OPEN MEETING ITEM

ORIGINAL

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

Executive Director

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AZ CORP COMMISSION
DOCKET CONTROL

ARIZONA CORPORATION COMMISSION

DATE: AUGUST 20, 2010

DOCKET NO.: E-04204A-09-0206

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Lyn Farmer. The recommendation has been filed in the form of an Opinion and Order on:

UNS ELECTRIC, INC.
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

SEPTEMBER 2, 2010

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Open Meeting to be held on:

SEPTEMBER 21, 2010 and SEPTEMBER 22, 2010

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

Arizona Corporation Commission
DOCKETED
AUG 20 2010
DOCKETED BY

ERNEST G. JOHNSON
EXECUTIVE DIRECTOR

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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

IN THE MATTER OF THE APPLICATION OF UNS ELECTRIC, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS ELECTRIC, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. E-04204A-09-0206 DECISION NO. _______________ **OPINION AND ORDER**

DATES OF HEARING:	June 16, 2009 (Procedural Conference - Tucson); January 29, 2010 (Pre-Hearing – Phoenix); February 4, 5, 8, 10 and 11, 2010 (Hearing)
PLACE OF HEARING:	Tucson and Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Lyn Farmer
IN ATTENDANCE:	Kristen K. Mayes, Chairman
APPEARANCES:	Mr. Philip J. Dion, III, UNISOURCE ENERGY SERVICES; and Mr. Michael W. Patten ROSHKA, DeWULF & PATTEN, PLC, on behalf of UNS Electric, Inc.; Mr. Daniel Pozefsky, on behalf of the Residential Utility Consumer Office; Mr. Timothy Hogan, ARIZONA CENTER FOR LAW IN THE PUBLIC INTEREST, on behalf of the Arizona School Boards Association and the Arizona Association of Business School Officials; and Ms. Maureen Scott, Senior Staff Attorney and Mr. Wesley Van Cleve, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

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BY THE COMMISSION:

On April 30, 2009, UNS Electric, Inc. ("UNSE" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for a rate increase for electric service in the above-captioned docket.

On May 26, 2009, UNSE filed a Notice of Errata, revising Schedules H-3 and H-4 of the application.

On May 29, 2009, the Commission's Utilities Division Staff ("Staff") filed a Letter of Sufficiency in the docket indicating that UNSE's application had met the sufficiency requirements of Arizona Administrative Code ("A.A.C.") R14-2-103. Staff classified UNSE as a Class A utility.

On June 9, 2009, Staff filed a Request for Procedural Order, recommending dates for the filing of testimony and a hearing in this matter.

On June 10, 2009, UNSE filed a Response to Staff's Request for a Procedural Order, requesting a Procedural Conference to discuss scheduling.

On June 15, 2009, a Procedural Order was issued scheduling a procedural conference for June 16, 2009.

The June 16, 2009 procedural conference was held as scheduled.

On June 18, 2009, a Procedural Order was issued setting procedural dates for filing testimony and other deadlines, and also scheduling the hearing to commence on February 4, 2010.

On July 14, 2009, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene.

On August 31, 2009, UNSE filed a Notice of Errata concerning corrections to certain tariffs.

On September 1, 2009, intervention was granted to RUCO.

On September 14, 2009, UNSE filed a Notice of Errata concerning corrections to testimony.

On September 17, 2009, the Arizona School Boards Association ("ASBA") and the Arizona Association of School Business Officials ("AASBO") (collectively "ASBA/AASBO") filed for leave to intervene.

On September 25, 2009, UNSE filed a Notice of Filing Affidavits of Publication and Proof of Mailing.

On October 1, 2009, ASBA/AASBO were granted intervention.

On October 2, 2009, UNSE filed a Notice of Errata concerning additional corrections to tariffs filed on August 31, 2009.

On October 20, 2009, RUCO filed a Motion to Extend the Time to File its Direct Required Revenue and Rate Design Testimony.

On October 22, 2009, Staff filed a Response to RUCO's Motion, confirming it did not object to the request and requesting that the extended deadlines should apply to Staff's and any Intervenor testimony as well as to RUCO.

By Procedural Order issued on October 27, 2009, RUCO's Motion was granted.

On November 6, 2009, ASBA/AASBO filed testimony of Chuck Essigs; RUCO filed testimony of William A. Rigsby and Dr. Ben Johnson; and Staff filed testimony of Dr. Thomas H. Fish, David C. Parcel, W. Michael Lewis, and Kenneth C. Rozen.

On November 13, 2009, RUCO filed the direct rate design testimony of Dr. Johnson and Staff filed the rate design direct testimony of William C. Stewart.

On December 11, 2009, UNSE filed rebuttal testimony of Michael J. DeConcini, Thomas A. McKenna, Kentton C. Grant, Karen G. Kissinger, Martha B. Pritz, Dallas J. Dukes, and D. Bentley Erdwurm and an exhibit to Mr. McKenna's testimony.

On January 15, 2010, ASBA/AASBO filed surrebuttal testimony of Mr. Essigs; RUCO filed the surrebuttal testimony of Mr. Rigsby and Dr. Johnson; and Staff filed the surrebuttal testimony of Dr. Fish, Mr. Parcell, Mr. Lewis, Mr. Stewart, and Mr. Rozen.

On January 25, 2010, UNSE filed rejoinder testimony of Mr. DeConcini, Mr. McKenna, Mr. Grant, Ms. Pritz, Mr. Dukes, and Mr. Erdwurm, and the Joint Matrix of Major Issues.

The hearing was held beginning on February 4, 2010 and continuing on February 5, 8, 10, and 11, 2010.

On February 9, 2010, UNSE filed a revised exhibit to Mr. McKenna's rejoinder testimony.

On March 1, 2010, RUCO filed its final post-hearing schedules; UNSE filed its final post-hearing schedules; and Staff filed a Motion for an Extension of Time to File Final Schedules, Late Filed Exhibits, and Extension of Briefing Schedule.

On March 2, 2010, RUCO filed its response to Staff motion, indicating that RUCO did not object to the motion.

On March 3, 2010, UNSE filed its response to Staff's motion, taking no position on the requested extension of time.

On March 3, 2010, a Procedural Order was issued setting new dates for filing Staff's late-filed exhibit and final schedules, and for filing opening and reply briefs.

On March 12, 2010, Staff filed its Late-Filed Exhibit S-18 (Estimated Bill Impacts of Varying REST Levels and Recovery of 100% DSM Within Base Rates) and its Final Schedules.

On March 17, 2010, UNSE filed revisions to its Late-Filed Exhibit 36 and Staff filed its Errata to its Final Schedules.

On March 23, 2010, ASBA/AASBO, RUCO, UNSE, and Staff filed opening briefs and Staff filed an Errata with a complete set of its Final Schedules.

On March 24, 2010, UNSE filed its Appendix in Support of its opening brief.

On April 2, 2010, ASBA/AASBO, RUCO, UNSE, and Staff filed reply briefs.

On April 7, 2010, UNSE filed its revision to Exhibit UNSE 32 to include revised bill impacts reflecting the updated Purchased Power Fuel Adjustor Clause ("PPFAC") rate and filed an update to Revised Late-filed Exhibit 36.

On August 17, 2010, RUCO filed its Revised Final Post-Hearing Schedules.

RATE APPLICATION

UNSE is a public service corporation providing electric service to the majority of Mohave County and Santa Cruz County, serving over 71,000 customers in Mohave County and over 18,000 customers in Santa Cruz County. Approximately eighty-eight percent of its customers are residential customers; eleven percent are commercial customers; and less than one percent are industrial customers. UNSE obtains most of its power from the wholesale market as it owns no generation in the Mohave County service area, and owns 65 megawatts ("MWs") of gas-fired generation in the Santa Cruz service area.[1] The Company's current rates were established in Decision No. 70360 (May

[1] Ex. U-3 at 5 (DeConcini Direct Testimony).

27, 2008) using a test year ending June 30, 2006.

In its application, the Company requested that the Black Mountain Generating Station ("BMGS") be included in its rate base and it submitted two sets of schedules; one without BMGS, and one with BMGS. According to the Company, in the test year ended December 31, 2008, UNSE had adjusted operating income of $9,846,875, on an adjusted Original Cost Rate Base ("OCRB") of $175,688,714, for a 5.60 percent rate of return or, with BMGS included, $327,810,055 for a 6.53 percent return. The Company's proposed test year Reconstruction Cost New Depreciated ("RCND") rate base is $354,355,023, resulting in a rate of return of 2.78 percent, or with BMGS included, $418,548,539 and a 3.70 percent return; and its proposed Fair Value Rate Base ("FVRB") is $265,021,868, resulting in a test year rate of return of 3.72 percent or, with BMGS included, $327,810,055 and a 4.73 percent return on FVRB.

According to the Final Schedules, UNSE requests a gross revenue increase of $13,500,000; Staff recommends a gross revenue increase of $7,830,901; and RUCO proposes a gross revenue increase of $4,604,908. A summary of the parties' positions appears below:

	Company Proposed		Staff Proposed	RUCO Proposed
ORIGINAL COST	**W/O BMGS**	**BMGS**		
Adjusted Rate Base	$175,688,714	$237,071,572	$168,574,818	$229,945,361[2]
Rate of Return	10.3 %	10.01 %	8.40[3] %	8.06 %
Req'd Operating Inc.	$ 18,097,196	$ 23,741,671	$ 15,500,282	$ 18,533,596
Op. Inc. Available	9,846.875	15,491,350	10,714,545	16,640,136
Operating Inc. Def.	8,250,321	8,250,321	4,785,737	1,893,460
Rev. Conver. Factor	1.6363	1.6363	1.6363	1.6363
Gross Rev. Increase	$ 13,500,000	$ 13,500,000	$ 7,830,901	$ 3,098,269
FAIR VALUE				
Adjusted Rate Base	$265,021,868	$327,810,055	$257,907,973	$320,683,840
Rate of Return	6.83 %	7.24 %	6.01 %	5.96 %
Req'd Operating Inc.	$ 18,097,196	$ 23,741.671	$ 15,500,282	$ 19,112,757
Op. Inc. Available	9,846,875	15,491,350	10,714,545	16,640,136
Operating Inc. Def.	8,250,321	8,250,321	4,785,737	2,472,621
Rev. Conver. Factor	1.6362	1.6363	1.6363	1.6363
Gross Rev. Increase	$ 13,500,000	$ 13,500,000	$ 7,830,901	$ 4,045,949

[2] RUCO included BMGS in rate base.
[3] Staff added $1,339,997 as a "fair value adjustment."

REVENUE REQUIREMENT

Rate Base Issues

As shown above, UNSE proposed an OCRB of $175,688,714 or $237,071,572 including BMGS; Staff recommends an OCRB of $168,574,818; and RUCO proposed an OCRB of $229,945,361, including BMGS. Each of the contested issues regarding rate base items is discussed below.

Black Mountain Generating Station

Prior to May 31, 2008, UNSE had a full requirements Power Supply Agreement ("PSA") with Pinnacle West Capital Corporation which provided all energy and ancillary services at a fixed price per megawatt hour ("MWh"). In preparation for the expiration of the PSA, UNSE developed a procurement plan to serve its load through a mix of resources, including market power purchases, resource acquisitions, and contracts. Currently, UNSE acquires power through power supply contracts for base load and on-peak power; through the five year Purchased Power Agreement ("PPA" or "tolling agreement") between UNSE and UniSource Energy Development Company ("UED") for power from the BMGS;[4] and through use of UNSE's 65 MW of generation at the Valencia Generating Station in Santa Cruz County.[5]

BMGS is a two-unit peaking facility with a total capacity of 90 MW located near Kingman, Arizona. It was developed by UED, an affiliate of UNSE, after UED purchased two unused combustion turbines at a 50 percent discount over the cost of new units. BMGS began commercial operation on May 30, 2008. In the Company's previous rate case, it proposed a post test year adjustment to include BMGS in rate base, which both Staff and RUCO opposed. In Decision No. 70360 (May 17, 2008), the Commission agreed with Staff and RUCO that because the plant was not constructed or in operation during the test year or prior to the Decision being issued, there were numerous uncertainties, including: the eventual total cost of the plant; the plant's operational costs;

[4] In accordance with the Federal Energy Regulatory Commission ("FERC") requirements, UNSE initiated two competitive Requests for Proposals ("RFP") for tolling agreements for delivery of electric power, and as a result, UNSE entered into the PPA with UED. In Decision No. 70322 (April 29, 2008), the Commission declined to either approve or disapprove the PPA because it is a wholesale transaction falling under FERC jurisdiction.

[5] Ex. U-8 at 6 (McKenna Direct Testimony).

whether ultimate ownership would be with UNSE or with UED; whether the cost of the plant was prudent; and whether it would be more economical for UNSE to purchase BMGS or to buy power in the market. Staff and RUCO also expressed concern about rate base inclusion violating the test year matching principle that only "used and useful" plant be included in the ratemaking formula. Although the Commission did not adopt rate base treatment of BMGS at that time, it did provide encouragement for UNSE to acquire BMGS by authorizing an accounting order and also by providing financing approvals allowing UNSE to obtain up to $40 million of new debt financing and up to $40 million of equity infusion from its parent, UniSource Energy.

In this case, UNSE again requests that the Commission approve a rate base adjustment and proposes a rate reclassification associated with its proposed acquisition of the BMGS. The Company seeks inclusion of the original cost of BMGS net of depreciation as of December 31, 2008, as a post-test year adjustment of $62 million. According to UNSE, in order to fund that purchase, it must raise additional debt and equity capital using the financing authority from Decision No. 70360.[6] Mr. Kentton Grant testified on behalf of the Company that neither the Commission's previous financing approval nor the accounting order approving deferral of costs provided the cash flow or earnings necessary to finance the BMGS and still allow it to maintain its investment-grade rating.[7] He testified that the Company has the lowest investment grade credit rating assigned by Moody's Investor Service and that the Company was concerned that "even a modest decline in financial performance could cause a downgrading of the Company's credit rating to junk bond status."[8]

The Company proposed a "revenue neutral reclassification" of its rates, asserting that such a reclassification is necessary to allow it to raise that capital. Under the Company's proposed reclassification of rates, costs associated with BMGS that are currently collected pursuant to the tolling arrangement with UED will move from the "base power supply" rate classification to the "nonfuel base rate" classification when UNSE acquires BMGS and the tolling agreement ends. The natural gas costs for generating electricity at BMGS would continue to be collected through the Purchased Power and Fuel Adjustment Clause ("PPFAC"). According to Mr. Grant, "[c]ustomers

[6] Ex. U-12 at 3 (Grant Direct Testimony).
[7] Ex. U-12 at 10-12; Ex. U-13 at 4-5 (Grant Rebuttal Testimony); Ex. U-14 at 2 (Grant Rejoinder Testimony).
[8] Ex. U-12 at 10-12.

would see no net change in the price paid for electric service on the date of the rate reclassification."[9] UNSE witness Mr. D. Bentley Erdwurm also testified that the customers' bills will not increase if BMGS is placed into rate base.[10] Mr. Grant testified that essentially, the profit built into the tolling agreement currently going to UED, would be moved to UNSE.[11] According to the Company, "this increase in earnings and cash flow will allow [UNSE] to raise the additional capital needed to purchase BMGS."[12] If the Commission allows BMGS into rate base, UNSE will seek FERC approval of the purchase of BMGS from UED. Under the Company's proposal, upon FERC approval, UNSE will complete the transaction and within 15 days it will notify Staff and then the rate reclassification will take place.

The Company's witness, Mr. McKenna, testified about the benefits of owning generation and identified four categories of operational benefits from owning BMGS – flexibility, reliability, efficiency, and location.[13] Owning generation will give UNSE "full operational flexibility of the generator…[including] the ability to utilize its instantaneous, load following and emergency dispatch capabilities to provide its required reserves and ancillary services."[14] Owning BMGS will also help to optimize UNSE's portfolio by allowing "full, unlimited, economic dispatch in any market" and by having peaking combustion turbines with load following capabilities, UNSE will be able to address any intermittency issues associated with future renewable energy facilities. Mr. McKenna testified that ownership of UNSE will give it full control over maintenance, operation, and meeting high standards of reliability and safety. According to Mr. McKenna, owning BMGS will be efficient because it is the exact type of unit to meet its requirements – both its peaking capacity and reserve needs, and its location in UNSE's load area can help to minimize transmission costs and enhance the system reliability.[15]

Mr. Grant testified that the financial benefits to UNSE and its customers if the Commission were to approve rate base treatment of BMGS include a long-term source of economical peaking

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[9] Ex. U-12 at 3.
[10] Tr. at 268.
[11] Tr. at 225.
[12] UNSE Opening Brief at 9.
[13] Ex. U-8 at 17.
[14] Ex. U-7 at 17.
[15] Ex. U-8 at 18.

capacity, which, compared to continued reliance on the wholesale market, would promote long-term price stability to customers from the cumulative effects of depreciation and deferred income tax effects on rate base.[16] According to Mr. Grant, if the purchase is financed at the Company's current cost of capital, he expects net income to increase by about $3 million per year and net operating cash flow to increase by about $6 million per year. This would improve UNSE's creditworthiness and help with funding capital expenditures and acquisition of future energy resources.[17] Another financial benefit identified by Mr. Grant is that ownership of BMGS would reduce UNSE's reliance on purchased power and long-term lease agreements that can negatively impact credit and financial profiles.

