IN THE COURT OF APPEALS

STATE OF ARIZONA

DIVISION TWO

FREEPORT MINERALS CORPORATION, APPELLANT, v. THE ARIZONA CORPORATION COMMISSION, APPELLEE, TUCSON ELECTRIC POWER COMPANY, INTERVENOR.	Court of Appeals Division Two No. 2 CA-CC 17-0001 ACC Docket Nos. E-01933A-15-0239 E-01933A-15-0322 Decision No. 75975

ARIZONA CORPORATION COMMISSION ANSWERING BRIEF

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September 15, 2017

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The Arizona Corporation Commission ("Commission") is an agency created by article XV of the Arizona Constitution. The Commission is responsible for setting rates for Arizona's public service corporations.[1]

Tucson Electric Power Company ("TEP") is an Arizona public service corporation that serves almost 415,000 customers in Pima County, of which approximately 90 percent are residential, 9 percent are commercial, and less than 1 percent are industrial/mining.[2] TEP also provides power to Fort Huachuca, a U.S. Army base located in Cochise County.[3] TEP is a wholly-owned subsidiary of UNS Energy Corporation ("UNS Energy"). UNS Energy was purchased by Fortis, Inc. ("Fortis"), in August 2014. Fortis is an investor-owned utility holding company based in Canada. UNS Energy is also the parent of UNS Electric, Inc., which provides electric service in Santa Cruz and Mohave counties.[4]

Freeport Minerals Corporation ("Freeport") intervened in TEP's most recent rate case (Docket No. E-01933A-15-0239 *et al.*), as well as the last two TEP rate cases. Freeport is a manufacturer of copper and its Sierrita mine is located in TEP's

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1 *See, generally*, Ariz. Const. art. XV, sections 2, 3.
2 ROA-513, ep 9.
3 *Id.*
4 *Id.*

service territory.[5] Freeport has appealed the Commission's final order, Decision No. 75975, which gives rise to this proceeding.

INTRODUCTION

This case involves a challenge by Freeport to Commission Decision No. 75975, which established "just and reasonable" rates for TEP customers.[6] Although Freeport characterizes its challenge as a narrow one,[7] its appeal goes to the heart of the Commission's exclusive and fundamental ratemaking authority to set "just and reasonable" rates.

Freeport is essentially asking this Court to ignore the Commission's exclusive constitutional ratemaking mandate and determine that non-discriminatory and "just and reasonable" rates can only be set when the Commission bases rates strictly on the costs to serve each customer class. In other words, Freeport argues that, as a matter of law, the Commission must set rates based only upon the cost to serve customers.[8]

Freeport's position is contrary to the Commission's plenary ratemaking authority, as set forth in article XV, section 3 of the Arizona Constitution. The

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5 ROA-632, ep 4.

6 ROA-513.

7 Freeport's challenge is focused on the revenue allocations adopted by Decision No. 75975.

8 *See*, Op. Br. at 21 ("Although there is no Arizona case directly on point, case law supports the proposition that rates in excess of the customer's cost of service are unjust, unreasonable and discriminatory.").

constitution does not prescribe any set methodology for the Commission to use in determining rates but requires only that any rate set by the Commission be "just and reasonable."[9]

Freeport's challenge to Decision No. 75975 is essentially two-fold. Freeport alleges that Decision No. 75975's revenue allocation is, 1) discriminatory in violation of article XV, section 12 and A.R.S. § 40-334; and 2) not supported by substantial evidence.[10] Neither position has merit.

With respect to Freeport's first argument, the fact that rates differ does not by itself make the rate discriminatory. Arizona law prohibits *unreasonable* differences in rates among similarly situated customers.[11] Freeport is different than most other TEP customers and for that reason is in its own rate class (known as 138 kV).[12] Thus, Freeport is not "similarly situated" to other customers. In addition, the Commission's consideration of factors other than cost in establishing the revenue allocation, does not make the resulting rates discriminatory.[13] It is well established that the Commission may, pursuant to its plenary ratemaking authority, consider factors other than costs when setting rates.[14]

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9 Ariz. Const. art. XV.

10 Op. Br. 19-21, 31-34.

11 *General Cable Corp. v. Citizens Utils. Co.*, 27 Ariz. App. 381, 384 (App. 1976).

12 ROA-606, ep 57:17-59:12; ROA-632, ep 10:4-16.

13 ROA-513, ep 35-46.

14 *Consolidated Water Util. Ltd. v. Ariz. Corp. Comm'n*, 178 Ariz. 478, 483-84 (App. 1992); *Litchfield Park Svc. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 439-40 (App. 1994).

Freeport's second argument, that the Commission's Decision in this case is not supported by substantial evidence, is also without merit. The record demonstrates that the Commission utilized cost of service as a guide while at the same time recognizing the need to reduce class subsidies that have historically existed in TEP's rate design.[15] The Commission considered proposals on revenue allocation and inter-class subsidy reduction introduced by a number of parties. The Commission adopted an approach which considered cost of service, as well as other factors, in arriving at an allocation that is in the public interest. The Commission's action was also in line with the steps it has taken to reduce inter-class subsidies in each of TEP's recent rate cases. Beginning with TEP's 2007 rate case, the Commission has been adjusting TEP's rates to be more closely aligned with the cost of serving customers.[16] The Commission addressed inter-class subsidies again in TEP's 2012 rate case and now in this case. The Commission has also recognized in each case that moving to cost of service immediately would cause unreasonable rate shock. Thus, the Commission found it necessary to implement the reduction to inter-class subsidies over time.

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[15] ROA-513, ep 35-46.

[16] In fact, Freeport and its predecessor Phelps Dodge signed settlement agreements in the two prior rate cases where the rates set by the Commission were not purely based on cost of service, but were based upon other considerations as well.

Freeport itself proposed incremental movement in TEP's rates *towards* a cost of service by advocating for a reduction of revenue allocated to Freeport and other large power users resulting in a larger increase for the residential class. Freeport also argued to reduce the annual subsidy in half to mitigate the increase to the residential class.[17] In other words, Freeport acknowledges the Commission's movement of rates based on cost of service, but takes issue with the Commission's timeline for moving closer to cost of service and the amount of reduction in the revenue allocation to Freeport in this case.

Freeport also overlooks the fact that it is being allocated substantially less than the system average of the fuel costs and substantially less than the average fuel costs compared to the other rate classes. This is due, in part, to the fact that distribution losses are not being assigned to sales units for the 138 kV class and, in part, to simply reduce fuel costs to effect a lower overall bill impact to Freeport's rate class, which was used to derive the fuel costs for that class.[18] Further, of the $81.5 million of the revenue increase in this case, the 138 kV Class, which is currently only comprised of Freeport, is being allocated only .69 percent or $561,000.[19] These two factors have an impact on, and have the effect of, negating some of the overall revenue allocation to Freeport.

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17 Op. Br. at 16-17.

18 ROA-606, ep 58:22-59:10; S-11, ep 66:201-06, Column F (confidential, filed under seal).

19 ROA-513, ep 46:5-13.

The Commission is tasked with deciding how to allocate revenue recovery in a way that is just and reasonable, and in the public interest. These determinations fall squarely within the Commission's constitutional ratemaking authority. This Court should affirm the Commission's Decision on these issues.

STATEMENT OF THE CASE

On November 5, 2015, TEP filed with the Commission an Application for a rate increase, with accompanying testimony and exhibits ("2015 rate case").[20] Freeport, as well as a number of other parties, was granted intervention in that proceeding.[21]

A number of parties, including Freeport, entered into a settlement agreement dated August 15, 2016 ("2016 Settlement Agreement"), which resolved certain matters relating to TEP's 2015 rate case.[22] The 2016 Settlement Agreement did not resolve all issues in the matter, leaving open the issue of the allocation of revenue among the rate classes.[23] The Commission held an eleven-day hearing in this matter in September 2016.[24] After the conclusion of the hearing, an administrative law judge ("ALJ") prepared a recommended opinion and order ("ROO") for the

[20] ROA-513, ep 9:21-22.
[21] *Id.*, ep 10-11.
[22] *Id.*, ep 13:15-18.
[23] *Id.*, ep 13:18-21.
[24] *Id.*, ep 1.

Commission's consideration.[25] A number of parties, including Freeport, filed exceptions to the ALJ's ROO.[26]

On February 8, 2017, the Commission considered the ALJ's proposal at an open meeting.[27] The Commission adopted the ALJ's ROO, subject to some modifications in Decision No. 75975.[28]

Freeport filed a timely application for rehearing pursuant to A.R.S. § 40-253, which was subsequently denied by operation of law.[29] Freeport then timely filed this appeal pursuant to A.R.S. § 40-254.01.[30]

STATEMENT OF FACTS

I. INTRODUCTION.

This matter is a direct appeal of the Commission's rate order in Decision No. 75975. Freeport's primary complaint is its belief that the allocation of revenue across customer classes is inequitable, discriminatory, and not supported by substantial evidence.[31]

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25 ROA-454.
26 ROA-460, 477-484.
27 ROA-545.
28 ROA-513.
29 ROA-519.
30 Court of Appeals Docket No. 10, Notice of Appeal (May 3, 2017).
31 Op. Br. at 6.

