OPEN MEETING AGENDA ITEM

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BEFORE THE ARIZONA CORPORATION COMMISSION

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

DOCKET NO. E-04204A-09-0206

Arizona Corporation Commission
DOCKETED
SEP 2 2010
DOCKETED BY

UNS ELECTRIC, INC.'S EXCEPTIONS TO THE RECOMMENDED OPINION AND ORDER

September 2, 2010

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UNS Electric, Inc. ("UNS Electric" or the "Company"), through undersigned counsel, respectfully submits its Exceptions to the Recommended Opinion and Order ("ROO") issued in this case on August 20, 2010. The Company respectfully requests that the Arizona Corporation Commission ("Commission") adopt UNS Electric's proposed amendments to the ROO as set forth in Attachment A.

I. INTRODUCTION.

UNS Electric believes that the evidence in the record supports the Company's rate application and requested relief.[1] Accordingly, the Company concurs with the findings, conclusions, and recommendations in the ROO that are consistent with UNS Electric's requests. For example, UNS Electric acknowledges the operational and financial benefits that will result from the ROO's recommended rate base treatment of the Black Mountain Generating Station ("BMGS"). There are, however, some significant areas of divergence from the Company's request and the ROO.[2] Those matters, addressed herein, include:

(i) The ROO's recommended Return on Equity ("ROE") of 9.75% is too low and does not accurately reflect the Company's risk; and

(ii) The ROO's recommended Fair Value Rate of Return ("FVROR") is too low to provide UNS Electric a meaningful opportunity to earn its authorized ROE.

Additionally, one area of the ROO merits clarification:

(i) The timing for the filing of the next UNS Electric rate case.

For the forgoing reasons, UNS Electric requests that the Commission amend the ROO to reflect the Company's proposals, as set forth herein. The following chart delineates the impact on the Company's revenue requirement and the effect on an average residential ratepayer's monthly

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[1] The ROO at footnote 41, page 18 makes a modification to the Company's calculations regarding the acquisition adjustment related to the purchase of the Citizen's utilities assets. UNS Electric agrees with the ROO's adjustment as it corrects an error contained in an Excel spreadsheet used to calculate the acquisition adjustment.

[2] The Company has provided the Commission with a detailed analysis of the evidence in support of each of its requests in its post-hearing briefs, which are incorporated by reference herein.

bill of the Company's proposed amendments to the ROO:

The Company's Exceptions to the ROO	Increase to the ROO's Revenue Requirement	Increase to an Average Monthly Bill
FVROR at 7.23%	$4,150,514	$2.39
STAFF'S FVROR[3]	$1,581,151	$0.91
ROE at 11.4%	$3,004,182	$1.74
ROE at 10%	$474,345	$0.28

II. A ROE OF 9.75% DOES NOT ACCURATELY REFLECT THE RISK OF UNS ELECTRIC.

The ROO concludes that UNS Electric is not significantly riskier than peer companies.[4] The Company respectfully disagrees with this conclusion for several reasons. First, the evidence demonstrates the UNS Electric is riskier than the peer companies used in each witnesses' determination of cost of equity. The evidence in the record is undisputed: UNS Electric is smaller, does not pay a dividend and has a lower credit rating than each of the comparable companies used to estimate its cost of equity. Second, the evidence proves that 9.75% is less than the ROEs awarded to other utilities in 2009 through January 2010. Third, while the Company understands that the 11.0% ROE awarded to Arizona Public Service ("APS") is the result of a settlement agreement, the ROO is effectively stating that UNS Electric is 125 basis points less risky than APS. The Company believes this is a relevant factor, particularly considering the other evidence in the record showing that UNS Electric is a riskier utility than APS, and it should consequently be awarded a higher ROE than 9.75%.