RUCO recommends that the Commission approve both a post-test year rate base adjustment to include BMGS in rate base and a revenue neutral rate reclassification to reflect the cost of the BMGS. RUCO's witness, Dr. Johnson, testified about the benefits UNSE identified from owning BMGS compared to UNSE purchasing power and peaking capacity on the wholesale market. Those include operational benefits such as greater flexibility, reliability, efficiency, and a superior location. Dr. Johnson recommended the Commission approve the Company's proposed treatment because 1) UNSE has very little owned generating capacity, making it highly dependent on purchased power and thereby subject to the "inherent risks associated with nearly exclusive reliance on wholesale markets;"[18] 2) the combustion turbines appear to have been acquired at a reasonable cost and although he did not conduct an in-depth prudence analysis, Dr. Johnson knew of no allegation or claim of imprudence; 3) the Company has assured the Commission that there will not be an increase in customer rates upon ownership transfer, and the rate reclassification avoids the "potentially serious problem" of regulatory lag when the size of the investment is large compared to the current small capitalization; and 4) because adding BMGS to rate base could lead to improvements in the Company's financial metrics, including credit and bond ratings and cash flow, to the long-term best interests of its customers.[19]

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[16] Ex. U-12 at 4.
[17] Id. at 4-5.
[18] Ex. R-6 at 19 (Johnson Direct Testimony).
[19] Id. at 18-21.

Staff recommends that the Commission deny the request to include BMGS in rate base. Staff based its recommendation on the fact that BMGS is not owned by UNSE and not all facts are known regarding its proposed purchase or whether it will be purchased by UNSE. Staff argues that UNSE's "financial position does not necessarily preclude [UNSE] from purchasing BMGS without a rate base adjustment"[20] because Staff believes that interim financing could be accomplished through UniSource or using a revolving credit facility. Staff also believes that the Company and RUCO's testimony about a likely downgrade is merely speculation. Because BMGS is not owned by UNSE, Staff did not conduct a prudency review of the proposed purchase and did not make a used and useful determination. Staff argued that UNSE failed to demonstrate that operation and maintenance costs were known and certain and also noted that at the time of the hearing, one of BMGS' generating units was being repaired. Staff believes that despite the Commission's encouragement in Decision No. 70360, UNSE has not taken any steps to acquire BMGS and Staff continues to believe that the request to rate base BMGS is premature. Although Staff does not dispute that there are benefits to ownership of BMGS, Staff does not believe that extraordinary circumstances exist sufficient to warrant rate base inclusion. Staff recommends that the Commission continue to encourage UNSE to "fully explore a combination of internal and external financing options to allow UNSE to purchase this plant and include it in rate base in its next rate case."[21] Staff also recommends that the Commission direct Staff to conduct a prudence or due diligence evaluation of the BMGS prior to any purchase of BMGS by UNSE.[22]

<u>Conclusion on BMGS Rate Base Treatment</u>

All parties agree that there are benefits to UNSE owning BMGS. As testified to by the Company's witnesses, it will provide numerous operational benefits and Staff's witness agreed that from an engineering perspective, it would provide operational benefits. Staff did not dispute the Company's analysis of the financial benefits to its customers. The area of disagreement is over whether it is possible or prudent for UNSE to purchase BMGS without the Commission's rate base treatment of the plant.

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[20] Staff Opening Brief at 6.
[21] Staff Closing Brief at 8.
[22] Staff Opening Brief at 8.

Although Staff claims that the "Company concedes that because it is revenue neutral that it appears this would not help the Company finance BMGS,"[23] the referenced language in the Company's Opening Brief makes it clear that the Company believes the revenue neutrality would in fact result in increased earnings and cash flow which would allow UNSE to raise additional capital to purchase BMGS: "It *may appear* that because it is revenue neutral reclassification that it would not help the Company finance BMGS. *This is not the case*."[24] Staff disagrees with the Company's position that rate reclassification is necessary for financing the purchase of BMGS because "contrary to the Company's argument, the increase in cash flow resulting from UNSE no longer having to make a payment to UED under the PPA does not result from Commission preapproval or reclassification."[25]

Mr. Grant testified that UNSE would incur almost $5 million of cash expense with no means to recover those costs if it purchased BMGS without rate reclassification.[26]

UNSE's PPFAC Plan of Administration ("POA") defines "Base Cost of Fuel and Purchased Power" as "an amount generally expressed as a rate per kWh, which reflects the fuel and purchased power cost embedded in the base rates by customer class as approved by the Commission in UNS Electric's most recent rate case."[27] Under the POA, on an annual basis, the actual fuel and purchased power costs are reconciled against the revenues collected through the base fuel and purchased power cost rate, and any over- or under- recovery of fuel and purchased power costs are refunded/collected through a forward component rate in the new PPFAC charge. Because all costs of power from BMGS are purchased power and fuel costs and are currently collected through the "Base Power Supply Charge," if UNSE purchased BMGS without rate base treatment, those costs of power from BMGS would no longer be "purchased power" which could lead to an over collection in the PPFAC tracking account and a negative true-up component. This could actually result in a decrease in UNSE's cash flow and earnings. In other words, if UNSE purchased BMGS without its inclusion in rate base, revenues collected through the PPFAC would decrease because UNSE would no longer

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[23] Staff Closing Brief at 5.
[24] UNSE Opening Brief at 9 (emphasis added).
[25] Staff Closing Brief at 5.
[26] Tr. at 233-34.
[27] UNSE June 8, 2008 Plan of Administration p. 1.

be purchasing power from and making payments to UED under the tolling arrangement. In that event, because BMGS is not in rate base, the Company would be unable to recover its costs from either the PPFAC or in base rates. Staff did not explain how its recommendation to deny rate base treatment would allow UNSE to recover the ongoing cash operating expenses associated with that purchase, or how UNSE could obtain financing to purchase BMGS or pay those financing costs. Although a company may see a reduction in earnings when it adds new plant prior to that plant's inclusion in rate base in a rate case, it would be a perverse result if not only earnings, but also revenues, decreased as a result of acquiring new plant. This would be the result of moving plant whose costs are being recovered via a PPFAC into rate base without creating a mechanism to collect those costs.

BMGS began commercial operation in June 2008, providing service to UNSE's customers during the test year. UNSE employees operated it and were responsible for maintaining it. Although it was not owned by UNSE during the test year, it was used to provide electricity to UNSE's customers. Its purchase price is known and its operating and maintenance costs are also known and measurable.[28] Although the exact capital costs associated with financing the plant are unknown, the Commission has already granted UNSE the financing authority to acquire the plant. Decision No. 70360 also requires UNSE to file reports describing the financing transaction(s) and demonstrating that the terms are consistent with those generally available to comparable entities; to file documentation demonstrating compliance with the required minimum debt service coverage ratio and times interest earnings ratio; and to file copies of all executed loan documents.

Customers can gain long-term benefits such as rate stability and electric reliability from rate basing BMGS, without an increase in rates. UNSE presented credible testimony that it would not be financially prudent for UNSE to acquire BMGS without the ability to recover its associated ongoing costs, even if it were to use interim financing as suggested by Staff. We recognize that to approve such rate base treatment of a plant that is not currently owned by the utility is outside the normal regulatory framework, but we believe that the legitimate concerns raised by Staff can be addressed in a way that will protect the utility's customers.

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[28] Tr. at 371-373; U-15 at 31 (Dukes Direct Testimony); BMGS Final Schedules C-2. Seven months of actual expense charges incurred in the test year were annualized and UNSE proposed an adjustment of $1,158,464.

We agree that Staff should conclude its evaluation prior to UNSE's purchase of BMGS, especially in light of the warranty repair being made to one of the turbines at the time of the hearing, which the Company states has been completed and the unit is again operating. Staff should complete its review and UNSE should insure that UED allows access to all plant facilities and records that may be necessary. Although UNSE has proposed specific adjustments to include BMGS in rate base in setting rates in this case, we do not think it necessary to adopt specific adjustments at this time. Because the revenue neutral rate reclassification will produce the same amount of revenue while the size of rate base will increase, the only variable will be the rate of return, which will essentially be a "fall out" number. UNSE should prepare schedules showing the inclusion of BMGS in rate base, with the appropriate operating adjustments, together with a proof of revenues demonstrating that the reclassified rates will produce the revenue authorized herein. Staff and RUCO should assist UNSE to insure that the reclassified rates are revenue neutral. Further, in order for us to evaluate the continued reasonableness of the rates once BMGS is placed into rate base, we will require UNSE to file a rate application using the twelve month test year immediately following implementation of any rate reclassification.

Accordingly, we will allow the rate base treatment of the BMGS and the rate reclassification, with such treatment and reclassification effective only upon the following steps:

1) Staff shall complete its evaluation of BMGS and file its recommendation in this docket as a compliance item within 90 days of the date of this Decision;[29]

2) Commission determination confirming that BMGS should be included in rate base;

3) UNSE shall, with the assistance of Staff and RUCO, prepare and file in this docket as a compliance item within 60 days of the date of this Decision, schedules showing the inclusion of BMGS in rate base, with the appropriate operating adjustments, together with a proof of revenues demonstrating that the reclassified rates will produce the same revenue as authorized herein;

4) FERC approval of UNSE's acquisition of BMGS;

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[29] We note the testimony of Staff's witness, Mr. Lewis, whose inspection of the BMGS facility indicated that it was properly constructed and should be back to full operational levels once the repairs were completed. It was not clear from the record what review Staff believes is necessary beyond confirmation of the turbine's repair, but we will leave it to Staff's discretion to conduct the review that it believes is necessary and file a recommended order for the Commission's consideration.

5) Completion of UNSE's acquisition of BMGS; and

6) Customer notice of the revenue neutral reclassification in a manner acceptable to Staff.

No later than 18 months after any rate reclassification, UNSE should file a rate application using the twelve month test year beginning with the first month following implementation of the rate reclassification.

Post-Test-Year Plant

UNSE proposes to include $7,263,614 of post-test-year plant in rate base. The Company claims to have limited its request to plant added after the test year which is "non-revenue producing." According to Company witness Dukes, the post-test-year plant for which the Company seeks rate base recognition "is plant whose primary purpose is to serve existing customers and which would have been replaced regardless of customer growth."[30] Mr. Dukes testified that the plant in question includes transportation equipment, general plant, and replacement and relocation of existing facilities. These plant items were not service at the end of the test year, but Mr. Dukes testified they would be in service before rates go into effect.[31] The Company argues that there will be no material mismatch between revenues and expenses if the post test year plant is included in rate base, but there will be "regulatory lag" if it is not.

In support of its position, UNSE contends that it responded to concerns expressed by the Commission in the Company's last rate case, Decision No. 70360 (May 27, 2008), that the Company's request for post-test-year plant failed to segregate revenue producing plant from non-revenue-producing plant. UNSE claims that it "accepted the criticism and addressed it in this case by limiting its request to non-revenue producing plant."[32]

UNSE also cites to prior Commission decisions involving water companies wherein post-test-year plant was included in rate base. For example, in a case involving Bella Vista Water Company, Decision No. 65350 (November 1, 2002), the Commission permitted inclusion of post-test-year system improvements on the basis that the record did not reflect a material impact on revenues and expenses. The Company also points to a Chaparral City Water Company case, Decision No. 68176

[30] Ex. U-17 at 3 (Dukes Rejoinder Testimony).
[31] Id. at 3.
[32] UNSE Closing Brief at 9.

(September 30, 2005), in which the Commission allowed post-test-year plant in rate base despite the potential mismatch between revenues and expenses. The Company also cites a Rio Rico water and wastewater case, Decision No. 67279 (October 5, 2004) where the Commission allowed post-test-year plant in rate base where "there would not be a material impact on revenues or expenses"[33] and to an Arizona Water rate case, Decision No. 66849 (March 19, 2004) where the Commission allowed twelve months of post-test-year plant in rate base.

Staff opposes the Company's request for post-test-year plant on the basis that it would violate principles of ratemaking and would result in a mismatch of such plant with test year revenues, expenses and rate base. Staff witness, Dr. Fish, stated that the Company's plant investment after the test year could result in efficiencies and lower maintenance costs, thereby resulting in a mismatch with test year revenues and expenses.[34] He also testified that the Company's witness did not provide any studies or analyses (either in aggregate or by line item) that demonstrated the proposed adjustment was revenue neutral.[35]

Staff disputes the Company's interpretation of the cited Chaparral City case (Decision No. 68176), arguing that the Commission's inclusion of post-test-year plant was based on its determination that Chaparral City's plant was placed in service within three months of the end of the test year, and that the additional plant was needed to reliably meet peak demands, provide operational flexibility, and provide a safe capacity operating margin.[36] With respect to Bella Vista (Decision No. 65350), Staff states that the Commission indicated that the inclusion of post-test-year plant is a matter to be determined on a case-by-case basis and in that case, the investment amounted to about 24 percent of rate base, was installed to enhance service to existing customers, and the Commission did not want to discourage companies from proactively addressing system reliability needs. Dr. Fish also noted that the Commission's decision "agreed with Staff that the Company had the burden to demonstrate that the post test-year plant is revenue neutral."[37]

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[33] Decision No. 67279 at 7.
[34] Ex. S-9 at 12 (Fish Direct Testimony).
[35] Id. at 12.
[36] Id. at 15.
[37] Id. at 14.

Staff recommends that the Commission deny the request to include these post test-year capital investments in rate base because of the "small size of the investments relative to the Company's rate base, the relatively non-essential, or on-going, nature of the investments, and the lack of support for the revenue neutrality contention."[38]

RUCO similarly opposes inclusion of post-test-year plant in this case, basing its recommendation on the rate making matching principle, and the lack of evidence to support the revenue neutrality claim. RUCO states that the Company has not shown how the over $7 million of investments will be revenue neutral, and notes that if it is included in rate base, it will increase the Company's revenues. RUCO objects that the Company's adjustment does not include the operating efficiencies and reductions to expenses or the revenues from possible growth that is possible as a result of the new plant. RUCO does not believe that these "routine, ordinary type investments require extra-ordinary post-test year adjustments."[39]

Conclusion on Post-Test-Year-Plant

In Decision No. 70360, we denied UNSE's proposal for rate base recognition of post-test-year plant. In that Decision, we pointed out that although such plant has previously been allowed in several prior cases involving water companies, the records in those cases provided some assurance that a mismatch of rate base with revenues and expenses did not occur. UNSE identified portions of its post-test-year plant as "non-revenue-producing" in an attempt to satisfy what it interpreted as the Commission's primary concern in the last case related to such plant. Aside from the subjective nature of the "revenue-producing" versus "non-revenue-producing" inquiry undertaken by the UNSE employees, the Company's narrow reading of Decision No. 70360 is misplaced. That Decision observed that inclusion of post-test-year plant could result in a mismatch of rate base with revenues and expenses, but found that the record was insufficient to even evaluate the reasonableness of the Company's request. We also note that Decision No. 71448 (December 30, 2009) allowing Arizona Public Service Company's post-test year plant in rate base adopted a settlement agreement that balanced many issues and policy determinations.

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[38] Id. at 16.
[39] RUCO Opening Brief at 9.

Consistent with our recent decision in the UNS Gas' rate case, we believe that the decision of whether to allow inclusion of post-test-year plant in rate base should continue to be made on a case-by-case basis. As we said in Decision No. 71623:

> Some of the factors that may be considered in making that determination are: the amount of test year plant relative to overall capitalization; the impact on the company's financial health and ability to provide service; the presence of capacity or safety issues that require expedited plant investment for compliance purposes; and whether there is sufficient certainty regarding the revenue neutrality of the post-test-year plant, including consideration of whether the additional plant is non-revenue-producing and non-expense reducing. This list of factors is not intended to be exhaustive, but rather suggestive of the type of issues that may be considered.[40]

Pro forma adjustments are defined in Arizona Administrative Code ("A.A.C.") R14-2-103(A)(3)(i) as "adjustments to actual test year results and balances to obtain a normal or more realistic relationship between revenues, expenses and rate base." We find that UNSE has not demonstrated that these plant investments are anything other than ordinary, routine investments in plant required to be made by a utility to maintain its service and reliability. To allow these post test year investments into rate base would distort the level of investment needed to provide adequate and reliable service to UNSE's customers during the test year and would not reflect a "normal or more realistic relationship between revenues, expenses and rate base."

We agree with Staff and RUCO that UNSE has not demonstrated that the plant would be "revenue neutral" and has not provided sufficient justification for the Commission to deviate from its rule, A.A.C. R-14-2-103(a)(3)(p), using the one-year historical test year to determine rate base.

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

BMGS Working Capital

Consistent with our determination herein to allow BMGS into rate base upon satisfaction of the completed steps, we will not make such an adjustment in this decision but UNSE should make its adjustment to working capital in its subsequent filing with the rate reclassification.

Uncontested Rate Base Adjustments

[40] Decision No. 71623 (April 14, 2010) at 8.

UNSE proposed an Acquisition Discount Adjustment of $8,355,383 which was not disputed by any party. Consistent with our determinations herein, adjustments will also be made to accumulated deferred income taxes and working capital.

RCND

The Company's schedules contained an error in calculating the RCND value of the Citizens Acquisition Adjustment, and accordingly, the RCND Net Citizens Acquisition Discount was recalculated.[41]

Summary of Rate Base Adjustments

Based on the foregoing discussion, we adopt an adjusted OCRB of $168,574,818, RCND of $314,572,470,[42] and a FVRB of $241,573,644.

ORIGINAL COST RATE BASE:	Commission Approved
Plant in Service	$446,913,556
Less: Accumulated Depreciation	193,348,359
Net Plant in Service	$253,565,196
Citizens Acq. Discount	($93,273,341)
Less: Accum. Amort. Citizens Acq. Discount	20,876,317
Net Citizens Acq. Discount	($72,397,024)
Total Net Utility Plant	$181,168,172
Deductions:	
Customer Advances for Construction	$12,605,744
Customer Deposits	4,064,671
Accum. Deferred Income Taxes	2,028,227
Total Deductions	$18,698,641
Allowance for Working Capital	$6,105,287
Total OCRB	**$168,574,818**

[41] In its schedule developing the RCND acquisition adjustment, the Company calculated the RCN percentage increase as determined for the OCRB gross utility plant in service and applied it to the OCRB acquisition adjustment to calculate the RCND acquisition adjustment. (See Company Exhibit D). However, the OCRB acquisition adjustment values used in the calculation are net values (gross acquisition adjustment less accumulated amortization). (See Company Exhibit C). Therefore, the RCND acquisition adjustment as calculated in Exhibit D is also a net value. However, this net RCND acquisition adjustment value was carried forward to the Company's Revenue Requirement Model where additional accumulated amortization was calculated and applied, resulting in both gross and net RCND acquisition adjustment values that are understated. These understated values were then carried forward to the Company's Schedules B-3 and B-1, resulting in an overstated RCND rate base value on Company Schedule A-1.

