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BEFORE THE ARIZONA CORPORATION C

COMMISSIONERS

Arizona Corporation Commission
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MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR 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-06-0463
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831 DECISION NO. **70011** **OPINION AND ORDER**

DATES OF HEARING:	April 16, 17, 18, 19, 20, 24, and 25, 2007.
PLACE OF HEARING:	Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Dwight D. Nodes
IN ATTENDANCE:	Mike Gleason, Chairman Kristin K. Mayes, Commissioner
APPEARANCES:	Mr. Michael W. Patten and Mr. Timothy Sabo, ROSHKA, DEWULF & PATTEN, P.L.C. and Ms. Michelle Livengood, UNISOURCE ENERGY SERVICES, on behalf of Applicant; Mr. Scott S. Wakefield, Chief Counsel, on behalf of the Residential Utility Consumer Office; Ms. Cynthia Zwick, Executive Director, Arizona Community Action Association; Mr. Marshall Magruder, in propria persona; and Mr. Keith Layton and Ms. Maureen Scott, Staff Attorneys, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

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BY THE COMMISSION:

On November 10, 2005, the Arizona Corporation Commission ("Commission") opened an inquiry (Docket No. G-04204A-05-0831) into the prudence of the gas procurement practices of UNS Gas, Inc. ("UNS" "UNS Gas" or "Company") ("Prudence Case").

On January 10, 2006, UNS filed an application (Docket No. G-04204A-06-0013) with the Commission seeking review and revision of the Company's Purchased Gas Adjustor ("PGA Case").

On July 13, 2006, UNS filed an application with the Commission (Docket No. G-04204A-06-0463) for an increase in its rates throughout the State of Arizona ("Rate Case").

On July 20, 2006, UNS filed separate Motions to Consolidate in each of the above-captioned dockets.

On August 14, 2006, the Commission's Utilities Division Staff ("Staff") filed a Letter of Sufficiency indicating that the Company's Rate Case application met the sufficiency requirements outlined in A.A.C. R14-2-103, and classifying the Company as a Class A utility.

On August 18, 2006, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene.

On September 8, 2006, a Procedural Order was issued consolidating the Prudence, PGA, and Rate Case dockets; scheduling a hearing for April 16, 2007; setting various other procedural deadlines; directing UNS to publish notice of the applications and hearing date; and granting RUCO's request for intervention.

On September 20, 2006, Arizona Community Action Association ("ACAA") filed a Motion to Intervene.

By Procedural Order issued November 15, 2006, ACAA's Motion to Intervene was granted.

On November 17, 2006, Marshall Magruder filed a Motion to Intervene on his own behalf.

By Procedural Order issued January 10, 2007, Mr. Magruder's request to intervene was granted.

With its rate application, UNS filed its required schedules in support of the application, as well as the direct testimony of James Pignatelli, David Hutchens, Kentton Grant, Dallas Dukes, Karen Kissinger, Gary Smith, Ronald White, and Tobin Voge.

On February 9, 2007, Staff filed the direct testimony of Ralph Smith, David Parcell, Robert Gray, Julie McNeely-Kirwan, and George Wennerlyn; RUCO filed the direct testimony of William Rigsby, Marylee Diaz Cortez, and Rodney Moore; ACAA filed the direct testimony of Miquelle Scheier; and Mr. Magruder filed his direct testimony.

On February 9, 2007, Staff filed a Request for Extension of Time to file the direct testimony of two of its witnesses.

On February 15, 2007, a Procedural Order was issued granting Staff's extension request, and revising the dates for responsive testimony for the other parties.

On February 16, 2007, Staff filed the direct testimony of Jerry Mendl.

On February 23, 2007, Staff filed the direct testimony of Steven Ruback.

On March 1, 2007, a Procedural Order was issued rescheduling the prehearing conference to April 13, 2007.

On March 16, 2007, UNS filed the rebuttal testimony of D. Bentley Erdwurm, Mr. Grant, Mr. Dukes, Ms. Kissinger, Mr. Hutchens, Mr. Pignatelli, Gary Smith, and Denise Smith.

On March 30, 2007, ACAA filed the surrebuttal testimony of Ms. Scheier.

On April 4, 2007, Staff filed the surrebuttal testimony of Mr. Gray, Ms. McNeely-Kirwan, Mr. Parcell, Mr. Ruback, Mr. Mendl, and Ralph Smith; RUCO filed the surrebuttal testimony of Mr. Rigsby, Mr. Moore, and Ms. Diaz Cortez; and Mr. Magruder filed his surrebuttal testimony.

On April 11, 2007, UNS filed the rejoinder testimony of Denise Smith, Gary Smith, Mr. Pignatelli, Ms. Kissinger, Mr. Dukes, and Mr. Erdwurm.

On April 13, 2007, a prehearing procedural conference was conducted to address the order of witnesses and exhibits.

The evidentiary hearing commenced as scheduled on April 16, 2007, and additional hearing days were held on April 17, 18, 19, 20, 24, and 25, 2007. At the close of the hearing, a briefing schedule was established, with initial briefs due on May 31, 2007, and reply briefs due on June 14, 2007.

On May 30, 2007, Staff filed a Request for Extension of Time to File Initial Brief.

On May 31, 2007, a Procedural Order was issued granting Staff's extension request and directing initial and reply briefs to be filed by June 5 and June 19, 2007, respectively.

Initial briefs were filed on June 5, 2007, by UNS, Staff, RUCO, and Mr. Magruder. Final Schedules were also filed on June 5, 2007, by UNS and RUCO.

On June 6, 2007, Staff filed a Notice of Errata and Revised Initial Brief.

Reply Briefs were filed on June 19, 2007, by UNS, Staff, RUCO, and Mr. Magruder.

On June 21, 2007, Staff filed a Notice of Errata and Additional Authority.

Rate Application

According to the Company's application, as modified, in the test year ended December 31, 2005, UNS had adjusted operating income of $8,506,168,[1] on an adjusted Original Cost Rate Base ("OCRB") of $162,358,856, for a 5.24 percent rate of return. UNS requests a revenue increase of $9,459,023; Staff recommends a revenue increase of $4,312,354; and RUCO recommends an increase of $2,734,443. A summary of the parties' positions follows.

	Company Proposed	Staff Proposed	RUCO Proposed
ORIGINAL COST			
Adjusted Rate Base	$162,358,856	$154,547,272	$144,646,160
Rate of Return	8.80%	8.12%	8.22%
Req'd Operating Inc.	14,284,546	12,549,238	11,889,914
Op. Income Available	8,506,168	9,900,380	10,219,499
Operating Inc. Def.	5,778,378	2,648,858	1,670,416
Rev.Conver. Factor	1.6370	1.6370	1.6370
Gross Rev. Increase	9,459,023	4,336,098	2,734,443
FAIR VALUE			
Adjusted Rate Base	$191,875,209	$184,063,625	$171,189,139
Rate of Return	7.44%	6.81%	6.95%
Req'd Operating Inc.	14,284,546	12,534,733	11,889,914
Op. Income Available	8,506,168	9,900,380	10,219,499
Operating Inc. Def.	5,778,378	2,634,353	1,670,416
Rev.Conver. Factor	1.6370	1.6370	1.6370
Gross Rev. Increase	9,459,023	4,312,354[2]	2,734,443

[1] The Company's "Final Schedules," which were submitted at the time UNS' initial brief was filed, are inconsistent with the revenue requirement recommendations set forth in the Company's brief (compare, *e.g.*, UNS Initial Brief at 5-6 and Final Schedule A-1). No subsequent filings were submitted to explain the differences between these documents and the reason for the discrepancy is unknown. For purposes of this Decision, we have used the Company's "Revised Schedules," (admitted at the hearing as Ex. A-10), and as set forth in its brief.

[2] Staff's gross revenue increase was calculated by applying a zero cost value to the "excess" between OCRB and FVRB.

REVENUE REQUIREMENT

Rate Base Issues

UNS proposed an OCRB of $162,358,856; Staff recommends an OCRB of $154,547,272; and RUCO proposed an OCRB of $144,646,160. Each of the disputed issues regarding rate base items is discussed below.

Construction Work in Progress

Construction work in progress ("CWIP") is a regulatory concept under which, in limited circumstances, a regulatory body allows recovery in a company's rate base of plant that was under construction during the test year but not used and useful for purposes of serving customers. In this proceeding, UNS Gas seeks inclusion of approximately $7.2 million of CWIP (which would provide the Company with approximately $1.5 million in additional annual revenues). In support of its position, UNS argues that CWIP is an accepted aspect of ratemaking that has been used in many states and that the Arizona Supreme Court previously upheld the allowance of CWIP, citing *Arizona Community Action Assoc. v. Arizona Corp. Comm'n*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979). In that case, the Arizona Supreme Court stated that allowing CWIP "appears to be in the public interest to have stability in the rate structure within the bounds of fairness and equity rather than a constant series of rate hearings." (*Id.*).

UNS contends that it will not be able to earn its authorized rate of return even if its full rate request is granted in this case, due to the high rate of growth in its service area, which requires higher levels of capital investment to serve new customers. According to Company witness Kentton Grant, because investment in new plant creates additional fixed costs and because growth leads to capital requirements in excess of the Company's internal cash flow, the impact of regulatory lag on UNS Gas is more severe than for many other utilities (Co. Ex. 28 at 9; Co. Ex. 27 at 28). Mr. Grant testified that in 2006 UNS added $17 million in net plant, which resulted in an additional $3 million in fixed costs (*e.g.*, depreciation, property taxes), but new customers added in 2006 provided only $1.8 million in new revenues, resulting in a net loss of $1.2 million for UNS associated with serving growth in 2006 (Co. Ex. 28 at 10, Attach. KCG-10).

Staff and RUCO oppose inclusion of CWIP in the Company's rate base. Staff witness Ralph Smith stated that, although the Commission has previously allowed CWIP in rate base, the Commission's general practice has been not to allow CWIP. In support of Staff's disallowance recommendation, Mr. Smith claims that absent compelling reasons, which have not been shown by UNS in this case, there is no valid reason to grant CWIP. Mr. Smith asserts that the Company has not demonstrated that its test year CWIP balance was for non-revenue-producing and non-expense-reducing plant. He testified that much of the construction appears to be for mains, services, and meters related to serving customer growth, which plant is therefore revenue producing. Mr. Smith stated that, although test year revenues have been annualized to (2005) year-end customer levels, revenues have not been extended beyond the test year to correspond to customer growth. Thus, according to Mr. Smith, inclusion of CWIP in rate base, without recognition of the incremental revenue the plant supports, would cause a mismatch for regulatory purposes (Ex. S-25 at 9-10).

RUCO witness Marylee Diaz Cortez also recommends disallowance of CWIP for many of the same reasons cited by Staff witness Ralph Smith. Ms. Diaz Cortez stated that the Commission has previously allowed CWIP only in extraordinary circumstances, which she claims are not present in this case. She claims that recovery of earnings on CWIP plant balances prior to the plant becoming used and useful is accomplished through an Allowance for Funds Used During Construction ("AFUDC"), through which the Company may accrue interest on the CWIP balances. The AFUDC accruals are ultimately recovered over the life of the plant through depreciation expense once the asset becomes used and useful in provision of utility service (RUCO Ex. 5, at 7-9). Ms. Diaz Cortez testified that regulatory lag has always been a characteristic of rate of return regulation and that such lag may also provide a benefit to the Company, to the extent that plant retirements, accumulated depreciation, and expired amortizations allow it to earn a return on those items between rate cases. She also stated that the growth phenomenon in the UNS service area has a positive aspect due to the increase of revenues associated with serving new customers (*Id.* at 9-10).

We agree with Staff and RUCO that the request for CWIP in this case is not supported by the record. As the Staff and RUCO witnesses indicated, UNS is not faced with an extraordinary situation that would justify inclusion of CWIP in rate base because the plant required to serve new customers will help produce revenues; UNS has a means, through accrual of AFUDC, to mitigate the effect of the CWIP investment; allowance of CWIP would undermine the balancing of test year revenues and expenses; 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.

As Staff points out in its brief, one of the few instances in which the Commission previously allowed inclusion of CWIP in rate base occurred in 1984 in a case involving Arizona Public Service Company ("APS"). In that case, the Commission addressed the need for a CWIP allowance due to extraordinary circumstances involving the Palo Verde nuclear plant. The Commission allowed approximately $200 million of APS's $600 million CWIP balance as a means of addressing a critical cash-flow deficiency, and as a means to lessen the severe rate shock that would be experienced by customers if the entirety of the nuclear plant were placed in rate base at one time.[3] Staff argues that UNS is not faced with a comparable cash-flow crisis, and that the $7 million of CWIP requested by the Company does not present a rate shock concern that would justify inclusion of CWIP in this case. We therefore decline the Company's request for rate base recognition of CWIP in this proceeding.

Post-Test-Year Plant

UNS proposes that, if its request for CWIP is denied, the Commission should alternatively allow inclusion of post-test-year plant in rate base. The Company argues that the Commission has approved post-test-year plant in a number of recent cases, and UNS faces faster growth than many other utilities in Arizona. Therefore, UNS argues that, absent inclusion of CWIP, the Commission should recognize inclusion of post-test-year plant.

Staff opposes the Company's proposal for reasons similar to the arguments raised on the CWIP issue. Staff witness Ralph Smith testified that the post-test-year plant arguments suffer from the same flaws as the request for inclusion of CWIP. He stated his belief that recognition of post-test-year plant would be imbalanced because it fails to capture post-test-year revenue growth and decreases in maintenance costs associated with the new plant (Ex. S-27 at 14-15).

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[3] *Arizona Public Service Co.*, Decision No. 54247 (November 28, 1984), at 19-20.

We agree with Staff that post-test-year plant should not be included in rate base for the same reasons stated above with respect to the Company's request for CWIP. Although the Commission has allowed post-test-year plant in several prior cases involving water companies, it appears that the issue was developed on the record in those proceedings in a manner that afforded assurance that a mismatch of revenues did not occur. For example, in Decision No. 66849 (March 19, 2004), we stated that "we do not believe that adoption of this method would result in a mismatch because the post-test-year plant additions are revenue neutral (*i.e.*, not funded by CIAC or AIAC)" (*Id.* at 5). In the instant case, however, the Company's request appears to be simply a fallback to its CWIP position, and there is no development of the record to support inclusion of the post-test-year plant. The entirety of UNS's argument consists of two questions in Mr. Grant's direct testimony, which essentially provided that: the Commission has approved post-test-year plant in some prior cases, UNS is experiencing a high customer growth rate, and therefore the Company is entitled to inclusion of post-test-year plant if the Commission denies CWIP (Ex. A-27 at 28-29). Even if we were inclined to recognize post-test-year plant in this case, there is not a sufficient basis upon which to evaluate the reasonableness of the request (*i.e.*, whether a mismatch would exist). We therefore deny the Company's proposal on this issue.

<u>Deduction of Customer Advances</u>

The final issue raised in UNS's trilogy of CWIP-related issues is its plea that the Commission should not reduce rate base to recognize funds received for customer advances, if the Commission rejects UNS's request for CWIP or, alternatively, for post-test-year plant. The Company concedes that such advances are typically deducted from rate base because they represent customer-supplied capital. However, UNS contends that it has received approximately $4 million in customer advances related to the $7 million in CWIP plant investment (Ex. A-28 at 27). Thus, according to UNS, the net impact on rates (if the requested $7 million of CWIP were to be included in rate base) is $3 million, based on the net of the $7 million offset by $4 million in advances.

UNS argues that it is inherently unfair to exclude the advances from rate base if the plant associated with those advances is not yet in service and not included in rate base. UNS claims that the purpose of deducting advances (*i.e.*, recognizing customer-supplied capital) is not furthered when the plant is not in service. The Company also contends that the deduction of advances in this case would discourage utilities from seeking advances to offset infrastructure capital costs.

Both Staff and RUCO oppose the Company's recommendation. Staff witness Ralph Smith states that because advances represent non-investor-supplied capital, they should be reflected as a deduction to rate base. He stated that Staff is not aware of any instance in which CWIP was excluded for a major utility in Arizona and customer advances were not reflected as a deduction to rate base. Mr. Smith also cites to A.A.C. R14-2-103, Appendix B, Schedule B-1, which he claims requires companies to reflect advances as a deduction from rate base (Ex. S-27 at 15-16).

RUCO witness Marylee Diaz Cortez agreed with Staff's recommendation regarding advances. She testified that the Commission has historically excluded CWIP from rate base and recognized contributions (advances) as a deduction from rate base and that UNS is being afforded (under RUCO's and Staff's recommendations) the same rate base treatment as every other utility in Arizona (RUCO Ex. 6 at 8). Ms. Diaz Cortez claims that it is only the Company's proposal to include CWIP which creates a mismatch, because UNS failed to include the additional revenues the construction projects generate (*Id.* at 8-9).

We agree with Staff and RUCO that advances represent customer-supplied funds that are properly deducted from the Company's rate base. Indeed, the Commission's own rules contemplate that such a deduction is required, as Staff witness Smith testified. Had UNS not requested the inclusion of CWIP in rate base, a ratemaking treatment that is only afforded under extraordinary circumstances (and apparently has not occurred for more than 20 years), there would presumably not have been an issue raised by the Company with respect to an alleged "mismatch" between exclusion of CWIP and deducting advances from rate base. The Company's attempt to frame this issue as one in which it is being treated in a discriminatory manner is unpersuasive.

As we have stated in prior cases, regulated utility companies control the timing of their rate case filings and should not be heard to complain when their chosen test periods do not coincide with the completion of plant that may be considered used and useful and therefore properly included in rate base. We believe our conclusions regarding UNS's CWIP-related proposals are entirely consistent with the treatment that has been afforded to other utility companies regulated by the Commission and provide a result that is fair to both the Company and its customers.

Geographic Information System

UNS seeks to include in rate base $897,068 for expenses incurred during 2003 and 2004 to install a Geographic Information System ("GIS"). The GIS is a global positioning system that allows UNS to locate existing service lines. UNS witness Gary Smith testified that the Company installed the GIS in response to a Commission Pipeline Safety audit that recommended a complete mapping of the UNS system. He described several benefits of the GIS, including improved response times, better informed decisions regarding adding system infrastructure, and increased accuracy for field staff (Ex. A-15 at 6-7).

According to Staff witness Ralph Smith, the GIS costs should not be included in rate base because they were non-recurring expenses that were largely incurred outside of the test year. He explained that, according to internal Company memos, UNS initially decided to treat the GIS as a capitalized investment, but later determined that capitalization of the costs was inappropriate under Generally Accepted Accounting Principles ("GAAP"). Mr. Smith stated that, under GAAP, the GIS costs were required to be expensed during the period in which they were incurred and, since they were incurred prior to the test year, are not properly includable in rates (Ex. S-27 at 16-18).

RUCO also opposes inclusion of the GIS expenses in rates. RUCO witness Marylee Diaz Cortez stated that because UNS failed to obtain from the Commission an accounting order to treat the GIS expenses as a regulatory asset, which would be eligible for future rate recovery consideration, the Company is not entitled to recover those costs in this rate proceeding (RUCO Ex. 5 at 11-12; RUCO Ex. 6 at 9-10). RUCO argues that regardless of the Company's increased productivity claims, its failure to properly account for the GIS costs precludes recovery in UNS's rate base.

We agree with Staff and RUCO that the GIS costs are not properly recoverable as a regulatory asset in this proceeding. As described by Staff witness Ralph Smith, the GIS costs were required by GAAP to be expensed, and the vast majority of those costs were incurred prior to the test year and are non-recurring in nature (Ex. S-25 at 12-17). Further, the Company's failure to seek an accounting order from the Commission when the costs were incurred renders them unrecoverable as a regulatory asset. As Mr. Smith points out, it is not unusual for investors to be responsible for expenses incurred between test years, just as the utility's investors may benefit from cost decreases and increased revenues during the same period (Ex. S-27 at 16-19). As both Staff and RUCO contend, there is nothing inherently unfair about the treatment afforded to the GIS costs in this case because costs and revenues are ever changing, and moreover, the improved efficiencies touted by UNS as a result of the GIS inure to the benefit of the Company's investors at least as much as to ratepayers. Finally, any blame for UNS's inability to recover those costs through rates lies with the Company's prior failure to properly account for the costs under GAAP accounting standards.

Plant in Service

Although Staff did not challenge the Company's proposed plant-in-service amounts, RUCO recommends the disallowance of approximately $3.1 million in plant that it considers unsubstantiated. UNS claims that it provided adequate documentation for the plant, but RUCO contends that the Company failed to provide records supporting increased plant balances recorded on the books of Citizens Utilities between the end of the last test year (December 31, 2001) and the date the Company acquired the system from Citizens (August 11, 2003).

