounts on their bills, and an additional requirement for a
19 customer deposit to prevent disconnection, or for reconnection of service, would exacerbate the
20 burden on such customers. (Ex. Z-1, at 7-8.)

21 UNS Gas opposes Ms. Zwick's deposit waiver proposal on the basis that it would impose an
22 unfair burden on other customers. Company witness Hutchens stated that "we're stewards of our
23 entire customer base." (Tr. 85-86.) However, Mr. Hutchens was not aware of the number of CARES
24 customers disconnected during a given year, or the cost to the Company in making such
25 disconnections, that would justify the level of customer deposits currently allowed under the
26 Company's tariffs. (Tr. 708-09.)

27 Although we recognize the Company's concerns with waivers of customer deposits, the
28 Commission notes the pronounced and continued increases in customer disconnections due to current

1 economic conditions and believes limited waivers for vulnerable CARES customers are appropriate
2 at this time. We direct the Company to modify its deposit policies for CARES customers, in light of
3 this difficult economy. Such modifications will make specific provision for waivers, reduced
4 deposits and payment of deposits over multiple billing cycles.

5 Warm Spirits Program

6 Warm Spirits is a program funded by customer contributions that provides emergency bill
7 payment assistance to low-income customers, for purposes of avoiding disconnection or reconnection
8 of service. UNS Gas matches aggregate customer contributions up to \$25,000 annually. Currently,
9 customers contribute through a fixed-amount pledge that is added to their bills each month, or they
10 make random contributions through payment of their monthly bills. (Ex. A-8, at 3.) UNS Gas is
11 proposing to offer an additional option, called "round-up," that would allow customers to contribute
12 the difference between the actual bill amount and the amount rounded to the next even dollar as a
13 Warm Spirits contribution. (*Id.*) UNS Gas administers the Warm Spirits program in coordination
14 with the Arizona Community Action Association ("ACAA"). The Company disburses the collected
15 funds quarterly to the ACAA, which distributes the funds to assistance agencies within the
16 communities from which the funds were received. (*Id.* at 4.)

17 Ms. Zwick proposed that the Company be directed to increase its matching funding to the
18 Warm Spirits program up to \$50,000 annually, in recognition of the growth in number of customers
19 requiring assistance since the last rate case and expected customer growth. (Ex. Z-1, at 8.)

20 Staff agrees with the Company's Warm Spirits proposal, including creation of the round-up
21 option. RUCO did not take a position on the Company's Warm Spirits proposal.

22 UNS Gas agreed with Ms. Zwick's recommendation to increase its matching funding of
23 Warm Spirits, up to \$50,000 annually. (UNS Gas Initial Brief, at 45.)

24 We believe that the Company's agreement to increase its matching contributions to the Warm
25 Spirits program to \$50,000 annually, from the current level of \$25,000 per year, is a reasonable
26 commitment at this time. We encourage the Company to continue to promote the existence of the
27 Warm Spirits program and to strive to find additional ways that give customers the ability to make
28 voluntary contributions to this program.

1 Low-Income Weatherization Program

2 UNS Gas has four demand-side management ("DSM") programs approved by the
3 Commission, including a low-income weatherization ("LIW") program. Company witness Denise
4 Smith testified that the LIW program has a budget of approximately \$100,000 per year, with an
5 ability to increase that amount by up to an additional 25 percent. (Tr. 635-38.) Ms. Smith stated that
6 the DSM funds for this program are distributed to community action agencies, including the Northern
7 Arizona Council of Governments ("NACOG"), and those agencies administer the LIW program. She
8 also indicated that NACOG requested additional funding for the program and that UNS Gas was
9 discussing the request. (*Id.* at 638.) Ms. Smith testified that 52 homes in the UNS Gas service area
10 were weatherized under the LIW program in 2008; and that an additional 27 homes had received
11 LIW funding as of the date of the hearing in August 2009. (Tr. 646.)

12 Ms. Zwick recommended that the Company be required to increase its funding for the LIW
13 program to \$200,000 per year, and that the household funding level be increased from \$2,000 to
14 3,000 per weatherization. (Ex. Z-1, at 8-9.) She compared the spending levels of Southwest Gas and
15 UNS Gas, and asserted that Southwest Gas spends more on a per customer basis than UNS Gas for
16 this program. (*Id.*) However, at the hearing, Company witness Smith stated that UNS Gas spends
17 approximately \$0.68 per customer for LIW, compared to Southwest Gas's \$0.46 per customer level.
18 (Tr. 635.)

19 We find that the Company's current level of spending on the LIW is insufficient to meet
20 customer demand, particularly in light of the difficult economic climate. Accordingly, we direct the
21 Company to increase its level of spending on the LIW program to \$200,000 per year.

