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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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**COMMISSIONERS**

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**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 ITS ARIZONA PROPERTIES.**

**DOCKET NO. G-04204A-11-0158**

**NOTICE OF FILING**

**STAFF'S WITNESS SUMMARIES**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files Staff's Witness Summaries for Ralph C. Smith, David E. Dismukes, Ph.D, John A. Rosenkranz, David C. Parcell, Ryan Weight, and Robert G. Gray.

RESPECTFULLY SUBMITTED this 7th day of February, 2012.

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**Original and thirteen (13) copies of the foregoing filed this 7th day of February, 2012, with:**

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Arizona Corporation Commission
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**STAFF WITNESS SUMMARY - RALPH C. SMITH**
**UNS GAS, INC.**
**DOCKET NO. G-04204A-11-0158**
**FEBRUARY 7, 2012**

## SUMMARY OF DIRECT TESTIMONY

My direct testimony addresses the following issues, and responds to the testimony of UNS Gas, Inc. ("UNSG", "UNS Gas", or "Company") witnesses on these issues:

- The Company's proposed revenue requirement
- The determination of a Fair Value Rate of Return and its application to Fair Value Rate Base
- Staff's recommended base revenue increase
- Adjusted Rate base
- Adjusted Test year revenues, expenses, and net operating income

My direct testimony also addresses certain accounting related aspects of Staff's review of UNSG's gas procurement.[1]

My findings and recommendations for each of these areas are as follows:

### The Company's Proposed Revenue Requirement

The Company's proposed revenue requirement of a base rate increase of $5.6 million, or 4 percent, is significantly overstated. In its filing, UNSG proposed an original cost rate base ("OCRB") and fair value rate base ("FVRB") of approximately $184 million and $324 million, respectively. The Company also requests to set UNSG's FVRB at $254 million based on a 50/50 weighting of OCRB and RCND.

UNSG understated operating income. Additionally, the Company is requesting an excessive rate of return.

### Staff Recommended Base Rate Revenue Increase

The direct testimony of Staff witness David Parcell addresses Staff's recommended return on equity and weighted cost of capital to be applied to OCRB as well as the determination of the Staff recommended FVROR to be applied to the FVRB in view of the Court of Appeals decision concerning Chaparral Water Company. Attachment RCS-2, Schedule D, shows the derivation of the two FVROR calculations that were considered by Staff, including:

- Alternative 1 - With Fair Value Rate Base Increment at Zero Cost

[1] Staff's review of UNSG's gas procurement is primarily being addressed by Staff witness John Rosenkrantz.

- Alternative 2 - With Fair Value Rate Base Increment at 1.0 Percent

My Attachment RCS-2, Schedule A, columns A through D2, summarizes the resulting revenue deficiencies that would be produced in the current UNSG rate case from each of those FVROR figures. Schedule A, column D1, shows the amount of base rate revenue increase on FVRB of $734,000 under alternative 1 and in column D2, shows the amount of base rate revenue increase on FVRB of $1.885 million under alternative 2.

I recommend that UNSG be authorized a base rate increase of no more than $1.885 million on adjusted FVRB. That is an average revenue increase of approximately 3.5 percent over adjusted test year revenue of $53.752 million.

**Adjusted Rate Base**

The following adjustments to UNSG's proposed original cost rate base should be made:

| **Summary of Staff Adjustments to Rate Base** | | **OCRB** | | **RCND RB** | |
|---|---|---|---|---|---|
| Adj. No. | Description | Increase (Decrease) | | Increase (Decrease) | |
| B-1 | Customer Advances | $ | (658,511) | $ | (783,738) |
| B-2 | Remove One-Half of Prepaid D&O Insurance | $ | (19,830) | $ | (19,830) |
| B-3 | Cash Working Capital | $ | 332,157 | $ | 332,157 |
| B-4 | ADIT | $ | 824,165 | $ | 1,395,386 |
| | **Total of Staff Adjustments** | **$** | **477,981** | **$** | **923,976** |
| | UNS Gas Proposed Rate Base (Original Cost and RCND) | $ | 183,540,210 | $ | 323,814,323 |
| | **Staff Proposed Rate Base (Original Cost and RCND)** | **$** | **184,018,191** | **$** | **324,738,299** |