According to RUCO, Citizens' gas plant in service was approximately $234 million at the end of 2001, and UNS has records to support $10.7 million of additional plant in service between the end of 2001 and June 30, 2003 (Ex. A-8 at 2; RUCO Ex. 1). RUCO claims that UNS has no records to support additional plant in service as of the date of the transfer, yet the Company booked approximately $248 million of plant in service as of the acquisition date of August 11, 2003 (Tr. at 192-93). UNS witness Karen Kissinger testified that certain electronic files provided to RUCO supported the higher plant value, but conceded that those files do not provide a means of reconciling the plant balances claimed as of the acquisition date (*i.e.*, $248 million) (Tr. at 194-95, 214). RUCO also disputes the Company's argument that the higher plant balances were approved by the Federal Energy Regulatory Commission ("FERC"), based on Ms. Kissinger's concession that the submission to FERC was not a request for approval of the specific plant amounts, but simply a request for confirmation from FERC that the amounts are recorded to the proper FERC accounts (Tr. at 198). Based on the evidence presented, RUCO requests a decrease of $3,133,264 in the Company's proposed plant in service and a corresponding increase in accumulated depreciation of $3,857,413, (RUCO Ex. 3 at 12).

UNS contends that it provided adequate documentation to support its claimed plant-in-service balances for the period in question. The Company argues that, because Citizens was scrambling to wrap up its accounting for the final months at the time the sale was being finalized, it is not surprising that Citizens' records from that period were less extensive than normal (Tr. at 194-97). UNS relies on the electronic files provided to RUCO to support its position. The Company also points to testimony by RUCO witness Rodney Moore, who agreed that "records from Citizens are notoriously inadequate for a determination of the actual value of the pre-acquisition gross plant and accumulated depreciation" (RUCO Ex. 4 at 4). UNS asserts that other companies seeking post-acquisition approval of plant values based on Citizens' inadequate records have not been subject to downward adjustments[4], and that imposing downward adjustments on UNS would be inequitable. UNS also claims that the Commission's order approving the sale of the Citizens gas system assets to UNS did not include record retention requirements, although such requirements had been included in prior Commission Orders such as those related to the sale of Southern Union Gas Company's assets to Citizens (Ex. A-7 at 6).[5] Another argument raised by UNS is that it directly transferred the final plant-in-service values from Citizens' books to its own at the time of the acquisition. The Company contends that FERC's approval of UNS's accounting procedures and a subsequent audit of the Company's financial statements further support its claim that its proposed plant-in-service value is appropriate.

We find that UNS has explained adequately the basis for its plant-in service-proposal. As UNS witness Kissinger indicated in her rebuttal testimony, the acquisition of the Citizens assets was accounted for by UNS in accordance with applicable accounting standards, and the Company obtained a clean audit opinion regarding its financial statements from PricewaterhouseCoopers for the applicable period following the acquisition (Ex. A-7 at 2; Ex. A-6, Attach. KGK-1). The Company's accounting treatment was also approved by the accounting entries associated with the

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[4] *See, e.g., Arizona –American Water Co.*, Decision No. 67093 (June 30, 2004).
[5] Decision No. 57647 (December 2, 1991), at 14.

acquired plant (Ex. A-7 at 4). UNS Gas provided sufficient documentation to support the amount of plant in service transferred from Citizens, and we therefore reject RUCO's proposed adjustment to plant in service.

Test Year Accumulated Depreciation

RUCO has also proposed increasing the Company's accumulated depreciation by approximately $2,855,454, due to RUCO's assertion that UNS improperly applied depreciation rates that were requested in the last rate case (Docket No. G-01032A-02-0598). That case was later suspended and combined with a joint application between UNS and Citizens for acquisition of the Citizens assets by UNS. The consolidated dockets ultimately resulted in a settlement agreement that was approved in Decision No. 66028 (July 3, 2003). RUCO argues that, because the settlement approved in Decision No. 66028 did not specifically mention new depreciation or amortization rates, UNS should apply the depreciation rates approved in the prior Citizens gas rate case in Decision No. 58664 (June 16, 1994). RUCO witness Moore cited to A.A.C. R14-2-102(C)(4), which states that changed depreciation rates shall not become effective until the Commission authorizes such changes. (RUCO Ex. 3 at 13-14). Accordingly, Mr. Moore proposed that test year accumulated depreciation should have been calculated as approved in the prior Citizens rate case, resulting in a reduction to the Company's OCRB of $2,855,454 (*Id.* at 14).

UNS argues that RUCO's recommendation fails to recognize that the Commission approved new depreciation rates in Decision No. 66028 which, as noted above, approved the sale of Citizens' gas system assets to UNS and approved a rate increase pursuant to the terms of a settlement agreement. Although the Commission did not explicitly approve new depreciation rates in Decision No. 66028, UNS contends that the settlement agreement contained a specific schedule showing how the revenue requirement was calculated. UNS witness Kissinger testified that the depreciation rates that formed the basis of the settlement were approved by the Commission and that no party objected to the depreciation rates in that case (Ex. A-7 at 9). Ms. Kissinger also attached to her testimony the schedule that formed the basis of the revenue requirement and explained on cross-examination that the updated depreciation expense adjustment was subsumed within operating expenses in the settlement agreement schedule (*Id.* at Attach. KGK-11; Tr. at 201-03).

We agree with UNS that the depreciation rates contained within the revenue requirement schedules, and attached to the settlement agreement, were implicitly approved in Decision No. 66028. Although Decision No. 66028 approved a "black box" settlement, in the sense that the specific revenue requirement issues were not discussed individually, the basis of the underlying revenue requirement was attached to the settlement agreement, and no party objected to the individual components of that revenue requirement. Accordingly, it was reasonable for UNS to apply the accumulated depreciation rates that were a component of the settlement. Indeed, RUCO witness Diaz Cortez admitted that the prior Citizens rate case order (Decision No. 58664) contained a specific discussion of only 2 of the 28 depreciation accounts and that it would thus be necessary to refer to the underlying application even in that case to ascertain the specific depreciation rates that were approved by the Commission in that order (Tr. at 673-74). We therefore reject RUCO's recommendation on test year accumulated depreciation.

<u>Working Capital</u>

As described by UNS witness Karen Kissinger, working capital is generally defined as "investor funding in excess of the balance of net utility plant reflected in rate base that is required for the provision of utility service" (Ex. A-6 at 10). The components of working capital include materials and supplies, prepayments, and cash working capital. The amounts for materials and supplies, and prepayments, are determined based on test year recorded balances, whereas the cash working capital component was determined by UNS based on a lead-lag study (*Id.* at 10-11).

Staff witness Ralph Smith summarized the concept of cash working capital as follows:

> Cash working capital is the cash needed by the Company to cover its day-to-day operations. If the Company's cash expenditures, on an aggregate basis, precede the cash recovery of expenses, investors must provide cash working capital. In that situation, a positive cash working capital requirement exists. On the other hand, if revenues are typically received 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 (Ex. S-25 at 18-19).

Based on Staff's proposed adjustments, Mr. Smith proposed a corresponding adjustment to the Company's cash working capital requirements. Staff's recommendation results in a cash working capital requirement of negative $268,272, in accordance with Staff's other recommendations in this case (Ex. S-27 at 20, Attach. RCS-2S).

In its initial brief, UNS points out that a number of ratemaking adjustments will have an effect on the Company's working capital requirement. UNS also contends that RUCO's proposed working capital proposal should be rejected because RUCO failed to use a simultaneous equation to compute two elements of cash working capital: synchronized interest and current income taxes (Ex. A-7 at 12).

In its reply brief, RUCO responded that its schedules did account for synchronized interest in both the working capital and income tax calculations. RUCO cites to Mr. Moore's schedules to support its claim (RUCO Ex. 3, Sched. RLM-3, Line 15; Sched. RLM-14, Lines 3, 8, and 18; and Sched. RLM-6, Line 8).

It does not appear from the record that the parties are in disagreement with regard to the underlying working capital requirements, subject to the various adjustments that necessarily flow from the revenue requirement established in this Decision. The working capital requirement has been determined in accordance with the revenue requirement established in this Order.

<u>Accumulated Deferred Income Tax</u>

Based on its recommendations in this case, Staff adjusted rate base by $195,336 to account for removal of accumulated deferred income tax ("ADIT") related to the GIS deferral issue, removal of ADIT related to the Supplemental Executive Retirement Plan, and removal of 50 percent of the ADIT related to incentive compensation (Ex. S-25 at 19). Staff claims that UNS did not contest these ADIT adjustments, which Staff asserts are necessary to reconcile rate base with the components of operating income adjustments.

In its brief, UNS does not address the ADIT issues raised by Staff, which are reconciliation adjustments flowing through from several operating income issues and are addressed below. However, the Company does take issue with RUCO's alleged failure to make corresponding adjustments to ADIT and deferred income tax expense (Ex. A-7 at 11-12). Because RUCO did not address this issue in its briefs, presumably, it does not oppose the Company's position.

Based on the record before us, we agree that the appropriate reconciliation adjustments should be made to reflect the effect on ADIT and income tax expense in accordance with this Decision.

Summary of Rate Base Adjustments

Based on the foregoing discussion, we adopt an adjusted OCRB of $154,604,408 and a Fair Value Rate Base ("FVRB") of $184,120,761.

	Commission Approved
ORIGINAL COST:	
Gas Plant in Service	$271,980,463
Less: Accumulated Depreciation	(72,006,708)
Net Plant in Service	199,973,755
Citizens Acquisition Discount	(30,709,738)
Less: Accum. Amort. – Citizens Acq. Disc.	(1,876,981)
Net Citizens Acq. Discount	(28,832,757)
Total Net Utility Plant	171,140,998
Deductions:	
CIAC	(7,283,595)
Customer Deposits	(3,040,484)
Accum. Deferred Income Taxes	(6,289,473)
Allowance for Working Capital	(211,136)
Regulatory Liabilities	(19,721)
Total Deductions	(16,844,409)
Additions:	
Regulatory Assets	307,819
Total OCRB	$154,604,408
RCND[6] RATE BASE:	
Gas Plant in Service	$367,054,190
Less: Accumulated Depreciation	(97,114,865)
Net Plant in Service	269,939,325
Citizens Acquisition Discount	(41,822,562)
Less: Accum. Amort. – Citizens Acq. Disc.	(2,560,308)
Net Citizens Acq. Discount	(39,262,254)
Total Net Utility Plant	230,677,071
Deductions:	
CIAC	(7,786,962)
Customer Deposits	(3,040,484)
Accum. Deferred Income Taxes	(6,289,473)
Allowance for Working Capital	(211,136)
Regulatory Liabilities	(19,721)

[6] Reconstruction New (less) Depreciation

Total Deductions	(17,347,326)
Additions:	
Regulatory Assets	307,819
Total RCND	$213,637,114

FAIR VALUE RATE BASE:

Gas Plant in Service	$319,517,327
Less: Accumulated Depreciation	(84,560,787)
Net Plant in Service	234,956,540
Citizens Acquisition Discount	(36,266,150)
Less: Accum. Amort. – Citizens Acq. Disc.	2,218,645
Net Citizens Acq. Discount	(34,047,505)
Total Net Utility Plant	200,909,035
Deductions:	
CIAC	(7,535,279)
Customer Deposits	(3,040,484)
Accum. Deferred Income Taxes	(6,289,473)
Allowance for Working Capital	(211,136)
Regulatory Liabilities	(19,721)
Total Deductions	(17,096,093)
Additions:	
Regulatory Assets	307,819
Total FVRB	$184,120,761

Operating Income Issues

In the test year, the Company's reported operating revenues were $47,169,528, with reported adjusted test year operating expenses of $38,740,547, and test year net operating income of $8,428,981. As reported in its Surrebuttal Schedules, Staff's proposed adjusted test year operating revenues were $47,273,923, with adjusted test year operating expenses of $37,373,543, resulting in test year net operating income of $9,900,380. RUCO's Final Schedules show proposed adjusted test year operating revenues of $50,014,877, with adjusted test year operating expenses of $38,124,962, yielding test year net operating income of $11,889,914. The disputed expense adjustments are discussed below.

Revenues

Customer Annualization

UNS has proposed in this case to calculate customer revenue annualization based on a cyclical growth pattern, which the Company contends more accurately reflects its actual experience in its service territory. Company witness D. Bentley Erdwurm described the traditional approach of customer annualization as a comparison of customer counts in each month of the test year to the end of test year level of customers. Under this approach, the additional customers attributable to each month are multiplied by the average revenue per customer for each month to obtain the additional revenue attributable to the additional customers (Ex. A-20 at 2). Mr. Erdwurm testified that the traditional method works well when growth is steady and additional customers are similar in size to existing customers, but breaks down when a company, such as UNS, experiences cyclical seasonal growth (*Id.*). He conceded that the Commission has never before adopted a revenue annualization method such as the one advocated by UNS. However, he contends that the Company's proposed methodology is appropriate in this case because "in cases of cyclical growth, the mathematics break down and...[the traditional method] will often give you a totally counterintuitive result, where you would actually have a negative customer adjustment on a growing system" (Tr. at 447).

Staff and RUCO oppose adoption of the Company's annualization proposal. RUCO argues that although the Company's customer levels are somewhat seasonal, they do not exhibit a degree of seasonality or produce an aberrational result that would make the traditional method inappropriate. Ms. Diaz Cortez pointed out that the customer base for UNS's largest rate schedule, R10, increased from month to month for every month except April, May, and July, and that the decreases in those months ranged from .09 percent to .28 percent (RUCO Ex. 6 at 12, Sched. MDC-1). RUCO asserts that these changes do not exhibit an extreme level of seasonality that would justify departure from the traditional method advocated by RUCO and Staff.

Staff witness Ralph Smith testified that the traditional method of customer annualization has been effective in coordinating the revenue element of the ratemaking formula with other components, such as rate base, and that many of the Company's arguments are without merit (Ex. S-27 at 19-21). According to Mr. Smith, any method for determining an annualization adjustment should be transparent and straightforward to allow replication and verification of the results. He contends that while the traditional method satisfies these criteria, UNS's proposal to apply percentage growth factors instead of customer bill counts is difficult to follow and replicate and actually appeared to understate growth (*Id.* at 24).

We agree with Staff and RUCO that UNS has not presented a valid case for departing from the traditional method of calculating customer revenue annualization. Although the Company's arguments may have some validity in a theoretical sense, adoption of the cyclical methodology is not warranted in this proceeding. RUCO and Staff highlighted some of the flaws inherent in the Company's proposal, including the lack of any significant demonstrated seasonality, the complexity of the formula, lack of transparency, and the claim by the Staff witness that the methodology may actually result in an understatement of revenues. We therefore decline to adopt UNS's revenue annualization proposal.

Weather Normalization

Staff witness Ralph Smith stated that Staff's weather normalization adjustment increases retail revenue by $1,962, compared to UNS's proposal, because, in Staff's annualization, the weighted average number of customers exceeded the level reflected in the Company's corresponding annualization. Mr. Smith claims that both the Staff and UNS weather normalization adjustments reflect an increase to revenue due to warmer than normal temperatures during the test year (Ex. S-27 at 25).

In its brief, UNS states that the weather normalization adjustment should reflect the other positions taken herein, including the customer annualization adjustment proposed by the Company.

Although RUCO accepts the Company's proposed weather normalization, it proposes a further adjustment of $900 related to the additional customers/revenue the Company proposes be recognized as a result of its customer annualization proposal (RUCO Ex. 6 at 16).

It is not entirely clear whether the weather normalization issue remains in dispute given our determination above that the Company's customer annualization recommendation should not be adopted. To the extent that there is any remaining disagreement on this issue, we adopt Staff's weather normalization recommendation in accordance with the discussion above regarding customer annualization.

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Expenses

Legal Expenses Related to FERC Rate Case

During the 2005 test year, UNS incurred legal expenses of $311,051 related to settlement discussions involving an El Paso Natural Gas Company ("El Paso") FERC rate case. The El Paso case eventually settled, and due to the non-recurring nature of those legal expenses, both Staff and RUCO recommended removal of that amount from allowable expenses in this case (Ex. S-15 at 30; RUCO Ex. 5 at 21).

UNS witness Dallas Dukes testified that Staff's and RUCO's recommendations would set the Company's legal expenses at an amount well below the expected ongoing level (Ex. A-13 at 17). As an alternative, he proposed an allowance of $430,777 (pre-tax), which represents a two-year average of legal expenses actually incurred by UNS for 2004 and 2005 (*Id.* at 18). Mr. Dukes stated that the actual legal expenses incurred by UNS were $373,174 for 2004, $488,380 for 2005, and $425,540 for 2006, and that its projected legal expenses for 2007 are $425,208 (*Id.*; Ex. A-14 at 9).

We believe that the Company's allowable legal expenses should be set at a level that reflects more accurately its actual experience, both historical and anticipated. Staff and RUCO make a valid argument that the legal expenses incurred during 2005 were higher than normal due to the Company's participation in the El Paso rate case and that such expenses are likely non-recurring in nature. However, the RUCO and Staff recommendations fail to recognize that even after completion of the El Paso case, UNS incurred legal expenses of more than $400,000 in 2006 and is expected to do so again in 2007, legal expenses of in each year. Thus, even if 2005 is removed as an anomaly, actual legal expenses for 2004 and 2006 and projected legal expenses for 2007 produce an average of slightly more than $400,000 per year. We therefore believe it is reasonable, based on the record, to allow legal expenses of $400,000 to UNS in this case.

Rate Case Expense

UNS initially requested inclusion of $600,000 for rate case expense, amortized over three years. However, in his rebuttal testimony, Mr. Dukes amended the request to $900,000, amortized over three years, based on the Company's claim that UNS had already incurred almost $800,000 in costs related to pursuing its rate case (Ex. A-13 at 34-35). UNS contends that the proposals offered by Staff and RUCO ($255,000 and $251,000, respectively), which are based primarily on comparisons to the recent Southwest Gas rate case (Decision No. 68487), are deficient because they fail to recognize that Southwest Gas used internal personnel and support services, internal costs that are built into Southwest Gas' rate base. In comparison, UNS does not have in-house legal or rate departments, but instead relies heavily on the rate and legal personnel of Tucson Electric Power Company ("TEP") to prosecute its rate cases. Mr. Dukes testified that an allocation from TEP for such costs ensures that TEP customers do not subsidize UNS operations (*Id.*; Ex. A-14 at 9-11). Mr. Dukes added that UNS Gas received more than twice as many data requests as did Southwest Gas (Tr. at 632).

RUCO witness Moore stated that RUCO's recommendation in this case is appropriate based on a comparison to the recent Southwest Gas rate case, in which the approved rates included an allowance for $235,000 allocated over three years (RUCO Ex. 3 at 25-26). RUCO contends that the UNS case shares similar characteristics with the Southwest Gas case in that both companies extensively used in-house staff, both companies requested approval of a decoupling mechanism and PGA revisions, and both cases covered a comparable number of hearing days (*Id.*; Tr. at 655). RUCO therefore recommends a rate case expense allowance of $251,000, amortized over three years.

As indicated above, Staff recommends a rate case expense allowance of $255,000, amortized over three years, based on Staff's view that the Southwest Gas case raised many of the same issues addressed in this proceeding. Staff witness Ralph Smith disputed the rationale offered by UNS for its proposed rate case expense. Mr. Smith stated that although this may be the first rate case for this gas company under its current ownership, the Company had a number of prior periodic rate cases when it was owned by Citizens Utilities. He contends that the transfer of ownership to UNS should not be used as a basis for imposing "excessive" rate case costs (Ex. S-27 at 42-43). Mr. Smith also testified that because the UNS rate case presents many issues that are similar to those considered in the Southwest Gas case (such as a proposed decoupling mechanism and revisions to the PGA), the rate case expense allowed in that case is a useful benchmark for the UNS case (*Id.*). On cross-examination, Mr. Smith also expressed a concern with the overall allocation methodology used by TEP for UNS expenses. He testified that the direct allocation methodology used by TEP may result in a double recovery, to the extent that the same personnel are used for different companies, because "it could potentially result in loading a disproportionate amount of their cost onto each utility to their rate case they are working on" (Tr. at 896-97). He conceded that the Commission should allow an appropriate level of rate case costs, but indicated that "this is a potential cost here that can get totally out of control if some limits aren't placed on it" (Tr. at 898).

We agree with Staff and RUCO that the Company's proposed rate case expense of $900,000 is excessive and should be reduced significantly. As both Staff and RUCO suggest, the recent Southwest Gas case presented many of the same issues that were raised in this case, and the Southwest Gas case is an appropriate measure of comparison for UNS. In response to the Company's claim that Southwest Gas employed a different method of allocating such costs, and was therefore not comparable to UNS, Staff witness Smith pointed out potential problems with the method used by TEP to allocate costs such as rate case expense. We believe that proposed rate case expense of $900,000 is excessive when compared with similar rate case expense allowances in a long line of cases before the Commission. Although Staff and RUCO present strong arguments in support of their recommendations, given that this is the first UNS Gas rate case since the acquisition of the Citizens assets, and that UNS was required to respond to a substantially higher number of data requests than was Southwest Gas, we allow rate case expense of $300,000, amortized over three years.