22 Payments at Payday Loan Stores

23 In the Company's last rate case, we addressed the issue of whether it was appropriate for UNS
24 Gas to refer customers to "payday loan stores" for making cash payments. In that case, we stated as
25 follows:

26 In 2006, UNS closed local offices in Prescott, Cottonwood, Flagstaff, and
27 Show Low [but continues to operate local offices in Kingman, Lake
28 Havasu, and Nogales]. These closings coincided with the Company's
 consolidation of its Tucson call center operations for all of the UniSource

operating affiliates, which UNS claims was intended to improve customer service while at the same time cutting the Company's operating costs. At the time these offices were being closed, customers were notified that future payments could be made at various ACE Cash Express locations and other specified "cash only" stores. For payments made at these so-called "payday loan" stores in areas where UNS does not have a local office, UNS pays the fee charged by the payday loan stores, but customers who pay at such stores in an area that has a local office (*i.e.*, Kingman, Lake Havasu, and Nogales) must pay a \$1 fee in order to make a payment at the payday loan stores.

(Decision No. 70011, at 68-70, footnotes and citations omitted.) Due to the allegations raised in that case regarding the predatory lending practices of payday loan stores, we directed the Company to "make every reasonable effort to determine whether other payment locations may be utilized." (*Id.* at 69.) As a result, UNS Gas entered into an agreement in 2009 that allows customers to make payments at WalMart stores in the Company's service area. (Ex. Z-1, at 9.)

In her testimony, Ms. Zwick expressed appreciation for the WalMart solution, but indicated that the Company continued to refer customers to a payday loan store through its website. She requested that the Company be directed to delete any reference or link to ACE Cash Express from the Company's website. (*Id.*) At the hearing, Company witness Hutchens testified that UNS Gas removed the link to ACE Cash Express from the Company's website in response to Ms. Zwick's request. (Tr. 718.) Ms. Zwick stated that she was satisfied that the website reference has been removed. (Tr. 494.)

On September 8, 2009, a letter from Paul Bonavia, the Chairman, President and Chief Executive Officer of UniSource Energy, was filed in the docket addressing the issue of payments at local offices. The letter confirmed that UNS Gas, as well as TEP and UNS Electric, now allow bills to be paid at WalMart stores, but not at local Company offices (with the exception of Lake Havasu, Kingman, and Nogales). However, effective October 1, 2009, the Company no longer accepts payments at those three remaining local offices²⁵ but instead, offers a phone link and dedicated computer kiosk in each local Company office.

²⁵ Mr. Bonavia indicated that, in response to concerns expressed at the August 17, 2009, public comment meeting in Nogales, the Company would continue to accept customer payments at the Nogales office until an acceptable alternative could be determined.

1 UNS Gas should file, within 30 days of the effective date of this Decision, a statement
 2 regarding the current status of payment options available at the Nogales office, the current status of
 3 the phone links and computer kiosks in all local offices, and any other relevant information related to
 4 customer options for bill payments. If, prior to UNS Gas's next rate case Decision, any substantive
 5 changes are made to the Company's bill payment options or availability of customer contacts at local
 6 offices, UNS Gas shall file in this docket a statement regarding those changes.

7 Proposed Changes to Rules and Regulations

8 UNS Gas proposed several changes to its existing Rules and Regulations governing service.
 9 The proposed changes are summarized below.

10 Section 2

11 Add definitions for "Elderly," "Excess Flow Valve," "Service Transfer,"
 12 "Special Call Out," and "Trip Charge." Delete the definitions of "Senior
 13 Citizen" and "Working Hours." Clarify the definition of "Service
 14 Reconnection Charge."

15 Section 3

16 Clarify the applicability of service establishment, reestablishment and
 17 reconnection charges, as well as charges for service transfers and multiple
 18 attempts to connect.

19 Section 6

20 Increase the charge for service line establishments from \$16.00 per foot to
 21 \$22.50 per foot. For those customers who perform the trenching work, the
 22 charge for service line establishments will increase from \$12.00 per foot to
 23 \$16.50 per foot.

24 Section 8

25 Delete the "Table of Atmospheric Pressure Bases" by geographical zone
 26 descriptions in favor of a more simplified version that shows the
 27 atmospheric pressure bases within specific elevation ranges.

28 Section 17

 Add the Statement of Additional Charges to the end of the Rules and
 Regulations.

(Ex. A-8, at 5.) The Company's proposed changes to its Rules and Regulations were not opposed by
 any party in the proceeding. We find the changes to be reasonable and they shall be adopted.

