COURT OF APPEALS

STATE OF ARIZONA

DIVISION TWO

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

APPELLANT'S REPLY 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

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES

CASES **PAGE**

CONSTITUTIONS

STATUTES

OTHER

INTRODUCTION

Freeport asserts three arguments related to the $4.2 million subsidy Freeport must pay to benefit the residential class: (1) the revenue allocation is unjust and unreasonable in violation of the Constitution; (2) the revenue allocation is discriminatory in violation of the Constitution and statutes; and (3) the revenue allocation is not supported by substantial evidence.

Freeport is not arguing the Commission must set rates based only on cost of service to customers. Instead, Freeport argues the Constitutional requirement of "just and reasonable rates" must have some substantive content and meaning as to customers as well as public service corporations. Respondents' position is that the Commission is omnipotent and any rates that the Commission sets are necessarily "just and reasonable." That cannot be the standard.

Freeport is not arguing that all subsidies violate the Constitution. Deviation from cost of service in setting rates may be "just and reasonable" in certain situations such as low income assistance. With respect to subsidies to benefit low income assistance, for example, that subsidy is collected from a large (if not entire) group of ratepayers to help a smaller group. Low income assistance subsidies are imposed through pennies on each bill. Here, in contrast, one customer—Freeport—pays millions of dollars annually to benefit a larger group—the

residential class. Likening low income subsidies to the subsidy Freeport pays is intellectually disingenuous in light of the two foregoing critical distinctions.

Respondents characterize Freeport's position as one of impatience—Freeport does not believe the Commission is moving quickly enough towards cost of service in rate cases. That is absolutely correct. All parties agree that rates and ratemaking should reflect cost of service. Indeed, TEP noted in its answering brief that it "supports moving toward elimination of the interclass subsidy borne by the commercial and industrial classes," recognizing "that electric rates are especially important in an energy-intensive industry like mining." TEP Answering Brief at 2. TEP even acknowledged it "supported a greater reduction in the interclass subsidy than what the Commission ultimately approved." TEP Answering Brief at 2.

The Commission argues against cost of service, contending that "favoritism is not in the public interest." ACC Answering Brief at 52. Freeport agrees that favoritism is not in the public interest. The Commission employed favoritism on behalf of residential customers. The Commission is under the illusion that large customers like Freeport can simply pass-through its power costs through its business activities. ACC Answering Brief at 50. Unlike TEP (which is a regulated monopoly), Freeport must compete on a global scale, managing increased operating costs by, for example, reducing operations based on market conditions.

The Commission professes to understand the importance of cost-based rates while making no material move in that direction, expecting Freeport to sit idly by while its rights are violated and millions of dollars are at stake. Although the Commission has paid lip service to the need to move towards cost of service over the last two decades, Freeport filed this challenge because the Commission has not made meaningful progress towards that goal. The fact that Freeport offered a compromise before the Commission—by suggesting a lesser subsidy—does not mean it agreed with the premise of the $4.2 million dollar subsidy. To the contrary, like any other party in litigation, Freeport was willing to settle for less than what it is legally entitled to in an effort to obtain a certain and prompt result.

TEP claims it is impossible for this Court to provide a "North Star" to guide the Commission in setting rates. Precedent here and elsewhere belies this argument. Freeport is asking for this Court to provide a "North Star" to help guide the Commission in setting rates and to provide limits on the Commission's power to compel large customers like Freeport to subsidize an entire customer class.

LEGAL ARGUMENT

I. The Commission's compliance with the Constitutional and statutory standards is a legal issue that this Court reviews de novo.

Freeport's two legal arguments on appeal—that the Commission violated the Constitution and statutory standards—are subject to de novo review on appeal. TEP recognizes this fact and notes "[t]he Arizona Constitution . . . specifically provides for appeals as a check on the elected commissioners." TEP Answering Brief at 15 ("[R]eview of legal issues is *de novo*.").[1]

Freeport also presents a factual issue, arguing the Commission's rate for Freeport is not supported by substantial evidence. Again, TEP's explanation of the substantial evidence test is fitting: "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." TEP Answering Brief at 15.

II. The Commission's authority is not without limits and the Constitution provides this Court with the standards by which to judge the Decision.

Respondents' primary argument is that the Commission's ratesetting power is beyond the courts' reach. Although the Commission is given deference, its

[1] The Commission ignores that Freeport presents two *legal* issues through this appeal, focusing on the factual issue in the standard of review. The Commission also incorrectly contends that compliance with the Constitution is a fact question.

Decision is subject to appellate review, and there are justiciable standards by which to judge the Decision.