<u>Customer Call Center Expenses</u>

During the test year, on May 1, 2005, UNS changed its method of responding to customer calls by implementing a consolidated call center operated by TEP, with a level of costs allocated to UNS. RUCO witness Moore stated that prior to May 1, 2005, UNS Gas operated its call center separately, using 6 customer service representatives at a cost of $17,636 per month (RUCO Ex. 3 at 20). After consolidation of the call center, UNS began to incur allocated costs of $76,227 per month (*Id.*). The Company also subsequently closed walk-in customer service offices in Prescott, Cottonwood, Flagstaff, and Show Low, thereby requiring customers in those areas to use "payday loan"[7] stores if they want to pay their bills in person (Tr. at 418).

UNS witness Dallas Dukes stated that the consolidated call center provides a higher level of service to customers and indicated that the prior individualized system would have required a significant investment in new systems to respond to rapid growth in the Company's service area. Mr. Dukes cited a number of benefits of the consolidated operations, including the ability to handle increased call traffic, which has nearly doubled since the prior individual operations were in place; expanded service hours; a credit card payment option; call volume tracking ability; and one number availability for gas and electric customers in Mohave and Santa Cruz counties (Ex. A-13 at 29-30). In response to RUCO's claims that customer complaints have increased since the new call center was put in place, Mr. Dukes stated that the primary driver of the increased call volumes was higher gas costs that flowed through to customers. He reiterated that the former individual office format could not have handled the increased volume of calls and that the old system would have required increased staffing and investment to keep up with service demands (Ex. A-14 at 16).

RUCO witness Moore disagrees with the Company's contention that the consolidated call center provides increased customer service. He claims that in 2004, prior to the call center consolidation, 13 percent of the 178 total complaints against the Company related to customer service; in 2005, when the new call center was introduced, 22 percent of the 172 total complaints related to customer service; and in 2006, 17 percent of the 143 total complaints[8] related to customer service (RUCO Ex. 4 at 11; Tr. at 614-15). Based on this data, RUCO argues that UNS is providing worse customer service under the new call center format, despite a 432 percent increase in costs. Accordingly, RUCO recommends that the Company's customer service costs should be reduced to the level incurred prior to the introduction of the consolidated call center.

We do not believe that the record supports the disallowance sought by RUCO on this issue. RUCO's analysis is based on a simple comparison of complaint data and system costs, but does not

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[7] The payday loan store issue is discussed in detail below. UNS currently retains walk-in company offices in Nogales, Kingman, and Lake Havasu.

[8] Mr. Dukes claims that the Company's records reflect 120 UNS Gas complaints in 2005 and 149 complaints in 2006 (Ex. A-14 at 16).

consider the underlying reasons why consolidation to a modernized call center was necessary. The Company's witness cited a number of advantages associated with the new call center operations and pointed out that RUCO's proposal fails to account for the doubling of call volume since the new system was put in place and does not include recognition of the additional investment that would have been required to update the prior decentralized system of customer service. Although we believe that the consolidated call center costs should be allowed in the Company's expenses in this case, we have ongoing concerns regarding UNS's decision to close a number of local offices and farm out its customer service obligations to payday loan stores, as discussed below.

Miscellaneous "Unnecessary" Expenses

RUCO witness Rodney Moore presented testimony requesting that the Company's test year expenses should be reduced by $233,347 for expenses that were "questionable, inappropriate and/or unnecessary" (RUCO Ex. 3 at 22). Mr. Moore claims that his proposed adjustment is related to payments made to chambers of commerce and non-profit organizations and for donations; club memberships; gifts; awards; extravagant corporate events; advertising, and various meals, lodging and refreshments (*Id.*). He cites a sampling of the 1,995 questionable expenses, which include $1,200 for two people to play in a Flagstaff golf tournament, $5,750 for an employee appreciation dinner, $1,000 for Toys for Tots, $3,058 for the Flagstaff Chamber of Commerce, and $1,246 for a chartered air flight (*Id.* at 23).

In response to RUCO's claims, UNS witness Gary Smith testified that most of the expenses related to travel for "regulatory-mandated functions such as leak surveys, safety audits, and training"; that other expenses included "participation in the annual mandatory Commission Pipeline Safety audit and required operator qualification training, welder qualification training, and emergency response testing"; and that many of the remaining expenses are for "small tools that are necessary for maintaining the pipeline system" (Ex. A-16 at 5-6). UNS argues that Mr. Moore did not respond to Mr. Smith's explanation but, instead, attacked Mr. Dukes' suggestion that RUCO should limit its audit to material items because 90 percent of the challenged expenses are under $200 and 65 percent under $50 (Tr. at 636). The Company asserts that RUCO's demand for a specific explanation of why each claimed expense is reasonable is "profoundly unreasonable," (UNS Initial Brief at 25), because

RUCO did not consider the cost of preparing such a response and could have pursued alternate means of verification during discovery. However, in an attempt to appease RUCO, UNS witness Smith stated in his rejoinder testimony that the Company would agree to a disallowance of $27,968 (Ex. A-17 at 3).

This issue is eerily similar to the position taken by Southwest Gas in its last rate case, wherein its witness attempted to deflect the burden of proving the reasonableness of Southwest Gas's claimed expenses for a number of "small ticket" items including jeep tours, balloon rides, club memberships, charitable donations, sports events, barbecues, flowers, and various food and drinks expenses. In that case, the Southwest Gas witness agreed to exclude what she perceived to be clearly inappropriate miscellaneous expenses, but indicated that many of the expenses were too small for even the company to determine whether they should be included in cost of service. Southwest Gas's witness therefore concluded that RUCO had not presented sufficient evidence to support its proposed disallowance. Here, UNS makes an almost identical argument, claiming that because the costs individually are too small to track, RUCO's recommendation must fail. In the Southwest Gas Decision (Decision No. 68487 at 19-21), we rejected that argument, finding that Southwest Gas had not met its burden of proof. As we stated in Decision No. 68487, "[i]t is curious that Southwest Gas seeks to cast the burden of proving the unreasonableness of expenses on RUCO, especially once RUCO has provided some evidence that certain claimed expenses are inappropriate and which evidence, by the Company's own admission, should result in additional exclusions" (*Id.* at 21).

Consistent with the Southwest Gas Decision, we find that a portion of the claimed expenses in this "miscellaneous" category should be disallowed because UNS failed to meet its burden of proof as to their validity. Recognizing that many of the expenses appear to be legitimate expenses related to training, safety, and maintenance, however, we disallow half of RUCO's proposed disallowance ($233,347 x 50% = $116,674). While it may seem unfair for a utility company to be required to come forward with supporting evidence regarding the reasonableness of even small expenses, when the Company is seeking to place the burden of such expenses exclusively on the backs of its customers, it is required to prove that the expenses were reasonably necessary for the provision of service to those customers. If we were to adopt UNS's rationale regarding these relatively small, miscellaneous expenses, it would be akin to proclaiming the acceptability of the proverbial "death by 1,000 cuts."

Performance Enhancement Program

UNS allows its non-union employees to participate in its parent company's Performance Enhancement Program ("PEP"), which provides eligible employees compensation above their base pay for meeting financial targets (30 percent), cost containment goals (30 percent), and customer service goals (40 percent) (Ex. A-13 at 8-9). Company witness Dukes claims that the PEP is an integral part of its compensation package for employees and that UNS would be required to increase base salaries to attract and retain qualified employees if the program were eliminated (*Id.*).

Staff proposes to adjust the PEP expenses by 50 percent, based on Staff's claim that incentive compensation programs benefit both ratepayers and shareholders. Staff cites to the Southwest Gas Decision to support its position. In that case, the Commission adopted Staff's recommendation to disallow 50 percent of a similar program's costs, based on a finding that the Southwest Gas management incentive program benefited both customers and shareholders. Staff witness Ralph Smith stated that there is no relevant distinction between the UNS and Southwest Gas incentive programs and that the 50/50 sharing of costs is equally appropriate in this case (Ex. S-25 at 29).

RUCO proposes a complete disallowance of the PEP costs, based on its claim that it is not clear that the program is necessary to achieve the PEP's goals. RUCO witness Moore testified that during the test year (2005), no PEP payments were made because UniSource did not meet the program's financial goals. However, the UniSource Board of Directors authorized payment of a Special Recognition Award ("SRA") in 2005 to the employees eligible for the PEP. As a result, UNS is seeking in this proceeding to recover the average of the 2004 PEP payments and the 2005 SRA costs. Mr. Moore contends that the SRA is unique and does not meet the criteria of a typical and recurring test year expense for which rate recovery should be granted (RUCO Ex. 3 at 16-17). He also stated that 60 percent of the PEP payments are related to financial performance and cost containment, which are goals that primarily benefit shareholders. Finally, Mr. Moore asserts that because the PEP does not apply to 60 percent of its employees (*i.e.*, union employees), it is not clear that the program is necessary or will achieve the stated goals (*Id.*; RUCO Ex. 4 at 8).

We believe that Staff's recommendation provides a reasonable balancing of the interests between ratepayers and shareholders by requiring each group to bear half the cost of the incentive program. As RUCO points out, the program is comprised of elements that relate to the parent company's financial performance and cost containment goals, matters that primarily benefit shareholders. However, 40 percent of the program's incentive compensation is based on meeting customer service goals. This offers the opportunity for the Company's customers to benefit from improved performance in that area. For the same reasons, we also adopt Staff's recommendation to disallow 50 percent of the Officer's Long-Term Incentive Program (Ex. S-25 at 26).

Although we believe, on balance, that the 50/50 sharing is reasonable, we share RUCO's concerns that the SRA offered to employees in 2005 may have the effect of undermining the very goals the PEP is intended to achieve (*i.e.*, providing an incentive for participating employees to improve performance and thereby benefit both the Company and its customers). As described by Mr. Moore, despite failing to meet the PEP goals, the UniSource Board of Directors decided nonetheless to provide the affected employees with a surrogate means of compensation. It appears that the SRA sends a signal to employees that they will be compensated regardless of performance, which places the entire premise of the PEP at issue. We expect the program to be scrutinized in the Company's next rate case to determine the appropriateness of providing incentive compensation above base salaries to employees.

<u>Supplemental Executive Retirement Plan</u>

UNS Gas allows select executives to participate in a Supplemental Executive Retirement Plan ("SERP"). The SERP provides to eligible executives retirement benefits in excess of the limits allowed under Internal Revenue Service ("IRS") regulations for salaries in excess of specified amounts. UNS contends that the SERP costs are reasonable and that neither Staff nor RUCO have shown that the Company's overall executive compensation costs are excessive or out of line with industry standards.

Staff and RUCO recommend disallowance of the SERP costs ($93,075), in accordance with the Commission's Decision in the Southwest Gas case (Decision No. 68487, at 18-19). In that case, we disallowed Southwest Gas's SERP costs, finding:

> [T]he provision of additional compensation to Southwest Gas' highest paid employees to remedy a perceived deficiency in retirement benefits relative to the Company's other employees is not a reasonable expense that should be recovered in rates. Without the SERP, the Company's officers still enjoy the same retirement benefits available to any other Southwest Gas employee and the attempt to make these executives "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. (*Id.* at 19).

We disagree with the Company's argument that disallowance of the SERP costs effectively allows the IRS to dictate what compensation costs should be recovered. As was clearly stated in the passage cited above, the issue is not whether UNS may provide compensation to select executives in excess of the retirement limits allowed by the IRS, but whether ratepayers should be saddled with costs of executive benefits 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. We see no reason to depart from the rationale on this issue in the most recent Southwest Gas rate case,[9] and we therefore adopt the recommendations of Staff and RUCO and disallow the requested SERP costs.

More disturbing than the Company's advocacy on the relative merits of the SERP is the statement in its initial brief that "[h]ad UNS Gas been notified that SERP costs would not be allowed, it could have restructured its executive compensation package to take that into account. It would not be fair to hold UNS Gas to this new, unexpected standard." (UNS Initial Brief at 28.) Implicit in the Company's argument is the concept that "if we don't recover fully what we believe are our reasonable costs in our preferred manner, we'll simply shift those costs to another account to disguise the costs and ultimately ensure recovery." The approach to rate recovery seemingly advocated by UNS can serve only to increase the cynicism often expressed by ratepayers regarding the reasonableness of a given utility company's proposed rates and, if allowed, would at its essence turn the ratemaking process into a veritable regulatory version of "Three-Card Monte." We trust that in

[9] *See also Arizona Public Service Co.*, Decision No. 69663, at 27 (June 28, 2007), wherein SERP costs were excluded in their entirety.

future rate applications, Staff and RUCO will explore thoroughly the merits of individual expenses sought by UNS, as well as other companies, to ensure that customers are paying rates that include only the costs necessary to provide quality service.

Fleet Fuel Expense

UNS witness Dukes proposed that the Company's fleet fuel expense be established based on an average gasoline cost of $2.48 per gallon (Ex. A-13 at 19). Mr. Dukes stated that the average fuel price used by UNS reflects the Company's actual costs and that lower cost recommendations made by Staff and RUCO should be rejected. He testified that it is not surprising that UNS would have slightly higher fuel costs than some other utilities because the UNS Gas service area is farther from large metropolitan areas like Phoenix and Tucson and covers a larger number of square miles given its more rural location (*Id.*). In response to a proposed disallowance made by Staff witness Ralph Smith, Mr. Dukes reduced the Company's request by $12,657 (pre-tax) (*Id.* at 23-24).

In his surrebuttal testimony, Staff witness Smith agreed with Mr. Dukes' proposed reduction to fleet fuel expense (Ex. S-27 at 39). Although Staff appears to have reconciled its recommendation with the Company on this issue, UNS's brief continues to advocate rejection of Staff's position (UNS Initial Brief at 29-30). We assume that the Company failed to notice Mr. Smith's surrebuttal testimony agreeing with Mr. Dukes' rebuttal testimony, and we believe that there is no remaining dispute between UNS and Staff.

RUCO agrees that it is appropriate for UNS to annualize its fuel expense to reflect additional employees included in its payroll annualization adjustment. However, RUCO witness Diaz Cortez stated that because gasoline prices were abnormally high in early 2006, the Company's calculation inflated the annualized level of fuel expenses (RUCO Ex. 5 at 14-15). Instead of the proposal to base fuel expenses on an average of $2.48, RUCO recommends using $2.43 per gallon as the average cost (*Id.* at Sched. MDC-3). In addition, RUCO claims that UNS understated the actual miles per gallon (10.28 mpg) achieved by the UNS fleet (*Id.* at 15). On cross-examination, Mr. Dukes admitted that the Company did not respond to the second part of RUCO's recommendation (*i.e.*, the UNS fleet miles per gallon) (Tr. at 241-42). Nor did UNS address the miles per gallon issue in its brief.

We find that the Company has adequately supported the use of $2.48 per gallon as the basis for determining its fleet fuel costs in this proceeding. However, as Ms. Diaz Cortez pointed out, UNS did not respond to the second part of the RUCO recommendation dealing with fleet miles per gallon. We will therefore adopt RUCO's proposal to use the actual 2005 fleet miles per gallon as set forth in Ms. Diaz Cortez's schedules, adjusted by the inclusion of the $2.48 per gallon gasoline price recommended by UNS and Staff.

Bad Debt Expense

In its initial brief, UNS states that although the Company and Staff are in agreement as to the appropriate level of bad debt expense, RUCO's proposal to disallow $100,000 is based on a mismatch and should be rejected (UNS Initial Brief at 29). Ms. Diaz Cortez agreed in her surrebuttal testimony that "the numerator and the denominator of the bad debt ratio would have to be adjusted to remove the NSP and Griffith Plant" (RUCO Ex. 6 at 13). It appears that UNS failed to recognize RUCO's surrebuttal testimony on this issue and, as a result, continues to advocate rejection of a position RUCO conceded before the commencement of the hearing. Since there is no remaining disputed issue, we adopt the Company's recommendation on this issue.

Postage Expense

UNS proposed inclusion in operating expenses of $529,380 for postage costs, based on a two-year average (2005 and 2006) and including acknowledgement of a postal increase that became effective May 14, 2007 (from $.39 to $.41) (Ex. A-13 at 19-21).

In his surrebuttal testimony, Staff witness Ralph Smith modified an earlier adjustment and agreed with UNS that the postage expense starting point of $445,171 is appropriate, which produces an annualized postage expense of $476,960 to reflect a January 8, 2006 postage increase as well as customer growth that occurred during the test year. In addition, Mr. Smith agreed that the May 14, 2007, increase should be recognized, resulting in an overall postage allowance of $503,356 (Ex. S-27, at 39-40). The difference of $26,024 between the UNS and Staff recommendations relates to the Company's proposal to reflect the impact of 2006 postage expense. Mr. Smith stated that customer growth should only be reflected through the 2005 test year because inclusion of customer growth in

2006, without considering the commensurate growth in revenues, would result in an inappropriate mismatch (*Id.*).

RUCO witness Rodney Moore proposed an adjustment comparable to that proposed by Staff (RUCO Ex. 4 at 9). Like that of Staff, RUCO's adjustment is based on the use of historic test year levels, annualized for increases in customer levels and adjusted for known and measurable postal rate increases. As reflected in its final schedules (Final Sched. RLM-9), RUCO's recommendation is for an allowance of $502,018.

It is not clear whether the UNS initial brief recognized the adjustments made by Staff and RUCO in their surrebuttal testimonies, because the UNS brief states that the Staff and RUCO positions should be rejected due to "several errors" (UNS Initial Brief at 30). As described above, both Staff and RUCO eventually agreed with all of the Company's arguments on this issue except one: whether customer growth beyond the test year should be recognized in establishing postage expense. UNS did not address in its reply brief the arguments made in the Staff and RUCO initial briefs, so it is possible the Company is now in agreement with the Staff and RUCO recommendations on this issue. We agree with Staff and RUCO that customer growth should be recognized only through the end of the test year because to do otherwise would result in a clear mismatch between expenses and revenues under the Company's proposal. Although the Staff and RUCO recommendations result in slightly different amounts ($1,338 difference), the reason for the difference is not clear. We therefore adopt Staff's postage expense recommendation of $503,356.

<u>Depreciation and Property Taxes for CWIP</u>

Staff made adjustments to remove the Company's proposed pro forma amounts for depreciation and property taxes related to the request to include CWIP or, alternatively, post-test-year plant (Ex. S-27 at 26). Given our denial of the CWIP and post-test year plant proposals, Staff's adjustments are adopted.

<u>Overtime Payroll Expense</u>

Staff witness Ralph Smith recommended an adjustment to reduce the Company's proposed test year overtime payroll expense by $123,010 (Ex. S-25 at 28). The adjustment relates to Staff's normalization of the overtime payroll expenses (*Id.*). In his Rebuttal testimony, UNS witness Dukes agreed with Staff's proposal, conceding that Staff's recommendation is more reflective of expected overtime levels (Ex. A-13 at 17). Staff's recommendation is adopted.

Payroll Tax Expense

Staff witness Ralph Smith proposed a reduction to the Company's pro forma payroll tax expense by $9,348 to reflect Staff's adjustments to overtime payroll and incentive compensation expenses (Ex. S-27 at 34). Consistent with Staff's recommendations on the overtime payroll and incentive compensation issues, Staff's payroll tax expense adjustment is adopted accordingly.

Property Tax Expense

UNS proposed the use of a property tax rate of 24.5 percent (Ex. A-13, Attach. DJD-1). Both Staff and RUCO recommend setting allowable expenses for property tax based on a rate of 24.0 percent. Staff witness Ralph Smith testified that Staff's recommendation is based on the known and measurable assessment for 2007, pursuant to legislation passed by the Arizona State Legislature that reduces property tax assessments from a rate of 25 percent in 2005 by .5 percent in each successive year until a rate of 20 percent is achieved in 2015 (Ex. S-27 at 35-36). Mr. Smith stated that the Company's proposal fails to recognize the impact of the known tax change. He also indicated that Staff's recommendation is consistent with the recent Southwest Gas rate case (which had a test year ending August 31, 2004), wherein Southwest Gas, Staff, and RUCO agreed that a 24.5 percent assessment for the 2006 rate was appropriate for the calculation of property tax expense (*Id.*). RUCO witness Rodney Moore also proposed use of a 24.0 percent assessment rate for UNS in this case, based on the same rationale described by Mr. Smith (RUCO Ex. 4 at 14).

We agree with Staff and RUCO that the property tax expense allowance in this case should be based on the known and measurable assessment rate currently in effect. The rate for 2007 is currently 24.0 percent, and the rate will continue to decline in subsequent years while the rates established in this case are in effect. The Staff and RUCO recommendations are therefore adopted.

Membership and Industry Association Dues

UNS initially included $41,854 for dues paid to the American Gas Association ("AGA"). In his direct testimony, RUCO witness Moore recommended a partial disallowance of $1,523 of the

AGA dues based on an AGA/NARUC[10] Oversight Committee Report indicating that 1.54 percent of AGA dues are used for marketing and that 2.10 percent of dues are allocated for lobbying activities (RUCO Ex. 3 at 26-29). In his Rebuttal testimony, UNS witness Dukes agreed with Mr. Moore's proposed adjustment and revised the Company's proposed expenses in accordance with RUCO's recommendation (Ex. A-13, at 18-19).

