Rules of

Department of Economic Development

Division 240—Public Service Commission
Chapter 13—Service and Billing Practices for Residential Customers of Electric, Gas and Water Utilities

Title 4—DEPARTMENT OF ECONOMIC DEVELOPMENT
Division 240—Public Service Commission
Chapter 13—Service and Billing Practices for Residential Customers of Electric, Gas and Water Utilities

4 CSR 240-13.010 General Provisions

PURPOSE: This rule describes in general terms the provisions of this chapter.

(1) This chapter applies to residential utility service provided by all electric, gas and water public utilities, referred to in this chapter as utilities, which are subject to the jurisdiction of the Public Service Commission under the laws of the state.

(2) A utility shall not discriminate against a customer or applicant for service for exercising any right granted by this chapter.

(3) The informal procedures contained in these rules shall not constitute a formal complaint as defined in 4 CSR 240-2.070.

(4) A utility shall adopt rules governing its relations with customers and applicants for service which are consistent with this chapter. The rules shall be part of a utility's tariffs. Any tariff revisions, if required to comply with this chapter or to reflect any variances therefrom previously granted by the commission, shall be filed by the utility within ninety (90) days of the effective date of this rule. Once such revised tariffs become effective, the utility's tariffs shall be deemed to be in full compliance with this chapter.

AUTHORITY: section 386.250(6), RSMo Supp. 1991 and 393.140(11), RSMo 1986. Original rule filed Dec. 19, 1975, effective Dec. 30, 1975. Amended: Filed Oct. 14, 1977, effective Jan. 13, 1978. Rescinded and readopted: Filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority: 386.250(6), RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991 and 393.140(11), RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.015 Definitions

PURPOSE: This rule defines various terms that are used in this chapter.

(1) The following definitions shall apply to this chapter:

(A) Applicant means an individual(s) who has applied to receive residential service from the utility;

(B) Bill means a written demand for payment for service and the taxes and franchise fees related to it;

(C) Billing period means a normal usage period of not less than twenty-six (26) nor more than thirty-five (35) days for a monthly billed customer nor more than one hundred (100) days for a quarterly billed customer, except for initial, corrected or final bills;

(D) Complaint means an informal or formal complaint under 4 CSR 240-2.070;

(E) Customer means a person or legal entity responsible for payment for service except one denoted as a guarantor;

(F) Cycle billing means a system which results in the rendition of bills to various customers on different days of a month;

(G) Delinquent charge means a charge remaining unpaid by a monthly billed customer at least twenty-one (21) days and for at least sixteen (16) days by a quarterly billed customer from the rendition of the bill by the utility or a charge remaining unpaid after the preferred payment date selected by the customer;

(H) Delinquent date means the date stated on a bill, which shall be at least twenty-one (21) days for a monthly billed customer, and at least sixteen (16) days for a quarterly billed customer from the rendition of the bill or which shall be the preferred payment plan date selected by the customer, after which the utility may assess an approved late payment charge in accordance with a utility tariff on file with the commission;

(I) Denial of service means the utility's refusal to commence service upon an applicant's request for service at a particular location;

(J) Deposit means a money advance to a utility for the purpose of securing payment of delinquent charges which might accrue to the customer who made the advance;

(K) Discontinuance of service or discontinuance means a cessation of service not requested by a customer;

(L) Due date means the date stated on a bill when the charge is considered due and payable;

(M) Estimated bill means a charge for utility service which is not based on an actual reading of the meter or other registering device by an authorized utility representative;

(N) Extension agreement means a verbal agreement between the utility and the customer extending payment for fifteen (15) days or less;

(O) Guarantee means a written promise from a third party to assume liability up to a specified amount for delinquent charges which might accrue to a particular customer;

(P) In dispute means any matter regarding a charge or service which is the subject of an unresolved inquiry;

(Q) Late payment charge means an assessment on a delinquent charge in accordance with a utility tariff on file with the commission and in addition to the delinquent charge;

(R) Preferred payment date plan means a commission-approved plan offered at the utility's option in which the delinquent date for the charges stated on a bill shall occur on the same day during each billing period as selected by the customer;

(S) Purchased gas adjustment clause means the adjustment procedure approved by the commission to recognize variations in the cost of purchased gas;

(T) Rendition of a bill means the mailing or hand delivery of a bill by a utility to a customer;

(U) Residential service or service means the provision of or use of a utility service for domestic purposes;

(V) Seasonally billed customer means a residential customer billed on a seasonal basis in accordance with a utility tariff on file with the commission;

(W) Settlement agreement means an agreement between a customer and a utility which resolves any matter in dispute between the parties or provides for the payment of undisputed charges over a period longer than the customer's normal billing period;

(X) Tariff means a schedule of rates, services and rules approved by the commission;

(Y) Termination of service or termination means a cessation of service requested by a customer;

(Z) Utility means an electric, gas or water corporation as those terms are defined in section 386.020, RSMo; and

(AA) Utility charges means the rates for utility service and other charges authorized by the commission as an integral part of utility service.

AUTHORITY: sections 386.250(6) and 393.140(11), RSMo 2000. Original rule filed Sept. 22, 1993, effective July 10, 1994. Amended: Filed March 24, 2004, effective Oct. 30, 2004.*

**Original authority: 386.250(6), RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991, 1993, 1995, 1996 and 393.140(11), RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.020 Billing and Payment Standards

PURPOSE: This rule establishes reasonable and uniform billing and payment standards to be observed by utilities and customers.

(1) A utility shall normally render a bill for each billing period to every residential customer in accordance with its tariff.

(2) Each billing statement rendered by a utility shall be computed on the actual usage during the billing period except as follows:

(A) A utility may render a bill based on estimated usage—

1. To seasonally billed customers, provided an appropriate tariff is on file with the commission and an actual reading is obtained before each change in the seasonal cycle;

2. When extreme weather conditions, emergencies, labor agreements or work stoppages prevent actual meter readings; and

3. When the utility is unable to obtain access to the customer's premises for the purpose of reading the meter or when the customer makes reading the meter unnecessarily difficult. If the utility is unable to obtain an actual meter reading for these reasons, where practicable it shall undertake reasonable alternatives to obtain a customer reading of the meter, such as mailing or leaving postpaid, preaddressed postcards upon which the customer may note the reading unless the customer requests otherwise;

(B) A utility shall not render a bill based on estimated usage for more than three (3) consecutive billing periods or one (1) year, whichever is less, except under conditions described in subsection (2)(A) of this rule;

(C) Under no circumstances shall a utility render a bill based on estimated usage—

1. Unless the estimating procedures employed by the utility and any substantive changes to those procedures have been approved by the commission;

2. As a customer's initial or final bill for service unless conditions beyond the control of the utility prevent an actual meter reading;

(D) When a utility renders an estimated bill in accordance with these rules, it shall—

1. Maintain accurate records of the reasons for the estimate and the effort made to secure an actual reading;

2. Clearly and conspicuously note on the bill that it is based on estimated usage; and

3. Use customer-supplied readings, whenever possible, to determine usage; and

(E) When a utility underestimates a customer's usage, the customer shall be given the opportunity, if requested, to make payment in installments.

(3) If a utility is unable to obtain an actual meter reading for three (3) consecutive billing periods, the utility shall advise the customer by first class mail or personal delivery that the bills being rendered are estimated, that estimation may not reflect the actual usage and that the customer may read and report electric, gas or water usage to the utility on a regular basis. The procedure by which this reading and reporting may be initiated shall be explained. A utility shall attempt to secure an actual meter reading from customers reporting their own usage at least annually, except for quarterly-billing utilities in which case it shall be every two (2) years. These attempts shall include personal contact with the customer to advise the customer of the regular meter reading day. The utility shall offer appointments for meter readings on Saturday or prior to 9:00 p.m. on weekdays. The utility's obligation to make appointments shall begin only after a tariff, for the appointments, has been filed with and approved by the commission. Discontinuance of the service of a customer who is reading and reporting usage on a regular basis because of inability to secure an actual meter reading shall not be required.

(4) If a customer fails to report usage to the utility, the company shall obtain a meter reading at least annually. The utility shall notify the customer that if usage is not reported regularly by the customer and if the customer fails, after written request, to grant access to the meter, then service may be discontinued pursuant to 4 CSR 240-13.050.

(5) Notwithstanding section (2) of this rule, a utility may bill its customers in accordance with equal payment billing programs at the election of the utility customer, provided the equal payment billing program has been previously approved by the commission.

(6) A utility may bill its customers on a cyclical basis if the individual customer receives each billing on or about the same day of each billing period. If a utility changes a meter reading route or schedule which results in a change of nine (9) days or more of a billing cycle, notice shall be given to the affected customer at least fifteen (15) days prior to the date the customer receives a bill based on the new cycle.

(7) A monthly-billed customer shall have at least twenty-one (21) days and a quarterly-billed customer shall have at least sixteen (16) days from the rendition of the bill to pay the utility charges, unless a customer has selected a preferred payment date in accordance with a utility's preferred payment date plan. If the due date or delinquent date falls upon a Sunday, legal holiday, or any other day when the offices of the utility regularly used for the payment of customer bills are not open to the general public, the due date or delinquent date shall be extended through the next business day. The date of payment for remittance by mail is the date on which the utility receives the remittance. A utility shall not base an assessment of a deposit or delinquent charge, or a discontinuance of service, on a payment that was made to a payment agent on or before the due date or delinquent date.

(8) A utility shall not assess an additional charge upon a customer by reason of the customer's failure to pay any balance due and owing prior to the delinquent date unless this additional charge has been approved by the commission as a part of the utility's rate tariffs.

(9) Every bill for residential utility service shall clearly state—

(A) The beginning and ending meter readings of the billing period and the dates of these readings;

(B) The date when the bill will be considered due and the date when it will be delinquent, if different;

(C) Any previous balance which states the balance due for utility charges separate from charges for services not subject to commission jurisdiction;

(D) The amount due for the most recent billing period for electric, gas or water usage stated separately from the amount due for the same period for a deposit and the amount due for the same period for service not subject to commission jurisdiction;

(E) The amount due for other authorized charges;

(F) The total amount due;

(G) The telephone number the customer may call from the customer's service location without incurring toll charges and the address of the utility where the customer may initiate an inquiry or complaint regarding the bill as rendered or the service provided. Charges for measured local service are not toll charges for purposes of this rule;

(H) License, occupation, gross receipts, franchise and sales taxes; and

(I) Purchased gas adjustment cost in total or cents per unit basis.

(10) A utility shall render a separate billing for service provided at each address unless

otherwise requested by the customer and agreed to by the utility.

(11) A utility may include charges for special services together with utility charges on the same bill if the charges for special services are designated clearly and separately from utility charges. If partial payment is made, the utility shall first credit all payments to the balance outstanding for gas, electric or water charges, before crediting a deposit.

(12) During the billing period prior to any tariffed seasonal rate change, a utility shall notify each affected customer, on the bill or on a notice accompanying the bill, of the direction of the upcoming seasonal rate change and the months during which the forthcoming seasonal rate will be in effect.

AUTHORITY: sections 386.250(6), RSMo Supp. 1991 393.140(11), RSMo 1986. Original rule filed Dec. 19, 1975, effective Dec. 30, 1975. Amended: Filed Oct. 14, 1977, effective Jan. 13, 1978. Rescinded and readopted: Filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority: 386.250(6), RSMo 1939, amended 1963, 1967, 1980, 1987, 1988, 1991 and 393.140(11), RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.025 Billing Adjustments

PURPOSE: This rule establishes billing adjustments in the event of an overcharge or an undercharge.

(1) For all billing errors, the utility will determine from all related and available information the probable period during which this condition existed and shall make billing adjustments for the estimated period involved as follows:

(A) In the event of an overcharge, an adjustment shall be made for the entire period that the overcharge can be shown to have existed not to exceed sixty (60) consecutive monthly billing periods, or twenty (20) consecutive quarterly billing periods, calculated from the date of discovery, inquiry or actual notification of the utility, whichever comes first;

(B) In the event of an undercharge, an adjustment shall be made for the entire period that the undercharge can be shown to have existed not to exceed twelve (12) monthly billing periods or four (4) quarterly billing periods, calculated from the date of discovery, inquiry or actual notification of the utility, whichever was first;

(C) No billing adjustment will be made where the full amount of the adjustment is less than one dollar ($1);

(D) Where, upon test, an error in measurement is found to be within the limits prescribed by commission rules, no billing adjustment will be made; and

(E) When evidence of tampering is found, or there are misrepresentations of the use of service by the customer, the utility will calculate the billing adjustment period in accordance with the applicable statute of limitations for the prosecution of such claim after determining the probable period during which such condition existed from all related and available information.

AUTHORITY: section 393.140(11), RSMo 1986. Original rule filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority 1939, amended 1940, 1967.*

4 CSR 240-13.030 Deposits and Guarantees of Payment

PURPOSE: This rule establishes reasonable and uniform standards regarding deposits and guarantees required by utilities.

(1) A utility may require a deposit or other guarantee as a condition of new residential service if—

(A) The customer has outstanding with a utility providing the same type of service, an unpaid bill which accrued within the last five (5) years and, at the time of the request for service, remains unpaid and not in dispute;

(B) The customer has in an unauthorized manner interfered with or diverted the service of a utility providing the same service situated on or about or delivered to the customer's premises within the last five (5) years; or

(C) The customer is unable to establish an acceptable credit rating under standards contained in tariffs filed with and approved by the commission. The customer shall be deemed *prima facie* to have established an acceptable credit rating if the customer meets any of the following criteria:

1. Owns or is purchasing a home;
2. Is and has been regularly employed on a full-time basis for at least one (1) year;
3. Has an adequate regular source of income; or
4. Can provide adequate credit references from a commercial credit source.

(2) A utility may require a deposit or guarantee as a condition of continued residential service if—

(A) The service of the customer has been discontinued by the utility for nonpayment of a delinquent account not in dispute;

(B) In an unauthorized manner, the customer interfered with or diverted the service of the utility situated on or about or delivered to the customer's premises; or

(C) The customer has failed to pay an undisputed bill on or before the delinquent date for five (5) billing periods out of twelve (12) consecutive monthly billing periods, or two (2) quarters out of four (4) consecutive quarters. Prior to requiring a customer to post a deposit under this subsection, the utility shall send the customer a written notice explaining the utility's right to require a deposit or include such explanation with each written discontinuance notice.

(3) Deposits for gas and electric service assessed under the provisions of subsection (2)(A) or (C) of this rule during the months of November, December and January may be paid, if the customer is unable to pay the entire deposit, by installments over a six (6)-month period.

(4) A deposit shall be subject to the following terms:

(A) It shall not exceed two (2) times the highest bill for utility charges actually incurred or estimated to be incurred by the customer during the most proximate twelve (12)-month period at the service location or, in the case of a new customer, who is assessed a deposit under subsection (1)(C) of this rule, one-sixth (1/6) of the estimated annual bill for monthly billed customers and one-third (1/3) of the estimated annual bill for quarterly billed customers for utility charges at the requested service location;

(B) It shall bear interest at a rate specified in utility tariffs, approved by the commission, which shall be credited annually upon the account of the customer or paid upon the return of the deposit, whichever occurs first. Interest shall not accrue on any deposit after the date on which a reasonable effort has been made to return it to the customer. Records shall be kept of efforts to return a deposit. This rule shall not preclude a utility from crediting interest upon each service account during one (1) billing cycle annually;

(C) Upon discontinuance or termination other than for a change of service address, it shall be credited, with accrued interest, to the utility charges stated on the final bill and the balance, if any, shall be returned to the customer within twenty-one (21) days of the rendition of the final bill;

(D) Upon satisfactory payment of all undisputed utility charges during the last twelve (12) billing months, it shall be promptly refunded or credited, with accrued interest, against charges stated on subsequent bills. Payment of a charge is satisfactory if received prior to the date upon which the charge becomes delinquent provided it is not in dispute. Payment of a disputed bill shall be satisfactory if made within ten (10) days of resolution or withdrawal of the dispute. A utility may withhold refund of a deposit pending the resolution of a dispute with respect to charges secured by the deposit;

(E) A utility shall maintain records which show the name of each customer who has posted a deposit, the current address of the customer, the date and amount of deposit, the date and amount of interest paid and information to determine the earliest possible refund date;

(F) Each customer posting a security deposit shall receive, in writing, at the time of tender of deposit or with the first bill a receipt as evidence of deposit, unless the utility shows the existence or nonexistence of a deposit on the customer's bill, in which event the receipt shall not be required unless requested by the customer. The receipt shall contain the following minimum information:

1. Name of customer;
2. Date of payment;
3. Amount of payment;
4. Identifiable name, signature and title of the utility employee receiving payment; and
5. Statement of the terms and conditions governing the payment, retention and return of deposits;

(G) A utility shall provide means where a person entitled to a return of a deposit is not deprived of the deposit refund even though s/he may be unable to produce the original receipt for the deposit; provided, s/he can produce adequate identification to ensure that s/he is the customer entitled to refund of the deposit;

(H) No deposit or guarantee or additional deposit or guarantee shall be required by a utility because of race, sex, creed, national origin, marital status, age, number of dependents, source of income, disability or geographical area of residence; and

(I) A utility shall provide means where a customer required to make a deposit may pay the deposit in installments unless the utility can show a likelihood that the customer does not intend to pay for the service.

(5) In lieu of a deposit, a utility may accept a written guarantee. The limit of the guarantee shall not exceed the amount of a cash deposit.

(6) A guarantor shall be released upon satisfactory payment of all undisputed utility charges during the last twelve (12) billing months. Payment of a charge is satisfactory if received prior to the date upon which the charge becomes delinquent provided it is not in dispute. Payment of a disputed bill shall be satisfactory if made within ten (10) days of resolution or withdrawal of the dispute.

AUTHORITY: sections 386.250(6), RSMo Supp. 1991 and 393.140(11), RSMo 1986. Original rule filed Dec. 19, 1975, effective Dec. 30, 1975. Amended: Filed Oct. 14, 1977, effective Jan. 13, 1978. Amended: Filed June 10, 1992, effective Feb. 26, 1993. Rescinded and readopted: Filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority: 386.250(6), RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991 and 393.140(11), RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.035 Denial of Service

PURPOSE: This rule prescribes conditions under which utilities may refuse to commence service to an applicant for residential service and establishes procedures to be followed by utilities to insure reasonable and uniform standards exist for the denial of service. This rule also protects an applicant(s) at the time of their application, from being required to pay for the bill incurred by other individuals for service from which the applicant(s) did not receive substantial benefit.

(1) A utility may refuse to commence service to an applicant for any of the following reasons:

(A) Failure to pay an undisputed delinquent utility charge for services provided by that utility or by its regulated affiliate. To be considered to be disputed, the unpaid charge must be the subject of an open informal complaint at the commission.

(B) Failure to post a required deposit or guarantee in accordance with 4 CSR 240-13.030 or the utility's tariffs;

(C) Refusal or failure to permit inspection, maintenance, replacement or meter reading of utility equipment. If the applicant does not provide access to the utility for such purposes, the utility shall provide notice to the applicant regarding its need for inspection, maintenance, replacement or meter reading of utility equipment and shall maintain an accurate record of the notice provided.

1. The notice shall include one (1) of the following:

A. Written notice by first class mail sent to the applicant; or

B. Written notice delivered in hand to the applicant; or

C. At least two (2) telephone call attempts reasonably calculated to reach the applicant; or

D. Written notice in the form of a door hanger left at the applicant's premises.

2. The notice shall contain the following information:

A. The name and address of the applicant and the address where service is being requested;

B. How the applicant may comply with the requirements to have service connected;

C. A telephone number the applicant may call from the service location without incurring toll charges and the address of the utility prominently displayed where the applicant may make an inquiry;

D. A statement in Spanish either:

(I) Advising the applicant that if they do not read English, to ask someone who does to translate the notice for them; or

(II) Advising the applicant to call the utility for assistance if the utility provides telephone assistance in Spanish;

E. If the applicant is unable to resolve the matter satisfactorily with the utility, they may contact the Public Service Commission;

(D) Misrepresentation of identity;

(E) Violation of any other rules of the utility approved by the commission which adversely affects the safety of the customer or other persons or the integrity of the utility's system;

(F) As provided by state or federal law;

(G) Failure of a previous owner or occupant of the premises to pay a delinquent utility charges where the previous owner or occupant remains an occupant;

(H) Failure to comply with the terms of a settlement agreement; or

(I) Unauthorized interference, diversion of use of the utility's service by the applicant, or by a previous owner or occupant who remains an occupant.

(2) A utility may not refuse to commence service to an applicant for any of the following reasons:

(A) Failure to pay for merchandise, appliances or services not subject to commission jurisdiction as an integral part of the utility service provided by a utility;

(B) Failure to pay the bill of another customer, unless the applicant who is seeking service received substantial benefit and use of the service to that customer, or unless the applicant is the legal guarantor for a delinquent bill. In this instance, the utility refusing to commence service, shall have the burden of proof to show that the applicant received substantial benefit and use of the service, or that the applicant is the legal guarantor, provided that such burden shall not apply if the applicant refuses to cooperate in providing or obtaining information she/he/it does or should have regarding the applicant's residence history. To meet that burden the utility must have reliable evidence that:

1. The applicant and that customer resided together at the premises where the bill was incurred and during the period the bill was incurred; and

2. The bill was incurred within the last seven (7) years; and

3. The utility has attempted to collect the unpaid bill from the customer of record; and

4. At the time of the request for service, the bill remains unpaid and not in dispute.

(3) The utility shall commence service at an existing residential service location in accordance with this rule as close as reasonably possible to the day specified by the customer for service to commence, but no later than, three (3) business days following the day specified by the customer for service to commence provided that the applicant has complied with all requirements of this rule. When service to a new residential location is requested, the utility shall commence service in accordance with this rule as close as reasonably possible to the day specified by the applicant for service to commence, but normally no later than three (3) business days following the day that all required construction is completed and all inspections have been made.

(4) Notwithstanding any other provision of this rule, a utility may refuse to commence service temporarily for reasons of maintenance, health, safety or a state of emergency until the reason for such refusal has been resolved.

(5) Any provision of this rule may be waived or varied by the commission for good cause.

(6) The requirements of the rule shall be implemented by the utility no later than November 1, 2004.

AUTHORITY: sections 386.250(6) and 393.140(11), RSMo 2000 and 393.130(1), RSMo Supp. 2003. Original rule filed Nov. 3, 2003, effective May 30, 2004.*

**Original authority: 386.250, RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991, 1993, 1995, 1996; 393.130, RSMo 1939, amended 1949, 1967, 1969, 2002; 393.140, RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.040 Inquiries

PURPOSE: This rule establishes procedures to be followed when customers make inquiries of utilities so the inquiries are handled in a reasonable manner.

(1) A utility shall adopt procedures which will ensure the prompt and thorough receipt, investigation and, where possible, resolution of inquiries. The utility shall submit the procedures to the commission and the utility shall notify the commission and the public counsel of any substantive changes in these procedures prior to implementation.

(2) A utility shall establish personnel procedures which, at a minimum, insure that—

(A) Qualified personnel shall be available and prepared at all times during normal business hours to receive and respond to all customer inquiries, service requests and complaints. A utility shall make necessary arrangements to insure that customers unable to communicate in the English language receive assistance;

(B) Qualified personnel responsible for and authorized to enter into written agreements on behalf of the utility shall be available at all times during normal business hours to respond to customer inquiries and complaints;

(C) Qualified personnel shall be available at all times to receive and initiate response to customer contacts regarding any discontinuance of service or emergency condition occurring within the utility's service area; and

(D) Names, addresses and telephone numbers of personnel designated and authorized to receive and respond to the requests and directives of the commission regarding customer inquiries, service requests and complaints shall be provided to the commission.

(3) A utility shall prepare, in written form, information which in layman's terms summarizes the rights and responsibilities of the utility and its customers in accordance with this chapter. The form shall be submitted to the consumer services department of the Missouri Public Service Commission, and to the Office of the Public Counsel. This written information shall be displayed prominently, and shall be available at all utility office locations open to the general public, and shall be mailed or otherwise delivered to each residential customer of the utility if requested by the customer. The information shall be delivered or mailed to each new customer of the utility upon the commencement of service and shall be available at all times upon request. The written information shall indicate conspicuously that it is being provided in accordance with the rules of the commission, and shall contain information concerning, but not limited to:

(A) Billing and estimated billing procedures;

(B) Methods for customer verification of billing accuracy;

(C) Customer payment requirements and procedures;

(D) Deposit and guarantee requirements;

(E) Conditions of termination, discontinuance and reconnection of service;

(F) Procedures for handling inquiries;

(G) Explanation of meter reading procedures which would enable a customer to read his/her own meter;

(H) A procedure where a customer may avoid discontinuance of service during a period of absence;

(I) Complaint procedures under 4 CSR 240-2.070;

(J) The telephone number and address of a customer services office of the Missouri Public Service Commission, the commission's 800 telephone number, and the statement that the company is regulated by the Missouri Public Service Commission;

(K) The address and telephone number of the Office of Public Counsel and a statement of the function of that office; and

(L) If the utility is a gas distribution company, an explanation of the function of the purchased gas adjustment clause.

(4) At all of its public business offices, a utility shall make available for public inspection a copy of this chapter and the utility's tariffs. At these offices, conspicuous signs shall be posted which indicate that this information is available for public inspection.

(5) A utility shall maintain records on its customers for at least two (2) years which contain information concerning:

(A) The payment performance of each of its customers for each billing period;

(B) The number and general description of complaints registered with the utility;

(C) The number of settlement agreements made by the utility;

(D) The actual number of discontinuances of service due to each of the following categories of reasons:

1. The customer's failure to keep a settlement agreement or cold weather rule payment agreement;

2. The customer's failure to make any other required utility payment;

3. Unauthorized interference, diversion or use of utility service; and

4. All other reasons combined.

(E) Actual number of reconnections; and

(F) Refund of deposits.

(6) The utility shall submit to the commission, upon request, a written summary of the information required by section (5) of this rule.

AUTHORITY: sections 386.250(6), RSMo Supp. 1991 and 393.140(11), RSMo 1986. Original rule filed Dec. 19, 1975, effective Dec. 30, 1975. Amended: Filed Oct. 14, 1977, effective Jan. 13, 1978. Rescinded and readopted: Filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority: 386.250(6), RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991 and 394.140(11), RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.045 Disputes

PURPOSE: This rule establishes reasonable and uniform standards for handling disputes between customers and utilities.

(1) A customer shall advise a utility that all or part of a charge is in dispute by written notice, in person or by a telephone message directed to the utility during normal business hours. A dispute must be registered with the utility at least twenty-four (24) hours prior to the date of proposed discontinuance for a customer to avoid discontinuance of service as provided by these rules.

(2) When a customer advises a utility that all or part of a charge is in dispute, the utility shall record the date, time and place the contact is made; investigate the contact promptly and thoroughly; and attempt to resolve the dispute in a manner satisfactory to both parties.

(3) Failure of a customer to participate with the utility in efforts to resolve an inquiry which has the effect of placing charges in dispute shall constitute a waiver of the customer's right to continuance of service and the utility, not less than five (5) days after provision of the notification required by section (9), may proceed to discontinue service unless the customer files an informal complaint with the commission within the five (5)-day period.

(4) Customers presenting frivolous disputes shall have no right to continued service. A utility, before proceeding to discontinue the service of a customer presenting a dispute it deems frivolous, shall advise the consumer services department of the commission of the circumstances. The consumer services department shall attempt to contact the customer by telephone and ascertain the basis of the dispute. If telephone contact cannot be made, the consumer services department shall send the customer a notice by first class mail stating that service may be discontinued by the utility unless the customer contacts the consumer services department within twenty-four (24) hours. If it appears to the consumer services department that the dispute is frivolous or if contact with the customer cannot be made within seventy-two (72) hours following the utility's report, the utility shall be advised that it may proceed to discontinue service. If it appears that the dispute is not frivolous, service shall not be discontinued until ten (10) days after the notice required by 4 CSR 240-13.050(5) has been sent to the customer by the utility. The customer shall retain the right to make an informal complaint to the commission.

(5) If a customer disputes a charge, s/he shall pay to the utility an amount equal to that part of the charge not in dispute. The amount not in dispute shall be mutually determined by the parties. The parties shall consider the customer's prior consumption history, weather variations, the nature of the dispute and any other pertinent factors in determining the amount not in dispute.

(6) If the parties are unable to mutually determine the amount not in dispute, the customer shall pay to the utility, at the utility's option, an amount not to exceed fifty percent (50%) of the charge in dispute or an amount based on usage during a like period under similar conditions which shall represent the amount not in dispute.

(7) Failure of the customer to pay to the utility the amount not in dispute within four (4) working days from the date that the dispute is registered or by the delinquent date of the disputed bill, whichever is later, shall constitute a waiver of the customer's right to continuance of service and the utility may then proceed to discontinue service as provided in this rule.

(8) If the dispute is ultimately resolved in favor of the customer in whole or in part, any excess moneys paid by the customer shall be refunded promptly.

(9) If the utility does not resolve the dispute to the satisfaction of the customer, the utility representative shall notify the customer that each party has a right to make an informal complaint to the commission, and of the address and telephone number where the customer may file an informal complaint with the commission. If a customer files an informal complaint with the commission prior to advising the company that all or a portion of a bill is in dispute, the commission shall notify the customer of the payment required by sections (5) or (6) of this rule.

(10) A utility may treat a customer complaint or dispute involving the same question or issue based upon the same facts as already determined and is not required to comply with these rules more than once prior to discontinuance of service.

AUTHORITY: sections 386.250(6), RSMo Supp. 1991 and 393.140(11), RSMo 1986. Original rule filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority: 386.250(6), RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991 and 393.140(11), RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.050 Discontinuance of Service

PURPOSE: This rule prescribes the conditions under which service to a customer may be discontinued and procedures to be followed by utilities and customers regarding these matters so that reasonable and uniform standards exist for the discontinuance of service.

(1) Service may be discontinued for any of the following reasons:

(A) Nonpayment of an undisputed delinquent charge;

(B) Failure to post a required deposit or guarantee;

(C) Unauthorized interference, diversion or use of the utility service situated or delivered on or about the customer's premises;

(D) Failure to comply with terms of a settlement agreement;

(E) Refusal after reasonable notice to permit inspection, maintenance, replacement or meter reading of utility equipment. If the utility has a reasonable belief that health or safety is at risk, notice at the time inspection is attempted is reasonable;

(F) Misrepresentation of identity in obtaining utility service;

(G) Violation of any other rules of the utility approved by the commission which adversely affects the safety of the customer or other persons or the integrity of the utility's system; or

(H) As provided by state or federal law.

(2) None of the following shall constitute sufficient cause for a utility to discontinue service:

(A) The failure of a customer to pay for merchandise, appliances or services not subject to commission jurisdiction as an integral part of the utility service provided by a utility;

(B) The failure of the customer to pay for service received at a separate metering point, residence or location. In the event of discontinuance or termination of service at a separate residential metering point, residence or location in accordance with these rules, a utility may transfer and bill any unpaid balance to any other residential service account of the customer and may discontinue service after twenty-one (21) days after rendition of the combined bill, for nonpayment, in accordance with this rule;

(C) The failure of the customer to pay for a different class of service received at the same or different location. The placing of more than one (1) meter at the same location for the purpose of billing the usage of specific devices under optional rate schedules or provisions is not construed as a different class of service for the purpose of this rule;

(D) The failure to pay the bill of another customer, unless the customer whose service is sought to be discontinued received substantial benefit and use of the service;

(E) The failure of a previous owner or occupant of the premises to pay an unpaid or delinquent bill except where the previous occupant remains an occupant or user; or

(F) The failure to pay a bill correcting a previous underbilling, whenever the customer claims an inability to pay the corrected amount, unless a utility has offered the customer a payment arrangement equal to the period of underbilling.

(3) On the date specified on the notice of discontinuance or within eleven (11) business days after that, and subject to the requirements of these rules, a utility may discontinue service to a residential customer between the hours of 8:00 a.m. and 4:00 p.m. Service shall not be discontinued on a day when utility personnel are not available to reconnect the customer's service, or on a day immediately preceding such a day. After the eleven (11) business day effective period of the notice, all notice procedures required by this rule shall again be followed before the utility may discontinue service.

(4) The notice of discontinuance shall contain the following information:

(A) The name and address of the customer and the address, if different, where service is rendered;

(B) A statement of the reason for the proposed discontinuance of service and the cost for reconnection;

(C) The date on or after which service will be discontinued unless appropriate action is taken;

(D) How a customer may avoid the discontinuance;

(E) The possibility of a settlement agreement if the claim is for a charge not in dispute and the customer is unable to pay the charge in full at one (1) time; and

(F) A telephone number the customer may call from the service location without incurring toll charges and the address of the utility prominently displayed where the customer may make an inquiry. Charges for measured local service are not toll charges for purposes of this rule.

(5) A utility shall not discontinue residential service pursuant to section (1) unless written notice by first class mail is sent to the customer at least ten (10) days prior to the date of the proposed discontinuance. Service of notice by mail is complete upon mailing. As an alternative, a utility may deliver a written notice in hand to the customer at least ninety-six (96) hours prior to discontinuance. A utility shall maintain an accurate record of the date of mailing or delivery. A notice of discontinuance of service shall not be issued as to that portion of a bill which is determined to be an amount in dispute pursuant to sections 4 CSR 240-13.045(5) or (6) that is currently the subject of a dispute pending with the utility or complaint before the commission, nor shall such a notice be issued as to any bill or portion of a bill which is the subject of a settlement agreement except after breach of a settlement agreement, unless the utility inadvertently issues the notice, in which case the utility shall take necessary steps to withdraw or cancel this notice.

(6) Notice shall be provided as follows:

(A) At least ten (10) days prior to discontinuance of service for nonpayment of a bill or deposit at a multidwelling unit residential building at which usage is measured by a single meter, notices of the company's intent to discontinue shall be conspicuously posted in public areas of the building; provided, however, that these notices shall not be required if the utility is not aware that the structure is a single-metered multidwelling unit residential building. The notices shall include the date on or after which discontinuance may occur and advise of tenant rights pursuant to section 441.650, RSMo. The utility shall not be required to provide notice in individual situations where safety of employees is a consideration.

(B) At least ten (10) days prior to discontinuance of service for nonpayment of a bill or deposit at a multidwelling unit residential building where each unit is individually metered and for which a single customer is responsible for payment for service to all units in the building or at a residence in which the occupant using utility service is not the utility's customer, the utility shall give the occupant(s) written notice of the utility's intent to discontinue service; provided, however, that this notice shall not be required unless one (1) occupant has advised the utility or the utility is otherwise aware that s/he is not the customer; and

(C) In the case of a multidwelling unit residential building where each unit is individually metered or in the case of a single family residence, the notice provided to the occupant of the unit about to be discontinued shall outline the procedure by which the occupant may apply in his/her name for service of the same character presently received through that meter.

(7) At least twenty-four (24) hours preceding a discontinuance, a utility shall make reasonable efforts to contact the customer to advise

him/her of the proposed discontinuance and what steps must be taken to avoid it. Reasonable efforts shall include either a written notice following the notice pursuant to section (4), a doorhanger or at least two (2) telephone call attempts reasonably calculated to reach the customer.

(8) Immediately preceding the discontinuance of service, the employee of the utility designated to perform this function, except where the safety of the employee is endangered, shall make a reasonable effort to contact and identify him/herself to the customer or a responsible person then upon the premises and shall announce the purpose of his/her presence. When service is discontinued, the employee shall leave a notice upon the premises in a manner conspicuous to the customer that service has been discontinued and the address and telephone number of the utility where the customer may arrange to have service restored.

(9) Notwithstanding any other provision of this rule, a utility shall postpone a discontinuance for a time not in excess of twenty-one (21) days if the discontinuance will aggravate an existing medical emergency of the customer, a member of his/her family or other permanent resident of the premises where service is rendered. Any person who alleges a medical emergency, if requested, shall provide the utility with reasonable evidence of the necessity.

(10) Notwithstanding any other provision of this rule, a utility may discontinue residential service temporarily for reasons of maintenance, health, safety or a state of emergency.

(11) Upon the customer's request, a utility shall restore service consistent with all other provisions of this chapter when the cause for discontinuance has been eliminated, applicable restoration charges have been paid and, if required, satisfactory credit arrangements have been made. At all times, a reasonable effort shall be made to restore service upon the day restoration is requested, and in any event, restoration shall be made not later than the next working day following the day requested by the customer. The utility may charge the customer a reasonable fee for restoration of service, if provided in the utility's approved tariffs.