A. UNS Electric is considerably more risky than comparable companies.

The Company's Initial Post-Hearing Brief and Reply Brief explain the many ways in which UNS Electric is substantially more risky than comparable companies.[5] The record is replete

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[3] Subtracting 1.7% as the rate of inflation, which is the midpoint of Staff's range.
[4] ROO at 40, lines 18 to 20.
[5] UNSE Initial Post-Hearing Brief at 37-38; UNSE Reply Brief at 16-17.

with the same evidence. UNS Electric is a small electric company. It has never paid a dividend.[6] The Company's credit rating is below average for the sample groups of companies used by both Ms. Pritz and Mr. Parcell – and not one of the 17 sample companies used by Mr. Parcell has a credit rating as low as UNS Electric.[7] These comparable companies pay a dividend, whereas UNS Electric does not.[8]

B. The ROO recommends a ROE lower than the vast majority of ROE's granted in 2009 through the first part of 2010.

Company witness Martha B. Pritz testified that the average ROE awarded to other utilities in 39 rate orders in 2009 was 10.52%. For the five rate orders approved through January 25, 2010, the average allowed ROE was 10.52% - and the range was from 10.0% to 11.0%.[9] A 9.75% ROE is lower than any of the ROEs awarded to these other utilities. It is important to note that those ROEs were awarded during the current economic downturn.

C. The 9.75% ROE in the ROO implies that UNS Electric is significantly less risky than APS, which is not the case.

The Commission awarded APS an ROE of 11.0% in Decision No. 71448 (December 30, 2009 as part of a settlement agreement. This was consistent with Commission Staff's expert, who recommended an 11.0% ROE in his direct testimony in that case.[10] Staff's recommendation and the Commission's ultimate award of an 11% ROE to APS is relevant evidence that justifies increasing the ROE as recommended in the ROO from 9.75% to 11.4%, and at a minimum Staff's proposed 10.0%.

D. An 11.4% ROE would allow the Company the opportunity to earn a return equivalent to larger, less risky comparable companies.

The Company's ROE recommendation of 11.4% is based on a comprehensive analysis using the Capital Asset Pricing Model ("CAPM"), the multi-state Discounted Cash Flow ("DCF")

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[6] Ex. UNSE-22 (Pritz Direct) at 3, 17; Ex. UNSE-24 (Pritz Rejoinder) at 2.
[7] Compare Ex. UNSE-22 (Pritz Direct) at 3 with Ex. S-14 (Parcell Direct) at Ex. DCP-1, Schedule 6.
[8] Tr. (Pritz) at 720; Tr. (Parcell) at 796.
[9] Ex. UNSE-24 (Pritz Rejoinder) at 2-3.
[10] See Ex. UNSE-34 (Parcell APS excerpt) at 32.

model, and the bond yield plus risk premium ("BYRP") model. Using these models, the Company determined ROEs of 10.1%, 12.1% and 12.0% respectively.[11] The average of those three figures is 11.4%. This is a conservative recommendation considering the Company's small size and inability to pay a dividend.[12] This evidence supports the Company's recommendation of 11.4%. At a minimum, the Commission should adopt an ROE of 10.0% as this is the smallest percentage justified by the record. The ROO's 9.75% ROE gives insufficient recognition of the unadjusted CAPM results,[13] whereas the Company's 10.0% ROE more accurately reflects Staff's CAPM results in this case.[14]

The Commission should amend the ROO to adopt the Company's 11.4% ROE recommendation as just and reasonable and supported in the evidentiary record. Adopting the proposed 11.4% ROE would result in a $3.0 million increase in revenue requirement over the ROO. This is an additional 1.1% increase over test-year revenues and would result in an additional increase of approximately $1.74 to the average residential customer's monthly bill.

Alternatively, and at a minimum, the Commission should amend the ROO to adopt a 10.0% ROE. Adopting a 10.0% ROE would result in a $0.5 million increase in revenue requirement over the ROO. This is an additional .2% increase over test-year revenues and would result in an additional increase of approximately $0.28 to the average residential customer's monthly bill.

III. THE INFLATION FACTOR SHOULD ONLY APPLY TO THE RECONSTRUCTED COST NEW DEPRECIATED PORTION OF THE FAIR VALUE RATE BASE.