To understand the facts of this case, it is necessary to review the basic principles of ratemaking. In Arizona, rates for monopoly utilities are generally developed using the following rate of return formula:

[(Rate Base) (Rate of Return)] + Expenses = Revenue Requirement.[32]

The result of this formula is called the "Revenue Requirement," which is the approximate amount of revenue that the utility is authorized to collect from its customers through rates.[33] In determining the inputs to the formula, a test year is used to ensure the appropriate matching of revenues and expenses.[34] Once the revenue requirement is determined, the Commission must design the combination of rates that will produce that revenue requirement each year.[35] This process is called rate design.[36]

The objective of rate design is to distribute the recovery of the revenue requirement fairly and equitably among a utility's customers.[37] Generally, rate

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[32] *Litchfield Park Svc. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 435 (App. 1994).

[33] Charles F. Phillips, Jr., *The Regulation of Public Utilities* at 176-177 (Public Utility Reports, Inc. 3d ed. 1993). Relevant excerpts of this will be provided upon request.

[34] *Id.* at 177; *see also*, 73 C.J.S. Public Utilities Section 108.

[35] *The Regulation of Public Utilities* at 179.

[36] *Id*.

[37] *Id.* at 434.

design follows the principle that the costs of utility service should be borne by the cost causer.[38] Typically, the utility will perform a fully allocated class cost of service study to be used as a guideline to allocate revenue among classes.[39] The Commission, however, will also consider economic, social, historical and other factors that may affect customers when determining revenue allocation.[40] Such considerations often result in rates that deviate from strict cost of service. The Commission also considers the concept of *gradualism*, a well-recognized tenet and basic principle of rate design[41] that rates and rate structures should not change so suddenly and so drastically that customers cannot reasonably anticipate the changes.[42]

To design rates that will approximate the revenue requirement, the Commission then considers the various customer classes, such as residential and commercial, the number of customers within each class, and their various usage patterns.[43] The Commission uses this information to establish rates that will recover the revenue requirement, thereby allocating responsibility for cost recovery among the various customer classes using the principles discussed above.[44]

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38 James C. Bonbright, *et al*., *Principles of Public Utility Rates* at 109-112 (Public Utility Reports, Inc.2d ed. 1988).
39 ROA-716, ep 18.
40 *Id.*
41 *Id*., ep 6, 25:14-16.
42 *Id*., ep 13:8-9.
43 *The Regulation of Public Utilities* at 179.
44 *Id.* at 841.

At the start of this case, TEP had five rate classes: Residential, Small General Services, Large General Services, Lighting, and Large Light and Power.[45] In the 2015 rate case, the Commission approved several additional rate classes including classes for Medium General Service customers and very Large Commercial customers (those taking service at 138 kV or higher). Freeport is the only customer in the 138 kV or higher class,[46] a class which TEP agreed to propose in the 2012 Settlement Agreement and which Freeport supported.[47]

II. RATE CASE HISTORY.

Since 2005, TEP has filed three rate cases that have resulted in Commission decisions that have continued to reduce inter-class subsidies and move TEP's rate structure to one that is more cost-based. All of these cases have taken important steps to bring Freeport's rates closer to its cost of service. The 2007 and 2012 cases adopted settlement agreements in which Freeport or its predecessors, Phelps Dodge Mining Company ("Phelps Dodge") or Freeport-McMoRan Copper & Gold ("Freeport-McMoRan"), joined. In the case now before the Court, the Commission approved a partial settlement agreement that addressed revenue requirement issues but left rate design and revenue allocation issues to be addressed by parties in the

[45] ROA-716, ep 18:21-23.
[46] ROA-513, ep 37, n. 133.
[47] http://docket.images.azcc.gov/0000146156.pdf, Decision No. 73912 at 30:3-4.

evidentiary hearing.[48] A number of parties addressed those issues in testimony at the evidentiary hearing and the Commission's Decision balanced cost and non-cost factors in arriving at an appropriate revenue allocation. The three cases are discussed in more detail below.

A. 2007 Rate Case.

TEP filed for an increase in rates on July 2, 2007.[49] This was the first opportunity for the Commission to review TEP's cost of service and rates since 1999. The majority of the parties to the rate case docket, including Freeport's predecessor, Phelps Dodge, entered into a settlement agreement ("2007 Settlement Agreement"), which the Commission approved in Decision No. 70628.[50] TEP sought to simplify its tariffs by consolidating multiple tariffs and eliminating tariffs that had been frozen. The revenue increase was allocated evenly across all rate classes, including Freeport's rate class, except that low income customers were held harmless from the increase.[51] The revenue attributable to the low income customers was allocated to all other customer classes, meaning that those other classes

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48 ROA-513, ep 13:15-21.

49 http://edocket.azcc.gov/Docket/DocketDetailSearch?docketId=3333, Docket No. E-01933-98-0471, In the Matter of the Application of Tucson Electric Power Co. for the Approval of its Plan for Stranded Cost Recovery.

50 http://edocket.azcc.gov/Docket/DocketDetailSearch?docketId=3333, Docket No. E-01933-98-0471, In the Matter of the Application of Tucson Electric Power Co. for the Approval of its Plan for Stranded Cost Recovery.

51 http://docket.images.azcc.gov/0000146156.pdf, Decision No. 73912 at 30:3-4.

subsidized the low income customers.[52] The 2007 Settlement Agreement also included the retention of cost of service ratemaking treatment.[53] A rate freeze was imposed until December 31, 2012.[54]

B. 2012 Rate Case.

TEP filed its next general rate case on July 2, 2012.[55] In its rate application, TEP requested an increase in base rates of $127.8 million or 15.3 percent.[56] A number of parties intervened in the matter, including the predecessor to Freeport.[57] That case culminated in a settlement agreement among the majority of the parties ("2012 Settlement Agreement"). The 2012 Settlement Agreement provided for a simplification of TEP's rate design and a rate increase of $76.2 million or 13.3 percent.[58] Under the terms of the 2012 Settlement Agreement, the portion of the overall revenue requirement recovered through base rates was allocated to the customer classes as follows: the Residential Class received an increase of 13.3 percent; the Small Commercial Class received an increase of 12.3 percent; and the Water Pumping, Large Commercial (Freeport's class), Lighting, and Large Light

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52 *Id.*
53 *Id.*
54 *Id.*
55 http://docket.images.azcc.gov/0000146156.pdf, Decision No. 73912 at 2.
56 *Id.* at 66.
57 *Id.*
58 *Id.* at 33.

and Power, classes all received an increase of 14.1 percent.[59] TEP witness Dallas Dukes testified that the revenue allocation under the 2012 Settlement Agreement somewhat mitigated the rate impact on residential and small business customers.[60] As a result of the treatment for the residential and small commercial classes, the percent increase to the other customer classes (Large Commercial, Water Pumping, Lighting, and Large Light and Power) was slightly higher than the aggregate increase.[61] TEP argued that the revenue allocation under the 2012 Settlement Agreement was equitable, while gradually moving towards matching customer classes to their actual costs.[62]

Freeport signed the 2012 Settlement Agreement and supported not only the revenue allocation but also the requirement for TEP to develop and file a rate for very large customers, (those taking service at 138 kV or higher) in the next rate case.[63]

C. 2015 Rate Case.

TEP filed its current application for a rate increase on November 15, 2015.[64] TEP requested an increase in rates that would result in a non-fuel revenue increase

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59 *Id.* at 23:13-18.
60 *Id.* at 34.
61 *Id.*
62 *Id.*
63 *Id.* at 30:3-4.
64 ROA-1.

of approximately $109.5 million or approximately 12 percent.[65] Freeport was also an Intervenor.[66] The majority of the parties entered into a Settlement Agreement regarding the revenue requirement ("2015 Settlement Agreement").[67] The 2015 Settlement Agreement provided for an $81.5 million increase in test year revenues.[68] The parties litigated issues related to rate design and revenue allocation.[69] In addition to Freeport, the other large power users who were parties included Wal-Mart Stores, Inc. and Sam's West, Inc. (collectively "Wal-Mart"), the Kroger Co. ("Kroger"), the Department of Defense and all other Federal Executive Agencies ("DOD"), Arizonans for Electric Choice and Competition ("AECC"), and Noble America Energy Solutions, L.L.C. ("Noble Solutions").[70]

TEP proposed new rate designs for its commercial and industrial customers.[71] A new rate class—the Medium General Services Class—was created, which is a middle ground between the Small General Services ("SGS") and the Large General Service ("LGS") classes.[72] Previously, TEP had only two general service classes, SGS and LGS.[73] These two customer classes each contained a wide range of

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65 ROA-513, ep 9.
66 *Id.*, ep 10:16-17.
67 *Id.*, ep 13:15-17.
68 ROA-513, ep 13:24-14:1.
69 *Id.*, ep 13:18-21.
70 *Id.*, ep 13:17-18.
71 *Id.*, ep 36.
72 *Id.*, ep 77.
73 *Id.*, ep 77:25-26.

customer load sizes.[74] As was required by Decision No. 73912, TEP also proposed a new 138 kV rate class.[75]

Freeport is currently TEP's only customer who takes services at the 138 kV voltage.[76] TEP sold certain facilities to Freeport to allow Freeport to take service at this voltage.[77] The rate excludes distribution costs because customers that receive service at transmission level voltage do not use the distribution system.[78]

TEP conducted a Class Cost of Service Study ("CCOSS") to determine the cost to serve each customer class.[79] A properly performed CCOSS analyzes all costs and services provided to each of the rate classes.[80] The CCOSS also provides a guide as to how those costs should be recovered from each rate class.[81] TEP stated its goal was to create fair and equitable rates for all customer classes under sound cost of service and rate design principles.[82] TEP testified, to achieve this goal, it used the principle of gradualism to reduce inter-class subsidies, by bringing the revenue allocation closer to the actual cost of service. TEP did not propose a revenue allocation that would immediately accomplish that goal.[83]

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74 *Id.*, ep 78.
75 http://docket.images.azcc.gov/0000146156.pdf, Decision No. 73912 at 30.
76 ROA-513, ep 84:15.
77 *Id.*, ep 15-17.
78 *Id.*
79 ROA-621; ROA-606, ep 6.
80 ROA-606, ep 6.
81 *Id.*
82 *Id.*, ep 11.
83 ROA-607, ep 9.

