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 ACC Docket No. E-01933A-15-0322 ACC Docket No. E-01933A-15-0239

APPELLANT'S OPENING BRIEF

FENNEMORE CRAIG, P.C. (No. 00022300)
Timothy Berg (No. 004170)
Patrick J. Black (No. 017141)
Carrie Ryerson (No. 028072)
2394 East Camelback Road
Suite 600
Phoenix, AZ 85016-3429
Telephone (602) 916-5000

Attorneys for Appellant Freeport Minerals Corporation

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INTRODUCTION

Freeport Minerals Corporation ("Freeport") challenges one narrow but very important aspect of Arizona Corporation Commission's (the "Commission") Decision No. 75975 ("Decision"), which resolved a rate case filed by Tucson Electric Power ("TEP"). Specifically, Freeport appeals the revenue allocation that resulted in Freeport continuing to subsidize other customer classes in the amount of millions of dollars annually through base rates.[1] The Commission violated the constitutional and statutory mandates of "just and reasonable" and non-discriminatory utility rates by establishing new base rates for Freeport that far exceed TEP's costs to provide electric service to Freeport. In lieu of aligning TEP's revenue requirement with the costs to serve each customer rate class, the Commission instead allocated to Freeport more than its reasonable share of TEP's costs, forcing it to continue subsidizing other rate classes, particularly the residential customer class.

Although the Commission undoubtedly has significant discretion in setting rates and charges, the parties below and the Commission itself recognized the ratemaking principle of matching cost causation with cost recovery—that rates for

[1] In Arizona, a "base rate" includes all costs to produce and deliver electricity, but does not include charges based on adjustment clauses or riders that usually add to the total amount of a customer's final monthly bill.

a particular class of customer or service should recover the cost of that service and provide a reasonable rate of return on the utility's investment. When rates are not based on cost, they distort customer behavior in two respects. First, customers make decisions without regard to the true costs of their usage, and subsidized customers are not incented to conserve services such as electricity or water because they do not perceive the true cost of that service or commodity. Second, excessive commercial and industrial rates beyond cost impede economic development as new large commercial and industrial customers can choose to locate new facilities elsewhere. The Commission's authority to set rates is not without limits, and rates must bear at least a reasonable relation to the cost of service standard.

Beyond the facial invalidity of the revenue allocation, the Decision's rate allocations—which maintain historic inequities by mandating that Freeport and other large power users pay monies purely to benefit other classes—are simply not supported by substantial evidence. The revenue allocation to certain classes of customers was arbitrary. There is no evidence in the TEP rate proceeding or the Decision that supports a conclusion that the residential class as a whole should continue to receive a large subsidy from other classes of ratepayers. Further, the Commission's justification for continued subsidization—based on principles of rate shock and gradualism—does not sustain the Decision and is inconsistent with the Commission's other recent decisions that allow for significant rate increases to residential customers.

There is no on-point Arizona case that provides the outer limits for the Commission's power to require large customers like Freeport to subsidize other customer classes.[2] For these reasons and the others expressed in this brief, Freeport respectfully requests that the Court reverse the Commission's revenue allocation and remand this matter to the Commission, putting an end to continued subsidization that is so far removed from cost-based rates as to make them unjust, unreasonable and discriminatory for Freeport.

[2] Costs include the authorized rate of return approved by the Commission.

STATEMENT OF THE CASE

This matter is a direct appeal, pursuant to A.R.S. § 40-254.01, of the Decision. On February 24, 2017, the Commission issued the Decision setting rates for TEP. ROA 513. Freeport challenges only one aspect of the Decision—the revenue allocation that resulted in Freeport continuing to subsidize other customer classes in a manner that is unjust, unreasonable and discriminatory. Freeport, the sole member of the newly-created 138,000 volt ("138kV") customer class, contends that the Commission-set rates violate Arizona law by requiring Freeport to subsidize approximately $4.2 million annually primarily for the residential customer class.

Freeport was an Intervenor before the Commission and timely filed an Application for Rehearing pursuant to A.R.S. § 40-253 on March 15, 2017. ROA 519. The Commission failed to act on the Application for Rehearing within 20 days, resulting in its denial pursuant to A.R.S. § 40-253(A) on April 10, 2017. Freeport timely filed its Notice of Appeal with this Court on May 3, 2017.

STATEMENT OF FACTS

For many years, large customers such as Freeport have not only been paying for the plant and facilities needed to serve them, but a portion of the plant and facilities needed to serve other customer classes in the form of large subsidies. This appeal concerns the allocation of TEP's total annual revenue requirement of $954,290,000 across the various customer classes, and Freeport asks that this Court recognize that Arizona law places limits on the Commission's power to require Freeport to continue subsidizing other customer classes to such a degree that the revenue allocation becomes unjust, unreasonable and discriminatory.

I. A brief overview of the ratemaking process is important for context.

Under the approach to ratemaking embodied in Arizona law, a public service corporation is permitted the opportunity to earn total revenue, including income from utility rates and charges, that "should be sufficient to meet a utility's operating costs and to give the utility and its stockholders a reasonable return of the utility's investment." *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 534 (App. 1978) (citation omitted).