Staff witness Ralph Smith recommended a larger percentage disallowance of the AGA dues and also proposed eliminating dues paid by the Company to a number of other organizations (primarily for dues to a number of local Chambers of Commerce within the UNS service area) (Ex. S-27 at 37-39; Sched. C-14). Mr. Smith stated that Staff's more aggressive disallowance proposal is based on language in the Southwest Gas Order, (Decision No. 68487, at 14), which admonished Southwest Gas in its next rate case to "provide a clearer picture of AGA functions and how the AGA's activities provide specific benefits to the Company and its Arizona Ratepayers." Mr. Smith acknowledged that the Southwest Gas Order disallowed only the marketing and lobbying portions of the AGA dues (3.64 percent), consistent with RUCO's recommendation in this proceeding. However, he believes UNS should have been on notice to provide additional details regarding AGA activities, which the Company failed to supply. Mr. Smith based his 40 percent disallowance on 1999 and 2000 NARUC audit reports of AGA expenditures (which appear to indicate that approximately 40 percent of AGA dues are used for marketing and lobbying efforts) and on a decision issued by the Florida Public Service Commission disallowing 40 percent of AGA dues from expenses (Ex. S-25 at 34-37, Sched. RCS-3; Ex. S-27 at 37-39).

Mr. Smith raises a valid point regarding the nature of AGA dues and whether a higher percentage of such dues should be disallowed as related to activities that are not necessary for the provision of service to UNS customers. However, we believe it is reasonable, in this case, to allow $40,331 ($41,854 - $1,523), in accordance with RUCO's recommendation. As we indicated in the Southwest Gas Order, however, we expect UNS in its next rate case to provide more detailed support

[10] National Association of Regulatory Commissioners

for allowance of AGA dues and how the AGA's activities benefit the Company's customers aside from marketing and lobbying efforts.

With respect to Mr. Smith's proposal to disallow a number of smaller dues to Chambers of Commerce and similar organizations, we believe these types of expenses are encompassed within RUCO's recommendation regarding so-called "unnecessary" expenses, which are addressed in a prior section of this Order. Given that we disallowed 50 percent of those expenses, it is likely that an additional disallowance under Staff's recommendation would represent a double counting of the types of expenses identified by RUCO. We therefore decline to adopt Staff's recommendation on this issue.

Interest Synchronization

There does not appear to be any dispute that an interest synchronization adjustment is necessary to coordinate the income tax calculation with rate base and cost of capital. As set forth in Staff witness Ralph Smith's testimony, this adjustment decreases income tax expense and increases the Company's achieved operating income by a similar amount (Ex. S-27, Attach. RCS-2S, Sched. C-17).

CARES Related Amortization

Staff recommended that UNS cease deferral of costs related to the Customer Assistance Residential Energy Support ("CARES") program upon approval of the new rates established in this case. According to Staff witness Ralph Smith, Staff has recognized CARES program discounts in Staff's proposed rate design, and Staff recognizes UNS has accumulated some deferred costs related to the program (Ex. S-27 at 44). Based on Staff witness McNeely-Kirwan's recommendation regarding the ratemaking treatment for the accumulated deferred CARES costs, Mr. Smith reduced operating expenses by $441,511 (*Id.*, Sched. C-20). Given our adoption of staff's recommendation regarding the CARES program (see discussion below), Staff's proposed adjustment to operating income is appropriate.

Nonrecurring Severance Payment

Staff witness Ralph Smith initially proposed an adjustment to remove a nonrecurring severance payment for an employee who was dismissed in 2004, but whose severance payment was made in 2005 (Ex. S-25 at 27-28). UNS witness Dukes opposed Staff's recommendation, stating in his rebuttal testimony that because there was never an offsetting expense for this payment posted to the Company's books in 2005, payroll expense was understated by approximately $52,000 (Ex. A-13 at 15). In his surrebuttal testimony, Mr. Smith stated that Staff's prior adjustment was unnecessary because the item "was effectively adjusted to zero in the UNS Gas filing" (Ex. S-27 at 33).

In its Initial Brief, Staff contends that it disagrees with the attempt by Mr. Dukes "to revise its filing to add this nonrecurring severance expense back twice" (Staff Initial Brief at 15). UNS did not address this issue in either of its Briefs, but it appears from reading Mr. Smith's testimony that the issue was resolved prior to the hearing, considering Mr. Smith's statement that the prior Staff adjustment was unnecessary.

Nonrecurring Union Training

RUCO witness Moore recommended disallowance of $2,584 related to M.A.R.C. (Union) Training that, according to Mr. Moore, UNS had described as "a one-time only instructional session to acquaint Company personnel with working in a unionized environment" (RUCO Ex. 4 at 16). Mr. Moore claims that the expense is nonrecurring and should therefore be disallowed (*Id.*).

UNS witness Gary Smith stated that while the M.A.R.C. training was a one-time event, training is an ongoing activity that is required to comply with regulatory mandates. He claims that, since the end of the test year, another mandatory training program has been established for gas distribution companies to provide training to both the public and employees (Ex. A-17, at 4). The Company therefore requests that RUCO's recommendation be rejected. On cross-examination, Mr. Smith admitted that the M.A.R.C. training was a one-time event and that RUCO had not proposed to disallow any other training expenses incurred by the Company (Tr. at 416-17).

We agree with RUCO that the specific expense item identified by Mr. Moore is related to a one-time training cost that will not occur in the future. No other training costs are recommended for disallowance, and although the Company may face increasing training costs in the future, those costs will be addressed in a future rate case where all relevant test year revenues and expenses will be evaluated for inclusion in rates. We therefore adopt RUCO's recommendation on this issue.

New Depreciation Rates

Staff witness Ralph Smith indicated that Staff is in agreement with the Company's proposed new depreciation rates (Ex. S-25 at 63). However, Mr. Smith recommended that each of the new depreciation rates proposed by UNS should be clearly broken out by a service life and a net salvage rate. He indicated that this would allow the depreciation expense related to the inclusion of estimated future cost of removal in depreciation rates to be tracked and accounted for by plant account (*Id.*). There does not appear to be a dispute regarding the new depreciation rates to be employed by UNS. Further, the Company did not oppose Mr. Smith's suggestions for separating the depreciation rates for service life and net salvage. Staff's recommendation is therefore adopted.

Net Operating Income

Consistent with the foregoing discussion, we will allow adjusted test year operating expenses of $37,652,416, which based on test year revenues of $47,273,923, results in test year adjusted operating income of $9,621,507, a 5.30 percent rate of return on FVRB.

COST OF CAPITAL

UNS Gas recommends that the Commission determine the Company's cost of common equity to be 11.0 percent, with an overall weighted cost of capital recommendation of 8.80 percent. Staff recommends a cost of common equity of 10.0 percent, with an overall weighted cost of capital determination of 8.12 percent. RUCO proposes adoption of a cost of common equity of 9.84 percent, with an overall weighted cost of capital of 8.22 percent (RUCO Ex. 8 at 2).

Capital Structure

At the end of the test year, UNS had a capital structure consisting of 55.33 percent long-term debt and 44.67 percent equity (Ex. A-27 at 8). UNS proposes using a hypothetical capital structure of 50 percent debt and 50 percent equity because it is striving to increase its equity ratio to 50 percent and believes that the rates set in this case should reflect the capital structure that would exist when the rates set in this case are in effect (Tr. 964).

According to UNS witness Kentton Grant, "it is reasonable for the Company to target a higher common equity ratio due to the Company's small size, large capital spending needs and limited borrowing capacity" (Ex. A-27 at 8-9). He claims that UNS forecasts achieving a 50 percent equity ratio by the end of 2008 (*Id.*). In support of the Company's improving equity ratio, Mr. Grant points out that UNS Gas has improved its equity ratio from 33 percent in August of 2003 to 45 percent at the end of 2005. He stated that this improvement has been achieved by UNS Gas's retaining 100 percent of its annual earnings and through additional equity investments from its parent, UniSource Energy. Mr. Grant testified that despite the absence of any dividends being paid by UNS to UniSource over the past several years, UniSource has invested an additional $16 million of equity capital in UNS Gas (*Id.*).

UNS cites to the most recent Southwest Gas Order to support its request for employing a hypothetical capital structure (Decision No. 68487, at 23-25). In that case, the Commission agreed with Staff's request to use a hypothetical capital structure of 40 percent equity, but rejected Southwest Gas' request to use 42 percent equity in the capital structure. During the test year in that case, Southwest Gas had an average actual capital structure of 34.5 percent equity, 5.3 percent preferred stock, and 60.2 percent long-term debt (*Id.* at 23). In this case, Mr. Grant indicated that using the Company's recommended hypothetical capital structure would help alleviate the current weakness in earnings and cash flow in order to offset the negative credit impact of weak cash flows (*Id.* at 10).

RUCO supports the Company's request to use a 50/50 hypothetical capital structure to establish UNS's cost of capital in this proceeding. RUCO witness William Rigsby stated that UNS's capital structure is more heavily weighted with debt than the average of the companies used in his comparable company analysis. He also indicated that the other local gas distribution companies ("LDCs") in his sample group had an average of 48 percent debt and 52 percent equity, compared to UNS at approximately 55 percent and 45 percent, respectively (RUCO Ex. 7 at 43). As a result, Mr. Rigsby suggested, the LDCs in his proxy group would have a lower level of financial risk compared to UNS. As discussed below, Mr. Rigsby did not make an adjustment to his cost of equity analysis to account for a higher level of financial risk but, instead, testified that his hypothetical capital structure recommendation gives recognition to this higher risk (*Id.* at 44).

Although UNS and RUCO are in agreement on the employment of a 50/50 capital structure, Staff contends that a hypothetical capital structure is not appropriate in this case. Staff witness David

Parcell testified that both UNS Gas and UNS Electric currently have higher equity ratios than either TEP or UniSource Energy, and the actual UNS equity ratio is comparable to those of other electric and combination gas and electric utilities (Ex. S-36 at 19-20). Mr. Parcell stated that using a hypothetical capital structure would have the effect of "increasing the actual return on equity to a level exceeding that intentionally approved by the Commission" (*Id.* at 20). According to Mr. Parcell, adopting the Company's proposed 50/50 capital structure would have the net effect of increasing the actual authorized return on equity by 50 basis points, or 0.50 percent (*Id.* at 21).

With respect to the Commission's use of hypothetical capital structures in prior cases, Staff argues that the circumstances are different for UNS. Staff cites to a recent Arizona-American Water Company (Mohave) case in which the Commission adopted a hypothetical capital structure of 40 percent equity and 60 percent debt, although the company's actual structure consisted of 37.2 percent equity and 62.8 percent debt (Decision No. 69440, at 13). Staff asserts that the Commission's Decision in that case was based on its concern that Arizona-American was more highly leveraged than its comparable companies. According to Staff, UNS's capital structure is in line with other comparable companies, so no similar concern exists. Staff contends that the same reasoning holds true with respect to Southwest Gas, which had a highly leveraged capital structure, with more than 60 percent long-term debt during the test year. Staff argues that a hypothetical capital structure should be employed only where a company's actual capital structure is out of line with comparable companies, or where the actual capital structure contains higher cost equity capital, which would be unduly expensive to ratepayers.

Although we understand and appreciate Staff's concerns, we believe the hypothetical capital structure recommendation recommended by UNS and RUCO is reasonable in this case. We believe the Company's efforts to improve its equity ratio over the past several years, through retained earnings and additional equity investment by its parent, should be recognized and encouraged. As indicated by UNS witness Grant, the Company's equity ratio has improved steadily since 2003, and UNS anticipates achieving a 50 percent equity ratio by the end of 2008.

While we recognize that, from a capital structure standpoint, UNS is situated differently from Southwest Gas, we believe it is necessary to express the same concern that was indicated in the

Southwest Gas case regarding ongoing use of a hypothetical capital structure for establishing a company's cost of capital and the rates that flow from that determination. As stated therein, "[a]t some point, we must send Southwest Gas a signal that it must improve its capital structure up to the hypothetical level that has been employed for many years or it must live with the results of its actual capital structure" (Decision No. 68487, at 25). Given the historical and anticipated progress of UNS in improving its equity ratio, we believe it is likely that use of the Company's actual capital structure in future cases would produce a reasonable cost of capital result. In this case, however, we find that the record supports use of the Company's 50/50 capital structure.

Cost of Debt

All parties in the case agreed that the Company's cost of debt was 6.60 percent during the test year. Since there is no dispute regarding this issue, we will adopt a cost of debt of 6.60 percent for purposes of establishing UNS Gas's weighted cost of capital in this proceeding.

Cost of Common Equity

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

UNS Gas

UNS witness Kentton Grant based his common equity cost recommendation of 11.0 percent on the results of his common equity models, namely the Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM"). Mr. Grant also examined the risk profile of UNS Gas relative to a comparable company group to determine a point in the range produced by those models. The estimated cost of equity produced by this analysis was then compared to the allowed returns for other LDCs in the United States to confirm the reasonableness of the Company's estimate. As a final matter, Mr. Grant examined the financial impact of the recommended return on equity ("ROE") and the overall rate request to assess the Company's ability to attract capital on reasonable terms (Ex. A-27 at 10-11).

Mr. Grant claims that it was appropriate to use a comparable group of LDCs in his analysis because the cost of equity capital for UNS Gas's parent company, UniSource Energy, which is heavily weighted toward the electric industry, may not be representative of the cost of equity capital for UNS Gas. Mr. Grant's comparable group was based on all 16 LDCs evaluated by *Value Line Investment Survey* ("*Value Line*"), from which 11 companies were selected based on several criteria that Mr. Grant believes make them comparable to UNS Gas (*Id.* at 12).

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

According to Mr. Grant, an annual long-term growth rate of 6 percent represents a reasonable estimate of investor expectations for earnings and dividends, which he claims is consistent with the 6.1 percent median growth rate in earnings per share ("EPS") for his comparable company group published by *Value Line*, as well as a five-year estimate of EPS growth reported by *Thomson Financial* of 5.6 percent for the gas utility industry and 6.4 percent for the broader utilities sector (*Id.* at 16). Based on his application of a multi-stage DCF model, the estimated cost of equity for the sample companies produced a range of 9.1 percent to 10.5 percent, with a median value of 9.9 percent (*Id.* at 18).

Mr. Grant stated that use of the CAPM is premised on the concept that capital markets are highly efficient and that investors attempt to optimize their risk/return profiles through diversification. He indicated that the CAPM assumes that risk is comprised of systematic risk (which is unavoidable) and unsystematic risk (which is company-specific and can theoretically be eliminated through portfolio diversification). As a result, Mr. Grant explained that the CAPM is based on the theory that investors should be compensated only for systematic risk (*Id.*). Applying the CAPM produced a result of 9.9 percent to 11.0 percent. Based on his comparison of the DCF and CAPM results, Mr. Grant selected a range of 9.5 percent to 11.0 percent as the Company's estimate of the cost of equity for the comparable company group (*Id.* at 20).

The next step in the Company's analysis was to determine the appropriate return on equity ("ROE") in this proceeding for UNS Gas, based on a comparison of the "risk profiles" of UNS and the comparable companies. Mr. Grant asserts that an equity investment in UNS Gas is "decidedly riskier" than an equity investment in the comparable companies due to several factors, including UNS Gas's smaller size, a higher growth rate in net plant investment, the lack of a decoupling mechanism, and lower credit ratings for UNS Gas than for most of the comparable companies. Based on these relative risk factors, Mr. Grant proposes that the ROE for UNS Gas be set at the top of the range for comparable companies and that the Commission award a ROE of 11.0 percent in this proceeding (*Id.* at 21-23).

UNS is critical of the ROE recommendations of both Staff and RUCO based on the Company's claim that Staff and RUCO's use of a geometric means in calculating the market risk premium of their CAPM models is contrary to sound financial theories. UNS argues that an arithmetic means is supported by academics and financial professionals. The Company also contends that RUCO's analysis placed too much emphasis on near-term analyst growth forecasts, a methodology that UNS contends has been rejected by the Commission in two recent cases. UNS is also critical of RUCO's use of a single-stage DCF model, which assumes that company growth rates will continue in perpetuity, and of RUCO's over-reliance on analyst forecasts.

Finally, UNS criticizes Staff's and RUCO's ROE recommendations based on the Company's claim that the results fail a basic test of reasonableness. UNS contends that Staff's (10.0 percent ROE) and RUCO's (9.64 percent ROE)[11] recommendations are below ROEs approved by other state commissions and that UNS Gas bears much greater risk than comparable LDCs due to the factors cited in Mr. Grant's testimony (UNS Initial Brief at 37-38). Based on the Company's higher risk assertion, it claims, it must be awarded a higher ROE commensurate with that risk.

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[11] UNS apparently failed to observe that RUCO made an upward adjustment in its ROE recommendation (to 9.84 percent) through Mr. Rigsby's surrebuttal testimony filed on April 4, 2007 (RUCO Ex. 8, at 2).

RUCO

RUCO witness William Rigsby proposes adoption of a ROE of 9.84 percent based on his analysis using DCF and CAPM methodologies (RUCO Ex. 8 at 2). As noted above, Mr. Rigsby employed a single-stage DCF analysis, as opposed to the multi-stage version used by UNS. RUCO contends that Mr. Rigsby's DCF analysis is appropriate because it takes into consideration both short-term and long-term growth projections that are specific to the LDCs used in Mr. Rigsby's proxy group (RUCO Ex. 7 at 46).

RUCO is critical of Company witness Grant's DCF model, which RUCO claims assumes a long-term growth rate for LDCs that would be comparable to an inflation-adjusted growth rate for all goods and services produced by labor and property in the United States in perpetuity. According to Mr. Rigsby, a valid argument could be made that regulated utility company growth rates may not be comparable to national Gross Domestic Product ("GDP") growth rates, and therefore, the multi-stage DCF advocated by UNS is inappropriate (*Id.*). Mr. Rigsby also stated that the multi-stage DCF used by the FERC requires more weight to be given to short-term growth expectations rather than inflation-adjusted estimates of future GDP growth (RUCO Ex. 8 at 9). Mr. Rigsby pointed out that if the Company's DCF inputs (excluding Cascade Natural Gas – which RUCO claims has a stock price that is affected by a merger proposal) were applied to RUCO's single-stage DCF model, the resulting mean average would be significantly less than even Mr. Rigsby's DCF estimate (RUCO Ex. 7 at 47).

With respect to its CAPM analysis, RUCO asserts that the use of both geometric and arithmetic means of historical returns is more reasonable than the Company's exclusive reliance on arithmetic returns (*Id.* at 28). Similar to the arguments made by Staff (see below), RUCO contends that it is appropriate to use both means in the CAPM analysis, because investors have access to both forms of information regarding historical returns. Mr. Rigsby added that he believes the geometric mean provides "a truer picture of the effects of compounding on the value of an investment when return variability exists" (RUCO Ex. 8 at 12).

RUCO also disagrees with UNS regarding the effect that customer growth should have on the Company's return on equity. Contrary to the Company's claim that high growth presents additional risk that must be reflected through a higher authorized return, RUCO argues that high growth in

Arizona is a positive factor that should be a selling point to UniSource investors. RUCO cites to UniSource's 2005 Annual Report, in which UniSource's Chairman touted the company's customer growth rate in excess of 4 percent as a positive factor (*Id.* at Attach. E). RUCO also notes that a Standard & Poors report attached to Mr. Grant's testimony indicates that high customer growth could produce greater profitability or rate stability for an LDC (Ex. A-28, Attach. KCG-12). RUCO claims that it has not ignored the demand for capital that customer growth places on UNS operations, as reflected by RUCO's support for use of the Company's proposed 50/50 hypothetical capital structure.

Staff

Staff witness David Parcell presented Staff's ROE recommendation in this case. In developing his recommendation, Mr. Parcell utilized DCF, CAPM, and Comparable Earnings Method ("CEM") analyses. He indicated that because UNS Gas is not publicly traded, it is not possible to directly apply cost of equity models. In his analysis, Mr. Parcell employed 2 comparable groups of companies as a proxy for UNS Gas (Ex. S-36, at 21-23). The first sample group was comprised of a group of nine combination gas and electric companies and the second group consisted of the same 11 natural gas companies used by the Company's witness.

Mr. Parcell's DCF analysis produced a range of 9.25 percent to 10.5 percent for the proxy groups' cost of equity. His CAPM model produced a cost of equity range of 9.5 percent to 10.25 percent for the sample groups (*Id.* at 25-28). Mr. Parcell also utilized a CEM analysis, which he described as a method designed to measure the returns expected to be earned on the original cost book value of similar risk companies. According to Mr. Parcell, his CEM analysis was based on market data using market-to-book ratios, and is therefore a market test that should not be subject to criticisms leveled at other analyses that are based on past earned returns. He also claims that the CEM uses prospective returns and is therefore not backward-looking (*Id.* at 31-32). Using the CEM, Mr. Parcell concluded that the cost of equity for the proxy companies is "no more than 10 percent" (*Id.* at 33).