[42] In adopting the RCND, as adjusted to correct the error related to the Citizens Acquisition Adjustment, we note that no issue was raised by the parties as to the development of the RCND or its use to determine FVRB.

RCND RATE BASE:

Plant in Service	$837,037,541
Less: Accumulated Depreciation	367,590,759
Net Plant in Service	$469,446,782
Citizens Acq. Discount	($174,198,445)
Less: Accum. Amort. Citizens Acq. Discount	38,706,171
Net Citizens Acq. Discount	($135,492,275)
Total Net Utility Plant	$333,954,507
Deductions:	
Customer Advances for Construction	$17,555,056
Customer Deposits	4,064,671
Accum. Deferred Income Taxes	3,867,598
Total Deductions	$25,487,324
Allowance for Working Capital	$6,105,287
Total RCND	**$314,572,470**

FAIR VALUE RATE BASE:

Plant in Service	$641,975,548
Less: Accumulated Depreciation	280,469,559
Net Plant in Service	$361,505,989
Citizens Acq. Discount	($133,735,893)
Less: Accum. Amort. Citizens Acq. Discount	29,791,244
Net Citizens Acq. Discount	($103,944,649)
Total Net Utility Plant	$257,561,340
Deductions:	
Customer Advances for Construction	$15,080,400
Customer Deposits	4,064,671
Accum. Deferred Income Taxes	2,947,912
Total Deductions	$22,092,983
Allowance for Working Capital	$6,105,287
Total FVRB	**$241,573,644**

Operating Revenue and Income Issues

In the test year, the Company's reported operating revenues were $160,926,065, with reported adjusted test year operating expenses of $151,079,190 and test year net operating income of

$9,846,875. As reported in its Final Schedules, Staff's proposed adjusted test year operating revenues were $160,926,065, with adjusted test year operating expenses of $150,211,520, resulting in test year net operating income of $10,714,545. RUCO's Revised Final Schedules show proposed adjusted test year operating revenues of $160,926,065, with adjusted test year operating expenses of $144,285,929, yielding test year net operating income of $16,640,136.

Operating Revenues

The Company made several unopposed adjustments to operating revenue, including Retail Revenue and Purchased Power Annualization ($10,733,456); Wholesale Revenue and Purchased Power (negative $10,168,115); Weather Normalization (negative $1,017,300); Customer Energy and Demand Normalization (negative $2,820,565); Fuel and PPFAC Revenue and Expense Normalization (negative $29,192,263); Customer Assistance Residential Energy Support ("CARES") Discount (negative $61,797);[43] and Demand Side Management ("DSM") and Renewables Revenue and Expense (negative $1,458,039). All parties agree that the Company's test year revenues were $160,926,065. We find that UNSE's test year revenues are $160,926,065.

Operating Expenses

Uncontested Operating Expenses

The Company made several unopposed adjustments to operating expenses, including Retail Revenue and Purchased Power Annualization (negative $956,469); Wholesale Revenue and Purchased Power (negative $10,168,115); Weather Normalization (negative $830,613); Customer Energy and Demand Normalization (negative $1,079,814); Fuel and PPFAC Revenue and Expense Normalization (negative $19,024,147); DSM and Renewables Revenue and Expense (negative $1,626,826); Pension and Benefits ($210,866); Post-Retirement Medical ($161,929); Interest on Customer Deposits (negative $145,701); Workers Compensation (negative $115,528); A&G Expense Capitalized (negative $229,429); and Depreciation and Amortization Expense Annualization (negative $507,792). We will adopt these unopposed expense adjustments.

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[43] Although Staff initially recommended disallowance of this adjustment, Staff was able to substantiate it and in Staff's Opening Brief at page 10, Staff agreed with the adjustment.

Fleet Fuel Expense

In its application, the Company included the actual fleet fuel expenses from the test year, reflecting an average price per gallon for gasoline of $3.32 and $3.82 for diesel. Staff's witness, Dr. Fish, testified that fuel prices for the first part of the test year were unusually high, so he proposed an adjustment based upon the average of 2009 actual monthly and projected average monthly prices. His adjustment reflects an average price per gallon of $2.52 for gasoline and $2.65 for diesel.[44] RUCO did not object to use of the Company's test year expense level.

In its rebuttal testimony, UNSE proposed its own adjustment. UNSE used the three year average to normalize the cost, and believes that this adjustment reflects known and measurable costs incurred by UNSE in its largely rural service area. UNSE's adjustment reflects an average fuel cost of $3.00 per gallon.

We agree that the test year level of fleet fuel expense is not indicative of ongoing fuel costs. Because UNSE's adjustment is based upon a normalization of actual costs incurred by UNSE, we find that it best reflects the costs incurred in its service area.[45] Accordingly, we will decrease test year fleet fuel expenses by $56,333.

Customer Call Center Expenses

UNSE included in its application the actual allocated test year costs associated with operations at the call center shared with its affiliate companies, UNS Gas and Tucson Electric Power Company ("TEP"). The call center operates twelve hours per day from 7 a.m. to 7 p.m. five days per week, with an after-hours service available for emergencies.[46] The Company's witness testified that the call center employs over 75 customer service representative and has 230 incoming telephone lines, allowing the service representative to handle "virtually any" transaction, including service connection and disconnection; account balance information; payment arrangements; and outage reporting. "Virtual hold" was implemented in May 2008 and the call center's automatic call distributor[47] and interactive voice response system[48] are being replaced, which Mr. McKenna testified

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[44] Ex. S-9 at 30.
[45] Dr. Fish acknowledged that his adjustment was based upon a statewide price of fuel and agreed that to some extent, fuel prices are higher in rural areas. Tr. at 477.
[46] Ex. U-8 at 7.
[47] Automatic call distributor is designed to provide a more stabilized, reliable platform for incoming calls.

will enhance system reliability.[49] Mr. McKenna also testified that "due to improvements made to the call center and the enhancement of the payment options" UNSE's customers' call volume decreased by fifteen percent in 2008, and the "hold time" for customers decreased from 4 minutes 23 seconds in 2006 to 2 minutes 51 seconds in 2008.[50] During the test year, UNSE's allocation of call center expenses totaled $880,553. RUCO did not object to UNSE's actual call center expenses.

Staff witness Dr. Fish testified that the increase in the Company's call center expenses compared to the last case is unjustified because the call center volume decreased by fifteen percent since the last rate case.[51] Dr. Fish recommends that UNSE's authorized call center expenses be reduced by $99,476, to the level authorized in the Company's last case.

UNSE opposes Staff's proposed adjustment and believes that Dr. Fish ignores the cost increases since the last test year. Mr. Dukes testified that the increase in expense is reasonable because investment, wages, and benefit costs have increased since the June 2006 test year.[52]

We find that UNSE has justified the basis for the increased call center costs compared to the Company's last rate case. As the Company's witness pointed out, the expenses authorized in the prior case were based on a June 2006 test year, and the amount of investment as well as wage and benefits costs have increased substantially since that time. We do not believe that Staff's justification for decreasing the call center expenses to a June 2006 level is supported by the record. Reliance on a single factor (decreased service order volumes) is not a sufficient basis for disallowing almost $100,000 of test year expenses related to providing important services to customers. Consistent with our recent decision for UNS Gas, we will adopt UNSE's position on this issue and will allow recovery of the Company's test year call center expenses of $880,553.

Payroll and Payroll Tax Expense

The Company proposed adjustments to payroll expense in the amount of $220,252 and to payroll tax expense in the amount of $55,054. These adjustments are to reflect increases that were

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[48] Interactive voice response system will include automated outage call handling and automated outbound courtesy payment reminders.
[49] Ex. U-8 at 8.
[50] Id. at 9.
[51] Ex. S-9 at 25-6.
[52] Wages have increased over 3 percent annually and benefits have increased over 10 percent annually during the last 3 years. Ex. U-16 at 25 (Dukes Rebuttal Testimony).

effective January 1, 2010 and were applied to employee levels as of the test year. Staff did not oppose these adjustments. RUCO accepts the adjustment to include the 2009 pay rate increase because it will synchronize the payroll expense with other test year calculations, but opposes the 2010 pay rate adjustment because it is too far beyond the test year. RUCO proposes that the adjustment to payroll expense be limited to $79,628 and the payroll tax expense be adjusted by $35,430.

Consistent with our recent decision in UNS Gas, we find that the 2010 wage increases should be recognized in the rates approved in this proceeding. Those increases are known and measurable and have been reconciled with end-of-test year employee levels to avoid a mismatch of revenues and expenses. Allowance of the known and measurable wage increases is also consistent with the Commission's treatment of this issue for UNSE in Decision No. 70360 (May 27, 2008) and for Southwest Gas Corporation in Decision No. 70665 (December 24, 2008). Accordingly, we will accept the Company's adjustment to payroll expense in the amount of $220,252 and payroll tax expense in the amount of $55,054.

Rate Case Expense

The Company requests $500,000 in rate case expenses, amortized over 3 years, resulting in an adjustment of $138,890.[53] Mr. Dukes testified that the final cost after hearing, briefing, and open meeting will be in excess of $500,000 and reflects the cost of a utility that does not have in-house regulatory counsel or a rate department whose costs are recovered in base rates.[54] He believes that UNSE is "handling its rate cases in the most cost efficient manner possible and should be compensated for its actual costs."[55]

RUCO and Staff recommend $300,000 in rate case expense. Dr. Johnson testified for RUCO that this case was filed just two years after the last rate case was decided and involved many of the same company witnesses and issues.[56] Since he could see no reason why rate case expenses should increase substantially over the $300,000 level the Commission found reasonable, he recommended an

[53] This is net after including $30,556 remaining from the last rate case and subtracting $58,333 already collected in the test year.
[54] Ex. U-16 at 22.
[55] Id. at 23.
[56] Ex. R-6 at 36.

allowance of $300,000 amortized over three years. Dr. Johnson believes that "[t]o the extent the Company chooses to spend more than this amount, the excess amount should be the responsibility of the stockholders, and not borne by the customers."[57]

Staff's witness, Dr. Fish, testified that the Company's proposed rate case expense of $500,000 is not reasonable. Dr. Fish cited to UNSE and UNS Gas' last rate cases, where the Commission authorized rate case expenses of $300,000 amortized over three years. Staff does not believe that the Company's arguments that it must use TEP employees and that it responded to numerous data requests support the high level of expenses requested.[58] Staff also recommended rate case expense of $300,000, amortized over three years.

We agree with Staff and RUCO that the Company's proposed rate case expense of $500,000 should be reduced significantly. As RUCO and Staff point out, the recent UNS Gas and UNSE cases, as well as the two most recent Southwest Gas cases, presented many of the same issues that were raised in this case, and the Decisions in those cases represent an appropriate measure of comparison for UNSE in this case. We note that there were even more hearing days in those cases. In fact, the prior UNSE case presented more issues than were litigated in this case, as it was the first one filed and considered following UNSE's acquisition of Citizens Utilities' assets. For these reasons, we find a reasonable and appropriate level of rate case expense to be $300,000, normalized over three years.

<u>Edison Electrical Institute Membership Dues</u>

The Company requests that dues it pays to the Edison Electrical Institute ("EEI") be recovered in rates. Mr. Dukes testified that an adjustment was needed to increase test year expenses by $11,172 because due to a posting error, the EEI dues were not included in the starting test year expenses. Both Staff and RUCO recommend that a portion of the EEI dues be disallowed. Staff recommended disallowing 49.93 percent, for a $4,763 adjustment to the Company's ($451,888) industry dues adjustment, and RUCO recommended a disallowance of 40 percent of the dues. RUCO believes that these expenses are paid for purposes that do not benefit ratepayers, but do benefit shareholders.[59] In Decision No. 70360 we adopted Staff's position and disallowed 49.93 percent of

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[57] Id.
[58] Staff Closing Brief at 8.
[59] RUCO Opening Brief at 13.

EEI dues because EEI's "core dues related to legislative advocacy, regulatory advocacy, advertising, marketing, and public relations total 49.93 percent of the total dues."[60]

The Company failed to provide a sufficient reason why ratepayers should pay for advocacy, advertising, marketing, and public relations that are not required for the provision of electric service and do not otherwise benefit ratepayers. Accordingly, we will adopt Staff's recommendation of disallowing 49.93 percent of EEI dues.

Postage Expense

The Company included an adjustment to increase test-year postage expense to reflect postage rate increases that became effective on May 12, 2008 and May 11, 2009. Staff does not oppose the adjustment, but RUCO opposes the May 11, 2009 adjustment as it occurred five months beyond the test year.

The adjustments are known and measurable and outside the control of the Company. Consistent with our recent decision in the UNS Gas rate case, we will adopt both adjustments.

Outside Legal Expenses

The Company requests a $109,434 adjustment to outside legal expense. According to Mr. Dukes, the test year level did not fairly reflect a normal and recurring level of expense, so the Company normalized three years of outside legal expense.[61] The Company's adjustment used the method adopted in UNS Gas' last two rate cases. RUCO also proposed a three year average using 2006, 2007 and 2008 with adjustments to exclude rate case support during the test year, and Staff used a four year normalization period.

As we indicated in our recent Decision No. 71623 (UNS Gas' last rate case) 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. We used a three year average to normalize outside legal expenses in the last two UNS Gas rate cases, and we can see no reason to depart from this practice in this case. RUCO's recommendation is reasonable as it includes the three most recent

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[60] Decision No. 70360 at 26.

[61] Ex. U-15 at 25. The Company used years 2005, 2006, and 2007.

years and includes the test year. Accordingly, we will adopt an adjustment of $76,503 to test year outside legal expenses in this case.

Bad Debt Expense

The Company proposed a bad debt expense adjustment to reflect a level of "final, pro forma weather-normalized, customer-annualized test-year operating revenues, and the average percentage of actual account write-offs experienced during the past three years."[62] Mr. Dukes explained that the Company's calculation was prepared and calculated in the same manner the Commission adopted in its last rate case. RUCO did not oppose the Company's proposed adjustment.

Staff's witness believes that the Company has understated its bad debt expense by $105,487.[63] Dr. Fish testified that the actual bad debt expense for the test year was about $1.2 million and that the Company's normalized expense (calculated by averaging the bad debt ratio to gross revenue for the years 2006, 2007, and 2008) should have been multiplied by gross retail revenue rather than by test year adjusted retail revenues.[64]

We agree with the Company's contention that the accounting undertaken for normalizing bad debt expense is appropriate. We used this method in UNSE's last rate case and in calculating bad debt expense for UNS Gas. We find that UNSE has explained sufficiently the basis of its accounting treatment of bad debt expense and we therefore decline to adopt Staff's recommendation on this issue. Accordingly, we will adopt the Company's bad debt expense adjustment.

Depreciation and Property Tax on Post-Test-Year Plant

The Company proposed a $442,526 adjustment to increase depreciation and property tax associated with its request to include post-test-year plant in rate base. Staff and RUCO opposed this adjustment consistent with their positions opposing post-test-year plant in rate base. Consistent with our determination herein to disallow rate base treatment of the post-test-year plant, we will not adopt this proposed adjustment.

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[62] Id. at 23.
[63] Ex. S-11 at 13 (Fish Surrebuttal Testimony).
[64] Id.

Property Tax Rate

UNSE initially proposed a property tax expense adjustment of ($7,358) based on final adjusted plant in service at the end of the test year, using the statutory assessment ratio of 21 percent which was scheduled to become effective January 1, 2010, and the most currently known average property rates.[65] In the Company's rebuttal testimony, witness Karen Kissinger supplemented the property tax adjustment to use the average tax rate implicit in the tax bills the Company received in September 2009. Using the most current information, the proposed adjustment increased test year property tax expense by $105,181.[66] Staff accepted the Company's initial adjustment and did not revise its position. RUCO recommends that the Commission use the assessment ratio that went into effect in 2009 because that would be more consistent with an historical test year, although it does concede that it is a "close call."[67]

We agree with the Company 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 2010 is 21.0 percent and is known and measurable. Our adoption of the known property tax rate for 2010, when the rates set in this case will become effective, is consistent with prior cases that addressed this issue, as well as our inclusion of known and measurable wage increases that took effect in 2010. Accordingly, property tax expense should be increased by $105,181.

Incentive Compensation

UNSE proposed to include in test year expenses the cost of its cash-based incentive paid to non-union employees through its Performance Enhancement Program ("PEP"). The Company believes that the PEP program costs are a net savings to customers and provide a "valuable management tool to promote increased earnings, to promote additional cost savings, to motivate individual employees, to encourage groups of employees to work together to impact specific goals, and to aid in the retention of higher-performing employees."[68] UNSE acknowledged that the Commission has previously allowed only 50 percent of the PEP in the previous UNS Gas and UNSE

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[65] Ex. U-6 at 8 (Kissinger Direct Testimony).
[66] Ex. U-7 at 2 (Kissinger Rebuttal Testimony).
[67] RUCO Opening Brief at 11.
[68] Ex. U-16 at 17.

rate cases, but argues that its PEP is very similar to Arizona Public Service Company's ("APS") cash-based incentive compensation plan which the Commission allowed recovery of in Decision No. 69663 (June 28, 2007).