The method by which rates are set is a rate case. In a rate case, the Commission determines, among other things, (1) the reasonable operating expenses of the utility and (2) a reasonable return on the fair value of the property or investment of the utility in providing service. This reasonable return is the utility's profit. The utility's annual revenue requirement is the sum of the Commission-determined reasonable operating expenses and reasonable return. *See Residential Util. Consumer Office v. Ariz. Corp. Comm'n*, 240 Ariz. 108, 110 ¶ 6 (2016).

The Commission then determines the utility's test year[3] operating revenue. If the test year operating revenue is less than the utility's annual revenue requirement, the utility has a revenue requirement deficiency and rates must be adjusted to permit the utility the opportunity to recover an additional amount of revenue that will offset the deficiency.

After the revenue requirement and revenue requirement deficiency are determined, rates for individual classes of customers or service are adjusted to produce the additional revenue that will meet the deficiency. Rates for individual classes of service are adjusted upward or downward to achieve the end goal of meeting the deficiency.

In this case, many of the parties agreed to a settlement with respect to TEP's revenue requirement deficiency. ROA 513, ep 13. The Commission adopted that settlement. The settling parties did not, however, agree to a series of rates or a rate

[3] To ensure the elements of a rate case match, the Commission uses a test year for income, expenses and investment. A.A.C. R14-2-103(A)(3); (B).

spread that would produce revenues sufficient to meet the total annual revenue requirement deficiency. *Id.* In the Decision, the Commission adopted the total annual revenue allocation recommended by the Administrative Law Judge. ROA 513, ep 45-46. Freeport and other large commercial and industrial users of power opposed this revenue allocation. ROA 513, ep 36-43.

II. The Decision perpetuates historic "inequities" because it requires Freeport to subsidize other customer classes by paying millions of dollars beyond Freeport's cost of service.

At the outset of the revenue allocation analysis in the Decision, the Commission acknowledged that the rates (pre-Decision) have "significant inter-class subsidies . . . with the large power users subsidizing the residential class." ROA 513, ep 45. As a result, allocating the "$81.5 million [revenue requirement deficiency] evenly across classes would perpetuate existing inequities, burdening the subsidizing classes." *Id.* Although the Commission appreciated that these subsidies should not continue,[4] the Decision does not significantly address this concern in the new rates.

TEP proposed and the Commission approved the removal of Freeport from the same customer class as other large power users, creating a class that includes

[4] "[T]he current rates produce substantial interclass subsidies, and . . . a reduction of the amount of subsidies is in the public interest." *Id.*

only Freeport—the 138kV customer class. The Commission imposed an annual subsidy on Freeport of $4.2 million. In other words, Freeport (as the sole member of the 138kV class) must now pay $4.2 million annually, in addition to the $31 million that Freeport pays to meet TEP's cost to serve Freeport.[5]

The extent of the subsidy is illustrated by both the rate of return and the cost of providing service to the relevant customers. Under the revenue allocation proposed by Commission's Utility Division Staff ("Staff"), Freeport would have paid rates producing a 22.25 percent rate of return for TEP, which is far in excess of TEP's overall rate of return authorized by the Commission at 7.19 percent. Under Staff's proposal, Freeport would have paid a unitized rate of return ("UROR") of 3.093 while residential ratepayers would have paid only 0.363.[6] Although the Decision did not fully adopt Staff's recommendation, it nonetheless established rates for Freeport that produce a UROR that is between two to three times what Freeport would otherwise be paying if all classes were at parity and paying the costs required to serve them. The base rates that Freeport pays exceed

[5] The rates Freeport pays to TEP (as compared with the rates at the other mines Freeport operates in the region) are the highest on a price per kilowatt hour and are the highest when considering the cost on a per pound basis of producing copper. ROA 537, ep 61.

[6] All classes pay base rates that can be translated into a UROR for TEP, and each class would have a UROR of 1.00 if all cost causation and cost recovery by class was evenly matched.

TEP's cost of providing service to Freeport by approximately 12 percent, which is not just and reasonable.

III. The Decision ignores the class cost of service as a basic principle of rate design and instead arbitrarily allocates the revenue requirement among the customer classes based on the Commission's own perception of the appropriate level of gradualism as a matter of policy, not law.

The parties agreed below that the standard in rate design is to match cost-causation with cost recovery. In other words, in allocating revenue, aligning rates with the costs "caused by each customer class is essential for ensuring fairness, as it minimizes cross subsidies among customers. It also sends proper price signals, which improves efficiency in resource utilization." ROA 628, ep 11. Indeed, TEP's initial goal in this rate case was to move revenue recovery from each customer class closer to actual cost of service. ROA 395, ep 15. And testimony indicated that rates should reflect the cost of service to each customer class—a rate design referred to as the "gold standard." ROA 606, ep 11.