A. The Commission's ratemaking process is quasi-judicial and subject to appellate review.

Arizona courts have held that ratemaking proceedings are quasi-judicial in nature and subject to appellate review. *See, e.g.*, *State ex rel. Corbin v. Ariz. Corp. Comm'n*, 143 Ariz. 219, 221 (App. 1984); *Residential Util. Consumer Office v. Ariz. Corp. Comm'n*, 199 Ariz. 588, 591 (App. 2001) ("Although the Commission's authority to prescribe rates is plenary . . . , the Commission's rate-making authority is subject to the 'just and reasonable' clauses of . . . Constitution.").

For example, at issue in *Residential Utility Consumer Office* was a substantive Constitutional challenge to Commission rates, alleging, among other things, the rates were not just and reasonable. Although the specific facts are irrelevant, the fact that an appeal was well-taken following a ratesetting process supports Freeport's position here that judicial review is appropriate to determine whether the Commission has met the controlling constitutional requirements.

Similarly, in *State ex rel. Corbin*, improper *ex parte* communications occurred during the pendency of TEP's application for rate increases, which violated the other parties' right to a full and fair hearing. Although the

Commission in *Corbin* "recognize[d] . . . that agency proceedings leading to rate decisions are quasi-judicial in nature and thus subject to judicial scrutiny and review relating to compliance with statutory requirements and constitutional due process standards[,]" the Commission took the position that it was nonetheless immune from judicial review. *State ex rel. Corbin*, 143 Ariz. at 224.

This Court soundly rejected that premise: "[W]e find no validity in the Commission's contention that its constitutional genesis gives rise to the claimed complete procedural autonomy in rate proceedings, free from legislative control or judicial scrutiny and review." *Id.* at 224-25. The Court plainly stated that ratemaking (even if legislative in nature) was subject to judicial review: "even though an agency rate decision is of a legislative character, the proceedings leading to that decision are quasi-judicial in nature and therefore subject to judicial review for compliance with constitutional or legislatively imposed requirements and compliance with general due process standards governing quasi-judicial proceedings." *Id.* at 225-26 ("[W]e hold that in a rate-making proceeding the process by which the Commission gathers evidence through evidentiary hearings

and reaches its ultimate decision is quasi-judicial in nature and therefore subject to judicial review.").[2]

The fact that a party can appeal from a ratemaking case is evidence in and of itself that Commission decisions are reviewable. Both Arizona's Constitution and statutes set forth this appellate right. Ariz. Const. Art. 15 § 17; A.R.S. § 40-254. Commission decisions are subject to judicial review to ensure compliance with the Constitutional and statutory standards. Indeed, in *Corbin*, the Court noted that the Constitution's provision of a right to appeal—through which this instant case is brought—evidences the fact that the Commission's ratemaking process is reviewable. *State ex rel. Corbin*, 143 Ariz. at 225. TEP even acknowledges that the Commission's authority in this space "is not boundless[.]" TEP Answering Brief at 15.

Setting aside Respondents' hyperbole, Freeport is not asking this Court to overturn well-established precedent regarding the Commission's authority. To the

[2] The Commission quotes the Arizona Constitutional Convention out of context, implying the framers indicated that ratemaking is beyond a court's review. ACC Answering Brief at 24. That quote is in the middle of a discussion related to a proposed amendment to give the Commission the "power to put a fair valuation on all public service corporations and may base charges and rates thereon." In response, a framer noted it would be too time-consuming "for a Corporation Commission in one year to fix the valuation for the public service corporations in the territory would be a big task." Records of the Arizona Constitutional Convention of 1910 at 979 (John S. Goff, ed. 1991).

contrary, Freeport is requesting that this Court vindicate Freeport's clearly established appellate rights found in Arizona's Constitution and statutes.

B. There are standards by which to judge the Commission's Decision and Freeport requests that the Court provide a "North Star" to flesh out those Constitutional and statutory standards.

TEP argues "[t]here is no North Star here," contending that the Constitution empowers the Commission to set just and reasonable rates and that "only the Commission" can assess whether that standard is met.[3] TEP Answering Brief at 25. In support of this argument, TEP likens the "just and reasonable" standard to the Constitutional requirement that tuition at state universities be "as nearly free as possible." *Id*. at 24-25. This analogy is wrong. "Just and reasonable" is not a content-less standard and is judicially discernible. To hold otherwise would ignore precedent in Arizona and elsewhere.