Staff and RUCO recommended that the Commission disallow 50 percent of the PEP costs, consistent with the Commission's previous treatment of this expense. Staff's witness testified that

> Incentive pay, of course, is distinctively different compared to payroll expense. Incentive pay is earned over and above base pay, and its purpose is to induce greater efficiency and productivity from employees than payroll expense alone. This extra reward for above normal productivity makes this cost unique and subject to separate treatment. Normal payroll expenses are a normal and ongoing cost of providing service. Incentive pay is designed as a reward for extraordinary and above normal service and benefit to the Company and as such its cost should be borne by the parties that enjoy the above normal service and benefit, the Company's owners and ratepayers.[69]

In response to the Company's comparison of the treatment of APS' cash-based incentive plan, Staff disagreed that UNSE had demonstrated that the two plans were structured in the same manner, and noted that APS' expense of its stock-based incentive plan was disallowed because it was based upon the financial performance of Pinnacle West Capital Corporation.

We believe that the Staff and RUCO recommendations, to require a 50/50 sharing of incentive compensation costs, provide a reasonable balancing of the interests between ratepayers and shareholders. The equal sharing of such costs recognizes that the program is comprised of elements that relate to the parent company's financial performance and cost containment goals, matters that primarily benefit shareholders, while at the same time recognizing that a portion 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.

Therefore, consistent with the recent cases cited above, we will adopt the recommendation of Staff and RUCO on this issue, and will disallow $132,159 in PEP expense and the related $10,110 payroll tax expense.

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[69] Ex. S-11 at 9.

Stock-Based Compensation

UNSE proposes to include costs allocated to it from TEP for stock-based incentive compensation for officers. RUCO opposes inclusion of these costs in expenses as it believes that the expense of providing stock options and stock-based compensation beyond the normal level of compensation should be a shareholder expense, and not borne by ratepayers. Staff did not take a position on this issue. UNSE argues that for the same reasons it identified in the UNS Gas rate case (the stock-based compensation is tied to long-term benefits and long-term incentives) it opposes RUCO's proposed adjustment in this case.

We agree with RUCO that UNSE's proposal to include the costs of stock-based compensation should be denied. In the last UNSE case, we agreed with Staff that "test year expenses should be reduced to remove stock-based compensation to officers and employees."[70] In our recent decision in the UNS Gas rate case, we agreed with RUCO's recommendation to exclude stock-based incentive compensation, stating:

> As we have indicated in prior cases, tying employee compensation to a company's stock price has the potential to 'negatively affect the Company's provisions of safe, reliable utility service at a reasonable rate' because management decisions (*e.g.*, delaying maintenance costs) could be influenced by the effect on earnings. (Decision No. 69663, at 36.) Further, as RUCO's witness pointed out, current economic conditions should cause utility companies to reconsider whether it is appropriate to seek recovery from captive ratepayers of incentive programs, such as providing stock options to management and employees.[71]

The Company has not presented a compelling reason to depart from previous and recent determinations on this issue. In accordance with RUCO's recommendation, we find that $271,855 should be excluded from test year expenses related to stock-based compensation.

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[70] Decision No. 70360 at 22.
[71] Decision No. 71623 at 32.

Supplemental Executive Retirement Plan

UNSE 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.

UNSE 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. The Company claims that SERP costs do not represent an excess benefit, but are necessary to keep management benefits equal as a percentage of compensation to the eligible employees.[72] UNSE argues that SERP expenses are normal, reasonable and recurring compensation costs that are incurred in the provision of service, and the costs should therefore be recoverable.

Staff and RUCO recommend disallowance of the SERP costs ($102,042), in accordance with the Commission's Decisions in several recent cases.

In a prior Southwest Gas case we disallowed 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. [73]

We reached the same conclusion regarding SERP expenses in the previous UNSE rate case stating:

> [T]he 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

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[72] Ex. U-16 at 20.
[73] Decision No. 68487, at 19.

> chooses to do so, shareholders rather than ratepayers should be responsible for the retirement benefits afforded only to those executives.[74]

More recent Commission Orders have consistently denied recovery of SERP expenses in rates. For example, in Decision No. 69663 (June 28, 2007), we disallowed SERP expenses for APS based on the finding made in the earlier Southwest Gas proceeding.[75] In the most recent Southwest Gas case we again found that SERP expenses should not be recoverable from ratepayers.[76] And in our most recent UNS Gas rate case, we again denied recovery of SERP expenses.[77]

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

We therefore adopt the recommendations of Staff and RUCO and disallow $102,042 in SERP expenses proposed by UNSE.

Wholesale Credit Support

The Company requested that the costs incurred for wholesale credit support (cash collateral placed in escrow and letters of credit issued for the benefit of suppliers) be recovered through the PPFAC. Staff opposed the inclusion of wholesale credit support costs through the PPFAC, but does not oppose the inclusion of these costs in base rates.[78] In its rebuttal testimony, the Company calculated that the annual credit support costs would be $195,500, derived by using the weekly average balance of wholesale credit support provided between August 10, 2008 and April 12, 2009, and multiplying that by the 1.15 percent annual cost rate for credit support.[79] This adjustment was unopposed and we will adopt it.

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[74] Decision No. 70360 at 22.
[75] Decision No. 69663, at 26-27.
[76] Decision No. 70665, at 17-18.
[77] Decision No. 71623, at 32-34.
[78] Staff Reply Brief at 10.
[79] Ex. U-13 at 28.

Income Tax and Interest Synchronization

UNSE proposed an income tax expense of $2,026,033 which includes synchronization of interest, in order to coordinate the income tax calculation with the rate base and cost of capital. RUCO also used an interest synchronization adjustment to coordinate the income tax calculation with rate base and cost of capital. In surrebuttal testimony, Staff's witness revised his recommendation and did not make an interest synchronization adjustment. Dr. Fish testified that due to the fair value adjustment, the Company would not have a problem of recovering its cost of capital, so the justification for using synchronization is not applicable.[80]

The Commission has used interest synchronization to coordinate the income tax calculation with rate base and the cost of capital for over 30 years. Dr. Fish's recommendation appears to be tied to Staff's recommended fair value adjustment to the cost of capital. We agree with RUCO and the Company that the long-standing method of calculating income tax expense using interest synchronization is appropriate and will avoid providing a return of interest cost on capital not used to serve present customers.

BMGS Operating Expense

Consistent with its requested rate base treatment and revenue neutral reclassification, UNSE proposed operating expense adjustments related to BMGS that would become effective after its acquisition. Those include: (1) BMGS purchase power agreement adjustment (negative $10,960,779)[81]; (2) BMGS Operations & Maintenance Expense (positive $1,158,464); (3) BMGS Depreciation & Amortization Annualization Expense (positive $1,649,496); (4) BMGS Property Tax Expense (positive $434,148); and (5) BMGS Income Tax Expense (positive $2,074,196). RUCO does not dispute the adjustments but its property tax and income tax expense were slightly different. Consistent with our determination herein, we will adopt the BMGS operating expense adjustments necessary to implement the revenue neutral rate reclassification upon completion of the above described steps.

[80] Tr. at 654-655.

[81] Although not identical to the cost of the BMGS purchase power agreement, it is "very comparable to the annual costs incurred by UNSE under the BMGS PPA. And since any difference between this credit and the actual cost of the BMGS PPA will be completely reconcilable through the PPFAC process, the customers of UNSE will not pay any more or less than the actual cost incurred for purchased power expense." Ex. U-15 at 31.

New Depreciation Rates

The Company's Application included 2009 technical updates of depreciation rates. Dr. Ronald White prepared the updates and his testimony was stipulated to by the parties. Accordingly, we will adopt the proposed depreciation rates and the updates in Dr. White's direct testimony.

Net Operating Income

Consistent with the foregoing discussion, we will allow adjusted test year operating expenses of $150,497,582 which based on test year revenues of $160,926,065, results in test year adjusted operating income of $10,428,483.

COST OF CAPITAL

UNSE recommends that the Commission determine the Company's cost of common equity to be 11.4 percent, its cost of debt of to be 7.05 percent, for an overall weighted average cost of capital ("WACC") of 9.04 percent. Staff recommends a cost of common equity of 10.0 percent, a cost of debt of 7.05 percent, with an overall weighted cost of capital of 8.40 percent. RUCO proposes adoption of a cost of common equity of 9.25 percent, a cost of debt of 7.05 percent, with an overall weighted cost of capital of 8.06 percent.

Capital Structure

At the end of the test year, UNSE had a capital structure consisting of 56.16 percent long-term debt and 43.84 percent equity.[82] The Company adjusted its actual capital structure as of the end of the test year to exclude UNSE's revolving credit facility borrowings, resulting in a capital structure consisting of 54.24 percent long-term debt and 45.76 percent common equity. Staff and RUCO agreed that it is appropriate to use the Company's adjusted capital structure.[83] We find that it is appropriate to use UNSE's adjusted test year capital structure for the purpose of determining the Company's cost of capital in this proceeding.

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[82] Ex. U-22 at 4.

[83] Ex. S-14 at 23; Ex. R-10 at 49; Ex. R-11 at 3.

Cost of Debt

The parties agree that the Company's cost of debt is 7.05 percent.[84] Since there is no dispute regarding this issue, we will adopt a cost of debt of 7.05 percent for purposes of establishing UNSE's weighted cost of capital in this proceeding.

Cost of Common Equity

There is no mathematical, mechanical, or precise procedure or formula for determining a company's cost of capital. Because the cost of capital is an opportunity cost and is prospective-looking, it can only be estimated. Experts rely on various analyses to reach recommendations and those recommendations reflect their use of assumptions and forecasts.

UNSE

UNSE witness Martha Pritz based her common equity cost recommendation of 11.4 percent on the results of her common equity models, including a multi-stage Discounted Cash Flow ("DCF"), Capital Asset Pricing Model ("CAPM"), and the Bond Yield Plus Risk Premium ("BYRP") method. Because UNSE is not a publicly traded company, she used data from a 10 company proxy group in her DCF and CAPM models.

The DCF method is "based on the premise that the value of an asset is equal to the discounted sum of its future cash flows."[85] The DCF model uses current stock prices and estimates of expected dividends to reach an estimate of the required return. Ms. Pritz used a multi-stage growth model which allows the expected dividend growth rate to change. She used forward-looking estimates of dividend and earnings growth rates from Value Line, Zacks Investment Research, and SNL Financial for near-term growth rates and calculated the expected dividends for the first stage (5 years) by using the most recent quarterly payments for the first year, and applying the near-term growth rate to expected first year dividends for years 2 through 5. She chose a long-term growth rate of 6.5 percent from a range of 5.4 percent for the U.S. economy, 6.5 percent for the proxy group, and 8.6 percent for the electric utility industry. Using her inputs, the DCF model produced a cost of equity of 12.1 percent.

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[84] Ex. U-22 at 17; Ex. S-14 at 24; Ex. R-10 at 48.
[85] Ex. U-22 at 7.

Ms. Pritz also used the CAPM model to determine the cost equity. Under this method, the investor's rate of return is calculated by adding a risk-free rate of return to a market risk premium for overall market risk, and adjusting for the beta value of the individual stock. In calculating the market risk premium, Ms. Pritz adjusted the historical market risk premium upward by 2.29 percent. She claimed this was necessary "to adequately reflect increased risk premiums required by investors in the current economic environment."[86] Ms. Pritz' CAPM model produced a cost of equity of 10.1 percent.

The Bond Yield plus Risk Premium Method is designed to estimate the cost of equity by estimating the difference between returns required by stockholders and debt holders. This estimate of risk is added to a required bond yield, resulting in an estimated cost of equity. Ms. Pritz used 7.9 percent as the bond yield, which was the average yield on Baa-rated utility bonds for January 2009, and used 4.07 percent as the risk premium, which she calculated by comparing utility commission allowed returns on equity to bond yields. Ms. Pritz' BYRP method produced a 12 percent cost of equity.

Ms. Pritz testified that an appropriate cost of equity would be no lower than 11.4 percent, which is the average of the cost of equity results for her three models. She believes that 11.4 percent is a conservative return on equity for UNSE because it is currently unable to pay a dividend and its small size makes it more vulnerable to financial stresses.

The Company criticized the return on equity ("ROE") recommendations of both Staff and RUCO. Ms. Pritz criticized Staff witness Parcell's single-stage version of the DCF and its use of low retention growth rates in perpetuity. She also testified that his use of "several weak sets of data as indicators of dividend growth" caused his estimate of cost of equity to be too low.[87] According to Ms. Pritz, the Comparable Earnings ("CE") method uses historical accounting returns which she believes are inappropriate for forward-looking cost of equity estimations. Ms. Pritz is also critical of Staff's use of a geometric mean return in its CAPM analysis, which she claims is contrary to sound financial theories. UNSE argues that the use of an arithmetic mean return in determining the market

[86] Id. at 14.

[87] Ms. Pritz criticized Mr. Parcell's use of Value Line's forward-looking estimates because she believes that the historical data is redundant and produces a downward-biased estimate of growth. Ex. U-23 at 2.

risk premium is supported by academics and financial professionals.[88] In response to Mr. Parcell's observation that the bond yields had fallen from 7.9 percent to about 6.1 percent in September 2009, Ms. Pritz testified that using the resulting cost of equity (10.2 percent) would be below the average allowed ROEs for electric utilities, and because UNSE is smaller and riskier with the lowest possible investment grade rating, investors would expect a higher return. She found that using the average Baa public utility bond yield for January 2006 through January 2009 (6.7 percent), the cost of equity would be 10.8 percent.[89]

The Company criticized RUCO's recommended 9.25 percent cost of equity resulting from what the Company calls inappropriate inputs into RUCO's CAPM analysis and its single-stage DCF model. Ms. Pritz testified that RUCO's witness Rigsby used a risk-free rate based upon a five year timeframe when he should have used a long-term rate, and that he inappropriately used intermediate term and total Treasury returns instead of long-term and income Treasury returns, as well as geometric means of historical data series in his calculation of the market risk premium. She calculated that with her corrections, the resulting return on equity would be 9.07 percent, not 6.83 percent.[90] Ms. Pritz also criticized RUCO's calculation of the growth rate used in its DCF analysis, arguing that Mr. Rigsby should not have made an adjustment based upon an assumption that utilities market-to-book ratios will tend to move toward 1.0.

RUCO

RUCO witness William Rigsby's DCF and CAPM methodologies resulted in a range of estimated ROE from 5.46 percent to 9.55 percent, with a recommended adoption of a ROE of 9.25 percent. Mr. Rigsby employed a single-stage DCF analysis, as opposed to the multi-stage version used by UNSE. RUCO contends that Mr. Rigsby's DCF analysis is appropriate because it already takes into consideration both short-term and long-term growth by using five-year growth rates specific to the electric utilities used in Mr. Rigsby's proxy group, whereas Ms. Pritz' DCF model assumes a long-term growth rate that would be comparable to an inflation-adjusted growth rate for all

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[88] Ex. U-23 at 8-9.
[89] Id. at 13.
[90] Ex. U-23 at 16.

goods and services produced by labor and property in the United States in perpetuity.[91] According to Mr. Rigsby, the multi-stage DCF used by the FERC requires more weight to be given to short-term growth expectations, which is similar to the one-to-five-year projections used in his DCF analysis.[92] Mr. Rigsby pointed out that if the Company's DCF inputs were applied to RUCO's single-stage DCF model, the resulting mean average would be 11.40 percent, lower than the Company's multi-stage DCF estimate.[93] 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.[94] 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."[95] RUCO disagrees with UNSE's characterization that the CAPM is producing "illogical results" given the current economic environment, and also criticizes Ms. Pritz' 2.29 percent upward adjustment to the market risk premium.[96]

Mr. Rigsby also testified that the current economic environment should be considered because "trends in interest rates, present and projected levels of inflation, and the overall state of the U.S. economy determine the rates of return that investors earn on their invested funds."[97] He believes that his recommended cost of equity will provide UNSE with a reasonable rate of return when the economic data on interest rates and a low, stable outlook for inflation are taken into consideration.

Staff

Staff witness David Parcell presented Staff's ROE recommendation in this case. In developing his recommendation, Mr. Parcell utilized DCF, CAPM, and CE analyses. He indicated that because UNSE is not publicly traded, it is not possible to directly apply cost of equity models. In his analysis, Mr. Parcell employed two comparable groups of companies as a proxy for UNSE and

[91] Ex. R-11 at 19-21.
[92] Id. at 21-22.
[93] Ex. R-10 at 55.
[94] Ex. R-11 at 8-12.
[95] Ex. R-11 at 8.
[96] Ex. R-10 at 56-57.
[97] Id. at 33.

UniSource.[98] The first sample group was comprised of a group of seven electric utilities and the second group consisted of the same ten electric utilities used by the Company's witness.

Mr. Parcell testified that the DCF model is one of the oldest, most commonly used models for estimating the cost of equity for utilities. He explained that it is "based on the 'dividend discount model' of financial theory, which maintains that the value (price) of any security or commodity is the discounted present value of all future cash flows."[99] Mr. Parcell's DCF analysis produced a range of 9.4 percent to 10.1 percent for the proxy groups' cost of equity. Mr. Parcell testified that the CAPM is a version of the risk premium method which "describes and measures the relationship between a security's investment risk and its market rate of return."[100] His CAPM model produced a cost of equity range of 7.6 percent to 8.3 percent for the sample groups.[101] Mr. Parcell also utilized a CE 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.[102] According to Mr. Parcell, his CE 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 CE uses prospective returns and is therefore not backward-looking.[103] Based on his CE analysis, Mr. Parcell concluded that the cost of equity for the proxy companies is "no more than 9.5 percent to 10.5 percent." [104]

Based on the results of two the three methodologies (DCF and CE), Mr. Parcell found an overall range of 9.5 percent to 10.5 percent ROE for the proxy companies, and concluded that the appropriate cost of equity rate for UNSE 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, which is the same return on equity approved in UNSE' last rate proceeding.