AUTHORITY: sections 386.250(6), RSMo Supp. 1991 and 393.140(11), RSMo 1986. Original rule filed Dec. 19, 1975, effective Dec. 30, 1975. Amended: Filed Oct. 14, 1977, effective Jan. 13, 1978. Emergency amendment filed Jan. 30, 1984, effective Feb. 9, 1984, expired April 1, 1984. Rescinded and readopted: Filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority: 386.250(6), RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991 and 393.140(11) 1939, amended 1949, 1967.*

4 CSR 240-13.055 Cold Weather Maintenance of Service: Provision of Residential Heat-Related Utility Service During Cold Weather

PURPOSE: This rule protects the health and safety of residential customers receiving heat-related utility service by placing restrictions on discontinuing and refusing to provide heat-related utility service from November 1 through March 31 due to delinquent accounts of those customers. Reporting requirements regarding heat-related utility service are found at 4 CSR 240-3.175 for electric utilities and at 4 CSR 240-3.250 for gas utilities.

(1) The following definitions shall apply in this rule:

(A) Energy Crisis Intervention Program (ECIP) means the federal ECIP administered by the Missouri Division of Family Services under section 660.100, RSMo;

(B) Heat-related utility service means any gas or electric service that is necessary to the proper function and operation of a customer's heating equipment;

(C) Low Income Home Energy Assistance Program (LIHEAP) means the federal LIHEAP administered by the Missouri Family Support Division under section 660.110, RSMo;

(D) Registered elderly or disabled customer means a customer's household where at least one (1) member of the household has filed with the utility a form approved by the utility attesting to the fact that s/he:

1. Is sixty-five (65) years old or older;
2. Is disabled to the extent that s/he has filed with their utility a medical form submitted by a medical physician attesting that such customer's household must have natural gas or electric utility service provided in the home to maintain life or health; or
3. Has a formal award letter issued from the federal government of disability benefits.

In order to retain his/her status as a registered elderly or disabled customer, each such customer must renew his/her registration with the utility annually. Such registration should take place by October 1 of each year following his/her initial registration; and

(E) Low income registered elderly or disabled customer means a customer registered under the provisions of subsection (1)(C) of this rule whose household income is less than one hundred fifty percent (150%) of the federal poverty guidelines, and who has a signed affidavit attesting to that fact on file with the utility. The utility may periodically audit the incomes of low income registered elderly or disabled customers. If, as a result of an audit, a registered low income elderly or disabled customer is found to have materially misrepresented his/her income at the time the affidavit was signed, that customer's service may be discontinued per the provisions of this rule that apply to customers who are not registered low income elderly or disabled customers and payment of all amounts due, as well as, a deposit may be required before service is reconnected.

(2) This rule takes precedence over other rules on provision of heat-related utility service from November 1 through March 31 annually.

(3) Notice Requirements. From November 1 through March 31, prior to discontinuance of service due to nonpayment, the utility shall—

(A) Notify the customer, at least ten (10) days prior to the date of the proposed discontinuance, by first-class mail, and in the case of a registered elderly or handicapped customer the additional party listed on the customer's registration form of the utility's intent to discontinue service. The contact with the registered individual shall include initially two (2) or more telephone call attempts with the mailing of the notice;

(B) Make further attempts to contact the customer within ninety-six (96) hours preceding discontinuance of service either by a second written notice as in subsection (3)(A), sent by first class mail; or a door hanger; or at least two (2) telephone call attempts to the customer;

(C) Attempt to contact the customer at the time of the discontinuance of service in the manner specified by 4 CSR 240-13.050(8);

(D) Make a personal contact on the premises with a registered elderly or handicapped customer or some member of the family above the age of fifteen (15) years, at the time of the discontinuance of service; and

(E) Ensure that all of the notices and contacts required in this section shall describe the terms for provisions of service under this rule, including the method of calculating the required payments, the availability of financial assistance from the Division of Family Services and social service or charitable organizations that have notified the utility that they provide that assistance and the identity of those organizations.

(4) The utility will not make oral representations of service termination for nonpayment when termination would occur on a known "no-cut" day as governed by the temperature moratorium.

(5) Weather Provisions. Discontinuance of gas and electric service to all residential users, including all residential tenants of apartment buildings, for nonpayment of bills where gas or electricity is used as the source of space heating or to control or operate the only space heating equipment at the residence is prohibited—

(A) On any day when the National Weather Service local forecast between 6:00 a.m. to 9:00 a.m., for the following twenty-four (24) hours predicts that the temperature will drop below thirty-two degrees Fahrenheit (32°F); or

(B) On any day when utility personnel will not be available to reconnect utility service during the immediately succeeding day(s) (Period of Unavailability) and the National Weather Service local forecast between 6:00 a.m. to 9:00 a.m. predicts that the temperature during the Period of Unavailability will drop below thirty-two degrees Fahrenheit (32°F); or

(C) From November 1 through March 31, for any registered low income elderly or low income disabled customer (as defined in this rule), provided that such customer has entered into a cold weather rule payment plan, made the initial payment required by section (10) of this rule and has made and continues to make payments during the effective period of this rule that are at a minimum the lesser of fifty percent (50%) of:

1. The actual bill for usage in that billing period; or

2. The levelized payment amount agreed to in the cold weather rule payment plan. Such reductions in payment amounts may be recovered by adjusting the customer's subsequent levelized payment amounts for the months following March 31.

(D) Nothing in this section shall prohibit a utility from establishing a higher temperature threshold below which it will not discontinue utility service.

(6) Discontinuance of Service. From November 1 through March 31, a utility may not discontinue heat-related residential utility service due to nonpayment of a delinquent bill or account provided—

(A) The customer contacts the utility and states his/her inability to pay in full;

(B) The utility receives an initial payment and the customer enters into a payment agreement both of which are in compliance with section (10) of this rule;

(C) The customer complies with the utility's requests for information regarding the customer's monthly or annual income; and

(D) There is no other lawful reason for discontinuance of utility service.

(7) Whenever a customer, with a cold weather rule payment agreement, moves to another residence within the utility's service area, the utility shall permit the customer to receive service if the customer pays in full the amounts that should have been paid pursuant to the agreement up to the date service is requested, as well as, amounts not included in a payment agreement that have become past due. No other change to the terms of service to the customer by virtue of the change in the customer's residence with the exception of an upward or downward adjustment to payments necessary to reflect any changes in expected usage between the old and new residence shall be made.

(8) Deposit Provisions. A utility shall not assess a new deposit or bill deposits that were previously assessed during or after the period of this rule to those customers who enter into a payment agreement and make timely payments in accordance with this rule.

(9) Reconnection Provisions. If a utility has discontinued heat-related utility service to a residential customer due to nonpayment of a delinquent account, the utility, from November 1 through March 31, shall reconnect service to that customer without requiring a deposit; provided—

(A) The customer contacts the utility, requests the utility to reconnect service and states an inability to pay in full;

(B) The utility receives an initial payment and the customer enters into a payment agreement both of which are in compliance with section (10) of this rule;

(C) The customer complies with the requests of the utility for information regarding the customer's monthly or annual income;

(D) None of the amount owed is an amount due as a result of unauthorized interference, diversion or use of the utility's service, and the customer has not engaged in such activity since last receiving service; and

(E) There is no other lawful reason for continued refusal to provide utility service.

(10) Payment Agreements. The payment agreement for service under this rule shall comply with the following:

(A) A pledge of an amount equal to any payment required by this section by the agency which administers LIHEAP shall be deemed to be the payment required. The utility shall confirm in writing the terms of any payment agreement under this rule, unless the extension granted the customer does not exceed two (2) weeks.

(B) Payment Calculations.

1. The utility shall first offer a twelve (12)-month budget plan which is designed to cover the total of all preexisting arrears, current bills and the utility's estimate of the ensuing bills.

2. If the customer states an inability to pay the budget plan amount, the utility and the customer may upon mutual agreement enter into a payment agreement which allows payment of preexisting arrears over a reasonable period in excess of twelve (12) months. In determining a reasonable period of time, the utility and the customer shall consider the amount of the arrears, the time over which it developed, the reasons why it developed, the customer's payment history and the customer's ability to pay.

3. A utility shall permit a customer to enter into a payment agreement to cover the current bill plus arrearages in fewer than twelve (12) months if requested by the customer.

4. The utility may revise the required payment in accordance with its budget or levelized payment plan.

5. If a customer defaults on a cold weather rule payment agreement but has not yet had service discontinued by the utility, the utility shall permit such customer to be reinstated on the payment agreement if the customer pays in full the amounts that should have been paid pursuant to the agreement up to the date service is requested, as well as, amounts not included in a payment agreement that have become past due.

(C) Initial Payments.

1. For a customer who has not defaulted on a payment plan under the cold weather rule, the initial payment shall be no more than twelve percent (12%) of the twelve (12)-

month budget bill amount calculated in subsection (10)(B) of this rule unless the utility and the customer agree to a different amount.

2. For a customer who has defaulted on a payment plan under the cold weather rule, the initial payment shall be an amount equal to eighty percent (80%) of the customer's balance, unless the utility and customer agree to a different amount.

(11) If a utility refuses to provide service pursuant to this rule and the reason for refusal of service involves unauthorized interference, diversion or use of the utility's service situated or delivered on or about the customer's premises, the utility shall maintain records concerning the refusal of service which, at a minimum, shall include: the name and address of the person denied reconnection, the names of all utility personnel involved in any part of the determination that refusal of service was appropriate, the facts surrounding the reason for the refusal and any other relevant information.

(12) The commission shall recognize and permit recovery of reasonable operating expenses incurred by a utility because of this rule.

(13) A utility may apply for a variance from this rule by filing an application for variance with the commission pursuant to the commission's rules of procedure. A utility may also file for commission approval of a tariff or tariffs establishing procedures for limiting the availability of the payment agreements under section (10) of this rule to customers residing in households with income levels below one hundred fifty percent (150%) of the federal poverty level, and for determining whether, and under what circumstances, customers who have subsequently defaulted on a new payment plan calculated under paragraph (10)(C)2. should be required to pay higher amounts toward delinquent installments owed under that payment plan.

(14) This section only applies to providers of natural gas services to residential customers. Other providers of heat-related utility services will continue to provide such service under the terms of sections (1) through (13) of this rule. The provisions of sections (1) through (13) of this rule continue to apply to providers of natural gas service except where inconsistent with the terms of this section.

(A) From November 1 through March 31, notwithstanding paragraph (10)(C)2. of this rule to the contrary, a gas utility shall restore service upon initial payment of the lesser of fifty percent (50%) or five hundred dollars ($500) of the preexisting arrears, with the deferred balance to be paid as provided in subsection (10)(B). Any reconnection fee, trip fee, collection fee or other fee related to reconnection, disconnection or collection shall also be deferred. Between November 1 and March 31, any customer threatened with disconnection may retain service by entering into a payment plan as described in this section. Any payment plan entered into under this section shall remain in effect (as long as its terms are adhered to) for the term of the payment plan, which shall be twelve (12) months' duration, unless the customer requests a shorter period or the utility agrees to a longer period. However, a gas utility shall not be required to offer reconnection or retention of service under this subsection (14)(A) more than once every two (2) years for any customer or to any customer who has defaulted on a payment plan under this section three (3) or more times.

(B) Any customer who is not disconnected or in receipt of a disconnect notice shall, at the customer's request, be permitted to enroll immediately in a gas utility's equal payment, budget-billing or similar plan. Any current bill or existing arrearage at the time of enrollment shall be dealt with consistent with paragraphs (10)(B)1. through (10)(B)4. of this rule, provided that the customer agrees to make the initial payment prescribed in paragraph (10)(C)1. or subsection (14)(A) as applicable.

(C) If a customer enters into a cold weather rule payment plan under this section:

1. Late payment charges shall not be assessed except with respect to failure to make timely payments under the payment plan; and

2. The gas utility shall not charge customers interest on the account balance for any deferral period.

(D) Any customer who enters into a cold weather rule payment agreement under this section and fully complies with the terms of the payment plan shall be treated, going forward, as not having defaulted on any cold weather rule payment agreement.

(E) A gas utility shall describe the provisions of section (14) in any notices or contacts with customers. In telephone contacts with customers expressing difficulty paying their gas bills, gas utilities shall inform those customers of their options under section (14).

(F) A gas utility shall be permitted to recover the costs of complying with this section as follows:

1. The cost of compliance with this section shall include any reasonable costs incurred to comply with the requirements of this section;

2. No gas utility shall be permitted to recover costs under this section that would have been incurred in the absence of this section, provided that the costs calculated in accordance with paragraph (14)(F)1. shall be considered costs of complying with this section;

3. Any net cost resulting from this section as of June 30 each year shall accumulate interest at the utility's annual short-term borrowing rate until such times as it is recovered in rates; and

4. No bad debts accrued prior to the effective date of this section may be included in the costs to be recovered under this section, provided that a gas utility may continue to calculate and defer for recovery through a separate Accounting Authority Order the costs of complying with the commission's January 1, 2006 emergency amendment to this rule upon the same terms as set forth herein. The costs eligible for recovery shall be the unpaid charges for new service received by the customer subsequent to the time the customer is retained or reconnected by virtue of this section plus the unpaid portion of the difference between the initial payment paid under this section and the initial payment that could have been required from the customer under the previously enacted payment provisions of section (10) of this rule, as measured at the time of a subsequent disconnection for nonpayment or expiration of the customer's payment plan.

(G) A gas utility shall be permitted to defer and recover the costs of complying with this rule through a one (1)-term Accounting Authority Order until such time as the compliance costs are included in rates as part of the next general rate proceeding or for a period of two (2) years following the effective date of this amendment:

1. The commission shall grant an Accounting Authority Order, as defined below, upon application of a gas utility, and the gas utility may book to Account 186 for review, audit and recovery all incremental expenses incurred and incremental revenues that are caused by this section. Any such Accounting Authority Order shall be effective until September 30, of each year for the preceding winter;

2. Between September 30 and October 31 each year, if a utility intends to seek recovery of any of the cost of compliance with this section, the utility shall file a request for determination of the cost of compliance with this section for the preceding winter season.

The request by the utility shall include all supporting information. All parties to this filing will have no longer than one hundred twenty (120) days from the date of such a filing to submit to the commission their position regarding the company's request with all supporting evidence. The commission shall hold a proceeding where the utility shall present all of its evidence concerning the cost of compliance and other parties, including commission staff, shall present any evidence that the costs asserted by the utility should be disallowed in whole or part. Such a proceeding may be waived by the unanimous request of the parties or by a non-unanimous request without objection. The commission shall establish the amount of costs it determines have been reasonably incurred in complying with this section within one hundred eighty (180) days of the utility's request and such amount will be carried forward into the utility's next rate case without reduction or alteration. Such costs shall be amortized in rates over a period of no greater than five (5) years and shall be recovered in a manner that does not impair the utility's ability to recover other costs of providing utility service. If the commission fails to establish the amount of costs within one hundred eighty (180) days, then the amount requested by the utility shall be deemed reasonably incurred.

3. The commission has adopted the Uniform System of Accounts in 4 CSR 240-4.040. Accounting Authority Orders are commission orders that allow a utility to defer certain expenses to Account 186 under the Uniform System of Accounts for later recovery as determined by the commission in a subsequent general rate case; and

4. Although the Accounting Authority Order allows the gas utility to recover the reasonably incurred expenses only within the context of a general rate case, all such reasonably incurred expenses shall be recovered by the gas utility, together with interest thereon, as set forth above.

AUTHORITY: sections 386.250 and 393.140, RSMo 2000 and 393.130, RSMo Supp. 2005. Original rule filed June 13, 1984, effective Nov. 15, 1984. Amended: Filed Dec. 30, 1992, effective Oct. 10, 1993. Amended: Filed March 10, 1995, effective Jan. 30, 1996. Emergency amendment filed Nov. 8, 2001, effective Nov. 18, 2001, expired March 31, 2002. Amended: Filed Aug. 16, 2002, effective April 30, 2003. Emergency amendment filed Dec. 16, 2005, effective Dec. 26, 2005, expired March 31, 2006. Amended: Filed April 9, 2004, effective Oct. 30, 2004. Emergency amendment filed Dec. 16, 2005, effective Dec. 26, 2005, expired March 31, 2006. Amended: Filed May 15, 2006, effective Nov. 1, 2006.*

**Original authority: 386.250, RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991, 1993, 1995, 1996; 393.130, RSMo 1939, amended 1949, 1967, 1969, 2002; and 393.140, RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.060 Settlement Agreement and Extension Agreement

PURPOSE: This rule establishes procedures where a customer may enter into a settlement agreement or obtain an extension of time in which to pay charges due a utility so that reasonable and uniform standards are established with regard to payment.

(1) When a utility and a customer arrive at a mutually satisfactory settlement of any dispute or the customer does not dispute liability to the utility but claims inability to pay the outstanding bill in full, a utility and the customer may enter into a settlement agreement. A settlement agreement which extends beyond sixty (60) days shall be in writing and mailed or otherwise delivered to the customer.

(2) Every settlement agreement resulting from the customer's inability to pay the outstanding bill in full shall provide that service will not be discontinued if the customer pays the amount of the outstanding bill specified in the agreement and agrees to pay a reasonable portion of the remaining outstanding balance in installments until the bill is paid. For purposes of determining reasonableness, the parties shall consider the following: the size of the delinquent account, the customer's ability to pay, the customer's payment history, the time that the debt has been outstanding, the reasons why the debt has been outstanding, and any other relevant factors relating to the customer's service.

(3) If a customer fails to comply with the terms and conditions of a settlement agreement, a utility may discontinue service after notifying the customer in writing by personal service or first class mail in accordance with 4 CSR 240-13.050—that the customer is in default of the settlement agreement; the nature of the default; that unless full payment of all balances due is made, the utility will discontinue service; and the date upon or after which service will be discontinued.

(4) The utility may enter into an extension agreement upon the request of a customer who claims an inability to pay the bill in full.

AUTHORITY: sections 386.250(6), RSMo Supp. 1991 and 393.140(11), RSMo 1986. Original rule filed Dec. 19, 1975, effective Dec. 30, 1975. Amended: Filed Oct. 14, 1977, effective Jan. 13, 1978. Rescinded and readopted: Filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority: 386.250(6), RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991 and 393.140(11), RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.065 Variance

PURPOSE: This rule establishes the procedure to be followed by a utility seeking a variance from any provision of this chapter.

(1) Any utility may file an application with the commission seeking a variance from all or parts of Chapter 13, which may be granted for good cause shown.

(2) A utility filing an application for a variance with the commission shall mail, contemporaneously with the filing, copies of the application by first class mail to the newspaper with the largest circulation in each county within the utility's service area affected by the variance, the public counsel and each party in the utility's most recent rate case who represented residential customers.

(3) Any variance granted by the commission shall be reflected in a tariff.

AUTHORITY: sections 386.250(6), RSMo Supp. 1991 and 393.140(11), RSMo 1986. Original rule filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority: 386.250(6), RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991 and 393.140(11), RSMo 1939, amended 1949, 1967.*

4 CSR 240-13.070 Commission Complaint Procedures

PURPOSE: This rule sets forth the procedures to be followed prior to and in filing formal or informal complaints with the commission regarding matters covered in this chapter.

(1) Prior to filing an informal or formal complaint, the customer shall pursue remedies directly with the utility as provided in this chapter. The commission specifically reserves the right to waive this requirement when circumstances so require.

(2) Any person aggrieved by a violation of any rules in this chapter or the Public Service commission laws of Missouri relating to utilities may file an informal or formal complaint under 4 CSR 240-2.070.

(3) If a utility and a customer fail to resolve a matter in dispute, the utility shall advise the customer of his/her right to file an informal complaint with the commission under 4 CSR 240-2.070.

(4) If the staff is unable to resolve the complaint to the satisfaction of the parties, the staff shall send a dated letter to that effect to the complainant and to the utility.

(A) The letter shall advise the complainant that, if s/he desires, s/he may file a formal complaint in accordance with 4 CSR 240-2.070.

(B) If the complaint concerns a bill, the nonpayment of which could subject the complainant to discontinuance of service under the provisions of 4 CSR 240-13.050, the staff's letter shall advise the complainant that if a formal complaint is not filed within thirty (30) days of the date of the letter, the complainant may become subject to discontinuance of service.

(5) The commission staff may treat an informal complaint involving the same question or issue based upon the same facts dealt with in a prior informal complaint as already decided, and may advise the complainant that this informal complaint will not be reviewed.

(6) A utility shall not discontinue residential service relative to the matter in dispute during the pendency of an informal complaint and until at least thirty-one (31) days after the date of the letter issued pursuant to section (4), and shall in no case discontinue this service without leaving a notice of discontinuance after the date of the letter issued pursuant to section (4).

(7) Failure of the customer to pay the amount of a bill which is not in dispute, as determined pursuant to sections 4 CSR 240-13.045(5) or (6) of these rules, shall be grounds for dismissal of an informal or formal complaint.

AUTHORITY: sections 386.250(6), RSMo Supp. 1991 and 393.140(11), RSMo 1986. Original rule filed Dec. 19, 1975, effective Dec. 30, 1975. Amended: Filed Oct. 14, 1977, effective Jan. 13, 1978. Amended: Filed Jan. 14, 1981, effective July 15, 1981. Rescinded and readopted: Filed Sept. 22, 1993, effective July 10, 1994.*

**Original authority: 386.250(11), RSMo 1939, amended 1963, 1967, 1977, 1980, 1987, 1988, 1991 and 393.140(11), RSMo 1939, amended 1949, 1967.*

In the Matter of the Application of PACIFIC BELL, a corporation for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California and Related Matters.

Decision No. 86-01-026

California Public Utilities Commission

1986 Cal. PUC LEXIS 890; 20 CPUC2d 237

III. Quality of Service

PacBell's showing on service quality is in Exhibit 80 and staff addresses service in Exhibit 140. The subject of service to private line alarm customers is being addressed in the rate design phase **[*13]** of these proceedings, so our discussion today relates to ordinary telephone service.

Staff's overall assessment, from reviewing measured service indices and its customer surveys, is that PacBell's service is very good. This finding comports with our tentative observation based on the statements of customers at public hearings and the hundreds of letters received. Although customers complain about the level of rate increase requested by PacBell, some of the confusion caused by divestiture, and aspects of the rate structure they do not like, we have had almost no complaints in these proceedings about what is more objectively called inadequate service, e.g., long outages, call cutoffs, slow repair response times, or inaccurate billing. A lot of letters complain about "paying more for less service," but they address this in the context of being charged for directory assistance calls, nonpublished directory listings, and service order changes. Overall, we find PacBell's service to be good, and certainly better than that of some of the other local exchange utilities.

A. Directory Assistance (DA) operator, toll operator, and trouble report service answering times

Staff's Singh notes **[*14]** that our General Order (GO) 133A, which was adopted in November 1983 to supercede GO 133, established reporting requirements for these service indices, and he finds that PacBell is not reporting results as required. Whereas average answering time per reporting entity is quantified and reported by PacBell, Singh correctly points out that GO 133A requires the reporting of the percentage of calls waiting for answer beyond certain intervals. He was told by PacBell's representatives that its equipment limits its reporting to average answering times. Singh is perturbed by this because he believes PacBell should have pointed this out during the proceeding which led to GO 133A, I88, or have petitioned for modification of the decision adopting GO 133A. Singh found other utilities were also not reporting these service results as required under GO 133A. Unless PacBell shows good reason for not complying fully with GO 133A it should be fined $ 4 million, according to Singh.

Our ALJ asked Singh why staff did not take the more direct route of submitting a proposed order instituting investigation or order to show cause re contempt when it discovered GO 133A was not being complied with. Singh **[*15]** said he thought bringing the matter to our attention in these proceedings was about as expeditious. In his rebuttal testimony PacBell's Revelle acknowledged that this matter deserves review, and said that PacBell would spearhead initiating a review by the GO 133A "technical subcommittee" in order to get the GO modified, if need be, so it can be complied with. This course seems constructive, because all parties agree that even if PacBell modified its equipment to comply with existing GO 133A, service to customers would not materially improve. We urge staff and PacBell to move ahead with the review of these aspects of GO 133A, an undertaking which we wish had started in early 1984 instead of now.

B. Reporting major service interruptions

Singh said PacBell had 57 major or reportable service interruptions in 1984, but only 15 were reported to this Commission. There are many reasons why expeditious reports about service interruptions are of interest and value to us. As Singh notes, often we receive calls from customers and the media when service is interrupted, and this Commission cannot respond if we lack information. Appendix D to Exhibit 140 contains his proposed rules **[*16]** and criteria for all telephone utilities to follow in reporting major service interruptions, and Singh asks that we order the respondents to I.85-03-078 to follow them.

In rebuttal Revelle said that PacBell was "sporadic" in reporting major service interruptions in 1984 due to the disruption of divestiture and its internal reorganization. Things are back to normal, Revelle testified, and he believes issuing the order recommended by Singh would be essentially overkill.

This did not appear to be a problem with PacBell before divestiture, and Singh did not indicate that it has been a problem with other smaller telephone utilities. The rules and criteria proposed by Singh should logically be taken up in the context of amending GO 133A because they would impose a standing service reporting requirement. If staff finds, contrary to Revelle's assertion, that PacBell has not improved its reporting of service interruptions in 1985, or that this is a chronic problem with smaller utilities, it may propose appropriate amendments to GO 133A, and we will be receptive to adopting formal reporting requirements. But at this juncture today we conclude that it is premature to adopt Singh's recommendation.

[*17]

C. Costs for customer surveys

Prior to divestiture PacBell participated in an AT&T-directed customer survey process called TELSAM. It was a telephone interview with randomly selected customers aimed at finding out how they viewed their telephone service. Another survey, with almost the same name, TELCAM, was conducted, but it was aimed at determining customers' attitudes about the corporate image. By D.82-12-025, mimeo. pages 68-69, we disallowed all expense for TELCAM, and reduced the expense for TELSAM to reflect the need for fewer interviews. Since divestiture PacBell has dropped TELSAM and replaced it with the

External Measurement System (EMS).EMS differs from its predecessor, TELSAM, in several respects. Instead of only sampling residential customers EMS also samples business customers of all sizes, and whereas TELSAM sampled about 70 customers per "district," EMS samples down to the smaller entities with interviews of about 200 customers monthly.

Staff's Singh believes we should recognize for ratemaking purposes only EMS expense for surveys twice per year, with follow-up surveys three successive months for the 10% of entities or areas with the lowest overall satisfaction **[*18]** or, put another way, the highest complaint levels. These were the criteria adopted in D.83-12-025 for our adjustment to TELSAM expense. The effect of staff's adjustment would be to allow $ 675,500 for this expense instead of the almost $ 3 million proposed by PacBell. Singh's rationale is that EMS, just as TELSAM, seeks to measure primarily PacBell's "courtesy and responsiveness," and while it is worthwhile to monitor these aspects of customer satisfaction the frequency of the EMS interviews is overkill. In rebuttal, Revelle testified that according to PacBell's statisticians, doing the surveys only twice a year, with no increase in the usual size of the sample, would drop the confidence level of the survey results below 95%. He criticizes staff for not addressing the statistical validity aspect which flows from its recommendation. Accurate survey results, which are more current than twice a year, are critical, Revelle said, because under PacBell's incentive compensation program salaries for some of its management force are tied to EMS survey results; e.g., if there is poor customer satisfaction in a district key management employees may not see a pay raise. He stressed that **[*19]** monthly surveys enable PacBell to spot problem areas or trends, and take corrective action before problems escalate.

We conclude that PacBell has demonstrated the reasonableness of the EMS program expense. Overall we are favorably disposed toward PacBell's expanded use of performance incentives to compensate its management force and we believe there should be little question about the statistical validity of the results if salary levels are to hinge on them. Also, on balance, we believe monthly surveys are preferable to semiannual ones so PacBell can react more responsively where problems are developing. Finally, we think EMS may be of more overall value than Singh implies. He is correct that it does not measure the more concrete aspects of service, but then none of the GO 133A indices capture the more intangible but nevertheless important aspects such as courtesy and demeanor of employees. EMS appears the only primary means that PacBell has to "get a handle" on how these aspects of service are doing on a companywide and local basis. We are mindful that our conclusion today differs from that reached in D.83-12-025, but today's decision is based on considering more aspects of **[*20]** the issue.

IV. Rate of Return

A. Background

Following is the capital structure and cost of capital components which underlie PacBell's present authorized return on rate base of 12.64% (D.85-12-025, mimeo. page 181), as modified by D.84-04-104):

	Ratio	Adopted Cost	Weighted Cost
Long-term debt	47.90%	9.70%	4.6463%
Preferred stock	3.80	8.45	0.3211
6% preferred	0.60	6.00	0.0360
Common equity	47.70	16.00	7.6320
Total	100.00		12.64%

PacBell presented three witnesses on rate of return, Vander Weide (Exhibits 57 and 58), Downing (Exhibits 59 and 60), and Meyer (Exhibit 64). Aside from staff who sponsored Mowrey (Exhibit 157), two interested parties presented witnesses: City of Los Angeles' Kroman (Exhibits 155 and 156) and the Department of Defense's Langsam (Exhibit 158). All the parties take issue with PacBell's requested 16.75% cost for common equity, and the Department of Defense recommends imputing a capital structure closer to 50% debt and 50% equity.

A Report on the Payday Loan Industry

http://www.in.gov/dfi/2366.htm

The Growth of Legal Loan Sharking: A Report on the Payday Loan Industry

Jean Ann Fox, Director of Consumer Protection

Consumer Federation of America

November 1998

Lending small sums of money at exorbitant interest rates for short periods of time was once considered a social problem requiring the solution of usury and small loan laws. However, payday lenders have persuaded nineteen states to legalize triple digit interest short-term lending and are pressing the remaining states to make payday loans legitimate.

Payday loans have proved very controversial due to the high interest rates charged, collection practices by some lenders, and disputes over compliance with credit laws. These loans sanction the writing of bad checks and entice consumers into relying on very expensive debt to live beyond their means.

In 1997 CFA published a report on check cashing and payday loan practices which found that state consumer protections are inadequate to prevent rate-gouging and to promote informed decisions. This report updates the status of payday lending under state laws and regulations, surveys payday loan terms in 8 states, and offers recommendations to policymakers and advice to consumers.

Payday Loans Provide Quick Easy Credit At a Steep Price

Check cashers, stand-alone companies, and banks are making small sum, short term, very high rate loans that go by a variety of names: "payday loans," "cash advance loans," "check advance loans," "post-dated check loans" or "delayed deposit check loans." Typically, a borrower writes a personal check payable to the lender for the amount he wishes to borrow plus the fee. Fees for payday loans are typically a percentage of the face value of the check or a fee per $100 loaned. Under the federal Truth in Lending Act, the cost of loans must be disclosed as both a finance charge (in this case the fee) and as an annual percentage rate (APR), the standard cost of credit to the borrower on an annual basis.

In a payday loan, both the lender and the borrower know that sufficient funds to cover the check are not available when the check is tendered. The check casher agrees to hold the check until the consumer's next payday, usually up to two weeks. At that point, the consumer can either redeem the check with cash or a money order, permit the check to be deposited, or renew the loan by paying another fee. Payday lenders charge the same fee to roll-over the loan although the transaction costs for a renewal are not comparable.

Although payday lenders typically do not get a credit report on borrowers, they do ask for evidence of an open bank account and current employment. Payday lenders use data base companies, such as TeleTrack, to screen out risky borrowers.

A cash advance loan secured by a personal check is very high priced credit. The National Consumer Law Center reports effective interest rates for payday loans earlier in the decade of 700 to 2000%. The APR varies depending on the fee and how long the check is held before being deposited or redeemed. For a $100 loan for a seven-day period under Iowa's law, the annual percentage rate is 780%; for a five-day period, the annual rate is 1,034%. Loans which are renewed over and over because the borrower cannot afford to pay off the principle while keeping up the fees every 7 to 15 days, carry a steep finance charge. A $100 loan with a $15 fee every two weeks costs 391% APR. This loan, rolled-over three times, costs $60 to borrow $100 for 56 days for the same 391% APR.

Why Payday Lenders Use Personal Checks to Make Small Loans

When payday loans were first offered in the mid-'90s, most state usury or small loan laws made these transactions illegal. By labeling the transaction as check cashing instead of lending, companies sought to avoid credit laws. Litigation by

Attorneys General and private class action lawsuits have produced court decisions and settlements confirming that payday loans are subject to usury, limits small loan caps, and other credit protection laws.

Recently enacted laws in some states to permit payday lending define this transaction as "deferred presentment" with the fee not to be considered interest for purposes of state usury laws. Other states have muddled the distinction between check cashing and payday lending by permitting loans to be made if the fee charged is the same as that for cashing a check. Regulators in Florida permit payday loans if the fee charged is the same as that allowed for check cashing (10%) but consider rollovers to be extensions of credit not permitted under Florida's money transmitter law.

Payday lenders benefit from using personal checks as the loan device although the transactions do not require that a check be written. In many cases, the "check" is never cashed, but is returned to the borrower when cash to pay the loan is exchanged for the "check." Loaning money based on personal checks sets up the advantageous comparison in fees between bank bounced check charges and the payday loan fee. A $15 per $100 payday loan fee might look like a bargain compared to a bank's $25 bounced check charge plus a merchant's fee in addition. However, the proper cost comparison for payday loans is with other sources of small loans. A 14 day payday loan with a $15 fee costs 391% APR compared to the typical state small loan interest cap of up to 36% APR. A typical rate for a secured credit card is 24%. Overdraft protection on a checking account costs in range of 18 to 24% plus a small one-time fee.

Use of a personal check makes collection easier for lenders. Consumers can be frightened into paying up to avoid prosecution for bad check charges or civil litigation for triple damages. Use of the criminal process gives payday lenders a collection advantage that no other creditor enjoys. The Florida Comptroller brought charges against a payday lender who used fake sheriff's office letterhead for collection purposes. Attorneys in Ohio report that lenders use the checks without supplying the contract as if they were the victims of bad checks, not a contract in dispute. Holding a borrower's check eases debt collection even when threats are not involved. There is a cost savings to the lender who can "collect" on the debt by sending the check through the bank clearing process. Some payday lenders get borrowers to sign authorization to permit the lender to electronically withdraw funds from the consumer's bank account, using the Automated Clearinghouse system.

Payday Loan Industry

Payday loans are made by check cashing outlets, pawn shops, and other entities that fill the vacuum left by the majority of mainstream lenders that have left the small loan market. Traditional small loan companies are more likely today to be offering home equity lines of credit than loans for a few hundred dollars for a short period of time. Although some banks, credit unions, and small loan companies make relatively small loans, payday lenders have targeted that market.

Payday lending has exploded in the last few years. Colorado is one of the few states with an industry-wide annual report available. For 1997, the Attorney General reported that 188 lenders made 374,477 post-dated check loans totaling $42,823,089. The average annual percentage rate charged on these loans was 485.26%. The average term for loans was 16.58 days. Over 58,000 of these loans, or 15.5%, were refinanced. For the year ended 12/31/97, Washington reported 562,031 loans made by check cashers. These loans were for a total of $144,923,986. The average size loan was $255. Lenders collected $21,541,338 in fees and charged off $2,054,338. Indiana reports that the number of payday lenders jumped from 11 in 1995 to 59 in 1997, with loan volume increasing from $12,688,599 in 1995 to $98 million in 1997.

Missouri licenses about 450 lenders and reports fast growth. Oklahoma estimates that 900 of 1400 licensed small lenders are in the payday loan business. Idaho, which had two payday lenders in 1993, now has 74. In two years, Iowa payday lenders increased from eight to sixty-four. Louisiana licenses 345 lenders. The number of lenders almost tripled in Wyoming in two years with over $5 million in loans made in 1997, compared to $2.3 million in 1996. Mississippi officials estimated over 350 locations made payday loans in 1998 before regulation. By late March of 1998, Indiana had 96 licensees with 225 branches for a total of 321 locations in Indiana.

Public data on the profitability of payday lending is sketchy. An Internet posting by Aaffordable Payday Loans claims that company has "$800,000 'on the street' with an average 30% per month return on our money." A cover story in the trade magazine of the check cashing industry noted that "holding a check for a fee is bringing a bundle of profits to increasing numbers of operators."

Check cashing outlets

A seminar at the National Check Cashers Association 1998 convention drew standing room only crowds for check cashers interested in going into payday lending. As check cashers lose a portion of their traditional business to electronic delivery of state benefits and federal payments, check cashers are searching for profitable financial services to replace check cashing. The National Check Cashers Association has issued a position paper in support of payday lending and is working on a model legislative proposal for states that have not authorized payday lending. Loan & Check, a vendor to the trade, claims that payday loans will grow by 600% over the next ten years.

Ace Cash Express, the largest chain of check cashing outlets is based in Irving, Texas, and operates 725 Company-owned stores and 100 franchise stores in 29 states. Its small-loan product offered in 240 stores provides earnings growth. Ace's 1997 payday loan revenue of $10.1 million was double the volume of business in 1996. Act is now opening stores inside Wal-Mart Supercenters. An Oregon news report noted that Ace Cash Express charges $18 to borrow $100 for 14 days, for an effective interest rate of 469%..