TEP's brief makes clear that it agrees "just and reasonable" is justiciable. TEP believes that the standard requires rates that provide TEP with a reasonable

[3] If that were the case, then the Constitution would have stated: "The Corporation shall have the full power to, and shall, prescribe ~~just and reasonable~~ classifications to be used and ~~just and reasonable~~ rates and charges to be made and collected . . . ." The words "just and reasonable" cannot be ignored when interpreting the Constitution. *See City of Phx. v. Yates*, 69 Ariz. 68, 71 (1949) ("In the interpretation of a . . . constitution . . ., the cardinal principle is to give full effect to the intent of the lawmaker. . . . Each word, phrase, and sentence must be given meaning so that no part will be void, inert, redundant, or trivial."). The fact that there are standards and an appellate review process in the Constitution certainly indicates the Commission's plenary authority is subject to judicial review.

return on its investment. TEP Answering Brief at 16. TEP's clear view is that the Constitution protects only the utility from confiscatory rates that result in insufficient return to TEP. According to TEP, the just and reasonable rate standard provides no protection to the utility's customers. This asymmetrical view cannot be the purpose of the Constitutional requirement of "just and reasonable" rates. Taking TEP's argument to its logical extreme, the Commission could impose subsidies across the board without any limits. It could require one customer to pay rates that would support the provision of free service to all of the utility's other customers. Such a reading of the Constitution is insupportable. The more rational and symmetrical view is that "just and reasonable" not only protects utilities from confiscatory rates but also protects customers from unreasonable rates that are far removed from the cost of service. *See Adams v. Bolin*, 74 Ariz. 269, 275-77 (1952) (holding it is a fundamental tenet of constitutional interpretation that the Court should not apply a rule that would lead to absurd results).

Tellingly, the Commission did not join TEP's argument that "just and reasonable" is not justiciable. It would be difficult to do so in light of the Arizona precedent interpreting the "just and reasonable" standard. *See, e.g., Ariz. Corp. Comm'n v. Mountain States Tel. & Tel. Co.*, 71 Ariz. 404, 406-7 (1951). Arizona's "just and reasonable" language is similar to the standard imposed in other states,

and courts have interpreted similar language, demonstrating it is a "manageable" standard. *See* Freeport Opening Brief at 24-26.

Misinterpreting Freeport's argument, the Commission tries to defeat a straw man, contending the reviewing courts in *Scates* and *Simms* "criticized the Commission for mechanical formula based rate setting[.]" ACC Answering Brief at 26. Freeport is not advocating that this Court impose a rigid formula on the Commission. Even if Freeport were arguing as much, the Commission misreads those cases. *Scates* and *Simms* invalidated rates for a failure to meet the Constitutional mandate of determining fair value, not the use of a rigid formula.

Whether the rate set for Freeport is "just and reasonable" or "discriminatory" are questions this Court can and must address. Freeport is asking for this Court to provide guidance as to when a subsidy wholly unconnected to cost of service is too much. Freeport contends that occurred here, and this case presents a good example in which the Court can identify an outer limit.

III. The Commission's revenue allocation is not "just and reasonable" and, thus, violates the Arizona Constitution.

A. The "just and reasonable" rate standard supports that rates cannot be set on the basis of ability to pay but rather on the cost of service.

The Arizona Constitution mandates "[a]ll charges made for service rendered . . . shall be just and reasonable, and no discrimination in charges, service or

facilities shall be made between persons or places for rendering a like and contemporaneous service . . . ." Ariz. Const. Art. 15 § 12. This section has been interpreted to stand for the proposition that "rates may not be set on the basis of ability to pay, but rather on the basis of the service provided." John D. Leshy, The Arizona State Constitution 296 (1993) (citing *S. Pac. Co. v. Corp. Comm.*).

The Arizona Constitution similarly states "[t]he corporation commission shall . . . prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations . . . ." Ariz. Const. Art. 15 § 3.

The Commission argues that because rates for senior citizens or other discrete deserving groups such as low income populations do not run afoul of the Constitution, providing lower rates to certain classes that are unrelated to cost of service is part of the "policy-making" powers that are unreviewable by this Court. The Arizona Attorney General disagrees.

In Opinion No. 63-2, the issue was whether the Commission could "authorize a lower water rate (just and reasonable) to natural persons living on pensions, welfare, or relief, and who are also over the age of 65 . . . taking into consideration Arizona Constitution Art. 15 § 12 and A.R.S. § 40-334?" Arizona Attorney General Opinion 63-2 (Dec. 1962). The Attorney General first noted that

"[i]t is a well known rule of law that a public utility cannot discriminate unjustly in its rates to consumers similarly situated or of the same class for the same kind of service." *Id*. As a corollary, it is not discrimination if the rates are "based upon a reasonable classification **corresponding to actual differences** in the situation of the consumers or the furnishing of the service." *Id.* (emphasis added). Differential rates would veer into discrimination if the classifications were "arbitrary." In light of the non-discrimination mandates in the Constitution and given that A.R.S. § 40-335 identified who could be given free or reduced rates and persons over 65 were not listed, the Attorney General concluded the Commission did not have the power to provide lower public utility rates to those persons.[4]

Whether lower economic classes and senior citizens may benefit from subsidies paid by others is not at issue.[5] The subsidy here goes to the entire

[4] The Commission cites this Attorney General opinion. ACC Answering Brief at 32. Both the Commission and Freeport read the opinion the same way but the issue presented is whether there is a basis for treating Freeport differently by imposing the subsidy. In other words, the issue is whether the difference in treatment as to the subsidy is reasonably related to the differences between Freeport and residential customers.