TEP prepared a class cost of service study to analyze several components of the company's overall costs to serve different rate classes of customers. Class cost of service studies are essential in the ratemaking process in order to determine cost causation by different customer classes. For instance, since Freeport takes electric service at the transmission level (138kV) as a large industrial customer, it does not utilize TEP's electric distribution system and, therefore, should not be responsible for the costs associated with building and maintaining those facilities, especially new ones. This is the primary reason TEP created a new customer class in which Freeport is the only existing customer taking service at the transmission level. ROA 395, ep 42. The results of TEP's class cost of service study showed that some customer classes–mainly large commercial and industrial customers–were paying rates significantly above TEP's cost to serve them and that other classes, such as the residential customer class, were paying rates significantly below TEP's cost to serve them. Specifically, although TEP's overall rate of return during the test year was 6.57 percent, the rate of return it received from serving the residential customer class was only 0.94 percent. ROA 513, ep 45. By contrast, TEP had earned a 21.33 percent rate of return on providing service to customers in the General Service class and a 10.94 percent rate of return from customers in the Large Power Service and 138kV classes. *Id.*

Justifying the Decision's rejection of rate parity for all customer classes, the Commission reasoned that "gradualism" provided a basis to continue the payment of subsidies because moving "all the rate classes to a UROR of 1.000 [which would result in each class covering its cost of service] would cause unreasonable rate shock[.]" *Id.* Specifically, the Commission determined that applying a UROR at parity among all customers would result in an unreasonable 39.5 percent increase in margin revenue to the residential class, thereby causing "rate shock."[7] *Id*. This, of course, assumes that rates for all customer classes would be moved to cost. Elimination of the subsidy imposed on the 138kV customer class and Freeport alone (which is at issue in this appeal) would have had a smaller impact. ROA 396, ep 9-12.

Indeed, the Commission rejected proposals that attempted to move large industrial customers' base rates closer to rate parity. For example, the Decision rejected Freeport's arguments that attempted to *incrementally* move TEP's rates towards a cost of service model that more accurately matched cost with cost recovery by customer class. Freeport advocated for a reduction of revenue allocated to itself and other large power users based on the class cost of service study that results in a smaller increase of only 18.2 percent for the residential class. ROA 396, ep 13. Freeport further argued to eliminate half the $4.2 million subsidy, resulting in a rate increase for residential users of less than 1 percent above the rates ultimately approved in the Decision (from 12.6 percent to 13.11 percent for the residential class). ROA 484, ep 4; ep 12.

Although the rate allocation that the Commission eventually adopted reduced the overall amount of subsidies already being paid by large commercial

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[7] A 39.5% increase in margin revenue equates to only a 23.5% increase in total revenue to the residential class. ROA 717, ep 31-34.

and industrial users, the negative financial impact to the new 138kV customer class (*i.e.*, Freeport) is still so severe that the base rates can be neither just nor reasonable.

STATEMENT OF THE ISSUES

1. Did the Commission set unjust, unreasonable and discriminatory rates when it established base rates that require Freeport to pay an annual $4.2 million subsidy to benefit other customer classes?
2. Is the Commission's total annual revenue requirement allocation and continued subsidy requirement for Freeport supported by substantial evidence?

ARGUMENT

I. The Commission's rate allocation, which forces Freeport to subsidize other customer classes in the amount of $4.2 million annually, is unjust, unreasonable and discriminatory.

A. Arizona law prohibits the Commission from setting unjust, unreasonable and discriminatory rates.

The Arizona Constitution mandates that the Commission set "just and reasonable rates" for public services. Ariz. Const. Art. 15, § 3. Notwithstanding what has been described as the Commission's plenary authority in this area, the constitutionally prescribed "just and reasonable" standard imposes outer limits for ratesetting. *See Residential Util. Consumer Office*, 199 Ariz. at 591. Satisfying this standard requires the imposition of rates that are fair from the perspective of both the customer and the utility: "In determining what is a reasonable price to be charged for services by a public-service corporation, an examination must be made not only from the point of view of the corporation, but from that of the one served. . . ." *Ariz. Cmty. Action Ass'n v. Ariz. Corp. Comm'n*, 123 Ariz. 228, 231 (1979) (citation omitted).

Both the Arizona Constitution and statutes forbid discrimination in ratesetting. Utilities cannot discriminate when setting rates "for a like and contemporaneous service" and cannot impose an "unreasonable difference as to rates, charges, service, facilities or in any other respect, either between localities or *between classes of service*." Ariz. Const. Art. 15, § 12; A.R.S. § 40-334(B) (emphasis added); *see also* A.R.S. § 40-334(A) ("A public service corporation shall not, as to rates, charges, service, facilities or in any other respect, make or grant any preference or advantage to any person or subject any person to any prejudice or disadvantage."). These provisions demand that differential rates between customer classes must be reasonable and based on relevant differences with ample evidence supporting the varying treatment. *See Marco Crane & Rigging v. Ariz. Corp. Comm'n*, 155 Ariz. 292, 298 (App. 1987) ("It would be discriminatory and therefore unlawful for Southern Union to place Marco Crane in a better position than its other customers.").

Arizona law also mandates that a utility treat all similarly situated customers alike and charge the same rate for the same service regardless of the impact on the customer. *See S. Pac. Co. v. State Corp. Comm'n*, 39 Ariz. 1, 5-6 (1931). "A public service corporation must treat all similarly situated customers alike. It cannot extend a privilege to one and refuse the same privilege to another." *Marco Crane & Rigging*, 155 Ariz. at 297 (citation omitted); *see also Town of Wickenburg v. Sabin*, 68 Ariz. 75, 77-78 (1948) ("The common law upon the subject is founded on public policy which requires one engaged in a public calling to charge a reasonable and uniform price to all persons for the same service rendered under the same circumstances.") (citation omitted).

Plainly, unjust, unreasonable or discriminatory rates run afoul of Arizona law. Rates must be just and reasonable for the particular customer and also non-discriminatory when comparing the rates set among customers. As explained more fully below, the base rates set for Freeport fail to comport with these principles because they result in Freeport subsidizing other customer classes and are set far in excess of the cost of service to Freeport.