According to TEP's witness Craig Jones, TEP developed the rate for the 138 kV class using cost of service principles.[84] According to Mr. Jones, the rate properly reflects sound cost causative factors that result in an appropriate level of costs assigned to customers on this rate while also avoiding any undue subsidy to this class by other rate classes.[85]

TEP initially proposed its own revenue allocations using the CCOSS as a guide, but ultimately revised its initial position and accepted much of the Commission's Utilities Division Staff's ("Staff") allocation guidelines, which included not decreasing rates for any customer class.[86] In its proposal, TEP allocated less to the Residential, Large Power Service, and 138 kV Classes than Staff.[87]

Staff recommended using the CCOSS as a general guide and following the principles of gradualism in allocating revenue recovery among the classes rather than a strict adherence to the CCOSS results.[88] Staff used a number of factors to arrive at its recommendation that the Residential Class receive 66.9 percent of the increase and the new 138 kV Class receive 2.4 percent of the increase.[89]

AECC, Freeport, and Noble Solutions jointly argued that TEP's and Staff's proposed revenue allocations did not produce just and reasonable rates because they

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84 *Id.*, ep 58-59.
85 *Id.*, ep 59.
86 ROA-513, ep 37:1-3.
87 ROA-608, ep 6.
88 ROA-513, ep 43.
89 *Id.*, ep 44.

retain significant inter-class subsidies.[90] However, Freeport's witness, Kevin Higgins, testified that in "determining revenue allocation, it is important to align rates with cost causation to the greatest extent practicable" but "[a]t the same time, it can be appropriate to mitigate the impact of moving immediately to cost-based rates for customer groups that would experience significant rate increases from doing so. This principle of ratemaking is known as 'gradualism.'[91]

DOD suggested that TEP's original allocation to the Residential Class be used and the remainder of the revenue allocation should be allocated proportionately to the other rate classes.[92] Wal-Mart offered an alternative proposal to reduce inter-class subsidies over time.[93] Kroger, on the other hand, accepted TEP's revised revenue allocation.[94]

After an eleven day hearing on all the applicable rate case issues, the Commission issued Decision No. 75975 on February 24, 2017.[95] The Commission approved the 2015 Settlement Agreement that provided for a non-fuel revenue increase of $81.5 million.[96] With respect to the revenue allocation, Decision No. 75975 recognized that under the then existing rates, the CCOSS indicated that there

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90 *Id.*, ep 36.
91 ROA-629, ep 25:23-26:7; *see also*, ROA-628, ep 25:1-2.
92 ROA-513, ep 42.
93 *Id.*, ep 40-41.
94 *Id.*
95 ROA-513.
96 *Id.*, ep 46:2-3, 197:28-198:1.

were significant inter-class subsidies, with the large power users subsidizing the residential class.[97] The Commission adopted Staff's $54.5 million allocation of the rate increase to the Residential Class and TEP's proportionate allocations for the remaining $27 million.[98] Staff's (and TEP's) overall recommendations were based upon both cost and non-cost considerations.[99] The Commission made several changes to the rate structure that specifically benefited Freeport. These changes include allocation of substantially less than the system average of the fuel costs and substantially less than the average fuel costs compared to the other rate classes,[100] and Freeport's placement in a separate class that recognized that it was primarily a transmission only customer. Under the revenue allocation the Commission adopted, Freeport received an allocation of $561,000 of the revenue increase or 0.69 percent.[101]

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97 *Id.*, ep 45.
98 *Id.*, ep 46:3-4.
99 *Id.*, ep 35:25-36:16, 43:12-45.7.
100 ROA-606, ep 58:22-59:10; S-11, ep 66:201-06, column F (confidential, filed under seal).
101 ROA-513, ep 46.

STATEMENT OF ISSUES PRESENTED

A. Did Freeport demonstrate by clear and convincing evidence that the Commission's order was unlawful, arbitrary, or capricious?

B. Is the Commission's authorized revenue allocation discriminatory?

C. Is the Commission's authorized revenue allocation supported by substantial evidence?

ARGUMENT

I. STANDARD OF REVIEW.

A. It Is Freeport's Burden To Show That The Record Lacks Substantial Evidence To Support The Commission's Decision.

The Commission has full and exclusive power to set just and reasonable rates for public service corporations.[102] The Commission also has a wide range of legislative discretion in exercising its ratemaking authority.[103] To successfully challenge a Commission ratemaking decision, one must demonstrate by a clear and satisfactory showing that the [Commission's] order is unlawful or unreasonable."[104] *Clear and satisfactory* means *clear and convincing*, which is a higher standard than *preponderance of the evidence*.[105]

To meet this burden, an opponent to a Commission decision must demonstrate that the decision is not supported by substantial evidence or is arbitrary or unlawful.[106] So long as the Commission's decision is supported by substantial evidence, the decision will stand even if the record also supports a different

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[102] Ariz. Const. art. XV, § 3; *State v. Tucson Gas, Elec. Light & Power Co. v. Ariz. Corp. Comm'n*, 15 Ariz. 294, 299 (1914).
[103] *Ariz. Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 294 (1992).
[104] A.R.S. § 40-254.01(E).
[105] *Tucson Elec. Power Co. v. Ariz. Corp. Comm'n,* 132 Ariz. 240, 243 (1982).
[106] *Tucson Elec. Power*, 132 Ariz. 243; A.R.S. § 40-254(E).

conclusion.[107] In making that determination, the Court may not reweigh the evidence and substitute its judgment for that of the Commission.[108]

B. The Court Will Afford Great Deference When Reviewing Matters That Fall Within The Commission's Exclusive Ratemaking Authority.

The Commission was created by the Arizona Constitution, not by legislative enactment.[109] The Commission's ratemaking authority stems directly from this constitutional genesis:

> The Corporation Commission shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations . . . .

Ariz. Const. article XV, section 3.

Arizona courts have construed the Commission's ratemaking authority as an *exclusive* grant of power, *i.e.*, the other branches of state government may neither exercise ratemaking authority, nor interfere with the Commission's reasonable exercise of that authority. *See, Tucson Gas, Elec. Light & Power Co. v. Ariz. Corp. Comm'n,* 15 Ariz. 294, 300 (1914).

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[107] *See*, *DeGroot v. Ariz. Racing Comm'n,* 141 Ariz. 331, 336 (App. 1984); *see also, Nutek Info. Sys. v. Ariz. Corp. Comm'n,* 194 Ariz. 104, 107-108 ¶ 15 (App. 1998); *Ariz. Corp. Comm'n v. Citizens Util. Co.,* 120 Ariz. 184, 187 (App. 1978).

[108] *See*, *Tucson Elec. Power Co.*, 132 Ariz. at 243.

[109] *See*, Ariz. Const. art. XV, § 1.

The Commission's constitutional origin has a significant impact upon the applicable standard of review. This heightened standard recognizes not only the Commission's constitutional status but its specialized knowledge and expertise. *See, e.g., Marco Crane & Rigging v. Ariz. Corp. Comm'n*, 155 Ariz. 292, 294 (App.1987)*; Campbell v. Mtn. States Tel. & Tel. Co.*, 120 Ariz. 426, 430 (App. 1978).

The nature of this elevated standard imposes *deference* to the Commission's resolution of factual issues.[110] The Commission's determination of just and reasonable rates involves a question of fact.[111] Therefore, a court may not substitute its own judgment for that of the Commission's when reviewing factual questions or matters involving the agency's particular expertise.[112] To the extent the Court believes the issues in this appeal present mixed questions of fact and law, a point the Commission does not concede, this heightened standard is also applicable to the fact portion of any mixed questions.[113]

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[110] *See, Grand Canyon Trust v. Ariz. Corp. Comm'n*, 210 Ariz. 30, 34 ¶ 11 (equating the "clear and convincing" standard with the "substantial evidence" test).

[111] *See, Tonto Creek Estates Homeowners Ass'n v. Ariz. Corp. Comm'n*, 177 Ariz. 49, 58 (App. 1993); *Governor's Office of Consumer Servs. v. Illinois Commerce Comm'n*, 580 N.E. 2d 920, 924 (Ill. 1991); *Texas Ass'n of Long Distance Tel. Co. v. Public Utils. Comm'n of Texas,* 798 S.W. 2d 875, 887 (Tex. 1990); *Office of Consumer Advocate v. Iowa State Commerce Comm'n*, 428 N.W. 2d 302, 305 (Iowa 1988).

[112] *Winters v. Ariz. Bd. Of Educ.*, 207 Ariz. 173, 176 ¶ 10 (App. 2004).

[113] *See*, *Bayless v. Indus. Comm'n,* 179 Ariz. 434, 439 (App. 1993).