[5] There are subsidies that may satisfy the just and reasonable standard. Low income assistance programs are examples of where all rate classes (*i.e.*, the many) pay just a little bit more in rates to help subsidize the needy (*i.e.*, the few). In this case, however, the Commission makes one very large customer (*i.e.*, the few) pay millions of dollars more in rates in order to help residential ratepayers (*i.e.*, the many). That is not just and reasonable.

residential and lighting classes, not discrete disadvantaged groups. The concept that can be gleaned from the Attorney General opinion is that if certain classes who are otherwise similarly situated are treated differently, then there needs to be a reasonable justification for the differential treatment and the differential treatment must be related to the difference between the groups.[6]

The Commission argues that *Town of Wickenburg v. Sabin* should be ignored because it relates to municipality utility rates. ACC Answering Brief at 37. That argument, however, is not based on a principled distinction. For purposes of assessing what constitutes discrimination and whether the "just and reasonable" standard is violated, there is no difference between utility rates for a municipal provider and utility rates for a public service corporation. Indeed, the Court of Appeals has previously cited *Town of Wickenburg* for the proposition that public service corporations cannot discriminate, undercutting the Commission's argument that *Town of Wickenburg* only applies to cities and not public service corporations. *See Phelps Dodge Corp. v. Ariz. Elec. Power Co-op., Inc.*, 207 Ariz. 95, 118 ¶ 98 (App. 2004) (citing *Town of Wickenburg* for this proposition: "public

[6] The fact that other customers also may be paying subsidies is beyond the scope of this appeal because those parties did not exercise their appellate rights to challenge unlawful discrimination.

service corporation obligated to furnish service to each patron at same price charged to other patrons for substantially similar service").

Respondents argue the Constitution does not require a "strictly-cost based approach" in ratemaking. TEP Answering Brief at 16-18. The Court need not reach that issue. The question before this Court is whether the Commission exceeded the Constitutional standard by setting a rate that imposed an arbitrary $4 million subsidy on Freeport. This Court need not find the Constitution requires a "strictly-cost based approach" but rather simply needs to hold the Constitutional standard was exceeded here because the amount of the required subsidy renders the rates both discriminatory and not just and reasonable.[7]

[7] To the extent Respondents argue the subsidy is just and reasonable because the amount of Freeport's increase was not substantial, that argument misses the point. Just and reasonable is not measured by the amount of the increase to which Freeport was subjected but whether the resulting rates are just and reasonable. TEP's witness responded to the question "Is there one principle in rate design that is foundational or primary?" in the following instructive way: "Yes. The principle of cost-causation, *i.e.* rates should reflect cost based recovery. The further away you get from this fundamental foundation, the closer you get to unduly burdensome and discriminatory rate structures that allow for both intra- & inter-class subsidization." ROA 597, ep 12:15-19. Without such a standard, the line between "just and reasonable" and "unduly burdensome and discriminatory" rate structures will continue to render the protections afforded to customers under the Constitution meaningless.

B. The Commission cannot create a new class for only Freeport to subvert the Constitutional and statutory standards.

Respondents argue the Constitution does not prohibit interclass subsidies and the fact that Freeport is the only member of its class necessarily means that its rate does not violate the Constitution's mandate that persons receiving "a like and contemporaneous service" not be discriminated against in ratesetting. TEP Answering Brief at 18-20; ACC Answering Brief at 31-32.

If taken to the logical extreme, TEP's argument would mean that the Commission need only relegate customers to a separate class in order to discriminate against them. Classifications in and of themselves must be just and reasonable and cannot be created solely to support rate differences. The issue is whether the differences in characteristics support different rates.

The fact that Freeport is in its own class does not mean that the rate is otherwise just and reasonable. *See* TEP Answering Brief at 19-20. As the single member of the 138kV, which is a new class created through the Decision, the Commission actually fixed a problem in the rates that had existed for years. Freeport is the only TEP power consumer that takes its power directly from the transmission grid, obviating the need to use most, if not all, of TEP's distribution equipment. ROA 628, ep 20-22. Thus, Freeport should not be paying such distribution-related costs, which it had been historically paying. TEP's own

witness Edwin Overcast admitted that Freeport should not be charged for certain distribution-related costs. ROA 533, ep 75. In other words, allowing Freeport to not pay for distribution costs (when it was not using TEP's distribution system) is an action to which Freeport was already entitled under proper ratemaking processes, and thus Freeport did not receive "favorable" treatment as TEP suggests. *See* TEP Answering Brief at 25-26. The fact that this problem was finally addressed does not negate the harm to Freeport that continues in the form of the subsidy at issue here.