Stand Alone Payday Lenders

Stand alone payday loan companies have experienced explosive growth in the last five years. Advance America, Cash Advance Centers, a South Carolina company, have 426 branches in 16 states. The company opened its first store in November 1997 and expects to have over 500 outlets by the end of 1998.

Check Into Cash, Inc., based in Cleveland, TN, opened its first store in 1993 and now operates 340 outlets in 15 states. The company reported revenues of $21.4 million in 1997 and almost exceeded that amount ($21.2 million) for the first half of 1998. For the first six months of 1998, Check Into Cash completed 652,000 transactions attributable to 120,000 customers. Bad debt expense has ranged from 2.3% to 5.6% since 1993.

Other large stand alone payday lenders include National Cash Advance and Check & Go. The company reported a volume of $9.9 million in 1996, nearly triple 1995 revenue. National Cash Advance, another Tennessee company, opened 165 stores in less than three years. Another large stand-alone payday lender, Check 'N Go, started with one store in Cincinnati in 1994 and has about 400 outlets nationwide. Check 'N Go charges $20 for every $100 loaned.

National Banks

Check cashing outlets have formed partnerships with national banks to make payday loans, including in states where check cashers are prohibited from charging typical payday loan rates or extending credit. Eagle National Bank, a federally charted bank located in Upper Darby, Pennsylvania, makes "Cash Till Payday" loans of up to $500 through Dollar Financial Group's check cashers in several states. Dollar Financial Group claims that Eagle National Bank is able to export Pennsylvania's deregulated bank loan fees to consumers in other states. Eagle charges up to $17.50 per $100 for 14 day payday loans (454% APR). In 1997, Eagle National Bank made 204,499 payday loans, with $31 million of the bank's loans small consumer loans (36% of loans made). The Comptroller of the Currency gave a "Satisfactory" Community Reinvestment Act rating to the bank in 1998, despite complaints by consumer organizations about the bank's triple-digit interest rate loans.

The Market for Payday Loans

The market for payday loans is made up of consumers who have personal checking accounts, but who are stretched to the limit financially. These consumers are not even living paycheck to paycheck, but are borrowing against their next paycheck to meet living expenses. Ace Cash Express' Vice President says payday loan customers "tend to be people at the bottom of the middle-class structure in this country." Stephens, Inc., an Arkansas investment company, estimates that the potential market for individuals utilizing store front financial service companies, such as rent to own, check cashing or small loan services, is roughly equivalent to those without an unsecured credit card, or approximately 35 million households.

A Washington regulator says that payday loans are a symptom of whopping credit card debt, as people who are highly leveraged need cash to pay bills. A CFA report on the burden of credit card debt reveals that 55 to 60 million households (55 – 60% of all households) carry credit card balances and that these balances average more than $7,000. A CFA report shows that the typical household with debt repayment problems has a moderate income and credit card debts of more than $10,000.

Lenders claim that their customers prefer to borrow from them than to hock their appliances at a pawnshop or to ask their employers for pay advances. Pawnshop loans are always for a fraction of the present value of the used pawned item, making a pawn transaction a poor comparison. The industry argues that consumers use payday loans to cover emergencies or unexpected medical bills. The West Coast Vice President for Check Into Cash claims that 30% of their customers need money to get their cars repaired. If true that payday loan customers have no savings to cover an emergency prescription or repair job, they are the classic "necessitous" borrower who perceive they have no choices but to borrow at triple-digit rates.

Payday Loans Place Borrowers on a Debt Treadmill

It is not unusual for borrowers to become mired in debt and renew cash advance loans every week or two. Payday loans are structured to make it difficult for consumers to pay in full at the end of the loan period without needing to borrow again before the next payday. A consumer paying off a loan of $100 to $300 plus the $15 to $45 fee within a few days often finds it difficult to make it to the next payday without having to borrow again.

A class action lawsuit filed in Tennessee described borrowers who renewed cash advance loans 20 to 29 times, paying fees of $19 to $24 per $100 loaned. One plaintiff "rolled over" loans 24 times in 15 months, borrowing a total of $400 and paying $1,364 while still owing $248. Bank Rate Monitor Online described a Kentucky consumer who borrowed $150 and had paid over $1,000 in fees over a six-month period without paying down the principal. Her solution was to declare bankruptcy. A Wisconsin news article described a consumer who borrowed more than $1200 from all five payday lenders in her town and was paying $200 every two weeks just to cover the fees without reducing principal.

State Payday Loan Laws

In the last few years, nineteen states and the District of Columbia have adopted legislation or regulations that authorize and regulate payday loans. The District of Columbia, Mississippi, Kentucky, Nevada, and South Carolina legislatures enacted bills in their 1998 session to permit and regulate payday loans. Alabama's legislature considered a bill but adjourned without adopting pending legislation. Pennsylvania's 1998 legislature adopted a check cashing law that prohibits cashing or advancing money on post-dated checks. A bill to raise the loan amount ceiling in California was withdrawn after consumer advocates objected and proposed amendments to establish reporting requirements for lenders. The Georgia legislature did not adopt bills filed to permit payday lending. Typical payday loan laws exempt these transactions from usury or interest rate caps, set a maximum fee and term for loans, restrict roll-overs or multiple loans, and require licensing by state regulators. Six state payday loan laws or regulations require lenders to disclose their fees as an Annual Percentage Rate. The maximum fees result in APRs for a $100 14-day loan range from 261% in Florida to 625% in Colorado. Thirteen of the 20 jurisdictions set the maximum fee at $15 per $100 loaned, a 391% APR on a 14 day loan. Sixteen states set a maximum loan term, but only Oklahoma sets a minimum term of 30 days to repay payday loans of $101 or less.

Most states create some type of criminal or administrative penalties. However, only seven states provide for some type of limited private right of action allowing the consumer to obtain relief against the lender. Only a small number prohibit the lender from threatening to file or filing criminal charges against a consumer as a mechanism to collect on the debt. These payday loan laws apply to check cashers in seven of the nineteen states.

Table One

States With Specific Payday Loan Law/Regulations

State	**Maximum Term/Amt.**	**Maximum Fee%[*]/$**	**Effective APR 7 day/14 day**	**TILA Disclosure Req.**	**Rollover/Refi. Prohibited**	**Max. Loan At 1 time # / $**
CA	30/$300	15%	782%/391%	N	N	1
CO	/$500	<25% or $25	1250%/625%	Y	Y	2
DC	31/$1000	10% +fee Up to $20	782%/391%	N	N	No Limit
FL[cc]		>10% or $5	521%/261%	N	N	No Limit
IO	/$500	$15 per $100 $10 per next $100	782%/391%	N	Y	2
KS	30/$780	scale of fees[$]	782%/391%	Y	Y	No Limit
KY	60/$500	$15 per $100 For 14 days	782%/391%	Y	N	2
LA	30/$500	scale of fees[$$]	521%/261%	N	Y	No Limit
MN	30/$350	scale of fees[$$$]	782%/391%	N	Y	No Limit
MS	30/$400	18%	938%/469%	N	N	No Limit
MO	10 mon/$500	$15/$100	782%/391%	N	N	No Limit
NE	31/$500	$15/$100	782%/391%	N	N	2

NV		To be set by regulation		N	N	No Limit
NC	31/$300	15%	782%/391%	N	Y	No Limit
OH	6 mon/$500	5%/mon. +	782%/391%	N	Y	No Limit
OK	30/$101	20%	1042%/521%	Y	N	$100
SC	31/$300	15%	782%/391%	Y	Y	No Limit
TN	31/$500	15% or $30	782%/391%	Y	Y	3
WA	31/$500	15% +	782%/391%	N	Y	No Limit
WY	30/	$30 or 20%	1042%/521%	Y	Y	No Limit

* % of face amount of check

cc Applies to check cashers only

$ $5.50 for loans $0 to $50, 10% of loans + $5 for $50 to $100, 7% + $5 for $100 to $250, 6% +$5 for $250 to $300.

$$ $5 for loans $0 to $99, $10 for loans $100-$200, $15 for loans $201-$500.

$$$ $5.50 for loans $0 - $50, 10% + $5 loans $50 - $100, 7% + $5 loans $100 - $250, 6% + $5 for loans $250 - $350.

Nineteen states and the United States Virgin Islands do not permit payday loans due to small loan interest rate caps and by specific prohibitions against payday lending by check cashers. States have enforced this ban with varying degrees of enthusiasm. The Attorneys General in Virginia, West Virginia, Pennsylvania, Michigan, and Maryland have brought cases against payday lenders as unlicensed small loan companies. Georgia's Industrial Loan Commissioner ruled in 1998 that payday lending violated the Georgia Industrial Loan Act. Alabama's Department of Banking issued 150 cease and desist orders in mid-1998, charging payday lenders with violating interest rate caps. A consent agreement negotiated between the Alabama Check Cashers Association and the Department of Banking, however, permits payday lending to continue in Alabama under restrictions until the case is heard or the legislature adopts legislation. (See Appendix B).

Table Two

States That Prohibit Payday Loans Through Small Loan Law and Check Casher Law

State	Cap Small Loan Rate	Check Casher Law Prohibits
Alabama	36%	
Alaska	36%	
Arizona	36%	
Arkansas	17%	
Connecticut	28.52%	Yes
Georgia	57.68%	Yes
Hawaii	24%	
Maine	30%	Yes
Maryland	33%	
Massachusetts	39.86%	Yes
Michigan	25%	
New Hampshire	24%	
Pennsylvania	23.57%	Yes
Puerto Rico	25%	
Rhode Island	36%	
Texas	31.65%	
Vermont	24%	
Virginia	36%	Yes
Virgin Islands	26%	
West Virginia	31%	Yes

Other states permit payday lending due to weaknesses in state laws that govern small loan companies or due to the lack of a usury cap. Twelve states do not cap interest rates for small loan companies, permitting payday lenders to get licenses and charge any rate they choose. Indiana permits payday lending due to its minimum $33 finance charge for consumer loans. Three of these states

(Delaware, New Jersey, and New York) only prohibit check cashers from making payday loans.

Table Three

States that Permit Payday Loans Through Small Loan Act Provisions

State	Small Loan Act APR on $200 Loan	Permitted for Check Cashers
Delaware	No Cap	No
Idaho	No Cap	Yes
Illinois	No Cap	Yes
Indiana	$33 min. finance charge/36% cap	Yes
Montana	No Cap	Yes
New Jersey	No Cap	No
New Mexico	No Cap	Yes
New York	No Cap	No
North Dakota	No Cap	Yes
Oregon	No Cap	Yes
South Dakota	No Cap	Yes
Utah	No Cap	Yes
Wisconsin	No Cap	Yes

CFA Payday Loan Survey

CFA member organizations surveyed payday lenders in eight states to learn the terms of payday loans and whether key disclosures are being made to consumers. Groups in Florida, California, South Carolina, Tennessee, Oregon, Illinois, Virginia, and Pennsylvania called 85 payday lenders during mid-1998 to ask the maximum loan and term, the fee, whether roll-over of loans is allowed, if a written agreement is required, and what the Annual Percentage Rate is the quoted loan. (See Appendix A for state surveys.)

Payday loans are permitted by state law in all of the states surveyed except in Pennsylvania and Virginia. Virginia prohibits payday lending through its check casher law and the small loan act with its 36% interest rate cap. Callers found that payday loans are being made in both Pennsylvania and Virginia. National chain payday loan companies in Western Pennsylvania charge 391% APR for 14-day loans ($15/$100 loaned). In Virginia payday loans are being made at

Dollar Financial Group check cashers in Tidewater by Eagle National Bank out of Pennsylvania. Eagle charges $17.50 per $100 for 14 days or 456% APR.

Fees for payday loans in Florida, South Carolina, California, and Tennessee are capped at rates from 10% in Florida to 15% of the face value of the check. Surveyors were quoted higher than legal fees in at least one entity in Florida, South Carolina, Tennessee, and California. There is no state fee cap in Oregon and Illinois where payday lenders with small loan licenses can set their own rates. Rates quoted in Oregon ranged from $15/$100 to $20/$100. Illinois surveyors found the highest rates quoted, ranging from $18 to $22/$100 loaned. Pennsylvania lenders quoted $15 per $100 for loans of up to $300, although there is no legal authority for payday lending in the state. The range of Annual Percentage Rates for $100 loan for 14 days ranged from 261% to 782% APR. The size of loans offered by payday lenders ranged from $100 to $1,000, with some lenders loaning amounts based on the consumer's take-home pay. Although state payday loan laws typically set 30 or 31-day maximum terms, loan terms quoted to surveyors were most often 14 or 15 days, with some terms as short as "your next payday" and 7 days.

Callers asked payday lenders what the annual percentage rate was for the loans described in the surveys. Only Tennessee lenders quoted triple digit interest rates consistently. Annual percentage rates were also quoted by some lenders in California, Illinois, and Oregon. Other lenders responded with "I don't know," "it's not a loan," or simply quoted the fee.

Policy Recommendations

- States should enforce current usury and small loan laws that outlaw payday or cash advance loans. Those states without interest rate or usury caps should impose maximum interest limits on loans of $1,000 or less to prevent rate-gouging with payday loans and other small loans. States that already outlaw cash advance loans made by check cashers should close any loopholes that permit state licensed check cashers to offer cash advance loans provided by banks if those banks are not subject to usury caps.
- Failing an outright ban on cash advance loans, this type of loan should be explicitly regulated through state small loan laws requiring licensing or registration with state banking officials. Disclosures must comply with the federal Truth in Lending Act. There should be an absolute cap on effective annual interest

rates. States should limit the size of these loans, set a minimum term that realistically permits the loan to be repaid, require written contracts, forbid multiple loans and roll-over of cash advances into new loans, and prohibit lenders from threatening borrowers with bad check laws if they fall behind on payments. Lenders should not be permitted to bring criminal prosecution for failure to pay cash advance loans on checks and these loans should be treated as unsecured debt for purposes of bankruptcy. States should collect industry-wide data to monitor the business. (See Appendix C.)

- The federal government should close any loopholes that permit national banks to make payday loans in any state that prohibits state check cashers or state chartered financial institutions from making this type of loan. The Comptroller should require banks to comply with the consumer protections in the states where they do business.
- Treasury should adopt consumer protection rules for accounts opened voluntarily by consumers to comply with the federal law requiring electronic deposit of federal checks staring in 1999. Check cashers and other financial service companies are negotiating agreements with banks to provide access to EFT99 accounts. Check cashers can be expected to offer payday loans based on anticipated delivery of federal benefits through EFT'99 accounts accessible at their stores.

Advice to Consumers

- Make a realistic budget and build up a nest egg of savings to avoid the need to borrow small sums to meet emergencies and unexpected expenses. Just $300 in a savings account would save payday loan borrowers the steep fees. Saving the fee on a typical $300 payday loan for six months will provide a $300 buffer against financial emergencies.
- Shop for the lowest cost credit available from cash advances on credit cards, small loans from your credit union or a small loan company, an advance on your pay from your employer, and loans from friends or family. Some local community based organizations may make small business loans to individuals. Ask for more time to pay utility bills. Compare both the Annual Percentage Rate (APR) and the finance charge (loan fee stated in dollars) to get the lowest cost credit. Do not simply compare the payday loan fee with a bank bounced check charge. Consider overdraft protection on your checking account.
- If you do use payday loans, borrow only as much as you can afford to pay with your next paycheck and still have enough to make it to the next payday..

Appendix A

CFA Payday Loan State Surveys

Florida

Florida's check cashing law was enacted before payday lending was offered. The 10% cap on check cashing fees has been applied to payday lending as long as the loan is not renewed. The Florida Public Interest Research Group was quoted rates that exceed the 10% fee cap in ten of nineteen instances, with effective APRs ranging from 261% to 573%. The longest loan term was 15 days, with five lenders demanding repayment on the next payday. None of the companies quoted an APR when asked.

Florida Payday Loan Survey Florida Public Interest Research Group

Company City	Max. Loan	Max. Term	Fee/$100	APR/$100 14 days	Roll-Over Allowed?
Check Express Inc. Orlando	$200	14 days	$12.91	336%	No
CCS Payment Store Sunrise	10-15% paycheck	14 days	$10	261%	Yes
Check Cashing Store Davie	10% paycheck	14 days/next pay	$10	261%	No
Cash Cow Ft. Lauderdale	$100	15 days	$10/3 days $22/15 days	573%	Yes
Broward Tags & Cks Ft. Lauderdale	50% of paycheck	Next payday	$10	261%	No
Ace America's Cash Express Hialeah	$500	14 days	$10	261%	Yes $3.25 late fee
Check Cashing Store Miami	Based on paycheck	Next payday	$10	261%	Yes
Check Cashers of FL Miami	50% of paycheck	Next payday	$13	338%	Yes
Check Cashers of Sarasota	50% of paycheck	14 days	$15	391%	No
Sun Check Cashers Sarasota	$100	Next payday	$11	286%	No
Pawn Depot Inc. St. Petersburg	$300	15 days	$15	391%	Yes
Cash Cow Tallahassee	$100	15 days	$22	573%	Yes
Express Title Loans Tallahassee	$200	7 days	$10	261%	Yes
Check-N-Go St.	$100	14 days	$16	417%	No

Petersburg					
EZ Cash Tallahassee	$100	15 days	$22	573%	Yes
Check-N-Go Tampa	50% of paycheck	14 days	$16	417%	No
Cash Your Check Tampa	up to 12% monthly income	14 days	$10	261%	No
24-Hour Checks Cashed, Tampa	$100	Next payday	$10	261%	Yes
Ace America's Cash Express Tampa	25% of income	14 days	$10	261%	No
FL Stat. Ann. § 560.201	NA	NA	$10	261%	NA

Pennsylvania

Payday lending is not legal in Pennsylvania. The small loan interest rate cap is $9.50 per $100 loaned per year, or an APR of 23.57%. Pennsylvania's Attorney General has brought cases against payday lending in Philadelphia. The check cashing law adopted in 1998 prohibits check cashers from making payday loans. The Mercer County Community Action Agency surveyors found payday lending thriving in Western Pennsylvania. All of the six lenders surveyed charged $15 per $100, or 391% APR for 14 day loans. One lender set a 7 day maximum term, producing a 782% APR. Only one lender permitted rollovers on loans, while two would lend again the next day. None of those surveyed quoted an APR when asked.

Pennsylvania Payday Loan Survey Mercer Co. Community Action Agency

Company/City	Max. Loan	Max. Term	Fee/$100	APR/$100 14 days	Roll-Over Allowed?
American Cash Advance/ Hermitage	$300, up to 50% payck	Next payday Up to 14 days	$15	391%	No, next day advance
Local Cash Advance/ Hermitage	$300	Next payday Up to 14 days	$15	391%	Yes
National Cash Advance/ Hermitage	$300, up to 80% payck	Next payday	$15	391%	No

United Cash Advance/ Sharon	$300, up to 70% payck	Next payday Up to 14 days	$15	391%	No
PayDay Cash Advance/ Sharon	$300, up to 50% payck	Next payday Up to 14 days	$15	391%	No, next day advance
Arctic Cash Advance/ Sharpsville	$300	Next payday Up to 14 days	$15/7 days $22/14 days	573%	No, "not a loan"

PA Check Cashing Licensing Act of 1998, § 505 (a) prohibits check cashers from making payday loans.

7 Pa. Cons Stat. Ann. § 6201 *et seq.* Caps small loan fees at $9.50/$100/year or 23.57% APR.

South Carolina

The Columbia Consumer Education Council called twelve companies advertising payday loans in South Carolina. Legislation adopted in 1998 sets a maximum $15/$100 fee and limits loans to $300 for a maximum term of 31 days. Fees quoted by lenders ranged from $15 per $100 to $30 per $100 loaned. Although South Carolina law prohibits rollovers, two companies stated that loans could be renewed. None of those surveyed quoted an APR when asked.

South Carolina Payday Loan Survey Columbia Consumer Education Council

Company/City	Max. Loan	Max. Term	Fee/$100	APR/$100 14 days	Roll-Over Allowed?
Check World/ Columbia	$125	14 days	$18.75 Deducted	460%	No
Money Lines/ Columbia	$200	Next payday	$30	782%	No
Payday Chex Ctr/ Columbia	$100	Next payday	$15 Deducted	460%	No
E-Z Check Cashing/ Columbia	$500	Next payday Up to 14 days	$18.75 Deducted	460%	No
Cash Advance/ Columbia	$100	Next payday Up to 14 days	$15 Deducted	460%	No
Fast Check Cashing/ Columbia	$200	Next payday Up to 14 days	$15	391%	Yes
Quick Cash Check Cashing/ Columbia	$125	Next payday	$18.75 Deducted	460%	No
Greenview Check Cashers/ Columbia	$100	Next payday	$15	391%	No

B-n-A Check Cashing/ Columbia	$125	14 days	$18.75	460%	No
Cash-O-Matic/ Lexington	$150	14 days	$22.50 Deducted	585%	No
Instant Check Cashing/ Columbia	$125	14 days	$18.75	460%	Yes
Ace America's Cash Express/ Orangeburg	$200	14 days	$30	782%	No
S.C. Code Ann. § 34-39-110 *et seq.*	$300	31 days	$15	391%	No

Oregon

The Oregon Public Interest Research Group called five payday lenders in Portland to check on fees. Oregon has no limits on payday loan rates charged by licensed loan companies. OsPIRG found fees ranging from $15 to $20 per $100, with APRs for 14-day loans of 391% to 521%. Three lenders agreed to rollover loans for an additional fee. Two lenders accurately quoted an APR for loans when asked.

Oregon Payday Loan Survey Oregon Public Interest Research Group

Company/City	Max. Loan	Max. Term	Fee/$100	APR/$100 14 days	Roll-Over Allowed?
Check-X-Change/ Portland	$100	14 days	$18	469%	Yes
Check Mart/ Portland	$500 25% payck	14 days	$15	391%	Yes
Cash Connection/ Portland	$500 25% payck	14 days	$15	391%	NA
Payroll Advance Systems/ Portland	$200	10 days	$20	521%	No
Check Cash/ Portland	$300	14 days	$15	391%	Yes

Or. Rev. Stat. § 725.340 Consumer Finance Act applies to payday loans. No cap on fees or limits on loan terms.

Illinois

The Champaign County Predatory Lending Task Force surveyed five payday lenders in Champaign, Illinois and found interest rates ranging from 469% to 573% APR. Illinois Public Interest Research Group surveyed 13 payday lenders in the Chicago area. Illinois does not cap interest rates. The maximum loan quoted was $1,000 or one week's pay. Five lenders correctly quoted an APR when asked.

Illinois Payday Loan Survey Champaign County Predatory Lending Task Force/Illinois Public Interest Research Group

Company/City	Max. Loan	Max. Term	Fee/$100	APR/$100 14 days	Roll-Over Allowed?
Campus Cash/ Champaign	$300	14 days	$18	469%	Yes
Advance America/ Champaign	$300	14 days	$20	521%	Yes, three times
Check and Go/ Champaign	$1,000 1 wk payck	14 days	$20	521%	Yes, three times
Check Into Cash/ Champaign	$300	Next payday up to 16 days	$22	573%	Yes, three times
Check Advance/ Champaign	$300 up to $500	14 days	$20	521%	Yes
Azteca-26th St. Currency/ Chicago	$500	"Depends"	$14	365%	Doesn't know
Campus Cash/ Elmhurst	$300	14 days	$18	469%	Yes, one time
Check 'N Go/ Chicago	Half one week's pay	14 days	$20	521%	Yes, three times
Insta Cash Advance/ Chicago	Half one week's pay	Next payday	$20	521%	Yes
Payday Loans/ Chicago	$300	Depends on loan amount	$20	521%	Yes, three times
Insta Cash/ Chicago	$150	Next payday	$21	547%	No
Pay Day Loan Corp IL/ Chicago	$300	14 days	$20	521%	Yes
Milennium Title, Inc./ Des Plains	Half of pay check	14 days	$10	261%	Yes
Checks-N-Advance/ Chicago	$600	14 days	$15	391%	Yes
Clark Lunt Currency Exchange Corp./ Chicago	Half of net pay	Next payday			Yes
79th & Jefferson Exchange, Inc./ Chicago	$150	21 days	$14	365%	Yes

Colonial Currency Exchange/ Chicago	$150	Next payday	$14	365%	NA
Currency Exchange/ Chicago	$100	14 days	$14	365%	Yes

205 Ill. Comp. Stat. 670/15 Ill. Consumer Installments Loan Act applies to payday lenders. No cap on fees or limits on loan terms.

Tennessee

A telephone survey of payday lenders was conducted in central Tennessee by CFA staff. Eight companies quoted fees per $100 ranging from $14 to $17.50. Tennessee's Deferred Presentment law caps fees at 15% of the total check. None of the lenders made loans for the maximum 31 day period, while one company set a 7-day loan limit. Almost all of the surveyed lenders quoted a triple-digit interest rate when asked the APR, while five were accurate.

Tennessee Payday Loan Survey Consumer Federation of America

Company/ City	Max. Loan	Max. Term	Fee/$100	APR/$100 14 days	Roll-overs Allowed?
National Cash Advance/ Shelbyville	$200	Next payday	$15	391%	No
Cash Advance/ Shelbyville	$200	14 days	$14	365%	No
America's Cash Advance/ Tullahoma	$200	7 days	$15	391%	No, write loan
Check Into Cash/ Tullahoma	$200	14 days	$15	391%	No, write new loan
Check Exchange/ Winchester	$150	14 days	$17.50	456%	No, write new loan
Cash Express/ Winchester	$200	14 days	$17.50	456%	No, write new loan
National Check Cash/ Winchester	$200	14 days	$17.50	456%	No, write new loan
Quick Cash/ Winchester	$100 1st time	14 days	$17.50	456%	No
Tenn. Code Ann. § 45-17-101 *et seq.*	$300	31 days	$15	391%	No

California

California Public Interest Research Group surveyed fifteen payday lenders in Sacramento and Los Angeles. None of the companies quoted an accurate APR for loans.

California Payday Loan Survey California Public Interest Research Group

Company/ City	Max. Loan	Max. Term	Fee/$100	APR/$100 14 days	Roll-Over Allowed?
Community Check Cash/ Los Angeles	$300	14 days	$15	391%	Yes
AnyKind Check Cash/ Los Angeles	$200	14 days	$15	391%	Yes
Continental Currency/ Los Angeles	$300	14 days	$15 + $10 1st time	391%	Yes
Check Cashing Ctr./ Los Angeles	$300	Next payday	$15	391%	Yes
Check Into Cash/ Sacramento	Based on pay	Next payday	$15 + $10 1st time	391%	No
Check-x-Change/ Sacramento	$250	14 days	$15	391%	Yes
Cash Check/ Sacramento	$150	Next payday	$15	391%	No
AnyKind Check Cash/ Sacramento	$200	14 days	$15	391%	Yes
Gold Star Check Cash/ Sacramento	$100	14 days	$15	391%	Yes
Madison Ave. Ck Csh/ Sacramento	$250	14-30 days	$15	391%	Yes
California Ck Cash/ Sacramento	$250	15 days	$15	391%	No
Check & Go/ Sacramento	Based on paycheck	14 days	$17.50	456%	No
Cash & Go/ Sacramento	$255	14 days	$15	391%	No
Cash Connection/ Sacramento	$300	14 days	$15	391%	Yes
C&C Check Cashing/ Sacramento	$200	14 days	$15	391%	Yes
Cal. Civ. Code § 1789.30 *et seq.*	$300 incl. Fee	30 days	$15	391%	Yes

Virginia

Virginia enforces its small loan and check casher laws to prevent payday lending. The Virginia Citizens Consumer Council conducted a telephone survey of 11 check cashers in Northern Virginia to verify that payday loans were not being offered. The Dollar Financial Group's Almost A Banc locations in Tidewater make 'Cash 'Til Payday' loans through Eagle National Bank, a Pennsylvania institution.

Virginia Payday Loan Survey Virginia Citizens Consumer Council

Company/ City	Max. Loan	Max. Term	Fee/$100	APR/$100 14 days	Roll-overs Allowed?
Almost-A-Banc/ Newport News, Chesapeake, Hampton, Norfolk, Portsmouth, Virginia Beach	$500	14 days	$17.50	456%	No, New loan

Va. Code Ann. § 6.1-432 *et. seq.* Check cashers are prohibited from making loans or cashing post-dated checks. Consumer Finance Act, Va. Code Ann. § 6.1-272.1 caps interest rates for loans of $2500 or less at 36% APR.

Appendix B

State Actions Involving Payday Lenders

Several states have challenged payday loans as violating state usury laws, as unauthorized small loan lending, or as violations of consumer protection laws. The following state reports illustrate efforts to curb payday lending across the country.

Alabama

The Alabama Attorney General issued an opinion July 7, 1994 that payday loans are loans covered by the Alabama Small Loan Act, the Mini-Code and are subject to Truth in Lending disclosure requirements. No action to enforce the 1994 opinion was taken until July 1, 1998 when the Alabama State Banking Department filed cease and desist orders against 150 check cashing companies making payday loans in violation of Alabama's small loan act which prohibits making loans for $749 or less without a license. The Alabama Check Cashers Association counter sued the state, seeking a declaratory judgment on whether the Alabama Small Loan Act applies to "Payday Loans" and "Catalog Sales." The trade association complaint sought injunctive relief to stop enforcement of the cease and desist orders. The case was assigned to a retired judge for mediation pending trial.[30] The consent agreement issued by Judge Reese October 9, 1998 permits payday lending to continue with restrictions pending a final court ruling or the adoption of legislation in Alabama. Parties to the injunction can make payday loans with fees up to 16.67% of the check including the fee. (This computes to 521% APR if the loan is repaid in 14 days or 1042% APR if repaid in 7 days.) Lenders may not renew or consolidate one payday loan with another, must provide written agreements, and may not file criminal charges for NSF returned checks.[31] Other payday lenders may sign the consent agreement to remain in business pending the final resolution of the case.

Three private class action lawsuits are pending in Huntsville, Alabama involving seven lenders in Huntsville as well as Greenstreet and Dollar Express. Two smaller class actions are in settlement.[32]

[30] Alabama Attorney General Opinion No. 94-00210, issued July 7, 1994

[31] State of Alabama State Banking Department Summary of Consent Order Regarding "Payday Loans," October 14, 1998

[32] Telephone interview with Lange Clark, Esq., Birmingham, Alabama attorney, 11/2/98.

Florida

The Florida Comptroller, Department of Banking and Finance, sought an emergency cease and desist order June 8, 1998 against Treasure Coast Cash, Inc, an unlicensed Stuart, Florida payday lender. The Comptroller cited Treasure and its principals for unlicensed lending under Chapters 516 and 687, Florida Statutes. Typical loans cost consumers 520% APR, with some payday loans up to 1560%. The Order also cited Treasure for collection practices that used, without authority, letterhead from the Martin County Sheriff's Office. The Comptroller listed violations including unlicensed consumer finance loans, interest in excess of 18% usury limit, and deceptive debt collection practices.

The Florida Department of Banking and Finance also filed an Administrative Complaint for Imposition of Sanctions and Notice of Rights August 28, 1998 against A Tropical Title Loan, Inc, located in Port St. Lucie, FL for unlicensed lending. At least 350 small loans were made at finance charges of 520% APR. Private class action litigation is underway in Florida against Cash-2-U and Treasure Coast Cash Co, accusing the companies of charging illegal interest and attempting to collect illegal debts.

Georgia

Georgia's Industrial Loan Commissioner John Oxendine found that EZ Cash, Inc., formerly known as Cash Cow, Inc., a Florida payday lender with branches in Georgia, was making small loans in violation of the Georgia Industrial Loan Act. Investigators testified at hearings in January that Cash Cow loaned money at rates of $25 per $100 payable in 15 days, resulting in annual simple interest rates of 600%. In Georgia, it is criminal usury to charge more than 60% interest on loans of less than $3,000. Although the Company used a variety of devices to obscure the loan, such as discount car title vouchers or check-cashing fees, Georgia officials found that these transactions are loans in violation of state law.

Kansas

The Kansas Attorney General obtained a 1992 consent judgment against Greenbacks, Inc. d/b/a Advance Checking and Check-Time in a case alleging that consumers were charged $25 per $100 loaned, resulting in annual percentage rate of 1,300% for a one-week loan.

Kentucky

A payday loan complaint brought by Addison Parker, a legal aid attorney with the Appalachian Research and Defense Fund of Kentucky, Inc., resulted in the first published Federal court decision involving payday lending. Judge Joseph M. Hood of the Eastern District of Kentucky issued an order December 11, 1997, refusing to dismiss a complaint against Larry York d/b/a HLT Check Exchange. The Court found the transactions to be interest bearing loans, not check cashing. Judge Hood held that HLT's payday loans were subject to Kentucky's Usury statute, the Kentucky Consumer Loan Act, the Civil RICO statute (18 U.S.C. _ 1964(c)), the federal Truth In Lending Act, and the Kentucky Consumer

Protection Act. The Acting General Counsel for the Kentucky Department of Financial Institutions, which licenses check cashers, filed an affidavit in support of the lender but failed to persuade the judge that payday lending is permitted under Kentucky's check casher law. The case was settled.

At least eight cases are pending in state and federal courts in Kentucky. Judge Hood, of the United States District Court for the Eastern District of Kentucky granted class status in October 1998 in Lucille Riley, et al v. Larry K. York D/B/A Hazard Check Exchange, No. 98-268. Action has been stayed in federal court on other cases while the Kentucky Supreme Court considers issues raised by litigation.

Maryland

Maryland's Attorney General brought a case against Cash-2-You Leasing, a Maryland company that loaned $200 at interest rates of 780% APR. The suit alleges that the company attempted to avoid Maryland's usury law that caps rates at 33% APR by having the consumer "sell" a household item which Cash-2-U then "leased" back. For a $200 loan, the borrower was required to write a check for $260 payable to the company. If the borrower failed to repay the $200 loan and $60 fee after 15 days, the company deposited the check. The Attorney General has charged that the sham "sale-leaseback" transaction is an unfair and deceptive practice used to obfuscate a usurious loan. The case has not been decided.

Michigan

In 1997, the Michigan Attorney General issued Notices of Intended Action to five check cashers for operating an illegal consumer loan service. Payday loan companies were charging in excess of 1000% APR. Michigan investigators found that five check-cashing companies charged annual rates of interest ranging from 416 to 1,095 percent while Michigan law allows a 25 percent rate for consumer loans. Michigan's Financial Institutions Bureau issued a ruling in 1995 that cash advances on checks held for future deposit is lending under Michigan's Regulatory Loan Act of 1963. Three of the entities signed assurances of discontinuance to settle the complaints brought by the Attorney General, agreeing to comply with the Michigan Consumer Protection Act and with applicable usury and licensing statutes. The Michigan Financial Institutions Bureau has determined that check cashers who charge their regular check cashing fee plus a 5% interest rate are in compliance with Michigan's general usury law and do not have to be licensed under the Regulatory Loan Act. Since Michigan does not regulate check cashers or set maximum check cashing fees, this decision permits payday loans at unlimited rates without APR disclosure.

Oregon

Within the last year Oregon's Division of Finance and Corporate Securities took regulatory action against three payday loan operations for unlicensed consumer finance activity. The companies were required to return all interest on the loans made prior to licensing, pay a civil penalty to the state, and cease and desist future violations. All three submitted license applications which were approved.

Pennsylvania

The Pennsylvania Bureau of Consumer Protection in Philadelphia settled a case with Universal Financial Enterprises, formerly Instant Check Co., that charged over 700% interest to first make payday loans, then a variation in which they "bought" a household item from the consumer, then "leased" it back under similar terms to the payday loan.

South Carolina

The South Carolina Department of Consumer Affairs closed a 1992 complaint against Speedy Cash, Inc. for making loans without a license from the South Carolina Board of Financial Institutions for making payday loans. Speedy Cash was accused of charging $60 to lend $200 for 14-day periods on personal checks held for deposit. Without admitting violations of law, the company ceased operations in South Carolina. The Department got a preliminary injunction against GSC Enterprises in 1994 for illegal and unconscionable collection practices and unlicensed lending. One complaint against GSC involved a $68 charge to borrow $100 for two weeks for an effective interest rate of 1632%. The

Department filed a third case in 1997 against check cashing outlets, alleging illegal loans, excess charges, violation of Truth in Lending, unconscionable debt collection, and violation of South Carolina's Unfair Trade Practices Act.

Tennessee

James Logan and Richard Fischer, Cleveland, Tennessee attorneys, sued Creditcorp, Inc. d/b/a Check Into Cash, alleging illegal practices and violation of the federal Truth in Lending Act and Fair Debt Collection Act. Check Into Cash settled the case, paying $2.2 million to the class and $500,000 in attorneys' fees. A second class action case was settled for an undisclosed sum involving National Check Advance. Seven other payday loan cases are pending in Circuit Court of Bradley County and one case in United States District Court, Eastern Division of Tennessee at Chattanooga is pending decision on plaintiff's motion for class certification.