As to the standard of review applicable to questions of law, it is accurate that some cases apply a *de novo* review.[114] But, deference should be accorded to the Commission's interpretations of the statutes and regulations that it implements, especially when those matters are related to its ratemaking authority. *See, Woods*, 171 Ariz. at 295; *Marco Crane & Rigging*, 155 Ariz. at 294.[115]

The Commission decision that is challenged by Freeport is a rate order, which was processed and entered under Arizona Administrative Code ("A.A.C.") R14-2-103.[116] It is clearly subject to the heightened and deferential standards described above. Freeport's challenge to the Commission's rate determination relates solely to ratemaking. Freeport disputes the ratemaking methodology and discretion used by the Commission to determine and evaluate the reasonableness of the revenue allocation in this case.[117] As the issues appealed are ratemaking matters, the Commission's conclusions are entitled to deference.[118] Unless the Commission's decision is contrary to law, it is not the role of this Court to second-guess the decisions made by the Commission pursuant to its constitutional authority over

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[114] *See, e.g., Babe Inv. v. Ariz. Corp. Comm'n,* 189 Ariz. 147, 150 (App. 1997).

[115] *See also, MCI Worldcom Network Serv., Inc. v. FCC,* 274 F.3d 542, 547 (D.C.Cir. 2001). ("[A]n agency's interpretation of the intended effect of its own orders is controlling unless clearly erroneous."); *UGI Util., Inc. v. Pa. Pub. Util. Comm'n,* 677 A.2d 882, 885 (Pa. 1996) ("[M]uch deference is to be accorded an agency's interpretations of its own regulations and orders.").

[116] A.A.C. R14-2-103 is the Commission regulation that applies to the filing and processing requirements for general rate cases.

[117] Op. Br. at 21-23.

[118] *Woods,* 171 Ariz. at 294.

ratemaking.[119] Freeport has not met its burden in this case, and the Court should affirm the Commission's Decision.

II. THE COMMISSION HAS EXCLUSIVE CONSTITUTIONAL AUTHORITY OVER RATEMAKING AND A WIDE RANGE OF LEGISLATIVE DISCRETION.

The standard of review discussed above is founded on well-established legal principles developed by Arizona courts over several decades. These principles must guide the Court in its review of the issues raised by Freeport. As one constitutional framer stated, "the work of fixing rates is the most complicated subject in the economic world. There are all sorts of things to be taken into consideration in fixing rates...."[120]

A. The Commission Is Not Bound To Any Formula Or Method In Setting Just and Reasonable Rates.

There is nothing contained in article XV of the Arizona Constitution that requires the Commission to utilize a particular methodology in determining the appropriate revenue allocation when setting just and reasonable rates. There are likewise no statutes that direct the Commission to use a particular methodology in developing revenue allocations in exercising its ratemaking authority. The imposition of such a rigid methodology would violate the Commission's exclusive plenary ratemaking grant of authority.

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[119] *Tucson Gas, Elec. Light & Power*, 15 Ariz. at 300.

[120] *Woods*, 171 Ariz. at 295, citing *Records of the Arizona Constitutional Convention of 1910* at 979 (John S. Goff, ed 1991).

> It was clearly the policy of the framers of the Constitution, and the people in adopting it, to take the powers of supervision, regulation, and control of public utilities from the legislative branch and vest them in the corporation commission, whose powers and jurisdiction are *sui generis*, and whose functions in the aggregate necessarily in their very nature comprehend those which ordinarily are separately vested in the legislative, judicial, and executive departments of government, respectively.

Tucson Gas, Electric Light & Power, 15 Ariz. at 302.

The Supreme Court of Arizona has found that it would be contrary to the intent of the framers of the Arizona Constitution for the legislature to require the Commission to use a particular methodology in ratemaking:

> . . . in the matter of prescribing classifications, rates, and charges or public service corporations and in making rules, regulations, and orders concerning such classifications, rates, and charges by which public service corporations are to be governed, the Corporation Commission has full and exclusive power. In such field the Commission is supreme and such exclusive field may not be invaded by the courts, the legislature, or the executive.

Ethington v. Wright, 66 Ariz. 382, 392 (1948).

The only restrictions on the Commission's ratemaking authority relevant to this appeal are article XV, section 12, and A.R.S. § 40-334, neither of which are implicated by the revenue allocation the Commission adopted. Arizona Revised Statutes § 40-334 prohibits unreasonable differences in rates between classes of service, and article XV, section 12 only applies to discrimination in charges for rendering *like and contemporaneous* service. As addressed more fully below, there are no "unreasonable differences" between the classes of service in the revenue

allocation adopted by the Commission, and there is no discrimination involving the rendering of *like and contemporaneous* service.

Freeport argues that the Court should require the Commission to strictly apply cost of service as the basis for authorizing the allocation of revenue among the customer classes in this case.[121] However, Freeport does not cite any Arizona authority for the proposition that the Commission is bound to specific formulas or methods in the exercise of its ratemaking authority.[122] In fact, Freeport cannot provide any authorities to support its position because the judicial precedent actually supports the exact opposite conclusion.

The opinions in *Scates v. Ariz. Corp. Comm'n*[123] and *Simms v. Round Valley Light & Power Co.*[124] both provide that the Commission should consider all relevant factors when setting rates. In both cases, the reviewing courts criticized the Commission for mechanical formula based rate setting that failed to consider all available information.[125] It is important to note that Freeport ultimately acknowledges that Arizona law does not require the Commission to solely adopt cost of service as the method of developing revenue allocations.[126]

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[121] Op. Br. at 14-17.
[122] *Id*.
[123] 118 Ariz. 531 (App. 1978).
[124] 80 Ariz. 145 (1956).
[125] *Scates*, 118 Ariz. at 534; *Simms*, 80 Ariz. at 151.
[126] ROA-484, ep 4:19-20.

B. The Weighing Of Evidence Is Within The Commission's Discretion.

In the 2015 Rate Case, several parties presented rate design alternatives. Many of the rate design alternatives presented were not based strictly on cost of service and considered other factors.[127] The Commission ultimately weighed the evidence presented with respect to the various alternatives and chose a rate design that balanced cost of service with other considerations.[128]

Freeport contends the Decision's sole "evidentiary" basis for requiring it to pay a subsidy is the need to avoid rate shock by purporting to employ gradualism in moving rates towards costs.[129] In actuality, the Commission considered many other factors in addition to gradualism.[130] For instance, the Commission Staff witness noted that there was a 20 percent increase in distribution plant and a 47 percent increase in net production plant, as well as a change to the allocation methodology, all of which magnified the impact of the revenue increase on the classes.[131] The change in the allocation methodology increases the allocation of costs to lower load factor classes.[132] In addition, Staff advocated that consideration be given to TEP's acquisition of the combined-cycle Gila River plant which was purchased to stabilize

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[127] ROA-513, ep 35-46.
[128] *Id.*
[129] Op. Br. at 34.
[130] ROA-513, ep 35-46 (from Peaks and Average allocator used in the last rate case to the Average and Excess Demand method).
[131] ROA-513, ep 43; ROA-716, ep 23:17-22, 25:9-16.
[132] ROA-513, ep 43; ROA-716, ep 6:15-18.

energy costs, and benefits all customers.[133] Staff also proposed a number of other factors to consider in any revenue allocation.[134]

Freeport wrongly asserts that the Commission fails to appreciate that a 39.5 percent increase in margin revenue only results if all customers' rates were immediately moved to cost of service.[135] None of the revenue allocations proposed in this case, including Freeport's allocations, has this result. The residential allocation adopted in the Decision is a 12.6 percent increase in margin revenue – with the Residential Class being apportioned 66 percent of the total increase.[136] Even Freeport's revenue allocation proposals do not reflect a true cost of service approach for all rate classes, *except* for Freeport's rate class.[137] In other words, while Freeport is critical of the Commission's use of gradualism as a factor in determining the appropriate revenue allocation, that is exactly what Freeport proposed with its revenue allocation alternatives.[138]

It is entirely within the Commission's discretion to determine how much weight is given to relevant factors, so long as that discretion is not abused.[139] Despite what Freeport argues, there is substantial evidence in this case supporting the

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133 ROA-513, ep 44.
134 *Id.* ep 43-44.
135 Op. Br. at 15-16.
136 ROA-513, ep 46 (Table).
137 Op. Br. at 34.
138 *Id.*
139 *See, e.g., Ariz. Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 202 (1959).

revenue allocation adopted by the Commission.[140] The mere fact that there are differences between the various revenue allocations proposed in this case, and that Freeport, not surprisingly, prefers its allocation, does not invalidate the Commission's decision. "The acceptance of evidence presented by one person over that presented by another is not necessarily decisive because the weight given any of the evidence is within the Commission's discretion, so long as that discretion is not abused." *City of Tucson v. Citizens Util. Water Co.*, 17 Ariz. App. 477, 480-481 (1972).[141] So long as the Commission's decision is supported by substantial evidence, the decision will stand, even if the record also supports a different conclusion.[142]

In this case, the Commission considered a range of alternative proposals for revenue allocation, all of which were subject to scrutiny through an eleven day evidentiary hearing.[143] The Commission carefully considered all of these alternative proposals and based on the evidence presented, adopted a revenue allocation that was in the public interest, and that established just and reasonable rates. The

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[140] ROA-513, ep 35-46.

