IN THE COURT OF APPEALS

STATE OF ARIZONA

DIVISION TWO

FREEPORT MINERALS CORPORATION, Appellant, v. THE ARIZONA CORPORATION COMMISSION, Appellee.	Court of Appeals Division Two No. 2 CA-CC 2017-0001 Arizona Corporation Commission Dockets No. E-01933A-15-0322 and No. E-01933A-15-0239
v. TUCSON ELECTRIC POWER COMPANY, Intervenor.	

TUCSON ELECTRIC POWER COMPANY'S ANSWERING BRIEF

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS

Page

TABLE OF CITATIONS

Cases

Statutes and Constitutions

Regulations

Introduction

When the Arizona Corporation Commission ("Commission") sets rates for a utility, it must determine how much revenue the utility should have the opportunity to collect from customers (the "revenue requirement"). The revenue requirement is based on the utility's expenses, investments in utility assets used to serve customers ("rate base"), cost of debt, and cost of equity. Once the revenue requirement is determined, the Commission must then develop a rate schedule that produces the required level of revenue. *See Consol. Water Utilities, Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 485 (App. 1993)(reversing Commission decision where rate schedule did not produce revenue requirement). When the utility has multiple classes of customers, there is an additional step—a portion of the revenue requirement must be allocated to each class; the allocated revenue is then used to develop rate schedules for each customer class. This additional step is called class revenue allocation, and it is the subject of this case.

Here, Appellant Freeport Minerals Corporation ("Freeport") argues that too much revenue responsibility was allocated to the 138kV class, a class of which it is the only member. This unique

class-of-one was created in this case specifically to benefit Freeport.

Historically, in setting rates for Tucson Electric Power Company ("TEP") and other electric utilities, the Commission has favored the residential customer classes in the class revenue allocation, essentially producing a subsidy received by the residential customers at the expense of the commercial and industrial customers. The Commission moved to reduce this interclass subsidy. Freeport's argument is, in essence, that the Commission isn't moving fast enough to eliminate this subsidy.

TEP can appreciate this argument. After all, Freeport is TEP's largest customer, and Freeport looms large in TEP's service area as a major employer and source of economic activity. TEP is keenly aware that electric rates are especially important in an energy-intensive industry like mining. Therefore, TEP supports moving toward elimination of the interclass subsidy borne by the commercial and industrial classes. Accordingly, in the rate case TEP supported a greater reduction in the interclass subsidy than what the Commission ultimately approved.

While TEP is thus somewhat sympathetic to Freeport's cause, Freeport's appeal must fail. Class revenue allocation is the classic

type of "judgment call," involving questions of social policy, where the Court must defer to the Commission. After all, the Commissioners are elected by the citizens of Arizona to decide exactly these sorts of policy questions. Indeed, the Arizona Constitution vests the Commission with "full and exclusive power" over setting rates. *Residential Util. Consumer Office v. Arizona Corp. Comm'n*, 240 Ariz. 108, 111, ¶ 12 (2016). The Commission's "full and exclusive power" over ratemaking includes the power to determine the amount of revenue requirement to be allocated to each customer class.

At points, Freeport seems to argue that subsidies of any type in the class revenue allocation are impermissible as a matter of law—that is, that the allocation of revenue requirement responsibility to each class must exactly match the allocation of costs to the class. There is no authority in Arizona for such a rule. While aligning the costs caused by each customer class with revenue responsibility is a sound guideline, it is not in inexorable command. Departures from a strict cost-only approach are common in utility ratemaking in Arizona and other states, including discounted rates for low income customers and special rates to

encourage economic development. Indeed, both low income rates and business development rates were approved by the Commission in this case, without objection by Freeport. Thus, Freeport's purported cost-only rule—that is, a rule against any subsidies—must be rejected.