IV. The Commission's rate for Freeport is discriminatory and, thus, violates A.R.S. § 40-334.

A. Freeport did not waive the A.R.S. § 40-334 claim.

TEP admits Freeport included the statutory discrimination claim in its Application for Rehearing. TEP Answering Brief at 20. That is sufficient to preserve such an argument for appeal under the controlling law.

TEP's waiver argument has been previously rejected. *See Litchfield Park Serv. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 438 (App. 1994) (indicating there is no requirement to include arguments in a post-hearing brief in order to preserve an issue for appeal).

Tellingly, TEP cites no precedent dealing with Commission decisions for its argument. None likely exists because the statute under which this appeal is

brought makes plain the preservation of an issue for appeal arises out of the application for rehearing: "No claim arising from any order or decision of the commission shall accrue in any court to any party or the state unless the party or the state makes, before the effective date of the order or decision, application to the commission for rehearing." A.R.S. § 40-253(B). "We find this language clear and unequivocal—a party cannot challenge an order or decision of the Commission in court unless an application for rehearing has been previously filed with the Commission." *Save Our Valley Ass'n v. Ariz. Corp. Comm'n*, 216 Ariz. 216, 220 ¶ 15 (App. 2007) (citation omitted). The obvious policy reason behind the statute "is to give the Commission the opportunity to correct its own errors before a party seeks judicial relief." *Id*. at 220, ¶ 17 (citation omitted).

TEP's cases are wholly distinguishable and stand for generic propositions of law that are not in the context of a Commission appeal. *In re General Adjudication Of All Rights To Use Water In Gila River System*, 217 Ariz. 276 (2007) relates to the unremarkable principle that an issue not in an opening brief in a traditional appeal is waived and cannot be raised in reply. Similarly, *Continental Lighting & Contracting, Inc. v. Premier Grading & Utilities, LLC*, 227 Ariz. 382 (App. 2011) simply recites that an issue cannot be raised on appeal unless addressed in the trial court. Neither of these cases even remotely suggest that an

issue properly raised pursuant to A.R.S. § 40-253(B) is nonetheless waived because it was not also presented to the Commission in post-hearing briefs or exceptions to the proposed order. TEP's waiver argument lacks merit.

B. Under A.R.S. § 40-334, a rate difference is not ipso facto non-discriminatory merely because the Commission approves it.

TEP argues A.R.S. § 40-334's ban of only "unreasonable differences" "between classes of service" is not violated where the Commission approves rates "after a lengthy hearing and based on an extensive record." TEP Answering Brief at 22-24. In other words, TEP argues the rates are per se not discriminatory simply because the Commission approved them. This argument reads the protection against discriminatory rates out of the Constitution and the statutes. Presumably TEP would not take the same position if, for example, it contended rates set by the Commission were confiscatory or discriminated between TEP and other utilities.

TEP argues that Freeport is reading A.R.S. § 40-334 more broadly than what the Constitution permits with respect to ratesetting. In other words, TEP argues that since the Constitution gives the Commission authority to set rates, a legislative act limiting that ratesetting power by prohibiting discrimination is unconstitutional and, thus, a narrow interpretation is required. TEP mischaracterizes Freeport's position. Freeport's argument is not framed in terms of whether the statute is read

broadly or narrowly. Instead, Freeport argues the Constitution and statute are complementary.

The Constitution forbids discrimination, and the statute reflects the Legislature's understanding of what the Constitution means. The statute was initially codified in 1912 and, thus, has been around since statehood. The Commission has never argued the statute unconstitutionally usurps its power. The Legislature's interpretation of Article 15 § 12 as embodied in this statute has been followed since statehood and is entitled to deference for that reason. *See Ariz. Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 293-94 (1992) (upholding the proposition that courts should continue to interpret statutes and the constitution as they have been because utilities and the public have relied on these interpretations).

C. Freeport is not arguing the statute prohibits all subsidies but rather argues the statute bars unreasonable differences between customer classes.

Contrary to TEP's argument (TEP Answering Brief at 26-28), Freeport does not contend that A.R.S. § 40-334 mandates that no subsidy between classes occur. The statute bars unreasonable differences between or among classes, not just members of the same class. Freeport Opening Brief at 19-20.