Based on the results of the three methodologies, Mr. Parcell found an overall range of 9.25 percent to 10.5 percent ROE for the proxy companies. He indicated that the range of mid-points for the three methodologies is 9.88 percent to 10.0 percent. Mr. Parcell concluded that the appropriate cost of equity rate for UNS Gas is in the range of 9.5 percent to 10.5 percent. He recommended that the Commission adopt the mid-point of the range (10.0 percent) as the ROE in this case.

With respect to the arguments raised by the Company, Staff asserts that UNS failed to give any weight to its own DCF analysis and relied exclusively on its excessive CAPM results. Staff contends that UNS's CAPM analysis is flawed because it uses a risk-free rate of 5.3 percent, which Staff claims is outdated and exceeds the current level of U.S. Treasury Bond yields, and the Company used an inappropriate equity risk premium of 7.1 percent, which is based exclusively on the arithmetic means of common stock and bond returns from 1926 to 2005.

In response to the Company's criticism of Staff's use of geometric means in its analysis, Staff cites to Mr. Parcell's surrebuttal testimony, wherein he indicated that investors have access to both arithmetic and geometric returns in making investment decisions and that many mutual fund investors rely on geometric returns in evaluating historic and prospective returns of funds (Ex. S-37 at 3). Staff also points to Mr. Parcell's testimony indicating that *Value Line* reports show historic returns based on a geometric or compound growth rate basis (*Id.*).

Conclusion on Cost of Equity

Having considered the testimony, exhibits, and arguments, we believe that Staff's recommended cost of equity capital produces a reasonable result and should be adopted. Staff witness Parcell's proposed 10.0 percent cost of equity provides a reasonable balance between the Company's attempt to place the ROE at the very top of the range produced by the Company's analysis and the results achieved through the methodologies employed by Staff and RUCO.

As noted above, Mr. Parcell's DCF analysis produced a range of 9.25 percent to 10.5 percent for the proxy groups' cost of equity, his CAPM model produced a cost of equity range of 9.5 percent to 10.25 percent for the sample groups, and his CEM analysis produced a result for the proxy companies of no more than 10 percent. Based on his conclusion that UNS Gas has an estimated ROE of 9.5 to 10.5 percent, Mr. Parcell recommended awarding the Company a ROE at the mid-point of the range, or 10.0 percent.

We agree with the Staff and RUCO witnesses that it is appropriate to consider the geometric returns in calculating a comparable company CAPM because to do otherwise would fail to give recognition to the fact that many investors have access to such information for purposes of making investment decisions. Although there continues to be disagreement regarding the risk effect from high customer growth, we believe that high growth has the potential for providing benefits through increased revenues. In any event, our adoption of the hypothetical capital structure proposed by UNS and RUCO gives recognition to the short-term capital needs associated with growth.

Accordingly, we adopt Staff's recommended 10.0 percent ROE in this proceeding for UNS Gas, which results in an overall weighted average cost of capital of 8.30 percent.

	Percentage	Cost	Avg.Weighted Cost
Common Equity	50.0%	10.0%	5.00%
Total Debt	50.0%	6.60%	3.30%
			8.30%

Chaparral City Decision and Fair Value Rate Base

In its application, UNS proposed that the weighted average cost of capital ("WACC") should be applied to its original cost rate base to determine the required operating income in this case (Ex. A-10, Sched. A-1). However, in the rebuttal testimony submitted by UNS witness Pignatelli, the Company suddenly made the claim that its WACC should be applied to FVRB. UNS claims that its change of position was based on its understanding of a recent 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*"). According to Mr. Pignatelli's rebuttal testimony, UNS is not requesting that its change of position result in a revenue requirement finding that would exceed the amount originally requested by the Company (Ex. A-2 at 8).

UNS argues that in the Chaparral City case before the Commission, the Commission adopted Staff's recommendation to calculate the revenue requirement by multiplying OCRB by the cost of capital (Decision No. 68179, at 26-28). UNS claims that only after this exercise was completed did Staff calculate the FVRB for Chaparral City, which resulted in what UNS contends is a "backing-in" approach because the FVRB calculation is a meaningless exercise that flows from the OCRB and cost of capital equation. UNS witness Grant asserted that the approach advocated by Staff in this case is mathematically equivalent to the methodology used in the Chaparral City case and rejected by the Court of Appeals (Ex. A-29, at 13).

In support of its argument, UNS cites 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..." UNS cites several cases[12] in support of its argument that the Commission is required to determine a company's fair value rate base and use that rate base in establishing the company's rates. UNS concedes that its proposal to apply the WACC to FVRB is not the only possible approach to setting rates, but suggests that it is the only approach presented in this case that complies with the Arizona Constitution. The Company claims that other permissible methods may be developed in future cases but, that for now, the UNS methodology is the only available choice for the Commission to apply.

RUCO argues in its brief that application of the WACC to FVRB, rather than to the OCRB initially requested by UNS, could be significant if the Commission adopts any of the positions advocated by Staff or RUCO regarding the Company's rate request. RUCO contends that the Company's change of position was untimely and, for that reason alone, should be rejected. Ms. Diaz Cortez stated in her surrebuttal testimony that, had UNS made its request to apply WACC to FVRB in its original application, RUCO's analysis of the cost of capital would have been entirely different and would likely have produced different results. She indicated that RUCO did not have sufficient time to conduct discovery regarding the change of position between the filing of the Company's rebuttal testimony and the filing of RUCO's surrebuttal testimony, some 13 business days later (RUCO Ex. 6, at 4-5). RUCO also argues that because *Chaparral City* was a Memorandum Decision, it cannot be regarded as precedent or cited. RUCO further asserts, citing Paragraph 17 of the Decision, that the Court confirmed the Commission is not required to apply a WACC to FVRB.

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[12] *U.S. West Communications, Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 246, 34 P.3d 351, 355 (2001); *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956); *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-534, 578 P.2d 612, 614-615 (App. 1979); *Phelps Dodge Corp. v. Arizona Electric Power Co-op*, 207 Ariz. 95, 83 P.3d 573, 586 (App. 2004).

Staff argues that the Company's reliance on the unpublished *Chaparral City* decision is misplaced. Staff points out that the Court of Appeals specifically indicated that the Commission was not required to apply the WACC to FVRB in order to set rates. Staff contends that it is still reviewing the Court's remand order, but the methodology proposed by Mr. Grant would result in an unreasonable and excessive return on equity for UNS. Staff cites to Mr. Parcell's testimony addressing the Company's amended proposal. Mr. Parcell testified that, under UNS's proposal, the link between rate base and capital structure would be broken because the "excess" of fair value rate base over original cost rate base is not financed with investor-supplied funds, and therefore the cost of capital cannot be applied to the fair value rate base because there is no financial link between the two concepts (Ex. S-37 at 8-9). Mr. Parcell's proposed solution is to recognize that the difference between FVRB and OCRB is not financed with investor funds by attributing no cost to the excess between the two. He stated that this recommendation would provide for a return being earned on all investor-supplied funds, which is consistent with sound financial and regulatory standards (*Id.*).

In support of its proposal, Staff cites to decisions rendered in several other states which recognized the problem of applying the cost of capital to fair value rate base[13]. Staff contends that, consistent with the problems identified by Mr. Parcell, application of modern cost of capital models, such as DCF and CAPM, directly to FVRB would create redundancies and double counting. Staff cites the case of *Railroad Commission of Texas v. Entex, Inc.*, 599 S.W.2d 292 (Tx. 1980), in which the Texas Supreme Court discussed the so-called "backing-in" method of determining fair value rate of return. In that case, the court stated that "[i]n a fair value jurisdiction the rate of return multiplied by the rate base usually resulted in a higher return to the book common equity than in an original cost jurisdiction because of the inclusion of the reproduction cost new factor." (*Id.* at 298). In rejecting the "backing-in" argument presented by the utility company, the Texas Supreme Court observed that, in fair value jurisdictions, the return to book common equity is used as a performance indicator by investors, and that fact could not be ignored by blindly applying a rate of return to fair value rate base

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[13] In *Re Harbour Water C*orporation, 2001 WL 170550 (Indiana Utility Regulatory Commission); *Gary-Hobart Water Corp. v. Indiana Utility Regulatory Comm'n*, 591 N.E.2d 649, 653 (Ind. App. 1992); *State of North Carolina ex rel. Utilities Commission et al. v. Duke Power Co.*, 285 N.C. 377, 397, 206 S.E.2d 269, 294 (N.C. 1974); *State of North Carolina ex rel. Utilities Commission et al. v. Virginia Electric and Power*, 285 N.C. 398, 206 S.E.2d 283 (N.C. 1974).

without recognizing the consequences of such a rate of return on the elements of the company's capital structure. The court also stated:

> [T]he fairness of the rate base or the rate of return can be measured by the cash requirements of the utility. All are interdependent and ultimately need to be reconciled....*a return to book common equity which is out of proportion...cannot be ignored since it is more than necessary to attract capital, and therefore, unfair to the ratepayer*. (*Id.* at 299, emphasis added).

Staff argues that, as recognized in the *Entex* case quoted above, the question that must properly be addressed is whether investors expect an additional return in excess of the return resulting from application of the financial models used for calculating the appropriate authorized return. Staff contends that there is no evidence that investors expect such an excess return and that the record supports an opposite conclusion. Staff asserts that the difference between applying the return to OCRB and FVRB would be, in effect, a windfall on unrealized paper profits. Staff claims that Mr. Parcell's proposal to assign no cost to the "excess" between OCRB and FVRB is logical and consistent with investor expectations. Staff argues that, to the extent that investors may expect a return on the so-called paper profits, such a return is already incorporated into the cost of capital models employed by the experts in this case. Staff states that, as an example, forecasted earnings per share and dividends per share would be higher if investors expect a utility's assets to grow in value, and historical EPS and DPS would also incorporate growth between a utility's prior and current rate cases. Staff indicates that it will continue to evaluate how to calculate a fair value rate of return, in accordance with the *Chaparral City* decision, and it is possible that a different mathematical adjustment may be developed in the future. Staff argues that UNS did not present any evidence as to how to adjust the cost of capital models in order to determine an appropriate fair value rate of return and that adopting the Company's request would create excessive returns for UNS.

We find the Company's eleventh-hour proposal to substantially amend its application on this issue to be inappropriate, because it is prejudicial to the other parties. Having prepared discovery based on the original proposal, Staff and RUCO were left with insufficient time to conduct discovery regarding the Company's amended proposal and were therefore prejudiced by having insufficient time to adequately prepare for hearing in this matter. If UNS wished to amend its application regarding a substantial change in the underlying theory of ratemaking upon which it decided to rely, it should have withdrawn its original application and started the entire process over. Based on the procedural deficiencies of the Company's amendment to its application and the prejudicial impact on the opposing parties, its proposal is unreasonable.

UNS attempts to portray its amended proposal as an innocuous placeholder, by claiming that there is no harm due to its willingness to be limited only to the revenue requirement set forth in its original application. However, as RUCO succinctly points out, the underlying premise of the Company's argument is fallacious unless the Commission were to agree with every revenue requirement position advocated by the Company. As discussed above, we have rejected a number of the arguments raised by UNS. As a result, the Company's revised position regarding application of FVRB, if it were adopted, would have a substantial impact on the rates that are established in this Decision.

The purpose of the Company's reliance on the cases it cites is unclear, given that no party disputes the concept that fair value rate base must be determined and applied in setting rates. The cases cited by UNS do not, however, stand for the proposition espoused by the Company (*i.e.*, that the Commission *must* apply the Company's WACC to FVRB to determine just and reasonable rates). In fact, those cases make clear that the Commission, although required to ascertain a company's fair value rate base and use that fair value rate base in determining rates, has broad discretion in how the rate-setting formula should be applied.

Even if we were inclined to consider the Company's proposal, its arguments are premature at best. Through his rebuttal testimony, UNS witness Grant suggests that the Commission must apply the WACC to fair value rate base pursuant to the *Chaparral City* decision (Ex. A-28 at 28). However, Mr. Grant's proposal ignores the explicit language of the Court's decision, which states: "the Commission asserts that it was not bound to use the weighted average cost of capital as the rate of return to be applied to the FVRB. The Commission is correct....[t]he Commission has the discretion to determine the appropriate methodology." (*Chaparral City, supra,* at p. 13, ¶17). Despite this unambiguous explanation, UNS would have us employ the very methodology the Court of Appeals specifically stated the Commission was not required to apply in setting rates.

Aside from the disingenuousness of the Company's argument, the current posture of the *Chaparral City* case is that it has been remanded to the Commission for further consideration. At this point, the Commission has not held hearings on the issue remanded by the Court, and thus no decision has been rendered by the Commission on the issue. Once the Commission issues a subsequent order in the remanded case, the Commission's decision may, or may not, be appealed to the Court of Appeals for a determination of compliance with the Court's remand. Thus, entirely aside from the inappropriateness of citing the unpublished *Chaparral City* decision as precedent, using it as the foundation for requiring a specific methodology in another unrelated case is clearly improper given that the Commission has been given an opportunity to cure the perceived defects in the *Chaparral City* case. Until that case has been decided under the Court's remand order, and the Court of Appeals has determined whether the Commission's Decision on Remand satisfies the Court's prior order, it is premature for UNS (or any other company) to suggest that the Commission must apply a particular methodology, especially a methodology that the Court specifically stated the Commission is not required to adopt.

We also believe that Staff has raised a number of relevant concerns with the Company's attempt to apply the WACC to FVRB without further modification. As Staff points out, there is no logical basis for applying such a methodology because investors have no expectation that they will earn a return on the excess between OCRB, which represents investor supplied funds, and FVRB, which represents unrealized paper profits. If the Company's proposal were to be adopted, the underlying basis of the cost of capital analysis would be called into question and would likely require substantial modification to avoid a result that grants excessive windfall returns to investors at the expense of ratepayers. We note that UNS states in its reply brief that, pursuant to the holding in *Ariz. Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959), the Commission may not consider the argument raised by Staff regarding investor-supplied funds. The *Arizona Water* case is clearly distinguishable from the instant case, however, given the fact that the Court in *Arizona Water* was asked to consider only whether a recent purchase price paid for the utility company could be used by the Commission as the fair value of the utility for setting rates. No such set of facts is presented in this proceeding, and we do not believe the *Arizona Water* holding is applicable to the arguments presented by Staff.

For all of these reasons, we reject the Company's proposal on this issue.

AUTHORIZED INCREASE

Based on our findings herein, we determine that UNS Gas is entitled to a gross revenue increase of $5,257,468.

Fair Value Rate Base	$184,120,761
Adjusted Operating Income	9,621,507
Required Rate of Return	6.97%
Required Operating Income	12,833,217
Operating Income Deficiency	3,211,710
Gross Revenue Conversion Factor	1.6370
Gross Revenue Increase	$5,257,468

RATE DESIGN ISSUES

Customer Charge and Seasonal Rates

UNS Gas

UNS proposes in this case to increase the monthly customer charge for its largest customer class (Residential – R10) from $7 to $20 per month during the "summer" months (April through November) and from the current $7 to $11 per month during the "winter" months (December through March). The Company also proposes to decrease the current commodity rate for the R10 class from the current rate of $0.3004 per therm to $0.1862 per therm.[14]

UNS claims that its proposed rate design is intended to mitigate the cross-subsidization that currently exists between customers in colder climates and customers in warmer climates. According to the Company, it incurs approximately $26 per month in fixed costs to serve a customer, yet the residential customer charge is only $7 per month, with the remaining fixed costs being recovered through volumetric charges. UNS witness Tobin Voge stated that, as an example, a customer in Flagstaff pays substantially more towards the Company's fixed costs (through a higher percentage of volumetric charges) compared to a customer in Lake Havasu (Ex. A-18 at 8, Attach. TVL-1).

[14] Although the $0.1862 rate appears in UNS's original schedules (Ex. A-9, Sched. H-4), and in the Company's post-hearing brief, the Company's Final Schedules reflect a per therm rate proposal of $0.1844.

UNS argues that its proposed rate design would allow the Company to recover more of its fixed costs from all customers and would result in a more equitable policy in an environment of higher gas commodity costs. In support of the Company's position, UNS witness Grant cited a 2006 report from Moody's, which indicated that the volumetric approach to cost recovery is a faulty equation for LDCs that should be rectified through ratemaking (Ex. A-29 at 23). UNS also cites an AGA report, which suggests that, under a traditional volumetric rate design, a gas company's profits and earnings will decline if customers use less gas (Ex. A-37 at 2). The Company contends that it is time to address these alleged inequities through approval of higher monthly service charges and decoupling mechanisms (see discussion below regarding the Company's proposed "Throughput Adjustment Mechanism").

Under the Company's proposal, the monthly customer charge would be increased from $7 to an average of $17 per month (subject to the seasonal differences described above), which UNS claims would enable it to recover approximately 60 percent of its costs incurred in serving a residential customer (Tr. at 512). Because Staff and RUCO oppose the Company's seasonal customer charge proposal, UNS indicated that it is willing to accept a year-round customer charge of $17 (UNS Initial Brief at 46).

UNS asserts that the rate design proposals advocated by Staff and RUCO should be rejected. According to the Company, Staff's recommendation to increase the fixed monthly customer charge to $8.50, and RUCO's proposal to increase the customer charge to no more than $8.13, are an inadequate means of moving rates closer to the Company's cost of service. UNS asserts that its proposal to increase the customer charge by $10 over current levels is not drastic, will not result in "rate shock," and does not violate the principle of "gradualism," given the corresponding request to decrease the commodity charge.

UNS witness D. Bentley Erdwurm addressed the inequities between cold weather and warm weather customers and concluded that substantial cross-subsidization by customers in colder climates exists. He testified that the average customer in Flagstaff currently pays $133 more in annual margin costs than an average customer in Lake Havasu City for the same fixed costs (Ex. A-19 at 10). UNS argues that this inequity is especially unfair because customers in colder areas have little ability to reduce their overall bills due to the need to use natural gas for heating purposes.

With respect to the avoidance of rate shock and compliance with the principle of gradualism, UNS contends that the Staff and RUCO rate design recommendations focus too narrowly on the customer charge and fail to consider the Company's overall rate design proposal. The Company claims that the increase in the customer charge would be offset by the reduction of the commodity charge. UNS also asserts that the concepts of rate shock and gradualism must be balanced against other rate design elements, including rate stability and matching principles.

Finally, UNS argues that its rate design proposal does not eliminate the incentive for customers to conserve (by the proposal to reduce the commodity charge). According to the Company, even if its proposed per therm charge of approximately 18 cents were adopted, when that rate is combined with an estimated PGA charge of 60 cents per therm, the overall volumetric charge would be decreased by approximately 13 percent, which UNS claims is not enough to stifle conservation incentives.

Mr. Magruder

Intervenor Marshall Magruder opposes the Company's request to impose seasonal rates and to collect a higher percentage of rates from customers in warmer climates. Mr. Magruder claims that the Company's proposal would discriminate against customers in warmer areas and he suggests that customers choose whether to live in colder or warmer climates. He also asserts that UNS's proposed rate structure would send the wrong signal by rewarding high usage customers and penalizing low usage customers. He recommends instead that Staff's proposal to increase the customer charge to $8.50 be adopted.

RUCO

RUCO opposes the Company's recommendation to increase the monthly customer charge significantly. RUCO points out that UNS's proposal would shift more revenue to its fixed costs than it is seeking for its entire rate increase. As UNS witness Erdwurm admitted on cross-examination, the Company's entire requested revenue increase is approximately $10 million, yet it is seeking to recover an additional $16.4 million per year through the fixed monthly charge alone. In order to remedy this imbalance, UNS proposes to reduce the commodity charge by approximately $6.4 million (Tr. at 475-76). As a result, higher usage customers would experience a reduction in their bills, while lower usage customers would see a much higher percentage increase.

RUCO contends that some shifting of costs to the customer charge is appropriate and recommends that the current recovery of approximately 26 percent through the monthly fixed charge should be increased to 36 percent (under RUCO's revenue requirement recommendation) (RUCO Ex. 5 at 34). RUCO also disagrees with the Company's seasonal customer charge proposal. RUCO asserts that the justification offered by UNS in support of this proposal (to levelize customer bills) is not appropriate because the Company's customers already have a voluntary means to levelize their bills through an existing billing program. Ms. Diaz Cortez stated that if the Company believes more customers would benefit from levelized billing, it should make a greater effort to publicize the existing program's availability rather than seeking to impose a Commission-mandated seasonal rate design (*Id.* at 30).