Alternatively, at places, Freeport appears to concede that some subsidies are acceptable, but the subsidy it pays is "unreasonable" under the Arizona Constitution or A.R.S. § 40-334 because it is simply too big. This argument must fail. First, the subsidy is not unreasonable because it was approved by the Commission. Second, there is simply no judicially ascertainable standard for how big is too big in terms of interclass subsidies. Third, while Freeport may pay a subsidy, the actual rate Freeport pays is lower than the rates paid by residential customers, so Freeport's rates are hardly unreasonable. Fourth, the focus on interclass subsidies is somewhat misplaced—the customer classes are by necessity rough groupings, and even if all interclass subsidies were eliminated, there is no practical way to eliminate all subsidies within a class. This is because different customers will have different usage characteristics and will thus impose different amounts of cost on

the utility. As a result, it is impossible to calculate individual rates for hundreds of thousands of unique customers. The best that can be managed is a rough correspondence between the cost of service and the allocation of revenue requirements, which has been achieved here.

In sum, Freeport's rate includes more revenue responsibility than a strict cost allocation would suggest. TEP will continue to urge the Commission to move towards a closer match between costs and revenue responsibility in its next rate case. But the degree of subsidy is ultimately a matter for the Commission to decide, and this Court should affirm the Commission's decision.

Statement of the Case

This case is a direct appeal under A.R.S. § 40-254.01 brought by Freeport against a rate case decision of the Commission. Freeport submitted a timely Application for Rehearing and a timely notice of appeal.

Statement of Facts

I. Allocating costs to each class requires discretionary judgment calls by the Commission.

Once the revenue requirement is determined, the revenue

must be allocated to the various customer classes, and then specific rate schedules must be developed for each class. As a starting point for allocating revenue requirement to each class, the utility's costs are first allocated to each class. This is done through a "Class Cost of Service Study" or "CCOSS." As the Commission's Utilities Division's ("Staff") rate design witness, Howard Solganick testified, the CCOSS is "intended to assist the Commission to allocate revenue requirements among customer classes." [ROA 716, EP 18 at 15:1-2] Solganick explained that "regulators have historically used" the CCOSS "as a guideline to allocate revenue among classes" but "[r]egulators typically also consider economic, social, historical and other factors that may affect customers when determining revenue allocation" and that such factors "often results in rates that deviate from strict cost of service." [Id. at 15:5-9].

Preparing the CCOSS is far from a straightforward endeavor. As Solganick explained, preparing a CCOSS "involves judgment and decisions on the part of the practitioner in assigning costs to the various customer classes." [Id. at 15:12-13]. TEP's CCOSS witness, Craig Jones, made the same point:

> Fundamentally, performing cost of service

> studies is comprised of applying experience and science.... The art of applying experience involves the subjective application of certain methods, in conjunction with the application of policy objectives, regulatory case law, emerging issues, and other factors, within the framework of the regulatory process.... The art of the cost study is having an understanding of how the unique characteristics of the utility should be combined with the various scientific methodologies.

[ROA 606, EP 20-21 at 17-18].

As U.S. Department of Defense and all other Federal Executive Agencies ("DOD/FEA") witness Maurice Brubaker explained, there are three steps in preparing a CCOSS, "identify the different types of costs (functionalization), determine their primary causative factors (classification) and then apportion each item of cost amount the various rate classes (allocation)." [ROA 633, EP 9 at 8:6-10].

In this case, TEP prepared both a traditional embedded (*i.e.* historical) class cost of service study [ROA 606, EP 17-29], as well as a marginal cost of service study. [Id. at EP 29-35]. The Commission Staff recommended that a different cost allocation method be used for the CCOSS. [ROA 716, EP 20-23; see also ROA 513, EP 43-44]. TEP accepted the revised method, and this revised CCOSS was accepted by the Commission and used to analyze the

class revenue allocation. [Id. at EP 45-46]. Freeport has not appealed the Commission's acceptance of the revised class cost of service study.

II. Allocating revenue to each class requires discretionary judgment calls by the Commission.

Once the CCOSS is complete, it may be used to measure the degree each class rate schedule produces more or less revenue than would be produced if revenue were allocated solely using the CCOSS, that is, the degree of "subsidy" paid by (or received by) each customer class. There are various ways this can be measured, such as computing the relative rate of return produced by each class, or alternatively by computing a "Unitized Rate of Return" or "UROR" for each class. A UROR of 1.00 means the class revenues exactly match cost (as shown in the CCOSS), while a UROR under 1.00 means that the class is producing less revenue than suggested by the CCOSS. [*See e.g.*, ROA 716, EP 25 at 22:1-7].