Virginia

Virginia's Attorney General brought a series of cases in 1992 and 1993 against check cashers making payday loans, charging unauthorized small loan lending in violation of the Virginia Consumer Finance Act. In 1994, Virginia's Attorney General reached a $2.5 million settlement with an Alexandria-based "cash advance" firm, Cash Now Three, which advanced funds against personal checks, held them for 14 days, and charged a service fee of 28 percent of the amount financed, or an effective annual rate of 730%. Cash Now should have been a licensed small loan company in which case they would have been limited by a 36% APR usury cap on loans of $2500 or less. A Virginia court ruled that the practice of advancing cash against a customer's check dated for sometime in the future constituted the making of loans and that the fees charged greatly exceeded the limits imposed by the Consumer Finance Act.

Allstate Express Check Cashing, Inc., charged a 30% fee that amounted to an effective annual percentage rate of 730 percent when the check was held 15 days. The Circuit Court of the City of Richmond ruled that the owner of Allstate was personally liable for the $237,254 restitution judgment entered against the company in March 1995. Greenberg was ordered to pay $30,000 for attorney's fees to the Commonwealth, but the order was overturned by the Virginia Supreme Court. Claims for restitution were filed by 642 former customers.

West Virginia

In a 1996 case, Cash-N-Go of West Virginia signed a Consent Order with the Attorney General's office. The complaint alleged that Cash-N-Go made loans through its check cashing business without being licensed as a financial company. A permanent injunction was entered to halt the business and to pay refunds. (Circuit Court of Kanawha County, West VA. Civil Action No. 96-C-2291.) Check cashing legislation adopted in 1998 continued the prohibition against payday lending.

Appendix C

CFA/NCLC Model State Payday Loan Legislation

In states that chose to permit payday lending, model legislation should be adopted to protect consumers and curb abuses from excessive fees, roll-overs of loans, and punitive collection practices. Key points in a model payday loan law:

A. Purpose: To regulate delayed deposit loans as a credit transaction and to protect consumers.

B. Definitions: Broadly define "deferred deposit loan" to cover post-dated and present-dated check loans. Define "licensee" to include direct lenders and other lenders who make deferred deposit loans indirectly, including banks. Define "check" as a negotiable instrument.

C. Applicability: Act applies to lenders and those who facilitate or act as a conduit for another who may be exempt from state licensing but who makes deferred deposit loans, such as out-of-state national bank making deferred deposit loans through a check casher.

D. Exemptions: Exempt retail sellers who only incidentally cash checks. Financial institutions would not have to obtain a state license but must otherwise comply with the act.

E. Licensing: Sets up a state licensing regime with qualifications, bonding, minimum assets, and a public hearing to ascertain whether applicant has a clean record. Gives Commissioner powers to investigate, handle complaints, revoke or suspend a license, and issue regulations. Gives public access to complaint records.

F. Information and Annual Reports: Requires licensees to keep certain records, file an annual report, and to verify that licensees have not used the criminal process to collect deferred deposit loans. Licensees must file a copy of loan documents and fee schedules with Commissioner.

G. Required Acts: Sets term of loan to be no less than two weeks per $50 loaned. Sets maximum loan at $300 and the minimum at $50. Require licensee to stamp the back of the check with endorsement that check is being negotiated as a deferred deposit loan and that any holder of the check takes it subject to all claims and defenses of the maker.

H. Required Disclosures: Requires extensive disclosures including a written agreement describing the loan, an information brochure explaining consumer rights, Truth in Lending disclosures, and clear notice that borrower cannot be criminally or civilly prosecuted under bad check laws. Licensees required to post information at point of sale.

I. Prohibited Charges: Set maximum annual interest rate for deferred deposit loans at maximum small loan interest rate cap at a rate comparable to small loan laws. Limits charges for NSF fees to the lesser of $15 or the charge imposed by the financial institution as sole late fee. Unearned interest for prepaid loans must be rebated by actuarial method.

J. Prohibited Acts: Prohibits licensees from engaging in unfair and deceptive practices, from entering into unconscionable loans, from repaying or refinancing a deferred deposit loan with the proceeds of another, threatening to use or using the criminal process to collect loans, making repeat loans within 30 days, and selling extras such as insurance with loans.

K. Enforcement: Civil and criminal remedies, including a private right of action for borrowers to sue for actual, consequential, and punitive damages with $1,000 minimum penalty per violation. Class actions permitted. Knowing violation of act a misdemeanor, subject to $1,000 fine or imprisonment not to exceed six months or both.

For a copy of the CFA/NCLC Model State Deferred Deposit Loan Act, send $10 to Consumer Federation of America, 1424 16th Street NW, Suite 604, Washington, DC 20036.

The National Check Cashers Association policy position on payday lending supports state regulation of payday lending, state fee caps and disclosures, maximum loan size of up to $1,000 with inflation adjustment, and a maximum loan term of 31 days. NaCCA's position on "extensions and rollovers" would limit them to avoid an undue spiraling of obligations. NaCCA also supports limits on multiple deferred deposit transactions by setting a cap on the total amount of all transactions with the same provider. NaCCA supports a Code of Ethical Standards for the deferred deposit industry. ("The Consumer's Choice: The Role of Deferred Deposit Services in Meeting Short Term Financial Needs," National Check Cashers Association, June 8, 1998.)

ASSEMBLY BILL No. 2511

Introduced by Assembly Member Salas

February 21, 2008

An act to add Article 10 (commencing with Section 640) to Chapter 3 of Part 1 of Division 1 of the Public Utilities Code, relating to public utilities.

legislative counsel's digest

AB 2511, as introduced, Salas. Public utilities: bill payment.

Under existing law, the Public Utilities Commission has regulatory authority over public utilities. Existing law authorizes the commission to establish rules for all public utilities, subject to control by the Legislature.

The existing California Deferred Deposit Transaction Law provides for regulation of persons engaged in the business of making or negotiating deferred deposit transactions, which are transactions in which the lender defers depositing a consumer's personal check until a specific date pursuant to a written agreement. The California Deferred Deposit Transaction law provides for the licensing of those persons by the Commissioner of Corporations, imposes various duties on a person engaged in the business of making or negotiating deferred deposit transactions, and specifies the rights of a consumer in that regard.

This bill would prohibit a public utility from authorizing a licensee under the California Deferred Deposit Transaction Law to be an additional authorized payment location, as defined, and would require the commission to ensure compliance with this requirement. The bill would require any public utility that, prior to January 1, 2009, authorized a licensee to be an authorized payment location to actively search for alternative authorized payment locations, and to discontinue utilizing a licensee as an authorized payment location when an adequate alternative has been obtained. The bill would prohibit a public utility from having a licensee as an authorized payment location on or after January 1, 2011.

Existing law makes any public utility, as defined, and any corporation other than a public utility, that violates the Public Utilities Act, or that fails to comply with any part of any order, decision, rule, direction, demand, or requirement of the commission guilty of a crime.

Because the provisions of this bill would be a part of the act and because a violation of an order or decision of the commission implementing its requirements would be a crime, the bill would impose a state-mandated local program by creating a new crime.

The California Constitution requires the state to reimburse local agencies and school districts for certain costs mandated by the state. Statutory provisions establish procedures for making that reimbursement.

This bill would provide that no reimbursement is required by this act for a specified reason.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: yes.

The people of the State of California do enact as follows:

SECTION 1. Article 10 (commencing with Section 640) is added to Chapter 3 of Part 1 of Division 1 of the Public Utilities Code, to read:

Article 10. Utility Bill Payment

640. For purposes of this chapter, the following terms have the following meanings:

(a) "Authorized payment location" means a location approved by a public utility for customers to pay billings from the utility.

(b) "Licensee" means a licensee pursuant to the California Deferred Deposit Transaction Law, as defined in Section 23001 of the Financial Code.

641. (a) No public utility shall, after January 1, 2009, authorize a licensee to be an authorized payment location.

(b) The commission shall ensure that no public utility authorizes a licensee to be an authorized payment location.

(c) The commission shall require each public utility that, prior to January 1, 2009, authorized a licensee to be an authorized payment location to actively search for alternative authorized payment locations, and to discontinue utilizing a licensee as an authorized payment location when an adequate alternative has been obtained.

(d) Each public utility that has a licensee as an authorized payment location prior to January 1, 2009, shall report to the commission on June 30, 2009, December 31, 2009, June 30, 2010, and December 31, 2010, on the number of licensee that are an authorized payment locations. The commission may require the public utility to report information relative to efforts taken pursuant to subdivision (c) to obtain alternative authorized payment locations. The commission shall relieve the public utility of making further reports pursuant to this subdivision upon the public utility having obtained replacement authorized payment locations and discontinuing the use of any licensee as an authorized payment location.

(e) No public utility shall have any licensee as an authorized payment location on or after January 1, 2011.

SEC. 2. No reimbursement is required by this act pursuant to Section 6 of Article XIII B of the California Constitution because the only costs that may be incurred by a local agency or school district will be incurred because this act creates a new crime or infraction, eliminates a crime or infraction, or changes the penalty for a crime or infraction, within the meaning of Section 17556 of the Government Code, or changes the definition of a crime within the meaning of Section 6 of Article XIII B of the California Constitution.

O

Alternative Way to Pay Utility Bills Draws Fire

BY REBECCA SMITH

Word Count: 1,300 | Companies Featured in This Article: Pinnacle West Capital, Unisource Energy, PG&E, CheckFree, Fiserv, Edison International

(See Corrections & Amplifications item below.)

Retired high-school math teacher Cynthia Elgar often pays her bills online, but when she got a disconnection notice from her Phoenix electric utility, Arizona Public Service, she realized a payment had gone awry somehow. In the past, she would have scooted over to a nearby utility office to make the late payment. But the utility has shut down most of its neighborhood offices and relies on a network of retail stores and check-cashing facilities to receive in-person payments. APS directed Ms. Elgar to a Cash & More storefront in Phoenix. There, she waited along ...

ARIZ PSC RATE CASE THATB INCLUDES DECISION ON PAYDAY LOAN STORES AS PAYMENT CENTER

*2007 Ariz. PUC LEXIS 241, **

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.

DOCKET NO. G-04204A-06-0463; DOCKET NO. G-04204A-06-0013; DOCKET NO. G-04204A-05-0831; DECISION NO. 70011

Arizona Corporation Commission

2007 Ariz. PUC LEXIS 241

November 27, 2007

CORE TERMS: staff, customer, recommendation, rate base, plant, rate case, therm, capital structure, recommended, monthly, bandwidth, usage, depreciation, comparable, decoupling, inclusion, investor, methodology, payday, working capital, recommend, developer, surcharge, volumetric, billing, oppose, fair value, residential, surrebuttal, interest rate

[*1] APPEARANCES: Mr. Michael W. Patten and Mr. Timothy Sabo, ROSHKA, DEWULF & PATTEN, P.L.C. and Ms. Michelle Livengood, UNISOURCE ENERGY SERVICES, on behalf of Applicant; Mr. Scott S. Wakefield, Chief Counsel, on behalf of the Residential Utility Consumer Office; Ms. Cynthia Zwick, Executive Director, Arizona Community Action Association; Mr. Marshall Magruder, in propria persona; and Mr. Keith Layton and Ms. Maureen Scott, Staff Attorneys, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

PANEL: COMMISSIONERS MIKE GLEASON, Chairman; WILLIAM A. MUNDELL; JEFF HATCH-MILLER; KRISTIN K. MAYES; GARY PIERCE; ADMINISTRATIVE LAW JUDGE: Dwight D. Nodes; DEAN S. MILLER, INTERIM EXECUTIVE DIRECTOR

OPINIONBY: MILLER

OPINION: OPINION AND ORDER

DATES OF HEARING: April 16, 17, 18, 19, 20, 24, and 25, 2007.

PLACE OF HEARING: Phoenix, Arizona

BY THE COMMISSION:

On November 10, 2005, the Arizona Corporation Commission ("Commission") opened an inquiry (Docket No. G-04204A-05-0831) into the prudence of the gas procurement practices of UNS Gas, Inc. ("UNS" "UNS Gas" or "Company") ("Prudence Case").

On January 10, 2006, UNS filed an application (Docket No. G-04204A-06-0013) with **[*2]** the Commission seeking review and revision of the Company's Purchased Gas Adjustor ("PGA Case").

On July 13, 2006, UNS filed an application with the Commission (Docket No. G-04204A-06-0463) for an increase in its rates throughout the State of Arizona ("Rate Case").

On July 20, 2006, UNS filed separate Motions to Consolidate in each of the above-captioned dockets.

On August 14, 2006, the Commission's Utilities Division Staff ("Staff") filed a Letter of Sufficiency indicating that the Company's Rate Case application met the sufficiency requirements outlined in A.A.C. R14-2-103, and classifying the Company as a Class A utility.

On August 18, 2006, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene.

On September 8, 2006, a Procedural Order was issued consolidating the Prudence, PGA, and Rate Case dockets; scheduling a hearing for April 16, 2007; setting various other procedural deadlines; directing UNS to publish notice of the applications and hearing date; and granting RUCO's request for intervention.

On September 20, 2006, Arizona Community Action Association ("ACAA") filed a Motion to Intervene.

By Procedural **[*3]** Order issued November 15, 2006, ACAA's Motion to Intervene was granted.

On November 17, 2006, Marshall Magruder filed a Motion to Intervene on his own behalf.

By Procedural Order issued January 10, 2007, Mr. Magruder's request to intervene was granted.

With its rate application, UNS filed its required schedules in support of the application, as well as the direct testimony of James Pignatelli, David Hutchens, Kentton Grant, Dallas Dukes, Karen Kissinger, Gary Smith, Ronald White, and Tobin Voge.

On February 9, 2007, Staff filed the direct testimony of Ralph Smith, David Parcell, Robert Gray, Julie McNeely-Kirwan, and George Wennerlyn; RUCO filed the direct testimony of William Rigsby, Marylee Diaz Cortez, and Rodney

Moore; ACAA filed the direct testimony of Miquelle Scheier; and Mr. Magruder filed his direct testimony.

On February 9, 2007, Staff filed a Request for Extension of Time to file the direct testimony of two of its witnesses.

On February 15, 2007, a Procedural Order was issued granting Staffs extension request, and revising the dates for responsive testimony for the other parties.

On February 16, 2007, Staff filed the direct testimony of Jerry Mendl.

On February 23, 2007, **[*4]** Staff filed the direct testimony of Steven Ruback.

On March 1, 2007, a Procedural Order was issued rescheduling the prehearing conference to April 13, 2007.

On March 16, 2007, UNS filed the rebuttal testimony of D. Bentley Erdwurm, Mr. Grant, Mr. Dukes, Ms. Kissinger, Mr. Hutchens, Mr. Pignatelli, Gary Smith, and Denise Smith.

On March 30, 2007, ACAA filed the surrebuttal testimony of Ms. Scheier.

On April 4, 2007, Staff filed the surrebuttal testimony of Mr. Gray, Ms. McNeely-Kirwan, Mr. Parcell, Mr. Ruback, Mr. Mendl, and Ralph Smith; RUCO filed the surrebuttal testimony of Mr. Rigsby, Mr. Moore, and Ms. Diaz Cortez; and Mr. Magruder filed his surrebuttal testimony.

On April 11, 2007, UNS filed the rejoinder testimony of Denise Smith, Gary Smith, Mr. Pignatelli, Ms. Kissinger, Mr. Dukes, and Mr. Erdwurm.

On April 13, 2007, a prehearing procedural conference was conducted to address the order of witnesses and exhibits.

The evidentiary hearing commenced as scheduled on April 16, 2007, and additional hearing days were held on April 17, 18, 19, 20, 24, and 25, 2007. At the close of the hearing, a briefing schedule was established, with initial briefs due on May 31, 2007, and reply briefs **[*5]** due on June 14, 2007.

On May 30, 2007, Staff filed a Request for Extension of Time to File Initial Brief.

On May 31, 2007, a Procedural Order was issued granting Staff's extension request and directing initial and reply briefs to be filed by June 5 and June 19, 2007, respectively.

Initial briefs were filed on June 5, 2007, by UNS, Staff, RUCO, and Mr. Magruder. Final Schedules were also filed on June 5, 2007, by UNS and RUCO.

On June 6, 2007, Staff filed a Notice of Errata and Revised Initial Brief

Reply Briefs were filed on June 19, 2007, by UNS, Staff, RUCO, and Mr. Magruder.

On June 21, 2007, Staff filed a Notice of Errata and Additional Authority.

Rate Application

According to the Company's application, as modified, in the test year ended December 31, 2005, UNS had adjusted operating income of $ 8,506,168, n1 on an adjusted Original Cost Rate Base ("OCRB") of $ 162,358,856, for a 5.24 percent rate of return. UNS requests a revenue increase of $ 9,459,023; Staff recommends a revenue increase of $ 4,312,354; and RUCO recommends an increase of $ 2,734,443. A summary of the parties' positions follows.
[*6]

- - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - - -

n1 The Company's "Final Schedules," which were submitted at the time UNS' initial brief was filed, are inconsistent with the revenue requirement recommendations set forth in the Company's brief (compare, *e.g.,* UNS Initial Brief at 5-6 and Final Schedule A-1). No subsequent filings were submitted to explain the differences between these documents and the reason for the discrepancy is unknown. For purposes of this Decision, we have used the Company's "Revised Schedules," (admitted at the hearing as Ex. A-10), and as set forth in its brief.
n2 Staff's gross revenue increase was calculated by applying a zero cost value to the "excess" between OCRB and FVRB.

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - - -

REVENUE REQUIREMENT

Rate Base Issues

UNS proposed an OCRB of $ 162,358,856; Staff recommends an OCRB of $ 154,547,272; and RUCO proposed an OCRB of $ 144,646,160. Each of the disputed issues regarding rate base items is discussed below.

Construction Work in Progress

Construction work in progress ("CWIP") is a regulatory concept under **[*7]** which, in limited circumstances, a regulatory body allows recovery in a company's rate base of plant that was under construction during the test year but not used and useful for purposes of serving customers. In this proceeding, UNS Gas seeks inclusion of approximately $ 7.2 million of CWIP (which would provide the Company with approximately $ 1.5 million in additional annual revenues). In support of its position, UNS argues that CWIP is an accepted aspect of ratemaking that has been used in many states and that the Arizona Supreme Court previously upheld the allowance of CWIP, citing *Arizona Community Action Assoc. v. Arizona Corp. Comm'n,* 123 Ariz.

228, 230, 599 P.2d 184, 186 (1979). In that case, the Arizona Supreme Court stated that allowing CWIP "appears to be in the public interest to have stability in the rate structure within the bounds of fairness and equity rather than a constant series of rate hearings." (*Id.*).

UNS contends that it will not be able to earn its authorized rate of return even if its full rate request is granted in this case, due to the high rate of growth in its service area, which requires higher levels of **[*8]** capital investment to serve new customers. According to Company witness Kentton Grant, because investment in new plant creates additional fixed costs and because growth leads to capital requirements in excess of the Company's internal cash flow, the impact of regulatory lag on UNS Gas is more severe than for many other utilities (Co. Ex. 28 at 9; Co. Ex. 27 at 28). Mr. Grant testified that in 2006 UNS added $ 17 million in net plant, which resulted in an additional $ 3 million in fixed costs (*e.g.,* depreciation, property taxes), but new customers added in 2006 provided only $ 1.8 million in new revenues, resulting in a net loss of $ 1.2 million for UNS associated with serving growth in 2006 (Co. Ex. 28 at 10, Attach. KCG-10).

Staff and RUCO oppose inclusion of CWIP in the Company's rate base. Staff witness Ralph Smith stated that, although the Commission has previously allowed CWIP in rate base, the Commission's general practice has been not to allow CWIP. In support of Staff's disallowance recommendation, Mr. Smith claims that absent compelling reasons, which have not been shown by UNS in this case, there is no valid reason to grant CWIP. Mr. Smith asserts that the Company has **[*9]** not demonstrated that its test year CWIP balance was for non-revenue-producing and non-expense-reducing plant. He testified that much of the construction appears to be for mains, services, and meters related to serving customer growth, which plant is therefore revenue producing. Mr. Smith stated that, although test year revenues have been annualized to (2005) year-end customer levels, revenues have not been extended beyond the test year to correspond to customer growth. Thus, according to Mr. Smith, inclusion of CWIP in rate base, without recognition of the incremental revenue the plant supports, would cause a mismatch for regulatory purposes (Ex. S-25 at 9-10).

RUCO witness Marylee Diaz Cortez also recommends disallowance of CWIP for many of the same reasons cited by Staff witness Ralph Smith. Ms. Diaz Cortez stated that the Commission has previously allowed CWIP only in extraordinary circumstances, which she claims are not present in this case. She claims that recovery of earnings on CWIP plant balances prior to the plant becoming used and useful is accomplished through an Allowance for Funds Used During Construction ("AFUDC"), through which the Company may accrue interest on the **[*10]** CWIP balances. The AFUDC accruals are ultimately recovered over the life of the plant through depreciation expense once the asset becomes used and useful in provision of utility service (RUCO Ex. 5, at 7-9). Ms. Diaz Cortez testified that regulatory lag has always been a characteristic of rate of return regulation and that such lag may also provide a benefit to the Company, to the extent that plant retirements, accumulated depreciation, and expired amortizations allow it to earn a return on those items between rate cases. She also stated that the growth phenomenon in the UNS service area has a positive aspect due to the increase of revenues associated with serving new customers (*Id.* at 9-10).

We agree with Staff and RUCO that the request for CWIP in this case is not supported by the record. As the Staff and RUCO witnesses indicated, UNS is not faced with an extraordinary situation that would justify inclusion of CWIP in rate base because the plant required to serve new customers will help produce revenues; UNS has a means, through accrual of AFUDC, to mitigate the effect of the CWIP investment; allowance of CWIP would undermine the balancing of test year revenues and expenses; **[*11]** and the regulatory lag inherent in **utility regulation** may provide benefits to the extent that items such as plant retirements and accumulated depreciation occur between test periods and thereby help to mitigate periods of higher plant investment associated with customer growth.

As Staff points out in its brief, one of the few instances in which the Commission previously allowed inclusion of CWIP in rate base occurred in 1984 in a case involving Arizona Public Service Company ("APS"). In that case, the Commission addressed the need for a CWIP allowance due to extraordinary circumstances involving the Palo Verde nuclear plant. The Commission allowed approximately $ 200 million of APS's $ 600 million CWIP balance as a means of addressing a critical cash-flow deficiency, and as a means to lessen the severe rate shock that would be experienced by customers if the entirety of the nuclear plant were placed in rate base at one time. n3 Staff argues that UNS is not faced with a comparable cash-flow crisis, and that the $ 7 million of CWIP requested by the Company does not present a rate shock concern that would justify inclusion of CWIP in this case. We therefore decline the Company's request **[*12]** for rate base recognition of CWIP in this proceeding.

- - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - - -

n3 *Arizona Public Service Co.,* Decision No. 54247 (November 28, 1984), at 19-20.

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - - -Post-Test-Year Plant

UNS proposes that, if its request for CWIP is denied, the Commission should alternatively allow inclusion of post-test-year plant in rate base. The Company argues that the Commission has approved post-test-year plant in a number of recent cases, and UNS faces faster growth than many other utilities in Arizona. Therefore, UNS argues that, absent inclusion of CWIP, the Commission should recognize inclusion of post-test-year plant.

Staff opposes the Company's proposal for reasons similar to the arguments raised on the CWIP issue. Staff witness Ralph Smith testified that the post-test-year plant arguments suffer from the same flaws as the request for inclusion of CWIP. He stated his belief that recognition of post-test-year plant would be imbalanced because it fails to capture post-test-year revenue growth and decreases in maintenance costs associated with **[*13]** the new plant (Ex. S-27 at 14-15).

We agree with Staff that post-test-year plant should not be included in rate base for the same reasons stated above with respect to the Company's request for CWIP. Although the Commission has allowed post-test-year plant in several prior cases involving water companies, it appears that the issue was developed on the record in those proceedings in a manner that afforded assurance that a mismatch of revenues did not occur. For example, in Decision No. 66849 (March 19, 2004), we stated that "we do not believe that adoption of this method would result in a mismatch because the post-test-year plant additions are revenue neutral (*i.e.,* not funded by CIAC or AIAC)" (*Id.* at 5). In the instant case, however, the Company's request appears to be simply a fallback to its CWIP position, and there is no development of the record to support inclusion of the post-test-year plant. The entirety of UNS's argument consists of two questions in Mr. Grant's direct testimony, which essentially provided that: the Commission has approved post-test-year plant in some prior cases, UNS is experiencing a high customer growth rate, and therefore the Company is entitled **[*14]** to inclusion of post-test-year plant if the Commission denies CWIP (Ex. A-27 at 28-29). Even if we were inclined to recognize post-test-year plant in this case, there is not a sufficient basis upon which to evaluate the reasonableness of the request (*i.e.,* whether a mismatch would exist). We therefore deny the Company's proposal on this issue.

Deduction of Customer Advances

The final issue raised in UNS's trilogy of CWIP-related issues is its plea that the Commission should not reduce rate base to recognize funds received for customer advances, if the Commission rejects UNS's request for CWIP or, alternatively, for post-test-year plant. The Company concedes that such advances are typically deducted from rate base because they represent customer-supplied capital. However, UNS contends that it has received approximately $ 4 million in customer advances related to the $ 7 million in CWIP plant investment (Ex. A-28 at 27). Thus, according to UNS, the net impact on rates (if the requested $ 7 million of CWIP were to be included in rate base) is $ 3 million, based on the net of the $ 7 million offset by $ 4 million in advances.

UNS argues that it is inherently unfair to exclude **[*15]** the advances from rate base if the plant associated with those advances is not yet in service and not included in rate base. UNS claims that the purpose of deducting advances (*i.e.,* recognizing customer-supplied capital) is not furthered when the plant is not in service. The Company also contends that the deduction of advances in this case would discourage utilities from seeking advances to offset infrastructure capital costs.

Both Staff and RUCO oppose the Company's recommendation. Staff witness Ralph Smith states that because advances represent non-investor-supplied capital, they should be reflected as a deduction to rate base. He stated that Staff is not aware of any instance in which CWIP was excluded for a major utility in Arizona and customer advances were not reflected as a deduction to rate base. Mr. Smith also cites to A.A.C. R14-2-103, Appendix B, Schedule B-1, which he claims requires companies to reflect advances as a deduction from rate base (Ex. S-27 at 15-16).

RUCO witness Marylee Diaz Cortez agreed with Staff's recommendation regarding advances. She testified that the Commission has historically excluded CWIP from rate **[*16]** base and recognized contributions (advances) as a deduction from rate base and that UNS is being afforded (under RUCO's and Staff's recommendations) the same rate base treatment as every other utility in Arizona (RUCO Ex. 6 at 8). Ms. Diaz Cortez claims that it is only the Company's proposal to include CWIP which creates a mismatch, because UNS failed to include the additional revenues the construction projects generate (*Id.* at 8-9).

We agree with Staff and RUCO that advances represent customer-supplied funds that are properly deducted from the Company's rate base. Indeed, the Commission's own rules contemplate that such a deduction is required, as Staff witness Smith testified. Had UNS not requested the inclusion of CWIP in rate base, a ratemaking treatment that is only afforded under extraordinary circumstances (and apparently has not occurred for more than 20 years), there would presumably not have been an issue raised by the Company with respect to an alleged "mismatch" between exclusion of CWIP and deducting advances from rate base. The Company's attempt to frame this issue as one in which it is being treated in a discriminatory manner is unpersuasive.

As we have stated in **[*17]** prior cases, regulated utility companies control the timing of their rate case filings and should not be heard to complain when their chosen test periods do not coincide with the completion of plant that may be considered used and useful and therefore properly included in rate base. We believe our conclusions regarding UNS's CWIP-related proposals are entirely consistent with the treatment that has been afforded to other utility companies regulated by the Commission and provide a result that is fair to both the Company and its customers.

Geographic Information System

UNS seeks to include in rate base $ 897,068 for expenses incurred during 2003 and 2004 to install a Geographic Information System ("GIS"). The GIS is a global positioning system that allows UNS to locate existing service lines. UNS witness Gary Smith testified that the Company installed the GIS in response to a Commission Pipeline Safety audit that recommended a complete mapping of the UNS system. He described several benefits of the GIS, including improved response times, better informed decisions regarding adding system infrastructure, and increased accuracy for field staff (Ex. A-15 at 6-7).

According to Staff **[*18]** witness Ralph Smith, the GIS costs should not be included in rate base because they were non-recurring expenses that were largely incurred outside of the test year. He explained that, according to internal Company memos, UNS initially decided to treat the GIS as a capitalized investment, but later determined that capitalization of the costs was inappropriate under Generally Accepted Accounting Principles ("GAAP"). Mr. Smith stated that, under GAAP, the GIS costs were required to be expensed during the period in which they were incurred and, since they were incurred prior to the test year, are not properly includable in rates (Ex. S-27 at 16-18).

RUCO also opposes inclusion of the GIS expenses in rates. RUCO witness Marylee Diaz Cortez stated that because UNS failed to obtain from the Commission an accounting order to treat the GIS expenses as a regulatory asset, which would be eligible for future rate recovery consideration, the Company is not entitled to recover those costs in this rate proceeding (RUCO Ex. 5 at 11-12; RUCO Ex. 6 at 9-10). RUCO argues that regardless of the Company's increased productivity claims, its failure to properly account for the GIS costs precludes recovery **[*19]** in UNS's rate base.

We agree with Staff and RUCO that the GIS costs are not properly recoverable as a regulatory asset in this proceeding. As described by Staff witness Ralph Smith, the GIS costs were required by GAAP to be expensed, and the vast majority of those costs were incurred prior to the test year and are non-recurring in nature (Ex. S-25 at 12-17). Further, the Company's failure to seek an accounting order from the Commission when the costs were incurred renders them unrecoverable as a regulatory asset. As Mr. Smith points out, it is not unusual for investors to be responsible for expenses incurred between test years, just as the utility's investors may benefit from cost decreases and increased revenues during the same period (Ex. S-27 at 16-19). As both Staff and RUCO contend, there is nothing inherently unfair about the treatment afforded to the GIS costs in this case because costs and revenues are ever changing, and moreover, the improved efficiencies touted by UNS as a result of the GIS inure to the benefit of the Company's investors at least as much as to ratepayers. Finally, any blame for UNS's inability to recover those costs through rates lies with the Company's **[*20]** prior failure to properly account for the costs under GAAP accounting standards.

Plant in Service

Although Staff did not challenge the Company's proposed plant-in-service amounts, RUCO recommends the disallowance of approximately $ 3.1 million in plant that it considers unsubstantiated. UNS claims that it provided adequate documentation for the plant, but RUCO contends that the Company failed to provide records supporting increased plant balances recorded on the books of Citizens Utilities between the end of the last test year (December 31, 2001) and the date the Company acquired the system from Citizens (August 11, 2003).

According to RUCO, Citizens' gas plant in service was approximately $ 234 million at the end of 2001, and UNS has records to support $ 10.7 million of additional plant in service between the end of 2001 and June 30, 2003 (Ex. A-8 at 2; RUCO Ex. 1). RUCO claims that UNS has no records to support additional plant in service as of the date of the transfer, yet the Company booked approximately $ 248 million of plant in service as of the acquisition date of August 11, 2003 (Tr. at 192-93). UNS witness Karen Kissinger testified that certain electronic files provided **[*21]** to RUCO supported the higher plant value, but conceded that those files do not provide a means of reconciling the plant balances claimed as of the acquisition date (*i.e.,* $ 248 million) (Tr. at 194-95, 214). RUCO also disputes the Company's argument that the higher plant balances were approved by the Federal Energy Regulatory Commission ("FERC"), based on Ms. Kissinger's concession that the submission to FERC was not a request for approval of the specific plant amounts, but simply a request for confirmation from FERC that the amounts are recorded to the proper FERC accounts (Tr. at 198). Based on the evidence presented, RUCO requests a decrease of $ 3,133,264 in the Company's proposed plant in service and a corresponding increase in accumulated depreciation of $ 3,857,413, (RUCO Ex. 3 at 12).

UNS contends that it provided adequate documentation to support its claimed plant-in-service balances for the period in question. The Company argues that, because Citizens was scrambling to wrap up its accounting for the final months at the time the sale was being finalized, it is not surprising that Citizens' records from that period were less extensive than normal (Tr. at 194-97). UNS relies **[*22]** on the electronic files provided to RUCO to support its position. The Company also points to testimony by RUCO witness Rodney Moore, who agreed that "records from Citizens are notoriously inadequate for a determination of the actual value of the pre-acquisition gross plant and accumulated depreciation" (RUCO Ex. 4 at 4). UNS asserts that other companies seeking post-acquisition approval of plant values based on Citizens' inadequate records have not been subject to downward adjustments, n4 and that imposing downward adjustments on UNS would be inequitable. UNS also claims that the Commission's order approving the sale of the Citizens gas system assets to UNS did not include record retention requirements, although such requirements had been included in prior Commission Orders such as those related to the sale of Southern Union Gas Company's assets to Citizens (Ex. A-7 at 6). n5 Another argument raised by UNS is that it directly transferred the final plant-in-service values from Citizens' books to its own at the time of the acquisition. The Company contends that FERC's approval of UNS's accounting procedures and a subsequent audit of the Company's financial statements further support **[*23]** its claim that its proposed plant-in-service value is appropriate.

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n4 *See, e.g., Arizona --American Water Co.,* Decision No. 67093 (June 30, 2004).
n5 Decision No. 57647 (December 2, 1991), at 14.

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We find that UNS has explained adequately the basis for its plant-in service-proposal. As UNS witness Kissinger indicated in her rebuttal testimony, the acquisition of the Citizens assets was accounted for by UNS in accordance with applicable accounting standards, and the Company obtained a clean audit opinion regarding its financial statements from PricewaterhouseCoopers for the applicable period following the acquisition (Ex. A-7 at 2; Ex. A-6, Attach. KGK-1). The Company's accounting treatment was also approved by the accounting entries associated with the acquired plant (Ex. A-7 at 4). UNS Gas provided sufficient documentation to support the amount of plant in service transferred from Citizens, and we therefore reject RUCO's proposed adjustment to plant in service.

Test Year Accumulated Depreciation

RUCO **[*24]** has also proposed increasing the Company's accumulated depreciation by approximately $ 2,855,454, due to RUCO's assertion that UNS improperly applied depreciation rates that were requested in the last rate case (Docket No. G-01032A-02-0598). That case was later suspended and combined with a joint application between UNS and Citizens for acquisition of the Citizens assets by UNS. The consolidated dockets ultimately resulted in a settlement agreement that was approved in Decision No. 66028 (July 3, 2003). RUCO argues that, because the settlement approved in Decision No. 66028 did not specifically mention new depreciation or amortization rates, UNS should apply the depreciation rates approved in the prior Citizens gas rate case in Decision No. 58664 (June 16, 1994). RUCO witness Moore cited to A.A.C. R14-2-102(C)(4), which states that changed depreciation rates shall not become effective until the Commission authorizes such changes. (RUCO Ex. 3 at 13-14). Accordingly, Mr. Moore proposed that test year accumulated depreciation should have been calculated as approved in the prior Citizens rate case, resulting in a reduction to the Company's OCRB **[*25]** of $ 2,855,454 (*Id.* at 14).

UNS argues that RUCO's recommendation fails to recognize that the Commission approved new depreciation rates in Decision No. 66028 which, as noted above, approved the sale of Citizens' gas system assets to UNS and approved a rate increase pursuant to the terms of a settlement agreement. Although the Commission did not explicitly approve new depreciation rates in Decision No. 66028, UNS contends that the settlement agreement contained a specific schedule showing how the revenue requirement was calculated. UNS witness Kissinger testified that the depreciation rates that formed the basis of the settlement were approved by the Commission and that no party objected Ito the depreciation rates in that case (Ex. A-7 at 9). Ms. Kissinger also attached to her testimony the schedule that formed the basis of the revenue requirement and explained on cross-examination that the updated depreciation expense adjustment was subsumed within operating expenses in the settlement agreement schedule (*Id.* at Attach. KGK-11; Tr. at 201-03).

We agree with UNS that the depreciation rates contained within the revenue requirement schedules, and attached to the settlement agreement, **[*26]** were implicitly approved in Decision No. 66028. Although Decision No. 66028 approved a "black box" settlement, in the sense that the specific revenue requirement issues were not discussed individually, the basis of the underlying revenue requirement was attached to the settlement agreement, and no party objected to the individual components of that revenue requirement. Accordingly, it was reasonable for UNS to apply the accumulated depreciation rates that were a component of the settlement. Indeed, RUCO witness Diaz Cortez admitted that the prior Citizens rate case order (Decision No. 58664) contained a specific discussion of only 2 of the 28 depreciation accounts and that it would thus be necessary to refer to the underlying application even in that case to ascertain the specific depreciation rates that were approved by the Commission in that order (Tr. at 673-74). We therefore reject RUCO's recommendation on test year accumulated depreciation.