B. TEP's base rate for the 138kV customer class (Freeport) is unjust, unreasonable and discriminatory because it far exceeds the cost of service.

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.

When the Commission sets rates, it must consider whether the rate is confiscatory in that rates should reflect the utility's operating costs and also provide a reasonable rate of return on the utility's investment and provision of a public service. *See Ariz. Corp. Comm'n v. Mountain States Tel. & Tel. Co.*, 71 Ariz. 404, 413 (1951); *Scates*, 118 Ariz. at 533-34, 537 (overturning a rate increase because it did not consider the utility's costs or rate of return). As noted above, the rates must not only be fair to the utility under this standard but must be fair to the utility's customers.

Although not in the context of Commission-set rates, *Jung v. City of Phoenix*, 160 Ariz. 38 (1989) is instructive. After the City of Phoenix "doubled the water rates for those residing outside the geographical boundaries of the city[,]" water users outside of the city impacted by the increased rates filed suit. *Id*. at 39. The trial court dismissed the complaint, and the Court of Appeals reversed. On review, the Supreme Court held that the lawsuit could proceed, explaining that the city needed to set "reasonable" rates and must otherwise "have a reasonable basis for the discrimination in its charges." *Id*. at 41 (citation omitted). The Supreme Court further provided an example of how the city, on remand, could demonstrate reasonableness in setting the rates: "[p]roof that service of nonresidents involves greater expenses is sufficient to show a city acted reasonably in charging high rates for nonresidents." *Id*. (citations omitted). In other words, differential rates between customer classes can be explained by evidence of higher cost of service but there cannot be arbitrary differences.

In anticipation of the Commission's argument that the case law tolerates discrimination *between* classes and merely prohibits discrimination *among* members of a class, any such precedent is inapposite because of Arizona's specific non-discrimination language found in A.R.S. § 40-334(B), which provides that utilities cannot impose an "unreasonable difference as to rates, charges, service, facilities or in any other respect, either between localities or *between* classes of service." A.R.S. § 40-334(B) (emphasis added).

Here, the Commission set base rates for Freeport that significantly exceed TEP's costs to serve Freeport. In assigning a $4.2 million subsidy to Freeport to benefit other customer classes, the Commission set rates that are approximately 12 percent above Freeport's cost of service. Several revenue allocation witnesses in the proceeding before the Commission recognized that revenue should be derived through rates that reflect the cost of service to each customer class. ROA 606, ep 6; ROA 628, ep 10-11. In setting rates that are based on costs for each customer class, the Commission would insure equity among customers and encourage appropriate usage by those customers. By setting rates that exceed the cost of providing service to Freeport by such a significant margin, and by not adopting the cost standard of rate design, the Commission has set rates that are not just and reasonable.

C. TEP's rate for Freeport is unjust, unreasonable and discriminatory because it results in Freeport subsidizing other customer classes.

Precedent from other jurisdictions squarely addresses the issue presented through this appeal, holding that ratesetting should not result in the subsidization of one customer class by another class.

For example, in *Philadelphia Suburban Water Co. v. Pennsylvania Public Utility Commission*, 808 A.2d 1044 (Pa. Cmmw. Ct. 2002), the issue was whether a water utility's provision of essentially free hydrant service for the city of Coatesville established an unreasonable preference for that city as compared to the utility's other municipal customers. *Id*. at 1059. The law prohibited an unreasonable preference or advantage to a customer similar to Arizona law. Against this backdrop, the court found that the free service violated the law, focusing on cost as the key inquiry in that the utility could not favor one customer to the detriment of another: "in order for a rate differential to survive a challenge . . . the utility must show that the differential can be justified by the difference in costs required to deliver service to each class. The rate cannot be illegally high for one class and illegally low for another." *Id*. at 1060-61 (citation omitted); *see also City of Chicago v. Ill. Commerce Comm'n*, 666 N.E.2d 1212, 1218 (Ill. App. Ct.

1996) ("[I]t is unjust to charge one group of ratepayers for the costs of serving another group.").

In *City of Montrose v. Public Utilities Commission*, 590 P.2d 502 (Colo. 1979), the Colorado Supreme Court invalidated rates for ratepayers within Montrose City limits that surcharged only those ratepayers, rather than the general body of ratepayers, for franchise fees imposed by the city. In reaching that conclusion, the court indicated: "It follows that surcharging the franchise fees only to municipal customers is discriminatory. Those ratepayers already subsidize the rural customers by the fact that rural service is more expensive. To increase the municipal ratepayers' bill by surcharging the franchise fee only increases this subsidization." *Id*. at 505. The court held that these rates were unjust and discriminatory due to the increased subsidization. *Id*. at 506 ("Where all relevant costs are . . . attributed to the respective customers responsible for them, different rates would adequately and fairly reflect the differences in costs of service. Such a practice would clearly be just and reasonable. . . . [N]o attempt was made in this case to ascertain costs of service along municipal/non-municipal lines.").