Most parties to the rate case agreed that the class revenue allocation should more closely reflect the costs allocated to each class in the CCOSS, especially to reduce the subsidy paid by the industrial and commercial classes in favor of the residential classes.

But most parties also recognized that it would not be feasible to completely eliminate the subsidy of the residential class in one rate case. For example, DOD/FEA witness Brubaker explained that "Ideally, all classes would be moved to cost of service in this case. However,... doing so at one time would not be consistent with the principle of gradualism, under which the objective is to move toward the goal of equal rates of return over time without imposing unduly disruptive or disproportionate increases on any group of customers." [ROA 633, EP 26]. Likewise, Commission Staff witness Solganick explained that, over the long term, rates "should be based on cost derived from class cost of service studies" but this must be done gradually, and that "revenue allocation is not just an algorithm-based process but it is tempered by a Commission's evaluation of other factors." [ROA 716, EP 29:14-17]. TEP witness Jones likewise recognized that the process must be gradual, although he supported a greater reduction in the subsidy than proposed by the Commission Staff and ultimately adopted by the Commission. [ROA 607, EP 13:19-27; ROA 608, EP 6 at 4:24-27]. Even Freeport's own revenue allocation witness, Kevin Higgins, agreed, testifying 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.'" [ROA 628, EP 25-26 at 23:23 to 24:7].

III. Freeport received many special benefits.

Customer classes are not immutable. Indeed, in this case, TEP proposed a new customer class—the 138 kV class—to specifically benefit Freeport, the only customer in the new class. To enable Freeport to take service under this new class, TEP sold Freeport certain facilities (including a substation). [ROA 537, EP 53 at 1742:11-14]. This sale enabled Freeport to take most of its service directly from the high-voltage transmission grid. Doing so allowed Freeport to receive favorable treatment in the CCOSS, including having no distribution-level costs assigned to Freeport. [ROA 606, EP 57-59]. Distribution costs—including substations, transformers, and the poles and lines running to individual customer locations—are considerable, so this change was a significant advantage for them. In addition, other allocation factors

were calculated in a way favorable to Freeport, thus further benefiting them. [Id.].

Freeport's Director of Energy Services, Michael McElrath, agreed that the new 138kV rate class was designed with Freeport in mind, and that there are "benefits of Freeport taking service under that 138 kV rate compared to its current rate" including "lower distribution and line lost costs." [ROA 537, EP 53 at 1742:11-24].

TEP's President, David Hutchens, testified that TEP is "deeply concerned about the long-term economic viability of the Sierrita mine [owned by Freeport] – our single largest customer and a huge employer in our community." [ROA 583, EP 10 at 8:13-15]. Freeport's witness McElrath agreed that TEP's concerns were sincere. [ROA 537, EP 53 at 1740:1-8]. Mr. McElrath also acknowledged numerous efforts TEP has made to ensure more favorable rate treatment for Freeport. For example, "as recently as this rate case, TEP has changed its rate allocation model [to one] that's more friendly towards industrial customers." [Id., EP 54 at 1741:1-4]. Mr. McElrath acknowledged other efforts by TEP towards more favorable rate treatment for Freeport, including co-generation deferrals, exemption from TEP's Demand Side

Management surcharge, a cap on the Renewable Energy Standard and Tariff surcharge, and an exemption from the Lost Fixed Cost Recovery adjustor. [ROA 537, EP 51-53 at 1740:16-1742:10].

Overall, TEP has made, and the Commission has approved, significant efforts to accommodate Freeport in hopes of keeping Freeport's mine in operation. However, Mr. McElrath testified that "the biggest factor in determining the level of activity" at the mine "would be the copper and molybdenum prices." [ROA 537, EP 49 at 1738:14-23]. Thus, no level of electricity costs, no matter how low, can guarantee any level of employment or economic activity at the mine. [ROA 537, EP 49-50 at 1738:24-1739:25].