The ROO proposes to subtract an inflation component from the Weighted Average Cost of Capital ("WACOC") – and to not subtract inflation from the equity component of WACOC. The ROO's methodology erroneously applies an inflation factor to the Original Cost Rate Base

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[11] Ex. UNSE-22 (Pritz Direct) at 17.
[12] Ex. UNSE-22 (Pritz Direct) at 17; Tr. (Pritz) at 692-93, 719-20, 733.
[13] ROO at 41, lines 5 to 11.
[14] See Ex. S-14 (Parcell Direct) at 38-39 (where Mr. Parcell indicates the CAPM results should be considered and that "it would not be proper to disregard the lower CAPM results while not discounting the higher DCF results" after recommending a 10.0% ROE for UNS Electric.)

("OCRB") portion of the Fair Value Rate Base ("FVRB"). This methodology ignores that one-half of FVRB is comprised of OCRB, which has no inflation component. Throughout the proceeding, UNS Electric recommended using methods supported by Commission precedent as these methods reflect that only 50% of FVRB is impacted by inflation.[15]

The ROO proposes adopting a measure similar to what was recently adopted for UNS Gas in its most recent rate case (Decision No. 71623 (April 14, 2010)) to: (1) afford appropriate recognition to the fact that inflation exists in both the debt and equity components of the Company's capital structure; and (2) reflect that the reconstruction cost estimates likely exceed the rate of inflation based on the factors cited in the ROO.[16] Contrary to the methodology adopted by the ROO, the record does not support applying an inflation factor to the OCRB portion of FVRB.

A. The FVROR calculation should not include an inflation component in OCRB.

While inflation may exist in both the debt and equity components, the evidence in the record explains why OCRB has no inflation component.[17] The Company does not object to the FVROR reflecting inflation so long as the inflation factor is adjusted to reflect the fact that FVRB is comprised of one-half OCRB. Accordingly, UNS Electric requests that the Commission adjust the inflation factor by one-half (to 1.05%) instead of the full inflation factor of 2.10% that the ROO uses to determine FVROR from WACOC. Under this approach, the FVROR would be 7.23% (8.28% WACOC – 1.05% inflation factor).

B. The record supports that reconstruction costs do not materially exceed the rate of inflation.

The Company submitted evidence showing that the weighted compound growth rate resulting from the reconstructed cost new ("RCN") plant escalation rates equaled 3.32% from 1983 to 2008; the Consumer Price Index ("CPI") over the same 25-year period grew by 2.96%.[18] This evidence shows that while the reconstruction cost estimates may be slightly above the rate of

[15] See Ex. UNSE-13 (Grant Rebuttal) at 16-17; Tr. (Grant) at 247.
[16] ROO at 49, line 23, to page 50, line 2.
[17] Ex. UNSE-13 (Grant Rebuttal) at 16-17. Decision No. 71308 at 43 (noting that OCRB does not include inflation).
[18] Ex. UNSE-14 (Grant Rejoinder) at 7-8, Exhibit KCG-5.

inflation, that margin does not justify reducing the WACOC by the *entire* rate of inflation as proposed in the ROO.

The ROO also states that the inflation factor should not be reduced by 50% because that would fail to recognize that Reconstruction Cost New Depreciation ("RCND") estimations are based on estimates to reconstruct the Company's entire system – and do not consider efficiencies and costs savings due to factors including technological advances.[19] No party submitted empirical evidence in the record demonstrating that this will likely be the case. Further, with the advancement and proliferation of smart-grid and meter technologies, it may be that the system will require more infrastructure to ensure maximally-efficient operation and reliability. For these reasons, the Company maintains its position that the inflation rate should be reduced by one-half to reflect the OCRB element in FVRB.

The ROO adopted an inflation rate of 2.1%, in part because that was the inflation rate embedded in the Company's DCF analysis.[20] The Company's DCF analysis, however, yielded a cost of equity equaling 12.1%.[21] The rate of inflation embedded in a ROE of 9.75% would be less than the rate of inflation embedded in a ROE equaling 12.1%.[22] Further, while RUCO and Staff supported an inflation rate of 2.1% and 2.0% respectively, Staff's analysis indicated that forecasts of the CPI for 2009-2010 are from 1.3% to 2.1%.[23]

If the Commission were to adopt the ROO's FVROR calculation, then it <u>should not</u> adopt an inflation rate that is at the very top end of Staff's own analysis. The midpoint of Staff's range would be more appropriate, which under the ROO's methodology would result in a FVROR of 6.58% (8.28% WACOC - 1.7% inflation factor).