The same principle expressed in the foregoing cases applies here. The Commission acknowledged that large power users like Freeport have historically subsidized residential users. ROA 513, ep 45. The Commission further acknowledged that to allocate the revenue deficiency evenly across the customer classes would widen this disparity and further entrench unfair and unjust subsidies. Indeed, the Decision rejected the option of simply spreading the $81.5 million revenue requirement deficiency evenly across the classes, as that "would perpetuate existing inequities, burdening the subsidizing classes." *Id*. The Decision also appreciated that the inter-class subsidies in the current rates support a "higher proportionate allocation of the revenue increase to those classes below the overall return, i.e. Residential, LGS and Lighting." *Id*. In fact, during the test year under those rates, the combined LPS/138 kV classes paid rates that produced a rate of return of 10.94 percent while residential customers paid rates that produced a 0.94 percent rate of return. *Id*.

Notwithstanding the fact that the Commission appreciated the inequity of this substantial subsidy, the Decision still established rates resulting in a $4.2 million subsidy by Freeport. ROA 513, ep 45-46. Similar to *City of Montrose* where municipal users inherently subsidized rural users even without paying additional fees, Freeport subsidizes residential customer class users by virtue of the fact that it is a large power user subject to improper cost allocations. The Decision did not make a significant movement to reduce or eliminate those inter-class subsidies by failing to provide Freeport a rate decrease based on the class cost of service study and, indeed, by raising the rates paid by Freeport.

D. The Commission's imposition of a subsidy on Freeport is a "policy" choice that disregards the "legal" standards under Arizona law and is inconsistent with the purpose of regulation.

Allowing the Commission to set rates in a way that results in a significant subsidy encourages the Commission to legislate, favoring one group over another as a matter of public policy. In that way, the Commission is engaging in socio-economic rulemaking unhinged from the Constitutional and statutory guideposts that are supposed to set the limits for ratemaking. Requiring Freeport to pay an additional subsidy on top of Freeport's cost of service is, in effect, a tax used to benefit selected other classes of customers. Revenue allocation is not a "policy" decision for the Commission but rather a "legal" decision based on the duty imposed on the Commission to set "just and reasonable rates" for all classes of customers.

For example, in *Mountain States Legal Foundation v. Public Utilities Commission*, 197 Colo. 56 (1979), the utility commission ordered that utility companies must provide a lower rate to low income elderly and disabled persons irrespective of the cost of service. When this challenge made its way to the Colorado Supreme Court, the court noted although these customers are "an unquestionably deserving group," "[e]stablishing a discount gas rate plan which differentiates between economically needy individuals who receive the same service is unjustly discriminatory." *Id*. at 59-60. Thus, although the commission had broad ratemaking authority, that commission's "power to effect social policy through preferential rate making is restricted by statute no matter how deserving the group benefiting from the preferential rate may be." *Id*. at 60.

Similar to *Mountain States Legal Foundation* where the public utility commission attempted to discount rates to low income individuals, subsidizing residential users at the expense of large commercial customers such as Freeport cannot be permitted even if the policy of avoiding rate shock or achieving gradualism for the favored classes appeals to the Commission. The Decision not only fails to rectify that subsidization but makes it worse by increasing the rates for the 138kV class (*i.e.*, Freeport), running afoul of the statutory bar on preferential ratemaking. Energy cost is Freeport's second-highest operating cost at the Sierrita Mine. ROA 519, ep 5; ROA 537, ep 17. The Commission failed to appreciate that if Freeport ceases to consume power as TEP's largest customer, then TEP will have to recover its annual revenue from the remainder of its existing customers. Certainly, this result would not be in the best interest of the other customer classes.

At a minimum, this Court should remind the Commission that the Constitutional and statutory provisions impose limits, which were exceeded here.

In addition to the fact that the Commission's policymaking disregards the legal standards, subsidies are not consistent with the underlying theory of regulation. Regulation of utilities is intended to operate as a substitute or proxy for competition in markets where competition does not exist—an unregulated monopoly can charge whatever rates it chooses whereas a competitive company cannot. To that end, the goal of regulating monopoly utilities is to provide customers with products and services at fair and reasonable prices that would exist in a competitive market. A competitive market would not tolerate rate class subsidies because consumers would choose a lower priced alternative that exists in such a market.

In fact, Freeport proposed a pilot program for TEP that would provide large customers limited access to the competitive market in the purchase of electric generation. Despite acknowledging the potential benefits to large customers, the Commission rejected the proposal based, in part, on the unknown "harm" it may cause to other customers and customer classes already receiving the benefit of subsidies. ROA 513, ep 125-126. Ironically, rather than provide Freeport with the intended benefits of regulated monopoly service, the Commission instead saddled Freeport with a $4.2 million subsidy for the benefit of those very same customers who the Commission determined might be potentially harmed as a result of Freeport's market-based proposal. The Commission's determination of rates in this regard was unjust and unreasonable and clearly discriminatory to Freeport and other large customers.

At least once the Arizona Supreme Court has noted the importance of cost-based charges as a way to avoid discrimination albeit in the context of an electric utility cooperative. In *Application of Trico Electric Cooperative, Inc.*, after citing the non-discrimination provisions found in the Arizona Constitution and statutes, the Court explained that "courts and regulatory bodies have frequently recognized that electric cooperatives [are] organized to serve members only . . . at cost . . . ." 92 Ariz. 373, 385-86 (1962). Because a cooperative is comprised of the individuals to whom service is rendered, the members only pay the cost of service without a return on investment. To render nondiscriminatory rates by a cooperative, all customers must be charged rates at cost if the members are charged their cost of service. In other words, a cooperative cannot charge some members rates based on cost but charge others cost plus a rate of return, requiring the latter to essentially subsidize the former. The same principle applies here.