Statement of the Issues

1. The Arizona Constitution [Article 15, §§ 3, 12] requires the Commission to set "just and reasonable" rates. Does this requirement mandate that the Commission allocate revenue between classes exactly in accordance with a class cost of service study?

2. The Arizona Constitution prohibits rate discrimination "between persons or places for receiving a like and contemporaneous service." [Article 15, § 12]. Does this anti-

discrimination clause bar all interclass subsidies?

3. An Arizona statute [A.R.S. § 40-334] prohibits "unreasonable" differences in rates between customer classes. Can a difference approved by the Commission be "unreasonable"? And if so, are there judicially manageable standards for this Court to determine when a subsidy is too big to be reasonable?

Argument

I. The Commission has exclusive, Constitutional jurisdiction over ratemaking, which limits this Court's review.

Because ratemaking is a function specifically entrusted to the Commission by the Arizona Constitution, a stringent standard of review applies to challenges to Commission ratemaking decisions. Freeport "is required to demonstrate, clearly and convincingly, that the Commission's decision is arbitrary, unlawful or unsupported by substantial evidence." *Litchfield Park Serv. Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 434 (App. 1994). Freeport must also contend with the presumption that the Commission's actions are constitutional. *Residential Util. Consumer Office v. Arizona Corp. Comm'n*, 240 Ariz. 108, 111, ¶ 10 (2016)("We generally presume the Commission's actions are constitutional, and we uphold them

unless they are arbitrary or an abuse of discretion").

And because the Commission's ratemaking power is granted directly by the Arizona Constitution, a court's review of ratemaking questions is limited. As this Court recently observed, the "Commission occupies a unique place in Arizona's government, with our state constitution expressly stating the Commission's purpose and powers. Our supreme court has described the Commission as 'another department of government, with powers and duties as well defined as any branch[.]' This special status makes the judicial review process for the Commission's decisions distinct from the process for reviewing other administrative decisions, although they share many similarities." *Sierra Club--Grand Canyon Chapter v. Arizona Corp. Comm'n*, 237 Ariz. 568, ¶ 9 (App. 2015)(citations omitted). Further, "when the reviewing court is examining a ratemaking decision", the court's review is "limited." *Id.*, ¶ 10. Thus, the "Commission is accorded broad discretion in its rate-making authority." *Turner Ranches Water & Sanitation Co. v. Arizona Corp. Comm'n*, 195 Ariz. 574, 576, ¶ 5 (App. 1999). While these limitations are rooted in a respect for the Commission's exclusive Constitutional jurisdiction over rates, there is also a

practical aspect to these limitations because "courts are simply ill-prepared to independently judge the merits of rate applications." *Tucson Elec. Power Co. v. Arizona Corp. Comm'n*, 132 Ariz. 240, 248 (1982). Freeport thus faces a steep uphill road in this appeal.

Of course, while the Commission's discretion in ratemaking is broad, it is not boundless. The Arizona Constitution [Article 15, § 17] specifically provides for appeals as a check on the elected commissioners. Review of legal issues is *de novo*. *Hirsch v. Arizona Corp. Comm'n*, 237 Ariz. 456, 462, ¶ 18 (App. 2015); *Sw. Transmission Co-op., Inc. v. Arizona Corp. Comm'n*, 213 Ariz. 427, 430, ¶¶ 13-15 (App. 2006)(declining to defer to Commission's legal interpretation). Even on fact issues, the Commission will be reversed if its decision is not supported by substantial evidence. *City of Tucson v. Citizens Utilities Water Co.*, 17 Ariz. App. 477, 481 (1972)(affirming reversal of Commission order where Commission relied on testimony "full of speculative theories"). Further, the substantial evidence standard is "deferential but not abject" and the court must consider all of the evidence, not just the evidence supporting the agency: "We may not find substantial evidence merely on the basis of evidence which in and of itself justified the

Board's decision, without taking into account contradictory evidence or evidence from which conflicting inferences could be drawn." *Bellagio, LLC v. Nat'l Labor Relations Bd.*, 863 F.3d 839, 847 (D.C. Cir. 2017)(citation and quotation marks omitted).