Revised Fees for Additional Charges

 UNS Gas also proposed revisions to various fees in its Statement of Additional Charges. The
 Company claims that the proposed changes reflect rising costs associated with the provision of the
 services. The proposed changes are summarized below.

	<u>Current</u>	<u>Proposed</u>
Service Transfer	\$15.00	\$20.00
Collection Fee	\$20.00	\$20.00
Customer Req. Meter Re-Reads	\$15.00	\$20.00
Mult. Attempts to Connect	\$15.00	\$20.00
Service Estab. & Reestablishment		
During Working Hours	\$25.00	\$35.00
Reestablishment of Service Due to		
Non-Payment – Working Hours	\$45.00	\$35.00
Service Estab. & Reestablishment		
Outside Working Hours	\$35.00	\$50.00
Reestablishment of Service Due to		
Non-Payment – O/S Working Hours	\$55.00	\$50.00
Customer Requested Meter Test	\$65.00	\$90.00
Insufficient Funds	\$15.00	\$10.00
Interest on Customer Deposits	One-Year Treasury Rate	

(Ex. A-8, at 7.) The Company's proposed changes to its Statement of Additional Charges were not opposed by any party in the proceeding. Staff witness Dr. Fish stated that UNS Gas conducted incremental cost studies for most of the charges, and the proposed rates are in line with the results of those studies. We find the changes to be reasonable and they shall be adopted.

Gas Procurement Practices and Policies

For purposes of evaluating the prudence and reasonableness of UNS Gas's gas procurement practices, Staff retained an outside consultant, Ms. Rita Beale of Energy Ventures Analysis, Inc. (Ex. S-6.) Ms. Beale conducted a prudence review of the Company's practices for the period January 2006 to June 2008, resulting in the following ten recommendations:

- (1) UNS Gas should conduct a thorough analysis of excess interstate pipeline capacity that could be optimized through Asset Management Arrangements ("AMA");
- (2) If excess pipeline capacity is available, UNS Gas should have TEP seek potential counterparties on UNS Gas's behalf, at least annually, to optimize all of its excess capacity on both the Transwestern and El Paso pipelines, although not at the expense of incurring a net increase in charges and penalties by El Paso;
- (3) UNS Gas should be required to supplement the information filed monthly to the Commission to tie out and support all entries of the PGA Bank Balance, and to specifically include the UNSG Core Market/System Supply Imbalance Report, which finalizes tie-out of the commodity balances by pipeline;

- (4) To ensure accuracy of the PGA filings, personnel from the Energy Settlements & Billing Department should receive additional training in the operating practices and terminology of the TEP Wholesale Department for gas procurement;
- (5) The UNS Gas Inc. Price Stabilization Policy should be changed to require consideration of purchases during the excluded months of August, September and October. Automatically excluding these months created missed opportunities to buy lower-priced gas during 2006, 2007 and 2008;
- (6) To increase its hedge documentation, UNS Gas should create a record indicating the months that management decides to deviate from a ratable purchasing pattern, even if it is as simple as using a checklist denoting "management decided not to hedge;"
- (7) The UNS Gas Inc. Price Stabilization Policy should also be amended for any strategy changes effective September 2008, when TEP took over gas procurement;
- (8) The UNS Gas Inc. Price Stabilization Policy must be updated at least annually to reflect the current practices and procedures before being approved by the Corporate Risk Management Committee;
- (9) All parties involved with gas procurement should acknowledge the UNS Gas Inc. Price Stabilization Policy by signing annually, including Gas Scheduling, Transportation Contracts, Risk Management, and Risk Control, and not just the traders; and
- (10) A single person should be assigned as the "policy owner" of the UNS Gas Inc. Price Stabilization Policy to ensure, on an annual basis, that the policy is accurate before it is approved by the Corporate Risk Management Committee.

(*Id.* at 4-5.) UNS Gas witness Hutchens testified that the Company accepts all of Staff's gas procurement recommendations, as discussed in the testimony of Ms. Beale and described above. (Ex. A-6, at 8-12; Tr. 48.)

There is no dispute on the issue of prudence during the identified audit period. We therefore agree that the Company's natural gas procurement practices and policies during the audit period of January 2006 through June 2008 are deemed prudent, subject to implementation of and compliance with Staff's recommendations.