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[19] ROO at 49, lines 15 to 20.

[20] ROO at 50, lines 3 to 5.

[21] See Ex. UNSE-22 (Pritz Direct) at 11; ROO at 34, lines 25-26.

[22] See Ex. UNSE-13 (Grant Rebuttal) at 17-18.

[23] Ex. S-14 (Parcell Direct) at 56.

C. The Applicable FVROR should allow the Company a reasonable opportunity to earn its authorized ROE.

Both Staff witness David C. Parcell and RUCO Witness Dr. Ben Johnson agreed that it is important that the Company have a reasonable opportunity to earn its cost of capital.[24] UNS Electric's witness Kentton C. Grant showed that under Staff's and RUCO's respective FVROR recommendations, the Company would fall significantly short of earning its allowed ROE; and that the Company earned only a 6.9% ROE for the first twelve months after the rates the Commission approved in Decision No. 70360.[25] In other words, with a FVROR of 7.03%[26] and an authorized ROE of 10.0%,[27] the Company only earned an ROE of 6.9%. This return is below even the Company's current cost of debt of 7.05%[28] and, therefore, confiscatory.

In conclusion, the Company believes the record supports reducing the rate of inflation deducted from WACOC by one-half to ascertain FVROR. Subtracting half the 2.1% rate of inflation from ROO's WACOC of 8.28% results in a 7.23% FVROR on FVRB. A FVROR of 7.23% is slightly higher than the Company's actual cost of debt. Adopting this methodology would result in a $2.5 million increase in required operating income and $4.2million increase in the Company's revenue requirement over the ROO's proposal. This represents an additional 1.6% increase over test-year revenues and would result in an additional increase of approximately $2.39 to the average residential customer's monthly bill.

Alternatively, if the Commission adopted the ROO's methodology, but only subtracted 1.7% as the rate of inflation (the midpoint of Staff's range), the resulting FVROR of 6.58% would result in a $1.0 million increase in required operating income and $1.6 million increase in the Company's revenue requirement over the ROO's proposal. This represents an additional 0.6%

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[24] See Ex. RUCO-6 (Johnson Direct) at 4-8; Ex. S-14 (Parcell Direct) at 5-8
[25] Ex. UNSE-13 (Grant Rebuttal) at 22, 25-26.
[26] See Decision No. 70360 at 48-49.
[27] See Decision No. 70360 at 43.
[28] ROO at 34, lines 1 to 4; Ex. UNSE-22 (Pritz Direct) at 17; Ex. S-14 (Parcell Direct) at 24; Ex. RUCO-10 (Rigsby Direct) at 48.

increase over test-year revenues and would result in an additional increase of approximately $0.91 to the average residential customer's monthly bill.

IV. UNS ELECTRIC SEEKS MODIFICATION TO THE ROO'S RECOMMENDATION THAT IT FILE ITS NEXT RATE APPLICATION USING A TEST-YEAR BEGINNING WITH THE FIRST MONTH FOLLOWING THE RATE RECLASSIFICATION INCLUDING BMGS IN RATE BASE.

The ROO requires UNS Electric to file a rate application using a twelve-month test year immediately following implementation of any rate reclassification involving placing BMGS into rate base.[29] The stated purpose of this requirement is to ensure the reasonableness of the rates with BMGS in rate base. The ROO, at Finding of Fact No. 64, goes on to say that the twelve-month test year is to begin with the first month following implementation of the rate reclassification.[30] UNS Electric seeks a modification to this finding – to allow it the flexibility to file its rate application using data reflecting no less than six months of BMGS in rate base.

Assuming a Commission order is issued by late September 2010, the Company anticipates applying to the Federal Energy Regulatory Commission ("FERC") in early October 2010 to approve the transfer of BMGS. The Company believes the process of obtaining FERC approval could take up to six months. Further, assuming simultaneous Staff review and Commission confirmation of BMGS as contemplated by the ROO, this would mean the rate reclassification would take place in April or May of 2011. UNS Electric would then have to wait until late 2012, at a minimum, to file its next rate case – in order to develop a 12-month test year with BMGS in rate base. This would mean that determining the reasonableness of UNS Electric's rates with BMGS in rate base may not occur until the end of 2013 at the earliest. Therefore, UNS Electric proposes and seeks clarification by the Commission that it can use a test year with BMGS in rate base for no less than six months in its next rate filing in order to timely file a rate case in which the Commission can review the reasonableness of UNS Electric's rates.