The following table summarizes UNS Gas' requested and Staff's recommend OCRB, reconstruction cost new depreciated ("RCND") rate base and FVRB, and the differences:

| Summary of Rate Base | Company | | Staff | | Difference | |
|---|---|---|---|---|---|---|
| Original Cost Rate Base | $ | 183,540,210 | $ | 184,018,191 | $ | 477,981 |
| RCND Rate Base | $ | 323,814,323 | $ | 324,738,299 | $ | 923,976 |
| Fair Value Rate Base | $ | 253,677,268 | $ | 254,378,245 | $ | 700,977 |

**Adjusted Net Operating Income**

The following adjustments to UNSG's proposed revenues, expenses and net operating income should be made:

**STAFF WITNESS SUMMARY - RALPH C. SMITH**
**UNS GAS, INC.**
**DOCKET NO. G-04204A-11-0158**
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| **Summary of Staff Adjustments to Net Operating Income** | | Pre-Tax Adj. to Revenue or Expense | Net Operating Income |
|---|---|---|---|
| Adj. No. | Description | Increase (Decrease) | Increase (Decrease) |
| C-1 | Customer and Weather Normalization | $ 37,916 | $ (23,281) |
| C-2 | Bad Debt Expense | $ (130,827) | $ 80,329 |
| C-3 | Incentive Compensation | $ (190,491) | $ 116,963 |
| C-4 | Stock-Based Compensation | $ (155,879) | $ 95,711 |
| C-5 | Supplemental Executive Retirement Plan Expense | $ (134,618) | $ 82,657 |
| C-6 | American Gas Association Dues | $ (22,444) | $ 13,781 |
| C-7 | Rental Expenses | $ (40,258) | $ 24,719 |
| C-8 | Printing and Mailing | $ (39,511) | $ 24,260 |
| C-9 | Rate Case Expense | $ (177,778) | $ 109,158 |
| C-10 | Interest Synchronization | $ - | $ 9,468 |
| C-11 | Directors' and Officers' Liability Insurance | $ (41,786) | $ 25,657 |
| C-12 | Software Maintenance | $ (45,939) | $ 28,207 |
| C-13 | Property Tax Expense | $ (554,771) | $ 340,635 |
| **Total of Staff's Adjustments to Net Operating Income** | | $ (1,496,385) | $ 928,263 |
| | Adjusted Net Operating Income per Southwest Gas | | $ 13,840,203 |
| | **Adjusted Net Operating Income per Staff** | | **$ 14,768,466** |

## Gas Procurement

From a review of the internal audit reports and Sarbanes-Oxley ("SOX") control documentation provided by UNSG concerning gas procurement, I conclude that the Company appears to have appropriate procedures in place to periodically review the accuracy of its reported PGA balances, and appropriate internal controls in place and tests those internal controls periodically as it relates to gas procurement. Accordingly, I have no additional recommendations to add concerning UNSG's gas procurement beyond those being made by Staff witness John Rosenkrantz. Mr. Rosenkrantz addresses several other aspects of UNSG's gas procurement in his prefiled direct testimony.

## SUMMARY OF SURREBUTTAL TESTIMONY

My Surrebuttal Testimony addresses the following issues, and responds to the rebuttal testimony of UNS Gas, Inc. ("UNSG", "UNS Gas", or "Company") witnesses Dawn Sabers, David Hutchens, Dallas Dukes, and Gail Boswell on these issues:

The Company's proposed revenue requirement
Adjusted rate base
Adjusted test year revenues, expenses, and net operating income

My findings and recommendations for each of these areas are as follows:

**The Company's Proposed Revenue Requirement**

The Company's proposed revenue requirement of a base rate increase of $5.6 million, or 4 percent, is significantly overstated. In its original filing, UNSG proposed an original cost rate base ("OCRB") and fair value rate base ("FVRB") of approximately $184 million and $324 million, respectively. The Company also requests to set UNSG's FVRB at $254 million based on a 50/50 weighting of OCRB and RCND. In its rebuttal filing, UNSG claims to now support a base rate increase of $6.366 million, but is not requesting more than its originally filed amount of $5.6 million.

UNSG understated operating income. Additionally, the Company is requesting an excessive rate of return.