II. The "just and reasonable" clauses of the Arizona Constitution do not mandate a strictly-cost based approach.

Arizona's Constitution requires the Commission to set "just and reasonable" rates for public service corporations. Article 15, §§ 3, 12. Typically, just and reasonable rates are determined using the "traditional" rate of return formula, although that formula is not required in every context. *Residential Util. Consumer Office v. Arizona Corp. Comm'n*, 240 Ariz. 108, 112, ¶ 13 (2016). Under the traditional formula, "utility rates are set to allow a recovery for all reasonable expenses, plus a return on investment (rate base)." *Tucson Elec. Power Co.*, 132 Ariz. at 245. Thus, "total revenue, including income from rates and charges, should be sufficient to meet a utility's operating costs and to give the utility and its stockholders a reasonable rate of return on the utility's investment." R*esidential Util. Consumer Office v. Arizona Corp. Comm'n*, 199 Ariz. 588, 591, ¶ 10 (App. 2001) *quoting Scates v. Arizona Corp. Comm'n,*

118 Ariz. 531, 534-35 (App. 1979).

The Commission applied the traditional formula, and no party challenged that decision. The Arizona cases describing the traditional formula do not describe the class cost of service study or the class revenue allocation. As long as the rate schedules, in total, produce sufficient revenue, allocation to specific classes is within the Commission's discretion. Nor can the cost allocation and revenue allocation steps be found within the text of the Arizona Constitution. These steps, then, while necessary for ratemaking, are within the Commission's discretion. In the absence of any command in the Constitution's text or in the cases applying it, there is no basis for Freeport to challenge the Commission's determination as not just and reasonable. After all, the "Arizona Constitution grants the Commission broad discretion within its unique decision-making sphere." *Residential Util. Consumer Office,* 240 Ariz. at 111, ¶ 10.

Further, the courts "would not presume to instruct the Commission as to how it should exercise its legislative functions." *Arizona Corp. Comm'n v. Arizona Pub. Serv. Co.*, 113 Ariz. 368, 371 (1976). Here, decisions about whether and how much the class

revenue allocation should depart from the class cost allocation (that is, how much one class should "subsidize" another) are legislative policy judgements for the Commission. These legislative judgments include difficult questions of social policy, such as how much low income customers should be subsidized and whether certain businesses should be subsidized to encourage economic development. The courts are not well situated to second-guess decisions on such topics.

III. The anti-discrimination clause of Article 15, Section 12 of the Arizona Constitution does not prohibit interclass subsidies.

The framers of Arizona's Constitution included an anti-discrimination clause in Article 15, Section 12. That clause provides: "no discrimination in charges, service, or facilities shall be made between persons or places for rendering a like and contemporaneous service" with an exception not relevant here. This clause only prohibits discrimination within a class, that is, "between persons" receiving "a like and contemporaneous service."

Specific customer classes are not established in the Arizona Constitution. Rather, the Constitution provides that the Commission "shall have full power to, and shall, prescribe just and

reasonable classifications to be used..., by public service corporations within the state for service rendered therein,...." Article 15, § 3. Because the Commission's power to establish customer classifications is constitutionally based, the Commission has broad discretion in exercising this power. "The Commission is constitutionally endowed with a very broad power to prescribe classifications and to establish categories to consider in setting rates." *Consol. Water Utilities, Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 483–84 (App. 1993).

Here, the Commission used its constitutional classification power to establish a special class-of-one designed to specifically benefit Freeport. TEP's and Freeport's witnesses agreed about the considerable benefits this special classification provides to Freeport. [ROA 616, EP 57-59; ROA 537, EP 53 at 1742:11-24].

Because Freeport is the only member of this class, it cannot claim discrimination under Article 15, Section 12. That is because § 12 is limited to customers receiving "a like and contemporaneous service," *i.e.*, customers in the same class. Here, Freeport is the only customer receiving this unique class of service. Thus, there can be no discrimination within this class.