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[29] ROO at 13, lines 12 to 15.
[30] ROO at 75, lines 4 to 6, and 77, lines 2 to 4.

V. CONCLUSION.

The ROO's proposed ROE too low and not representative of the real investment risk associated with the Company. Moreover, the FVROR in the ROO is too low to provide UNS Electric with a reasonable opportunity to earn its authorized return on equity. Adopting the Company's proposed ROE and FVROR will allow it a reasonable opportunity to earn its cost of capital, maintain its financial integrity, and allow it to attract capital on reasonable terms.

The Company further seeks to modify Finding of Fact No. 64 to allow it to file its next rate application using no less than six months of data with BMGS in rate base.

Proposed language for the amendments relating to these items are included in Attachment A as follows:

Amendment	Issue
1.	Return on Equity
2.	Fair Value Rate of Return
3.	Modifying Finding of Fact No. 64 Regarding UNS Electric's Next Rate Application.

RESPECTFULLY SUBMITTED this 2nd day of September 2010.

UNS Electric, Inc.

By ______________________________
Michael W. Patten
Jason D. Gellman
ROSHKA DEWULF & PATTEN, PLC.
One Arizona Center
400 East Van Buren Street, Suite 800
Phoenix, Arizona 85004

and

Philip J. Dion, Esq.
Melody Gilkey, Esq.
UniSource Energy Services
One South Church Avenue
Tucson, Arizona 85702

Attorneys for UNS Electric, Inc.

Original and thirteen copies of the foregoing filed this 2nd day of September 2010, with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copy of the foregoing hand-delivered/mailed this 2nd day of August 2010, to:

Chairman Kristin K. Mayes
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

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

Commissioner Paul Newman
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Sandra Kennedy
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Bob Stump
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Daniel Pozefsky
Residential Utilities Consumer Office
1110 West Washington, Suite 200
Phoenix, Arizona 85007

Timothy M. Hogan
Arizona Center for Law in the Public Interest
202 East McDowell Road, Suite 153
Phoenix, Arizona 85004

Lyn A. Farmer, Esq.
Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Maureen A. Scott, Esq.
Wesley Van Cleve, Esq.
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Steve Olea
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

By Mary Ippolito

ATTACHMENT

"A"

UNS Electric Proposed Amendment No. 1

<u>Return on Equity</u>

DELETE

From Page 39, line 22 to Page 41, line 21.

INSERT

At Page 39, line 22:

"RUCO's estimate is far below any energy return on equity we have approved in recent times. Moreover, RUCO's CAPM analysis appears suffer from inappropriate inputs – including using a risk-free rate based upon a five-year timeframe when a long-term rate should have been used. Further RUCO presented no evidence justifying its adjustment to the DCF growth rate past (on the assumption that utilities market-to-book ratios will tend to move toward 1.0) is appropriate. We further note that RUCO's sole reliance on a single-stage DCF is less accurate. This is because it is not reasonable to believe that investors expect a constant rate of growth in perpetuity, as assumed in the single-stage DCF.

We also do not believe that Staff's recommended return on equity range of 9.5 to 10.5 percent accurately reflects the risk of UNS Electric and we do not believe that UNS Electric's return on equity is identical to that of the sample group. UNS Electric is smaller than the sample group companies and it has a lower credit rating than all of the 17 sample companies. UNS Electric has never been able to declare a dividend, while Mr. Parcell testified that the comparable group companies pay dividends. (Tr. at 796). Further, UNS Electric's actual returns have fallen short of the 10.0% return on equity from its last rate case. These factors justify UNS Electric having a higher return on equity than the sample group.