A revenue increase of not more than $1.885 million was recommended in my direct testimony, as shown on Attachment RCS-2, Schedule A, filed with my direct testimony. I have revised Staff's revenue requirement as shown on Attachment RCS-6, Schedule A to show a revenue increase for UNSG of approximately $2.7 million. The following changes to rate base and expense adjustments have been made and are reflected on Attachment RCS-6, attached to my Surrebuttal Testimony:

- Staff adjustment B-1 is revised to reduce rate base by $574,357 to reflect additional Customer Advances not reflected in Staff's direct filing.
- Staff Adjustment C-12 is revised to allow UNSG's requested normalized software maintenance expense of $45,939.
- Staff Adjustment C-13 is revised to reflect a modified amount for property tax expense of $3.2 million. This amount is within the range of property tax expense recommended by the parties, which is summarized in the following table:

| Property Tax Expense | Amount | Reference for Amount |
|---|---|---|
| Recommended In: | | |
| UNSG Direct | $ 2,919,767 | UNSG Boswell Rebuttal, p.6, line 11 |
| UNSG Rebuttal | $ 3,694,077 | UNSG Boswell Rebuttal, p.6, line 27 |
| Staff Direct | $ 2,364,996 | Attachment RCS-2, Schedule C-13 |
| RUCO Direct | $ 3,332,365 | Schedule RLM-11, line 22 |
| Actual: | | |
| Tax Year 2011 | $ 2,686,011 | UNSG Exhibit GKB-1 |
| Tax Year 2010 | $ 2,374,657 | UNSG Boswell Rebuttal, p.3, line 16 |

It is higher than the amount recommended in my direct testimony and is lower than the amount proposed by Residential Utility Consumer Office in its direct testimony and the amount requested by UNSG in rebuttal.

Conforming changes have also been reflected for Cash Working Capital (Staff Adjustment B-3) and Interest Synchronization (Staff Adjustment C-10).

Accordingly, I have revised Staff's revenue requirement as shown on Attachment RCS-6, Schedule A to show a revenue increase for UNSG of approximately $2.7 million.

Staff's revised recommended revenue requirement reflects a return on equity of 9.75 percent, a 1.00 percent return on the FVRB increment, a weighted cost of capital for original cost rate base of 8.27 percent and a fair value rate of return ("FVROR") of 6.26 percent. Staff's return recommendations are addressed in the direct and Surrebuttal Testimony of David Parcell. The 6.26 percent FVROR has been applied to a FVRB of approximately $253.380 million as shown on RCS-6, Schedule A, column D2.

**STAFF WITNESS SUMMARY – DAVID E. DISMUKES, PH.D.**
**TESTIMONY OF DAVID E. DISMUKES, PH.D.**
**UNS TAS, INC.**
**DOCKET NO. G-04204A-11-0158**
**FEBRUARY 7, 2012**

**Decoupling Recommendations and Conclusions and Modified by Surrebuttal Testimony**

Staff recommends that the Commission approve Staff's proposed Lost Fixed Cost Recovery ("LFCR") mechanism rather than full decoupling as proposed by the Company. Staff proposes a Plan of Administration ("POA") that sets forth the major features of the LFCR mechanism and contains accompanying schedules supporting the calculations for the LFCR. The POA was filed with my surrebuttal testimony as Exhibit DED-1.

Below are the main features of the proposed LFCR:

- The LFCR mechanism essentially allows the Company to recover the lost revenue associated with customer energy efficiency ("EE") savings. Under the proposal, the Company will be allowed to recover from customers lost fixed costs from EE savings, as measured by revenue, that has been authorized by the Commission and has also been determined to have occurred.
- The LFCR would be a separate surcharge included on each customer's bill, much like a gas adjustment surcharge. The LFCR will only be collected from residential and small commercial customers. The LFCR does not apply to the following customer classes: lighting, irrigation, compressed natural gas, and the larger customer classes (C-22, I-30, I-32, PA-42, PA-44, IR-60, and T-2).
- The POA includes an annual cap of one percent (1%). If the annual LFCR adjustment results in a surcharge and the annual incremental increase exceeds 1% of applicable

revenue, any revenue in excess of the cap will be deferred until the next future adjustment period that these costs would not cause the annual increase to exceed the cap.

- Under the proposed LFCR, the Company would be required to submit annual compliance filings on April 15th of each year. The annual compliance filings would consist of five schedules which were included as part of the POA.
- The proposed POA is similar to the one approved by the Commission in the Arizona Public Service Company rate case.

**Rate Design Recommendations and Conclusions**

- The existing customer charges should be held at their current levels.
- Volumetric rates for residential customers should be increased by 5.02 percent, which is the recommended percentage increase. All other classes' volumetric rates should be increased to move each class' rate of return closer to the system average rate of return in the same manner as proposed by the Company.
- Staff recommends that the Company be allowed to require proof of income on a pilot basis until the next rate case for CARES customers.