[141] *See also, State of North Carolina ex rel. Util. Comm'n v. Virginia Elec. and Power Co.*, 285 N.C. 398, 409-10, 206 S.E.2d 283, 292 (N.C. 1974)(the Commission is not required to accept testimony of a witness even if it is not controverted by another).

[142] *See*, *DeGroot*, 141 Ariz. at 336.

[143] ROA-513, ep 35-46.

Commission's Decision is supported by substantial evidence and should be affirmed by the Court.

III. THE AUTHORIZED RATES ARE JUST AND REASONABLE.

After considering all of the parties' positions, the Commission adopted the Staff's revenue allocation of $54,501,050.00, or 66.9 percent of the overall revenue increase for the Residential Class, and utilized TEP's proportional allocations for the remaining $27.0 million revenue increase.[144] Under the Commission's approach, classes other than the Residential Class received the following proportional share of the remaining $27.0 million: [145]

CLASS	INCREASE	PERCENTAGE OF TOTAL INCREASE
Small General Service	-$3,598,000	-4.42%
Medium General Service/Large General Service	$25,335,000	31.09%
Large Power Service	$3,869,000	4.75%
138 kV	$561,000	0.69%
Lighting	$823,000	1.01%

Freeport contends that the revenue allocation for its customer class is discriminatory because: (i) the allocation exceeds the cost of service; and (ii) the rates result in Freeport subsidizing other customer classes.[146]

[144] ROA-513, ep 46.
[145] *Id.* (Table).
[146] Op. Br. at 21-26.

None of the authorities relied upon by Freeport create a rigid rule that an allocation that exceeds the cost of service is unlawful or that some subsidization of other rate classes, in some circumstances, is unlawful or unreasonable. Instead, the cases seek to prevent unreasonable, arbitrary, or *ad hoc* differences or discrimination in rates. The revenue allocations established in Decision No. 75975 do not suffer from these sorts of defects because the Commission relied upon a fully vetted CCOSS and evaluated multiple revenue allocation proposals to arrive at the revenue allocation adopted in the instant case.[147]

Freeport also argues that the rates set are discriminatory under article XV, section 12 of the Arizona Constitution. Article XV, section 12 provides in relevant part:

> All charges made for service rendered or to be rendered by public service corporations within this state shall be just and reasonable, and no discrimination in charges, service or facilities shall be made between persons or places for rendering a like and contemporaneous service….

Whether Freeport receives *like and contemporaneous* service for purposes of article XV, section 12 is a question of fact.[148] Freeport is in a separate and unique class of service and, thus, clearly does not receive *like and contemporaneous* service for purposes of article XV, section 12 of the Arizona Constitution. The record in this

[147] ROA-513, ep 35-46.

[148] *See, Philadelphia Elec. Co. v. Pa. Pub. Util. Comm'n,* 79 Pa. Cmwlth. 445, 451, 470 A.2d 654, 657 (1984).

case establishes that there are differences in providing service to Freeport.[149] Unlike the majority of TEP's customers, Freeport primarily takes service at a very high voltage. It is also primarily a transmission-only customer.[150]

Arizona Attorney General Opinion 63-2 recognizes that "discrimination as to rates is not unlawful when based upon *reasonable* classifications corresponding to actual differences in the situation of the consumers or the furnishing of the service.[151] Here, the treatment of Freeport is not discriminatory; it is based on Freeport's unique position as a large commercial customer, which primarily receives transmission-only service.

The Commission's Decision likewise does not offend A.R.S. § 40-334. Although A.R.S. § 40-334 addresses discrimination, it does not establish a *per se* prohibition:

> [n]o public service corporation shall establish or maintain any *unreasonable difference* as to rates, charges, service, facilities or in any other respect, either between localities or between classes of service.

(Emphasis added).

The fact that there are differences in rates does not make the rates set for Freeport discriminatory. Arizona Revised Statutes § 40-334 prohibits "unreasonable" differences in rates. There is ample evidence in the record to support

[149] ROA-513, ep 43:12-14; ROA-632, ep 10:4-16; ROA-606, ep 57:17-59:12.
[150] ROA-606, ep 57:17-59:12.
[151] Arizona Atty. Gen. Op. 63-2 at 2 (Dec. 1962).

the Commission's decision on the revenue allocation.[152] Other states have recognized that differences in rates do not automatically mean that rates are discriminatory. For instance, the relevant statute in North Carolina is almost identical to the Arizona statute:

> No public utility shall, as to rates or services, make or grant any unreasonable preference or advantage to any person or subject any person to any unreasonable prejudice or disadvantage. No public utility shall establish or maintain any unreasonable difference as to rates or services either as between localities or as between classes of service. The Commission may determine any questions of fact arising under this section . . . .[153]

In *State ex rel. Util. Comm'n v. Carolina Util. Customers Ass'n, Inc.*,[154] the North Carolina Court held that the North Carolina Commission could classify customers or establish rates based on reasonable differences in conditions, so long as the variances in charges bore a reasonable proportion to the variance in conditions.[155] The North Carolina Court identified a number of factors to consider when evaluating claims of discrimination: "including (1) quantity of use; (2) time of use; (3) manner of service; and (4) costs of rendering the various services."[156] In that case, the North Carolina Commission had approved a rate structure that provided for different rates of return among a natural gas company's customer

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[152] ROA-513, ep 35-46.
[153] *Compare* A.R.S. § 40-334(B) *with* N.C.G.S.A. § 62-140.
[154] 351 N.C. 223, 524 S.E.2d 10 (2000).
[155] *See*, *Carolina Util*, 351 N.C. at 243-44.
[156] *Id.* at 243.

classes. The court held that such a structure was not discriminatory.[157] The same conclusion should be reached here.

A. The Commission Uses Cost Of Service Studies As A Guideline When Setting Rates.

Freeport argues that because its rates are above its cost of service, its rates are discriminatory.[158] There are a number of acceptable reasons why the Commission, as well as other regulatory authorities, appropriately deviate from an application of strict cost of service. It is helpful to understand a cost of service study.

A fully allocated cost of service study is used to determine the approximate individual costs to serve each customer class and subclass.[159] Such a study is used as a guide and assists the Commission in determining the revenue allocation among the customer classes.[160] But as discussed above, other criteria are also considered including economic, social, historical, and other factors that may affect customers when determining revenue allocation.[161] Such considerations often result in rates that deviate from strict cost of service.[162]

The Colorado Court, in *CF&I Steel, LP. v. Public Utilities Comm'n of State of Colo.*,[163] recognized that although cost of service is an important consideration in

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157 *Id.*
158 Op. Br. at 21-23.
159 ROA-716, ep 17:23-18:2.
160 *Id.*, ep 18.
161 *Id.*, ep 18:5-9.
162 *Id.*, ep 19.
163 949 P.2d 577 (Colo. 1997).

setting an appropriate rate, it is also true that the ratemaking discretion of its public utility commission includes the reasoned use of various other factors that are rationally-related to legitimate regulatory purposes.[164]

The weighing of these cost and non-cost factors requires experienced judgment as it is not a purely mathematical exercise. The Commission has the special expertise in ratemaking to make such a reasoned judgment and used its expertise in this case. Cost of service is a factor in the consideration of setting rates, but it is not the exclusive factor. If such were the case, the Commission would have little ratemaking discretion and it would become a rubber stamp relegated to examining cost studies of utilities.[165] Revenue allocation and the move to rate parity among the customer classes rests squarely within the Commission's ratemaking authority. The Commission's judgment is supported by substantial evidence, and the decision of the Commission must not be disturbed.[166]

B. Subsidies Are Not *Per Se* Discriminatory.

It is within the Commission's discretion, however, to determine how quickly to reduce the subsidies between classes. The Commission has recognized that the current rates produce significant inter-class subsidies.[167] The Commission also

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[164] *Id.* at 588.
[165] *See, Intergrated Network Servs., Inc. v. Public Utils. Comm'n*, 875 P.2d. 1373, 1383 (Colo. 1994).
[166] *Litchfield Park Svc.*, 178 Ariz. at 434; *Tucson Elec.*, 132 Ariz. at 247.
[167] ROA-513, ep 45.

found that to allocate the entire revenue increase of $81.5 million evenly across rate classes would perpetuate existing inequities and recognized that a reduction in the amount of subsidies is in the public interest.[168] The Commission is on a path to further reduce inter-class subsidies among TEP's customer classes, but recognizes that it will take some time to accomplish this goal.[169] The Commission does not act in a vacuum and must consider the facts and circumstances that exist at the time its decision is made.

Removing inter-class subsidies must be approached in a measured and careful way to avoid unintended consequences and rate shock. A move too quickly could subject the Residential Class, TEP's largest customer class, to rate shock.[170] The decision of how quickly to remove the subsidies adheres to the principles of gradualism and falls to the Commission in the exercise of its ratemaking authority. The Commission considered the evidence presented and determined that the allocations of revenue were just and reasonable and that the facts do not present an issue of unreasonable discrimination.[171] The Court may not substitute its judgment for that of the Commission, and may not set aside the Commission's factual determinations unless they are clearly arbitrary,[172] which they are not in this case.

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168 *Id*.
169 ROA-717, ep 14:21-15:9.
170 ROA-513, ep 45:17-20.
171 *Id*., ep 35-46.
172 *See*, A.R.S. § 40-334(C); *Arizona Water*, 85 Ariz. at 202; *City of Tucson*, 17 Ariz. App. at 480-81.