Working Capital

As described by UNS witness Karen Kissinger, working capital is generally defined as "investor funding in excess of the balance of net utility plant reflected in rate base that is required for the provision of utility **[*27]** service" (Ex. A-6 at 10). The components of working capital include materials and supplies, prepayments, and cash working capital. The amounts for materials and supplies, and prepayments, are determined based on test year recorded balances, whereas the cash working capital component was determined by UNS based on a lead-lag study (*Id.* at 10-11).

Staff witness Ralph Smith summarized the concept of cash working capital as follows:

> Cash working capital is the cash needed by the Company to cover its day-to-day operations. If the Company's cash expenditures, on an aggregate basis, precede the cash recovery of expenses, investors must provide cash working capital. In that situation, a positive cash working capital requirement exists. On the other hand, if revenues are typically received prior to when expenditures are made, on average, then ratepayers provide the cash working capital to the utility, and the negative cash working capital allowance is reflected as a reduction to rate base. In this case, the cash working capital requirement is a reduction to rate base as ratepayers are essentially supplying these funds (Ex. S-25 at 18-19).

Based on Staff's proposed adjustments, **[*28]** Mr. Smith proposed a corresponding adjustment to the Company's cash working capital requirements. Staff's recommendation results in a cash working capital requirement of negative $ 268,272, in accordance with Staff's other recommendations in this case (Ex. S-27 at 20, Attach. RCS-2S).

In its initial brief, UNS points out that a number of ratemaking adjustments will have an effect on the Company's working capital requirement. UNS also contends that RUCO's proposed working capital proposal should be rejected because RUCO failed to use a simultaneous equation to compute two elements of cash working capital: synchronized interest and current income taxes (Ex. A-7 at 12).

In its reply brief, RUCO responded that its schedules did account for synchronized interest in both the working capital and income tax calculations. RUCO cites to Mr. Moore's schedules to support its claim (RUCO Ex. 3, Sched. RLM-3, Line 15; Sched. RLM-14, Lines 3, 8, and 18; and Sched. RLM-6, Line 8).

It does not appear from the record that the parties are in disagreement with regard to the underlying working capital requirements, subject to the various adjustments that necessarily flow from the revenue requirement established **[*29]** in this Decision. The working capital requirement has been determined in accordance with the revenue requirement established in this Order.

Accumulated Deferred Income Tax

Based on its recommendations in this case, Staff adjusted rate base by $ 195,336 to account for removal of accumulated deferred income tax ("ADIT") related to the GIS deferral issue, removal of ADIT related to the Supplemental Executive Retirement Plan, and removal of 50 percent of the ADIT related to incentive compensation (Ex. S-25 at 19). Staff claims that UNS did not contest these ADIT adjustments, which Staff asserts are necessary to reconcile rate base with the components of operating income adjustments.

In its brief, UNS does not address the ADIT issues raised by Staff, which are reconciliation adjustments flowing through from several operating income issues and are addressed below. However, the Company does take issue with RUCO's alleged failure to make corresponding adjustments to ADIT and deferred income tax expense (Ex. A-7 at 11-12). Because RUCO did not address this issue in its briefs, presumably, it does not oppose the Company's position.

Based on the record before us, we agree that the appropriate **[*30]** reconciliation adjustments should be made to reflect the effect on ADIT and income tax expense in accordance with this Decision.

Summary of Rate Base Adjustments

Based on the foregoing discussion, we adopt an adjusted OCRB of $ 154,604,408 and a Fair Value Rate Base ("FVRB") of $ 184,120,761.

	Commission Approved
ORIGINAL COST:	
Gas Plant in Service	$ 271,980,463
Less: Accumulated Depreciation	(72,006,708)
Net Plant in Service	199,973,755
Citizens Acquisition Discount	(30,709,738)
Less: Accum. Amort. -- Citizens Acq. Disc.	(1,876,981)
Net Citizens Acq. Discount	(28,832,757)
Total Net Utility Plant	171,140,998
Deductions:	
CIAC	(7,283,595)
Customer Deposits	(3,040,484)
Accum. Deferred Income Taxes	(6,289,473)
Allowance for Working Capital	(211,136)
Regulatory Liabilities	(19,721)
Total Deductions	(16,844,409)
Additions:	
Regulatory Assets	307,819
Total OCRB	$ 154,604,408

RCND n6 RATE BASE:	
Gas Plant in Service	$ 367,054,190
Less: Accumulated Depreciation	(97,114,865)
Net Plant in Service	269,939,325
Citizens Acquisition Discount	(41,822,562)
Less: Accum. Amort. -- Citizens Acq. Disc.	(2,560,308)
Net Citizens Acq. Discount	(39,262,254)
Total Net Utility Plant	230,677,071
Deductions:	
CIAC	(7,786,962)
Customer Deposits	(3,040,484)
Accum. Deferred Income Taxes	(6,289,473)
Allowance for Working Capital	(211,136)
Regulatory Liabilities	(19,721)
Total Deductions	(17,347,326)
Additions:	
Regulatory Assets	307,819
Total RCND	$ 213,637,114
FAIR VALUE RATE BASE:	
Gas Plant in Service	$ 319,517,327
Less: Accumulated Depreciation	(84,560,787)
Net Plant in Service	234,956,540
Citizens Acquisition Discount	(36,266,150)
Less: Accum. Amort. -- Citizens Acq. Disc.	2,218,645
Net Citizens Acq. Discount	(34,047,505)
Total Net Utility Plant	200,909,035
Deductions:	
CIAC	(7,535,279)
Customer Deposits	(3,040,484)
Accum. Deferred Income Taxes	(6,289,473)
Allowance for Working Capital	(211,136)
Regulatory Liabilities	(19,721)
Total Deductions	(17,096,093)
Additions:	
Regulatory Assets	307,819
Total FVRB	$ 184,120,761

[*31]

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n6 Reconstruction New (less) Depreciation

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - - -**Operating Income Issues**

In the test year, the Company's reported operating revenues were $ 47,169,528, with reported adjusted test year operating expenses of $ 38,740,547, and test year net operating income of $ 8,428,981. As reported in its Surrebuttal Schedules, Staff's proposed adjusted test year operating revenues were $ 47,273,923, with adjusted test year operating expenses of $ 37,373,543, resulting in test year net operating income of $ 9,900,380. RUCO's Final Schedules show proposed adjusted test year operating revenues of $ 50,014,877, with adjusted test year operating expenses of $ 38,124,962, yielding test year net operating income of $ 11,889,914. The disputed expense adjustments are discussed below.

Revenues

Customer Annualization

UNS has proposed in this case to calculate customer revenue annualization based on a cyclical growth pattern, which the Company contends more accurately reflects its actual experience in its service territory. Company **[*32]** witness D. Bentley Erdwurm described the traditional approach of customer annualization as a comparison of customer counts in each month of the test year to the end of test year level of customers. Under this approach, the additional customers attributable to each month are multiplied by the average revenue per customer for each month to obtain the additional revenue attributable to the additional customers (Ex. A-20 at 2). Mr. Erdwurm testified that the traditional method works well when growth is steady and additional customers are similar in size to existing customers, but breaks down when a company, such as UNS, experiences cyclical seasonal growth (*Id.*). He conceded that the Commission has never before adopted a revenue annualization method such as the one advocated by UNS. However, he contends that the Company's proposed methodology is appropriate in this case because "in cases of cyclical growth, the mathematics break down and... [the traditional method] will often give you a totally counterintuitive result, where you would actually have a negative customer adjustment on a growing system" (Tr. at 447).

Staff and RUCO oppose adoption of the Company's annualization proposal. **[*33]** RUCO argues that although the Company's customer levels are somewhat seasonal, they do not exhibit a degree of seasonality or produce an aberrational result that would make the traditional method inappropriate. Ms. Diaz Cortez pointed out that the customer base for UNS's largest rate schedule, R10, increased from month to month for every month except April, May, and July, and that the decreases in those months ranged from .09 percent to .28 percent (RUCO Ex. 6 at 12, Sched. MDC-1). RUCO asserts that these changes do not exhibit an extreme level of seasonality that would justify departure from the traditional method advocated by RUCO and Staff.

Staff witness Ralph Smith testified that the traditional method of customer annualization has been effective in coordinating the revenue element of the ratemaking formula with other components, such as rate base, and that many of the Company's arguments are without merit (Ex. S-27 at 19-21). According to Mr. Smith, any method for determining an annualization adjustment should be transparent and straightforward to allow replication and verification of the results. He contends that while the traditional method satisfies these criteria, UNS's proposal **[*34]** to apply percentage growth factors instead of customer bill counts is difficult to follow and replicate and actually appeared to understate growth (*Id.* at 24).

We agree with Staff and RUCO that UNS has not presented a valid case for departing from the traditional method of calculating customer revenue annualization. Although the Company's arguments may have some validity in a theoretical sense, adoption of the cyclical methodology is not warranted in this proceeding. RUCO and Staff highlighted some of the flaws inherent in the Company's proposal, including the lack of any significant demonstrated seasonality, the complexity of the formula, lack of transparency, and the claim by the Staff witness that the methodology may actually result in an understatement of revenues. We therefore decline to adopt UNS's revenue annualization proposal.

Weather Normalization

Staff witness Ralph Smith stated that Staff's weather normalization adjustment increases retail revenue by $ 1,962, compared to UNS's proposal, because, in Staff's annualization, the weighted average number of customers exceeded the level reflected in the Company's corresponding annualization. Mr. Smith claims that both **[*35]** the Staff and UNS weather normalization adjustments reflect an increase to revenue due to warmer than normal temperatures during the test year (Ex. S-27 at 25).

In its brief, UNS states that the weather normalization adjustment should reflect the other positions taken herein, including the customer annualization adjustment proposed by the Company.

Although RUCO accepts the Company's proposed weather normalization, it proposes a further adjustment of $ 900 related to the additional customers/revenue the Company proposes be recognized as a result of its customer annualization proposal (RUCO Ex. 6 at 16).

It is not entirely clear whether the weather normalization issue remains in dispute given our determination above that the Company's customer annualization recommendation should not be adopted. To the extent that there is any remaining disagreement on this issue, we adopt Staff's weather normalization recommendation in accordance with the discussion above regarding customer annualization.

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Expenses

Legal Expenses Related to FERC Rate Case

During the 2005 test year, UNS incurred legal expenses of $ 311,051 related to settlement discussions involving an **[*36]** El Paso Natural Gas Company ("El Paso") FERC rate case. The El Paso case eventually settled, and due to the non-recurring nature of those legal expenses, both Staff and RUCO recommended removal of that amount from allowable expenses in this case (Ex. S-15 at 30; RUCO Ex. 5 at 21).

UNS witness Dallas Dukes testified that Staff's and RUCO's recommendations would set the Company's legal expenses at an amount well below the expected ongoing level (Ex. A-13 at 17). As an alternative, he proposed an allowance of $ 430,777 (pre-tax), which represents a two-year average of legal expenses actually incurred by UNS for 2004 and 2005 (*Id.* at 18). Mr. Dukes stated that the actual legal expenses incurred by UNS were $ 373,174 for 2004, $ 488,380 for 2005, and $ 425,540 for 2006, and that its projected legal expenses for 2007 are $ 425,208 (*Id.;* Ex. A-14 at 9).

We believe that the Company's allowable legal expenses should be set at a level that reflects more accurately its actual experience, both historical and anticipated. Staff and RUCO make a valid argument that the legal expenses incurred during 2005 were higher than normal due to the Company's participation in the El Paso rate case **[*37]** and that such expenses are likely non-recurring in nature. However, the RUCO and Staff recommendations fail to recognize that even after completion of the El Paso case, UNS incurred legal expenses of more than $ 400,000 in 2006 and is expected to do so again in 2007, legal expenses of in each year. Thus, even if 2005 is removed as an anomaly, actual legal expenses for 2004 and 2006 and projected legal expenses for 2007 produce an average of slightly more than $ 400,000 per year. We therefore believe it is reasonable, based on the record, to allow legal expenses of $ 400,000 to UNS in this case.

Rate Case Expense

UNS initially requested inclusion of $ 600,000 for rate case expense, amortized over three years. However, in his rebuttal testimony, Mr. Dukes amended the request to $ 900,000, amortized over three years, based on the Company's claim that UNS had already incurred almost $ 800,000 in costs related to pursuing its rate case (Ex. A-13 at 34-35). UNS contends that the proposals offered by Staff and RUCO ($ 255,000 and $ 251,000, respectively), which are based primarily on comparisons to the recent Southwest Gas rate case (Decision No. 68487), are deficient because they fail **[*38]** to recognize that Southwest Gas used internal personnel and support services, internal costs that are built into Southwest Gas' rate base. In comparison, UNS does not have in-house legal or rate departments, but instead relies heavily on the rate and legal personnel of Tucson Electric Power Company ("TEP") to prosecute its rate cases. Mr. Dukes testified that an allocation from TEP for such costs ensures that TEP customers do not subsidize UNS operations (*Id.;* Ex. A-14 at 9-11). Mr. Dukes added that UNS Gas received more than twice as many data requests as did Southwest Gas

(Tr. at 632).

RUCO witness Moore stated that RUCO's recommendation in this case is appropriate based on a comparison to the recent Southwest Gas rate case, in which the approved rates included an allowance for $ 235,000 allocated over three years (RUCO Ex. 3 at 25-26). RUCO contends that the UNS case shares similar characteristics with the Southwest Gas case in that both companies extensively used in-house staff, both companies requested approval of a decoupling mechanism and PGA revisions, and both cases covered a comparable number of hearing days (*Id.;* Tr. at 655). RUCO therefore recommends a rate case **[*39]** expense allowance of $ 251,000, amortized over three years.

As indicated above, Staff recommends a rate case expense allowance of $ 255,000, amortized over three years, based on Staff's view that the Southwest Gas case raised many of the same issues addressed in this proceeding. Staff witness Ralph Smith disputed the rationale offered by UNS for its proposed rate case expense. Mr. Smith stated that although this may be the first rate case for this gas company under its current ownership, the Company had a number of prior periodic rate cases when it was owned by Citizens Utilities. He contends that the transfer of ownership to UNS should not be used as a basis for imposing "excessive" rate case costs (Ex. S-27 at 42-43). Mr. Smith also testified that because the UNS rate case presents many issues that are similar to those considered in the Southwest Gas case (such as a proposed decoupling mechanism and revisions to the PGA), the rate case expense allowed in that case is a useful benchmark for the UNS case (*Id.*). On cross-examination, Mr. Smith also expressed a concern with the overall allocation methodology used by TEP for UNS expenses. He testified that the direct allocation methodology **[*40]** used by TEP may result in a double recovery, to the extent that the same personnel are used for different companies, because "it could potentially result in loading a disproportionate amount of their cost onto each utility to their rate case they are working on" (Tr. at 896-97). He conceded that the Commission should allow an appropriate level of rate case costs, but indicated that "this is a potential cost here that can get totally out of control if some limits aren't placed on it" (Tr. at 898).

We agree with Staff and RUCO that the Company's proposed rate case expense of $ 900,000 is excessive and should be reduced significantly. As both Staff and RUCO suggest, the recent Southwest Gas case presented many of the same issues that were raised in this case, and the Southwest Gas case is an appropriate measure of comparison for UNS. In response to the Company's claim that Southwest Gas employed a different method of allocating such costs, and was therefore not comparable to UNS, Staff witness Smith pointed out potential problems with the method used by TEP to allocate costs such as rate case expense. We believe that proposed rate case expense of $ 900,000 is excessive when compared **[*41]** with similar rate case expense allowances in a long line of cases before the Commission. Although Staff and RUCO present strong arguments in support of their recommendations, given that this is the first UNS Gas rate case since the acquisition of the Citizens assets, and that UNS was required to respond to a substantially higher number of data requests than was Southwest Gas, we allow rate case expense of $ 300,000, amortized over three years.

Customer Call Center Expenses

During the test year, on May 1, 2005, UNS changed its method of responding to customer calls by implementing a consolidated call center operated by TEP, with a level of costs allocated to UNS. RUCO witness Moore stated that prior to May 1, 2005, UNS Gas operated its call center separately, using 6 customer service representatives at a cost of $ 17,636 per month (RUCO Ex. 3 at 20). After consolidation of the call center, UNS began to incur allocated costs of $ 76,227 per month (*Id.*). The Company also subsequently closed walk-in customer service offices in Prescott, Cottonwood, Flagstaff, and Show Low, thereby requiring customers in those areas to use "payday loan" n7 stores if they want to pay their bills **[*42]** in person (Tr. at 418).

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n7 The payday loan store issue is discussed in detail below. UNS currently retains walk-in company offices in Nogales, Kingman, and Lake Havasu.

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UNS witness Dallas Dukes stated that the consolidated call center provides a higher level of service to customers and indicated that the prior individualized system would have required a significant investment in new systems to respond to rapid growth in the Company's service area. Mr. Dukes cited a number of benefits of the consolidated operations, including the ability to handle increased call traffic, which has nearly doubled since the prior individual operations were in place; expanded service hours; a credit card payment option; call volume tracking ability; and one number availability for gas and electric customers in Mohave and Santa Cruz counties (Ex. A-13 at 29-30). In response to RUCO's claims that customer complaints have increased since the new call center was put in place, Mr. Dukes stated that the primary driver of the increased call volumes **[*43]** was higher gas costs that flowed through to customers. He reiterated that the former individual office format could not have handled the increased volume of calls and that the old system would have required increased staffing and investment to keep up with service demands (Ex. A-14 at 16).

RUCO witness Moore disagrees with the Company's contention that the consolidated call center provides increased customer service. He claims that in 2004, prior to the call center consolidation, 13 percent of the 178 total complaints against the Company related to customer service; in 2005, when the new call center was introduced, 22 percent of the 172 total complaints related to customer service; and in 2006, 17 percent of the 143 total complaints n8 related to customer service (RUCO Ex. 4 at 11; Tr. at 614-15). Based on this data, RUCO argues that UNS is providing worse customer service under the new call center format, despite a 432 percent increase in costs. Accordingly, RUCO recommends that the Company's customer service costs should be reduced to the level incurred prior to the introduction of the consolidated call center.

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n8 Mr. Dukes claims that the Company's records reflect 120 UNS Gas complaints in 2005 and 149 complaints in 2006 (Ex. A-14 at 16).

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We do not believe that the record supports the disallowance sought by RUCO on this issue. RUCO's analysis is based on a simple comparison of complaint data and system costs, but does not consider the underlying reasons why consolidation to a modernized call center was necessary. The Company's witness cited a number of advantages associated with the new call center operations and pointed out that RUCO's proposal fails to account for the doubling of call volume since the new system was put in place and does not include recognition of the additional investment that would have been required to update the prior decentralized system of customer service. Although we believe that the consolidated call center costs should be allowed in the Company's expenses in this case, we have ongoing concerns regarding UNS's decision to close a number of local offices and farm out its customer service obligations to payday loan stores, as discussed below.

Miscellaneous "Unnecessary" Expenses

RUCO witness Rodney Moore presented testimony requesting that the Company's test year expenses should be reduced by $ 233,347 for expenses that were "questionable, inappropriate and/or unnecessary" (RUCO Ex. 3 **[*45]** at 22). Mr. Moore claims that his proposed adjustment is related to payments made to chambers of commerce and non-profit organizations and for donations; club memberships; gifts; awards; extravagant corporate events; advertising, and various meals, lodging and refreshments (*Id.*). He cites a sampling of the 1,995 questionable expenses, which include $ 1,200 for two people to play in a Flagstaff golf tournament, $ 5,750 for an employee appreciation dinner, $ 1,000 for Toys for Tots, $ 3,058 for the Flagstaff Chamber of Commerce, and $ 1,246 for a chartered air flight (*Id.* at 23).

In response to RUCO's claims, UNS witness Gary Smith testified that most of the expenses related to travel for "regulatory-mandated functions such as leak surveys, safety audits, and training"; that other expenses included "participation in the annual mandatory Commission Pipeline Safety audit and required operator qualification training, welder qualification training, and emergency response testing"; and that many of the remaining expenses are for "small tools that are necessary for maintaining the pipeline system" (Ex. A-16 at 5-6). UNS argues that Mr. Moore did not respond to Mr. Smith's explanation **[*46]** but, instead, attacked Mr. Dukes' suggestion that RUCO should limit its audit to material items because 90 percent of the challenged expenses are under $ 200 and 65 percent under $ 50 (Tr. at 636). The Company asserts that RUCO's demand for a specific explanation of why each claimed expense is reasonable is "profoundly unreasonable," (UNS Initial Brief at 25), because RUCO did not consider the cost of preparing such a response and could have pursued alternate means of verification during discovery. However, in an attempt to appease RUCO, UNS witness Smith stated in his rejoinder testimony that the Company would agree to a disallowance of $ 27,968 (Ex. A-17 at 3).

This issue is eerily similar to the position taken by Southwest Gas in its last rate case, wherein its witness attempted to deflect the burden of proving the reasonableness of Southwest Gas's claimed expenses for a number of "small ticket" items including jeep tours, balloon rides, club memberships, charitable donations, sports events, barbecues, flowers, and various food and drinks expenses. In that case, the Southwest Gas witness agreed to exclude what she perceived to be clearly inappropriate miscellaneous expenses, but **[*47]** indicated that many of the expenses were too small for even the company to determine whether they should be included in cost of service. Southwest Gas's witness therefore concluded that RUCO had not presented sufficient evidence to support its proposed disallowance. Here, UNS makes an almost identical argument, claiming that because the costs individually are too small to track, RUCO's recommendation must fail. In the Southwest Gas Decision (Decision No. 68487 at 19-21), we rejected that argument, finding that Southwest Gas had not met its burden of proof. As we stated in Decision No. 68487, "[i]t is curious that Southwest Gas seeks to cast the burden of proving the unreasonableness of expenses on RUCO, especially once RUCO has provided some evidence that certain claimed expenses are inappropriate and which evidence, by the Company's own admission, should result in additional exclusions" (*Id.* at 21).

Consistent with the Southwest Gas Decision, we find that a portion of the claimed expenses in this "miscellaneous" category should be disallowed because UNS failed to meet its burden of proof as to their validity. Recognizing that many of the expenses appear to be legitimate expenses **[*48]** related to training, safety, and maintenance, however, we disallow half of RUCO's proposed disallowance ($ 233,347 x 50% = $ 116,674). While it may seem unfair for a utility company to be required to come forward with supporting evidence regarding the reasonableness of even small expenses, when the Company is seeking to place the burden of such expenses exclusively on the backs of its customers, it is required to prove that the expenses were reasonably necessary for the provision of service to those customers. If we were to adopt UNS's rationale regarding these relatively small, miscellaneous expenses, it would be akin to proclaiming the acceptability of the proverbial "death by 1,000 cuts."

Performance Enhancement Program

UNS allows its non-union employees to participate in its parent company's Performance Enhancement Program ("PEP"), which provides eligible employees compensation above their base pay for meeting financial targets (30 percent), cost containment goals (30 percent), and customer service goals (40 percent) (Ex. A-13 at 8-9). Company witness Dukes claims that the PEP is an integral part of its compensation package for employees and that UNS would be required to increase **[*49]** base salaries to attract and retain qualified employees if the program were eliminated (*Id.*).

Staff proposes to adjust the PEP expenses by 50 percent, based on Staff's claim-that incentive compensation programs benefit both ratepayers and shareholders. Staff cites to the Southwest Gas Decision to support its position. In that case, the Commission adopted Staff's recommendation to disallow 50 percent of a similar program's costs, based on a finding that the Southwest Gas management incentive program benefited both customers and shareholders. Staff witness Ralph Smith stated that there is no relevant distinction between the UNS and Southwest Gas incentive programs and that the 50/50 sharing of costs is equally appropriate in this case (Ex. S-25 at 29).

RUCO proposes a complete disallowance of the PEP costs, based on its claim that it is not clear that the program is necessary to achieve the PEP's goals. RUCO witness Moore testified that during the test year (2005), no PEP payments were made because UniSource did not meet the program's financial goals. However, the UniSource Board of Directors authorized payment of a Special Recognition Award ("SRA") in 2005 to the employees eligible **[*50]** for the PEP. As a result, UNS is seeking in this proceeding to recover the average of the 2004 PEP payments and the 2005 SRA costs. Mr. Moore contends that the SRA is unique and does not meet the criteria of a typical and recurring test year expense for which rate recovery should be granted (RUCO Ex. 3 at 16-17). He also stated that 60 percent of the PEP payments are related to financial performance and cost containment, which are goals that primarily benefit shareholders. Finally, Mr. Moore asserts that because the PEP does not apply to 60 percent of its employees (*i.e.,* union employees), it is not clear that the program is necessary or will achieve the stated goals (*Id.;* RUCO Ex. 4 at 8).

We believe that Staff's recommendation provides a reasonable balancing of the interests between ratepayers and shareholders by requiring each group to bear half the cost of the incentive program. As RUCO points out, the program is comprised of elements that relate to the parent company's financial performance and cost containment goals, matters that primarily benefit shareholders. However, 40 percent of the program's incentive compensation is based on meeting customer service goals. This **[*51]** offers the opportunity for the Company's customers to benefit from improved performance in that area. For the same reasons, we also adopt Staffs recommendation to disallow 50 percent of the Officer's Long-Term Incentive Program (Ex. S-25 at 26).

Although we believe, on balance, that the 50/50 sharing is reasonable, we share RUCO's concerns that the SRA offered to employees in 2005 may have the effect of undermining the very goals the PEP is intended to achieve (*i.e.,* providing an incentive for participating employees to improve performance and thereby benefit both the Company and its customers). As described by Mr. Moore, despite failing to meet the PEP goals, the UniSource Board of Directors decided nonetheless to provide the affected employees with a surrogate means of compensation. It appears that the SRA sends a signal to employees that they will be compensated regardless of performance, which places the entire premise of the PEP at issue. We expect the program to be scrutinized in the Company's next rate case to determine the appropriateness of providing incentive compensation above base salaries to employees.

Supplemental Executive Retirement Plan

UNS Gas allows select **[*52]** executives to participate in a Supplemental Executive Retirement Plan ("SERP"). The SERP provides to eligible executives retirement benefits in excess of the limits allowed under Internal Revenue Service ("IRS") regulations for salaries in excess of specified amounts. UNS contends that the SERP costs are reasonable and that neither Staff nor RUCO have shown that the Company's overall executive compensation costs are excessive or out of line with industry standards.

Staff and RUCO recommend disallowance of the SERP costs ($ 93,075), in accordance with the Commission's Decision in the Southwest Gas case (Decision No. 68487, at 18-19). In that case, we disallowed Southwest Gas's SERP costs, finding:

> [T]he provision of additional compensation to Southwest Gas' highest paid employees to remedy a perceived deficiency in retirement benefits relative to the Company's other employees is not a reasonable expense that should be recovered in rates. Without the SERP, the Company's officers still enjoy the same retirement benefits available to any other Southwest Gas employee and the attempt to make these executives "whole" in the sense of allowing a greater percentage of retirement benefits **[*53]** does not meet the test of reasonableness. If the Company wishes to provide additional retirement benefits above the level permitted by IRS regulations applicable to all other employees it may do so at the expense of its shareholders. (*Id.* at 19).

We disagree with the Company's argument that disallowance of the SERP costs effectively allows the IRS to dictate what compensation costs should be recovered. As was clearly stated in the passage cited above, the issue is not whether UNS may provide compensation to select executives in excess of the retirement limits allowed by the IRS, but whether ratepayers should be saddled with costs of executive benefits that exceed the treatment allowed for all other employees. If the Company chooses to do so, shareholders rather than ratepayers should be responsible for the retirement benefits afforded only to those executives. We see no reason to depart from the rationale on this issue in the most recent Southwest Gas rate case, n9 and we therefore adopt the recommendations of Staff and RUCO and disallow the requested SERP costs.

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n9 *See also Arizona Public Service Co.,* Decision No. 69663, at 27 (June 28, 2007), wherein SERP costs were excluded in their entirety.

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More disturbing than the Company's advocacy on the relative merits of the SERP is the statement in its initial brief that "[h]ad TINS Gas been notified that SERP costs would not be allowed, it could have restructured its executive compensation package to take that into account. It would not be fair to hold TINS Gas to this new, unexpected standard." (TINS Initial Brief at 28.) Implicit in the Company's argument is the concept that "if we don't recover fully what we believe are our reasonable costs in our preferred manner, we'll simply shift those costs to another account to disguise the costs and ultimately ensure recovery." The approach to rate recovery seemingly advocated by TINS can serve only to increase the cynicism often expressed by ratepayers regarding the reasonableness of a given utility company's proposed rates and, if allowed, would at its essence turn the ratemaking process into a veritable regulatory version of "Three-Card Monte." We trust that in future rate applications, Staff and RUCO will explore thoroughly the merits of individual expenses sought by UNS, as well as other companies, to ensure that customers are paying rates that include only the costs necessary to **[*55]** provide quality service.

Fleet Fuel Expense

UNS witness Dukes proposed that the Company's fleet fuel expense be established based on an average gasoline cost of $ 2.48 per gallon (Ex. A-13 at 19). Mr. Dukes stated that the average fuel price used by UNS reflects the Company's actual costs and that lower cost recommendations made by Staff and RUCO should be rejected. He testified that it is not surprising that UNS would have slightly higher fuel costs than some other utilities because the UNS Gas service area is farther from large metropolitan areas like Phoenix and Tucson and covers a larger number of square miles given its more rural location (*Id.*). In response to a proposed disallowance made by Staff witness Ralph Smith, Mr. Dukes reduced the Company's request by $ 12,657 (pre-tax) (*Id.* at 23-24).

In his surrebuttal testimony, Staff witness Smith agreed with Mr. Dukes' proposed reduction to fleet fuel expense (Ex. S-27 at 39). Although Staff appears to have reconciled its recommendation with the Company on this issue, UNS's brief continues to advocate rejection of Staff's position (UNS Initial Brief at 29-30). We assume that the Company failed to notice Mr. Smith's surrebuttal **[*56]** testimony agreeing with Mr. Dukes' rebuttal testimony, and we believe that there is no remaining dispute between UNS and Staff.

RUCO agrees that it is appropriate for UNS to annualize its fuel expense to reflect additional employees included in its payroll annualization adjustment. However, RUCO witness Diaz Cortez stated that because gasoline prices were abnormally high in early 2006, the Company's calculation inflated the annualized level of fuel expenses (RUCO Ex. 5 at 14-15). Instead of the proposal to base fuel expenses on an average of $ 2.48, RUCO recommends using $ 2.43 per gallon as the average cost (*Id.* at Sched. MDC-3). In addition, RUCO claims that UNS understated the actual miles per gallon (10.28 mpg) achieved by the UNS fleet (*Id.* at 15). On cross-examination, Mr. Dukes admitted that the Company did not respond to the second part of RUCO's recommendation (*i.e.,* the UNS fleet miles per gallon) (Tr. at 241-42). Nor did UNS address the miles per gallon issue in its brief

We find that the Company has adequately supported the use of $ 2.48 per gallon as the basis for determining its fleet fuel costs in this proceeding. However, as Ms. Diaz Cortez pointed out, **[*57]** UNS did not respond to the second part of the RUCO recommendation dealing with fleet miles per gallon. We will therefore adopt RUCO's proposal to use the actual 2005 fleet miles per gallon as set forth in Ms. Diaz Cortez's schedules, adjusted by the inclusion of the $ 2.48 per gallon gasoline price recommended by UNS and Staff.

Bad Debt Expense

In its initial brief, UNS states that although the Company and Staff are in agreement as to the appropriate level of bad debt expense, RUCO's proposal to disallow $ 100,000 is based on a mismatch and should be rejected (UNS Initial Brief at 29). Ms. Diaz Cortez agreed in her surrebuttal testimony that "the numerator and the denominator of the bad debt ratio would have to be adjusted to remove the NSP and Griffith Plant" (RUCO Ex. 6 at 13). It appears that UNS failed to recognize RUCO's surrebuttal testimony on this issue and, as a result, continues to advocate rejection of a position RUCO conceded before the commencement of the hearing. Since there is no remaining disputed issue, we adopt the Company's recommendation on this issue.

Postage Expense

UNS proposed inclusion in operating expenses of $ 529,380 for postage costs, based on **[*58]** a two-year average (2005 and 2006) and including acknowledgement of a postal increase that became effective May 14, 2007 (from $ .39 to $ .41) (Ex. A-13 at 19-21).

In his surrebuttal testimony, Staff witness Ralph Smith modified an earlier adjustment and agreed with UNS that the postage expense starting point of $ 445,171 is appropriate, which produces an annualized postage expense of $ 476,960 to reflect a January 8, 2006 postage increase as well as customer growth that occurred during the test year. In addition, Mr. Smith agreed that the May 14, 2007, increase should be recognized, resulting in an overall postage allowance of $ 503,356 (Ex. S-27, at 39-40). The difference of $ 26,024 between the UNS and Staff recommendations relates to the Company's proposal to reflect the impact of 2006 postage expense. Mr. Smith stated that customer growth should only be reflected through the 2005 test year because inclusion of customer growth in 2006, without considering the commensurate growth in revenues, would result in an inappropriate mismatch (*Id.*).

RUCO witness Rodney Moore proposed an adjustment comparable to that proposed by Staff (RUCO Ex. 4 at 9). Like that of Staff, RUCO's adjustment **[*59]** is based on the use of historic test year levels, annualized for increases in customer levels and adjusted for known and measurable postal rate increases. As reflected in its final schedules (Final Sched. RLM-9), RUCO's recommendation is for an allowance of $ 502,018.

It is not clear whether the UNS initial brief recognized the adjustments made by Staff and RUCO in their surrebuttal testimonies, because the UNS brief states that the Staff and RUCO positions should be rejected due to "several errors" (UNS Initial Brief at 30). As described above, both Staff and RUCO eventually agreed with all of the Company's arguments on this issue except one: whether customer growth beyond the test year should be recognized in establishing postage expense. UNS did not address in its reply brief the arguments made in the Staff and RUCO initial briefs, so it is possible the Company is now in agreement with the Staff and RUCO recommendations on this issue. We agree with Staff and RUCO that customer growth should be recognized only through the end of the test year because to do otherwise would result in a clear mismatch between expenses and revenues under the Company's proposal. Although the Staff and **[*60]** RUCO recommendations result in slightly different amounts ($ 1,338 difference), the reason for the difference is not clear. We therefore adopt Staff's postage expense recommendation of $ 503,356.

Depreciation and Property Taxes for CWIP

Staff made adjustments to remove the Company's proposed pro forma amounts for depreciation and property taxes related to the request to include CWIP or, alternatively, post-test-year plant (Ex. S-27 at 26). Given our denial of the CWIP and post-test year plant proposals, Staff's adjustments are adopted.

Overtime Payroll Expense

Staff witness Ralph Smith recommended an adjustment to reduce the Company's proposed test year overtime payroll expense by $ 123,010 (Ex. S-25 at 28). The adjustment relates to Staff's normalization of the overtime payroll expenses (*Id.*). In his Rebuttal testimony, UNS witness Dukes agreed with Staff's proposal, conceding that Staff's recommendation is more reflective of expected overtime levels (Ex. A-13 at 17). Staff's recommendation is adopted.

Payroll Tax Expense

Staff witness Ralph Smith proposed a reduction to the Company's pro forma payroll tax expense by $ 9,348 to reflect Staff's adjustments to overtime **[*61]** payroll and incentive compensation expenses (Ex. S-27 at 34). Consistent with Staff's recommendations on the overtime payroll and incentive compensation issues, Staff's payroll tax expense adjustment is adopted accordingly.

Property Tax Expense

UNS proposed the use of a property tax rate of 24.5 percent (Ex. A-13, Attach. DJD-1). Both Staff and RUCO recommend setting allowable expenses for property tax based on a rate of 24.0 percent. Staff witness Ralph Smith testified that Staff's recommendation is based on the known and measurable assessment for 2007, pursuant to legislation passed by the Arizona State Legislature that reduces property tax assessments from a rate of 25 percent in 2005 by .5 percent in each successive year until a rate of 20 percent is achieved in 2015 (Ex. S-27 at 35-36). Mr. Smith stated that the Company's proposal fails to recognize the impact of the known tax change. He also indicated that Staff's recommendation is consistent with the recent Southwest

Gas rate case (which had a test year ending August 31, 2004), wherein Southwest Gas, Staff, and RUCO agreed that a 24.5 percent assessment for the 2006 rate was appropriate for the calculation of property tax **[*62]** expense (*Id.*). RUCO witness Rodney Moore also proposed use of a 24.0 percent assessment rate for UNS in this case, based on the same rationale described by Mr. Smith (RUCO Ex. 4 at 14).