And even setting aside the classification approved by the Commission, in practical terms, none of TEP's other customers are like Freeport. Freeport owns its own substation and primarily receives electricity directly from the high voltage transmission grid, rather than using the local distribution system. It uses vastly more power than other customers. No other customer receives a "like" service to the service received by Freeport.

IV. The Commission's class revenue allocation does not violate the statutory ban on discrimination in A.R.S. § 40-334.

A. Freeport waived its A.R.S. § 40-334 claim because it did not raise it in its post-hearing briefs or in its exceptions.

Freeport also argues that the Commission's class revenue allocation violates a utility anti-discrimination statute, A.R.S. § 40-334. [See e.g., Freeport Brief at 20]. Although Freeport included a reference to this statute in its Application for Rehearing, Freeport never mentioned A.R.S. § 40-334 in its post-hearing briefs or in its exceptions. Here, the Administrative Law Judge ("ALJ") ordered initial and reply briefs after the hearing. The purpose of these briefs is to inform the ALJ and the Commission of the issues in dispute, to assist them in addressing those issues, and to allow

parties to respond to arguments raised in the briefs of other parties. *See* A.A.C. R14-3-110(A)("proceeding is submitted for decision by the Commission after… the filing of briefs… as may have been prescribed by the presiding officer"). Likewise, exceptions inform the Commission of any concerns a party has with the ALJ's recommended order. *See* A.A.C. R14-3-110(B). Here, by waiting until its Application for Rehearing to raise the § 40-334 issue, Freeport denied the Commission and the ALJ a reasonable opportunity to address the issue, and Freeport denied TEP any opportunity to develop an argument on this issue, because the rehearing statute does not provide for replies to rehearing applications. *See* A.R.S. § 40-253. Thus, Freeport has waived its § 40-334 argument by failing to include it in its post-hearing briefs or in its exceptions. *See In re Gen. Adjudication Of All Rights To Use Water In Gila River Sys.*, 217 Ariz. 276, 279 n. 5, (2007)("issue not raised in opening brief is waived"); *Cont'l Lighting & Contracting, Inc. v. Premier Grading & Utilities*, LLC, 227 Ariz. 382, 386, ¶ 12 (App. 2011)("The general law in Arizona is that legal theories must be presented timely to the trial court so that the court may have an opportunity to address all issues on their merits.")

B. A rate difference is not "unreasonable" if the difference is approved by the Commission.

Freeport argues that A.R.S. § 40-334 enacts a ban on subsidies—that is, a ban on class revenue allocations that are different than class cost allocations. The statute does no such thing. Rather, A.R.S. § 40-334(B) provides that "[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." The statute only bans "unreasonable" differences. Here, the difference was approved by the Commission—after a lengthy hearing and based on an extensive record—and is therefore reasonable.

This is shown by the different subjects of A.R.S. § 40-334(B) and (C). Subsection (B) applies to any "public service corporation"; it does not prohibit nor direct the Commission to do anything. In contrast, subsection (C) provides that the "commission may determine any question of fact arising under this section." Thus, under this statute, the Commission determines what differences are reasonable or unreasonable.

An interpretation that sweeps more broadly than that, such as

Freeport's interpretation, must be rejected as intruding on the Commission's constitutional powers. The Arizona Constitution grants the Commission "exclusive authority to set rates." *Arizona Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 294 (1992). The Commission thus has a "right to deal with matters entrusted exclusively to it—free from interference by the legislative department of the state." *Ethington v. Wright*, 66 Ariz. 382, 390 (1948). Therefore, any statute that intrudes into the Commission's exclusive constitutional authority is void. "Where the Constitution has said that public service corporations shall be governed by the Corporation Commission in a given respect, it is the last, the highest, and controlling fundamental law as to that matter. No act of the Legislature, for it must proceed in accordance with the terms of the Constitution, can exercise the power, or place it elsewhere." *State v. Tucson Gas, Elec. Light & Power Co.*, 15 Ariz. 294, 301 (1914). The Arizona Constitution grants the Commission authority to "prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations within the state...." Article 15, § 3. Thus, if A.R.S. § 40-334 is interpreted broadly—as Freeport

proposes—to prohibit certain types of rates, it would intrude into the Commission's exclusive constitutional authority and be void.