**STAFF WITNESS SUMMARY - JOHN A. ROSENKRANZ**
**UNS GAS, INC.**
**DOCKET NO. G-04204A-11-0158**
**FEBRUARY 7, 2012**

## SUMMARY OF DIRECT TESTIMONY

Mr. Rosenkranz presents the results of his review of UNS Gas' procurement activities for the period July 2008 through December 2010. This review includes the Purchase Gas Adjustor (PGA) filings, the Price Stabilization Policy, and the Company's interstate pipeline contract portfolio. Mr. Rosenkranz conducted a site visit on August 24-25, 2011, during which he interviewed gas procurement personnel, examined the available documentation for a sample of transactions, and observed the gas buying, nominating and scheduling process.

Mr. Rosenkranz finds that Company's gas procurement practices and price hedging program are generally reasonable, but is unable to confirm that UNS Gas has conducted an adequate review of its long-term pipeline capacity needs. Mr. Rosenkranz also identifies several areas of concern related to the Negotiated Sales Program (NSP), including an instance where core sales customers subsidized the Company for a negative margin on NSP sales through the PGA.

Based on his review, Mr. Rosenkranz makes ten recommendations related to the Company's price hedging practices, PGA reporting, and documentation of offers received in response to requests for proposals:

1. UNS Gas should consider modifying its price hedging program to: (a) lift the prohibition on non-discretionary purchases during the months of August, September, and October; (b) utilize other financial transactions, in addition to swaps; and (c) reduce the initial stabilization purchase quantities for delivery months that are two and three years out to reduce the risk of over-hedging due to overly-optimistic long-term sales forecasts.

2. The Company should ensure that there is a complete record of all final offers received, and any non-price factors used for evaluating offers, when it conducts a request for proposals process.

3. UNS Gas should submit a comprehensive pipeline capacity plan with the Commission before committing to any further extensions of its existing El Paso Natural Gas transportation agreements.

4. UNS Gas should modify the Purchased Gas Adjustor (PGA) reports to include the following information:

   (a) Report winter-period firm purchases and other call option transactions as a separatecategory on the Purchased Gas Detail Report.
   (b) Include the quantity of gas covered by financial hedge transactions.

(c) Report total NSP revenue, the total NSP margin, and the amount of NSP margin retained by the Company.

(d) Separate out the margins related to the affiliate contract for the Black Mountain Generating Station from the NSP margins for reporting purposes.

(e) Report, for each pipeline, (i) the total pipeline reservation cost before capacity release credits; (ii) the amount of capacity released during the month; and (iii) the capacity release credits received.

(f) Separately report excess gas sales that are done for balancing purposes and excess gas sales that are discretionary sales for resale, and show the margin calculation for each discretionary off-system sale.

5. UNS Gas should include asset management agreement (AMA) revenue in the calculation of the Natural Gas Cost Rate, not as an adjustment to the PGA Bank Balance.

6. Margin sharing on NSP sales should be changed from 50/50 to 75/25, with 75 percent of the margin going to ratepayers.

7. The pipeline transportation costs allocated to NSP sales in the PGA, and used for margin calculation purposes, should be the 100 percent load factor rate, not the variable cost.

8. UNS Gas should ensure that pipeline imbalance charges or penalties that are caused by NSP sales transactions are not passed through to core sales customers.

9. If, for any reason, UNS Gas has a negative margin on an NSP gas sale, this negative margin should be excluded from the NSP margin calculation for the PGA.

10. No later than the next rate application, UNS Gas should file a report with the Commission describing all aspects of the Negotiated Sales Program, quantifying the net benefits or costs of the program for core sales customers, and describing any proposed changes to the program.

**SUMMARY OF SURREBUTTAL TESTIMONY**

Mr. Rosenkranz responds to the rebuttal testimony of UNS Gas, Inc. witness David G. Hutchens. Two main issues are addressed. The first is the Staff recommendation that Company prepare and file a comprehensive pipeline capacity plan (Recommendation 3 in Mr. Rosenkranz's Direct Testimony). Mr. Rosenkranz agrees that requiring a plan to be filed before the Company commits to any future pipeline contract extensions could create problems, and modifies this recommendation to require that the Company submit a pipeline capacity plan by October 1, 2012.