Compelling Freeport to pay an additional several million dollars a year purely in subsidies is unreasonable, unhinged from the legal standards and inconsistent with the purpose of the regulation. The fact that the Commission is effectively legislating through its subsidy determinations underscores the unjust and unreasonableness of the Decision, as the Commission has plainly disregarded the Constitutional and statutory standards.

II. Even if this Court determines that rates for Freeport are not facially unconstitutional or discriminatory, the Commission's rates are not supported by substantial evidence.

Assuming *arguendo* that the rates set are not facially invalid, the Commission erred in setting rates that were not based on substantial evidence. A party appealing a decision of the Commission has the burden of proof to establish by "clear and satisfactory evidence" that a rate is unreasonable or unlawful. A.R.S. § 40-254(E). A decision of the Commission on a litigated issue, however, in a rate case must be supported by substantial evidence. *See Litchfield Park Serv. Corp. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 434 (App. 1994). Evidence that is wholly speculative is not substantial and cannot support a Commission order. *See City of Tucson v. Citizens Utils. Water Co.*, 17 Ariz. App. 477, 481 (App. 1972) ("Mere speculation and arbitrary conclusions are not substantial evidence and cannot be determinative.").

Courts in other states have reversed commission decisions where the record did not contain substantial evidence to support the rate design even after concluding that the rates were not facially discriminatory or unreasonable.

For example, in *California Manufacturers Ass'n v. Public Utilities Commission*, 24 Cal.3d 251 (1979), certain customers challenged the commission's allocation of rate increases among consumers and argued that conservation rates were unsupported by the evidence. *Id*. at 255-56. Rejecting a facial challenge that the commission set discriminatory rates because the rates were not reflective of cost of service, the court concluded that the commission could consider factors other than cost of service in setting rates, but found the record was insufficient to determine whether the differences resulted in rates that were arbitrary or discriminatory. *Id*. at 260-61. The court remanded the case to the commission to adopt a new rate spread supported by adequate findings. *Id*. at 261-62.

In *Colorado-Ute Electric Ass'n, Inc. v. Public Utilities Commission*, 760 P.2d 627 (Colo. 1988), the Colorado Supreme Court upheld a trial court order vacating a portion of a commission rate order allocating $24 million in demand costs to rates that recover variable energy costs. *Id*. at 645-46. The customers challenged these rates as not supported by substantial evidence and as discriminatory in requiring high load customers and summer customers to subsidize low load and winter users. The court noted that the expert witness testifying in support of the proposal offered no substantial evidence to support it. *Id*. at 647-48. The Supreme Court declined to reach the discrimination claim as it had already reversed the portion of the order setting these rates due to a lack of evidence in the record. *Id*. at 649.

Finally, in *Application of Hawaiian Electric Light Co., Inc.*, 594 P.2d 612 (Ha. 1979), the court invalidated portions of a declining block rate for electricity where there was no evidence offered by the utility to support the basis for some of the declining blocks and, therefore, the rates would be set aside as unsupported by the evidence and otherwise discriminatory.

Here, the record plainly establishes that the rates set for the 138kV class are not supported by substantial evidence in two respects, both of which are explained more below.

First, the Decision does not provide substantial evidence as to why the Commission should continue to "perpetuate existing inequities" other than to reference two concepts: rate shock and gradualism. The only justification provided for continued subsidization and inequity—the need to avoid rate shock—has been rejected by another jurisdiction. Indeed, no evidence in the record suggested that eliminating or reducing the subsidy paid by Freeport would result in rate shock for any customer class. To the contrary, the evidence demonstrates that the rate increase needed to bring the residential class to cost of service does not constitute "rate shock" because the Commission has imposed much higher rate increases on other utility customers. *See infra* at 36. Likewise, the Commission's purported application of the concept of "gradualism" to reduce existing subsidies does not alone render the resulting rates for Freeport just and reasonable when the parties agree that cost causation should be the rate design and cost allocation methodology. The Decision furthers historic inequities by requiring Freeport to pay a tax used to benefit the residential customer class without the substantial evidence necessary to continue such a practice.

Second, the revenue allocation to the favored customer classes was set without regard to the class cost of service study, and the only witness who provided testimonial support as to the allocation did so on the basis of his own "principles" that are completely arbitrary.

A. Rate shock and gradualism cannot sustain requiring Freeport to further subsidize the residential class.

The Decision's sole "evidentiary" basis for requiring Freeport to pay a subsidy is the need to avoid rate shock by purporting to employ gradualism in moving rates towards cost. In that regard, although the Decision suggests that an increase of 39.5 percent in margin revenue for the residential class would be unreasonable, the Commission fails to appreciate that such an increase only results if ALL customers' rates were immediately moved to cost. However, a reduction of the revenue requirement allocated to some of the classes would assist in the process of moving TEP towards rate parity for all its customer classes without necessarily increasing rates for other classes in an amount that might cause rate shock. The Commission failed to provide any reasoned explanation or threshold for "unreasonable rate shock." For example, reducing the revenue allotted to the 138kV and Large Power Service classes to reflect the true cost of those rates would result in an increase to residential customers of 18.2 percent. ROA 396, ep 13. In fact, the evidence before the Commission demonstrates that eliminating half the subsidy to be paid solely by Freeport, which Freeport advocated below as a reasonable alternative to the recommendations made by the Administrative Law Judge, would result in a reallocation of revenue to the residential class that would raise those rates by less than one percent (from 12.6 percent to 13.11 percent). ROA 484, ep 4; ep 12. This approach is consistent with the concept of gradualism.