Mr. Parcell also addressed how he believes the current financial crisis impacts the cost of equity for UNS. He stated that because the economic conditions affect almost all segments of the

[98] Ex. S-14 at 25 (Parcell Direct Testimony).
[99] Id. at 25.
[100] Id. at 29.
[101] Id. at 33.
[102] Id. at 33.
[103] Id. at 34.
[104] Id. at 37.

economy, and UNSE is a regulated utility that sells a relatively inelastic product, the Company is largely insulated from the impacts of depressed economic conditions. Mr. Parcell added that: (1) there is no justification for increasing returns awarded to regulated utilities at the same time that other businesses are experiencing lower profits; (2) unlike unregulated firms, UNSE has the opportunity to pass on higher costs to customers in its next rate case; (3) there is no indication that UNSE's risks have increased since its last case; and (4) a number of measures are being undertaken by the United States and other governments to make credit more accessible and restore confidence in financial markets.[105]

With respect to the arguments raised by the Company, Mr. Parcel responded that the Company's DCF analysis' exclusive reliance on short-term growth rates (analysts' forecasts of earnings per share ("EPS")) is improper because such an exclusive reliance is not reflective of investor expectations.[106] He believes that Ms. Pritz' position that "short-term growth (in a DCF context) should only reflect prospective data, whereas long-term growth should only use historic data"[107] is internally inconsistent.

Regarding the Company's criticism of the use of geometric means in the CAPM, 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.[108] Staff also points to Mr. Parcell's testimony indicating that the Commission found it appropriate in the last UNSE rate case to use a geometric or compound growth rate in using the CAPM model.[109]

<u>Conclusion on Cost of Equity</u>

Based on the competing positions presented through the testimony, exhibits, and arguments, we believe that Staff's recommended cost of equity capital range of 9.5 percent to 10.5 percent is appropriate. We agree with Staff that the CAPM results are reflective of the combination of lower bond yields and a lower risk premium associated with a decline in stock prices, and that the same

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[105] Id. at 39-40.
[106] Ex. S-15 at 2 (Parcell Surrebuttal Testimony).
[107] Id. at 4.
[108] Id.
[109] Ex. S-15 at 5.

stock market decline tends to produce higher DCF results.[110] We also continue to believe, consistent with our findings in several prior cases, 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.

As noted above, Mr. Parcell's DCF analysis produced a range of 9.4 percent to 10.1 percent for the proxy groups' cost of equity, his CAPM model produced a cost of equity range of 7.6 percent to 8.3 percent for the sample groups, and his CE analysis produced a result for the proxy companies of no more than 9.5 to 10.5 percent. Based on his conclusion that UNSE has an estimated ROE of 9.5 to 10.5 percent, Mr. Parcell recommended setting the Company's ROE at the mid-point of the range, or 10.0 percent.

In his testimony, Mr. Parcell raises valid arguments with respect to the effect of current economic conditions on all aspects of the economy, and on society in general. Although Mr. Parcell recommended adoption of the 10.0 percent midpoint in his cost of equity range, he confirmed his testimony[111] given in the recent UNS Gas case where he testified that it is "'appropriate for the Commission should they choose to do so, to go to the low end of the range to reflect economic conditions,' and that setting the ROE at 9.5 percent 'would be proper and supportable.'" [112]

As we recently found in Decision No. 71623 for UNS Gas, we do not believe UNSE has demonstrated that its risk is significantly greater compared to other comparable companies; nor has it shown that its risks have increased substantially since its last rate case. The Company does not operate in a vacuum and the challenges it faces are not unique. Indeed, relative to a number of unregulated industries, the utility industry is insulated from the vagaries of the marketplace to the extent that it does not face direct competition for its product and there is a high degree of inelasticity in the need for utility services. Although UNSE argues that it is not less risky than APS, which was granted an 11 percent cost of equity pursuant to a settlement agreement, the two companies are very different electric utilities and cannot be directly compared. The cost of equity established in the APS

[110] Ex. S-14 at 39.
[111] Tr. at 782, 768, 776-81.
[112] Decision No. 71623 at 42, citing Tr. at 844.

rate case was the result of a settlement agreement that included a number of trade-offs between various parties, and would not necessarily reflect the current financial analysis or economic conditions affecting UNSE's cost of equity. Therefore, comparison to the ROE adopted for APS is not appropriate in this case.

We believe that adoption of an estimated ROE of 9.75 percent will allow the Company to attract capital at a reasonable rate, and strikes a reasonable balance between its proposal for an estimated ROE near the top of the range produced by its own analysis and the results achieved through the methodologies employed by Staff and RUCO. We also believe that adoption of an estimated cost of equity at slightly less than the mid point of Staff's ROE range, 10.0 percent, provides at least some minimal recognition of the (unadjusted) CAPM results, which the Company acknowledges are "particularly impacted by the current economic conditions."[113] Although we recently found a cost of equity for UNS Gas of 9.50 percent, we believe that in order for UNSE to acquire BMGS and maintain its investment grade rating, both of which will benefit its ratepayers, its authorized cost of equity will need to be slightly higher in order to attract sufficient capital.

Accordingly, we adopt a 9.75 percent ROE in this proceeding for UNSE, which results in an overall weighted average cost of capital of 8.28 percent.

	Percentage	Cost	Weighted Avg. Cost
Common Equity	45.76	9.75%	4.46%
Total Debt	54.24	7.05%	3.82%
Weighted Average Cost of Capital			**8.28 %**

Fair Value Rate of Return

The Company proposes a fair value rate of return ("FVROR") of 6.88 percent; Staff proposes a FVROR of 6.01 percent; and RUCO proposes a FVROR of 5.96 percent.

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[113] UNSE Opening Brief at 39.

FVRB in Decision No. 70360

In its last rate case, UNSE proposed in its application to apply the weighted average cost of capital ("WACC") to its OCRB to determine its required operating income. In its rebuttal testimony, the Company proposed that the WACC should be applied directly to its fair value rate base. The Company based its proposal on a Memorandum Decision issued by the Arizona Court of Appeals in *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, 1 CA-CC 05-0002 (Ariz. App. Feb. 13, 2007) ("*Chaparral City*").

UNSE argued in its prior case that the Commission's Decision in the underlying Chaparral City case adopted Staff's recommendation to calculate the revenue requirement by multiplying OCRB by the cost of capital.[114] The Company claimed that, only after the OCRB revenue requirement was completed did Staff calculate the FVRB for Chaparral City, which resulted in what UNSE asserted was a "backing-in" approach that was mathematically equivalent to the methodology rejected by the Court of Appeals in *Chaparral City*. In support of its argument, UNSE cited to Article 15, §14 of the Arizona Constitution, which states in part that "[t]he Corporation Commission shall, to aid it in the proper discharge of its duties, ascertain the fair value of the property within the State of every public service corporation doing business therein..."

In the last UNSE case, we rejected the Company's arguments on this issue, indicating that no party disputed that the Commission is required to consider the Company's FVRB in determining rates.[115] However, we disagreed with UNSE's reliance on *Chaparral City* to support its position, on the basis that we have broad discretion in determining how FVRB is to be used in the ratemaking exercise. In the prior case, we stated:

> 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, UNSE would have us

[114] Decision No. 70360 at 44.
[115] Decision No. 70360 at 47.

> employ the very methodology the Court of Appeals specifically stated the Commission was not required to apply in setting rates.[116]

We also pointed out that the *Chaparral City* case was on remand at that point, that the Commission had not yet rendered a decision on the issue remanded by the Court, and that it was inappropriate to use an unpublished decision as a foundation for requiring a specific methodology.

We also raised concerns with respect to UNSE's attempt to apply the WACC to FVRB without modification, citing to Staff's testimony which claimed that "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."[117]

Finally, we noted that our recent Decision in the UNS Gas rate case[118] had also rejected the same argument.

<u>Chaparral City Remand Decision and Subsequent Chaparral City Rate Decision</u>

In Decision No. 70441 (July 28, 2008) ("Decision No. 70441" or "Chaparral City Remand Case"), we addressed the issue that was remanded by the Court of Appeals in *Chaparral City*. Decision No. 70441 did not adopt the company's proposal to determine a FVROR by applying the WACC directly to the FVRB, but revised the method used in Decision No. 68176 (the prior Chaparral City Decision) to calculate operating income. We found that applying the WACC directly to the FVRB would over-compensate Chaparral City Water Company ("Chaparral City") for inflation, and therefore calculated the FVROR by adjusting the WACC to reflect an inflation adjustment that reduced the cost of equity. The FVROR was then applied to the FVRB to determine operating income.[119]

In its recent rate case ("Decision No. 71308" or "Chaparral City Rate Case"), Chaparral City raised many of the same arguments addressed by the Commission in Decision No. 70441, including the proposal that the WACC should be applied directly to Chaparral City's FVRB without an

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[116] Id. at 47.
[117] Id. at 48.
[118] Decision No. 70011 (November 27, 2007).
[119] Decision No. 70441 at 41. Chaparral City appealed Decision No. 70441 to the Court of Appeals which affirmed the Commission's Decision. *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, 1 CA-CC 08-0002 (App.2010)(Memorandum Decision).

inflation adjustment. (Decision No. 71308, October 21, 2009.) We rejected Chaparral City's arguments and adopted Staff's recommendation that the FVROR should be calculated by subtracting an inflation factor from both the debt and equity components of the WACC. In reaching that conclusion, we reiterated the findings set forth in Decision No. 70441, stating that:

> [Chaparral City] is advocating for a rate of return methodology which would produce comparably higher rates, which conflicts with the most basic tenet of rate regulation, which is that a utility should be provided with rates that will allow it an opportunity to earn a return that is comparable to those of similarly situated enterprises.[120]

We concluded that "using [Chaparral City's] proposed methodology would produce excessive returns."[121] Accordingly, we adopted Staff's recommendation to apply an inflation adjustment to the WACC to determine the FVROR.[122]

<u>UNSE's Position</u>

The Company explained that its 6.88 percent FVROR was arrived at by applying it to the Company's FVRB of $265 million and determining that amount of a rate increase would provide it with a reasonable opportunity to earn its cost of capital, support its credit ratings, and attract capital on reasonable terms.[123] According to UNSE, applying the methodology used in Decision No. 70441, the resulting FVROR would be 9.30 percent, and applying the methodology adopted in Decision No. 71308, the FVROR would be 7.99 percent. The Company requests that if BMGS is included in rate base, a different rate of return should be applied to the BMGS plant. It argues that "since the fair value of this investment is very close to the original cost of the BMGS net of accumulated depreciation...it is appropriate to apply the Company's WACC to this increment of FVRB."[124]

The Company criticizes Staff and RUCO's proposals, arguing that they are unconstitutional, unjustified, and arbitrary. Mr. Grant testified that Staff's primary recommendation to apply a zero percent return on the portion of FVRB that exceeds the OCRB is "nearly identical to the now-

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[120] Decision No. 71308 at 48.
[121] Id. at 48-49.
[122] Chaparral City also appealed Decision No. 71308 to the Court of Appeals which stayed the appeal while that matter is in the rehearing process at the Commission. *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, 1 CA-CC 10-0001 (Stayed March 22, 2010).
[123] Ex. U-12 at 13.
[124] Id. at 15.

discredited 'backing-in' method formerly used by the Commission."[125] He believes that Mr. Parcell's alternative recommendation would result in a revenue requirement that is too low to support UNSE' financial integrity; that represents an unwarranted and unsupported departure from the Commission's methodologies approved in Decision Nos. 70441 and 71308; that is based upon Mr. Parcell's belief that the fair value should be given little, if any, weight in setting rates; that uses the lowest possible cost of capital (inflation adjusted rate of return on risk-free U.S. Treasury securities) as the highest possible rate of return to apply to the fair value increment; is based upon an arbitrary inflation rate; and which contains a mathematical error.[126] Mr. Grant criticized RUCO's witness, Dr. Johnson's recommendation that the full rate of inflation should be subtracted from both the cost of debt and equity. UNSE asserts that RUCO fails to explain why this method is superior to methods already adopted in previous Commission decision. Mr. Grant also criticizes the method's subtraction of inflation from the WACC as applied to the OCRB portion of the RCND, arguing that the OCRB does not include inflation. Finally, the Company asserts that RUCO's 5.96 percent FVROR is too low to support the financial integrity of UNSE as it will only allow it to earn a return on equity of 6.0 percent, which is 105 basis points below its cost of debt.

RUCO's Position

RUCO's witness, Dr. Johnson, presented five methods for determining the FVROR. His preferred method, Method 1, applies a 2.1 percent inflation rate to the WACC. His Method 2 subtracted inflation only from the cost of equity, and his other three methods are ones that have been proposed by Staff. The various methods result in FVRORs ranging from 5.39 percent to 7.01 percent, with a midpoint of 6.20 percent and an average of 6.25 percent. Dr. Johnson testified that the greatest weight should be given to Method 1 because it is the most theoretically sound approach. Dr. Johnson explained that a "typical cost of capital, which includes inflation, cannot be applied to the fair value rate base because this would result in a double counting of inflation."[127] In explaining why FVRORs are not applied to OCRB, Dr. Johnson testified:

[125] Ex. U-13 at 10.
[126] Id. at 12.
[127] Ex. R-6 at 49.

> Since the dollar magnitude of the fair value rate base is larger than an original cost rate base, reflecting past growth in the value of the utility's property, and since the future income stream can reasonably be expected to increase in the future, due to inflation and other factors which tend to push up property values as time passes, a 5.00% return on fair value is likely to provide investors with as large a total return (over time) as a 7.50% return applied to an original cost rate base. The exact amounts received by investors may differ somewhat, and they certainly will differ during any specific year, but the key point is that investors will have as strong an opportunity to recover their capital costs and to earn a competitive return through the application of a 5.00% return on an escalating estimate of fair value as with a 7.50% return on the original. The regulatory goal of simulating the effects of the competitive markets, and compensating investors for the impact of inflation, can be achieved either way.[128]

This illustrates one of the key points of his testimony – "that the percentage rate of return earned by an investment that grows in value over time will normally be lower than the analogous return paid on an investment that does not grow over time."[129] In response to the Company's argument that the inflation rate should be cut in half to recognize that the OCRB does not contain inflation, Dr. Johnson testified that "slashing the inflation rate in half" is inappropriate because "reproduction costs tend to grow faster than the rate of inflation, because they don't fully consider the favorable impact of technological changes, increasing economies of scale, and other sources of increased efficiency and cost savings – factors which tend to hold back the pace at which prices escalate over time."[130]

<u>Staff's Position</u>

Staff's witness, David Parcell proposed a FVROR of 6.01 using his method of assigning a zero cost to the "fair value increment" of RCND. He testified that since the "increment between FVRB and OCRB is not financed with investor-supplied funds, it is logical and appropriate, from a financial standpoint, to assume that this increment has no financing cost."[131] Using this method, he calculated a FVROR of 5.65 percent. Mr. Parcell testified that, from a financial theory perspective, there is not a need to provide any return on the fair value increment, since it is not investor supplied

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[128] Id.
[129] Id. at 54.
[130] Ex. R-6 at 56, Ex. R-8 at 4 (Johnson Surrebuttal Testimony).
[131] Ex. S-14 at 53.

capital; however, he recognizes that from both a financial and public policy perspective, the Commission may choose to allow such a return. So, as an alternative, Mr. Parcell provided a procedure whereby a specific return greater than zero could be applied to the FVRB increment. He recommended that any such return should be no larger than the real (after inflation is removed) risk-free rate of return. Mr. Parcell calculated the real risk-free rate to be 3.0 percent, and recommended that a mid-point of the range between 0 – 3.0, or 1.5 percent as the return on the fair value increment.[132]

In response to criticism by the Company, Mr. Parcell disagreed that his method amounted to a "backing in" method of assigning a FVROR, stating that his method recognizes the value of the FVRB increment and applies the actual cost of capital to it.

<u>Conclusion on FVROR</u>

As is clearly delineated in the Arizona Constitution, the Commission is obligated to establish rates and charges that are "just and reasonable"[133] and to "ascertain the fair value of the [utility's] property."[134] Arizona courts have interpreted the constitution's "fair value" language as requiring fair value to be used in setting rates.[135] In Decision No. 70441, we recognized the fair value requirement for one component of the rate setting exercise (*i.e.*, rate base), but observed that:

> The Constitution is silent as to how the Commission is to determine the rate of return, thereby leaving that duty to the Commission and allowing it to use its knowledge and expertise, with the caveat that resulting rates and charges must be just and reasonable.[136]

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

> ...included a history of 'fair value' in the context of rate regulation with an explanation of how in the early 1900s, a distrust of the book cost

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[132] Id. at 57.
[133] Article 15, §3.
[134] Article 15, §14.
[135] *See*, e.g., *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 294 P.2d 378 (1956). "While our constitution does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates. The reasonableness and justness of the rates must be related to this finding of fair value."
[136] Decision No. 70441, at 20.