Freeport argues that its rates are discriminatory because the rates result in Freeport subsidizing other customer classes.[173] While it is understandable that Freeport, as well as other large General Service customers, seek to reduce the their allocation of costs and the related subsidies of the Residential Class by the non-residential classes, there is a difference of opinion on how quickly to shift revenue recovery to the Residential Class.[174] The larger customer intervenors continue to advocate for more revenue to be allocated to the Residential Class (and less to them).[175] In support of its argument that any subsidies are unlawful, Freeport again relies upon several cases, each of which is distinguishable from this case.

Freeport cites *Town of Wickenburg v. Sabin*,[176] in support of its contention that a public service corporation must treat all similarly-situated customers alike, but its reliance on that case is misplaced.[177] *Sabin* addresses municipal utility rate setting, and has no application here.[178]

Additionally, in *Sabin*, the Town of Wickenburg had imposed an added fee to connect a prospective customer to its municipal electric system.[179] In finding that this charge was improper, the court noted that the customer's premises were within

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[173] Op. Br. at 19-21.
[174] ROA-513, ep 35-45.
[175] *Id.*, ep 36-43.
[176] *Sabin*, 68 Ariz. 75 (1948).
[177] Op. Br. at 20-21.
[178] 68 Ariz. at 76.
[179] *Id.* at 76-77.

an "established service zone," and thus, the regular fee should have applied.[180] Additionally, there was no ordinance that allowed the collection of the additional fee.[181] The imposition of the fee in *Sabin* was simply arbitrary—and therefore discriminatory—because the Town had applied it selectively (to one customer) as opposed to universally (to all similarly-situated customers).[182] Such arbitrary actions stand in stark contrast to the Commission's careful deliberations in the present case.

A prime example of where the Commission deviates from cost of service is in the realm of low income assistance. There is wide-spread implementation of low-income assistance programs among Arizona utilities. All investor-owned electric and gas utilities, such as Arizona Public Service Company, UNS Electric, Southwest Gas Corp., and UNS Gas, as well as TEP, have low income programs.[183] Many of the large water and wastewater utilities, such as EPCOR Water Arizona, Liberty

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[180] *Id.* at 80.
[181] *Id.* at 79.
[182] *Id.*
[183] *See* http://docket.images.azcc.gov/0000137042.pdf, Decision No. 73183 at 20:5-12 (Arizona Public Service); http://docket.images.azcc.gov/0000091400.pdf, Decision No. 70628 at 25:20-22 (Tucson Electric Power): http://docket.images,azcc.gov/0000150616.pdf, Decision No. 74235 at 9:6-7, 22:10-11 (UNS Electric): http://docket.images.azcc.gov/0000133931.pdf, Decision No. 72723 at 11:16-25 (Southwest Gas); http://docket.images,azcc.gov/0000111281.pdf, Decision No. 71623 at 57:12-17 (UNS Gas).

Utilities and Global Water, have proposed the adoption of reduced rates for low income customers.[184]

Another example involves the Commission's rules that established the Arizona Universal Service Fund, Arizona Administrative Code ("A.A.C.") R14-2-1201, *et seq*. The Fund collects a surcharge that is used to subsidize the provision of basic telephone service in rural and high cost areas.

Freeport relies upon a Colorado case, *Mountain States Legal Foundation v. Public Util. Comm'n,*[185] to call into question low income programs such as those adopted by the Commission.[186] In *Mountain States Legal Foundation*, the Colorado Supreme Court found that "[e]stablishing a discount gas rate plan which differentiates between economically needy individuals who receive the same service is unjustly discriminatory.[187] There is another line of cases, however, that have found that low income programs such as those adopted by the Commission, are not discriminatory.[188]

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[184] *See* http://docket.images.azcc.gov/0000124374.pdf, Decision No. 72251 at 43:7-44:5 (Liberty- Bella Vista); http://docket.images.azcc.gov/0000146970.pdf, Decision No. 73996 at 47:24-25 (Liberty – Rio Rico); http://docket.images.azcc.gov/0000152796.pdf, Decision No. 74437 at 9:15-24 (Liberty - Litchfield Park Water & Wastewater); http://docket.images.azcc.gov/0000117028.pdf, Decision No. 71878 at 67, 86-87 (Global Water).

[185] 197 Colo. 56 (1979).

[186] Op. Br. 27-28.

[187] *Mountain States Legal Found.*,197 Colo. at 60.

[188] *Util. Comm'n v. Cooper*, 367 N.C. 644, 766 S.E.2d 827 (N.C. 2014); *Missouri Ofc. of Public Counsel v. Public Svc. Comm'n*, 293 S.W.3d 63 (S.D. 2009);

The electric and gas utilities also offer a low income weatherization program.[189] To recover the lost revenues associated with these programs, the revenues are recouped from the other customer classes. In other words, the other customer classes subsidize these low income programs. The Commission has decided there is societal benefit to allow the other customer classes to subsidize these low income programs.

Freeport cites another Colorado case, the *City of Montrose v. Public Util. Comm'n*,[190] in support of its contention that rate setting should not result in the subsidization of one customer class by another class.[191] Freeport's reliance on this case is misplaced and is also distinguishable from the instant case.

In *Montrose*, Rocky Mountain Natural Gas Co., Inc. entered into a franchise agreement to serve the City of Montrose.[192] Rocky Mountain agreed it would pay two percent of its gross receipts from sales in the city.[193] In consideration for the fee, Rocky Mountain received the exclusive right to serve and treated those charges

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Consumers Energy Co. v. Michigan Public Svc. Comm'n, 279 Mich. App. 180 (Mich. 2008); *Ohio Consumers Counsel v. Public Util. Comm'n*, 856 N.E.2d 213, 111 Ohio St.3d 300 (OH 2007); *Magruder v. Ariz. Corp. Comm'n*, No. 1 CA-CV 15-0002, 2016 WL 6211744 (App. Oct. 25, 2016) (unpublished), review denied (Apr. 18, 2017).

189 *See* http://docket.images.azcc.gov/0000137374.pdf, Decision No. 71444 at 4, 14; http://docket/images.azcc.gov/0000099060.pdf, Decision No. 71106 at 5-6; http://docket.images.azcc.gov/0000137374.pdf, Decision No. 73229 at 13.

190 590 P.2d 502 (1979).

191 Op. Br. at 25.

192 *Montrose* at 504-05.

193 *Id.* at 505.

as general operating expenses.[194] When Rocky Mountain filed for a rate increase, the Colorado Public Utility Commission ordered Rocky Mountain to surcharge its municipal customers.[195] Rocky Mountain computed its rates without the cost of the franchise fees and then implemented a surcharge with the costs which resulted in municipal customers paying higher rates than non-municipal customers for the same service. The court found that because a cost of service study had not been done, the public utility commission's actions were arbitrary and capricious.[196] However, the court did not hold that different rates could not be charged to different classes of customers, where the cost of service varies between those classes. Rather, in the *Montrose* case, there was no attempt to ascertain the costs of service along municipal/non-municipal lines.[197] The *Montrose* case stands for the proposition that to begin to assess costs to a customer class, a cost of service study needs to be performed.[198] Further, the court recognized that a subsidy already existed between the rural customer and the municipal customers but offered no opinion as to its legality.[199] Here, TEP performed a CCOSS.[200] The CCOSS was used as a guide in setting rates for Freeport and other customers, along with other factors.[201]

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194 *Id.* at 504.
195 *Id.*
196 *Id.* at 506.
197 *Id.*
198 *Id.*
199 *Id.*
200 ROA-621.
201 ROA-513, ep 35-46.

Freeport also cites *Philadelphia Suburban Water Co. v. Pennsylvania Public Util. Comm'n* to bolster its argument.[202] The subject of the *Suburban* case was not a rate case, but instead involved the approval of a sale of a city's water system to another utility.[203] When the court focused on the fact that no cost of service study was performed, the court also acknowledged that the mere variation in rates among classes of customers does not create a, *per se*, discriminatory rate.[204] The determination of whether a rate is too high for one or too low for another is a question of fact to be determined by the Commission.

The Court should reject Freeport's arguments that the rates set by the Commission are discriminatory and affirm the Commission's Decision on these issues.

IV. THE RATES SET BY THE COMMISSION ARE SUPPORTED BY SUBSTANTIAL EVIDENCE.

Freeport argues that the Commission erred in setting rates that were not based on substantial evidence.[205] Considerable evidence was presented by various parties on the revenue allocation and how to best reduce inter-class subsidies.[206] The Commission carefully considered all of this evidence in developing the revenue allocation in this case.

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[202] 808 A.2d 1044 (Pa. 2002); Op. Br. at 24.
[203] *Id.* at 1049.
[204] *Id.* at 1059 (cites omitted).
[205] Op. Br. at 31.
[206] ROA-513, ep 35-46.

A number of parties in this case presented evidence regarding the appropriate revenue allocation for the Commission to adopt including TEP, AECC/Freeport/Noble Solutions, Wal-Mart, Kroger, Department of Defense, and the Commission's Staff.[207] As noted above and discussed below, the Commission ultimately adopted a combination of the revenue allocation presented by TEP and the Commission Staff.[208]

While Freeport is critical of the fact that the Commission did not adopt its proposal, the fact that there were differing opinions presented in evidence does not affect the validity of the Commission's determination regarding the appropriate revenue allocation. Further, "the acceptance of evidence presented by one person over that presented by another is not necessarily decisive because the weight given any of the evidence is within the Commission's discretion, so long as that discretion is not abused."[209] In other words, "if two inconsistent factual conclusions could be supported by the record, then there is substantial evidence to support an administrative decision that elects either conclusion." *Webster v. State Bd. Of Regents,* 123 Ariz. 363, 365-66 (App. 1979). The evidence in this case supports the Commission's Decision regarding the adopted revenue allocation.