We agree with Staff and RUCO that the property tax expense allowance in this case should be based on the known and measurable assessment rate currently in effect. The rate for 2007 is currently 24.0 percent, and the rate will continue to decline in subsequent years while the rates established in this case are in effect. The Staff and RUCO recommendations are therefore adopted.

Membership and Industry Association Dues

UNS initially included $ 41,854 for dues paid to the American Gas Association ("AGA"). In his direct testimony, RUCO witness Moore recommended a partial disallowance of $ 1,523 of the AGA dues based on an AGA/NARUC n10 Oversight Committee Report indicating that 1.54 percent of AGA dues are used for marketing and that 2.10 percent of dues are allocated for lobbying activities (RUCO Ex. 3 at 26-29). In his Rebuttal testimony, UNS witness Dukes agreed with Mr. Moore's proposed adjustment and revised the Company's proposed expenses in accordance with RUCO's recommendation (Ex. A-13, **[*63]** at 18-19).

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n10 National Association of Regulatory Commissioners

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Staff witness Ralph Smith recommended a larger percentage disallowance of the AGA dues and also proposed eliminating dues paid by the Company to a number of other organizations (primarily for dues to a number of local Chambers of Commerce within the UNS service area) (Ex. S-27 at 37-39; Sched. C-14). Mr. Smith stated that Staff's more aggressive disallowance proposal is based on language in the Southwest Gas Order, (Decision No. 68487, at 14), which admonished Southwest Gas in its next rate case to "provide a clearer picture of AGA functions and how the AGA's activities provide specific benefits to the Company and its Arizona Ratepayers." Mr. Smith acknowledged that the Southwest Gas Order disallowed only the marketing and lobbying portions of the AGA dues (3.64 percent), consistent with RUCO's recommendation in this proceeding. However, he believes UNS should have been on notice to provide additional details regarding AGA activities, which the Company **[*64]** failed to supply. Mr. Smith based his 40 percent disallowance on 1999 and 2000 NARUC audit reports of AGA expenditures (which appear to indicate that approximately 40 percent of AGA dues are used for marketing and lobbying efforts) and on a decision issued by the Florida Public Service Commission disallowing 40 percent of AGA dues from expenses (Ex. S-25 at 34-37, Sched. RCS-3; Ex. S-27 at 37-39).

Mr. Smith raises a valid point regarding the nature of AGA dues and whether a higher percentage of such dues should be disallowed as related to activities that are not necessary for the provision of service to UNS customers. However, we believe it is reasonable, in this case, to allow $ 40,331 ($ 41,854 - $ 1,523), in accordance with RUCO's recommendation. As we indicated in the Southwest Gas Order, however, we expect UNS in its next rate case to provide more detailed support for allowance of AGA dues and how the AGA's activities benefit the Company's customers aside from marketing and lobbying efforts.

With respect to Mr. Smith's proposal to disallow a number of smaller dues to Chambers of Commerce and similar organizations, we believe these types of expenses are encompassed within RUCO's **[*65]** recommendation regarding so-called "unnecessary" expenses, which are addressed in a prior section of this Order. Given that we disallowed 50 percent of those expenses, it is likely that an additional disallowance under Staff's recommendation would represent a double counting of the types of expenses identified by RUCO. We therefore decline to adopt Staff's recommendation on this issue.

Interest Synchronization

There does not appear to be any dispute that an interest synchronization adjustment is necessary to coordinate the income tax calculation with rate base and cost of capital. As set forth in Staff witness Ralph Smith's testimony, this adjustment decreases income tax expense and increases the Company's achieved operating income by a similar amount (Ex. S-27, Attach. RCS-2S, Sched. C-17).

CARES Related Amortization

Staff recommended that UNS cease deferral of costs related to the Customer Assistance Residential Energy Support ("CARES") program upon approval of the new rates established in this case. According to Staff witness Ralph Smith, Staff has recognized CARES program discounts in Staff's proposed rate design, and Staff recognizes UNS has accumulated some deferred **[*66]** costs related to the program (Ex. S-27 at 44). Based on Staff witness McNeely-Kirwan's recommendation regarding the ratemaking treatment for the accumulated deferred CARES costs, Mr. Smith reduced operating expenses by $ 441,511 (*Id.,* Sched. C-20). Given our adoption of staff's recommendation regarding the CARES program (see discussion below), Staff's proposed adjustment to operating income is appropriate.

Nonrecurring Severance Payment

Staff witness Ralph Smith initially proposed an adjustment to remove a nonrecurring severance payment for an employee who was dismissed in 2004, but whose severance payment was made in 2005 (Ex. S-25 at 27-28). UNS witness Dukes opposed Staff's recommendation, stating in his rebuttal testimony that because there was never an offsetting expense for this payment posted to the Company's books in 2005, payroll expense was understated by approximately $ 52,000 (Ex. A-13 at 15). In his surrebuttal testimony, Mr. Smith stated that Staff's prior adjustment was unnecessary because the item "was effectively adjusted to zero in the UNS Gas filing" (Ex. S-27 at 33).

In its Initial Brief, Staff contends that it disagrees with the attempt by Mr. Dukes "to **[*67]** revise its filing to add this nonrecurring severance expense back twice" (Staff Initial Brief at 15). UNS did not address this issue in either of its Briefs, but it appears from reading Mr. Smith's testimony that the issue was resolved prior to the hearing, considering Mr. Smith's statement that the prior Staff adjustment was unnecessary.

Nonrecurring Union Training

RUCO witness Moore recommended disallowance of $ 2,584 related to M.A.R.C. (Union) Training that, according to Mr. Moore, UNS had described as "a one-time only instructional session to acquaint Company personnel with working in a unionized environment" (RUCO Ex. 4 at 16). Mr. Moore claims that the expense is nonrecurring and should therefore be disallowed (*Id.*).

UNS witness Gary Smith stated that while the M.A.R.C. training was a one-time event, training is an ongoing activity that is required to comply with regulatory mandates. He claims that, since the end of the test year, another mandatory training program has been established for gas distribution companies to provide training to both the public and employees (Ex. A-17, at 4). The Company therefore requests that RUCO's recommendation be rejected. On cross-examination, **[*68]** Mr. Smith admitted that the M.A.R.C. training was a one-time event and that RUCO had not proposed to disallow any other training expenses incurred by the Company (Tr. at 416-17).

We agree with RUCO that the specific expense item identified by Mr. Moore is related to a one-time training cost that will not occur in the future. No other training costs are recommended for disallowance, and although the Company may face increasing training costs in the future, those costs will be addressed in a future rate case where all relevant test year revenues and expenses will be evaluated for inclusion in rates. We therefore adopt RUCO's recommendation on this issue.

New Depreciation Rates

Staff witness Ralph Smith indicated that Staff is in agreement with the Company's proposed new depreciation rates (Ex. S-25 at 63). However, Mr. Smith recommended that each of the new depreciation rates proposed by UNS should be clearly broken out by a service life and a net salvage rate. He indicated that this would allow the depreciation expense related to the inclusion of estimated future cost of removal in depreciation rates to be tracked and accounted for by plant account (*Id.*). There does not appear **[*69]** to be a dispute regarding the new depreciation rates to be employed by UNS. Further, the Company did not oppose Mr. Smith's suggestions for separating the depreciation rates for service life and net salvage. Staff's recommendation is therefore adopted.

Net Operating Income

Consistent with the foregoing discussion, we will allow adjusted test year operating expenses of $ 37,652,416, which based on test year revenues of $ 47,273,923, results in test year adjusted operating income of $ 9,621,507, a 5.30 percent rate of return on FVRB.

COST OF CAPITAL

UNS Gas recommends that the Commission determine the Company's cost of common equity to be 11.0 percent, with an overall weighted cost of capital recommendation of 8.80 percent. Staff recommends a cost of common equity of 10.0 percent, with an overall weighted cost of capital determination of 8.12 percent. RUCO proposes adoption of a cost of common equity of 9.84 percent, with an overall weighted cost of capital of 8.22 percent (RUCO Ex. 8 at 2).

Capital Structure

At the end of the test year, UNS had a capital structure consisting of 55.33 percent long-term debt and 44.67 percent equity (Ex. A-27 at 8). UNS proposes using **[*70]** a hypothetical capital structure of 50 percent debt and 50 percent equity because it is striving to increase its equity ratio to 50 percent and believes that the rates set in this case should reflect the capital structure that would exist when the rates set in this case are in effect (Tr. 964).

According to UNS witness Kentton Grant, "it is reasonable for the Company to target a higher common equity ratio due to the Company's small size, large capital spending needs and limited borrowing capacity" (Ex. A-27 at 8-9). He claims that UNS forecasts achieving a 50 percent equity ratio by the end of 2008 (*Id.*). In support of the Company's improving equity ratio, Mr. Grant points out that UNS Gas has improved its equity ratio from 33 percent in August of 2003 to 45 percent at the end of 2005. He stated that this improvement has been achieved by UNS Gas's retaining 100 percent of its annual earnings and through additional equity investments from its parent, UniSource Energy. Mr. Grant testified that despite the absence of any dividends being paid by UNS to UniSource over the past several years, UniSource has invested an additional $ 16 million of equity capital in UNS Gas (*Id.*).

UNS **[*71]** cites to the most recent Southwest Gas Order to support its request for employing a hypothetical capital structure (Decision No. 68487, at 23-25). In that case, the Commission agreed with Staff's request to use a hypothetical capital structure of 40 percent equity, but rejected Southwest Gas' request to use 42 percent equity in the capital structure. During the test year in that case, Southwest Gas had an average actual capital structure of 34.5 percent equity, 5.3 percent preferred stock, and 60.2 percent long-term debt (*Id.* at 23). In this case, Mr. Grant indicated that using the Company's recommended hypothetical capital structure would help alleviate the current weakness in earnings and cash flow in order to offset the negative credit impact of weak cash flows (*Id.* at 10).

RUCO supports the Company's request to use a 50/50 hypothetical capital structure to establish UNS's cost of capital in this proceeding. RUCO witness

William Rigsby stated that UNS's capital structure is more heavily weighted with debt than the average of the companies used in his comparable company analysis. He also indicated that the other local gas distribution companies ("LDCs") in his sample group **[*72]** had an average of 48 percent debt and 52 percent equity, compared to UNS at approximately 55 percent and 45 percent, respectively (RUCO Ex. 7 at 43). As a result, Mr. Rigsby suggested, the LDCs in his proxy group would have a lower level of financial risk compared to UNS. As discussed below, Mr. Rigsby did not make an adjustment to his cost of equity analysis to account for a higher level of financial risk but, instead, testified that his hypothetical capital structure recommendation gives recognition to this higher risk (*Id.* at 44).

Although UNS and RUCO are in agreement on the employment of a 50/50 capital structure, Staff contends that a hypothetical capital structure is not appropriate in this case. Staff witness David Parcell testified that both UNS Gas and UNS Electric currently have higher equity ratios than either TEP or UniSource Energy, and the actual UNS equity ratio is comparable to those of other electric and combination gas and electric utilities (Ex. S-36 at 19-20). Mr. Parcell stated that using a hypothetical capital structure would have the effect of "increasing the actual return on equity to a level exceeding that intentionally approved by the Commission" (**[*73]** *Id.* at 20). According to Mr. Parcell, adopting the Company's proposed 50/50 capital structure would have the net effect of increasing the actual authorized return on equity by 50 basis points, or 0.50 percent (*Id.* at 21).

With respect to the Commission's use of hypothetical capital structures in prior cases, Staff argues that the circumstances are different for UNS. Staff cites to a recent Arizona-American Water Company (Mohave) case in which the Commission adopted a hypothetical capital structure of 40 percent equity and 60 percent debt, although the company's actual structure consisted of 37.2 percent equity and 62.8 percent debt (Decision No. 69440, at 13). Staff asserts that the Commission's Decision in that case was based on its concern that Arizona-American was more highly leveraged than its comparable companies. According to Staff, UNS's capital structure is in line with other comparable companies, so no similar concern exists. Staff contends that the same reasoning holds true with respect to Southwest Gas, which had a highly leveraged capital structure, with more than 60 percent long-term debt during the test year. Staff argues that a hypothetical capital structure **[*74]** should be employed only where a company's actual capital structure is out of line with comparable companies, or where the actual capital structure contains higher cost equity capital, which would be unduly expensive to ratepayers.

Although we understand and appreciate Staff's concerns, we believe the hypothetical capital structure recommendation recommended by UNS and RUCO is reasonable in this case. We believe the Company's efforts to improve its equity ratio over the past several years, through retained earnings and additional equity investment by its parent, should be recognized and encouraged. As indicated by UNS witness Grant, the Company's equity ratio has improved steadily since 2003, and UNS anticipates achieving a 50 percent equity ratio by the end of 2008.

While we recognize that, from a capital structure standpoint, UNS is situated differently from Southwest Gas, we believe it is necessary to express the same concern that was indicated in the Southwest Gas case regarding ongoing use of a hypothetical capital structure for establishing a company's cost of capital and the rates that flow from that determination. As stated therein, "[a]t some point, we must send Southwest Gas **[*75]** a signal that it must improve its capital structure up to the hypothetical level that has been employed for many years or it must live with the results of its actual capital structure" (Decision No. 68487, at 25). Given the historical and anticipated progress of UNS in improving its equity ratio, we believe it is likely that use of the Company's actual capital structure in future cases would produce a reasonable cost of capital result. In this case, however, we find that the record supports use of the Company's 50/50 capital structure.

Cost of Debt

All parties in the case agreed that the Company's cost of debt was 6.60 percent during the test year. Since there is no dispute regarding this issue, we will adopt a cost of debt of 6.60 percent for purposes of establishing UNS Gas's weighted cost of capital in this proceeding.

Cost of Common Equity

Determining a company's cost of common equity for purposes of setting its overall cost of capital requires an estimate based on a number of factors. There is no fool-proof methodology for making this determination, and the expert witnesses rely on various analyses to support their respective recommendations.

UNS Gas

UNS witness **[*76]** Kentton Grant based his common equity cost recommendation of 11.0 percent on the results of his common equity models, namely the Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM"). Mr. Grant also examined the risk profile of TINS Gas relative to a comparable company group to determine a point in the range produced by those models. The estimated cost of equity produced by this analysis was then compared to the allowed returns for other LDCs in the United States to confirm the reasonableness of the Company's estimate. As a final matter, Mr. Grant examined the financial impact of the recommended return on equity ("ROE") and the overall rate request to assess the Company's ability to attract capital on reasonable terms (Ex. A-27 at 10-11).

Mr. Grant claims that it was appropriate to use a comparable group of LDCs in his analysis because the cost of equity capital for UNS Gas's parent company, UniSource Energy, which is heavily weighted toward the electric industry, may not be representative of the cost of equity capital for UNS Gas. Mr. Grant's comparable group was based on all 16 LDCs evaluated by *Value Line Investment Survey ("Value Line"),* from which 11 companies **[*77]** were selected based on several criteria that Mr. Grant believes make them comparable to UNS Gas (*Id.* at 12).

Mr. Grant explained that the DCF methodology is based on the theory that the price of a share of stock is equal to the present value of all future dividends. As described by Mr. Grant, the constant growth form of the DCF model recognizes that the return to shareholders consists of both dividend yield and growth. He stated that the constant growth form of the model should not be used for companies with near-term growth rates that are significantly higher or lower than their long-term growth potential. For such companies, Mr. Grant claims that a multi-stage DCF model should be used to incorporate the various growth rates that are expected over time (*Id.* at 13).

According to Mr. Grant, an annual long-term growth rate of 6 percent represents a reasonable estimate of investor expectations for earnings and dividends, which he claims is consistent with the 6.1 percent median growth rate in earnings per share ("EPS") for his comparable company group published by *Value Line,* as well as a five-year estimate of EPS growth reported by *Thomson Financial* of 5.6 percent for **[*78]** the gas utility industry and 6.4 percent for the broader utilities sector (*Id.* at 16). Based on his application of a multi-stage DCF model, the estimated cost of equity for the sample companies produced a range of 9.1 percent to 10.5 percent, with a median value of 9.9 percent (*Id.* at 18).

Mr. Grant stated that use of the CAPM is premised on the concept that capital markets are highly efficient and that investors attempt to optimize their risk/return profiles through diversification. He indicated that the CAPM assumes that risk is comprised of systematic risk (which is unavoidable) and unsystematic risk (which is company-specific and can theoretically be eliminated through portfolio diversification). As a result, Mr. Grant explained that the CAPM is based on the theory that investors should be compensated only for systematic risk (*Id.*). Applying the CAPM produced a result of 9.9 percent to 11.0 percent. Based on his comparison of the DCF and CAPM results, Mr. Grant selected a range of 9.5 percent to 11.0 percent as the Company's estimate of the cost of equity for the comparable company group (*Id.* at 20).

The next step in the Company's analysis was to determine the **[*79]** appropriate return on equity ("ROE") in this proceeding for UNS Gas, based on a comparison of the "risk profiles" of UNS and the comparable companies. Mr. Grant asserts that an equity investment in UNS Gas is "decidedly riskier" than an equity investment in the comparable companies due to several factors, including UNS Gas's smaller size, a higher growth rate in net plant investment, the lack of a decoupling mechanism, and lower credit ratings for UNS Gas than for most of the comparable companies. Based on these relative risk factors, Mr. Grant proposes that the ROE for UNS Gas be set at the top of the range for comparable companies and that the Commission award a ROE of 11.0 percent in this proceeding (*Id.* at 21-23).

UNS is critical of the ROE recommendations of both Staff and RUCO based on the Company's claim that Staff and RUCO's use of a geometric means in calculating the market risk premium of their CAPM models is contrary to sound financial theories. UNS argues that an arithmetic means is supported by academics and financial professionals. The Company also contends that RUCO's analysis placed too much emphasis on near-term analyst growth forecasts, a methodology that UNS **[*80]** contends has been rejected by the Commission in two recent cases. UNS is also critical of RUCO's use of a single-stage DCF model, which assumes that company growth rates will continue in perpetuity, and of RUCO's over-reliance on analyst forecasts.

Finally, UNS criticizes Staff's and RUCO's ROE recommendations based on the Company's claim that the results fail a basic test of reasonableness. UNS contends that Staffs (10.0 percent ROE) and RUCO's (9.64 percent ROE) n11 recommendations are below ROEs approved by other state commissions and that UNS Gas bears much greater risk than comparable LDCs due to the factors cited in Mr. Grant's testimony (TINS Initial Brief at 37-38). Based on the Company's higher risk assertion, it claims, it must be awarded a higher ROE commensurate with that risk.

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n11 UNS apparently failed to observe that RUCO made an upward adjustment in its ROE recommendation (to 9.84 percent) through Mr. Rigsby's surrebuttal testimony filed on April 4, 2007 (RUCO Ex. 8, at 2).

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RUCO

RUCO witness William **[*81]** Rigsby proposes adoption of a ROE of 9.84 percent based on his analysis using DCF and CAPM methodologies (RUCO Ex. 8 at 2). As noted above, Mr. Rigsby employed a single-stage DCF analysis, as opposed to the multi-stage version used by UNS. RUCO contends that Mr. Rigsby's DCF analysis is appropriate because it takes into consideration both short-term and long-term growth projections that are specific to the LDCs used in Mr. Rigsby's proxy group (RUCO Ex. 7 at 46).

RUCO is critical of Company witness Grant's DCF model, which RUCO claims assumes a long-term growth rate for LDCs that would be comparable to an inflation-adjusted growth rate for all goods and services produced by labor and property in the United States in perpetuity. According to Mr. Rigsby, a valid argument could be made that regulated utility company growth rates may not be comparable to national Gross Domestic Product ("GDP") growth rates, and therefore, the multi-stage DCF advocated by TINS is inappropriate (*Id.*). Mr. Rigsby also stated that the multi-stage DCF used by the FERC requires more weight to be given to short-term growth expectations rather than inflation-adjusted estimates of future GDP growth (RUCO Ex. **[*82]** 8 at 9). Mr. Rigsby pointed out that if the Company's DCF inputs (excluding Cascade Natural Gas - which RUCO claims has a stock price that is affected by a merger proposal) were applied to RUCO's single-stage DCF model, the resulting mean average would be significantly less than even Mr. Rigsby's DCF estimate (RUCO Ex. 7 at 47).

With respect to its CAPM analysis, RUCO asserts that the use of both geometric and arithmetic means of historical returns is more reasonable than the Company's exclusive reliance on arithmetic returns (*Id.* at 28). Similar to the arguments made by Staff (see below), RUCO contends that it is appropriate to use both means in the CAPM analysis, because investors have access to both forms of information regarding historical returns. Mr. Rigsby added that he believes the geometric mean provides "a truer picture of the effects of compounding on the value of an investment when return variability exists" (RUCO Ex. 8 at 12).

RUCO also disagrees with UNS regarding the effect that customer growth should have on the Company's return on equity. Contrary to the Company's claim that high growth presents additional risk that must be reflected through a higher authorized **[*83]** return, RUCO argues that high growth in Arizona is a positive factor that should be a selling point to UniSource investors. RUCO cites to UniSource's 2005 Annual Report, in which UniSource's Chairman touted the company's customer growth rate in excess of 4 percent as a positive factor (*Id.* at Attach. E). RUCO also notes that a Standard & Poors report attached to Mr. Grant's testimony indicates that high customer growth could produce greater profitability or rate stability for an LDC (Ex. A-28, Attach. KCG-12). RUCO claims that it has not ignored the demand for capital that customer growth places on UNS operations, as reflected by RUCO's support for use of the Company's proposed 50/50 hypothetical capital structure.

Staff

Staff witness David Parcell presented Staff's ROE recommendation in this case. In developing his recommendation, Mr. Parcell utilized DCF, CAPM, and Comparable Earnings Method ("CEM") analyses. He indicated that because UNS Gas is not publicly traded, it is not possible to directly apply cost of equity models. In his analysis, Mr. Parcell employed 2 comparable groups of companies as a proxy for UNS Gas (Ex. S-36, at 21-23). The first sample group was comprised **[*84]** of a group of nine combination gas and electric companies and the second group consisted of the same 11 natural gas companies used by the Company's witness.

Mr. Parcell's DCF analysis produced a range of 9.25 percent to 10.5 percent for the proxy groups' cost of equity. His CAPM model produced a cost of equity range of 9.5 percent to 10.25 percent for the sample groups (*Id.* at 25-28). Mr. Parcell also utilized a CEM analysis, which he described as a method designed to measure the returns expected to be earned on the original cost book value of similar risk companies. According to Mr. Parcell, his CEM analysis was based on market data using market-to-book ratios, and is therefore a market test that should not be subject to criticisms leveled at other analyses that are based on past earned returns. He also claims that the CEM uses prospective returns and is therefore not backward-looking (*Id.* at 31-32). Using the CEM, Mr. Parcell concluded that the cost of equity for the proxy companies is "no more than 10 percent" (*Id.* at 33).

Based on the results of the three methodologies, Mr. Parcell found an overall range of 9.25 percent to 10.5 percent ROE for the proxy companies. **[*85]** He indicated that the range of mid-points for the three methodologies is 9.88 percent to 10.0 percent. Mr. Parcell concluded that the appropriate cost of equity rate for UNS Gas is in the range of 9.5 percent to 10.5 percent. He recommended that the Commission adopt the mid-point of the range (10.0 percent) as the ROE in this case.

With respect to the arguments raised by the Company, Staff asserts that UNS failed to give any weight to its own DCF analysis and relied exclusively on its excessive CAPM results. Staff contends that UNS's CAPM analysis is flawed because it uses a risk-free rate of 5.3 percent, which Staff claims is outdated and exceeds the current level of U.S. Treasury Bond yields, and the Company used an inappropriate equity risk premium of 7.1 percent, which is based exclusively on the arithmetic means of common stock and bond returns from 1926 to 2005.

In response to the Company's criticism of Staff's use of geometric means in its analysis, Staff cites to Mr. Parcell's surrebuttal testimony, wherein he indicated that investors have access to both arithmetic and geometric returns in making investment decisions and that many mutual fund investors rely on geometric returns **[*86]** in evaluating historic and prospective returns of funds (Ex. S-37 at 3). Staff also points to Mr. Parcell's testimony indicating that *Value Line* reports show historic returns based on a geometric or compound growth rate basis (*Id.*).

Conclusion on Cost of Equity

Having considered the testimony, exhibits, and arguments, we believe that Staff's recommended cost of equity capital produces a reasonable result and should be adopted. Staff witness Parcell's proposed 10.0 percent cost of equity provides a reasonable balance between the Company's attempt to place the ROE at the very top of the range produced by the Company's analysis and the results achieved through the methodologies employed by Staff and RUCO.

As noted above, Mr. Parcell's DCF analysis produced a range of 9.25 percent to 10.5 percent for the proxy groups' cost of equity, his CAPM model produced a cost of equity range of 9.5 percent to 10.25 percent for the sample groups, and his CEM analysis produced a result for the proxy companies of no more than 10 percent. Based on his conclusion that UNS Gas has an estimated ROE of 9.5 to 10.5 percent, Mr. Parcell recommended awarding the Company a ROE at the mid-point of **[*87]** the range, or 10.0 percent.

We agree with the Staff and RUCO witnesses that it is appropriate to consider the geometric returns in calculating a comparable company CAPM because to do otherwise would fail to give recognition to the fact that many investors have access to such information for purposes of making investment decisions. Although there continues to be disagreement regarding the risk effect from high customer growth, we believe that high growth has the potential for providing benefits through increased revenues. In any event, our adoption of the hypothetical capital structure proposed by UNS and RUCO gives recognition to the short-term capital needs associated with growth.

Accordingly, we adopt Staff's recommended 10.0 percent ROE in this proceeding for UNS Gas, which results in an overall weighted average cost of capital of 8.30 percent.

Chaparral City Decision and Fair Value Rate Base

In its application, UNS proposed that the weighted average cost of capital ("WACC") should be applied to its original cost rate base to determine the required operating **[*88]** income in this case (Ex. A-10, Sched. A-1). However, in the rebuttal testimony submitted by UNS witness Pignatelli, the Company suddenly made the claim that its WACC should be applied to FVRB. UNS claims that its change of position was based on its understanding of a recent Memorandum Decision issued by the Arizona Court of Appeals in *Chaparral City Water Co. v. Ariz. Corp. Comm'n,* 1 CA-CC 05-0002 (Ariz. App. Feb. 13, 2007) ("*Chaparral City*"). According to Mr. Pignatelli's rebuttal testimony, UNS is not requesting that its change of position result in a revenue requirement finding that would exceed the amount originally requested by the Company (Ex. A-2 at 8).

UNS argues that in the Chaparral City case before the Commission, the Commission adopted Staffs recommendation to calculate the revenue requirement by multiplying OCRB by the cost of capital (Decision No. 68179, at 26-28). UNS claims that only after this exercise was completed did Staff calculate the FVRB for Chaparral City, which resulted in what UNS contends is a "backing-in" approach because the FVRB calculation is a meaningless exercise that flows from the OCRB and cost of capital equation. UNS witness Grant asserted **[*89]** that the approach advocated by Staff in this case is mathematically equivalent to the methodology used in the Chaparral City case and rejected by the Court of Appeals (Ex. A-29, at 13).

In support of its argument, UNS cites to Article 15, § 14 of the Arizona Constitution, which states in part that "[t]he Corporation Commission shall, to aid it in the proper discharge of its duties, ascertain the fair value of the property within the State of every public service corporation doing business therein..." UNS cites several cases n12 in support of its argument that the Commission is required to determine a company's fair value rate base and use that rate base in establishing the company's rates. UNS concedes that its proposal to apply the WACC to FVRB is not the only possible approach to setting rates, but suggests that it is the only approach presented in this case that complies with the Arizona Constitution. The Company claims that other permissible methods may be developed in future cases but, that for now, the UNS methodology is the only available choice for the Commission to apply.

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n12 *U.S. West Communications, Inc. v. Ariz. Corp. Comm'n,* 201 Ariz. 242, 246, 34 P.3d 351, 355 (2001); *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956); *Scates v. Ariz. Corp. Comm'n,* 118 Ariz. 531, 533-534, 578 P.2d 612, 614-615 (App. 1979); *Phelps Dodge Corp. v. Arizona Electric Power Co-op,* 207 Ariz. 95, 83 P.3d 573, 586 (App. 2004).

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RUCO argues in its brief that application of the WACC to FVRB, rather than to the OCRB initially requested by UNS, could be significant if the Commission adopts any of the positions advocated by Staff or RUCO regarding the Company's rate request. RUCO contends that the Company's change of position was untimely and, for that reason alone, should be rejected. Ms. Diaz Cortez stated in her surrebuttal testimony that, had UNS made its request to apply WACC to FVRB in its original application, RUCO's analysis of the cost of capital would have been entirely different and would likely have produced different results. She indicated that RUCO did not have sufficient time to conduct discovery regarding the change of position between the filing of the Company's rebuttal testimony and the filing of RUCO's surrebuttal testimony, some 13 business days later (RUCO Ex. 6, at 4-5). RUCO also argues that because *Chaparral City* was a Memorandum Decision, it cannot be regarded as precedent or cited. RUCO further asserts, citing Paragraph 17 of the Decision, that the Court confirmed the Commission is not required to apply a WACC to FVRB.

Staff argues that the Company's reliance on the unpublished **[*91]** *Chaparral City* decision is misplaced. Staff points out that the Court of Appeals specifically indicated that the Commission was not required to apply the WACC to FVRB in order to set rates. Staff contends that it is still reviewing the Court's remand order, but the methodology proposed by Mr. Grant would result in an unreasonable and excessive return on equity for UNS. Staff cites to Mr. Parcell's testimony addressing the Company's amended proposal. Mr. Parcell testified that, under UNS's proposal, the link between rate base and capital structure would be broken because the "excess" of fair value rate base over original cost rate base is not financed with investor-supplied funds, and therefore the cost of capital cannot be applied to the fair value rate base because there is no financial link between the two concepts (Ex. S-37 at 8-9). Mr. Parcell's proposed solution is to recognize that the difference between FVRB and OCRB is not financed with investor funds by attributing no cost to the excess between the two. He stated that this recommendation would provide for a return being earned on all investor-supplied funds, which is consistent with sound financial and regulatory standards **[*92]** (*Id.*).

In support of its proposal, Staff cites to decisions rendered in several other states which recognized the problem of applying the cost of capital to fair value rate base. n13 Staff contends that, consistent with the problems identified by Mr. Parcell, application of modern cost of capital models, such as DCF and CAPM, directly to FVRB would create redundancies and double counting. Staff cites the case of *Railroad Commission of Texas v. Entex, Inc.*, 599 S.W.2d 292 (Tx. 1980), in which the Texas Supreme Court discussed the so-called "backing-in" method of determining fair value rate of return. In that case, the court stated that "[i]n a fair value jurisdiction the rate of return multiplied by the rate base usually resulted in a higher return to the book common equity than in an original cost jurisdiction because of the inclusion of the reproduction cost new factor." (*Id.* at 298). In rejecting the "backing-in" argument presented by the utility company, the Texas Supreme Court observed that, in fair value jurisdictions, the return to book common equity is used as a performance indicator by investors, and that fact **[*93]** could not be ignored by blindly applying a rate of return to fair value rate base without recognizing the consequences of such a rate of return on the elements of the company's capital structure. The court also stated:

> [T]he fairness of the rate base or the rate of return can be measured by the cash requirements of the utility. All are

> interdependent and ultimately need to be reconciled...*a return to book common equity which is out of proportion... cannot be ignored since it is more than necessary to attract capital, and therefore, unfair to the ratepayer.* (*Id.* at 299, emphasis added).

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n13 In *Re Harbour Water* Corporation, 2001 WL 170550 (Indiana Utility Regulatory Commission); *Gary-Hobart Water Corp. v. Indiana Utility Regulatory Comm'n,* 591 N.E.2d 649, 653 (Ind. App. 1992); *State of North Carolina ex rel. Utilities Commission et al. v. Duke Power Co.*, 285 N.C. 377, 397, 206 S.E.2d 269, 294 (N.C. 1974); *State of North Carolina ex rel. Utilities Commission et al. v. Virginia Electric and Power,* 285 N.C. 398, 206 S.E.2d 283 (N.C. 1974).

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Staff argues that, as recognized in the *Entex* case quoted above, the question that must properly be addressed is whether investors expect an additional return in excess of the return resulting from application of the financial models used for calculating the appropriate authorized return. Staff contends that there is no evidence that investors expect such an excess return and that the record supports an opposite conclusion. Staff asserts that the difference between applying the return to OCRB and FVRB would be, in effect, a windfall on unrealized paper profits. Staff claims that Mr. Parcell's proposal to assign no cost to the "excess" between OCRB and FVRB is logical and consistent with investor expectations. Staff argues that, to the extent that investors may expect a return on the so-called paper profits, such a return is already incorporated into the cost of capital models employed by the experts in this case. Staff states that, as an example, forecasted earnings per share and dividends per share would be higher if investors expect a utility's assets to grow in value, and historical EPS and DPS would also incorporate growth between a utility's prior and current rate cases. **[*95]** Staff indicates that it will continue to evaluate how to calculate a fair value rate of return, in accordance with the *Chaparral City* decision, and it is possible that a different mathematical adjustment may be developed in the future. Staff argues that UNS did not present any evidence as to how to adjust the cost of capital models in order to determine an appropriate fair value rate of return and that adopting the Company's request would create excessive returns for UNS.

We find the Company's eleventh-hour proposal to substantially amend its application on this issue to be inappropriate, because it is prejudicial to the other parties. Having prepared discovery based on the original proposal, Staff and RUCO were left with insufficient time to conduct discovery regarding the Company's amended proposal and were therefore prejudiced by having insufficient time to adequately prepare for hearing in this matter. If UNS wished to amend its application regarding a substantial change in the underlying theory of ratemaking upon which it decided to rely, it should have withdrawn its original application and started the entire process over. Based on the procedural deficiencies of the Company's **[*96]** amendment to its application and the prejudicial impact on the opposing parties, its proposal is unreasonable.

UNS attempts to portray its amended proposal as an innocuous placeholder, by claiming that there is no harm due to its willingness to be limited only to the revenue requirement set forth in its original application. However, as RUCO succinctly points out, the underlying premise of the Company's argument is fallacious unless the Commission were to agree with every revenue requirement position advocated by the Company. As discussed above, we have rejected a number of the arguments raised by UNS. As a result, the Company's revised position regarding application of FVRB, if it were adopted, would have a substantial impact on the rates that are established in this Decision.

The purpose of the Company's reliance on the cases it cites is unclear, given that no party disputes the concept that fair value rate base must be determined and applied in setting rates. The cases cited by UNS do not, however, stand for the proposition espoused by the Company (*i.e.,* that the Commission *must* apply the Company's WACC to FVRB to determine just and reasonable rates). In fact, those cases **[*97]** make clear that the Commission, although required to ascertain a company's fair value rate base and use that fair value rate base in determining rates, has broad discretion in how the rate-setting formula should be applied.

Even if we were inclined to consider the Company's proposal, its arguments are premature at best. Through his rebuttal testimony, UNS witness Grant suggests that the Commission must apply the WACC to fair value rate base pursuant to the *Chaparral City* decision (Ex. A-28 at 28). However, Mr. Grant's proposal ignores the explicit language of the Court's decision, which states: "the Commission asserts that it was not bound to use the weighted average cost of capital as the rate of return to be applied to the FVRB. The Commission is correct....[t]he Commission has the discretion to determine the appropriate methodology." (*Chaparral City, supra,* at p. 13, P17). Despite this unambiguous explanation, UNS would have us employ the very methodology the Court of Appeals specifically stated the Commission was not required to apply in setting rates.

Aside from the disingenuousness of the Company's argument, the current posture of the *Chaparral City* case is that **[*98]** it has been remanded to the Commission for further consideration. At this point, the Commission has not held hearings on the issue remanded by the Court, and thus no decision has been rendered by the Commission on the issue. Once the Commission issues a subsequent order in the remanded case, the Commission's decision may, or may not, be appealed to the Court of Appeals for a determination of compliance with the Court's remand. Thus, entirely aside from the inappropriateness of citing the unpublished *Chaparral City* decision as precedent, using it as the foundation for requiring a specific methodology in another unrelated case is clearly improper given that the Commission has been given an opportunity to cure the perceived defects in the *Chaparral City* case. Until that case has been decided under the Court's remand order, and the Court of Appeals has determined whether the Commission's Decision on Remand satisfies the Court's prior order, it is premature for UNS (or any other company) to suggest that the Commission must apply a particular methodology, especially a methodology that the Court specifically stated the Commission is not required to adopt.