<u>Staff</u>

Staff contends that the Company's rate design proposal in this case is designed to shift almost all of the risk of rate recovery to ratepayers and should therefore be rejected. Staff witness Steven Ruback presented Staff's rate design recommendation and stated that the UNS rate design would result in a "staggering" increase in the fixed customer charge for all classes of service (Ex. S-23 at 3). For the residential class, Mr. Ruback indicated, the Company's proposal would result in a customer charge increase of 185 percent in the summer period and 57 percent in the winter period (*Id.*). Mr. Ruback explained that, although the monthly charge increase would be partially offset by a lower volumetric charge, UNS's proposal presents a "serious front end loading problem, a decoupling issue and gradualism problem" (*Id.* at 4). He testified that it is not surprising that UNS would seek to increase the fixed customer charges and that such an approach is a common means that utilities use to lessen the risk of recovery (*Id.* at 6). Mr. Ruback stated UNS's proposal is unusual in that the Company has proposed to recover all of its increase, and some of the volumetric margin, through fixed charges (*Id.*).

According to Mr. Ruback, the Company's proposal represents a step towards a Straight Fixed Variable ("SFV") rate design, a concept employed by the FERC as a means of rationing pipeline design day capacity by price. Mr. Ruback stated that SFV rate design is inappropriate for retail distribution rate design because there is no need to ration retail distribution capacity. He further testified that UNS's rate design proposal "violates the well-established and long-standing regulatory principle that a utility should have a reasonable opportunity, not a guarantee to earn its allowed rate of return" (*Id.* at 9). Mr. Ruback indicated that he is aware of only one LDC, Atlanta Gas Light Company, that is permitted to employ the SFV rate design method to recover its distribution revenue requirement, and that exception to the general rule is mandated by state legislation that precludes the Georgia Public Service Commission from establishing an alternative rate design. Mr. Ruback stated that "other jurisdictions allow for reasonable fixed customer charges and reasonable fixed demand charges, but require that the bulk of the distribution revenue requirement be recovered over throughput" (*i.e.*, volumetric charges) (*Id.* at 10).

According to Staff witness Ralph Smith, Staff's rate design recommendation is based on the consideration of a number of factors, including cost of service; the desire to encourage energy conservation; the need to use gradualism in cases where rates are being charged, so that customers are not burdened with large rate increases; customer equity issues within and between rate classes; efforts to make rates and bills easier for customers to understand; revenue impacts on the Company; and other policy considerations. He stated that given all of these variables, it is understandable that rate design is considered more of an art than a science (Ex. S-26 at 2).

Under Staff's proposed rate design, the fixed monthly customer charge would be increased from $7 to $8.50 for residential customers, with no seasonal difference in the customer charge. Staff's proposed commodity charge for Rate R10 customers would increase to $0.3217 per therm, under Staff's revenue requirement recommendation (*Id.* at 9). Mr. Smith explained that if Staff's recommended revenue requirement and rate design were adopted, a residential customer (R10) using 100 therms of gas would experience a total bill increase from $115.48 to $119.11 (3.14 percent) (*Id.*). Staff asserts that its proposed rate design is reasonable and should be adopted by the Commission.

Conclusion

Although we understand that UNS would like to recover as much of its margin as possible through monthly customer charges, we do not believe it is reasonable to adopt a rate design that would impose a significant increase on customers based on where they live within the Company's service area. Under the Company's recommendation, residential customers with lower usage (*i.e.*, customers typically located in warmer climates) would bear the brunt of the revenue increase due primarily to the dramatic front-loading increase to the fixed monthly customer charge. As set forth in the UNS Final Schedules (based on UNS's proposed revenue requirement), in the "summer" months (April through November), a residential customer (R10) would experience an increase of 146 percent with 5 therms of usage, 118 percent with 10 therms of usage, and 82 percent with 20 therms of usage. During the "winter" months (December through March), the same customer would incur increases of 40 percent with 5 therms of usage, 28 percent with 10 therms of usage, and 13 percent with 20 therms of usage (UNS Final Schedules, Sched. H-4). While higher usage customers may realize lower increases, or even decreases (depending on usage), we do not believe that a dramatic increase imposed on lower usage customers is appropriate in this case. As we stated in the Southwest Gas Decision in rejecting a similar type of rate design proposal, "[such a] rate design would have the effect of encouraging greater usage of natural gas at a time when, by all accounts, an increase in demand for natural gas is coupled with shortages in supply. We do not believe that it is appropriate to send a signal to customers of 'the more you use, the more you save,'" (Decision No. 68487, at 37).

As discussed by Staff's witnesses, movement towards cost-based rates is just one of the many factors that must be considered in designing rates. The goal of moving closer to cost-based rates must be balanced with competing principles such as gradualism, fairness, and encouragement of conservation. Based on the testimony and evidence presented in the record, and considering the arguments raised regarding competing principles of the rate design equation, we believe that Staff's rate design recommendation appropriately makes significant movement towards cost-based rates and provides a reasonable level of protection for the customers who are affected by this base rate increase. Accordingly, we adopt Staff's recommended monthly charges, as set forth in the attachments to Exhibit S-27, with the accompanying commodity charges based on Staff's rate design flowing from the revenue requirement established in this Order.

For a residential customer on Rate R10, the fixed monthly customer charge would increase from $7 to $8.50, and the volumetric charge would increase from $0.3004 to $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 15.6 percent (from $13.01 to $15.04) and an overall monthly increase (including the cost of gas) from $28.70 to $30.73 (7.1 percent). The same customer with typical January consumption (87 therms) would see an increase in base rates of 11.5 percent (from $33.13 to $36.94) and an overall increase (including the cost of gas) from $101.37 to $105.18 (3.8 percent).

Throughput Adjustment Mechanism

UNS Gas

In its application, UNS proposed a Throughput Adjustment Mechanism ("TAM") which would increase or decrease the collection of volumetric revenues to match anticipated levels. The Company claims that the TAM would allow it to implement energy conservation programs without the concern that its revenues would be diminished if the conservation measures were successful. UNS indicated that under its proposed TAM, under-recovery or over-recovery of revenues during any given period would be trued-up in future periods through the use of a volumetric surcharge or credit.

As explained by Company witness Erdwurm, the TAM is a type of decoupling mechanism that has growing support from regulatory and environmental organizations. In his testimony, Mr. Erdwurm stated that organizations such as the Natural Resources Defense Council ("NRDC"), the American Council for an Energy Efficient Economy ("ACE"), and the AGA have expressed support for rate mechanisms that decouple utility retail sales from recovery of fixed costs (Ex. A-19 at 17-18). He claims that a NARUC Resolution encourages state commissions to adopt rate designs that include decoupling mechanisms such as the TAM (*Id.* at 18). The Company also introduced a newsletter issued by the AGA indicating that decoupling mechanisms have been implemented in 10 states (Ex. A-37).

According to UNS, the Company's return is highly dependent on customer usage because of the volumetric nature of its rates. UNS witness Tobin Voge's testimony stated that a warmer than normal winter will cause customer usage, and thus Company revenues, to decline, thereby rendering UNS unable to collect its full fixed costs (Ex. A-18 at 15). On the other hand, during a colder than normal winter, UNS would experience a surge in revenues. The Company contends that the TAM would make customer bills less volatile by evening out wide fluctuations due to weather.

Mr. Voge's testimony indicates that in order to implement the proposed TAM, a base use per customer ("UPC") must first be established. Under the Company's proposal, a separate base would be established for residential, small volume commercial, and small volume public authority customers. The UPCs would be calculated by dividing calendar year therm sales by average number of customers. The difference between the actual and base UPC would then be multiplied by the 2005 base number of customers, and the margin rate for the customer class, to determine the throughput adjustment in dollars (*Id.* at 12-13).

The Company asserts that, by minimizing the impact of weather on customer bills, the TAM would provide a more equitable rate design that ensures that customers do not pay more for the Company's fixed costs than they would under normal weather conditions (Ex. A-19 at 15). UNS also claims that the TAM would encourage conservation by reducing the conflict between conservation efforts and the Company's financial stake in the volumetric revenues associated with usage (Ex. A-18 at 15).

UNS dismisses the validity of RUCO's arguments that the TAM would eliminate the incentive for customers to conserve. The Company argues that, under its proposal, all customers would receive bills with identical TAM adjustments based on cumulative system usage, not personal household consumption. As a result, UNS claims, each individual customer would continue to benefit from conservation efforts because the individual customer's actions would represent only a small portion of the usage data reflected in future TAM adjustments.

UNS also disputes arguments made by Staff and RUCO that the TAM would remove the Company's risk of revenue recovery. The Company claims that the TAM would not alter the ability or inability to recover base rates established in the rate case, and that rising capital expenditure requirements associated with customer growth would continue. UNS also argues that its proposed TAM differs from the "conservation margin tracker" decoupling mechanism that was rejected in the

Southwest Gas case (Decision No. 68487 at 33-34). According to UNS, the TAM differs from the decoupling mechanism proposed by Southwest Gas in the following ways: the TAM would cover all small volume customers, not just residential customers; UNS has provided examples of the calculations needed to implement the TAM; and UNS is willing to consider the creation of a deferred adjustment account (Ex. A-18 at 14). Finally, UNS claims that it has pledged to continue supporting demand-side management ("DSM") programs, regardless of adoption of the TAM. The Company argues, therefore, that it cannot be accused of attempting to use its TAM proposal as leverage for its continued support for DSM.

RUCO

RUCO witness Marylee Diaz Cortez testified regarding the reasons for RUCO's opposition to the proposed TAM. She stated that the TAM would cause customers to pay for a fixed amount of consumption regardless of their actual usage and would remove any risk to the Company associated with revenue recovery (RUCO Ex. 5 at 30-31). Ms. Diaz Cortez testified that variations in consumption are already addressed by the rate case process based on weather normalization of revenues (Tr. at 706).

RUCO argues that it is not appropriate for the Commission to provide a guarantee of a certain stream of revenues because the regulatory process is intended to provide only the opportunity for a company to recover its revenue requirement. Ms. Diaz Cortez stated that UNS already has an exclusive service territory and a captive customer base, giving it a low business risk. She also indicated that the authorized rate of return set by the Commission compensates the Company for any business risk that may exist (RUCO Ex. 5 at 31).

RUCO next argues that approval of the TAM would present a departure from the historic test year concept, which RUCO claims is required under the Commission's rules and the Arizona Constitution. Finally, RUCO contends that Southwest Gas experiences greater decreases in consumption due to conservation than does UNS Gas, yet the Commission previously rejected Southwest Gas' decoupling mechanism proposal. RUCO points out that the Commission expressed concern that the decoupling mechanism proposed by Southwest Gas could have resulted in disincentives for customers to conserve (Decision No. 68287 at 34), and the same concern exists with respect to UNS Gas's proposed TAM.

Mr. Magruder

Mr. Magruder opposes adoption of the Company's proposed TAM for many of the same reasons identified by Staff and RUCO. He argues that UNS should not be insulated from risk and that customers should not have to pay for gas they have not used.

Staff

Staff witness Steven Ruback expressed several concerns with the Company's proposed TAM. Mr. Ruback stated that the TAM is essentially an automatic adjustment clause and that such adjustors traditionally are intended to recover volatile costs that, if left unrecovered, could jeopardize a company's financial health. He indicated three requirements for the types of costs generally allowed to be recovered through adjustor mechanisms: the costs must be large enough to jeopardize the utility's financial health, they must be volatile, and they must be substantially beyond a company's control. He claims that the TAM does not meet these tests because traditional ratemaking has not left UNS in poor financial condition, non-gas costs are not extremely volatile, and non-gas costs are within management's control (Ex. S-23 at 16).

Mr. Ruback also asserts that UNS already has in place two types of revenue decoupling mechanisms - the fixed customer charge, which is independent of throughput, and the PGA, which protects the Company from volatile spikes in the cost of gas (*Id.* at 16-17). At the hearing, Mr. Ruback testified that, in his opinion, "the TAM is overly broad because it compensates for reduced sales from anything – from weather variation, from economic activity, to loss of costs, to high commodity charges." (Tr. at 796). He conceded that it is not just UNS Gas's proposal he dislikes, stating, "I haven't seen a TAM I liked yet." (*Id.*) However, Mr. Ruback contends that adoption of the TAM would represent "piecemeal ratemaking" because there is no commensurate opportunity in the mechanism to consider offsetting adjustments related to cost of service reductions, cost of capital changes, and changes in customer allocation factors (Ex. A-23 at 14).

Finally, Staff points to the Southwest Gas rate case, in which the Commission rejected a similar proposal. Staff acknowledged that the Commission directed Southwest Gas and interested stakeholders to examine further decoupling mechanisms, and Staff indicated that it is willing to engage in discussions outside of this case regarding such mechanisms. However, Staff argues that UNS's proposal should be rejected based on the record in this case.

Conclusion

We do not believe the record supports adoption of UNS Gas's proposed decoupling mechanism in this case. In the Southwest Gas case, we cited a number of concerns with a decoupling mechanism that was similar to the TAM proposed by UNS Gas in this proceeding. We pointed out in the Southwest Gas Order that decoupling mechanisms require "customers [to] provide a guaranteed method of recovering authorized revenues, thereby virtually eliminating the Company's attendant risk." (Decision No. 68487 at 34) We also noted that, under such a mechanism, customers would "be required to pay for gas that they have not used in prior years, a phenomenon that could result in disincentives for such customers to undertake conservation efforts...[and would be] faced with a surcharge for not using 'enough' gas the prior year." (*Id.*) We therefore directed Southwest Gas to find rate design alternatives that truly encourage conservation and to engage in discussions with affected stakeholders to pursue implementation of a decoupling mechanism through the DSM policy process or through a proposal in Southwest Gas's next rate case (*Id.*).

Although the Company attempts to distinguish its TAM from the mechanism rejected in the Southwest Gas case, the differences are insignificant compared to the overall similarities between the proposals. The first difference cited by the Company, that it is willing to apply the TAM to all small volume customers, is not persuasive given Southwest Gas's concession that it was also willing to extend its decoupling mechanism to a broader base of customers (*Id.* at 31). The next difference claimed by UNS is essentially that its proposal provided a greater level of detail, by including examples of calculations that would be used to implement the TAM, than did that of Southwest Gas. As indicated in the passages quoted above, our primary concern with the Southwest Gas proposal was not specifically with the lack of implementation details, but rather with a concept that would provide the utility with a level of risk insulation, while possibly discouraging conservation efforts through imposition of a surcharge on an entire class of customers if that class did not use "enough" gas the preceding year. The final difference claimed by UNS is its offer "to consider the creation of a deferred throughput adjustment account." (Ex. A-18, at 14) Again, the distinction identified by UNS is not substantive in nature but instead provides an alternative means of accounting for the proposed surcharge. The Company's alternative accounting technique does not, however, address the underlying concerns clearly expressed regarding the Southwest Gas decoupling mechanism. We see no reason, based on the record in this proceeding, to depart from our finding in the Southwest Gas Decision regarding a proposed decoupling mechanism.

Having rejected UNS Gas's TAM proposal, we encourage the Company to engage in discussions with other stakeholders affected by this issue; to participate in the ongoing DSM workshops before the Commission; and, if possible, to develop a decoupling mechanism that does not suffer from the types of deficiencies identified by the parties in this case.

Demand-Side Management Programs

UNS Gas

UNS Gas proposes to implement several new DSM programs, including a residential furnace retrofit program, residential new construction home program, commercial HVAC retrofit program, and commercial gas-cooking efficiency program. The Company claims that these four new programs will require funding of $916,616 and that a proposed expansion of its low-income weatherization ("LIW") program will cost an additional $135,000, for a total annual DSM portfolio expense of $1,051,616 (Ex. A-15 at 13-15).

UNS states that it is largely in agreement with Staff's DSM recommendations, specifically with respect to submission of the programs for review by Staff. UNS witness Denise Smith testified that the Company prefers to have the new programs approved in this case so that they may be implemented as soon as possible (Tr. at 518). On May 4, 2007, the Company filed its DSM program proposals in a separate docket for Staff's review (Docket No. G-04204A-07-0274).

Ms. Smith indicated that the Company has agreed to use Staff's recommended Societal Cost Test to determine the effectiveness of the DSM programs, despite her reservations regarding how that test would be applied (Ex. A-21 at 4, 7; Ex. A-22 at 2). However, Ms. Smith stated that the other DSM tests - including the Participant Test, Program Administrator Cost Test, Total Resource Cost Test, and Rate Impact Measure Test - should also be utilized, to provide a full analysis of program effectiveness (Ex. A-21 at 7). Ms. Smith also agreed that the Company would continue to provide semi-annual reports to the Commission, but stated that the Company would seek at a later time to move to an annual reporting requirement (Ex. A-22 at 14).

With respect to calculation of the DSM adjustor mechanism, Ms. Smith indicated that UNS agrees initially to limit recovery to 25 percent of the new program costs ($230,000) and LIW program costs ($113,400), plus the cost of the baseline study that is needed to evaluate thoroughly the effectiveness of the programs ($82,000). The total amount of $425,400 would translate to a DSM adjustor surcharge of $0.0031 per therm, when divided by total test year therms of 138,223,864 (*Id.* at 3).

Mr. Magruder

Mr. Magruder indicates that he is a proponent of DSM programs but believes that additional review of the Company's programs is necessary prior to approval. However, he suggested that all the necessary information regarding the programs should be submitted to Staff as soon as possible so that the programs could be addressed in the Recommended Opinion and Order in this case, to allow the parties an opportunity to comment regarding the findings determined therein. He also suggested that an integration of the UNS Gas and UNS Electric DSM programs could be consolidated in the pending electric rate case for UNS. At the same time, however, Mr. Magruder recommended that UNS Gas's DSM programs should not be funded until after public hearings are held on those programs. He proposed that the Energy Smart Home ("ESH") program should include training of local city/county building inspectors to meet Energy Star requirements, using RESNET personnel. Finally, Mr. Magruder recommended that in-home energy audits should be continued due to their value (Magruder Brief at 38-41).

Staff

Staff witness Julie McNeely-Kirwan presented Staff's position regarding the Company's proposed DSM programs. She recommended that the LIW funding ($113,400) and 25 percent of the new program costs ($229,154) should be included in the initial DSM surcharge, but that UNS Gas's portion of the baseline study costs ($82,000) should not be included in the surcharge initially (Ex. S-

40 at 1-2, 8). Based on this recommendation, Staff calculated an initial DSM surcharge of $0.0025 which it recommends be established in this case (*Id.*).

Ms. McNeely-Kirwan also agreed with UNS that the DSM adjustor reset date should require a filing by April 1 of each year, with an adjustment date of June 1. As indicated above, UNS agreed with Staff's recommendation to require semi-annual DSM reports. In her direct testimony, Ms. McNeely-Kirwan recommended that the Company file a comprehensive DSM portfolio, which UNS has apparently provided through an attachment to Denise Smith's testimony (Ex. A-23), as well as in the separate docket cited above. However, Staff opposes approval of specific programs in this proceeding and recommends approval in a separate docket, consistent with past practice for other companies (Tr. at 1141).

Conclusion

We agree with Staff's recommendation to set the DSM adjustor surcharge at an initial level of $0.0025, which reflects exclusion of the baseline cost study. As indicated in Staff's recommendation, the costs of the baseline study may be included in a subsequent reset of the adjustor once sufficient justification of the allocated costs has been submitted for Staff's review. UNS agreed with Staff's proposal to shift the adjustor filing date to April 1, with an adjustor date of June 1, as well as with Staff's recommendation that semi-annual reports be required for the DSM programs. We also agree with Staff that the appropriate forum for a full review of the specific DSM programs is in the separate docket in which there is an application currently pending. This approach is consistent with that required for other companies, including APS and Southwest Gas (*See, e.g.*, Decision No. 68487, at 61-63).

Low-Income Customer Programs

UNS Gas currently offers several low-income assistance programs. The Customer Assistance Residential Energy Support ("CARES") program (Rate Schedule R12) provides a per therm discount to customers meeting eligibility requirements during the months of November through April. Warm Spirits is an emergency bill assistance program offered to eligible low-income customers. As discussed above, UNS also offers the LIW program, the costs of which would now be recovered through the DSM adjustor mechanism.

UNS Gas states that, in addition to offering these specific programs, it will continue to work with the ACAA on low-income customer issues. The Company contends that it is committed to automatically enrolling customers eligible for the Low-Income Home Energy Assistance Program ("LIHEAP") into the CARES program (Ex. A-16 at 8) and will continue to expand its outreach efforts. Those outreach efforts include distribution of CARES applications to local assistance agencies, public libraries, and municipal buildings and promotion of the program through residential bill inserts (Ex. A-17 at 4). UNS also contends that it is willing to explore opportunities to increase the marketing of low-income programs and to increase LIW funds to low-income agencies.

Miquelle Scheier testified on behalf of ACAA regarding various low-income customer issues, including CARES customers (ACAA Ex. 1). Ms. Scheier opposed the Company's proposal to increase the customer charge for low-income customers; urged the Commission to increase marketing efforts for the R12 tariff; requested the Commission to require automatic enrollment of LIHEAP customers into the CARES program; sought the elimination of payday loan offices as payment centers for cash-paying customers; requested that bill assistance money be increased from $21,500 to $50,000; asked that LIW funding be increased to $200,000, and that $20,000 of that amount be directed to community volunteer weatherization efforts; and requested that the proposal to reduce the due date for bills be denied (*Id.* at 2).