A narrower construction should be adopted to preserve the statute. *Hayes v. Cont'l Ins. Co.*, 178 Ariz. 264, 272 (1994) ("if possible this court construes statutes to avoid rendering them unconstitutional"). The statute can be construed to mean that differences approved by the Commission are not unreasonable. This construction would require the utility to adhere to the classifications and rate schedules approved by the Commission, and prohibit the utility from cutting special deals with favored customers. Such a construction is reasonable and prevents any conflict with the Commission's constitutional authority.

C. A question of "unreasonable" rate differences presents a nonjusticiable question.

Even if A.R.S. § 40-334 is construed more broadly, how can the court determine which differences are unreasonable? There are "no judicially discoverable and manageable standards" so this issue is nonjusticiable. *Kromko v. Arizona Bd. of Regents*, 216 Ariz. 190, 194, ¶ 21 (2007). *Kromko* dealt with requirement in the Arizona Constitution that tuition at state universities be "as nearly free as

possible." The Arizona Supreme Court found that this was not a justiciable question, noting that "there is no North Star to guide a court in making such a determination, at best, we would be substituting our subjective judgment of what is reasonable under all the circumstances for that of the Board and the Legislature, the very branches of government to which our Constitution entrusts this decision." *Id.*

There is no North Star here either. The statutory question of which rate differences are "unreasonable," simply restates the constitutional question of whether the rates are "just and reasonable"—and that is a question that the Constitution empowers the Commission—and only the Commission—to answer.

D. In any event, Freeport's rate is not unreasonably different from other customers.

If the Court does reach the reasonableness question, the rate difference here does not violate the statute.

1. The actual rate paid by Freeport is lower than the rate residential customers pay.

Freeport complains about the subsidy it pays to the residential class. But Freeport's actual rates are lower than the rates residential customers pay. This is because Freeport received such

favorable treatment in the class cost of service study. Because Freeport's rate is lower, Freeport cannot be heard to complain about an unreasonable difference in rates. Freeport's concern about revenue allocation exceeding cost allocation simply exceeds the scope of the statute.

Further, even if Freeport's complaint does fall within the ambit of A.R.S. § 40-334, the difference here is not "unreasonable." The statute does not prohibit all subsidies, because some subsidies are reasonable. And Freeport has not shown that the subsidy here is unreasonable.

2. A.R.S. § 40-334 does not create a strict "no subsidy" rule.

To the extent Freeport suggests that the class revenue allocation must match exactly the costs allocated to the class in the class cost of service study—that is, that there be no "subsidy"—such a rule must be rejected. It finds no support in the text of the Constitution. Nor does the statute define "unreasonable" in this way (or in any way). Further, even Freeport's own witness Kevin Higgins testified that some differences from cost can be appropriate, stating that ""[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.'" [ROA 628, EP 25-26 at 23:23-24:7].

Even worse, a rule prohibiting any deviation from cost would prohibit numerous other beneficial rate structures that the Commission has found just and reasonable. For example, low income customers are assessed a rate lower than their full cost of service. TEP believes that the essential nature of electricity in modern society justifies such a deviation from cost to ensure that the service is widely available. The Commission does not err when it agrees with that concept, as it did in this case. Likewise, TEP proposed a special economic development rate to encourage businesses to move to the Tucson area or to expand their operations in the Tucson area, with various qualifications and safeguards. [ROA 597, EP 40-43]. Again, the Commission did not err when it approved this tariff. Another example of departing from strict cost-of-service principles involves "water conservation" rates. Such rates charge large users of water a higher price to encourage water conservation. Under traditional cost analysis, large users

generate economies of scale and should be charged lower, not higher, rates. The Commission has rejected that approach, endorsing conservation rates to reduce use of a scarce, precious resource in our arid state.[1] Low-income rates, economic development rates, and water conservation rates all represent other policy considerations taking precedence over pure cost allocation. Under Arizona's Constitution, these are policy judgements for the Commission to make. Thus, the Court should reject a strict "no subsidy" rule.