> information provided by the utilities due to the practice of trading utility properties back and forth at escalating 'values,' recording 'cost' that included the profit of an affiliate, and the lack of standardized accounting methods led state commissions to favor 'fair value' over 'original cost' rate base determinations.[137]

We also observed that, although the fair value ratemaking method was prominent in the first half of the twentieth century, regulators began to use original cost information due to its greater reliability, ease of interpretation, and being less susceptible to abuses. In the Chaparral City Remand Case, we cited to the landmark United States Supreme Court case, *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281 (1944), which freed most regulatory commissions from fair value ratemaking requirements.[138] In that context, we indicated that "[o]nce regulators had the appropriate controls in place to regulate accounting and the double dealing transactions, the original cost was given more weight because it was a more reliable and trustworthy number."[139]

With respect to Arizona specifically, we pointed out that, at the time Arizona's constitutional framers adopted Article 15, §14, the NARUC Uniform System of Accounts did not exist and there were no modern financial models for estimating cost of equity. The Arizona Supreme Court, in *Arizona Corp. Com'n v. State ex rel. Woods*, 171 Ariz. 286, 830 P.2d 807 (1992), discussed the genesis of the Commission's constitutional powers and observed that at the time the Arizona Constitution was drafted, progressive and labor forces shared a distrust of corporate powers and combined to grant to the Commission broad authority to regulate public service corporations. The court stated that, "[t]he founders expected the Commission to provide both effective regulation of public service corporations and consumer protection against overreaching by those corporations."[140] In the Chaparral City Remand Case, we observed that "Arizona is apparently the only remaining state that continues to have a fair value requirement."[141]

With this historical framework in mind, we must analyze the constitutional requirement to ascertain the Company's fair value rate base with our concurrent constitutional obligation to set just

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[137] Id. at 21, footnote 56.
[138] Id. at 21.
[139] Decision No. 70441 at 21.
[140] *Woods* at 290, 830 P.2d 807, at 811. *See, also*, Deborah Scott Engelby, Comment, *The Corporation Commission: Preserving its Independence*, 20 Ariz. St. L. J. 241 (1988); Kris Mayes, *Encouraging Conservation by Arizona's Private Water Companies: A New Era of Regulation by the Arizona Corporation Commission*, 49 Ariz. L. R. 297 (2007).
[141] Decision No. 70441 at 33.

and reasonable rates. In both of the Chaparral City cases cited above, we attempted to reconcile the direction from the Court of Appeals regarding fair value rate of return with the obligation to protect utility customers from excessive rates that could result from inflated returns. In doing so, however, we emphasized that "there are many ways to analyze and calculate an appropriate rate of return on FVRB."[142] As stated in Decision No. 71308, the FVROR is intended to allow a utility to attract capital on reasonable terms; maintain the utility's financial integrity; and permit the utility an opportunity to realize a return that is commensurate with the returns earned by enterprises with commensurate risks.[143] At the same time, the FVROR must produce a result that does not over-compensate the utility for the fair value of its property through rates and charges that are not just and reasonable.[144]

In the Chaparral City Rate Case, we found that an inflation element exists in both the debt and equity components of the capital structure and, accordingly, the inflation adjustment was made to the entire cost of capital.[145] In that Decision, we reiterated that "the most basic tenet of rate regulation…is that a utility should be provided with rates that will allow it an opportunity to earn a return that is comparable to those of similarly situated enterprises."[146] However, as we recently found in the UNS Gas rate decision, we do not believe the inflation factor should be reduced by 50 percent, because such a methodology would fail to recognize that RCND estimations are based on estimates of the cost to reconstruct the entirety of the Company's system at current prices, and do not take into account in the RCND estimation efficiencies and cost savings that may exist due to factors such as technological advances. We note that the Chaparral City Remand Decision did not apply a 50 percent weighting factor to the inflation estimate, although inflation was calculated only on the equity component in that case due to a lack of sufficient evidence in the record concerning inflation in the cost of debt.[147] In this proceeding, we find that an unadjusted inflation factor should be subtracted from the entire WACC, to afford appropriate recognition to the fact that inflation exists in

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[142] Id.
[143] Decision No. 71308 at 47.
[144] Decision No. 70441 at 33.
[145] Decision No. 71308, at 49.
[146] *Id.* at 48, citing *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591, 64 S.Ct. 281 (1944).
[147] Decision No. 70441, at 36-37.

both the debt and equity components of the Company's capital structure, and that reconstruction cost estimates likely exceed the rate of inflation based on the factors cited above.

We turn next to the appropriate inflation rate to be applied to UNSE's WACC. In her direct testimony, Company witness Pritz indicated that an inflation factor of 2.1 percent was appropriate for purposes of her DCF analysis.[148] RUCO's witness, Dr. Johnson agreed that an inflation rate of 2.1 percent was reasonable.[149] Staff witness David Parcell suggested that an inflation factor of 2.0 percent should be used for calculating the FVROR, if Staff's alternative recommendation is adopted by the Commission.[150] Based upon the testimony of the Company and RUCO's witness, for purposes of determining an appropriate FVROR in this case we will adopt an inflation rate of 2.1, which we believe is a conservative estimate of the inflation factor that should be applied to the WACC in order to remove from it the effects of inflation. Subtracting the 2.1 percent inflation factor from the 8.28 percent WACC, results in a FVROR of 6.18 percent.

We find that a FVROR of 6.18 percent is also within the wide range of values found in the record as a result of the various methodologies used by the parties' expert witnesses in their calculations of FVROR. RUCO's witness testified that RUCO's final recommendation was 5.96 percent. Staff's recommendation is a FVROR of 6.01 percent, with an alternative methodology calculation of 6.14 percent. The Company offered two different recommendations, requesting a 6.88 FVROR without BMGS, or 7.29 percent including BMGS.

We find that the determination of FVROR is at best and estimation and not an exact science, and that the goal of the exercise is to afford the Company a reasonable return without providing excessive rates or windfall profits. Using our informed judgment concerning the record's range of values for calculation and determination of FVROR, we find that a FVROR of 5.96 percent is on the low side of the range and that 6.88 percent is too high. In the determination of an appropriate FVROR, we are accorded substantial discretion and may reasonably draw on our expertise in our consideration of the record. In this instance, we find that a FVROR of 6.18 percent strikes the

[148] Ex. U-22 at 11 (Pritz Direct Testimony).
[149] Ex. R-6 at 55.
[150] Ex. S-14 at 56.

appropriate balance on the implicated ratemaking issues, and it is within the range of values in the record. Therefore, we find that a FVROR of 6.18 is reasonable under the facts and circumstances of this case, when all the relevant factors are considered. Applying the FVROR to the FVRB determined herein produces an overall revenue increase of $7,364,607.

As this case makes clear, the substantial difference between UNSE's OCRB and estimated RCND produces a FVRB that is far in excess of the OCRB. The large gap between UNSE's OCRB and FVRB underscores the inherent flaw in attempting to apply a weighted average cost of capital directly to the FVRB, even with the modifications employed in the Chaparral City cases and herein for UNSE. Although historically the FVRB has been calculated by averaging the OCRB and RCND, the issue of whether a given company's estimated RCND is accurate, or whether it is appropriate to determine the FVRB by taking a simple average of OCRB and RCND, are matters that have not heretofore been analyzed in any substantial detail because, prior to the Court of Appeals' *Chaparral City* decision, the methodology employed by the Commission did not typically result in significant differences.

As we recently stated in Decision No. 71623, we believe that future cases should include a more detailed and comprehensive evaluation of how fair value rate base is determined, including a determination of the accuracy of the RCND estimation process; whether it is appropriate to average OCRB and RCND to calculate FVRB; and how, or whether, the Commission should use cost of capital models as part of the determination of fair value rate of return.

As we have stated in prior cases, the Constitution does not prescribe the methodology to be used by the Commission in ascertaining the fair value of a utility company's property, and it is undisputed that the Commission has broad discretion in making fair value determinations.[151] The Court of Appeals' decision in *Chaparral City* recognized the Commission's authority to craft appropriate methodologies for determining fair value. We indicated previously that there are a number of methods that may be appropriate for determining FVRB and FVROR and, as the facts of this case make clear, a one size fits all approach may not enable the Commission to satisfy its

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

obligation to establish just and reasonable rates without the ability to tailor a remedy that balances the Commission's concurrent constitutional obligations.

FVROR for BMGS

The Company requested that because the OCRB and the replacement cost for BMGS are "nearly identical" the Commission should use the WACC as the FVROR for BMGS. Staff and RUCO objected to the Company's proposal. We do not find it appropriate to use a separate FVROR with BMGS. A Company's rate base is comprised of both new and old plant, and it would be one-sided to apply a different (higher) rate of return to only newly acquired individual items of plant.

Fair Value Rate of Return Summary

Weighted Average Cost of Capital	8.28 percent
(Less) Inflation Adjustment	2.10 percent
Fair Value Rate of Return	**6.18 percent**

AUTHORIZED INCREASE

Based on our findings herein, we determine that UNSE is entitled to a gross revenue increase of $7,364,607.

Fair Value Rate Base	$2 41,573,644
Required Rate of Return	6.18 percent
Required Operating Income	$14,929,251
Operating Income Available	$10,428,483
Operating Income Deficiency	$4,500,768
Gross Revenue Conversion Factor	1.6363
Gross Revenue Increase	**$7,364,607**

CLASS COST OF SERVICE STUDY

UNSE prepared a class cost of service study ("CCOSS") designed to assign each cost component to the respective classes in order to determine an appropriate total cost to serve each class. Mr. D. Bentley Erdwurm testified that there are three steps involved in developing a CCOSS: functionalization, classification, and allocation. He explained that based on allocated costs, "the goal is to confirm the extent to which present and proposed rates generate revenue that recovers costs and provides for a reasonable return on investment per customer class."[152] The Company balanced the future need to move each class toward rates that are more reflective of their cost of service with the recognition that any move must take into account other factors such as gradualism and the avoidance of rate shock.

Staff's witness, Mr. William Stewart, reviewed, analyzed, and evaluated the Company's CCOSS and concluded that it followed the traditional structure previously approved in UNSE's last rate case.[153]

RATE DESIGN

UNSE, Staff, and RUCO all proposed rate designs to collect their recommended level of revenues.

UNSE

UNSE's proposed rate design generally follows the rate design approved in its last rate case, with a few modifications. UNSE proposes to keep the current residential inclining block structure with two rate blocks. The proposed modifications include increasing customer charges toward cost-based levels supported by the CCOSS; redesigning the time-of-use ("TOU") rates to expand the differentials between On-Peak, Shoulder-Peak, and Off-Peak periods; implementing Super-Peak Demand Response rates; and implementing a reclassification of rates associated with BMGS.

The customer charge changes are designed to bring the charges closer to the cost-based levels indicated in the Company's CCOSS and therefore increase the customer charges by $0.50 (Residential from $7.50 to $8.00; Small General Service from $12.00 to $12.50; and Large General Service from $15.50 to $16.00). Mr. Erdwurm testified that this modest increase will "reduce how much high-use customers subsidize lower-use customers for the costs of metering, meter reading, billing, and other customer-specific equipment installed on the customers' premises," and is "a step towards providing more incentive for encouraging energy efficiency programs because the revenue requirement is less dependent on customers consuming electricity."[154]

UNSE currently has five individual voluntary pricing plans that were approved in its last rate

[152] Ex. U-18 at 17 (Erdwurm Direct Testimony).
[153] Ex. S-12 at 2-4.
[154] Ex. U-18 at 20.

case, including Residential Weekends Off-Peak; Small General Service; Large Power Service; Large General Service; and Interruptible Power Service. All have both a Summer (May through October) and a Winter (November through April) billing cycle. UNSE proposes to adjust the base power supply charges so there is more of a difference between the per-kWh On-Peak charge as compared to the Shoulder-Peak and Off-Peak charges. Mr. Erdwurm testified that this "will provide a more accurate and pronounced price signal to customers that using energy during peak periods is substantially more expensive than during other periods of the day"[155] and will provide an enhanced incentive to shift load to off-peak periods. He also testified that this new design would allow customers who save money under the current TOU rates to save even more. Although such savings would result in revenue losses for the Company, Mr. Erdwurm testified that the Company sees long-term benefits in curbing peak demand, including deferral of capacity additions.

UNSE proposes to offer Super-Peak Demand Response rates for Residential and General Service customers with demands less than 3 MW. The rate design includes a single, "super-peak" summer hour where consumption during that hour would be priced significantly higher than other hours. Mr. Erdwurm testified that by limiting the super-peak to one hour, customers could make a drastic reduction in usage during a critical time, without causing undue inconvenience or discomfort. He explained that by reducing the peak, less power will be needed to be purchased when the prices are high on the spot market, which will result in savings to customers and to the Company. He further testified that "reducing peak period demand and shifting consumption to off-peak times helps increase load factor, which also reduces cost through the more intensive utilization of fixed resources."[156]

Mr. Erdwurm testified that RUCO's witness, Dr. Johnson, proposed a rate design that deviates from past regulatory practice by using a marginal cost approach instead of the average embedded cost approach used by Arizona electric utilities over the last twenty years. Mr. Erdwurm argues that UNSE's customer charge includes only costs that are "customer-related" and that are related to metering, meter-reading, billing and customer service, and customer-specific equipment at the

[155] Id. at 21.
[156] Ex. U-18 at 27.

customer's premises. Mr. Erdwurm testified that "[t]hese costs vary with changes in the number of customers, not with kWh sales."[157] The Company also criticizes RUCO's inclusion of only variable costs in the customer charge as being inconsistent with the Commission's direct access rules and anti-competitive to third party billing, metering, and meter-reading providers.

Mr. Erdwurm testified that because RUCO's rate design proposal radically shifts recovery away from the customer charge to the energy charge, there is a mismatch created between revenue collection and cost causation. He explained that when customer-related costs are shifted to energy (per kWh) charges, the Company over-recovers when sales are relatively high and under-recovers when sales are relatively low. He testified that RUCO's three tier rate design has "loaded up cost recovery on kWh sales in excess of 800 kWh per month. In other words, a significant portion of the Company's revenues will be obtained through a third tier"[158] and therefore, if there are sales reductions for any reason (including conservation and energy efficiency), UNSE will experience margin losses. Mr. Erdwurm argued that RUCO's rate design will drive UNSE's "need to recover its revenues towards increasing use of power and away from conservation."[159] The Company believes that the Commission-approved rate structure should align important policy goals such as conservation and efficiency with a financially-healthy public service corporation, by making sure that the correct level of fixed cost recovery is more independent of sales being at a certain level.

Staff

Staff's rate design proposal was presented by its witness, Mr. William Stewart. He testified that:

> The underlying rationale for the structure and magnitude of the tariffs that I am proposing is that they should be efficient, equitable, and result in providing the Company the opportunity to recover its cost of providing service. Rates should be simple and easy to understand, and minimize revenue fluctuations, they should be efficient in the sense that wasteful production and consumption practices are discouraged, and they should not be discriminatory. While cost-based rates are an important consideration in rate design, gradualism is also an important aspect in determining rate

157 Ex. U-20 at 2 (Erdwurm Rejoinder Testimony (emphasis original)).
158 Ex. U-19 at 7 (Erdwurm Rebuttal Testimony).
159 Ex. U-19 at 8.

levels and customer charges."[160]

Consistent with the Company's proposal, Staff's rate design used an equal or constant increase per customer class except for residential CARES. Mr. Stewart testified that he agreed with the Company's request to increase the customer charges to bring them more in line with the CCOSS. Concerning the Company's proposed TOU changes, he agreed that the new rate differentials should provide customers with additional incentive to use TOU rates. Further, he believes that to the extent peak demand is reduced, the customers and the Company will enjoy savings from not acquiring higher priced on-peak purchased power or building peaker generating plants. Mr. Stewart also agreed with the proposed Super Peak Demand Response tariff, stating that "by significantly reducing use during the selected peak hour, the customer can expect substantial savings on the electric bill and the Company can expect system peak to be restrained."[161]

<u>RUCO</u>

RUCO's witness, Dr. Johnson, testified concerning the Company's cost of service methodology and discussed fully allocated cost of service studies, focusing on the Company's Average and Peaks methodology. Dr. Johnson proposed an alternative revenue distribution methodology which gives "considerable weight to historic rate relationships, while also giving some consideration to the Company's cost of service result."[162] He recommended increasing Large Power Service, Interruptible Power Service, and Lighting by 1 percent more than Residential and Small General Service, and increasing Large General Power Service by 1 percent less than Residential and Small General Service classes.

RUCO disagrees with UNSE's proposed changes to the customer charges, and recommends reducing the customer charges instead of increasing them. Dr. Johnson believes that the Company's proposed charges are not justified by cost considerations and conflict with important policy objectives such as economic efficiency, energy conservation, and equity. He testified that raising customer charges "will tend to encourage kWh consumption and discourage energy conservation,

[160] Ex. S-12 at 5.
[161] Ex. S-12 at 10.
[162] Ex. R-7 at 16 (Johnson Direct Rate Design Testimony).

while lowering customer charges will discourage energy usage and encourage greater energy efficiency;"[163] would place a heavier burden on low use customers; and is "based upon a cost allocation approach which allocates substantial portions of the Company's distribution investment and operating expenses on the basis of customers, regardless of whether or not these items directly vary in response to decisions by customers to join or leave the system."[164] Dr. Johnson believes that because a full-allocated cost study includes fixed costs, a marginal cost study would better identify the costs affected by consumer decisions and result in price signals to conserve. Dr. Johnson believes that the customer charge should primarily collect the variable costs of metering, billing, and collecting the monthly bill. He proposes reducing the residential customer charge from $7.50 to $5.00, and offsetting this revenue reduction by increasing the revenues to be collected from higher per-kWh rates.

RUCO proposed a three block rate structure, with 400 kWh in the first block with the lowest rate; the second 400 kWh with a one cent higher rate; and all additional kWh with an additional one cent (2 cents above first block) higher rate. Dr. Johnson testified that the Company is to be commended for offering TOU rates and while he is sympathetic with UNSE's desire to increase TOU participation, he believed that more thought needed to be given to the appropriate differentials. Likewise, Dr. Johnson believed that the Super Peak proposal had merit, but he had some concerns regarding the specifics. He recommended that the Company develop a pilot program that would be more precisely targeted to actual load conditions on a day to day basis.

Dr. Johnson disagrees with the Company's characterization of his recommendation as "radical." He believes that the impact on customer bills and the Company's revenues and net income will be relatively mild.

<u>Rate Design Conclusion</u>

Regarding the proposed change to the customer charge, we note that if the customer charge is increased as recommended by Staff and UNSE, it will generate approximately $424,000 more per year, whereas RUCO's customer charge would generate $2,542,000 less than the current rate.