Purchased Gas Adjustor

In his direct testimony, Staff witness Robert Gray explained that UNS Gas's PGA mechanism was evaluated in its last rate case, and a number of changes were made to the PGA. The changes included setting the base cost of gas to zero, expanding the bandwidth on the monthly PGA rate,

1 eliminating the bank balance threshold on undercollections, increasing the bank balance threshold on
2 overcollections, and retaining the existing interest rate for the PGA bank balance. (Ex. S-9, at 3,
3 referencing Decision No. 70011, at 77-82.) Mr. Gray testified that Staff is not proposing any further
4 changes to the current PGA mechanism because additional time is needed to evaluate the impact of
5 the changes made in the last case. He stated that Staff did not see any compelling evidence to support
6 changes to UNS Gas's PGA, at this time. (*Id.*)

7 In its application, UNS Gas proposed only one change to its current PGA mechanism, to
8 increase the interest rate applied to its PGA bank balance.

9 PGA Bank Interest Rate

10 In its application, UNS Gas proposed that the interest rate applicable to its PGA bank balance
11 should be based on the three-month London Interbank Offered Rate ("LIBOR"), plus an additional
12 1.0 percent. (Ex. A-13, at 32-33.) Mr. Grant stated that the interest rate it pays on short-term credit,
13 pursuant to a revolving credit facility shared with UNS Electric, is LIBOR plus 1.0 percent. He
14 indicated that the current interest rate is tied to three-month commercial paper rates, but that rate is
15 inadequate to cover the Company's short-term borrowing needs. (*Id.*) In his rebuttal testimony, Mr.
16 Grant testified that the Company would accept use of the current three-month commercial paper rate,
17 as long as an additional 1.0 percent increment is added to cover its costs under the revolving credit
18 facility. (Ex. A-14, at 35-36.)

19 In his direct testimony, Staff witness Gray discussed the Commission's rejection of a nearly
20 identical argument in the last case, and recounted the history of how the PGA bank balance interest
21 rate was established. (Ex. S-9, at 4-5.) Mr. Gray testified that interest rates for PGA bank balances
22 were originally set in a generic docket (Decision No. 61225, issued October 30, 1998) and applied
23 uniformly to all Arizona LDCs as a result of the consensus of a working group that included LDCs,
24 Staff, and RUCO. (*Id.*) He indicated that the uniform interest rate established in that generic docket
25 was the monthly three-month commercial *non-financial* paper rate, as set by the Federal Reserve
26 (*Id.*) Mr. Gray stated that the interest rate was later changed in a subsequent generic proceeding
27 (Decision No. 68600, issued March 23, 2006), only because the Federal Reserve was no longer
28 publishing the previously established rate. Therefore, the current generic interest rate for PGA bank

1 balances is the monthly three-month commercial *financial* paper rate published by the Federal
2 Reserve. (*Id.*).

3 In response to UNS Gas's proposal in this case, Mr. Gray pointed out that the Federal Reserve
4 does not publish a three-month LIBOR rate. He indicated that the rate intended by the Company was
5 apparently based on rates on a British Bankers Association website and in the *Wall Street Journal*,
6 both of which are set on a daily basis. (*Id.* at 5.) Mr. Gray stated that the interest rate employed
7 currently, and in the past arising out of the generic dockets, is not intended to equal the LDC's cost of
8 borrowing. According to Mr. Gray, the Company's cost of borrowing is likely to change over time,
9 and it is therefore unlikely there is a simple way to set an interest rate that specifically tracks UNS
10 Gas's cost of borrowing. He reiterated the concern expressed in the last UNS Gas case that an
11 interest rate that allows full recovery of borrowing costs could cause the Company to become less
12 concerned with reducing the PGA bank balance, and ultimately the overall cost of gas procured for its
13 customers. (*Id.* at 6.) Mr. Gray concluded that the continued use of the three-month commercial
14 financial paper rate for UNS Gas's PGA bank balance is reasonable, and should not be changed
15 absent compelling reasons. (*Id.* at 7.)

16 Consistent with our findings in the last UNS Gas rate case, we agree with Staff that the
17 Company has not presented a sufficient basis for altering the PGA bank balance interest rate that
18 currently exists. Mr. Gray points out that a similar rate is in effect for Southwest Gas and APS, and
19 we see no reason why UNS Gas should be treated differently from those companies. We also agree
20 with Staff's concern that granting a higher interest rate could provide a disincentive for the Company
21 to reduce bank balances and could cause it to become less focused on taking all possible measures to
22 reduce the cost of gas for its customers. We therefore adopt Staff's recommendation to retain the
23 current interest rate for UNS Gas's PGA bank balances.

24 **Waiver Request**

25 On January 25, 2008, UNS Gas filed a Request for Waiver in Docket No. G-04204A-08-0050
26 ("Waiver Docket"). In that filing, the Company requested that the Commission issue an order
27 waiving certain requirements imposed in Decision No. 66028 (July 3, 2003). (Ex. A-9.) Decision No.
28 66028 required UniSource Energy, and subsequently UNS Gas, to, among other things: refrain from

1 using contract personnel for the performance of operation and maintenance functions, such as leak
2 surveys and valve maintenance; and independently inspect all new construction work performed by
3 contractor personnel regarding the installation of new service lines and main extensions. (*Id.* at 22;
4 IBEW-2.)