We also note that we recently awarded APS an 11% return on equity. (Decision No. 71448 (December 30, 2009)). This is the result of a settlement agreement and is not a reason alone to justify a higher return on equity for UNS Electric than recommended by Staff or RUCO. Even so, we believe we can and should take this into account along with all of the other relevant factors when determining the appropriate return on equity for UNS Electric. Also, that the returns on equity awarded to other utilities in 2009 equaled 10.52% - ranging from 10.0% to 11.0%. We believe there is evidence on the record demonstrating UNS Electric to be riskier than many of these other utilities. Taking those allowed returns on equity into account, combined with the factors specific to UNS Electric, we believe an 11.4% return on equity to be reasonable in this case.

Accordingly, we find UNS Electric's return on equity to be 11.4%, which results in an overall weighted cost of capital of 9.04%.

	Percentage	Cost	Weighted Avg. Cost
Common Equity	45.76%	11.4%	5.22%
Total Debt	54.24%	7.05%	3.82%
			9.04%"

MAKE ALL CONFORMING CHANGES

UNS Electric Proposed Amendment No. 2

Fair Value Rate of Return

DELETE:

Page 49, line 11 to Page 50, line 2.

INSERT:

At Page 49, line 11:

"Based on the record of this case, we find it appropriate to continue to use the FVROR method we developed for Chaparral City Water Company in Decision No. 70441, as further refined in Decision No. 71308. This method reasonably accounts for the impact of inflation on the fair value rate base, without overstating its impact. The RCND rate base includes inflation; the OCRB rate base does not. Thus, applying 50% of the inflation adjustment is appropriate because RCND represents only one-half of the fair value rate base calculation. Therefore, consistent with Decision No. 71308, we will deduct 50% of the inflation adjustment to calculate the FVROR."

DELETE:

The phrase beginning on Page 50, line 9 (starting at "which we believe") and ending on Page 50, line 12.

INSERT:

At Page 50, line 9:

"We then divide this rate in half to determine the inflation factor that should be applied to the WACOC in order to remove from it the effects of inflation. Deducting this inflation factor of 1.05 percent from the WACOC of 8.28 percent results in a FVROR of 7.23 percent."

DELETE 6.18% on Page 50, line 13 and **INSERT** 7.23%.

DELETE:

The sentence beginning on Page 50, line 21 (starting at "Using our informed judgment . . .") and ending on Page 50, line 23.

DELETE 6.18% on Page 50, line 25 and **INSERT** 7.23%.

DELETE 6.18% on Page 51, line 2 and **INSERT** 7.23%.

DELETE Page 51, Line 5 through Page 52, Line 2

DELETE "2.10 percent" on Page 51, line 11.5 and **INSERT** "1.05 percent".

DELETE "6.18 percent" on Page 52, line 12.5 and **INSERT** "7.23 percent".

MAKE ALL CONFORMING CHANGES

UNS Electric Proposed Amendment No. 3

<u>Modifying Finding of Fact No. 64 regarding UNS Electric's Next Rate Application.</u>

DELETE:

The phrase beginning on Page 13, line 13 (starting at "we will require UNSE to file a rate application. . . ") and ending on Page 13, line 15.

INSERT:

At Page 13, line 13:

"... we will require UNSE to file a rate application using a twelve month test year with data reflecting BMGS in rate base for no less than six months in the test year. This will ensure that the inclusion of BMGS in rate base be subject to a full rate review as soon as possible."

DELETE:

Page 14, lines 3 through 5.

INSERT:

At Page 14, line 3:

No later than 12 months after any rate reclassification, UNSE should file a rate application using a twelve month test year beginning with data reflecting BMGS in rate base for no less than six months in the test year."

DELETE:

Page 75, lines 4 to 6 (Finding of Fact No. 64)

INSERT:

At Page 75, line 4 (new Finding of Fact No. 64)

"No later than 12 months after any rate reclassification, UNSE shall file a rate application using a twelve month test year with data reflecting BMGS in rate base for no less than six months in the test year. This will ensure that the inclusion of BMGS in rate base be subject to a full rate review as soon as possible."

DELETE:

Ordering paragraph at Page 77, lines 2 through 4.

INSERT:

At Page 77, line 2 (new ordering paragraph):

"IT IS FURTHER ORDERED that UNS Electric, Inc. shall, no later than 12 months after any rate reclassification, file a rate application using a twelve month test year with data reflecting BMGS in rate base for no less than six months in the test year."

MAKE ALL CONFORMING CHANGES