The Commission touts gradualism without actually employing it, rendering it meaningless to those customers who must continue paying subsidies. Despite the Commission's acknowledgment that large customers have been subsidizing residential customers for many rate cases, the Commission has done very little in the past to address this ongoing inequity. The fact that $4.2 million represents an annual subsidy that may be slightly lower than the amount Freeport has paid in previous years is insignificant in light of the Commission's historic practice of recognizing that rates need to move toward rate parity, but continuing to set rates that involve a subsidy. Freeport and other large power users who pay subsidies can only conclude that eliminating the subsidy altogether–which is the intended result of gradualism–will not be achieved in the foreseeable future.

Further, the Commission's conclusion that bringing all customer classes to rate parity is unreasonable due to "rate shock" is inconsistent with numerous decisions of this Commission. In 2016 alone, the Commission approved a number of increases for rates that range between 51.1 percent to 274.6 percent. *See* Decision No. 75925 (Eden Water Co. – 51.1 percent); Decision No. 75811 (Dateland Water Co. – 274.6 percent); Decision No. 75696 (Oatman Water Co., – 100 percent); Decision No. 75686 (Picacho Peak Water Co. – 48.9 percent). As these figures demonstrate, the Commission's conclusion that bringing all customers to rate parity, or alternatively reducing the amount of subsidies paid by Freeport and other large power users, would constitute unreasonable rate shock is both arbitrary and capricious in light of their decisions in other contexts.

Finally, the concern of "rate shock" as a basis for sustaining continued inequitable subsidies has been rejected by another jurisdiction. In *Lloyd v. Pennsylvania Public Utility Commission*, 904 A.2d 1010 (Pa. Commw. Ct. 2006), the public utility commission determined that gradualism limited the increase of electricity rates for a subsidized residential customer class to 10 percent (to prevent rate shock when addressing a $164.4 million revenue shortfall). Rejecting this reasoning, the court noted the commission "does not explain why 10 percent of the total bill is the magic number that will prevent rate shock; it is just a number before which all other considerations must fall." *Id*. at 1020. The court found that this arbitrary restriction resulted in furthering historic inequities and disproportionality burdened business customers with higher rates to subsidize residential users.

The court also concluded that the commission did not explain how the discrimination between rate classes would be lessened, relying instead solely on principles of gradualism to limit increases to 10 percent to prevent rate shock. *Id*. The court rejected the commission's reliance on gradualism, writing that "gradualism is but one of many factors to be considered and weighed by the [c]ommission in determining rate designs" and that "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." *Id.* Due to the fact that the proposed increases furthered and exacerbated historic inequities, and because the commission offered no explanation on how this discrimination would be addressed, "in effect, the [c]ommission has determined that the principle of gradualism trumps all other ratemaking concerns–especially the polestar–cost of providing service." *Id.* The court therefore invalidated the commission's decision due to its reliance on the principle of gradualism rather than substantial evidence to support the rates set.

Here, *Lloyd* teaches that barring no other substantial reasons or evidence, gradualism and rate shock should not be used as justifiable principles to permit continued subsidization of one class of customers over another. The $4.2 million subsidy to be paid by Freeport is based primarily on the Commission's concern of rate shock to the residential class. Testimony incorporated into the Decision indicated that moving all classes to a UROR of 1.0 would translate into an overall increase of 39.5 percent in margin revenue for the residential class. As in *Lloyd*, however, the Commission provided no analysis as to what level of increase would constitute rate shock for the residential class. As previously addressed, the evidence that Freeport presented regarding rate shock was that a 39.5 percent rate increase in margin revenue for residential customers was actually lower than several other rate increases the Commission authorized for other public service corporations within the past 24 months.

The Decision's reliance on the principles of rate shock and gradualism are an insufficient evidentiary basis to support the revenue allocation.

B. The Decision's allocation of $54.5 million to the residential class was arbitrary.

The record developed in this proceeding simply does not support the revenue allocation fixed in the Decision. Despite the acknowledgment by the Commission for the need to reduce and eliminate subsidies by moving rates for each class of customers closer to the cost of providing service, the Decision nonetheless allocates a substantial portion of the revenue requirement to one customer in the 138kV class. This allocation was arbitrarily set.

The Commission relied primarily on the Staff's rate design witness (Solganick) as the basis for the revenue allocation to the residential class. Solganick relied on three "guiding principles" of revenue allocation that he arbitrarily decided should apply: (i) that individual rate classes should be gradually moved towards a UROR of 1.000 over one or more rate cases; (ii) there should be an upper bound of 150 percent for any class percentage increase in revenue compared to the overall percentage increase in revenue; and (iii) there should be a lower bound of 50 percent for any class's increase compared to the overall increase. ROA 716, ep 26. Solganick chose to apply a fourth principle in this case, which was that it would be inappropriate to provide any customer class a rate decrease due to TEP's purchase of the Gila River combined cycle generating unit for the "benefit" of all customers. ROA 717, ep 8.

These guiding principles are not found in any rule of the Commission and are not derived from statute or Arizona case law. In fact, they seem to cut against what every party–even Commission Staff–recognize as a basic tenet of revenue allocation and rate design, which is to match cost causation with cost recovery among customer classes. The arbitrariness of these principles is best illustrated by unpacking the last one—that no customer class should receive a rate decrease.