5 On February 14, 2008, Staff issued a Response in the Waiver Docket, recommending that the
6 waiver request be approved. (Ex. A-10.) Staff stated that UNS Gas's safety record is excellent, and
7 the Company is well beyond the transitional phase of operations for which the restrictions were
8 intended to cover following UniSource's acquisition of the former Citizens Utilities' assets. Staff
9 concluded that neither safety nor service would be jeopardized if the condition is waived. (*Id.* at 2.)

10 In his rebuttal testimony, Company witness Hutchens requested that the Commission approve
11 in this case the application submitted in the Waiver Docket, on the same grounds identified in that
12 case. (Ex. A-6, at 15-16.) In its reply brief, UNS Gas requests that if the Commission agrees with
13 Staff's procedural deficiency arguments (see below), the Waiver Docket application should be
14 considered in a timely manner. (UNS Gas Reply Brief, at 24.)

15 Staff contends that although its position regarding the requested waiver has not changed, it
16 does not believe the waiver should be approved in this rate case because the request is not properly
17 before the Commission. Staff contends that UNS Gas did not seek to consolidate the instant case
18 with the Waiver Docket, and did not seek reconsideration of the requirements established in Decision
19 No. 66028 pursuant to A.R.S. §40-252.

20 IBEW also opposes approval of the waiver request in this docket. IBEW argues that the
21 Company did not seek approval of the waiver in its rate application and did not request that the two
22 dockets be consolidated. IBEW contends approval of the request in this case "would constitute a
23 serious procedural error." (IBEW Initial Brief, at 3.) IBEW further claims that even if the procedural
24 defects were resolved, approval of the waiver is not in the public interest as evidenced by the
25 exemplary service record attained by having operation and maintenance functions performed by
26 Company personnel. (*Id.*)

27 We agree with Staff and IBEW that UNS Gas's request to shift consideration of the waiver
28 request into this rate case was untimely and procedurally deficient. We reach no conclusion, at this

1 time, regarding the merits of the Company's waiver request, but observe that the Waiver Docket
2 appears to seek amendment of a prior Commission Order (Decision No. 66028).

3 During public comment in this case, several individuals recommended that the Commission
4 consider adopting at UNS Gas a revolving loan fund and on-the-bill-financing mechanism designed
5 to help the customers of the Company adopt energy efficiency measures in a more timely, broad-
6 based manner. Members of the Flagstaff-based Sustainable Economic Development Initiative
7 ("SEDI") stated they are interested in helping to fashion such a program for their community, and
8 argued persuasively that aggressive deployment of energy efficiency measures is particularly
9 important in UNS Gas's service territory as customers of the Company have experienced a steep and
10 steady rise in the cost per therm of gas during the course of this decade. During the hearing in this
11 matter, a witness for the Company was asked whether a revolving loan fund coupled with on-the-bill
12 financing for energy efficiency, such as the program implemented at the Midwest Energy in Kansas,
13 would be feasible for UNS Gas. The Company's witness said that it had been in discussions with
14 SEDI about energy efficiency programs in Coconino County and that it was familiar with the Kansas
15 revolving loan fund.

16 We believe that under such a program, customers of UNS Gas could be given the opportunity
17 to receive loans for the up-front costs associated with implementing energy efficiency measures such
18 as efficient gas furnaces or ductwork, and could pay off these loans through the savings they achieve
19 on their gas bills created by the energy efficiency measures that have been installed. The revolving
20 loan fund could be launched through the DSM adjustor mechanism, or through the DSM adjustor in
21 combination with a partnership between UNS Gas and a bank, or potentially in partnerships with the
22 state Energy Office and/or the electric utilities in its service territory, and could then be replenished
23 by the loans that are paid off by customers. Given the interest among customers in UNS Gas's
24 service territory in implementing energy efficiency measures, and the need to deploy energy
25 efficiency as widely as possible to assist as many customers as possible in keeping their bills low, we
26 believe it is in the public interest to require UNS Gas to file, by July 30, 2010, a proposed energy
27 efficiency revolving loan fund with convenient customer access to and repayment of the financing,
28 possibly including on-the-bill repayment, for Commission consideration. If possible, the Company

1 should seek out participation in the fund by the State Energy Office, which is currently administering
 2 stimulus funding for energy efficiency efforts, and partnerships with the electric utilities in its service
 3 territory, but if it finds that the Energy office or electric utilities are unable to participate, the
 4 Company should not delay the formation of its proposed program. The Company should also
 5 investigate the possibility of partnering with banks and credit unions in addressing how the revolving
 6 loan fund would be initiated. Additionally, we believe that UNS Gas should craft its proposal for an
 7 energy efficiency revolving loan fund in conjunction with interested community groups in the
 8 Company's service territory, including but not limited to, SEDI.