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[207] *Id*.
[208] *Id*., ep 46.
[209] *City of Tucson*, 17 Ariz. App. 477 at 480-81; *see also, Arizona Water Co.*, 85 Ariz. at 202.

There is a common thread that exists with proposed revenue allocations that were presented by parties in this case, and the allocation the Commission ultimately adopted. The allocations essentially strive to reduce subsidies that currently exist between rate classes such as Residential and Commercial customers[210] by bringing revenue recovery from each class closer to its actual cost of service.[211]

Freeport must demonstrate by "clear and convincing" evidence that the Commission's Decision was "unlawful or unreasonable."[212] Freeport has not done so in this case.

A. The Record In This Proceeding Supports The Revenue Allocation Adopted by the Commission.

The Commission heard testimony from several parties on revenue allocation and inter-class subsidies.[213] These witnesses offered testimony with different positions on the allocation of the revenue requirement between classes and how to reduce inter-class subsidies.[214]

The Commission's Staff testified that the Commission should consider the relative position (from the CCOSS) of the classes along with the qualitative issues such as economic conditions for consumers, the business climate for commercial

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[210] TEP has Residential, Small General Service, Medium General Service, Large Power Service, Lighting, and 138 kV customer classes.
[211] ROA-513, ep 35, 38, 41; ROA-540, ep 64; ROA-717, ep 14; ROA-534, ep 98.
[212] *Tucson Elec. Power*, 132 Ariz. at 243.
[213] ROA-513, ep 35.46.
[214] *Id*.

and industrial customers, and past practices.[215] In considering these factors, Staff developed certain criteria in developing its revenue allocation recommendation, such as no rate class should receive a decrease and there should an upper bound of 150 percent for any class' percentage increase in revenue compared to the overall percentage increase in revenue and a lower bound of 50 percent for any class' increase compared to the overall increase.[216] In addition, Staff argued that consideration should be given to the Company's purchase of the combined-cycle generating unit.[217] The unit was purchased to stabilize energy costs, which is a benefit to all customers.[218] Staff also testified that it would be inappropriate to reduce rates for any customer class because that would send a confusing message about the plant expenditure.[219]

Based on the updated CCOSS, the principles discussed above, the impact of the purchase of the Gila River combined-cycle plant, the change in allocation methodology and the relative impacts between classes, Staff recommended the following allocation of the $81.5 million increase: (i) 66.9 percent or $54,501,050 to the Residential Class; (ii) 18.9 percent or $15,420,669 to the General Service Class; (iii) 3.8 percent or $3,070,470 to the Large General Service Class; (iv) 0.7

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[215] ROA-717, ep 8:2-7.
[216] ROA-716, ep 26:7-10.
[217] *Id.*, ep 6, 26:12-16.
[218] *Id.*, ep 26.
[219] *Id.*

percent or $591,468 to the Lighting Class, and the remainder allocated to the Large Power Service and 138 kV classes.[220] Staff's long term plan is that rates should be based on costs derived from the CCOSS, but that it will take more than one rate case to accomplish this goal.[221]

TEP stated that it supported a revenue allocation that reduces the subsidies paid by commercial and industrial customers and proposed a greater reduction in these subsides than Commission Staff, but less than those proposed by some of the commercial and industrial customers who were parties to the proceeding.[222] Adhering to the concept of gradualism, TEP did not recommend an allocation that moved to complete class parity based on the CCOSS.[223] While TEP accepted much of Staff's proposed revenue allocations, particularly Staff's goal of not having a rate decrease for any rate class,[224] TEP advocated for less revenue to be allocated to the very large customer classes, Large Power Service and 138 kV classes.[225]

Not surprisingly, the large Commercial customers offered proposals that would provide their customers the greatest benefit. For example Wal-Mart, a member of the Large General Services Class, urged the Commission to attempt to

[220] S-13, ep 31-34 (see confidential documents filed under seal).
[221] *Id.*; ROA-717, ep 14:21-15:9.
[222] ROA-513, ep 35-36.
[223] *Id.*, ep 36:1-2.
[224] *Id.*, ep 36:2-5.
[225] *Id.*, ep 36:5.

eliminate the subsidies between customer classes to create fair, cost-based rates.[226] Wal-Mart proposed a methodology to reapportion the revenue collections between classes each year until inter-class subsidies are eliminated.[227] Wal-Mart asserted that its proposal would result in more palatable annual reductions to the subsidies rather addressing subsidies through less frequent rate cases, where the impact would be more significant.[228]

The DOD testified that based on CCOSS, several classes should receive a decrease in the revenue allocation.[229] The DOD advocated for a decrease for the General Service Class and the Large Power Service Class, while using the revenue allocation percentage originally proposed by TEP.[230] Kroger, on the other hand, accepted TEP's proposed revenue allocation, specifically the spread to the LGS Class.[231]

Most of the parties recognized, however, that the Commission does not set rates solely on a cost of service basis, but considers non-cost factors as well. Staff considered a multitude of factors in its testimony.[232] Other jurisdictions also recognize the use of other factors in addition to cost of service in setting rates.[233]

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[226] ROA-398, ep 2.
[227] ROA-513, ep 41:14-18.
[228] ROA-513, ep 41.
[229] *Id.* at 42.
[230] ROA-385, ep 31; ROA-513, ep 42.
[231] ROA-513, ep 42.
[232] *Id.*, ep 43-45.
[233] *Supra* at III(A).

The Commission has the special expertise in ratemaking to make such a reasoned judgment and used its expertise in this case. While cost of service is a factor in the consideration of setting rates, it is not the exclusive factor. Revenue allocation and the move to rate parity among the customer classes rests squarely within the Commission ratemaking authority.

B. Freeport's Arguments That Decision No. 75975's Revenue Allocation Are Not Supported By Substantial Evidence Are Without Merit.

Freeport, in its Opening Brief, does not generally take issue with the CCOSS or that it was done incorrectly or was unsupported.[234] Instead, Freeport is asserting that its revenue allocation, which is *not* based on strict cost of service, is more appropriate than the one the Commission adopted.[235] It is within the Commission's discretion, not Freeport's, to weigh the evidence presented by the parties and determine the appropriate revenue allocation for TEP based on that evidence.[236]

Freeport erroneously states that the rates set for the 138 kV Class are not supported by substantial evidence because the Decision does not demonstrate the basis for continuing to "perpetuate existing inequities," besides the concepts of rate shock and gradualism.[237] Freeport argues that the revenue allocation to the "favored customer classes was set without regard to the class cost of service study."[238]

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[234] Op. Br. at 14-15.
[235] *Id*. at 15-16.
[236] *City of Tucson*, 17 Ariz. App. at 480-81; *Arizona Water Co.*, 85 Ariz. at 202.
[237] Op. Br. at 26.
[238] *Id*. at 34.

This was not the case. The CCOSS was used as a guide for revenue allocation for customer classes. Further, "rate shock" and "gradualism" are well-established ratemaking principles the Commission uses through its constitutional ratemaking authority to protect the public.[239]

The record is clear in this case that if all cross subsidies between rate classes were eliminated at one time, it would result in 39.5 percent increase in margin revenues to the residential rate class.[240] Freeport asserts that there is no evidence in the record that "eliminating or reducing" the subsidy it pays would result in rate shock for any customer class.[241] It is difficult to understand how a 39.5 percent increase to the residential class is not rate shock. What is clear is that the Commission adopted, in part, Commission Staff's revenue allocation.[242] Commission Staff based its allocation on the fact that TEP's net distribution plant had increased by 20 percent, and net production plant increased by 47 percent.[243] Simultaneously, TEP changed its production plant allocation methodology.[244] These two changes magnify the individual impact on classes.[245] Therefore, the

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239 *The Regulation of Public Utilities* at 434-435; *Principles of Public Utility Rates* at 383.
240 ROA-513, ep 45.
241 Op. Br. at 33-34.
242 ROA-513, ep 46.
243 ROA-716, ep 25:10-12.
244 *Id.*, ep 25:16.
245 *Id*.

Commission used TEP's CCOSS as a general guideline and used the concept of gradualism to move towards a revenue allocation based on cost of service.[246]

Further, the evidence demonstrates that the Commission considered the starting positions of the classes, using the CCOSS, along with qualitative issues such as economic conditions for consumers, the business climate for commercial and industrial customers, and past practices when deciding what portion of the revenue increase is allocated to each class in this case.[247] TEP is a regulated monopoly, and its customers have no choice in their service provider. Although Freeport has no choice in service providers, it has the ability to pass-through its power costs through its business activities. Residential customers do not have the same ability.

Importantly, even Freeport did not advocate for the complete elimination of subsidies between rate classes except as it relates to its own rate class, and the Large Power Service Class.[248] Freeport attempts to support its argument by citing to a handful of Commission Decisions wherein the Commission increased rates for several water companies between 51.1 to 274.6 percent, suggesting that rate shock is not a valid basis for the revenue allocation the Commission adopted.[249] A closer look at these cases reveals unique circumstances existed in those cases that

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246 *Id*.
247 ROA-513, ep 45-46.
248 ROA-621.
249 Op. Br. at 36.

warranted such large percentage rate increases irrespective of "rate shock" and "gradualism."[250]

The cited cases all involve small water utilities with between 13 and 135 customers that were experiencing problems such as high water loss, failure of infrastructure, or had not filed a rate application in decades, which ultimately necessitated the Commission increasing rates so that the utilities were able to continue providing service to their customers.[251] In other words, it was necessary to raise rates by such a high percentage to serve the public interest by balancing the utility's need to continue operating with the impact to the customers of those utilities.