The Commission cites *State ex rel. Utilities Commission v. Carolina Utility Customers Ass'n, Inc.*, 524 S.E.2d 10, 22 (N.C. 2000) in support of its argument

that the statute was not violated. ACC Answering Brief at 33. This case actually supports Freeport's position because it is an example of a court assessing whether a commission's conclusion as to cost of service is deficient, demonstrating two points. First, whether the Commission has violated the Constitution or statute in setting a subsidy far in excess of cost of service is a judicially determinable issue as it was in the North Carolina case. Second, the North Carolina Supreme Court has, in fact, provided a standard or "North Star" by which to judge the Commission's ratesetting process. *See State ex rel. Utils. Comm'n*, 524 S.E.2d at 21 ("[C]ost-of-service impacts whether the rate design unjustly discriminates between the various classes of customers. . . . [T]his Court required the Commission to independently identify and apply an appropriate cost-of-service allocation methodology before designing a nondiscriminatory rate structure."). Even if there are other non-cost factors that the Commission can consider as in North Carolina, courts can and should impose an outer limit or a "North Star" to help assess whether discrimination or unreasonable ratesetting has occurred.

D. Freeport's rate is discriminatory and unreasonable.

i. Freeport's base rate as compared with the base rate for residential customers is irrelevant to the issues in this appeal.

TEP argues that because Freeport's rate is lower than the residential class, Freeport's statutory discrimination claim fails. TEP Answering Brief at 25-26.

Freeport's base rate as it compares to the base rate for the residential class compares apples to oranges in the context of this appeal, which relates to the $4.2 million subsidy that Freeport is forced to pay (in addition to its base rate) that is intended solely to benefit the residential class.

Even if the base rate comparison were relevant to this appeal, Freeport's base rate *should* be lower than residential rates because it costs TEP *less* to serve Freeport than it does residential customers. ROA 621. For instance, Freeport is a "high-load factor" customer, which drives the per-unit cost of power down. *Id.* Likewise, Freeport takes service at the transmission level (through larger power lines), which is less costly for TEP to provide compared to providing service to customers at the distribution level (*i.e.*, the (above or below ground) smaller lines seen that carries power into neighborhoods), the latter of which requires more infrastructure. ROA 606, ep 24. Making such a comparison is both disingenuous and is akin to comparing what it costs Wal-Mart to purchase an apple as compared to an individual customer's cost to purchase that same apple.[8]

[8] TEP also argues that Freeport received "favorable" treatment in the class cost of service study as if that somehow justifies imposing an additional $4.2 million subsidy. Freeport did not receive any "favorable" treatment. Separating out transmission voltage customers in class cost of service studies is an industry standard without which the study would have produced skewed results. Several witnesses referred to this structure in the class cost of service study as "appropriate." ROA 606, ep 59:14-25; ROA 716, ep 19:18-22.

Freeport's objection is that the revenue allocation exceeds cost allocation to such a degree as to make it unjust and unreasonable because Freeport has to pay a $4.2 million dollar subsidy every year solely to benefit another customer class. There needs to be a "North Star" to guide the Commission based on the Constitutional and statutory standards to prevent the Commission from requiring customers such as Freeport to pay for everyone else's electricity.

ii. Compelling Freeport to pay a $4.2 million subsidy solely to benefit other customers is unreasonable.

As to the subsidy itself, TEP argues that Freeport has not shown that a $4.2 million gift—which is akin to a taking—to the residential customers is unreasonable. TEP Answering Brief at 28-30.

Failing to assert substantive arguments as to the subsidy's reasonableness, TEP instead takes issue with Freeport's record cites and math. TEP Answering Brief at 28-29. Not only did the Decision include express statements about the $4.2 million subsidy in several places,[9] but it was derived from TEP's witness's schedules. ROA 608, ep 37-38. The unitized rate of return was from the Staff's

[9] ROA 513, ep 37:17-18; ep 38:10. ROA 513, ep 37 cites the table showing Freeport pays a $4,246,566 annual subsidy as coming from ROA 608, ep 37-38.

witness who presented a revised Schedule HS-6 as part of his Surrebuttal Testimony on rate design. ROA 717, ep 31-34[10].

TEP argues the calculation of the subsidy amount is incorrect. TEP Answering Brief at 29. The Decision did not recalculate the amount of subsidy based on the recommended allocation. Instead, it simply adopted the $4.2 million subsidy as correct based on TEP's own witness testimony and the relevant schedules.[11] ROA 513, ep 37. Once the Recommended Opinion and Order was issued, Freeport filed Exceptions, which states the amount of the subsidy is "approximately" $4.2 million dollars annually. ROA 484, ep 3. TEP did not take issue with that calculation below.

The only substantive argument that TEP makes in relation to the subsidy's reasonableness is that the residential class would bear the brunt of the increase and, thus, it was reasonable for the Commission to reduce the subsidy slowly over several rate cases. TEP Answering Brief at 29. This is a strawman argument. TEP's witness, in describing the importance of cost causation in developing a cost

[10] Schedule HS-6 has been filed under seal.