9 * * * * *

10 Having considered the entire record herein and being fully advised in the premises, the
 11 Commission finds, concludes, and orders that:

12 **FINDINGS OF FACT**

13 1. On November 7, 2008, UNS Gas filed an application with the Commission (Docket
 14 No. G-04204A-08-0571) for an increase in its rates throughout the State of Arizona.

15 2. On December 8, 2008, Staff filed a Letter of Sufficiency indicating that the
 16 Company's application met the sufficiency requirements outlined in A.A.C. R14-2-103 and
 17 classifying the Company as a Class A utility.

18 3. On January 7, 2009, a Procedural Order was issued scheduling a hearing to commence
 19 August 10, 2009; directing UNS Gas to publish notice of the application and hearing date; and setting
 20 various other procedural deadlines.

21 4. Intervention was granted to RUCO, IBEW, and Cynthia Zwick.

22 5. With its application, UNS Gas filed its required schedules in support of the
 23 application, and the direct testimony of various witnesses.

24 6. On June 8, 2009, Staff, RUCO, IBEW, and Ms. Zwick filed direct testimony in
 25 accordance with the previously established procedural schedule.

26 7. On July 8, 2009, UNS Gas filed the rebuttal testimony of various witnesses in
 27 response to Staff and intervenor testimony.

28 8. By Procedural Order issued July 9, 2009, public comment meetings were scheduled

1 for Flagstaff on August 3, 2009; for Prescott on August 6, 2009; and for Nogales on August 17, 2009;
2 and the Company was directed to publish notice of the public comment meetings.

3 9. Surrebuttal testimony was filed on July 29, 2009, by Staff and RUCO.

4 10. On August 3, 2009, the prehearing procedural conference was conducted to address
5 the order of witnesses and exhibits.

6 11. On August 5, 2009, UNS Gas filed the rejoinder testimony of several witnesses in
7 response to Staff and intervenor testimony.

8 12. The evidentiary hearing commenced as scheduled on August 10, 2009, and additional
9 hearing days were held on August, 11, 12, 14, 17, and 18, 2009.

10 13. Public comment meetings were held, as scheduled, on August 3, 6, and 17, 2009, in
11 Flagstaff, Prescott, and Nogales, respectively.

12 14. On September 1, 2009, Chairman Mayes filed a letter in the docket requesting a
13 response from UNS Gas with respect to the Company's plans to expedite refunds of over-collected
14 amounts received through the PGA mechanism.²⁶

15 15. On September 1, 2009, Staff filed a Late-Filed Exhibit that included Arizona
16 unemployment statistics for 2005-09; July 2009 foreclosure rates for counties in the Company's
17 service area; UNS Gas disconnections from 2006-09; and information regarding a Kansas energy
18 efficiency program and Arizona Energy Office programs.

19 16. On September 3, 2009, UNS Gas filed Affidavits of Publication for the public
20 comment meetings, in accordance with the July 9, 2009 Procedural Order.

21 17. On September 8, 2009, UNS Gas filed a letter regarding the Company's policies for
22 acceptance of payments at local offices and other locations.

23 18. Initial briefs were filed on September 18, 2009, by UNS Gas, Staff, RUCO, IBEW,
24 and Ms. Zwick. UNS Gas, Staff, and RUCO also filed their Final Schedules on September 18, 2009,
25 setting forth their respective final revenue requirement and rate design positions.

26
27 ²⁶ In response, UNS Gas filed on September 22, 2009, an application for approval of a temporary customer credit, or
28 surcredit, of up to \$0.08 per therm for the period November 2009 through October 2010. The Company's application was
approved, and the \$0.08 per therm surcredit was adopted for the 12-month period beginning November 1, 2009, or until
the PGA bank balance reaches zero, whichever occurs first. (Decision No. 71316, October 30, 2009.)

1 19. Reply Briefs were filed on September 29, 2009, by IBEW; on September 30, 2009, by
2 RUCO; and on October 5, 2009, by UNS Gas and Staff.

3 20. According to the Company's application, as modified, in the test year ended June 30,
4 2008, UNS Gas had adjusted operating income of \$11,693,461 on an adjusted OCRB of
5 \$184,379,086, for a 6.34 percent rate of return. The Company's proposed RCND is \$330,365,912,
6 resulting in a rate of return on RCND of 3.54 percent; and its proposed FVRB is \$257,372,499,
7 resulting in a test year rate of return of 4.54 percent on FVRB.