CARES Program

Customers receiving service under the CARES program currently pay the same basic monthly charge of $7 as do other residential customers, but CARES customers receive a per therm discount of $0.15 on the first 100 therms of usage during the months of November through April. As described above in the rate design section of the Order, UNS proposed a seasonal monthly charge increase to $20 from December through March and to $11 from April through November. The Company also proposed to decrease the volumetric charge applicable to all customers. For CARES customers, UNS proposed a year-round customer charge discount of $6.50 per month, along with the reduction of the commodity charge discussed previously. Under the Company's recommendation, CARES customers' fixed monthly charge would increase from $7 to $13.50 from April through November, but would decrease to $4.50 per month from December through March. The same volumetric charges would apply to all residential customers.

The Company claims that its proposal would increase CARES customers' bills modestly, with an increase of $1.12 per month during winter months (assuming100 therms of usage), and $4.21 per month during summer months (assuming 20 therms of usage) (Ex. A-9, Sched. H-4). UNS contends that some higher usage CARES customers may actually see a rate decrease due to the Company's proposed commodity charge reduction.

Staff recommends that the current monthly charge of $7 be retained for CARES customers and that they continue to receive the current $0.15 per therm discount for the first 100 therms of usage during the months of November through April (Ex. S-40 at 2). Staff contends that its recommendation provides a price signal that would encourage conservation by CARES customers during winter months, because usage over 100 therms during those months would incur a substantial increase. Staff witness McNeely-Kirwan stated that the Company's rate design proposal would provide a disincentive for conservation, given UNS's recommendation to decrease the volumetric charge for all therms of usage (*Id.* at 3).

Given our prior rejection of UNS's seasonal customer charge and across-the-board volumetric rate reduction recommendation, the application of the Company's proposal to CARES customers is effectively a moot point. We agree with Staff that keeping the current customer charge in effect for CARES customers, and retaining the current winter volumetric discount for the first 100 therms, will help mitigate the effects of the rate increase approved in this case and will continue to provide a rate structure for the low-income customers enrolled in the program that offers an opportunity to reduce their overall bills through conservation efforts. We therefore adopt Staff's recommendation on this issue.

Warm Spirits Program

Warm Spirits is a program, funded by customer contributions, that provides emergency bill payment assistance to low-income customers. UNS witness Gary Smith testified that UniSource Energy promotes the program through bill inserts and bill messages encouraging customers to contribute to the program (Ex. A-15 at 10-11). The proceeds of the contributions are distributed to local service agencies, which assist qualified low-income customers in paying their bills, most often during the winter heating season. Mr. Smith stated that UNS Gas matches customer donations dollar-for-dollar with funds provided by UniSource shareholders. He indicated that UniSource made a one-time donation of $50,000 to the program in 2004 and that UNS matched $24,000 in donations in 2005. Mr. Smith testified that the Company would continue to match customer contributions on a dollar-for-dollar basis (*Id.*). As indicated above, ACAA proposes that the Commission require UNS to provide funding for Warm Spirits in the amount of $50,000 per year (ACAA Ex. 1 at 2).

The Company originally proposed that the Low-Income Weatherization Program include $21,600 in emergency bill assistance, separately and in addition to that already available through Warm Spirits. The $21,600 would have been part of the UNS Gas DSM portfolio and funded through the DSM adjustor. Staff objected because emergency bill assistance is not DSM and should not be funded as DSM. Staff proposed, and the Company agreed, that the $21,600 be moved into Warm Spirits and funded though base rates. We agree that the $21,600 in additional emergency bill assistance should not be funded through the DSM adjustor and that this amount should be moved into Warm Spirits and funded through base rates.

We believe that the Company's matching contributions to the Warm Spirits program, which currently amount to approximately $20,000 to $25,000 per year, are a reasonable commitment at this time. However, we encourage the Company to continue to promote the existence of the program and the ability for customers to make voluntary contributions.

It is not clear in the record whether UNS Gas currently has a section on customer bill payment stubs that allows customers to check a box to indicate that they would like to make a contribution at the time they write out their payment checks. This issue was raised in the Southwest Gas case, wherein we directed Southwest Gas to modify its billing statements to allow voluntary contributions (Decision No, 68487, at 59-60). In that Order, we pointed out that a contribution line is offered to APS customers and that "inclusion of a line on customer bills is preferable to [relying solely] on a bill insert, which may be discarded when customers open their bills." (*Id.* at 60) Therefore, if UNS Gas does not currently have in place a bill statement contribution option, it shall implement the change within 60 days of the effective date of this Decision.

Payments at Payday Loan Stores

In 2006, UNS closed local offices in Prescott, Cottonwood, Flagstaff, and Show Low[15] (Tr. at 434-35). 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 (Tr. at 436-40). 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 (Ex. A-16, Attach. GAS-3). 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 (*Id.* at 8).

ACAA witness Scheier expressed concern that cash paying customers, especially low-income customers, could be vulnerable to predatory lending practices at the payday loan stores. She testified that ACAA objects to the use of such stores because "it places already vulnerable customers in a more vulnerable situation." (ACAA Ex. 1 at 13) Ms. Scheier also stated that she did not understand why the Company could not place "ATM-like kiosks" that accept cash payments in local areas (*Id.*). She further claimed that some low-income clients had been encouraged to take out loans when they made payments at the payday loan stores (ACAA Ex. 2, at 2).

Mr. Magruder also opposes use of payday loan stores for taking payments. He suggested that other payment agents should be found by the Company or, alternatively, that a Company employee may need to be on-location at the payday loan stores during weekdays (Magruder Brief at 37).

UNS witness James Pignatelli testified that UNS does not send customers to predatory lenders by its acceptance of payments at payday loan stores. He indicated that customers could obtain loans from payday loan stores even if the Company had not closed its local offices or had in place ATM-like kiosks (Ex. A-3 at 1). Mr. Pignatelli stated that the decision to close some branch offices and

[15] UNS continues to operate local offices in Kingman, Lake Havasu, and Nogales.

offer alternative locations for cash-paying customers was made to keep down costs for all customers, including low-income customers (*Id.*).

UNS witness Gary Smith claims that Ms. Scheier's comments regarding customers' being encouraged to take out loans from the payday loan stores is not consistent with information the Company has received from payday loan store managers (Ex. A-17 at 5). He contends that UNS is not encouraging customers to utilize payday loan services at these locations (Ex. A-16 at 9). During the hearing, Mr. Smith testified that APS also utilizes payday loan stores for acceptance of cash payments, as does Citizens Frontier Communications (Tr. at 343). He indicated that UNS contacted grocery stores and local banks in the Prescott and Chino Valley areas about their willingness to accept payments, but was turned down. Mr. Smith stated that UNS was looking into a joint arrangement with APS under which a payday loan store in Flagstaff would have a dedicated window available for payment of utility bills, separate from the store's main counter. He also testified that the Company was discussing with APS the possibility of using a non-payday loan store site for acceptance of payments (Tr. at 344-47).

Although we encourage UNS to seek out cost-cutting opportunities, we are concerned when those efforts result in the diminution of service to customers. We understand the Company's call center consolidation decision was intended to provide consistency between the UniSource affiliates and to reduce costs in the long-term. On cross-examination, the Company's witness sought to justify the office closings on the basis that not enough people used the local offices to justify their continuation, and that more customers use the payday loan stores due to their convenience (Tr. at 342-43). However, the closing of a number of local offices, especially in northern Arizona, represents not just the elimination of a nearby location for making payments, but also the loss of an office where customers could talk to a representative of the Company face-to-face to work out payment arrangements or receive assistance in signing up for available programs.

We believe that additional efforts should be undertaken by UNS to explore fully all available alternatives for the provision of service to customers. We therefore direct the Company to make every reasonable effort to determine whether other payment locations may be utilized either in addition to, or in lieu of, the payday loan stores currently used by UNS. These efforts should include, but not be limited to, joining with other utilities to enlist alternative agents, such as banks or grocery stores, to accept cash payments and to explore of opening joint local offices to offset costs and any other alternatives that may enhance customer service without exposing customers to the potential of being solicited by predatory lenders in the course of making a utility payment. UNS shall file a copy of its recommendations consistent with this directive within 90 days of the effective date of this Decision.

Proposed Changes to Rules and Regulations

UNS proposed a number of changes to its existing Rules and Regulations governing service. Among those proposed changes are increases to charges for service lines and main extensions and a proposal to reduce the period, from 15 days to 10 days, that customers have to pay their bills before the bills are considered past due.

Line and Main Extension Policies

UNS proposes amendments to its Rules and Regulations (*i.e.*, tariffs) that it claims would ensure that developers and new customers pay a fair cost for infrastructure associated with connecting new developments to the UNS Gas system (Ex. A-15 at 19-20). As described by UNS witness Gary Smith, the Company proposes changes to both its service line and main extension policies (*Id.* at Sched. GAS-2). The Company's proposals, as set forth in its brief, are as follows:

1. For a new gas service line, the customer would be required to reimburse the Company at a rate of $16 per foot on the customer's property (the current rate is $8 per foot). For customers who provide the trench for the service line, the rate would be $12 per foot (*Id.* at 19).
2. Under the Company's proposal, there would be no free footage, so developers would pay the entire amount up front (subject to refund) (Tr. at 386-87).
3. In its effort to comply with A.A.C. R14-2-307, UNS prepared an incremental contribution study ("ICS") to determine an estimate of the costs and benefits of adding a customer to the system. Under the Company's proposal, the ICS component would be modified to reduce the credit applied to new customers or developers per service line or main extension (thereby increasing the required advances from new customers and developers). According to the Company, this change would ensure that the cost burden is initially placed on new customers and developers for main extensions or line extensions, subject to refund over a five-year period (Tr. at 384-87, 919; Ex. A-35).
4. For line extensions over $500,000, UNS would add a gross-up amount equal to the Company's estimated federal, state, and local income tax liability in advance (Ex. A-15, Sched. GAS-2).

UNS estimated that the changes described above would result in an additional $3.6 to $3.8 million per year in contributions, on average (Ex. A-30; Tr. at 915). The changes would result in an increased contribution from new customers/developers, from the current amount of approximately $300 to more than $500 per connection (*Id.*). In response to questions from Commissioner Mayes, UNS later offered the following two additional alternative proposals[16]:

1. Eliminating of the ICS and retaining tariff language requiring new customers to pay for the entire length of the new service line to their property, resulting in an additional estimated $1.2 million in contributions (Ex. A-31; Tr. at 916); and
2. Requiring that new customers/developers pay for excess flow valves (approximately $250 each), which will become a mandatory requirement for new service lines beginning in July 2008 (Ex. A-32; Tr. at 1067).

UNS points out that Staff witness Ralph Smith testified that the Company's line extension and main extension proposals (not including the alternatives) appear to be reasonably supported by the Company (Ex. S-25 at 64-67; Ex. S-27 at 44). Mr. Smith indicated that the Company's proposal appears to provide a feasibility study in compliance with Commission requirements (Tr. at 869-71). Therefore, Staff does not oppose the Company's tariff change requests on these issues. UNS also argues that its proposed ICS helps the Company specifically tailor a new customer's or developer's up-front contribution requirement rather than imposing a flat one-size-fits-all contribution requirement. UNS adds that because not all developments become fully built-out within the allotted five-year term of advance refunds, the balance of advances would become contributions after that five-year period (Tr. at 1055). UNS asserts that its proposals seek to hold developers and new customers responsible for a fair share of costs associated with serving growth.

We find that the Company's line and main extension proposals are a reasonable means of increasing the up-front contributions required from new customers and developers to connect to the UNS Gas system. However, we also believe that one of the alternatives suggested by the Company,

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[16] UNS witness Gary Smith testified that the Company does not advocate adoption of these alternatives because he believes the Company's proposal, if combined with the alternatives, would require a significant increase in contributions by new customers and developers, from the current average of approximately $310 per connection to nearly $1,000 per connection. He stated that requiring substantial increases in required contributions could put UNS Gas at a competitive disadvantage, relative to the construction of homes using all electric or propane, and thereby lessen the Company's ability to add new service connections (Tr. at 1069-72).

the charge for excess flow valve installation, should be implemented by UNS to further increase the amount required for system connections. Since the excess flow valves will become mandatory in 2008, it is reasonable that the costs to install those devices should be included in the contributions, i.e. non-refundable, required from new customers/developers.

As set forth in Exhibit A-30, it is estimated that institution of these combined measures would cause the average contribution per service line to increase from the current amount of approximately \$300 to \$383 in 2007, \$635 in 2008, and \$760 in 2009 and beyond. The net result is that new customer/developer contributions would more than double within the next year and would continue to increase in the following year. Although the contributions are actually advances that are refundable within the first five years, to the extent a development is not built out within that five-year period, the balance of the up-front contributions would become nonrefundable and would not be includable in rate base.

We believe that our finding on this issue achieves a result that is consistent with the rate design concept of gradualism because, although it represents a significant increase in the up-front contribution required to be financed by new customers/developers, it keeps intact the ability of developers to recapture all or part of the initial investment. At the same time, as described by the Company's witnesses, approval of this modified proposal avoids the potential competitive disadvantage that would be faced by UNS Gas if a fully nonrefundable hook-up fee were to be implemented suddenly. We recognize that, over the long-term, increasing the number of customers on the system and the revenues associated with those customers should provide a benefit to all customers. While we believe the extension measures approved in this Order are reasonable at this time, we direct UNS Gas to investigate fully the issue of developer contributions and present in its next rate case viable alternatives to the proposal adopted herein, including but not limited to nonrefundable hook-up fees and other measures that would hold harmless existing customers and require greater contributions to ensure that growth pays for itself.

<u>Reduction of Bill Payment Due Date</u>

UNS proposes to modify its billing terms in its tariffs by reducing from 15 days to 10 days (from the time the bill is rendered) the time for customers to pay bills before the bills are considered past due. The Company's proposed change would make its billing practices consistent with the requirements of the Commission's Rules, as set forth in A.A.C. R14-2-310(C). UNS witness Gary Smith contends that even under the proposed billing change, customers would have plenty of time to pay bills before late payment charges would apply or termination of service would be implemented (Ex. A-16 at 4). According to Mr. Smith, after the 10-day payment period, customers would have an additional 15 days before a late payment charge would be imposed, for a total of 25 days. At that point, the bill would be considered delinquent, but termination-of-service procedures (*i.e.*, notice of termination) would not commence for an additional 5 days, and several additional days would likely pass before actual termination occurred. Mr. Smith indicated that the Company would be able to waive the late fee if a customer presented good cause for late payment (*Id.*).

RUCO, ACAA, and Mr. Magruder oppose the Company's proposal to reduce the time to pay a bill. RUCO argues that, although the Company's proposal is consistent with the minimum requirements of the Commission's Rules, the only advantage identified by UNS is that the proposed tariff change would bring consistency to the three affiliated utility companies that are served by the UniSource consolidated call center (Tr. at 355). RUCO claims that the proposed payment dates are so short that a customer could go on vacation and return home to find the gas service shut off (RUCO Ex. 5 at 35). RUCO witness Diaz Cortez stated that RUCO has received calls from customers opposing the proposed changes and that a more flexible payment schedule should be retained. Ms. Diaz Cortez stated that the Company is already compensated, through the working capital calculation, for the delay that exists between the rendering of bills and the receipt of payment from customers (*Id.* at 36). RUCO also contends that the call center consistency rationale offered by the Company does not support the proposed changes because the call center representatives must be trained regarding gas-specific issues anyway. RUCO asserts that the payment schedule change would provide only a minimal benefit to the Company, but customers would bear the burden of the proposed changes.

Staff did not oppose the Company's proposal, but recommended a six-month waiver of the late payment penalty charge. Staff argues that during this initial six-month period, the penalty should be waived from day 10 to alleviate the hardship on customers from the proposed billing change.

According to UNS witness Gary Smith, the Company agrees with Staff's recommended six-month waiver period before the billing changes go into effect (Ex. A-16 at 3-4).

We agree with UNS that the proposed billing changes are reasonable. The billing changes would make the Company's tariffs consistent with the Commission's Rules and would remove an inconsistency among the billing tariffs currently in effect for the UniSource affiliates. The proposed change would also allow the customer call center representatives to have a single set of rules in place for all of the UniSource affiliates, which should minimize potential errors that may occur when information regarding delinquent bills and/or termination of service is provided to customers. In addition, as the UNS witness pointed out, a bill would not be subject to a late payment charge until at least 25 days after the bill is rendered, and a termination of service notice for nonpayment could not occur sooner than 30 days following issuance of a bill. We believe that these timeframes provide an adequate period for customers to either pay a bill or seek alternative payment arrangements prior to being subjected to a penalty or termination of service. We therefore approve the Company's proposed changes to its billing tariffs. However, in accordance with the Company's agreement to abide by Staff's six-month waiver recommendation, we direct UNS Gas not to implement the approved billing change for a period of six months following the effective date of this Decision.

Prudence of Gas Procurement Practices and Policies

As described above, this consolidated proceeding includes Docket No. G-04204A-05-0831 (the Prudence Case), which relates to an audit conducted by Staff of UNS Gas's natural gas procurement practices and policies during the period of September 2003 through December 2005 (Tr. at 761). Staff retained Jerry Mendl, President of MSB Energy Associates, Inc., and George Wennerlyn, President of Select Energy Consulting, LLC, to conduct the Prudence Case audit.

Based on his review of the Company's procurement practices during the audit period, Mr. Mendl concluded that the Company's procurement strategy during the audit period was reasonable (Ex. S-20 at 1). He reiterated at the hearing that "[UNS Gas's] natural gas procurement strategy that was set forth in the price stabilization policies was reasonable over the review period." (Tr. at 761)

Mr. Wennerlyn reached the same conclusion regarding the Company's practices during the 2003-2005 audit period. He stated that the Company's gas procurement practices and policies during that period "achieved appropriate objectives of a purchasing strategy which balances reliability, cost, and price stability. The purchases were reasonable and prudent." (Ex. S-18 at 4-5)

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 September 2003 through December 2005 are deemed prudent.

Price Stabilization Policy

This piece of the prudence equation relates to the request by UNS Gas for the Commission to approve its current "Price Stabilization Policy" ("PSP"). The basis for UNS Gas's request for what is effectively prudence pre-approval was described as follows by Company witness David Hutchens as follows:

> We believe that instead of the Commission attempting to second guess, after the fact, the individual acts that UNS Gas transacted in connection with gas procurement and hedging, it is more productive and beneficial to customers that the Commission review the policies and approve them prospectively. That way the Company will know the clear direction of the Commission and act accordingly. If the Company acts within the approved policies, its transactions will be conclusively prudent (Ex. A-4, at 7).

In his rebuttal testimony, Mr. Hutchens responded to Staff's concern that approval of the PSP in this case would put the Company on "autopilot" with respect to its procurement practices by indicating that such a practice would be inconsistent with the Company's past behavior and with the PSP itself (Ex. A-5 at 10). Mr. Pignatelli testified at the hearing that UNS sought the PSP approval in this case in order to avoid second-guessing during "the heat of a rate case three or four years after the fact" (Tr. at 106). He indicated that while the Company would keep adequate documentation of its procurement practices, he feared "a political decision down the road" (Tr. at 122).

Staff opposes the Company's request for approval of the PSP, arguing that approval of UNS Gas's hedging policy would insulate 45 percent of its gas purchases from a subsequent prudence review and is not necessary if the Company retains adequate documentation. Staff argues that UNS Gas and Staff have a fundamental disagreement regarding the purpose of the hedging plan. Staff claims that, as indicated by Mr. Hutchens, UNS views the hedging policy only as a means of reducing the volatility of natural gas prices (Tr. at 129, 157), whereas Staff believes that hedging policies ensure price stability, reliability, and competitiveness to achieve the lowest possible cost (Tr. at 744-45). Staff asserts that elimination of traditional prudence reviews in favor of the "compliance review" process sought by the Company would deprive Staff of the ability to properly employ its three-prong standard.

Staff witness Mendl also expressed concern with the higher burden of proof that would exist for Staff under the Company's proposal. He stated that if pre-approval of a particular plan is given, the Company may seek to abide by that plan instead of responding to market conditions, because adherence to the prior plan would be deemed presumptively reasonable (Tr. at 772). Staff argues that pre-approval is not necessary because, as pointed out by Mr. Mendl, prudence is judged based on what was known at the time decisions were made, not on a retrospective analysis (*Id.*). Staff contends that UNS can protect itself from future prudence disallowances by maintaining proper documentation regarding the decisions that were made and that the Company has not presented any evidence that the current standard is unfair.