We also believe that Staff **[*99]** has raised a number of relevant concerns with the Company's attempt to apply the WACC to FVRB without further modification. As Staff points out, there is no logical basis for applying such a methodology because investors have no expectation that they will earn a return on the excess between OCRB, which represents investor supplied funds, and FVRB, which represents unrealized paper profits. If the Company's proposal were to be adopted, the underlying basis of the cost of capital analysis would be called into question and would likely require substantial modification to avoid a result that grants excessive windfall returns to investors at the expense of ratepayers. We note that UNS states in its reply brief that, pursuant to the holding in *Ariz. Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959), the Commission may not consider the argument raised by Staff regarding investor-supplied funds. The *Arizona Water* case is clearly distinguishable from the instant case, however, given the fact that the Court in *Arizona Water* was asked to consider only whether a recent purchase price paid for the utility company **[*100]** could be used by the Commission as the fair value of the utility for setting rates. No such set of facts is presented in this proceeding, and we do not believe the *Arizona Water* holding is applicable to the arguments presented by Staff.

For all of these reasons, we reject the Company's proposal on this issue.

AUTHORIZED INCREASE

Based on our findings herein, we determine that UNS Gas is entitled to a gross revenue increase of $ 5,257,468.

Fair Value Rate Base	$ 184,120,761
Adjusted Operating Income	9,621,507
Required Rate of Return	6.97%
Required Operating Income	12,833,217
Operating Income Deficiency	3,211,710
Gross Revenue Conversion Factor	1.6370
Gross Revenue Increase	$ 5,257,468

RATE DESIGN ISSUES

Customer Charge and Seasonal Rates

UNS Gas

UNS proposes in this case to increase the monthly customer charge for its largest customer class (Residential -- R10) from $ 7 to $ 20 per month during the "summer" months (April through November) and from the current $ 7 to $ 11 per month during the "winter" months (December through March). The

Company also proposes to decrease the current commodity rate for the R10 class from the current rate of **[*101]** $ 0.3004 per therm to $ 0.1862 per therm. n14

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n14 Although the $ 0.1862 rate appears in UNS's original schedules (Ex. A-9, Sched. H-4), and in the Company's post-hearing brief, the Company's Final Schedules reflect a per therm rate proposal of $ 0.1844.

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UNS claims that its proposed rate design is intended to mitigate the cross-subsidization that currently exists between customers in colder climates and customers in warmer climates. According to the Company, it incurs approximately $ 26 per month in fixed costs to serve a customer, yet the residential customer charge is only $ 7 per month, with the remaining fixed costs being recovered through volumetric charges. UNS witness Tobin Voge stated that, as an example, a customer in Flagstaff pays substantially more towards the Company's fixed costs (through a higher percentage of volumetric charges) compared to a customer in Lake Havasu (Ex. A-18 at 8, Attach. TVL-1).

UNS argues that its proposed rate design would allow the Company to recover more of its fixed costs from **[*102]** all customers and would result in a more equitable policy in an environment of higher gas commodity costs. In support of the Company's position, UNS witness Grant cited a 2006 report from Moody's, which indicated that the volumetric approach to cost recovery is a faulty equation for LDCs that should be rectified through ratemaking (Ex. A-29 at 23). UNS also cites an AGA report, which suggests that, under a traditional volumetric rate design, a gas company's profits and earnings will decline if customers use less gas (Ex. A-37 at 2). The Company contends that it is time to address these alleged inequities through approval of higher monthly service charges and decoupling mechanisms (see discussion below regarding the Company's proposed "Throughput Adjustment Mechanism").

Under the Company's proposal, the monthly customer charge would be increased from $ 7 to an average of $ 17 per month (subject to the seasonal differences described above), which UNS claims would enable it to recover approximately 60 percent of its costs incurred in serving a residential customer (Tr. at 512). Because Staff and RUCO oppose the Company's seasonal customer charge proposal, UNS indicated that it is willing **[*103]** to accept a year-round customer charge of $ 17 (UNS Initial Brief at 46).

UNS asserts that the rate design proposals advocated by Staff and RUCO should be rejected. According to the Company, Staffs recommendation to increase the fixed monthly customer charge to $ 8.50, and RUCO's proposal to increase the customer charge to no more than $ 8.13, are an inadequate means of moving rates closer to the Company's cost of service. UNS asserts that its proposal to increase the customer charge by $ 10 over current levels is not drastic, will not result in "rate shock," and does not violate the principle of "gradualism," given the corresponding request to decrease the commodity charge.

UNS witness D. Bentley Erdwurm addressed the inequities between cold weather and warm weather customers and concluded that substantial cross-subsidization by customers in colder climates exists. He testified that the average customer in Flagstaff currently pays $ 133 more in annual margin costs than an average customer in Lake Havasu City for the same fixed costs (Ex. A-19 at 10). UNS argues that this inequity is especially unfair because customers in colder areas have little ability to reduce their overall bills **[*104]** due to the need to use natural gas for heating purposes.

With respect to the avoidance of rate shock and compliance with the principle of gradualism, UNS contends that the Staff and RUCO rate design recommendations focus too narrowly on the customer charge and fail to consider the Company's overall rate design proposal. The Company claims that the increase in the customer charge would be offset by the reduction of the commodity charge. UNS also asserts that the concepts of rate shock and gradualism must be balanced against other rate design elements, including rate stability and matching principles.

Finally, UNS argues that its rate design proposal does not eliminate the incentive for customers to conserve (by the proposal to reduce the commodity charge). According to the Company, even if its proposed per therm charge of approximately 18 cents were adopted, when that rate is combined with an estimated PGA charge of 60 cents per therm, the overall volumetric charge would be decreased by approximately 13 percent, which UNS claims is not enough to stifle conservation incentives.

Mr. Magruder

Intervenor Marshall Magruder opposes the Company's request to impose seasonal rates and to **[*105]** collect a higher percentage of rates from customers in warmer climates. Mr. Magruder claims that the Company's proposal would discriminate against customers in warmer areas and he suggests that customers choose whether to live in colder or warmer climates. He also asserts that UNS's proposed rate structure would send the wrong signal by rewarding high usage customers and penalizing low usage customers. He recommends instead that Staff's proposal to increase the customer charge to $ 8.50 be adopted.

RUCO

RUCO opposes the Company's recommendation to increase the monthly customer charge significantly. RUCO points out that UNS's proposal would shift more revenue to its fixed costs than it is seeking for its entire rate increase. As UNS witness Erdwurm admitted on cross-examination, the Company's entire requested revenue increase is approximately $ 10 million, yet it is seeking to recover an additional $ 16.4 million per year through the fixed monthly charge alone. In order to remedy this imbalance, UNS proposes to reduce the commodity charge by approximately $ 6.4 million (Tr. at 475-76). As a result, higher usage customers would experience a reduction in their bills, while lower **[*106]** usage customers would see a much higher percentage increase.

RUCO contends that some shifting of costs to the customer charge is appropriate and recommends that the current recovery of approximately 26 percent through the monthly fixed charge should be increased to 36 percent (under RUCO's revenue requirement recommendation) (RUCO Ex. 5 at 34). RUCO also disagrees with the Company's seasonal customer charge proposal. RUCO asserts that the justification offered by UNS in support of this proposal (to levelize customer bills) is not appropriate because the Company's customers already have a voluntary means to levelize their bills through an existing billing program. Ms. Diaz Cortez stated that if the Company believes more customers would benefit from levelized billing, it should make a greater effort to publicize the existing program's availability rather than seeking to impose a Commission-mandated seasonal rate design (*Id.* at 30).

Staff

Staff contends that the Company's rate design proposal in this case is designed to shift almost all of the risk of rate recovery to ratepayers and should therefore be rejected. Staff witness Steven Ruback presented Staffs rate design recommendation **[*107]** and stated that the UNS rate design would result in a "staggering" increase in the fixed customer charge for all classes of service (Ex. S-23 at 3). For the residential class, Mr. Ruback indicated, the Company's proposal would result in a customer charge increase of 185 percent in the summer period and 57 percent in the winter period (*Id.*). Mr. Ruback explained that, although the monthly charge increase would be partially offset by a lower volumetric charge, UNS's proposal presents a "serious front end loading problem, a decoupling issue and gradualism problem" (*Id.* at 4). He testified that it is not surprising that UNS would seek to increase the fixed customer charges and that such an approach is a common means that utilities use to lessen the risk of recovery (*Id.* at 6). Mr. Ruback stated UNS's proposal is unusual in that the Company has proposed to recover all of its increase, and some of the volumetric margin, through fixed charges (*Id.*).

According to Mr. Ruback, the Company's proposal represents a step towards a Straight Fixed Variable ("SFV") rate design, a concept employed by the FERC as a means of rationing pipeline design day capacity by price. Mr. Ruback **[*108]** stated that SFV rate design is inappropriate for retail distribution rate design because there is no need to ration retail distribution capacity. He further testified that UNS's rate design proposal "violates the well-established and long-standing regulatory principle that a utility should have a reasonable opportunity, not a guarantee to earn its allowed rate of return" (*Id.* at 9). Mr. Ruback indicated that he is aware of only one LDC, Atlanta Gas Light Company, that is permitted to employ the SFV rate design method to recover its distribution revenue requirement, and that exception to the general rule is mandated by state legislation that precludes the Georgia Public Service Commission from establishing an alternative rate design. Mr. Ruback stated that "other jurisdictions allow for reasonable fixed customer charges and reasonable fixed demand charges, but require that the bulk of the distribution revenue requirement be recovered over throughput" (*i.e.,* volumetric charges) (*Id.* at 10).

According to Staff witness Ralph Smith, Staff's rate design recommendation is based on the consideration of a number of factors, including cost of service; the desire to encourage energy **[*109]** conservation; the need to use gradualism in cases where rates are being charged, so that customers are not burdened with large rate increases; customer equity issues within and between rate classes; efforts to make rates and bills easier for customers to understand; revenue impacts on the Company; and other policy considerations. He stated that given all of these variables, it is understandable that rate design is considered more of an art than a science (Ex. S-26 at 2).

Under Staff's proposed rate design, the fixed monthly customer charge would be increased from $ 7 to $ 8.50 for residential customers, with no seasonal difference in the customer charge. Staffs proposed commodity charge for Rate R10 customers would increase to $ 0.3217 per therm, under Staffs revenue requirement recommendation (*Id.* at 9). Mr. Smith explained that if Staff's recommended revenue requirement and rate design were adopted, a residential customer (R10) using 100 therms of gas would experience a total bill increase from $ 115.48 to $ 119.11 (3.14 percent) (*Id.*). Staff asserts that its proposed rate design is reasonable and should be adopted by the Commission.

Conclusion

Although we understand **[*110]** that UNS would like to recover as much of its margin as possible through monthly customer charges, we do not believe it is reasonable to adopt a rate design that would impose a significant increase on customers based on where they live within the Company's service area. Under the Company's recommendation, residential customers with lower usage (*i.e.,* customers typically located in warmer climates) would bear the brunt of the revenue increase due primarily to the dramatic front-loading increase to the fixed monthly customer charge. As set forth in the UNS Final Schedules (based on UNS's proposed revenue requirement), in the "summer" months (April through November), a residential customer (R10) would experience an increase of 146 percent with 5 therms of usage, 118 percent with 10 therms of usage, and 82 percent with 20 therms of usage. During the "winter" months (December through March), the same customer would incur increases of 40 percent with 5 therms of usage, 28 percent with 10 therms of usage, and 13 percent with 20 therms of usage (UNS Final Schedules, Sched. H-4). While higher usage customers may realize lower increases, or even decreases (depending on usage), we do not **[*111]** believe that a dramatic increase imposed on lower usage customers is appropriate in this case. As we stated in the Southwest Gas Decision in rejecting a similar type of rate design proposal, "[such a] rate design would have the effect of encouraging greater usage of natural gas at a time when, by all accounts, an increase in demand for natural gas is coupled with shortages in supply. We do not believe that it is appropriate to send a signal to customers of 'the more you use, the more you save,'" (Decision No. 68487, at 37).

As discussed by Staff's witnesses, movement towards cost-based rates is just one of the many factors that must be considered in designing rates. The goal of moving closer to cost-based rates must be balanced with competing principles such as gradualism, fairness, and encouragement of conservation.

Based on the testimony and evidence presented in the record, and considering the arguments raised regarding competing principles of the rate design equation, we believe that Staff's rate design recommendation appropriately makes significant movement towards cost-based rates and provides a reasonable level of protection for the customers who are affected by this base rate **[*112]** increase. Accordingly, we adopt Staff's recommended monthly charges, as set forth in the attachments to Exhibit S-27, with the accompanying commodity charges based on Staff's rate design flowing from the revenue requirement established in this Order.

For a residential customer on Rate R10, the fixed monthly customer charge would increase from $ 7 to $ 8.50, and the volumetric charge would increase from $ 0.3004 to $ 0.3270 per therm. Based on these rates, a residential customer with 20 therms of usage would experience an increase in monthly base rates of 15.6 percent (from $ 13.01 to $ 15.04) and an overall monthly increase (including the cost of gas) from $ 28.70 to $ 30.73 (7.1 percent). The same customer with typical January consumption (87 therms) would see an increase in base rates of 11.5 percent (from $ 33.13 to $ 36.94) and an overall increase (including the cost of gas) from $ 101.37 to $ 105.18 (3.8 percent).

Throughput Adjustment Mechanism

UNS Gas

In its application, UNS proposed a Throughput Adjustment Mechanism ("TAM") which would increase or decrease the collection of volumetric revenues to match anticipated levels. The Company claims that the TAM would allow **[*113]** it to implement energy conservation programs without the concern that its revenues would be diminished if the conservation measures were successful. UNS indicated that under its proposed TAM, under-recovery or over-recovery of revenues during any given period would be trued-up in future periods through the use of a volumetric surcharge or credit.

As explained by Company witness Erdwurm, the TAM is a type of decoupling mechanism that has growing support from regulatory and environmental organizations. In his testimony, Mr. Erdwurm stated that organizations such as the Natural Resources Defense Council ("NRDC"), the American Council for an Energy Efficient Economy ("ACE"), and the AGA have expressed support for rate mechanisms that decouple utility retail sales from recovery of fixed costs (Ex. A-19 at 17-18). He claims that a NARUC Resolution encourages state commissions to adopt rate designs that include decoupling mechanisms such as the TAM (*Id.* at 18). The Company also introduced a newsletter issued by the AGA indicating that decoupling mechanisms have been implemented in 10 states (Ex. A-37).

According to UNS, the Company's return is highly dependent on customer usage because **[*114]** of the volumetric nature of its rates. UNS witness Tobin Voge's testimony stated that a warmer than normal winter will cause customer usage, and thus Company revenues, to decline, thereby rendering UNS unable to collect its full fixed costs (Ex. A-18 at 15). On the other hand, during a colder than normal winter, UNS would experience a surge in revenues. The Company contends that the TAM would make customer bills less volatile by evening out wide fluctuations due to weather.

Mr. Voge's testimony indicates that in order to implement the proposed TAM, a base use per customer ("UPC") must first be established. Under the Company's proposal, a separate base would be established for residential, small volume commercial, and small volume public authority customers. The UPCs would be calculated by dividing calendar year therm sales by average number of customers. The difference between the actual and base UPC would then be multiplied by the 2005 base number of customers, and the margin rate for the customer class, to determine the throughput adjustment in dollars (*Id.* at 12-13).

The Company asserts that, by minimizing the impact of weather on customer bills, the TAM would provide a more **[*115]** equitable rate design that ensures that customers do not pay more for the Company's fixed costs than they would under normal weather conditions (Ex. A-19 at 15). UNS also claims that the TAM would encourage conservation by reducing the conflict between conservation efforts and the Company's financial stake in the volumetric revenues associated with usage (Ex. A-18 at 15).

UNS dismisses the validity of RUCO's arguments that the TAM would eliminate the incentive for customers to conserve. The Company argues that, under its proposal, all customers would receive bills with identical TAM adjustments based on cumulative system usage, not personal household consumption. As a result, UNS claims, each individual customer would continue to benefit from conservation efforts because the individual customer's actions would represent only a small portion of the usage data reflected in future TAM adjustments.

UNS also disputes arguments made by Staff and RUCO that the TAM would remove the Company's risk of revenue recovery. The Company claims that the TAM would not alter the ability or inability to recover base rates established in the rate case, and that rising capital expenditure requirements **[*116]** associated with customer growth would continue. UNS also argues that its proposed TAM differs from the "conservation margin tracker" decoupling mechanism that was rejected in the Southwest Gas case (Decision No. 68487 at 33-34). According to UNS, the TAM differs from the decoupling mechanism proposed by Southwest Gas in the following ways: the TAM would cover all small volume customers, not just residential customers; UNS has provided examples of the calculations needed to implement the TAM; and UNS is willing to consider the creation of a deferred adjustment account (Ex. A-18 at 14). Finally, UNS claims that it has pledged to continue supporting demand-side management ("DSM") programs, regardless of adoption of the TAM. The Company argues, therefore, that it cannot be accused of attempting to use its TAM proposal as leverage for its continued support for DSM.

RUCO

RUCO witness Marylee Diaz Cortez testified regarding the reasons for RUCO's opposition to the proposed TAM. She stated that the TAM would cause customers to pay for a fixed amount of consumption regardless of their actual usage and would remove any risk to the Company associated with revenue recovery (RUCO Ex. 5 at **[*117]** 30-31). Ms. Diaz Cortez testified that variations in consumption are already addressed by the rate case process based on weather normalization of revenues (Tr. at 706).

RUCO argues that it is not appropriate for the Commission to provide a guarantee of a certain stream of revenues because the regulatory process is intended to provide only the opportunity for a company to recover its revenue requirement. Ms. Diaz Cortez stated that UNS already has an exclusive service territory and a captive customer base, giving it a low business risk. She also indicated that the authorized rate of return set by the Commission compensates the Company for any business risk that may exist (RUCO Ex. 5 at 31).

RUCO next argues that approval of the TAM would present a departure from the historic test year concept, which RUCO claims is required under the Commission's rules and the Arizona Constitution. Finally, RUCO contends that Southwest Gas experiences greater decreases in consumption due to conservation than does UNS Gas, yet the Commission previously rejected Southwest Gas' decoupling mechanism proposal. RUCO points out that the Commission expressed concern that the decoupling mechanism proposed by **[*118]** Southwest Gas could have resulted in disincentives for customers to conserve (Decision No. 68287 at 34), and the same concern exists with respect to UNS Gas's proposed TAM.

Mr. Magruder

Mr. Magruder opposes adoption of the Company's proposed TAM for many of the same reasons identified by Staff and RUCO. He argues that UNS should not be insulated from risk and that customers should not have to pay for gas they have not used.

Staff

Staff witness Steven Ruback expressed several concerns with the Company's proposed TAM. Mr. Ruback stated that the TAM is essentially an automatic adjustment clause and that such adjustors traditionally are intended to recover volatile costs that, if left unrecovered, could jeopardize a company's financial health. He indicated three requirements for the types of costs generally allowed to be recovered through adjustor mechanisms: the costs must be large enough to jeopardize the utility's financial health, they must be volatile, and they must be substantially beyond a company's control. He claims that the TAM does not meet these tests because traditional ratemaking has not left UNS in poor financial condition, non-gas costs are not extremely volatile, **[*119]** and non-gas costs are within management's control (Ex. S-23 at 16).

Mr. Ruback also asserts that UNS already has in place two types of revenue decoupling mechanisms - the fixed customer charge, which is independent of throughput, and the PGA, which protects the Company from volatile spikes in the cost of gas (*Id.* at 16-17). At the hearing, Mr. Ruback testified that, in his opinion, "the TAM is overly broad because it compensates for reduced sales from anything -- from weather variation, from economic activity, to loss of costs, to high commodity charges." (Tr. at 796). He conceded that it is not just UNS Gas's proposal he dislikes, stating, "I haven't seen a TAM I liked yet." (*Id.*) However, Mr. Ruback contends that adoption of the TAM would represent "piecemeal ratemaking" because there is no commensurate opportunity in the mechanism to consider offsetting adjustments related to cost of service reductions, cost of capital changes, and changes in customer allocation factors (Ex. A-23 at 14).

Finally, Staff points to the Southwest Gas rate case, in which the Commission rejected a similar proposal. Staff acknowledged that the Commission directed Southwest Gas and interested stakeholders **[*120]** to examine further decoupling mechanisms, and Staff indicated that it is willing to engage in discussions outside of this case regarding such mechanisms. However, Staff argues that UNS's proposal should be rejected based on the record in this case.

Conclusion

We do not believe the record supports adoption of UNS Gas's proposed decoupling mechanism in this case. In the Southwest Gas case, we cited a number of concerns with a decoupling mechanism that was similar to the TAM proposed by UNS Gas in this proceeding. We pointed out in the Southwest Gas Order that decoupling mechanisms require "customers [to] provide a guaranteed method of recovering authorized revenues, thereby virtually eliminating the Company's attendant risk." (Decision No. 68487 at 34) We also noted that, under such a mechanism, customers would "be required to pay for gas that they have not used in prior years, a phenomenon that could result in disincentives for such customers to undertake conservation efforts... [and would be] faced with a surcharge for not using 'enough' gas the prior year." (*Id.*) We therefore directed Southwest Gas to find rate design alternatives that truly encourage conservation and to **[*121]** engage in discussions with affected stakeholders to pursue implementation of a decoupling mechanism through the DSM policy process or through a proposal in Southwest Gas's next rate case (*Id.*).

Although the Company attempts to distinguish its TAM from the mechanism rejected in the Southwest Gas case, the differences are insignificant compared to the overall similarities between the proposals. The first difference cited by the Company, that it is willing to apply the TAM to all small volume customers, is not persuasive given Southwest Gas's concession that it was also willing to extend its decoupling mechanism to a broader base of customers (*Id.* at 31). The next difference claimed by UNS is essentially that its proposal provided a greater level of detail, by including examples of calculations that would be used to implement the TAM, than did that of Southwest Gas. As indicated in the passages quoted above, our primary concern with the Southwest Gas proposal was not specifically with the lack of implementation details, but rather with a concept that would provide the utility with a level of risk insulation, while possibly discouraging conservation efforts through imposition of **[*122]** a surcharge on an entire class of customers if that class did not use "enough" gas the preceding year. The final difference claimed by UNS is its offer "to consider the creation of a deferred throughput adjustment account." (Ex. A-18, at 14) Again, the distinction identified by UNS is not substantive in nature but instead provides an alternative means of accounting for the proposed surcharge. The Company's alternative accounting technique does not, however, address the underlying concerns clearly expressed regarding the Southwest Gas decoupling mechanism. We see no reason, based on the record in this proceeding, to depart from our finding in the Southwest Gas Decision regarding a proposed decoupling mechanism.

Having rejected UNS Gas's TAM proposal, we encourage the Company to engage in discussions with other stakeholders affected by this issue; to participate in the ongoing DSM workshops before the Commission; and, if possible, to develop a decoupling mechanism that does not suffer from the types of deficiencies identified by the parties in this case.

Demand-Side Management Programs

UNS Gas

UNS Gas proposes to implement several new DSM programs, including a residential **[*123]** furnace retrofit program, residential new construction home program, commercial HVAC retrofit program, and commercial gas-cooking efficiency program. The Company claims that these four new programs will require funding of $ 916,616 and that a proposed expansion of its low-income weatherization ("LIW") program will cost an additional $ 135,000, for a total annual DSM portfolio expense of $ 1,051,616 (Ex. A-15 at 13-15).

UNS states that it is largely in agreement with Staff's DSM recommendations, specifically with respect to submission of the programs for review by Staff. UNS witness Denise Smith testified that the Company prefers to have the new programs approved in this case so that they may be implemented as soon as possible (Tr. at 518). On May 4, 2007, the Company filed its DSM program proposals in a separate docket for Staff's review (Docket No. G-04204A-07-0274).

Ms. Smith indicated that the Company has agreed to use Staff's recommended Societal Cost Test to determine the effectiveness of the DSM programs, despite her reservations regarding how that test would be applied (Ex. A-21 at 4, 7; Ex. A-22 at 2). However, Ms. Smith stated that the other DSM tests - including the Participant **[*124]** Test, Program Administrator Cost Test, Total Resource Cost Test, and Rate Impact Measure Test - should also be utilized, to provide a full analysis of program effectiveness (Ex. A-21 at 7). Ms. Smith also agreed that the Company would continue to provide semi-annual reports to the Commission, but stated that the Company would seek at a later time to move to an annual reporting requirement (Ex. A-22 at 14).

With respect to calculation of the DSM adjustor mechanism, Ms. Smith indicated that UNS agrees initially to limit recovery to 25 percent of the new program costs ($ 230,000) and LIW program costs ($ 113,400), plus the cost of the baseline study that is needed to evaluate thoroughly the effectiveness of the programs ($ 82,000). The total amount of $ 425,400 would translate to a DSM adjustor surcharge of $ 0.0031 per therm, when divided by total test year therms of 138,223,864 (*Id.* at 3).

Mr. Magruder

Mr. Magruder indicates that he is a proponent of DSM programs but believes that additional review of the Company's programs is necessary prior to approval. However, he suggested that all the necessary information regarding the programs should be submitted to Staff as soon as **[*125]** possible so that the programs could be addressed in the Recommended Opinion and Order in this case, to allow the parties an opportunity to comment regarding the findings determined therein. He also suggested that an integration of the UNS Gas and UNS Electric DSM programs could be consolidated in the pending electric rate case for UNS. At the same time, however, Mr. Magruder recommended that UNS Gas's DSM programs should not be funded until after public hearings are held on those programs. He proposed that the Energy Smart Home ("ESH") program should include training of local city/county building inspectors to meet Energy Star requirements, using RESNET personnel. Finally, Mr. Magruder recommended that in-home energy audits should be continued due to their value (Magruder Brief at 38-41).

Staff

Staff witness Julie McNeely-Kirwan presented Staff's position regarding the Company's proposed DSM programs. She recommended that the LIW funding ($ 113,400) and 25 percent of the new program costs ($ 229,154) should be included in the initial DSM surcharge, but that UNS Gas's portion of the baseline study costs ($ 82,000) should not be included in the surcharge initially (Ex. S-40 at 1-2, **[*126]** 8). Based on this recommendation, Staff calculated an initial DSM surcharge of $ 0.0025 which it recommends be established in this case (*Id.*).

Ms. McNeely-Kirwan also agreed with UNS that the DSM adjustor reset date should require a filing by April 1 of each year, with an adjustment date of June 1. As indicated above, UNS agreed with Staffs recommendation to require semi-annual DSM reports. In her direct testimony, Ms. McNeely-Kirwan recommended that the Company file a comprehensive DSM portfolio, which UNS has apparently provided through an attachment to Denise Smith's testimony (Ex. A-23), as well as in the separate docket cited above. However, Staff opposes approval of specific programs in this proceeding and recommends approval in a separate docket, consistent with past practice for other companies (Tr. at 1141).

Conclusion

We agree with Staff's recommendation to set the DSM adjustor surcharge at an initial level of $ 0.0025, which reflects exclusion of the baseline cost study. As indicated in Staffs recommendation, the costs of the baseline study may be included in a subsequent reset of the adjustor once sufficient justification of the allocated costs has been submitted **[*127]** for Staffs review. UNS agreed with Staffs proposal to shift the adjustor filing date to April 1, with an adjustor date of June 1, as well as with Staffs recommendation that semi-annual reports be required for the DSM programs. We also agree with Staff that the appropriate forum for a full review of the specific DSM programs is in the separate docket in which there is an application currently pending. This approach is consistent with that required for other companies, including APS and Southwest Gas (*See, e.g.,* Decision No. 68487, at 61-63).

Low-Income Customer Programs

UNS Gas currently offers several low-income assistance programs. The Customer Assistance Residential Energy Support ("CARES") program (Rate Schedule R12) provides a per therm discount to customers meeting eligibility requirements during the months of November through April. Warm Spirits is an emergency bill assistance program offered to eligible low-income customers. As discussed above, UNS also offers the LIW program, the costs of which would now be recovered through the DSM adjustor mechanism.

UNS Gas states that, in addition to offering these specific programs, it will continue to work with the ACAA on **[*128]** low-income customer issues. The Company contends that it is committed to automatically enrolling customers eligible for the Low-Income Home Energy Assistance Program ("LIHEAP") into the CARES program (Ex. A-16 at 8) and will continue to expand its outreach efforts. Those outreach efforts include distribution of CARES applications to local assistance agencies, public libraries, and municipal buildings and promotion of the program through residential bill inserts (Ex. A-17 at 4). UNS also contends that it is willing to explore opportunities to increase the marketing of low-income programs and to increase LIW funds to low-income agencies.

Miquelle Scheier testified on behalf of ACAA regarding various low-income customer issues, including CARES customers (ACAA Ex. 1). Ms. Scheier opposed the Company's proposal to increase the customer charge for low-income customers; urged the Commission to increase marketing efforts for the R12 tariff; requested the Commission to require automatic enrollment of LIHEAP customers into the CARES program; sought the elimination of payday loan offices as payment centers for cash-paying customers; requested that bill assistance money be increased from $ 21,500 **[*129]** to $ 50,000; asked that LIW funding be increased to $ 200,000, and that $ 20,000 of that amount be directed to community volunteer weatherization efforts; and requested that the proposal to reduce the due date for bills be denied (*Id.* at 2).

CARES Program

Customers receiving service under the CARES program currently pay the same basic monthly charge of $ 7 as do other residential customers, but CARES customers receive a per therm discount of $ 0.15 on the first 100 therms of usage during the months of November through April. As described above in the rate design section of the Order, UNS proposed a seasonal monthly charge increase to $ 20 from December through March and to $ 11 from April through November. The Company also proposed to decrease the volumetric charge applicable to all customers. For CARES customers, UNS proposed a year-round customer charge discount of $ 6.50 per month, along with the reduction of the commodity charge discussed previously. Under the Company's recommendation, CARES customers' fixed monthly charge would increase from $ 7 to $ 13.50 from April through November, but would decrease to $ 4.50 per month from December through March. The same volumetric **[*130]** charges would apply to all residential customers.

The Company claims that its proposal would increase CARES customers' bills modestly, with an increase of $ 1.12 per month during winter months (assuming 100 therms of usage), and $ 4.21 per month during summer months (assuming 20 therms of usage) (Ex. A-9, Sched. H-4). UNS contends that some higher usage CARES customers may actually see a rate decrease due to the Company's proposed commodity charge reduction.

Staff recommends that the current monthly charge of $ 7 be retained for CARES customers and that they continue to receive the current $ 0.15 per therm discount for the first 100 therms of usage during the months of November through April (Ex. S-40 at 2). Staff contends that its recommendation provides a price signal that would encourage conservation by CARES customers during winter months, because usage over 100 therms during those months would incur a substantial increase. Staff witness McNeely-Kirwan stated that the Company's rate design proposal would provide a disincentive for conservation, given UNS's recommendation to decrease the volumetric charge for all therms of usage (*Id.* at 3).

Given our prior rejection of UNS's **[*131]** seasonal customer charge and across-the-board volumetric rate reduction recommendation, the application of the Company's proposal to CARES customers is effectively a moot point. We agree with Staff that keeping the current customer charge in effect for CARES customers, and retaining the current winter volumetric discount for the first 100 therms, will help mitigate the effects of the rate increase approved in this case and will continue to provide a rate structure for the low-income customers enrolled in the program that offers an opportunity to reduce their overall bills through conservation efforts. We therefore adopt Staff's recommendation on this issue.

Warm Spirits Program

Warm Spirits is a program, funded by customer contributions, that provides emergency bill payment assistance to low-income customers. UNS witness Gary Smith testified that UniSource Energy promotes the program through bill inserts and bill messages encouraging customers to contribute to the program (Ex. A-15 at 10-11). The proceeds of the contributions are distributed to local service agencies, which assist qualified low-income customers in paying their bills, most often during the winter heating season. **[*132]** Mr. Smith stated that UNS Gas matches customer donations dollar-for-dollar with funds provided by UniSource shareholders. He indicated that UniSource made a one-time donation of $ 50,000 to the program in 2004 and that UNS matched $ 24,000 in donations in 2005. Mr. Smith testified that the Company would continue to match customer contributions on a dollar-for-dollar basis (*Id.*). As indicated above, ACAA proposes that the Commission require UNS to provide funding for Warm Spirits in the amount of $ 50,000 per year (ACAA Ex. 1 at 2).

The Company originally proposed that the Low-Income Weatherization Program include $ 21,600 in emergency bill assistance, separately and in addition to that already available through Warm Spirits. The $ 21,600 would have been part of the UNS Gas DSM portfolio and funded through the DSM adjustor. Staff objected because emergency bill assistance is not DSM and should not be funded as DSM. Staff proposed, and the Company agreed, that the $ 21,600 be moved into Warm Spirits and funded though base rates. We agree that the $ 21,600 in additional emergency bill assistance should not be funded through the DSM adjustor and that this amount should be moved into **[*133]** Warm Spirits and funded through base rates.

We believe that the Company's matching contributions to the Warm Spirits program, which currently amount to approximately $ 20,000 to $ 25,000 per year, are a reasonable commitment at this time. However, we encourage the Company to continue to promote the existence of the program and the ability for customers to make voluntary contributions.

It is not clear in the record whether UNS Gas currently has a section on customer bill payment stubs that allows customers to check a box to indicate that they would like to make a contribution at the time they write out their payment checks. This issue was raised in the Southwest Gas case, wherein we directed Southwest Gas to modify its billing statements to allow voluntary contributions (Decision No, 68487, at 59-60). In that Order, we pointed out that a contribution line is offered to APS customers and that "inclusion of a line on customer bills is preferable to [relying solely] on a bill insert, which may be discarded when customers open their bills." (*Id.* at 60) Therefore, if UNS Gas does not currently have in place a bill statement contribution option, it shall implement the change within 60 **[*134]** days of the effective date of this Decision.

Payments at Payday Loan Stores

In 2006, UNS closed local offices in Prescott, Cottonwood, Flagstaff, and Show Low n15 (Tr. at 434-35). These closings coincided with the Company's consolidation of its Tucson call center operations for all of the UniSource operating affiliates, which UNS claims was intended to improve customer service while at the same time cutting the Company's operating costs (Tr. at 436-40). At the time these offices were being closed, customers were notified that future payments could be made at various ACE Cash Express locations and other specified "cash only" stores (Ex. A-16, Attach. GAS-3). For payments made at these so-called "payday loan" stores in areas where UNS does not have a local office, UNS pays the fee charged by the payday loan stores, but customers who pay at such stores in an area that has a local office (*i.e.,* Kingman, Lake Havasu, and Nogales) must pay a $ 1 fee in order to make a payment at the payday loan stores (*Id.* at 8).

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n15 UNS continues to operate local offices in Kingman, Lake Havasu, and Nogales.

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - - - **[*135]**

ACAA witness Scheier expressed concern that cash paying customers, especially low-income customers, could be vulnerable to predatory lending practices at the payday loan stores. She testified that ACAA objects to the use of such stores because "it places already vulnerable customers in a more vulnerable situation." (ACAA Ex. 1 at 13) Ms. Scheier also stated that she did not understand why the Company could not place "ATM-like kiosks" that accept cash payments in local areas (*Id.*). She further claimed that some low-income clients had been encouraged to take out loans when they made payments at the payday loan stores (ACAA Ex. 2, at 2).

Mr. Magruder also opposes use of payday loan stores for taking payments. He suggested that other payment agents should be found by the Company or, alternatively, that a Company employee may need to be on-location at the payday loan stores during weekdays (Magruder Brief at 37).

UNS witness James Pignatelli testified that UNS does not send customers to predatory lenders by its acceptance of payments at payday loan stores. He indicated that customers could obtain loans from payday loan stores even if the Company had not closed its local offices or **[*136]** had in place ATM-like kiosks (Ex. A-3 at 1). Mr. Pignatelli stated that the decision to close some branch offices and offer alternative locations for cash-paying customers was made to keep down costs for all customers, including low-income customers (*Id.*).

UNS witness Gary Smith claims that Ms. Scheier's comments regarding customers' being encouraged to take out loans from the payday loan stores is not consistent with information the Company has received from payday loan store managers (Ex. A-17 at 5). He contends that UNS is not encouraging customers to utilize payday loan services at these locations (Ex. A-16 at 9). During the hearing, Mr. Smith testified that APS also utilizes payday loan stores for acceptance of cash payments, as does Citizens Frontier Communications (Tr. at 343). He indicated that UNS contacted grocery stores and local banks in the Prescott and Chino Valley areas about their willingness to accept payments, but was turned down. Mr. Smith stated that UNS was looking into a joint arrangement with APS under which a payday loan store in Flagstaff would have a dedicated window available for payment of utility bills, separate from the store's main counter. He also **[*137]** testified that the Company was discussing with APS the possibility of using a non-payday loan store site for acceptance of payments (Tr. at 344-47).