8 21. UNS Gas requests a gross revenue increase of \$9,480,875; Staff recommends a
9 revenue increase of \$3,395,423, and RUCO recommends a revenue increase of \$1,265,000.

10 22. For purposes of this proceeding, we determine that UNS Gas has an OCRB of
11 \$180,054,851, RCND of \$326,041,676 and a FVRB of \$253,048,264.

12 23. UNS Gas's test year revenues are determined to be 53,418,509.

13 24. UNS Gas's test year expenses are determined to be 40,983,890.

14 25. The Company's cost of common equity is determined to be 9.50 percent; its cost of
15 debt is 6.49 percent; its capital structure is comprised of 49.9 percent equity and 50.1 percent debt;
16 and the Company's overall weighted average cost of capital is determined to be 8.00 percent.

17 26. Under the facts of this case, it is appropriate to apply an inflation factor of 2.25
18 percent to UNS Gas's WACC of 8.00 percent, resulting in a fair value rate of return of 5.75 percent.

19 27. UNS Gas is entitled to a gross revenue increase of \$3,462,445.

20 28. For residential customers under Schedule R10, the basic monthly customer charge
21 should be increased from \$8.50 to \$10.00, with the non-fuel volumetric charge remaining at the
22 current rate of \$0.3270 per therm.

23 29. For CARES customers (Schedule R12), the current customer charge of \$7.00 should
24 remain in place, and the non-fuel volumetric charge shall also be maintained at its current level of
25 \$0.3270 per therm, with a discounted rate of \$0.1770 for the first 100 therms during the months of
26 November through April.

27 30. The customer charges for the non-residential classes will be established at the levels
28 recommended by Staff and RUCO, with the applicable non-fuel volumetric charges for the non-

1 residential classes based on an even percentage allocation to each class.

2 31. The billing determinants proposed by the Company should be employed for setting
3 rates in this proceeding.

4 32. The Company's natural gas procurement practices and policies during the audit period
5 of January 2006 through June 2008 are deemed prudent, subject to the Company's implementation
6 of, and compliance with, Staff's recommendations.

7 33. UNS Gas should change its deposit policies for CARES customers, in recognition of
8 current economic conditions, and allow for waivers, reduced deposits and payment of deposits over
9 multiple billing cycles. UNS Gas should convene a meeting within 60 days with the parties to this
10 case, and any other interested stakeholders, to address CARES eligibility issues and deposit policies
11 for CARES customers, and revise its policies. Such policy revisions should specifically provide for
12 waivers, reduced deposits and deposit payments over multiple billing cycles, and the Company
13 should submit its revisions, for Commission consideration, within 120 days of the effective date of
14 this Decision.

15 34. UNS Gas's agreement to increase its matching contributions to the Warm Spirits
16 program to \$50,000 annually, from the current level of \$25,000 per year, is a reasonable commitment
17 at this time, but the Company should continue to promote the existence of the Warm Spirits program
18 and strive to find additional ways that give customers the ability to make voluntary contributions to
19 the program.

20 35. UNS Gas should increase its current level of spending on the LIW program by
21 \$100,000, to \$200,000, in order to better meet customer demand.

22 36. The interest rate for the Company's PGA bank balance should remain in place
23 (monthly three-month commercial financial paper rate published by the Federal Reserve), in
24 accordance with Staff's recommendation.

25 37. UNS Gas should file within 30 days of the effective date of this Decision, with Docket
26 Control as a compliance item in this docket, a statement regarding the current status of payment
27 options available at the Nogales office, the current status of the phone links and computer kiosks in
28 all local offices, and any other relevant information related to customer options for bill payments.

38. UNS Gas's proposed revisions to its Statement of Additional Charges are reasonable and are adopted.

39. UNS Gas's request to consider the Waiver Docket application in this case was untimely and procedurally deficient and will therefore not be adopted in this proceeding, but will instead be addressed in the waiver docket or pursuant to a request for modification of a prior Commission Order pursuant to A.R.S. §40-252.

CONCLUSIONS OF LAW

1. UNS Gas is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§40-250, 40-251, and 40-367.

2. The Commission has jurisdiction over UNS Gas and the subject matter of the above-captioned case.

3. The fair value of UNS Gas's rate base is \$253,048,264, and applying a 5.75 percent rate of return on this fair value rate base produces rates and charges that are just and reasonable.

4. The rates, charges, approvals, and conditions of service established herein are just and reasonable and in the public interest.