[11] Practically, it is impossible to cite to a specific number in the evidentiary record that existed pre-Decision because the final revenue allocation proposed and adopted by the Commission in the Decision was based on the Administrative Law Judge's ("ALJ") own calculations—separate and apart from what the parties presented—in setting the final rates. The ALJ did not adhere to any one party's proposal but adopted portions from what the Commission's Staff proposed and from what TEP proposed.

of service study, explained that "[j]ust and reasonable rates must avoid undue discrimination and must reflect the principle of 'user pays,' also known as 'cost causation,' or as I prefer to say, those who cause costs should pay the costs. Undue discrimination occurs when customers pay significantly different amounts for the same service without good cause." ROA 606, ep 15:9-13. In light of TEP's witness's testimony, TEP cannot now claim that the amount of the increase, rather than the justness of the resulting rates, is the key inquiry.

The residential class continues to pay rates below its cost of service and Freeport makes that possible by providing an annual $4.2 million dollar subsidy. The issue is whether the resulting rates (taking into account subsidies) comport with the Constitutional and statutory standards.

V. The Commission's rate for Freeport is not supported by substantial evidence.

A. Gradualism was the primary—if not only—basis for imposing a subsidy on Freeport.

Freeport contends that gradualism was the basis of the Commission's Decision to continue to impose the subsidy on Freeport, and it is an insufficient evidentiary basis to sustain the revenue allocation. Freeport Opening Brief at 34-39. The Commission contends the Decision relied on more than just the need to employ gradualism and avoid rate shock in requiring Freeport to pay a subsidy.

ACC Answering Brief at 27-28. That is inconsistent with the Decision's plain language.

The Decision states: "To allocate the $81.5 million increase evenly across classes would perpetuate existing inequities, burdening the subsidizing classes. However, to move all the rate classes to a UROR of 1.000 would cause unreasonable rate shock…." ROA 513, ep 45:17-19. The Decision explains: "In our attempt to move toward a more equitable revenue recovery **without overly burdening** an individual customer class, and considering the entirety of circumstances, we find the following allocation of the $81.5M non-fuel revenue increase is just and reasonable. This allocation adopts Staff's recommendation for the Residential Class of $54.5 million and employs TEP's proportionate allocations for the remaining $27 million." *Id.* at ep 45:25-46:4 (emphasis added). The revenue allocation in the Decision was based on the principle of gradualism.

To the extent there were "other considerations" guiding the revenue allocation, these considerations related to gradualism. For instance, Staff's basic rate design principles included: (1) individual rate classes should be gradually moved towards a UROR of 1.00 over one or more rate cases; (2) there should be an upper limit of 150 percent for any class percentage increase compared to overall

percentage increase; and (3) there should be a lower limit of 50 percent for any class increase compared to the overall increase. ROA 716, ep 26:1-10.

The Commission argues that deviations from the cost of service studies regularly occur and this does not render the rates unsupported by substantial evidence. ACC Answering Brief at 34-35. Although it is true that the cost of service study is used as a guideline in setting rates, deviations from the cost of service study should nonetheless satisfy the "just and reasonable" standard and be supported by substantial evidence.

As to the rate design evidence and the non-cost factors that the Commission allegedly considered when determining the revenue allocation, practically all of them—except for the principle of gradualism and need to avoid rate shock—support eliminating the subsidies. The evidence demonstrated that subsidies stifle economic development because high commercial industrial rates are disincentives to locate new businesses in TEP's territory and hurt existing businesses that pay taxes, which then may choose to move operations elsewhere. ROA 735; ROA737; ROA 680; ROA 628; ROA 632; ROA 736; ROA 681.

The Commission attempts to factually distinguish *Lloyd v. Pennsylvania Public Utility Commission*, 904 A.2d 1010 (Pa. Commw. Ct. 2006) but ultimately admits that the "main caveat" in *Lloyd* is 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*. at 1020. The Commission believes *Lloyd* is distinguishable on this basis because it claims to have considered factors other than gradualism in allocating a subsidy to Freeport.

The record, however, reflects the fact that gradualism was the driving factor in requiring Freeport to pay $4.2 million to benefit the residential class. Without other substantial evidence, gradualism and rate shock by themselves cannot be used to justify continued subsidization of one class of customer over another. Although the Commission can deviate from the cost of service study to address other factors (*e.g.*, low-income rates), there has to be a limit to the deviation for rates to remain "just and reasonable."

B. The parties agree that the Decision must be supported by substantial evidence to be sustained on appeal.

The parties agree that substantial evidence must support the revenue allocation. ACC Answering Brief at 20; TEP Answering Brief at 15. Notwithstanding this agreement, the Commission spends several pages attempting to distinguish Freeport's cases where courts overturned utility commission

decisions in other states after concluding that the rates were not facially discriminatory or unreasonable but were not supported by substantial evidence. ACC Answering Brief at 52-55.