It is somewhat puzzling that Freeport is critical of the Commission basing its decision, in part, on "rate shock" and "gradualism," but ultimately itself suggests that if the Commission reduced the revenue allocated to the 138 kV Class (Freeport is the only customer in this class) and the Large Power Service Class to true cost of service, while leaving the allocations to other rate classes above cost of service, the rate increase to the Residential Class would only be 18.2 percent.[252] Further, Freeport suggested for the first time in its Application for Rehearing another

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[250] http://docket.images.azcc.gov/0000176310.pdf, Decision No. 75925, http://docket.images.azcc.gov/0000174943.pdf, Decision No. 75811, http://docket.images.azcc.gov/0000172446.pdf, Decision No. 75696, and http://docket.images.azcc.gov/0000172436.pdf, Decision No. 75686.

[251] *Id.*

[252] Op. Br. at 16; ROA-513, ep 38 (second chart), ep 40; this assumes leaving all other classes paying above or below the cost to serve them.

proposal for the Commission's consideration, that again, does not move to the strict cost of service based revenue allocation advocated for in its Opening Brief.[253] Instead, the new Freeport proposal only reduces the subsidy that Freeport is paying, while leaving the remaining customer classes unchanged.

The Commission did not adopt either of Freeport's revenue allocation recommendations. Although Freeport's recommendations may be consistent with the concept of gradualism, those recommendations truly favor one or more rate classes over the others. Such favoritism is not in the public interest. The Commission's revenue allocation balances the public interest in arriving at "just and reasonable" rates with the ultimate goal of moving "toward more equitable revenue recovery without overly burdening an individual customer class."[254] According to Staff, this goal should ultimately be completed in subsequent rate cases.[255]

C. The Cases Relied Upon By Freeport Are Distinguishable.

Freeport argues that courts in other states have reversed commission decisions where the record did not contain substantial evidence to support the rate design, even

[253] ROA-519, ep 7; Op. Br. at 20.
[254] ROA-513, ep 45-46.
[255] ROA-717, ep 15:7-9.

after concluding the rates were not facially discriminatory or unreasonable.[256] These cases are all distinguishable.

First, Freeport cites to *California Mfg. Ass'n v. Public Utilities Commission*,[257] in support of its argument.[258] However, this case is distinguishable from the issue in this appeal. In the *California Mfg.* case, the issue was whether or not the rates that were adopted by the California Public Utilities Commission were more likely to result in conservation than another plan.[259] The court determined that logically, the higher the price, the higher the incentive to reduce consumption and conserve and conversely, the lower the price, the lower the incentive to conserve.[260] But, the court determined there was no evidence presented, either through expert testimony or empirical data that could be used to determine which plan presented will result in the least usage.[261]

The issues in this appeal do not suffer from this deficiency in the record. The parties presented their preferred revenue allocations, none of which were based on strict compliance with cost of service, and the Commission ultimately adopted a combination of the allocations presented by TEP and Staff.[262] It is squarely within

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[256] Op. Br. at 32-33.
[257] 595 P.2d 98 (1979).
[258] Op. Br. at 32.
[259] *California Mfg. Ass'n*, 595 P.2d at 102.
[260] *Id.*
[261] *Id.*
[262] ROA-513, ep 46.

the Commission's plenary ratemaking authority to choose the revenue allocation it believes best serves the public interest.

Freeport next cites to *Colorado-Ute Elec. Ass'n, Inc. v. Public Util. Comm'n,*[263] which again is distinguishable from the subject of this appeal.[264] In *Colorado-Ute Electric Ass'n, Inc.,* the issue related to the allocation of $24 million in generated fixed capital (demand) costs to the energy component of the demand-energy rate.[265] The Colorado Supreme Court determined the allocation was not supported by substantial evidence because it was based on a witness' unsupported opinion.[266] The court was critical of the fact that the necessary rate design studies had not been performed, even though the data had been collected and the creation of a study was entirely feasible.[267] Those circumstances do not exist in this case.

Freeport also cites to *Application of Hawaiian Electric Light Co., Inc.*[268] in support of its contention that the revenue allocation adopted by the Commission was not supported by substantial evidence.[269] Again, this case is distinguishable from what occurred here. The Hawaii Commission adopted a declining block rate based on the utility's witness's testimony, which was not supported by evidence in the

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[263] 760 P.2d 627 (Colo. 1988).
[264] Op. Br. at 32.
[265] *Colorado-Ute*, 760 P.2d at 631.
[266] *Id.* at 648.
[267] *Id.*
[268] 594 P.2d 612 (1979).
[269] Op. Br. at 33.

record that would justify the rate structure.[270] The court indicated that if the load factor was given as a justification for the declining block rate structure, the load factor needed to be quantified in the record, and it was not.[271] In the present case, each of the parties used the cost of service study prepared by TEP, and presented expert testimony regarding their preferred revenue allocation for the Commission to adopt.[272] The mere fact that the Commission adopted a revenue allocation that was a combination of the allocations presented by TEP and Commission Staff, and not that presented by Freeport, does not mean the revenue allocation is not supported by substantial evidence.

Finally, Freeport suggests that "rate shock," as a basis for sustaining continued inequitable subsidies, has been rejected by another jurisdiction.[273] Specifically, Freeport asserts that in *Lloyd v. Pennsylvania Public Utility Commission*,[274] the court rejected the public utility commission's use of gradualism to limit the increase of electricity rates for a subsidized residential class.[275] While the court did reject the public utilities commission use of 10 percent of the total bill as the limit on any rate increase, there were additional factors that distinguish *Lloyd* from this appeal. First, the court was critical of the public utility commission decision to use 10 percent

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[270] *Application of Hawaiian Electric Light Co., Inc.*, 594 P.2d at 625.
[271] *Id.* at 626.
[272] ROA-513, ep 35-45.
[273] Op. Br. at 37.
[274] 904 A.2d 1010 (Pa. 2006).
[275] *Id.* at 1020.

without any explanation as to how that would reduce rate shock.[276] Second, the public utility commission did not explain how the rate differentials between rate classes were going to be gradually alleviated.[277] Third, the court determined the total bill method used by the public utility commission was not in accord with applicable state law, the Competition Act.[278]

The facts and circumstances of this appeal are distinguishable from *Lloyd.* The Commission, contrary to the Pennsylvania commission in *Lloyd*, did not use an arbitrary percentage in determining the revenue allocation to each of the rate classes.[279] The parties to the case presented proposed revenue allocations for the Commission's consideration, and the Commission ultimately adopted a combined revenue allocation based on evidence presented by TEP and Staff.[280] Further, unlike in *Lloyd*, the parties and the Commission indicated a desire to move closer to cost of service gradually over several rate case cycles.[281] Finally, Arizona does not have the equivalent to the Competition Act in Pennsylvania, which mandates rates for services to be set primarily on a cost of service study.

Ultimately, the main caveat in *Lloyd* is that "gradualism is but one of many factors to be considered and weighed by the Commission in determining rate designs

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[276] *Id.*
[277] *Id.*
[278] *Id.*
[279] ROA-513, ep 35-46.
[280] *Id.*, ep 46.
[281] ROA-717, ep 15; ROA-513, ep 36; ROA-540, ep 264.

and principles of gradualism cannot be allowed to trump all other valid ratemaking concerns and do not justify allowing one class of customers to subsidize the cost of service for another class of customers over an extended period of time."[282] That has not occurred in this case. While the Commission certainly considered gradualism, it adopted a combination of the revenue allocations presented by TEP and the Commission Staff based on the additional substantive factors that both TEP and the Commission Staff presented in testimony.[283] Further, what made the revenue allocation more difficult in this case is the fact that TEP was seeking to create several new rate classifications, including the creation of the Small General Service, Medium General Service, Large General Service, and separating out the 138 kV Class, as requested by Freeport in TEP's last rate case.[284] This factor, in addition to those referenced above were all considered by the Commission in adopting the revenue allocation in this case.

[282] *Lloyd*, 904 A.2d at 1020.
[283] ROA-716, ep 18, 25; ROA-513, ep 46.
[284] http://docket.images.azcc.gov/0000146156.pdf, Decision No.73912 at 30:3-4, 48:14-16.

CONCLUSION

The Commission's Decision is supported by substantial evidence. Therefore, the Court should affirm Decision No. 75975.

DATED this 15th day of September, 2017.

ARIZONA CORPORATION COMMISSION

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IN THE COURT OF APPEALS

STATE OF ARIZONA

DIVISION TWO

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CERTIFICATE OF COMPLIANCE

Pursuant to Rules 13 and 14, Arizona Rules of Civil Appellate Procedure, the undersigned counsel certifies that this brief uses a proportionately spaced typeface of Times New Roman at 14 point. According to the Microsoft Word word-count function, this brief contains 12,150 words, excluding the Table of Contents, Table of Authorities, Certificate of Service, and this Certificate of Compliance.

DATED this 15th day of September, 2017.

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CERTIFICATE OF SERVICE

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