ORDER

IT IS THEREFORE ORDERED that UNS Gas, Inc., is hereby authorized and directed to file with the Commission, on or before April 30, 2010, revised schedules of rates and charges consistent with the discussion herein and a proof of revenues showing that, based on the adjusted test year level of sales, the revised rates will produce no more than the authorized increase in gross revenues.

IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective for all service rendered on and after April 1, 2010.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall notify its customers of the revised schedules of rates and charges authorized herein by means of an insert, in a form acceptable to Staff, included in its next regularly scheduled billing.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall modify its deposit policies for CARES customers. UNS Gas, Inc.'s revised policies shall explicitly allow for waivers, reduced deposits and payment of deposits over multiple billing cycles. UNS Gas, Inc. shall convene a

1 meeting within 60 days of the effective date of this Decision with the parties to this case, and any
2 other interested stakeholders, to address CARES eligibility issues and deposit policies for CARES
3 customers, and revise its policies to allow for waivers, reduced deposits and deposit payments over
4 multiple billing cycles, and should submit its revision, for Commission consideration, within 120
5 days of the effective date of this Decision.

6 IT IS FURTHER ORDERED that UNS Gas, Inc., shall continue to promote the existence of
7 the Warm Spirits program and strive to find additional ways that give customers the ability to make
8 voluntary contributions to the program.

9 IT IS FURTHER ORDERED that UNS Gas, Inc., shall increase its current level of funding
10 fro the LIW program from \$100,000 to \$200,000.

11 IT IS FURTHER ORDERED that UNS Gas, Inc., shall file with Docket Control as a
12 compliance item in this docket, within 30 days of the effective date of this Decision, a statement
13 regarding the current status of payment options available at the Nogales office, the current status of
14 the phone links and computer kiosks in all local offices, and any other relevant information related to
15 customer options for bill payments.

16 IT IS FURTHER ORDERED that UNS Gas's request to consider the Waiver Docket
17 application in this case was untimely and procedurally deficient and will therefore not be adopted in
18 this proceeding, but will instead be addressed in the Waiver Docket or pursuant to a request for
19 modification of a prior Commission Order pursuant to A.R.S. §40-252.

20 IT IS FURTHER ORDERED that UNS Gas, Inc. shall file for Commission consideration by
21 July 30, 2010, a proposed energy efficiency revolving loan fund with convenient customer access to
22 and repayment of the financing, possibly including on-the-bill repayment, for energy efficiency
23 measures such as ductwork and efficient gas furnaces, and shall work with interested community
24 groups in UNS Gas, Inc.'s service territory in the crafting of the proposal. The proposal shall include
25 a description of the steps UNS Gas, Inc. took to work with local community groups in the formation
26 of the proposal.

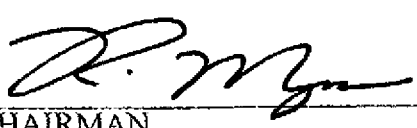

27 IT IS FURTHER ORDERED that the UNS Gas, Inc. shall seek out participation in the fund
28 by the State Energy Office, which is currently administering stimulus funding for energy efficiency

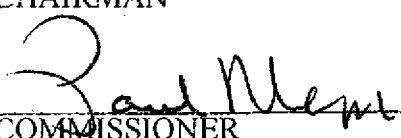
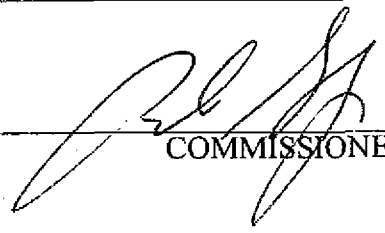
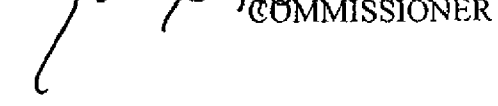
efforts, and partnerships with the electric utilities in its service territory, but if it finds that the State Energy Office or the electric utilities are unable to participate, UNS Gas, Inc. shall not delay the formation of the proposed program and shall investigate the possibility of partnering with banks and credit unions in addressing how the revolving loan fund will be initiated.

IT IS FURTHER ORDERED that UNS Gas, Inc. shall craft its proposal for an energy efficiency revolving loan fund in conjunction with interested community groups in the Company's service territory, including but not limited to, the Sustainable Economic Development Initiative based in Flagstaff.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.


 CHAIRMAN
 
 COMMISSIONER


 COMMISSIONER
 
 COMMISSIONER
 
 COMMISSIONER

IN WITNESS WHEREOF, I, ERNEST G. JOHNSON, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 14th day of April, 2010.


 ERNEST G. JOHNSON
 EXECUTIVE DIRECTOR

DISSENT 

DISSENT _____

1 SERVICE LIST FOR: UNS GAS, INC.
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