Solganick testified that the recommendation to allocate $54.5 million to the residential class was not based on any cost basis and, in fact, did not meet his own targets for rate design. ROA 540, ep 220-221. Rather, that allocation came from the fact that he believed (as a basic proposition) that no class should receive a rate decrease despite the results of the class cost of service study, which showed that large commercial and industrial customers like Freeport were paying rates significantly above TEP's cost to serve them. *Id.* There are two problems with relying on this testimony as substantial evidence to support the rates set in the Decision for Freeport.

First, Solganick based his position that no customer class should receive a rate decease on his own "perceptions" rather than "facts." During the test year, TEP purchased a combined cycle natural gas power plant, which Solganick hypothesized benefited all customers. ROA 717, ep 8. Solganick explained, in relation to that power plant, "there could be a perception, maybe not a fact, but there could be a perception among certain customers that they paid for the whole thing and some of the benefits went to people who didn't pay at all." ROA 540, ep 221. Whether a newly purchased power plant facility benefits "some" or "all" customers does not undercut the conclusions reached in the class cost of service study, and certainly should not be a basis to disregard the allocations set forth therein. *See City of Tucson*, 17 Ariz. App. at 481 (holding that speculative evidence is not substantial evidence). Plainly, Solganick discounted the results of matching cost causation with cost recovery in order to address his own "perceptions," not facts. Not only does basing part of the revenue allocation on this "perception" demonstrate a lack of evidence to support Staff's revenue allocation to the residential class, but it certainly underscores that the allocation was arbitrary and capricious.

Second, Solganik's principle that no customer should receive a rate decrease in light of the TEP revenue requirement deficiency does not support or explain allocating a portion of that deficiency to Freeport. Although Solganick's principle might suggest (albeit incorrectly) that the Commission should not lower the rates to Freeport even if the existing rates were above cost, it does not mandate increasing rates to Freeport by allocating additional revenue requirement to a class of service that is already paying rates that exceed its cost of service.

Finally, one of Solganick's "principles" was that he believed addressing the mismatch between cost causation and cost recovery between customer classes should be implemented over one or more rate cases. Thus, he explained that although the Commission Staff's revenue allocation plan articulated the concept that "[r]ates should be based on costs derived from class cost of service studies," it is only a long-term plan that may eventually be the case. ROA 717, ep 14. It was ultimately not the guide followed by Staff, Solganick or the Commission here. In other words, although setting rates based on cost of service in this case is the proper ratemaking methodology, as Solganick himself admits, doing so would violate Solganick's and Staff's guiding "principles" of gradualism employed in this proceeding. These principles, in the end, guided in significant part the revenue allocation adopted by the Administrative Law Judge and the Commission. They are not, however, substantial evidence to support the Decision.

Solganick's inability to provide a substantial evidentiary basis for his allocation of the revenue to the residential customer class, which was adopted by the Commission, requires that the allocation of the revenue requirement to the residential class be set aside.

CONCLUSION

The Court should reverse the Commission's revenue allocation and the subsidy imposed on Freeport and remand this matter to the Commission with guidance that explains the primary role of cost of service in setting just and reasonable rates.

RESPECTFULLY SUBMITTED this 8th day of August, 2017.

FENNEMORE CRAIG, P.C.

By *\/s/ Timothy Berg*

Timothy Berg (No. 004170)
Patrick J. Black (No. 017141)
Carrie Ryerson (No. 028072)
Attorneys for Appellant
Freeport Minerals Corporation

CERTIFICATE OF COMPLIANCE

Pursuant to Rule 14, Ariz. R. Civ. App. P., the undersigned counsel certifies that the Opening Brief of Appellant Freeport Minerals Corporation uses a proportionately spaced typeface of 14 points or more, and is double-spaced using a Time New Roman font. According to the Microsoft Word word count function, the Opening Brief contains 7,840 words, excluding the Table of Contents, Table of Authorities, Certificate of Service, this Certificate of Compliance, and any addendum.

RESPECTFULLY SUBMITTED this 8th day of August, 2017.

/s/ Timothy Berg
Timothy Berg

CERTIFICATE OF SERVICE

Timothy Berg hereby certifies that on August 8, 2017, he caused the Opening Brief of Appellant Freeport Minerals Corporation 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.

Bradley S. Carroll Megan DeCorse TEP Electric Power, Inc. 88 E. Broadway, MS HQE910 P.O. Box 711 Tucson, Arizona 85702 BCarroll@tep.com MDeCorse@tep.com Michael W. Patten Timothy Sabo Snell & Wilmer One Arizona Center, 400 E. Van Buren Phoenix, Arizona 85004 mpatten@swlaw.com tsabo@swlaw.com	Robin Mitchell Wesley VanCleve Legal Division Arizona Corporation Commission 1200 W. Washington Phoenix, AZ 85007 rmitchell@azcc.gov WVancleve@azcc.gov Arizona Corporation Commission Legal Division 1200 W. Washington Phoenix, AZ 85007 legaldiv@azcc.gov

Additionally, a courtesy copy of the Opening Brief was sent via U.S. Mail to:

Hon. Jane L. Rodda
Administrative Law Judge
1200 W. Washington
Phoenix, AZ 85007

/s/ Timothy Berg
Timothy Berg

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