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[163] Id. at 19.
[164] Id.

Although RUCO argues that any change would be offset by a change in revenues from the per kWh rates, it did not adequately address the argument made by the Company that if conservation is achieved, the offsetting revenues would not be realized because sales (and the dollars from per kWh rates) would decrease. Also, we are not necessarily convinced by RUCO's argument that a lower customer charge will result in more conservation, as it is possible that if a customer had budgeted $50 to spend on electricity, a lower customer charge would allow the customer to use more electricity and stay within the budget. It also seems likely that to the extent that the customer charge is larger, customers concerned about the size of the bill are more likely to use less electricity. However, while we do agree that RUCO has raised some interesting issues related to conservation, we are not satisfied that the issue related to recovery of fixed costs and the Company's ability or incentive to encourage conservation has been adequately addressed by RUCO's rate design proposal.

The proposed changes to the TOU rates will provide a more accurate and pronounced price signal to customers that using energy during peak periods is substantially more expensive and they will provide an enhanced incentive to shift load to off-peak periods. This new design will allow customers who save money under the current TOU rates to save even more. Although these savings may result in short-term revenue decreases for the Company, it realizes and appreciates the long-term benefits in curbing peak demand.

The Super-Peak Demand Response rates will allow customers to make a drastic reduction in usage during a critical time, without causing undue inconvenience or discomfort. Both the customers and the Company will benefit from peak reduction as less power will be have to be purchased when the prices are high on the spot market and the additional shift in consumption to off-peak times will help to increase the load factor. We expect the Company to continue to study this rate offering and make adjustments as necessary to increase the flexibility and precision of the demand response.

Accordingly, we will adopt the rate design proposed by UNSE and Staff, including the changes to the customer charges; maintaining the two block rate structure; the redesign of the TOU rates to expand the differentials between On-Peak, Shoulder-Peak, and Off-Peak periods; the Super-Peak Demand Response rates; and we will allow implementation of a reclassification of rates associated with BMGS as indicated herein.

For a residential customer with average monthly usage of 874 kWh, the current overall bill (including the PPFAC charge and DSM and REST adjustors) will increase by approximately $4.15, from $94.95 to $99.10, or approximately 4.37 percent. For a residential customer with median monthly usage of 681 kWh, the current overall bill (including the PPFAC charge and DSM and REST adjustors) will increase by approximately $3.52, from $74.75 to $78.27, or approximately 4.70 percent.

For a small commercial customer with average monthly usage of 1,001 kWh, the current overall bill (including the PPFAC charge and DSM and REST adjustors) will increase by approximately $5.42, from $121.69 to $127.10, or approximately 4.45 percent. For a small commercial customer with median monthly usage of 600 kWh, the current overall bill (including the PPFAC charge and DSM and REST adjustors) will increase by approximately $3.68, from $76.14 to $79.82, or approximately 4.83 percent.

LOW-INCOME PROGRAMS

CARES

The CARES program is a low-income assistance program for UNSE's customers. Mr. Erdwurm testified that subscription to CARES is increasing.[165] In this rate case, UNSE is proposing to hold most CARES customers harmless from the proposed rate increase by lowering the CARES customer charge from $7.50 to $3.50; reducing the base power supply for CARES customers; and by setting the PPFAC forward and true-up components at zero and freezing those rates. Under UNSE's proposal, CARES customers will continue to receive the additional discounts (30% for 0-300 kWh; 20% for 301-600 kWh; and 10% for 301-1000 kWh) and the flat $8.00 per month discount for customers with monthly usage in excess of 1,000 kWh. Mr. Erdwurm testified that many CARES customers will actually see decreases in their bills. The Company was willing to expand CARES eligibility beyond the 150 percent poverty threshold, but its support for an expanded program was contingent upon the program costs being fully recovered from other retail customers.

Staff witness, Mr. Stewart, testified that he agreed with the Company proposal to decrease the

[165] Ex. U-18 at 18.

CARES customer charge, set a discounted power supply rate, retain the existing CARES percentage discounts and the $8.00 discount, but he disagreed with the PPFAC rate freeze when rates become negative. Although Mr. Stewart agreed with the Company's proposal to expand CARES eligibility to customers whose income is 200 percent of poverty level, Staff believes that before a significant expansion is implemented, the appropriate parties need to discuss such an expansion, and Staff did not propose a mechanism to recover the additional costs from other retail customers.

RUCO agrees with ameliorating the impact of a rate increase on CARES customers, but recommends reducing the customer charge to $2.50 and increasing the usage-based discounts instead of modifying the base power supply rate and true-up mechanism. RUCO does not agree with the proposal to increase the cut-off for inclusion in CARES because it believes that no justification has been provided for increasing the current level and any such cut-off would be arbitrary. Dr. Johnson noted that the current difficult economic difficulties had "adversely affected many different types of customers, including middle class, two earner families where one of the family member has lost their job, but remain above 200% of the poverty line,"[166] and he believes that is it not clear that someone who is undergoing genuine hardship should be subsidizing someone else.

The Company has proactively recommended significant changes to the CARES program that will help these vulnerable customers. We agree that the reductions in the customer charge and base power supply are appropriate, and that the existing per kWh discounts should stay in effect as well as the flat $8.00 per month discount for customers with monthly usage in excess of 1,000 kWh. These changes will allow CARES customers to see decreases in their bills.

Although the Company recommended that the PPFAC forward and true-up components will be set to zero and frozen for CARES customers, Staff objects to the downward portion of the freeze, pointing out that CARES customers could being paying a higher PPFAC rate if the rate decreased. We believe that neither recommendation concerning the PPFAC is appropriate because they fail to send appropriate price signals to the customers. Instead, we find that UNSE should apply a discount to the PPFAC forward and true-up components that reflects the same percentage discount applied to

[166] Ex. R-7 at 32.

the base power supply for CARES customers. We believe that this discount together with the base power supply discount and the per kWh percentage discounts will ameliorate the PPFAC charges sufficiently. Accordingly, UNSE should modify its CARES program as set forth herein.

For a CARES customer with average monthly usage of 772 kWh, the overall bill (including the PPFAC charge and DSM and REST adjustors) will decrease by approximately \$3.45, from \$75.16 to \$71.71 or approximately negative 4.59 percent. For a CARES customer with median monthly usage of 621 kWh, the overall bill (including the PPFAC charge and DSM and REST adjustors) will decrease by approximately \$3.61, from \$61.07 to \$57.46 or approximately negative 5.91 percent.

The issue of expansion of CARES eligibility to 200% of the poverty level was also recently addressed in our UNS Gas Decision. There we directed the Company to convene a meeting with the parties and other interested stakeholders to address this issue and submit a recommendation. It is clear that this issue is also a concern for parties in this case, and we will also require UNSE to convene such a meeting within 60 days and submit its recommendations within 120 days of the effective date of this Decision.

PPFAC

UNSE's PPFAC is an adjustor mechanism that allows it to recover or refund changes in purchased power and fuel costs between rate cases. It was adopted in UNSE's last rate case and went into effect June 1, 2008. The PPFAC has a "forward component" which is based upon forecasted fuel and purchased power costs, and a "true-up component" which reconciles actual and forecasted fuel and purchased power costs and is incorporated in the following year's PPFAC rate. Staff's witness, Dr. Fish, reviewed the Company's expenses and verified that only allowable expenses were included in the PPFAC. He also testified that the Company's accounting system was adequate and reasonably maintained to collect, report, and audit the PPFAC filings, and to conduct testing. Dr. Fish also recommended that the PPFAC cap on the forward component be changed to \$0.01845 per kWh.[167] We accept Dr. Fish's findings.

[167] Ex. S-9 at 46.

Interest Rate

UNSE seeks Commission approval to change the PPFAC carrying cost from the one-year Nominal U.S. Treasury Constant Maturities rate to the 3-month London Interbank Offered Rate ("LIBOR") rate plus 1.0 percent. Mr. Grant testified that under the joint revolving credit facility UNSE shares with UNS Gas, it may borrow at LIBOR plus 1.0%. He also recommended that the rate be re-set monthly to reflect current market conditions and as the cost of credit under the credit facility changes.

Staff's witness, Dr. Fish, recommends that the Commission not change the interest rate as requested by the Company. He believes that "a higher interest rate could provide a disincentive to reduce bank balances and become less inclined to take all possible measures to reduce the cost of purchased power and fuel"[168] and that the Company's current interest rate is consistent with the authorized rates for UNS Gas and Southwest Gas.

In its last rate case, UNSE also requested that its interest rate be LIBOR plus 1.0 percent and we found that it had not provided a sufficient basis as to why its interest rate should be different than other utilities with fuel adjustors. We also cited to our Southwest Gas decision where we found that "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."[169] Further, in UNS Gas' recent rate case we also denied the request to modify the bank balance interest rate. We believe that the use of the one-year Nominal U.S. Treasury Maturities Rate is a reasonable and appropriate rate to apply to the PPFAC bank balance and it provides an incentive to the Company to keep the bank balances low. For the reasons discussed herein and identified in Decision Nos. 70360, and 71623, we again decline to modify the interest rate applied to the PPFAC balances.

Wholesale Credit Support Costs

UNSE originally requested that these costs be recovered through the PPFAC, but after Staff objected, the Company proposed that they be recovered through base rates as suggested by Dr. Fish.

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[168] Ex. S-9 at 47-48.
[169] Decision No. 70360 at 71, citing Decision No. 70011 at 80.

Consistent with that recommendation, we have included the wholesale credit support costs as an operating expense.

RUCO 90/10 sharing

RUCO recommends that the Commission modify the PPFAC to include a 90/10 sharing mechanism for the costs associated with purchased power and fuel. Dr. Johnson testified that as a matter of "sound public policy" a portion of the purchased power and fuel costs should be excluded "in order to provide an incentive for management to aggressively control these costs, and to manage its power and fuel acquisition process as efficiently as possible."[170]

UNSE opposed RUCO's recommendation, stating that the Commission rejected the same proposal in the last rate case, and arguing that RUCO failed to provide a rationale why the mechanism would be appropriate at this time. The Company argued that the sharing mechanism can work to the disadvantage of customers, such as when the PPFAC rate decreased by 22 percent on June 1, 2009. The Company notes that if a sharing mechanism had been in place, customers would have received less of a decrease.

In UNSE's last rate case where the Commission adopted the PPFAC, RUCO argued that a 90/10 sharing mechanism was appropriate as a means to give the Company an incentive to better control its fuel and purchases power costs. We did not adopt such a proposal, noting the potential volatility that the Company would likely experience as it was acquiring new sources of power to replace its long-standing full requirements contract. The PPFAC has been in effect for a little over two years, and we see no evidence that the Company is not adequately controlling its fuel and purchased power costs. We also note that the absence of a sharing mechanism has worked to the benefit of the customers since the adoption of the PPFAC. Accordingly, we find that there is no current need to implement a sharing mechanism and will not adopt RUCO's recommendation.

PPFAC Rate

The parties agreed that the average base cost of fuel and purchased power should be set at \$0.067700. The current true-up component rate is \$0.001375 and using the projected average net

[170] Ex. R-6 at 44.

fuel cost of $0.067093 per kWh,[171] the forward component rate will be ($0.000607), for a PPFAC rate of $0.000768 per kWh.

INVESTMENT RECOVERY MECHANISM PROPOSALS

Renewable Generation Ownership Plan

During the hearing in this matter, UNSE was asked to investigate and propose mechanisms for the recovery of utility investment in renewable energy projects and demand side management and energy efficiency. UNSE submitted its Renewable Generation Ownership Plan ("RGO Plan") during the hearing.[172] The RGO Plan will allow the Company to invest up to $5 million of capital each year to develop renewable technologies (as defined in the Renewable Energy Standard Tariff ("REST")) and will help the Company's efforts to diversify its renewable portfolio and meet the REST requirements of 15 percent retails sales from renewable resources by 2025. The revenue requirement would include depreciation, property taxes, income taxes, operating and maintenance expense and carrying costs using the authorized WACC.[173] UNSE requests that the revenue requirement for the RGO Plan be recovered through the REST adjustor mechanism until the investment is included in base rates. Specific projects will be identified and presented as part of UNSE's 2011 REST Implementation Plan. UNSE will use a competitive bid process and anticipates that the projects constructed and owned pursuant to the RGO Plan will be located in UNSE's service territory. The Company's witness, Mr. David Hutchens, testified that the RGO Plan "will increase both the pace and viability of cost effective renewable energy development in Arizona."[174] He explained that in order for the Company to qualify for the 30 percent Investment Tax Credit ("ITC"), UNSE needs to have rate recovery at the time the plant is put into service.[175]

Staff does not oppose approval of the Company's surcharge proposal. Staff noted that the RGO Plan is very similar to what the Commission has approved for APS (the type of costs to be included in the surcharge until the next rate case) and Staff has also recommended a similar approach

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[171] From Schedule 2 of the Company's April 1, 2010 report filed in Docket No. E-04204A-06-0783.
[172] Ex. U-28.
[173] UNSE estimates that RGO Plan revenue requirement to be included in the REST adjustor would be approximately $619,000 in 2011; $1,200,00 in 2012; $1,762,000 in 2013; and $2,336,000 in 2014.
[174] Tr. at 522.
[175] Tr. at 558-59; 565-66.

for UNSE's affiliate, TEP.

RUCO did not take a position on the Company's proposed RGO Plan.

The Company's RGO Plan is designed to increase both the pace and viability of cost effective renewable energy development in Arizona. Through the use of the surcharge to collect carrying costs, UNSE will qualify for the ITCs, which should help UNSE's ability to invest in renewables between rate cases, and also reduce the rate base associated with those renewable resources. No party has opposed UNSE's RGO Plan, and for the reasons set forth above, we find it in the public interest and will approve it.

Demand Side Management and Energy Efficiency Ownership

Also during the hearing, the Company was asked to propose a mechanism to recover utility investment in demand side management and energy efficiency projects. The Company committed to submit its Demand Side Management and Energy Efficiency Ownership Plan as part of its Energy Efficiency Implementation Plan filed in connection with the Commission's Energy Efficiency Rules.

MISCELLANEOUS ISSUES

Rules and Regulations

The Company proposed several revisions to its Rules and Regulations in its direct case. Staff witness Kenneth Rozen reviewed those proposals and made several recommendations, including approving revisions of rules governing meter error corrections and numerous technical and clarifying revisions; and rejecting the proposed Facilities Operation Charge, the revision requiring customers whose service is being reestablished or reconnected to pay monthly customer charges for the months during which service had been disconnected, and the inclusion of the type of accounting treatment as a part of the line extension tariff. Mr. Rozen also recommended that Subsections 9.A.3 and 9.B.1.e of the line extension tariff be revised to specify that materials costs given in a line extension construction cost estimates must be itemized; that the Company clarify the intent and effect of new language in the line extension tariff related to conditions for rectifying differences in estimated and actual construction costs; and that the Commission clarify that its Decision Nos. 70360 and 71285 (October 7, 2009) which approved revisions to the Company's line extension tariff granted a waiver to A.A.C. R14-2-207.C.

In response to Mr. Rozen's testimony and recommendations, the Company accepted all the recommendations and withdrew the proposed changes that Staff opposed.

All objections to the proposed revisions to Rules and Regulations have been resolved, and the Company has accepted all of Staff's recommendations. We agree with the Staff recommendations and will order the Company to implement the revisions to its Rules and Regulations. We also find that our Decision Nos. 70360 and 71285 granted a waiver to A.A.C. R14-2-207.C.

Engineering Issues

Staff's witness, W. Michael Lewis, testified that he evaluated the service quality and reliability of the distribution system, observed and evaluated some of the major items of investment proposed to be included in rate base, evaluated the comparative standards of construction between the acquired system and subsequent installations, and observed the facilities of BMGS as to construction quality.[176] He made several recommendations, including: 1) the Commission should require UNSE to file an annual report of the distribution indices including a listing of the worst performing circuits and what steps are being taken to mitigate these circuits' poor performance; 2) that the portion of plant items completed and used and useful at the end of the test year be included in rate base; 3) the inspection of the BMGS facility indicates that it is properly constructed and should be back to full operational levels once the repairs are completed; 4) that when and if UNSE acquires BMGS, the costs of repairs not covered by warranty should be borne by UED; 5) If UNSE acquires BMGS, it should be required to demonstrate that there are no limitations due to water availability on the required operations of Unit #1 and #2; and 6) that UNSE's maintenance scheduling at the BMGS facility should include thermal scanning of the substation/switchyard bus and connected lines on a regular basis.

UNSE agreed to recommendation #2, #3, #4, #5[177] and also agrees with #6 but indicates that thermal scanning is a "costly procedure that requires specially trained personnel and the Company should be allowed to determine the appropriate timing of the thermal scans consistent with sound operational practices."[178] The Company disputes Staff's recommendation that it submit an annual list

[176] Ex. S-7 at 2.
[177] In its Rebuttal testimony, the Company submitted evidence about its water availability to the satisfaction of Staff.
[178] UNSE Initial Brief at 63.

of worst performing circuits, arguing that the current reliability reporting is the most cost-effective and efficient approach for evaluating system reliability.