We agree with Staff that the Company's request is simply unnecessary because there has been no evidence presented to suggest that the current process is unfair or unreasonable. Indeed, Mr. Hutchens conceded that there has been no indication that "there would be some unfair or biased after-the-fact analysis based on ...[the] Staff recommendations" (Tr. at 140). Mr. Hutchens also admitted that the only benefits to be gained from granting UNS's request are to the Company and that the purpose of seeking the Commission's approval of the PSP is to insulate the Company from risk (Tr. at 778). As Staff indicates, UNS Gas can avoid future prudence disallowances by properly documenting its procurement practices and policies. Moreover, in spite of Mr. Pignatelli's cynical assertion that pre-approval is necessary to avoid politically based decisions in the future, the record suggests that just the opposite is true. As discussed above, two outside Staff consultants conducted a comprehensive audit of the Company's procurement practices from September 2003 through 2005 and found that UNS Gas's practices and policies were prudent. We agree with Staff's recommendations. We do not believe that UNS Gas has presented a sufficient justification for approval of the PSP, and we therefore deny its request.

Purchased Gas Adjustor

In Docket No. G-04204A-06-0013 (the PGA Case), which was previously consolidated in the above-captioned proceeding, UNS Gas filed an application seeking approval to revise its current Purchased Gas Adjustor ("PGA"). UNS witness Hutchens testified that the current volatile natural gas market has exposed weaknesses in the Company's existing PGA mechanism, which cause delays in cost recovery, and that such delays impact customer decisions based on the lack of timely price information and impact the Company's cash flows (Ex. A-4 at 7). Mr. Hutchens stated that the deficiencies in the current PGA include: 1) inappropriate price signals to customers, 2) the potential for large bank balances to accumulate 3) a below-market interest allowance earned on bank balances; 4) an inappropriately narrow bandwidth, and 5) a potentially adverse impact on the Company's ability to devote capital to necessary investments to serve customers (*Id.* at 7-8).

Based on these claimed deficiencies, Mr. Hutchens made the following recommendations in his direct testimony to improve the Company's PGA mechanism:

1. Bandwidth – The bandwidth should be eliminated or, in the alternative, increased to $0.25 per therm for an interim period of time and then eliminated.
2. Base Cost of Gas – The base cost of gas should be set at zero, and the entire cost of gas reflected in the PGA.
3. PGA Bank Interest – The interest earned on the PGA bank balance should reflect UNS Gas's actual cost of new debt, which is the London Inter-Bank Offering Rate ("LIBOR") plus 1.5 percent.
4. Bank Balance Thresholds – The new threshold level for under-collected bank balances established in Decision No. 68325 ($6,240,000) should also be adopted as the threshold level for over-collected bank balances.
5. Capital Structure – To the extent the PGA bank balances result in long-term financing, that debt should be excluded from the cost of capital calculation in rate case proceedings.
6. Surcharges – When surcharges are required, the Commission should approve a surcharge large enough to eliminate the bank balance in a reasonable time period and allow for timely recovery (*Id.* at 8).

In his direct testimony, Staff witness Robert Gray offered seven recommendations regarding the Company's PGA proposals. He stated as follows:

1. The base cost of gas should be set at zero.

2. UNS should provide specific customer education materials to explain the change (setting the cost to zero), and should represent the cost of gas as a specific and separate line item on customer bills, noting in a footnote any temporary PGA surcharge or credit in effect.
3. During the first 12 months the new PGA bandwidth is in effect, UNS should provide a comparison of the new monthly PGA rate to the sum of the base cost of gas and the monthly PGA rate in prior months.
4. The bandwidth on the monthly PGA rate should be expanded to $0.15 per therm.
5. The threshold on the PGA bank balance for *under-collected* balances should be eliminated.
6. The threshold on the PGA bank balance for *over-collected* balances should be set at $10 million.
7. The currently applicable interest rate for the PGA bank balance should be retained.

UNS claims that the parties are in agreement regarding most of the PGA issues. The Company points out that all parties agree that the entire cost of gas should be reflected in the PGA and that the base cost of gas should be set at zero in order to send proper price signals regarding the actual cost of gas. UNS also contends that all parties have agreed that some widening of the current bandwidth is appropriate, although Staff continues to disagree with the requested level of the widening. In his rebuttal testimony, Mr. Hutchens agreed with Staff's recommendation that the under-collection threshold for requesting a PGA surcharge should be eliminated and that the over-collection threshold should be set at $10 million (Ex. A-5 at 4). The two remaining disputed PGA issues are the appropriate bandwidth level and the PGA bank interest rate.

PGA Bank Interest Rate

UNS witness Hutchens testified that the Company is requesting that it be allowed to recover through the PGA one of two rates, depending on the size of the PGA bank balance. For balances below twice the PGA threshold (currently $6.24 million), UNS seeks to earn the interest rate based on LIBOR plus 1.0 percent.[17] For balances that exceed twice the PGA bank balance threshold, UNS seeks to recover a "carrying cost at a rate equal to UNS Gas' authorized rate weighted average cost of capital as determined in this proceeding" (Ex. A-4 at 14).[18]

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[17] UNS initially sought interest rate recovery based on LIBOR plus 1.5 percent, but amended the request to LIBOR plus 1.0 percent through Mr. Hutchens's rebuttal testimony, due to a lowering of the interest rate on the Company's short-term revolving credit facility (Ex. A-5 at 5).

[18] As discussed above, the WACC established in this proceeding is 8.30 percent, compared to the LIBOR plus 1.0 percent rate, which was 5.53 percent at the end of May 2007 (See Ex. A-4 at 13).

Although RUCO agreed to the LIBOR plus 1.5 percent rate (and would presumably also agree to the modified LIBOR plus 1.0 percent rate), RUCO opposes allowing the WACC rate to be applied to the higher balances requested by UNS (RUCO Ex. 5 at 24-25). RUCO contends that, given its agreement with the Company's proposal to double the current bandwidth and to provide for timely recovery of necessary surcharges, the higher interest rate would not be necessary because UNS would no longer be burdened with large under-collected balances. Ms. Diaz Cortez added that it would be inappropriate to predetermine outside of a rate case the ratemaking treatment to be afforded to the specific debt (*Id.* at 25-26).

Staff also opposes the Company's request to apply the WACC to higher PGA bank balances. Staff witness Robert Gray testified that interest rates for PGA bank balances were originally set in a generic docket (Decision No. 61225, issued October 30, 1998) and applied uniformly to all Arizona LDCs as a result of the consensus of a working group that included LDCs, Staff, and RUCO (Ex. S-41 at 13). The uniform interest established in that generic docket was the monthly three-month commercial *non-financial* paper rate, as established by the Federal Reserve (*Id.*). Mr. Gray stated that the interest rate was later changed in a subsequent generic proceeding (Decision No. 68600, issued March 23, 2006), only because the Federal Reserve was no longer publishing the previously established rate. Therefore, the current generic interest rate for PGA bank balances is the monthly three-month commercial *financial* paper rate published by the Federal Reserve. The rates are similar, although the current rate is slightly higher, on average, than the prior rate (*Id.*).

According to Mr. Gray, the Company's request should be rejected by the Commission for several reasons. He stated that the UNS proposal is unnecessary because it would add a level of administrative complexity to the process in making the calculations and because the PGA bank balances do not always trend upwards (*Id.* at 14). Mr. Gray testified that it was unclear which LIBOR rate the Company was proposing to use, that it appears the LIBOR itself would be very close to the interest rate currently in effect, and that it is only the application of an add-on component to the LIBOR rate (*i.e.*, the LIBOR plus 1.0 percent proposed by UNS) that raises the rate above the current rate by a substantial amount (*Id.* at 14-15). Mr. Gray indicated that the PGA interest rate approved recently for Southwest Gas was the one-year nominal Treasury constant maturities rate, which is comparable to the rate currently in effect for UNS Gas. The same rate is in effect for APS, and Mr. Gray asserts that UNS has not presented any justification for a different treatment (*Id.* at 15).

Mr. Gray also stated that Staff's recommendations to expand the PGA bandwidth (see discussion below) and to expand and eliminate the bank balance thresholds would reduce the likelihood of UNS Gas's incurring substantial bank balances for long periods of time (*Id.* at 16). He therefore recommended that the existing interest rate continue to be applied to UNS's PGA bank balances or, as an alternative, that the same interest rate applicable to both Southwest Gas and APS (the one-year nominal Treasury constant maturities rate) be applied (*Id.*). Finally, Mr. Gray recommended that if the applicable interest rate becomes unavailable (*i.e.*, unpublished) for one or more months, the prior month's interest rate apply. If the interest rate becomes unavailable on a recurrent basis, he recommends that UNS file a request to change to a comparable rate (*Id.* at 17).

We agree with Staff that UNS has not presented a sufficient basis for altering the PGA bank balance interest rate that currently exists. As Mr. Gray points out, a similar rate is in effect for Southwest Gas and APS, and we see no reason why UNS should be treated differently from those companies. In addition, granting a higher interest rate could provide a disincentive for the Company to reduce bank balances and could cause it to become less focused on taking all possible measures to reduce the cost of gas for its customers (*Id.* at 15-16). We therefore adopt Staff's recommendation to retain the current interest rate for UNS's PGA bank balances.

Expansion of Bandwidth

Under its current configuration, the Company's PGA bandwidth limits the movement of the monthly PGA rate over a 12-month period. The current bandwidth is \$0.10 per therm, which means that when a new PGA rate is calculated each month, the new monthly rate cannot be more than \$0.10 per therm different than the monthly PGA rate for any of the previous 12 months (Ex. S-41 at 5). Mr. Gray explained that the PGA bandwidth was initially established in 1999 at a rate of \$0.07 per therm for Arizona LDCs during a period of relatively stable gas prices. As prices became more volatile, that bandwidth level often limited the movement of monthly PGA rates for periods of time. In Decision No. 62994 (November 3, 2000), UNS's predecessor was granted a bandwidth increase to \$0.10 per therm (*Id.*). Mr. Gray testified that recent bandwidth adjustments were approved for

Southwest Gas (to $0.13 per therm) and for Duncan Rural (could change up to $1.20 per therm per year). However, he indicated that the Commission granted the significant expansion to Duncan Rural due to that company's small size and considerable financial constraints (*Id.* at 6).

In its application, UNS Gas initially requested that the PGA bandwidth be eliminated or, alternatively, set at $0.25 per therm for a period of time before being eventually eliminated (Ex. A-4 at 11-12). In his rebuttal testimony, UNS witness Hutchens agreed with RUCO's proposal to increase the current bandwidth to $0.20 per therm (Ex. A-5 at 3-4). Mr. Hutchens stated that setting the bandwidth at an inappropriately low level would fail to send proper price signals to customers regarding the actual cost of the gas being consumed (Ex. A-4 at 12).

Staff witness Gray recommended that the bandwidth be increased to $0.15 per therm. He stated that this bandwidth increase would provide the Company with significant additional room for movement of the monthly PGA rate, while providing a reasonable limit on the exposure of UNS customers to automatic adjustments without Commission review. Mr. Gray also indicated that Staff remains open to consideration of further changes to the PGA mechanism, if such changes are warranted (Ex. S-41 at 7-8). He explained in his surrebuttal testimony that setting a proper bandwidth level requires a balancing of several policy goals, including "timely recovery of gas costs by the utility, reduction of price volatility for ratepayers, and the Commission's interest in reviewing significant changes in rates before they are passed along to ratepayers." (Ex. S-42, at 2) He conceded that employing a bandwidth could result in the Company's accumulating large bank balances that must eventually be paid by customers (Tr. at 1133). However, he reiterated that the various policy goals, including protection of ratepayer interests, must be balanced in setting the bandwidth (*Id.*).

We agree with Staff's recommendations regarding the PGA issues, including increasing the Company's bandwidth to $0.15 per therm. The $0.15 per therm bandwidth is higher than the $0.13 bandwidth approved recently for Southwest Gas, and we believe it is reasonable under the facts of this case. Although UNS attempts to use the Duncan Rural case as a basis for seeking a greater increase in the bandwidth, Mr. Gray explained that Duncan is a very small natural gas cooperative with only 80 customers and that it has significant financial issues. UNS Gas is not in a comparable situation, and we do not believe a comparison with Duncan Rural is relevant for purposes of setting an appropriate bandwidth in this proceeding. Indeed, the 50 percent increase over UNS's current bandwidth is significant and properly balances the policy goals identified in Staff's testimony. The rate of $0.15 per therm will provide UNS Gas with a greater degree of flexibility in maintaining its PGA bank balances at a reasonable level, while also offering to customers a measure of protection from sudden automatic PGA increases outside of the Commission's purview.

* * * * * * * * * *

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

FINDINGS OF FACT

1. On November 10, 2005, the Arizona Corporation Commission opened an inquiry (Docket No. G-04204A-05-0831) into the prudence of the gas procurement policies and practices of UNS Gas Inc. (the Prudence Case).

2. On January 10, 2006, UNS Gas filed an application (Docket No. G-04204A-06-0013) with the Commission seeking review and revision of the Company's Purchased Gas Adjustor (the PGA Case).

3. On July 13, 2006, UNS Gas filed an application with the Commission (Docket No. G-04204A-06-0463) for an increase in its rates throughout the State of Arizona (the Rate Case).

4. On August 14, 2006, Staff filed a Letter of Sufficiency indicating that the Company's Rate Case application met the sufficiency requirements outlined in A.A.C. R14-2-103 and classifying the Company as a Class A utility.

5. On September 8, 2006, a Procedural Order was issued consolidating the Prudence Case, PGA Case, and Rate Case dockets; scheduling a hearing for April 16, 2007; and setting various other procedural deadlines.

6. Intervention was granted to RUCO, ACAA, and Marshall Magruder.

7. With its application in the Rate Case, UNS filed its required schedules in support of the application, and the direct testimony of various witnesses.

8. On February 9, 2007, Staff, RUCO, ACAA, and Mr. Magruder filed direct testimony in accordance with the previously established procedural schedule. Staff filed additional direct

testimony on February 16 and February 23, 2007.

9. On March 16, 2007, UNS filed the rebuttal testimony of various witnesses in response to Staff and intervenor testimony.

10. Surrebuttal testimony was filed by ACAA on March 30, 2007; and by Staff, RUCO, and Mr. Magruder on April 4, 2007.

11. On April 11, 2007, UNS filed the rejoinder testimony of several witnesses in response to the surrebuttal testimony of Staff and intervenor witnesses.

12. The evidentiary hearing commenced as scheduled on April 16, 2007, and additional hearing days were held on April 17, 18, 19, 20, 24, and 25, 2007.

13. Initial Post-Hearing Briefs were filed on June 5, 2007, by UNS, Staff, RUCO, and Mr. Magruder. Final Schedules were also filed on June 5, 2007, by UNS and RUCO. On June 6, 2007, Staff filed a Notice of Errata and revised Initial Brief.

14. Reply Briefs were filed on June 19, 2007, by UNS, Staff, RUCO, and Mr. Magruder.

15. On June 21, 2007, Staff filed a Notice of Errata and Additional Authority.

16. According to the Company's application, as modified, in the test year ended December 31, 2005, UNS had adjusted operating income of $8,506,168 on an adjusted OCRB of $162,358,856, for a 5.24 percent rate of return.

17. UNS requests a revenue increase of $9,459,023, Staff recommends a revenue increase of $4,312,354, and RUCO recommends a revenue increase of $2,734,443.

18. For purposes of this proceeding, we determine that UNS Gas has an OCRB of $154,604,408 and a FVRB of $184,120,761.

19. A rate of return on FVRB of 6.97 percent is reasonable and appropriate.

20. The Company's attempt to interject the issue of the *Chaparral City* decision through its rebuttal testimony was untimely, prejudicial to the other parties, and its late attempt to apply the weighted average cost of capital to FVRB is not reasonable and is not supported by the testimony and evidence in the record.

21. UNS Gas is entitled to a gross revenue increase of $5,257,468.

22. The Company's proposed decoupling mechanism proposal, the Throughput

Adjustment Mechanism, is not adopted in this proceeding.

23. The class responsibility for the revenue requirement should be allocated using the methodology of Staff's rate design expert witness.

24. For residential customers under Schedule R10, the basic monthly customer charge should be increased from $7.00 to $8.50, with a commodity charge increase to $0.3270 per therm, based on the revenue requirement established herein.

25. For CARES customers (Schedule R12), the current customer charge of $7.00 should remain in place, with a commodity charge increase to $0.3270 per therm, based on the revenue requirement established herein.

26. The rates for other customer classes should be set based on Staff's rate design recommendation, with the customer charges for each class established at the level recommended by Staff and with volumetric charges based on the revenue requirement determined herein.

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

28. Staff's recommendation to set the DSM adjustor surcharge at an initial level of $0.0025, which reflects exclusion of the baseline cost study, is reasonable. In addition, it is reasonable to require UNS to file semi-annual reports for the DSM programs, to shift the adjustor filing date to April 1 (with an Adjustor date of June 1), and that the appropriate forum for a full review of the specific DSM programs is in the separate docket in which there is an application currently pending.

29. In the event that UNS Gas does not currently have in place a bill statement contribution option, the Company should implement the change within 60 days of the effective date of this Decision.

30. The Company's natural gas procurement practices and policies during the audit period of September 2003 through December 2005 are deemed prudent.

31. UNS Gas has not presented a sufficient justification for approval of the Price Stabilization Plan.

32. With respect to the Company's Purchased Gas Adjustor mechanism, we adopt Staff's

recommendations, including setting the base cost of gas at zero and increasing the current $0.10 per therm adjustment band to $0.15 per therm.

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

34. DSM programs should be funded at the level recommended by Staff: LIW funding ($113,400) and 25 percent of the new program costs ($229,154) should be included in the initial DSM surcharge, but UNS Gas's portion of the baseline study costs ($82,000) should not be included in the surcharge initially. Staff's proposed initial DSM surcharge of $0.0025 is therefore adopted.

35. With respect to the use of payday loan stores for acceptance of customer payments, the Company should make every reasonable effort to determine whether other payment locations may be utilized either in addition to, or in lieu of, the payday loan stores currently used by UNS, and the Company should file a copy of its recommendations consistent with this directive within 90 days of the effective date of this Decision.

36. The Company's line and main extension proposals are a reasonable means of increasing the up-front contributions required from new customers and developers to connect to the UNS Gas system, subject to inclusion of the addition of a charge for excess flow valve installation, and subject to the additional requirement that UNS Gas investigate fully the issue of developer contributions and present in its next rate case viable alternatives to the proposal adopted herein, including but not limited to nonrefundable hook-up fees and other measures that would hold harmless existing customers and require greater contributions to ensure that growth pays for itself.

37. UNS Gas's proposed billing change, to reduce from 15 days to 10 days, the date for customers to pay bills before the bills are considered past due, is a reasonable modification that will make the Company's tariffs consistent with the Commission's Rules and would remove an inconsistency among the billing tariffs currently in effect for the other UniSource affiliates. However, in accordance with the Company's agreement to abide by Staff's six-month waiver recommendation, UNS Gas should not implement the approved billing change for at least six months following the effective date of this Decision.

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 Rate Case, Prudence Case, and PGA Case.

3. The fair value of UNS Gas's rate base is $184,120,761, and applying a 6.97 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 November 30, 2007, 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 December 1, 2007.

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 file in its next rate case more detailed support for allowance of AGA dues and an explanation of how the AGA's activities, aside from marketing and lobbying efforts, benefit the Company's customers.

IT IS FURTHER ORDERED that UNS Gas, Inc., should engage in discussions with other stakeholders affected by this issue, participate in the ongoing DSM workshops before the Commission, and, if possible, attempt to develop a decoupling mechanism that does not suffer from the types of deficiencies identified by the parties in this case.

IT IS FURTHER ORDERED that if UNS Gas, Inc., does not currently have in place a bill statement contribution option, it shall implement such a change within 60 days of the effective date of this Decision.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall set the DSM adjustor surcharge at an initial level of $0.0025, and shall make its DSM adjustor filing by April 1 of each year.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall file semi-annual reports for its DSM programs in accordance with Staff's recommendations.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall file a copy of its recommendations regarding available alternatives for payment and service center locations within 90 days of the effective date of this Decision.

IT IS FURTHER ORDERED that UNS Gas, Inc. shall submit, within 30 days of this Decision, a revised Excess Flow Valve Installation tariff indicating that all new customers/developers shall pay the full cost of installation and the payment shall be a contribution (i.e. non-refundable).

IT IS FURTHER ORDERED that UNS Gas, Inc., shall investigate fully the issue of developer contributions and present in its next rate case viable alternatives to the proposal adopted herein, including but not limited to nonrefundable hook-up fees and other measures that would hold harmless existing customers and require greater contributions to ensure that growth pays for itself.

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IT IS FURTHER ORDERED that UNS Gas, Inc., shall not implement the approved billing change to reduce the payment due date, for six months following the effective date of this Decision.

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, DEAN S. MILLER, Interim 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 27th day of Nov., 2007.

DEAN S. MILLER
INTERIM EXECUTIVE DIRECTOR

DISSENT ______________

DISSENT ______________

SERVICE LIST FOR: UNS GAS, INC.

DOCKET NOS.: G-04204A-06-0463, G-04204A-06-0013 and G-04204A-05-0831

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