Whether those cases are squarely on point with the subsidy issue here is beside the point. Freeport cited those cases purely as examples of courts invalidating commission decisions based on a lack of evidence even after concluding that the rates were not invalid on their face. Freeport Opening Brief at 31-33. To the extent the Court here decides the rates are facially valid as a legal matter, the Court could nonetheless reach the conclusion that the rates are not supported by substantial evidence as a factual matter.

C. The Decision's revenue allocation was arbitrary.

The Commission argues that considerable evidence was presented on how to reduce inter-class subsidies. ACC Answering Brief at 42. That view, however, is a backwards way of looking at rate design because it assumes the evidence supports the reasonableness of the existing rates that are used as a starting point.

The record does not support the reasonableness of taking existing subsidies as a given and then adding to or subtracting from those subsidies to achieve a politically desirable rate design. As a TEP witness testified, "Although existing circumstances may preclude reaching 'parity', the goal should be to use the results

of the CCOSS to minimize cross subsidies both between and within customer classes." ROA 606, ep 13:9-11. In other words, once presented with a baseline matching of cost causation with cost recovery, substantial evidence must be presented to establish why a customer should pay more than its "fair share" of costs in the form of a subsidy.

Instead, the Decision focused on existing rates, and then determined how to allocate rate increases in an small effort to reduce slightly inter-class subsidies. ROA 513, ep 45-46. There was not substantial evidence to support continuing the subsidy in the amount set by the Decision.

No evidence was presented to support the position that a 39.5 percent increase in margin revenue to the residential class would result in undue harm or that continuing the Freeport subsidy at a level of $4.2 million was just and reasonable.[12] Nothing in the record explains why rate increases of 50 percent or more imposed by the Commission in other cases prior to the Decision did not constitute unreasonable rate shock (*see* Freeport Opening Brief at 36), but the 39.5

[12] The Decision cites the need to avoid "unreasonable rate shock" without any analysis or consideration of evidence as to what constitutes "unreasonable rate shock" in this case. ROA 513, ep 45. The Commission's current standard for defining rate shock is akin to "I know it when I see it." This standard is unworkable, particularly in light of the fact that rate shock would have occurred according to the Commission here due to a 39.5 percent rate increase whereas the Commission approved larger rate increases in other decisions. Freeport Opening Brief at 36.

percent it would have taken to bring residential customers to rate parity here does constitute rate shock.

No evidence was presented that residential customers could not afford to pay rates that would result from eliminating Freeport's subsidy. As is explained in Freeport's opening brief, the impact on the residential class of eliminating the subsidy would be minimal. *Id.* at 35. The principle of gradualism cannot sustain what was already a flawed rate design while failing to address the underlying fact that Freeport paid an unreasonable subsidy under both existing rates and new rates adopted by the Decision. ROA 513, ep 35-36; ep 43.

By contrast, the record is replete with evidence about the continued detrimental effects on businesses and economic development in TEP's service territory if large industrial and commercial customers are forced to continue paying unduly burdensome and discriminatory rates. Subsidy-paying customers presented substantial evidence that continuing to pay large subsidies would be detrimental to their businesses, as well as economic development within TEP's service territory. ROA 632, ep 7; ROA 633, ep 22; ROA 735, ep 7; ROA 632, ep 4-6. Substantial evidence supported the elimination or significant reduction of the subsidy.

CONCLUSION

The Court should vacate that portion of the Decision setting rates for the 138kV class and remand to the Commission to reset Freeport's rate to remedy the unjust, unreasonable and discriminatory subsidy.

RESPECTFULLY SUBMITTED this 25th day of October, 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 Reply 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 Reply Brief contains 6,999 words, excluding the Table of Contents, Table of Authorities, Certificate of Service, this Certificate of Compliance, and any addendum.

RESPECTFULLY SUBMITTED this 25th day of October, 2017.

/s/ Timothy Berg
Timothy Berg

CERTIFICATE OF SERVICE

Timothy Berg hereby certifies that on October 25, 2017, he caused the Reply 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

Robin Mitchell
Wesley VanCleve
Legal Division
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007
rmitchell@azcc.gov
WVancleve@azcc.gov

Michael W. Patten
Timothy Sabo
Snell & Wilmer
One Arizona Center, 400 E. Van Buren
Phoenix, Arizona 85004
mpatten@swlaw.com
tsabo@swlaw.com

Arizona Corporation Commission
Legal Division
1200 W. Washington
Phoenix, AZ 85007
legaldiv@azcc.gov

Additionally, a courtesy copy of the Reply 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

13344518.1