In his analysis of the Company's quality of service as related to distribution, Mr. Lewis requested the Company's Customer Average Interruption Duration Index ("CAIDI"), System Average Interruption Frequency Index ("SAIFI") and System Average Interruption Duration Index ("SAIDI") for the years 2007, 2008, and part of 2009, and also requested the four worst performing circuits in both Mohave and Santa Cruz service areas based upon their indices. The Company did not provide the requested worst circuits list. Mr. Lewis testified that the reason the circuit identifications were requested was to "evaluate the effect of these outages on the over-all system results, to know the cause of the outages, and what (if any) mitigation efforts had been made or were planned to minimize those outages and thus, reduce the overall system indices values."[179]

He further testified that:

> The distribution indices represent an average performance in the affected service area or areas. If, in fact, some customers are experiencing much worse outages, either in frequency or duration, then otherwise acceptable values of indices are, or can be, misleading. A listing of the more poorly performing circuits can indicate to what extent that is the case, and what measures could be taken to mitigate the problems.[180]

The Company's witness, Mr. Thomas McKenna, testified that "[w]hile personnel are developing a method to determine 'worst performing circuits'" the Company does not agree that it should be required to submit an annual report. He indicated that circuits may be on the list for many reasons, some of which are not quickly or easily mitigated.[181]

In response, Staff stated that it is "aware of the problems inherent in addressing specific reliability problems as discussed by Mr. McKenna and will not have any unreasonable expectations as to the timing and nature of corrective actions."[182]

It appears that UNSE's primary objection to filing an annual report of worst performing circuits with Staff is that such a list may create costly or unrealistic expectations. Given the

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[179] Ex. S-7 at 6.
[180] Ex. S-8 at 3.
[181] Ex. U-9 at 12 (McKenna Rebuttal Testimony).
[182] Ex. S-8 at 3.

testimony of Staff's witness, it is clear that that is not the case. Staff does believe that identification of the worst performing circuits will give UNSE additional information that will lead ultimately to a better informed plan for corrective actions. We agree and will adopt the Staff recommendations.

Prudence Review of Fuel and Purchased Power Policy

Dr. Fish performed a prudence review of UNSE's fuel and purchased power policies. He reviewed Organization, Staffing and Controls; Fuel Management; Fuel and Purchased Power Contracts; Hedging and Risk Management; Forecasting and Modeling; Plant Operations; and Purchased Power and Off-System Sales. He found that the organization, staffing and controls functions are reasonable and appropriate; that risk management procedures are extensive and sound and incorporated with hedging policies; the hedging program is sound; segregation of utility and non-utility activity is adequate; modeling to predict fuel and purchased power volume and cost is sufficiently accurate; an appropriate least cost dispatch model is used; documentation is adequate for regulatory oversight; the performance measures of BMGS and Valencia demonstrate effective operation; the acquisition process for purchased power is adequate; and electric power trading is conducted with the goal of achieving least-cost dispatch.[183]

Dr. Fish made four recommendations as follows:

1. Strengthen the relationship between fuel contract management and procurement.
2. Create internal auditing procedures for contract management and procurement.
3. The analysis of possible excess interstate pipeline capacity optimization by UNS Gas should be extended to UNSE fuel procurement.
4. Hedging for gas procurement in August, September, and October should be considered but not required. The price of risk associated with hurricane season should be explicitly considered.[184]

The prudence review conducted by Staff revealed no major problems or concerns. The Company did not specifically object to Dr. Fish's recommendations, but explained that with a few of the recommendations, it was uncertain what specific problem it was supposed to address. We believe

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[183] Ex. S-9 at 68-69.
[184] Id. at 69.

that the recommendations are reasonable, and to the extent that UNSE needs more clarification, Staff should meet and explain in more detail what steps it expects UNSE to take.

ASBA and AASBO Issues

The ASBA represents over 1,200 school board members and over 1.12 million children in Arizona and its mission is to "promote community volunteer governance of public education and continue improvement of student success by providing leadership and assistance to public school governing boards."[185] The AASBO provides services to 1,300 members in school districts in Arizona. Both intervened in this proceeding to assist Arizona's public schools in managing their energy consumption in an economic and efficient manner. Mr. Chuck Essigs testified on behalf of ASBA/AASBO concerning potential school-specific renewable programs, energy efficiency programs and the use of TOU rates. ASBA/AASBO requests that the Commission: direct UNSE to develop a school-specific renewable program for inclusion in the Company's renewable energy implementation plan; require UNSE to file a school-specific program for energy efficiency in the DSM docket within three months from the date of this Decision; and direct UNSE to develop and file with the Commission an optional rate for schools within its service territory within 90 days of the date of this Decision.

UNSE indicated that it had worked with schools in its service area and remained committed to working with schools on the ASBA/AASBO issues. The Company does not believe that sufficient information is in this docket to actually adopt any specific program, but will work to develop the programs identified by ASBA/AASBO.

As indicated by ASBA/AASBO, Arizona school budgets have been impacted by reductions at the same time they are facing utility rate increases. We agree that UNSE should develop programs for schools to help them manage their energy costs through the use of DSM, energy efficiency and TOU rates. Accordingly, we will adopt the recommendation of ASBA/AASBO.

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Having considered the entire record herein and being fully advised in the premises, the

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[185] Ex. ASBA-1 at 1.

Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. On April 30, 2009, UNSE filed with the Commission its application for a rate increase for electric service.

2. With its application, UNSE filed its required schedules in support of the application, and the direct testimony of various witnesses.

3. On May 26, 2009, UNSE filed a Notice of Errata, revising Schedules H-3 and H-4 of the application.

4. On May 29, 2009, Staff filed a Letter of Sufficiency in the docket indicating that UNSE's application had met the sufficiency requirements of A.A.C. R14-2-103 and was classified as a Class A utility.

5. On June 16, 2009, a procedural conference was held.

6. On June 18, 2009, a Procedural Order was issued setting procedural dates for filing testimony and other deadlines, and also scheduling the hearing to commence on February 4, 2010.

7. On July 14, 2009, RUCO filed an Application to Intervene.

8. On August 31, 2009, UNSE filed a Notice of Errata concerning corrections to certain tariffs.

9. On September 1, 2009, intervention was granted to RUCO.

10. On September 14, 2009, UNSE filed a Notice of Errata concerning corrections to testimony.

11. On September 17, 2009, ASBA and AASBO filed for leave to intervene.

12. On September 25, 2009, UNSE filed a Notice of Filing Affidavits of Publication and Proof of Mailing.

13. On October 1, 2009, ASBA/AASBO were granted intervention.

14. On October 2, 2009, UNSE filed a Notice of Errata concerning additional corrections to tariffs filed on August 31, 2009.

15. On October 20, 2009, RUCO filed a Motion to Extend the Time to File its Direct Required Revenue and Rate Design Testimony.

16. By Procedural Order issued on October 27, 2009, RUCO's Motion was granted.

17. On November 6, 2009, ASBA/AASBO, RUCO, and Staff filed direct testimony.

18. On November 13, 2009, RUCO and Staff filed direct rate design testimony.

19. On December 11, 2009, UNSE filed its rebuttal testimony.

20. On January 15, 2010, ASBA/AASBO, RUCO, and Staff filed surrebuttal testimony.

21. On January 25, 2010, UNSE filed its rejoinder testimony.

22. On January 29, 2010, the prehearing procedural conference was conducted to address the order of witnesses and exhibits and UNSE filed the Join Matrix of Major Issues

23. The evidentiary hearing commenced as scheduled on February 4, 2010, and additional hearing days were held on February 5, 8, 10, and 11, 2010.

24. On February 9, 2010, UNSE filed a revised exhibit.

25. On March 1, 2010, RUCO filed its final post-hearing schedules; UNSE filed its final post-hearing schedules; and Staff filed a Motion for an Extension of Time to File Final Schedules, Late Filed Exhibits, and Extension of Briefing Schedule.

26. On March 3, 2010, a Procedural Order was issued setting new dates for filing Staff's late-filed exhibit and final schedules, and for filing opening and reply briefs.

27. On March 12, 2010, Staff filed its Late-Filed Exhibit S-18 (Estimated Bill Impacts of Varying REST Levels and Recovery of 100% DSM Within Base Rates) and its Final Schedules.

28. On March 17, 2010, UNSE filed revisions to its Late-Filed Exhibit 36 and Staff filed an Errata to its Final Schedules.

29. On March 23, 2010, ASBA/AASBO, RUCO, UNSE, and Staff filed opening briefs and Staff filed an Errata with a complete set of its Final Schedules.

30. On March 24, 2010, UNSE filed its Appendix in Support of its opening brief.

31. On April 2, 2010, ASBA/AASBO, RUCO, UNSE, and Staff filed reply briefs.

32. On April 7, 2010, UNSE filed its revision to Exhibit UNSE 32 to include revised bill impacts reflecting the updated PPFAC rate and filed an update to Revised Late-filed Exhibit 36.

33. On August 17, 2010, RUCO filed its Revised Final Post-Hearing Schedules.

34. According to the Company's application, as modified, in the test year ended December

31, 2008, UNSE had adjusted operating income of $9,846,875 on an adjusted OCRB of $175,688,714, for a 5.60 percent rate of return. The Company's proposed RCND is $354,355,023, resulting in a rate of return on RCND of 2.78 percent; and its proposed FVRB is $265,021,868 resulting in a test year rate of return of 3.72 percent on FVRB.

35. UNSE requests a gross revenue increase of $13,500,000; Staff recommends a revenue increase of $7,830,901, and RUCO recommends a revenue increase of $4,045,949.

36. For purposes of this proceeding, we determine that UNSE has an OCRB of $168,574,818, RCND of $314,572,470 and a FVRB of $241,573,644.

37. UNSE's test year operating revenues are determined to be $160,926,065.

38. UNSE's test year operating expenses are determined to be $150,497,582.

39. UNSE's test year operating income is determined to be $10,428,483.

40. The Company's cost of common equity is determined to be 9.75 percent; its cost of debt is 7.05 percent; its capital structure is comprised of 45.76 percent equity and 54.24 percent debt; and the Company's overall weighted average cost of capital is determined to be 8.28 percent.

41. Under the facts of this case, it is appropriate to apply an inflation factor of 2.10 percent to UNSE's WACC of 8.28 percent, resulting in a fair value rate of return of 6.18 percent.

42. UNSE is entitled to a gross revenue increase of $7,364,607.

43. The rate design proposed by UNSE and Staff is reasonable and appropriate and includes: applying an equal or constant increase per customer class except for residential CARES; changes to the customer charges; maintaining the two block rate structure; the redesign of the TOU rates to expand the differentials between On-Peak, Shoulder-Peak, and Off-Peak periods; and the new Super-Peak Demand Response rates.

44. The current overall bill[186] for a residential customer with average monthly usage of 874 kWh will increase by approximately $4.15, from $94.95 to $99.10, or approximately 4.37 percent, and the current overall bill for a residential customer with median monthly usage of 681 kWh will increase by approximately $3.52, from $74.75 to $78.27, or approximately 4.70 percent.

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[186] "Overall bill" includes the PPFAC charge and DSM and REST adjustors.

45. The current overall bill for a small commercial customer with average monthly usage of 1,001 kWh will increase by approximately $5.42, from $121.69 to $127.10, or approximately 4.45 percent, and the current overall bill for a small commercial customer with median monthly usage of 600 kWh will increase by approximately $3.68, from $76.14 to $79.82, or approximately 4.83 percent.

46. The authorized base cost of fuel and purchased power is $0.067700 per kWh, the PPFAC forward component is ($0.000607) per kWh, the true-up component is $0.001375 per kWh, for a total PPFAC rate of $0.000768 per kWh and an average total rate of $0.068468 per kWh.

47. The cap on the forward component in Purchased Power and Fuel Adjustor Clause should be changed to $.01845 per kWh.

48. UNSE's proposal to hold most CARES customers harmless from the proposed rate increase by lowering the CARES customer charge from $7.50 to $3.50 and reducing the base power supply for CARES customers is reasonable and appropriate and is adopted.

49. UNSE's proposal to set the CARES customers' PPFAC forward and true-up components at zero and freezing those rates is not reasonable and is not adopted.

50. UNSE should apply a discount to the PPFAC forward and true-up components that reflects the same percentage discount applied to the base power supply for CARES customers.

51. CARES customers will continue to receive the additional discounts (30% for 0-300 kWh; 20% for 301-600 kWh; and 10% for 301-1000 kWh) and the flat $8.00 per month discount for customers with monthly usage in excess of 1,000 kWh.

52. The current overall bill for a CARES customer with average monthly usage of 772 kWh will decrease by approximately $3.45, from $75.16 to $71.71, or approximately negative 4.59 percent, and the current overall bill for a CARES customer with median monthly usage of 621 kWh will decrease by approximately $3.61, from $61.07 to $57.46, or approximately negative 5.91 percent.

53. UNSE should convene a meeting with the parties in this case and other interested stakeholders within 60 days to address the issue of expansion of CARES eligibility and submit its recommendations within 120 days of the effective date of this Decision.

54. The proposed depreciation rates and the updates in Dr. White's direct testimony are approved.

55. UNSE's request to modify the interest rate applied to the PPFAC balances should be denied as set forth herein.

56. UNSE's proposed Renewable Generation Ownership Plan should be approved and UNSE's REST adjustor should be modified accordingly.

57. UNSE should submit its Demand Side Management and Energy Efficiency Ownership Plan as part of its Energy Efficiency Implementation Plan.

58. UNSE should revise its Rules and Regulations in accordance with Staff's recommendations.

59. UNSE should comply with the Staff recommendations on engineering issues.

60. UNSE should comply with the Staff recommendations concerning its Fuel and Purchased Power prudence review.

61. UNSE should develop a school-specific renewable program for inclusion in the Company's renewable energy implementation plan; UNSE should file a school-specific program for energy efficiency in the DSM docket within three months from the date of this Decision; and UNSE should develop and file with the Commission an optional rate for schools within its service territory within 90 days of the date of this Decision.

62. UNSE will be allowed rate base treatment of the BMGS and the rate reclassification, with such treatment and reclassification effective only upon the following steps: 1) Staff shall complete its evaluation of BMGS and file its recommendation in this docket as a compliance item within 90 days of the date of this Decision; 2) Commission determination confirming that BMGS should be included in rate base; 3) UNSE shall, with the assistance of Staff and RUCO, prepare and file in this docket as a compliance item within 60 days of the date of this Decision, schedules showing the inclusion of BMGS in rate base, with the appropriate operating adjustments, together with a proof of revenues demonstrating that the reclassified rates will produce the same revenue as authorized herein; 4) FERC approval of UNSE's acquisition of BMGS; 5) Completion of UNSE's acquisition of BMGS; and 6) Customer notice of the revenue neutral reclassification in a manner acceptable to

Staff.

63. This docket will remain open to allow UNSE and the parties to submit the documentation required in the above-numbered steps.

64. No later than 18 months after any rate reclassification, UNSE shall file a rate application using the twelve month test year beginning with the first month following implementation of the rate reclassification.

CONCLUSIONS OF LAW

1. UNSE 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 UNSE and the subject matter of the above-captioned case.

3. The fair value of UNSE's rate base is $241,573,644, and applying a 6.18 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.

5. Decision Nos. 70360 and 71285 granted a waiver to A.A.C. R14-2-207.C.

ORDER

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

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

IT IS FURTHER ORDERED that UNS Electric, 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 the cap on the forward component in Purchased Power and

Fuel Adjustor Clause is changed to $0.01845 per kWh.

IT IS FURTHER ORDERED that UNS Electric, Inc., shall file its Renewable Generation Ownership Plan and modification to its REST adjustor as a compliance item in this docket, within 30 days of the effective date of this Decision.

IT IS FURTHER ORDERED that UNS Electric, Inc., shall file its Demand Side Management and Energy Efficiency Ownership Plan as part of its Energy Efficiency Implementation Plan.

IT IS FURTHER ORDERED that UNS Electric, Inc., shall revise its Rules and Regulations in accordance with Staff's recommendations.

IT IS FURTHER ORDERED that UNS Electric, Inc., shall comply with the Staff recommendations on engineering issues.

IT IS FURTHER ORDERED that UNS Electric, Inc., shall comply with the Staff recommendations concerning its Fuel and Purchased Power prudence review.

IT IS FURTHER ORDERED that UNS Electric, Inc.'s proposed depreciation rates and updates are approved.

IT IS FURTHER ORDERED that UNS Electric, Inc., shall be allowed rate base treatment of the Black Mountain Generating Station and the rate reclassification, with such treatment and reclassification effective only upon the following steps: 1) Staff shall complete its evaluation of Black Mountain Generating Station and file its recommendation in this docket as a compliance item within 90 days of the date of this Decision; 2) Commission determination confirming that Black Mountain Generating Station should be included in rate base; 3) UNS Electric, Inc. shall, with the assistance of Staff and RUCO, prepare and file in this docket as a compliance item within 60 days of the date of this Decision, schedules showing the inclusion of Black Mountain Generating Station in rate base, with the appropriate operating adjustments, together with a proof of revenues demonstrating that the reclassified rates will produce the same revenue as authorized herein; 4) FERC approval of UNS Electric, Inc.'s acquisition of Black Mountain Generating Station; 5) Completion of UNS Electric, Inc.'s acquisition of Black Mountain Generating Station; and 6) Customer notice of the revenue neutral reclassification in a manner acceptable to Staff.

IT IS FURTHER ORDERED that this docket will remain open to allow UNS Electric, Inc.

and the parties to submit the documentation required in the above-numbered steps.

IT IS FURTHER ORDERED that UNS Electric, Inc., shall, no later than 18 months after any rate reclassification, file a rate application using the twelve month test year immediately following implementation of the rate reclassification.

IT IS FURTHER ORDERED that UNS Electric, Inc., shall convene a meeting with the parties in this case and other interested stakeholders within 60 days to address the issue of expansion of CARES eligibility and submit its recommendations within 120 days of the effective date of this Decision.

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IT IS FURTHER ORDERED that UNS Electric, Inc., shall develop a school-specific renewable program for inclusion in the Company's renewable energy implementation plan; file a school-specific program for energy efficiency in the DSM docket within three months from the date of this Decision; and shall develop and file with the Commission an optional rate for schools within its service territory within 90 days of the 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, ERNEST G. JOHNSON, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _______ day of ____________, 2010.

ERNEST G. JOHNSON
EXECUTIVE DIRECTOR

DISSENT ________________________

DISSENT ________________________

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