The second issue is the Negotiated Sales Program (NSP) (Recommendations 6 through 10). Mr. Rosenkranz agrees that any modifications to the NSP program should be based on a comprehensive review of the benefits and costs of the program, and recommends that this review be conducted in conjunction with the next UNS Gas rate proceeding. To initiate this review, UNS Gas should file testimony on the NSP program as part of its next rate case application.

**STAFF WITNESS SUMMARY - DAVID C. PARCELL**
**UNS GAS, INC.**
**DOCKET NO. G-04204A-11-0158**
**FEBRUARY 7, 2012**

My Direct and Surrebuttal Testimony provides my estimate of the cost of capital for UNS Gas, Inc. ("UNS Gas"). My cost of capital recommendation is as follows:

| | Percent | Cost | Return |
|---|---|---|---|
| Long-term Debt | 49.18% | 6.74% | 3.31% |
| Common Equity | 50.82% | 9.75% | 4.95% |
| Total Capital | 100.00% | | 8.27% |

My 9.75 percent cost of common equity is derived from my application of three cost of equity models:

| | |
|---|---|
| Discounted Flow | 9.0-9.5% |
| Capital Asset Pricing Model | 7.5% |
| Comparable Earnings | 9.5-10.5% |

In addition, my Direct Testimony addresses the Fair Value Rate of Return ("FVROR") which should be applied to the Fair Value Rate Base of UNS Gas. I recommend two alternative FVROR values for UNS Gas – a 5.98 percent value using a zero percent return on the Fair Value Increment (differential between Fair Value Rate Base and Original Cost Rate Base) and 6.26 percent value using a 1.00 percent inflation-adjusted risk-free return.

**STAFF WITNESS SUMMARY - RYAN WEIGHT**
**UNS GAS, INC.**
**DOCKET NO. G-04204A-11-0158**
**FEBRUARY 7, 2012**

My testimony addresses the safety record of UNS Gas for the 2010 and 2011 calendar years and use and usefulness of plant facilities.

The Commission's Pipeline Safety Section conducts annual audits to ensure that the natural gas pipeline system owned and operated by UNS Gas is operated and maintained in accordance with the regulations in Title 49, Code of Federal Regulations, Part 191 and 192, and is also in compliance with the Arizona Administrative Code R14-5-201, R14-5-202, and R14-5-203.

The audits consist of the review of UNS Gas operation and maintenance records, and new construction and/or repair records. The field portion of the audit is conducted at randomly selected locations within the UNS Gas pipeline system. In addition, a review of UNS Gas' written operations and maintenance procedures and written emergency response procedures are conducted once every three (3) years.

In 2010, an audit was conducted on UNS Gas facilities located in Nogales, Prescott, and Verde Valley areas. There was only one (1) finding of probable non-compliance that was identified. The item was promptly corrected, based on documentation provided by UNS Gas.

In 2011, an audit was conducted on UNS Gas facilities located in Flagstaff, Kingman, Lake Havasu and Show Low areas. In addition, a review was conducted on UNS Gas' operation and maintenance plan and emergency plan. There were no findings of probable non-compliance that were noted.

During the previous two (2) audits, I also reviewed new construction records to determine if any installed pipeline facilities were not used and useful. The new system build-out has decreased in the past 2-3 years. Based on records reviewed, it appears that all of the pipeline system is being used and is useful for the distribution of natural gas.

In conclusion, UNS Gas does not have any outstanding safety issues with the Commission's Pipeline Safety Section.

**STAFF WITNESS SUMMARY - ROBERT GRAY**
**UNS GAS INC.**
**DOCKET NO. G-04204A-11-0158**
**FEBRUARY 7, 2012**

My testimony in this proceeding addresses a number of issues related to UNS Gas Inc.' (UNS) Rules and Regulations. Specifically, my testimony includes the following recommendations:

1. Staff agrees with UNS' proposed changes to its Rules and Regulations, with the handful of exceptions discussed herein.
2. Staff recommends the addition of the following language in Section 3.A.1 in place of the language recommended by UNS: "Proof of identification (social security number, driver's license number, or other similar government issued identification)."
3. Staff further recommends that UNS retain references to life support equipment in Sections 3 and 11 of its Rules and Regulations.
4. Staff further recommends that UNS Gas be authorized to secure non-residential deposits for a period up to 24 months and base refunds on the most recent 12 months of activity.
5. Staff further recommends against adoption of the door hanger fee proposed by UNS.