3. Freeport has not shown that the subsidy it pays is unreasonable.

Freeport is then left to argue that the subsidy it pays is just too big. Freeport centers this argument around the claim that "The Commission imposed an annual subsidy on Freeport of $4.2 million." [Freeport Brief at 13]. No record cite is offered for this proposition, and TEP is not aware of this number appearing in the evidentiary record. To the best TEP can tell, Freeport calculated this figure using certain numbers that do exist in the record. TEP

[1] *See* Decision No. 75626, at Attachment No. 1, pages 10-13, "Policy Statement No. 2—Rate Design Issues", available at http://docket.images.azcc.gov/0000171835.pdf

believes that this calculation is erroneous. For example, Freeport's calculation fails to consider other subsidies granted to Freeport, such as in the calculation of system fuel costs. If Freeport's erroneous calculation is considered, then TEP requests permission to file a supplemental affidavit from its cost allocation expert, Craig Jones, explaining the errors in Freeport's calculation. But Freeport's number should not be considered, because it is not in the record.

Similarly, Freeport contends that various Unitized Rate of Return numbers show the subsidy is too big. [Freeport Brief at 13]. But again, no citation to the record is provided for these numbers, and they must be disregarded.

Finally, the Commission approved a total revenue increase of $81.5 million, but allocated only $561,000 (0.69% of the increase) to Freeport's special 138kV class. [ROA 513, EP 46 at 41:5-13]. In contrast, residential customers were responsible for $54.5 million of the increase, or 66.87%. [*Id.*] In the end, it was not "unreasonable" for the Commission to reduce the subsidy more slowly than Freeport preferred, especially in light of the impact on residential customers, who bore the brunt of the rate increase approved by the

Commission.

Conclusion

TEP recognizes the tremendous value of Freeport's operations to the Tucson area in terms of jobs and economic activity. During the rate case, TEP argued for Freeport to pay less of a subsidy than the Commission ultimately approved. But the Commission did not commit reversible error in reducing the subsidy more slowly than Freeport or TEP would have liked.

Rather, class revenue allocation is a judgment call, the type of ratemaking decision entrusted to the Commission by the Arizona Constitution. While the class cost of service study is an important guide in allocating revenue to each class, it not the only consideration, as TEP's, Staff's, DOD/FEA's and Freeport's witnesses all agreed. These sorts of social policy questions are best left to the Commission's legislative judgment. Nor are there judicially manageable standards to resolving these questions.

The Arizona Constitution [Article 15, Section 12] does bar discrimination between customers receiving "like and contemporaneous service", but no TEP customer is like Freeport. It is the only member of its class. All other customers receive service

from the distribution system at distribution voltages, while Freeport is primarily served from the transmission system at high voltage. Freeport also uses far more power than other customers.

There are sound reasons to read A.R.S. § 40-334(B) more narrowly than Freeport proposes—both based on the text of that statute, and to avoid a constitutional issue. Moreover, determining what rate differences are "unreasonable" is a job best left for the Commission. In any event, Freeport has not shown that the subsidy here is unreasonable. Accordingly, the Commission's decision should be affirmed.

RESPECTFULLY SUBMITTED this 15th day of September, 2017.

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CERTIFICATE OF SERVICE

Timothy J. Sabo hereby certifies that on September 15, 2017, he caused the Answering Brief of Intervenor Tucson Electric Power Company to be electronically transmitted for filing to the Clerk of the Arizona Court of Appeals, Division Two, using eFiler, the Court of Appeal's Electronic Filing Program, thereby accomplishing automatic e-service to opposing counsel of record through eFiler:

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CERTIFICATE OF COMPLIANCE

Pursuant to Rule 14, Ariz. R. Civ. App. P., the undersigned counsel certifies that the Answering Brief of Intervenor Tucson Electric Power Company uses a proportionately spaced typeface of 14 points or more, and is doubled-spaced using a Bookman Old Style font. According to the Microsoft Word word count function, the Answering Brief contains 5,757 words, excluding the Table of Contents, Table of Authorities, Certificate of Service, this Certificate of Compliance, and any addendum.

RESPECTFULLY SUBMITTED this 15th day of September, 2017.

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