Although we encourage UNS to seek out cost-cutting opportunities, we are concerned when those efforts result in the diminution of service to customers. We understand the Company's call center consolidation decision was intended to provide consistency between the UniSource affiliates and to reduce costs in the long-term. On cross-examination, the Company's witness sought to justify the office closings on the basis that not enough people used the local offices to justify their continuation, and that more customers use the payday loan stores due to their convenience (Tr. at 342-43). However, the closing of a number of local offices, especially in northern Arizona, represents not just the elimination of a nearby location for making payments, but also the loss of an office where customers could talk to a representative of the Company face-to-face to work out payment arrangements or receive assistance in signing up for available programs.

We believe that additional efforts should be undertaken by UNS to explore fully all available alternatives **[*138]** for the provision of service to customers. We therefore direct the Company to make every reasonable effort to determine whether other payment locations may be utilized either in addition to, or in lieu of, the payday loan stores currently used by UNS. These efforts should include, but not be limited to, joining with other utilities to enlist alternative agents, such as banks or grocery stores, to accept cash payments and to explore of opening joint local offices to offset costs and any other alternatives that may enhance customer service without exposing customers to the potential of being solicited by predatory lenders in the course of making a utility payment. UNS shall file a copy of its recommendations consistent with this directive within 90 days of the effective date of this Decision.

Proposed Changes to Rules and Regulations

UNS proposed a number of changes to its existing Rules and Regulations governing service. Among those proposed changes are increases to charges for service lines and main extensions and a proposal to reduce the period, from 15 days to 10 days, that customers have to pay their bills before the bills are considered past due.

Line and Main Extension **[*139]** Policies

UNS proposes amendments to its Rules and Regulations (*i.e.,* tariffs) that it claims would ensure that developers and new customers pay a fair cost for infrastructure associated with connecting new developments to the UNS Gas system (Ex. A-15 at 19-20). As described by UNS witness Gary Smith, the Company proposes changes to both its service line and main extension policies (*Id.* at Sched. GAS-2). The Company's proposals, as set forth in its brief, are as follows:

> 1. For a new gas service line, the customer would be required to reimburse the Company at a rate of $ 16 per foot on the customer's property (the current rate is $ 8 per foot). For customers who provide the trench for the service line, the rate would be $ 12 per foot (*Id.* at 19).
> 2. Under the Company's proposal, there would be no free footage, so developers would pay the entire amount up front (subject to refund) (Tr. at 386-87).
> 3. In its effort to comply with A.A.C. R14-2-307, UNS prepared an incremental contribution study ("ICS") to determine an estimate of the costs and benefits of adding a customer to the system. Under the Company's proposal, the ICS **[*140]** component would be modified to reduce the credit applied to new customers or developers per service line or main extension (thereby increasing the required advances from new customers and developers). According to the Company, this change would ensure that the cost burden is initially placed on new customers and developers for main extensions or line extensions, subject to refund over a five-year period (Tr. at 384-87, 919; Ex. A-35).
> 4. For line extensions over $ 500,000, UNS would add a gross-up amount equal to the Company's estimated federal, state,

and local income tax liability in advance (Ex. A-15, Sched. GAS-2).

UNS estimated that the changes described above would result in an additional $ 3.6 to $ 3.8 million per year in contributions, on average (Ex. A-30; Tr. at 915). The changes would result in an increased contribution from new customers/developers, from the current amount of approximately $ 300 to more than $ 500 per connection (*Id.*). In response to questions from Commissioner Mayes, UNS later offered the following two additional alternative proposals: n16

1. Eliminating of the ICS and retaining tariff language requiring new customers to pay for the entire length **[*141]** of the new service line to their property, resulting in an additional estimated $ 1.2 million in contributions (Ex. A-31; Tr. at 916); and
2. Requiring that new customers/developers pay for excess flow valves (approximately $ 250 each), which will become a mandatory requirement for new service lines beginning in July 2008 (Ex. A-32; Tr. at 1067).

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n16 UNS witness Gary Smith testified that the Company does not advocate adoption of these alternatives because he believes the Company's proposal, if combined with the alternatives, would require a significant increase in contributions by new customers and developers, from the current average of approximately $ 310 per connection to nearly $ 1,000 per connection. He stated that requiring substantial increases in required contributions could put UNS Gas at a competitive disadvantage, relative to the construction of homes using all electric or propane, and thereby lessen the Company's ability to add new service connections (Tr. at 1069-72).

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UNS points out that Staff witness **[*142]** Ralph Smith testified that the Company's line extension and main extension proposals (not including the alternatives) appear to be reasonably supported by the Company (Ex. S-25 at 64-67; Ex. S-27 at 44). Mr. Smith indicated that the Company's proposal appears to provide a feasibility study in compliance with Commission requirements (Tr. at 869-71). Therefore, Staff does not oppose the Company's tariff change requests on these issues. UNS also argues that its proposed ICS helps the Company specifically tailor a new customer's or developer's up-front contribution requirement rather than imposing a flat one-size-fits-all contribution requirement. UNS adds that because not all developments become fully built-out within the allotted five-year term of advance refunds, the balance of advances would become contributions after that five-year period (Tr. at 1055). UNS asserts that its proposals seek to hold developers and new customers responsible for a fair share of costs associated with serving growth.

We find that the Company's line and main extension proposals are a reasonable means of increasing the up-front contributions required from new customers and developers to connect to the UNS **[*143]** Gas system. However, we also believe that one of the alternatives suggested by the Company, the charge for excess flow valve installation, should be implemented by UNS to further increase the amount required for system connections. Since the excess flow valves will become mandatory in 2008, it is reasonable that the costs to install those devices should be included in the contributions, i.e. non-refundable, required from new customers/developers.

As set forth in Exhibit A-30, it is estimated that institution of these combined measures would cause the average contribution per service line to increase from the current amount of approximately $ 300 to $ 383 in 2007, $ 635 in 2008, and $ 760 in 2009 and beyond. The net result is that new customer/developer contributions would more than double within the next year and would continue to increase in the following year. Although the contributions are actually advances that are refundable within the first five years, to the extent a development is not built out within that five-year period, the balance of the up-front contributions would become nonrefundable and would not be includable in rate base.

We believe that our finding on this issue **[*144]** achieves a result that is consistent with the rate design concept of gradualism because, although it represents a significant increase in the up-front contribution required to be financed by new customers/developers, it keeps intact the ability of developers to recapture all or part of the initial investment. At the same time, as described by the Company's witnesses, approval of this modified proposal avoids the potential competitive disadvantage that would be faced by UNS Gas if a fully nonrefundable hook-up fee were to be implemented suddenly. We recognize that, over the long-term, increasing the number of customers on the system and the revenues associated with those customers should provide a benefit to all customers. While we believe the extension measures approved in this Order are reasonable at this time, we direct UNS Gas to investigate fully the issue of developer contributions and present in its next rate case viable alternatives to the proposal adopted herein, including but not limited to nonrefundable hook-up fees and other measures that would hold harmless existing customers and require greater contributions to ensure that growth pays for itself.

Reduction of Bill Payment **[*145]** Due Date

UNS proposes to modify its billing terms in its tariffs by reducing from 15 days to 10 days (from the time the bill is rendered) the time for customers to pay bills before the bills are considered past due. The Company's proposed change would make its billing practices consistent with the requirements of the Commission's Rules, as set forth in A.A.C. R14-2-310(C). UNS witness Gary Smith contends that even under the proposed billing change, customers would have plenty of time to pay bills before late payment charges would apply or termination of service would be implemented (Ex. A-16 at 4). According to Mr. Smith, after the 10-day payment period, customers would have an additional 15 days before a late payment charge would be imposed, for a total of 25 days. At that point, the bill would be considered delinquent, but termination-of-service procedures (*i.e.,* notice of termination) would not commence for an additional 5 days, and several additional days would likely pass before actual termination occurred. Mr. Smith indicated that the Company would be able to waive the late fee if a customer presented good cause for late payment **[*146]** (*Id.*).

RUCO, ACAA, and Mr. Magruder oppose the Company's proposal to reduce the time to pay a bill. RUCO argues that, although the Company's proposal is consistent with the minimum requirements of the Commission's Rules, the only advantage identified by UNS is that the proposed tariff change would bring consistency to the three affiliated utility companies that are served by the UniSource consolidated call center (Tr. at 355). RUCO claims that the proposed payment dates are so short that a customer could go on vacation and return home to find the gas service shut off (RUCO Ex. 5 at 35). RUCO witness Diaz Cortez stated that RUCO has received calls from customers opposing the proposed changes and that a more flexible payment schedule should be retained. Ms. Diaz Cortez stated that the Company is already compensated, through the working capital calculation, for the delay that exists between the rendering of bills and the receipt of payment from customers (*Id.* at 36). RUCO also contends that the call center consistency rationale offered by the Company does not support the proposed changes because the call center representatives must be trained regarding gas-specific issues anyway. **[*147]** RUCO asserts that the payment schedule change would provide only a minimal benefit to the Company, but customers would bear the burden of the proposed changes.

Staff did not oppose the Company's proposal, but recommended a six-month waiver of the late payment penalty charge. Staff argues that during this initial six-month period, the penalty should be waived from day 10 to alleviate the hardship on customers from the proposed billing change. According to UNS witness Gary Smith, the Company agrees with Staff's recommended six-month waiver period before the billing changes go into effect (Ex. A-16 at 3-4).

We agree with UNS that the proposed billing changes are reasonable. The billing changes would make the Company's tariffs consistent with the Commission's Rules and would remove an inconsistency among the billing tariffs currently in effect for the UniSource affiliates. The proposed change would also allow the customer call center representatives to have a single set of rules in place for all of the UniSource affiliates, which should minimize potential errors that may occur when information regarding delinquent bills and/or termination of service is provided to customers. In addition, **[*148]** as the UNS witness pointed out, a bill would not be subject to a late payment charge until at least 25 days after the bill is rendered, and a termination of service notice for nonpayment could not occur sooner than 30 days following issuance of a bill. We believe that these timeframes provide an adequate period for customers to either pay a bill or seek alternative payment arrangements prior to being subjected to a penalty or termination of service.

We therefore approve the Company's proposed changes to its billing tariffs. However, in accordance with the Company's agreement to abide by Staff's six-month waiver recommendation, we direct UNS Gas not to implement the approved billing change for a period of six months following the effective date of this Decision.

Prudence of Gas Procurement Practices and Policies

As described above, this consolidated proceeding includes Docket No. G-04204A-05-0831 (the Prudence Case), which relates to an audit conducted by Staff of UNS Gas's natural gas procurement practices and policies during the period of September 2003 through December 2005 (Tr. at 761). Staff retained Jerry Mendl, President of MSB Energy Associates, Inc., and George Wennerlyn, **[*149]** President of Select Energy Consulting, LLC, to conduct the Prudence Case audit.

Based on his review of the Company's procurement practices during the audit period, Mr. Mendl concluded that the Company's procurement strategy during the audit period was reasonable (Ex. S-20 at 1). He reiterated at the hearing that "[UNS Gas's] natural gas procurement strategy that was set forth in the price stabilization policies was reasonable over the review period." (Tr. at 761)

Mr. Wennerlyn reached the same conclusion regarding the Company's practices during the 2003-2005 audit period. He stated that the Company's gas procurement practices and policies during that period "achieved appropriate objectives of a purchasing strategy which balances reliability, cost, and price stability. The purchases were reasonable and prudent." (Ex. S-18 at 4-5)

There is no dispute on the issue of prudence during the identified audit period. We therefore agree that the Company's natural gas procurement practices and policies during the audit period of September 2003 through December 2005 are deemed prudent.

Price Stabilization Policy

This piece of the prudence equation relates to the request by UNS Gas for the **[*150]** Commission to approve its current "Price Stabilization Policy" ("PSP"). The basis for UNS Gas's request for what is effectively prudence pre-approval was described as follows by Company witness David Hutchens as follows:

> We believe that instead of the Commission attempting to second guess, after the fact, the individual acts that UNS Gas transacted in connection with gas procurement and hedging, it is more productive and beneficial to customers that the Commission review the policies and approve them prospectively. That way the Company will know the clear direction of the Commission and act accordingly. If the Company acts within the approved policies, its transactions will be conclusively prudent (Ex. A-4, at 7).

In his rebuttal testimony, Mr. Hutchens responded to Staff's concern that approval of the PSP in this case would put the Company on "autopilot" with respect to its procurement practices by indicating that such a practice would be inconsistent with the Company's past behavior and with the PSP itself (Ex. A-5 at 10). Mr. Pignatelli testified at the hearing that UNS sought the PSP approval in this case in order to avoid second-guessing during "the heat of a rate case **[*151]** three or four years after the fact" (Tr. at 106). He indicated that while the Company would keep adequate documentation of its procurement practices, he feared "a political decision down the road" (Tr. at 122).

Staff opposes the Company's request for approval of the PSP, arguing that approval of UNS Gas's hedging policy would insulate 45 percent of its gas purchases from a subsequent prudence review and is not necessary if the Company retains adequate documentation. Staff argues that UNS Gas and Staff have a fundamental disagreement regarding the purpose of the hedging plan. Staff claims that, as indicated by Mr. Hutchens, UNS views the hedging policy only as a means of reducing the volatility of natural gas prices (Tr. at 129, 157), whereas Staff believes that hedging policies ensure price stability, reliability, and competitiveness to achieve the lowest possible cost (Tr. at 744-45). Staff asserts that elimination of traditional prudence reviews in favor of the "compliance review" process sought by the Company would deprive Staff of the ability to properly employ its three-prong standard.

Staff witness Mendl also expressed concern with the higher burden of proof that would exist **[*152]** for Staff under the Company's proposal. He stated that if pre-approval of a particular plan is given, the Company may seek to abide by that plan instead of responding to market conditions, because adherence to the prior plan would be deemed presumptively reasonable (Tr. at 772). Staff argues that pre-approval is not necessary because, as pointed out by Mr. Mendl, prudence is judged based on what was known at the time decisions were made, not on a retrospective analysis (*Id.*). Staff contends that UNS can protect itself from future prudence disallowances by maintaining proper documentation regarding the decisions that were made and that the Company has not presented any evidence that the current standard is unfair.

We agree with Staff that the Company's request is simply unnecessary because there has been no evidence presented to suggest that the current process is unfair or unreasonable. Indeed, Mr. Hutchens conceded that there has been no indication that "there would be some unfair or biased after-the-fact analysis based on ... [the] Staff recommendations" (Tr. at 140). Mr. Hutchens also admitted that the only benefits to be gained from granting UNS's request are to the Company **[*153]** and that the purpose of seeking the Commission's approval of the PSP is to insulate the Company from risk (Tr. at 778). As Staff indicates, UNS Gas can avoid future prudence disallowances by properly documenting its procurement practices and policies. Moreover, in spite of Mr. Pignatelli's cynical assertion that pre-approval is necessary to avoid politically based decisions in the future, the record suggests that just the opposite is true. As discussed above, two outside Staff consultants conducted a comprehensive audit of the Company's procurement practices from September 2003 through 2005 and found that UNS Gas's practices and policies were prudent. We agree with Staff's recommendations. We do not believe that UNS Gas has presented a sufficient justification for approval of the PSP, and we therefore deny its request.

Purchased Gas Adjustor

In Docket No. G-04204A-06-0013 (the PGA Case), which was previously consolidated in the above-captioned proceeding, UNS Gas filed an application seeking approval to revise its current Purchased Gas Adjustor ("PGA"). UNS witness Hutchens testified that the current volatile natural gas market has exposed weaknesses in the Company's existing **[*154]** PGA mechanism, which cause delays in cost recovery, and that such delays impact customer decisions based on the lack of timely price information and impact the Company's cash flows (Ex. A-4 at 7). Mr. Hutchens stated that the deficiencies in the current PGA include: 1) inappropriate price signals to customers, 2) the potential for large bank balances to accumulate 3) a below-market interest allowance earned on bank balances; 4) an inappropriately narrow bandwidth, and 5) a potentially adverse impact on the Company's ability to devote capital to necessary investments to serve customers (*Id.* at 7-8).

Based on these claimed deficiencies, Mr. Hutchens made the following recommendations in his direct testimony to improve the Company's PGA mechanism:

> 1. Bandwidth -- The bandwidth should be eliminated or, in the alternative, increased to $ 0.25 per therm for an interim period of time and then eliminated.
> 2. Base Cost of Gas -- The base cost of gas should be set at zero, and the entire cost of gas reflected in the PGA.
> 3. PGA Bank Interest -- The interest earned on the PGA bank balance should reflect UNS Gas's actual cost of new debt, which is the London Inter-Bank Offering **[*155]** Rate ("LIBOR") plus 1.5 percent.
> 4. Bank Balance Thresholds -- The new threshold level for under-collected bank balances established in Decision No. 68325 ($ 6,240,000) should also be adopted as the threshold level for over-collected bank balances.
> 5. Capital Structure -- To the extent the PGA bank balances result in long-term financing, that debt should be excluded from the cost of capital calculation in rate case proceedings.
> 6. Surcharges -- When surcharges are required, the Commission should approve a surcharge large enough to eliminate the bank balance in a reasonable time period and allow for timely recovery (*Id.* at 8).

In his direct testimony, Staff witness Robert Gray offered seven recommendations regarding the Company's PGA proposals. He stated as follows:

1. The base cost of gas should be set at zero.
2. UNS should provide specific customer education materials to explain the change (setting the cost to zero), and should represent the cost of gas as a specific and separate line item on customer bills, noting in a footnote any temporary PGA surcharge or credit in effect.
3. During the first 12 months the new PGA bandwidth is in effect, UNS should provide **[*156]** a comparison of the new monthly PGA rate to the sum of the base cost of gas and the monthly PGA rate in prior months.
4. The bandwidth on the monthly PGA rate should be expanded to $ 0.15 per therm.
5. The threshold on the PGA bank balance for *under-collected* balances should be eliminated.
6. The threshold on the PGA bank balance for *over-collected* balances should be set at $ 10 million.
7. The currently applicable interest rate for the PGA bank balance should be retained.

UNS claims that the parties are in agreement regarding most of the PGA issues. The Company points out that all parties agree that the entire cost of gas should be reflected in the PGA and that the base cost of gas should be set at zero in order to send proper price signals regarding the actual cost of gas. UNS also contends that all parties have agreed that some widening of the current bandwidth is appropriate, although Staff continues to disagree with the requested level of the widening. In his rebuttal testimony, Mr. Hutchens agreed with Staff's recommendation that the under-collection threshold for requesting a PGA surcharge should be eliminated and that the over-collection threshold should be set at **[*157]** $ 10 million (Ex. A-5 at 4). The two remaining disputed PGA issues are the appropriate bandwidth level and the PGA bank interest rate.

PGA Bank Interest Rate

UNS witness Hutchens testified that the Company is requesting that it be allowed to recover through the PGA one of two rates, depending on the size of the PGA bank balance. For balances below twice the PGA threshold (currently $ 6.24 million), UNS seeks to earn the interest rate based on LIBOR plus 1.0 percent. n17 For balances that exceed twice the PGA bank balance threshold, UNS seeks to recover a "carrying cost at a rate equal to UNS Gas' authorized rate weighted average cost of capital as determined in this proceeding" (Ex. A-4 at 14). n18

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n17 UNS initially sought interest rate recovery based on LIBOR plus 1.5 percent, but amended the request to LIBOR plus 1.0 percent through Mr. Hutchens's rebuttal testimony, due to a lowering of the interest rate on the Company's short-

term revolving credit facility (Ex. A-5 at 5).
n18 As discussed above, the WACC established in this proceeding is 8.30 percent, compared to the LIBOR plus 1.0 percent rate, which was 5.53 percent at the end of May 2007 (See Ex. A-4 at 13).

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Although RUCO agreed to the LIBOR plus 1.5 percent rate (and would presumably also agree to the modified LIBOR plus 1.0 percent rate), RUCO opposes allowing the WACC rate to be applied to the higher balances requested by UNS (RUCO Ex. 5 at 24-25). RUCO contends that, given its agreement with the Company's proposal to double the current bandwidth and to provide for timely recovery of necessary surcharges, the higher interest rate would not be necessary because UNS would no longer be burdened with large under-collected balances. Ms. Diaz Cortez added that it would be inappropriate to predetermine outside of a rate case the ratemaking treatment to be afforded to the specific debt (*Id.* at 25-26).

Staff also opposes the Company's request to apply the WACC to higher PGA bank balances. Staff witness Robert Gray testified that interest rates for PGA bank balances were originally set in a generic docket (Decision No. 61225, issued October 30, 1998) and applied uniformly to all Arizona LDCs as a result of the consensus of a working group that included LDCs, Staff, and RUCO (Ex. S-41 at 13). The uniform interest established in that generic docket was the monthly three-month commercial **[*159]** *non-financial* paper rate, as established by the Federal Reserve (*Id.*). Mr. Gray stated that the interest rate was later changed in a subsequent generic proceeding (Decision No. 68600, issued March 23, 2006), only because the Federal Reserve was no longer publishing the previously established rate. Therefore, the current generic interest rate for PGA bank balances is the monthly three-month commercial *financial* paper rate published by the Federal Reserve. The rates are similar, although the current rate is slightly higher, on average, than the prior rate (*Id.*).

According to Mr. Gray, the Company's request should be rejected by the Commission for several reasons. He stated that the UNS proposal is unnecessary because it would add a level of administrative complexity to the process in making the calculations and because the PGA bank balances do not always trend upwards (*Id.* at 14). Mr. Gray testified that it was unclear which LIBOR rate the Company was proposing to use, that it appears the LIBOR itself would be very close to the interest rate currently in effect, and that it is only the application of an add-on component to the LIBOR rate (*i.e.*, the LIBOR plus **[*160]** 1.0 percent proposed by UNS) that raises the rate above the current rate by a substantial amount (*Id.* at 14-15). Mr. Gray indicated that the PGA interest rate approved recently for Southwest Gas was the one-year nominal Treasury constant maturities rate, which is comparable to the rate currently in effect for UNS Gas.

The same rate is in effect for APS, and Mr. Gray asserts that UNS has not presented any justification for a different treatment (*Id.* at 15).

Mr. Gray also stated that Staff's recommendations to expand the PGA bandwidth (see discussion below) and to expand and eliminate the bank balance thresholds would reduce the likelihood of UNS Gas's incurring substantial bank balances for long periods of time (*Id.* at 16). He therefore recommended that the existing interest rate continue to be applied to UNS's PGA bank balances or, as an alternative, that the same interest rate applicable to both Southwest Gas and APS (the one-year nominal Treasury constant maturities rate) be applied (*Id.*). Finally, Mr. Gray recommended that if the applicable interest rate becomes unavailable (*i.e.,* unpublished) for one or more months, the prior month's interest rate apply. If **[*161]** the interest rate becomes unavailable on a recurrent basis, he recommends that UNS file a request to change to a comparable rate (*Id.* at 17).

We agree with Staff that UNS has not presented a sufficient basis for altering the PGA bank balance interest rate that currently exists. As Mr. Gray points out, a similar rate is in effect for Southwest Gas and APS, and we see no reason why UNS should be treated differently from those companies. In addition, granting a higher interest rate could provide a disincentive for the Company to reduce bank balances and could cause it to become less focused on taking all possible measures to reduce the cost of gas for its customers (*Id.* at 15-16). We therefore adopt Staff's recommendation to retain the current interest rate for UNS's PGA bank balances.

Expansion of Bandwidth

Under its current configuration, the Company's PGA bandwidth limits the movement of the monthly PGA rate over a 12-month period. The current bandwidth is $ 0.10 per therm, which means that when a new PGA rate is calculated each month, the new monthly rate cannot be more than $ 0.10 per therm different than the monthly PGA rate for any of the previous 12 months (Ex. S-41 **[*162]** at 5). Mr. Gray explained that the PGA bandwidth was initially established in 1999 at a rate of $ 0.07 per therm for Arizona LDCs during a period of relatively stable gas prices. As prices became more volatile, that bandwidth level often limited the movement of monthly PGA rates for periods of time. In Decision No. 62994 (November 3, 2000), UNS's predecessor was granted a bandwidth increase to $ 0.10 per therm (*Id.*). Mr. Gray testified that recent bandwidth adjustments were approved for Southwest Gas (to $ 0.13 per therm) and for Duncan Rural (could change up to $ 1.20 per therm per year). However, he indicated that the Commission granted the significant expansion to Duncan Rural due to that company's small size and considerable financial constraints (*Id.* at 6).

In its application, UNS Gas initially requested that the PGA bandwidth be eliminated or, alternatively, set at $ 0.25 per therm for a period of time before being eventually eliminated (Ex. A-4 at 11-12). In his rebuttal testimony, UNS witness Hutchens agreed with RUCO's proposal to increase the current bandwidth to $ 0.20 per therm (Ex. A-5 at 3-4). Mr. Hutchens stated that setting the bandwidth at an inappropriately **[*163]** low level would fail to send proper price signals to customers regarding the actual cost of the gas being consumed (Ex. A-4 at 12).

Staff witness Gray recommended that the bandwidth be increased to $ 0.15 per therm. He stated that this bandwidth increase would provide the Company with significant additional room for movement of the monthly PGA rate, while providing a reasonable limit on the exposure of UNS customers to automatic adjustments without Commission review. Mr. Gray also indicated that Staff remains open to consideration of further changes to the PGA mechanism, if such changes are warranted (Ex. S-41 at 7-8). He explained in his surrebuttal testimony that setting a proper bandwidth level requires a balancing of several policy goals, including "timely recovery of gas costs by the utility, reduction of price volatility for ratepayers, and the Commission's interest in reviewing significant changes in rates before they are passed along to ratepayers." (Ex. S-42, at 2) He conceded that employing a bandwidth could result in the Company's accumulating large bank balances that must eventually be paid by customers (Tr. at 1133). However, he reiterated that the various policy goals, **[*164]** including protection of ratepayer interests, must be balanced in setting the bandwidth (*Id.*).

We agree with Staff's recommendations regarding the PGA issues, including increasing the Company's bandwidth to $ 0.15 per therm. The $ 0.15 per therm bandwidth is higher than the $ 0.13 bandwidth approved recently for Southwest Gas, and we believe it is reasonable under the facts of this case. Although UNS attempts to use the Duncan Rural case as a basis for seeking a greater increase in the bandwidth, Mr. Gray explained that Duncan is a very small natural gas cooperative with only 80 customers and that it has significant financial issues. UNS Gas is not in a comparable situation, and we do not believe a comparison with Duncan Rural is relevant for purposes of setting an appropriate bandwidth in this proceeding. Indeed, the 50 percent increase over UNS's current bandwidth is significant and properly balances the policy goals identified in Staff's testimony. The rate of $ 0.15 per therm will provide UNS Gas with a greater degree of flexibility in maintaining its PGA bank balances at a reasonable level, while also offering to customers a measure of protection from sudden automatic PGA **[*165]** increases outside of the Commission's purview.

* * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. On November 10, 2005, the Arizona Corporation Commission opened an inquiry (Docket No. G-04204A-05-0831) into the prudence of the gas procurement policies and practices of UNS Gas Inc. (the Prudence Case).

2. On January 10, 2006, UNS Gas filed an application (Docket No. G-04204A-06-0013) with the Commission seeking review and revision of the Company's Purchased Gas Adjustor (the PGA Case).

3. On July 13, 2006, UNS Gas filed an application with the Commission (Docket No. G-04204A-06-0463) for an increase in its rates throughout the State of Arizona (the Rate Case).

4. On August 14, 2006, Staff filed a Letter of Sufficiency indicating that the Company's Rate Case application met the sufficiency requirements outlined in A.A.C. R14-2-103 and classifying the Company as a Class A utility.

5. On September 8, 2006, a Procedural Order was issued consolidating the Prudence Case, PGA Case, and Rate Case dockets; scheduling a hearing for **[*166]** April 16, 2007; and setting various other procedural deadlines.

6. Intervention was granted to RUCO, ACAA, and Marshall Magruder. 7. With its application in the Rate Case, UNS filed its required schedules in support of the application, and the direct testimony of various witnesses.

8. On February 9, 2007, Staff, RUCO, ACAA, and Mr. Magruder filed direct testimony in accordance with the previously established procedural schedule. Staff filed additional direct testimony on February 16 and February 23, 2007.

9. On March 16, 2007, UNS filed the rebuttal testimony of various witnesses in response to Staff and intervenor testimony.

10. Surrebuttal testimony was filed by ACAA on March 30, 2007; and by Staff, RUCO, and Mr. Magruder on April 4, 2007.

11. On April 11, 2007, UNS filed the rejoinder testimony of several witnesses in response to the surrebuttal testimony of Staff and intervenor witnesses.

12. The evidentiary hearing commenced as scheduled on April 16, 2007, and additional hearing days were held on April 17, 18, 19, 20, 24, and 25, 2007.

13. Initial Post-Hearing Briefs were filed on June 5, 2007, by UNS, Staff, RUCO, and Mr. Magruder. Final Schedules were also filed on June 5, **[*167]** 2007, by UNS and RUCO. On June 6, 2007, Staff filed a Notice of Errata and revised Initial Brief.

14. Reply Briefs were filed on June 19, 2007, by UNS, Staff, RUCO, and Mr.

Magruder.

15. On June 21, 2007, Staff filed a Notice of Errata and Additional Authority.

16. According to the Company's application, as modified, in the test year ended December 31, 2005, UNS had adjusted operating income of $ 8,506,168 on an adjusted OCRB of $ 162,358,856, for a 5.24 percent rate of return.

17. UNS requests a revenue increase of $ 9,459,023, Staff recommends a revenue increase of $ 4,312,354, and RUCO recommends a revenue increase of $ 2,734,443.

18. For purposes of this proceeding, we determine that UNS Gas has an OCRB of $ 154,604,408 and a FVRB of $ 184,120,761.

19. A rate of return on FVRB of 6.97 percent is reasonable and appropriate.

20. The Company's attempt to interject the issue of the *Chaparral City* decision through its rebuttal testimony was untimely, prejudicial to the other parties, and its late attempt to apply the weighted average cost of capital to FVRB is not reasonable and is not supported by the testimony and evidence in the record.

21. UNS Gas is entitled to a gross revenue **[*168]** increase of $ 5,257,468.

22. The Company's proposed decoupling mechanism proposal, the Throughput Adjustment Mechanism, is not adopted in this proceeding.

23. The class responsibility for the revenue requirement should be allocated using the methodology of Staffs rate design expert witness.

24. For residential customers under Schedule R10, the basic monthly customer charge should be increased from $ 7.00 to $ 8.50, with a commodity charge increase to $ 0.3270 per therm, based on the revenue requirement established herein.

25. For CARES customers (Schedule R12), the current customer charge of $ 7.00 should remain in place, with a commodity charge increase to $ 0.3270 per therm, based on the revenue requirement established herein.

26. The rates for other customer classes should be set based on Staff's rate design recommendation, with the customer charges for each class established at the level recommended by Staff and with volumetric charges based on the revenue requirement determined herein.

27. The billing determinants proposed by the Company should be employed for setting rates in this proceeding.

28. Staff's recommendation to set the DSM adjustor surcharge at an initial level of **[*169]** $ 0.0025, which reflects exclusion of the baseline cost study, is reasonable. In addition, it is reasonable to require UNS to file semi-annual reports for the DSM programs, to shift the adjustor filing date to April 1 (with an Adjustor date of June 1), and that the appropriate forum for a full review of the specific DSM programs is in the separate docket in which there is an application currently pending.

29. In the event that UNS Gas does not currently have in place a bill statement contribution option, the Company should implement the change within 60 days of the effective date of this Decision.

30. The Company's natural gas procurement practices and policies during the audit period of September 2003 through December 2005 are deemed prudent.

31. UNS Gas has not presented a sufficient justification for approval of the Price Stabilization Plan.

32. With respect to the Company's Purchased Gas Adjustor mechanism, we adopt Staff's recommendations, including setting the base cost of gas at zero and increasing the current $ 0.10 per therm adjustment band to $ 0.15 per therm.

33. The interest rate for the Company's PGA bank balance should remain in place (monthly three-month commercial **[*170]** financial paper rate published by the Federal Reserve), in accordance with Staff's recommendation.

34. DSM programs should be funded at the level recommended by Staff: LIW funding ($ 113,400) and 25 percent of the new program costs ($ 229,154) should be included in the initial DSM surcharge, but UNS Gas's portion of the baseline study costs ($ 82,000) should not be included in the surcharge initially. Staffs proposed initial DSM surcharge of $ 0.0025 is therefore adopted.

35. With respect to the use of payday loan stores for acceptance of **customer payments,** the Company should make every reasonable effort to determine whether other payment locations may be utilized either in addition to, or in lieu of, the payday loan stores currently used by UNS, and the Company should file a copy of its recommendations consistent with this directive within 90 days of the effective date of this Decision.

36. The Company's line and main extension proposals are a reasonable means of increasing the up-front contributions required from new customers and developers to connect to the UNS Gas system, subject to inclusion of the addition of a charge for excess flow valve installation, and subject to the additional **[*171]** requirement that UNS Gas investigate fully the issue of developer contributions and present in its next rate case viable alternatives to the

proposal adopted herein, including but not limited to nonrefundable hook-up fees and other measures that would hold harmless existing customers and require greater contributions to ensure that growth pays for itself.

37. UNS Gas's proposed billing change, to reduce from 15 days to 10 days, the date for customers to pay bills before the bills are considered past due, is a reasonable modification that will make the Company's tariffs consistent with the Commission's Rules and would remove an inconsistency among the billing tariffs currently in effect for the other UniSource affiliates. However, in accordance with the Company's agreement to abide by Staffs six-month waiver recommendation, UNS Gas should not implement the approved billing change for at least six months following the effective date of this Decision.

CONCLUSIONS OF LAW

1. UNS Gas is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§40-250, 40-251 **[*172]** , and 40-367.

2. The Commission has jurisdiction over UNS Gas and the subject matter of the above-captioned Rate Case, Prudence Case, and PGA Case.

3. The fair value of UNS Gas's rate base is $ 184,120,761, and applying a 6.97 percent rate of return on this fair value rate base produces rates and charges that are just and reasonable.

4. The rates, charges, approvals, and conditions of service established herein are just and reasonable and in the public interest.

ORDER

IT IS THEREFORE ORDERED that UNS Gas, Inc., is hereby authorized and directed to file with the Commission, on or before November 30, 2007, revised schedules of rates and charges consistent with the discussion herein and a proof of revenues showing that, based on the adjusted test year level of sales, the revised rates will produce no more than the authorized increase in gross revenues.

IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective for all service rendered on and after December 1, 2007.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall notify its customers of the revised schedules of rates and charges authorized herein by means of an **[*173]** insert, in a form acceptable to Staff, included in its next regularly scheduled billing,.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall file in its next rate case more detailed support for allowance of AGA dues and an explanation of how the

AGA's activities, aside from marketing and lobbying efforts, benefit the Company's customers.

IT IS FURTHER ORDERED that UNS Gas, Inc., should engage in discussions with other stakeholders affected by this issue, participate in the ongoing DSM workshops before the Commission, and, if possible, attempt to develop a decoupling mechanism that does not suffer from the types of deficiencies identified by the parties in this case.

IT IS FURTHER ORDERED that if UNS Gas, Inc., does not currently have in place a bill statement contribution option, it shall implement such a change within 60 days of the effective date of this Decision.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall set the DSM adjustor surcharge at an initial level of $ 0.0025, and shall make its DSM adjustor filing by April 1 of each year.

IT IS FURTHER ORDERED that UNS Gas, Inc., shall file semi-annual reports for its DSM programs in accordance with Staffs recommendations.

IT IS FURTHER **[*174]** ORDERED that UNS Gas, Inc., shall file a copy of its recommendations regarding available alternatives for payment and **service center** locations within 90 days of the effective date of this Decision.

IT IS FURTHER ORDERED that UNS Gas, Inc. shall submit, within 30 days of this Decision, a revised Excess Flow Valve Installation tariff indicating that all new customers/developers shall pay the full cost of installation and the payment shall be a contribution (i.e. non-refundable).

IT IS FURTHER ORDERED that UNS Gas, Inc., shall investigate fully the issue of developer contributions and present in its next rate case viable alternatives to the proposal adopted herein, including but not limited to nonrefundable hook-up fees and other measures that would hold harmless existing customers and require greater contributions to ensure that growth pays for itself.

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IT IS FURTHER ORDERED that UNS Gas, Inc., shall not implement the approved billing change to reduce the payment due date, for six months following the effective date of this Decision.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY **[*175]** ORDER OF THE ARIZONA CORPORATION COMMISSION.

Mike Gleason
CHAIRMAN

William A. Mundell

COMMISSIONER

Jeff Hatch-Miller
COMMISSIONER

Gary Pierce

COMMISSIONER

IN WITNESS WHEREOF, I, DEAN S. MILLER, Interim Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 27<th> day of Nov. 2007.

DEAN S. MILLER

INTERIM EXECUTIVE DIRECTOR

BEWARE OF PAYDAY LENDERS

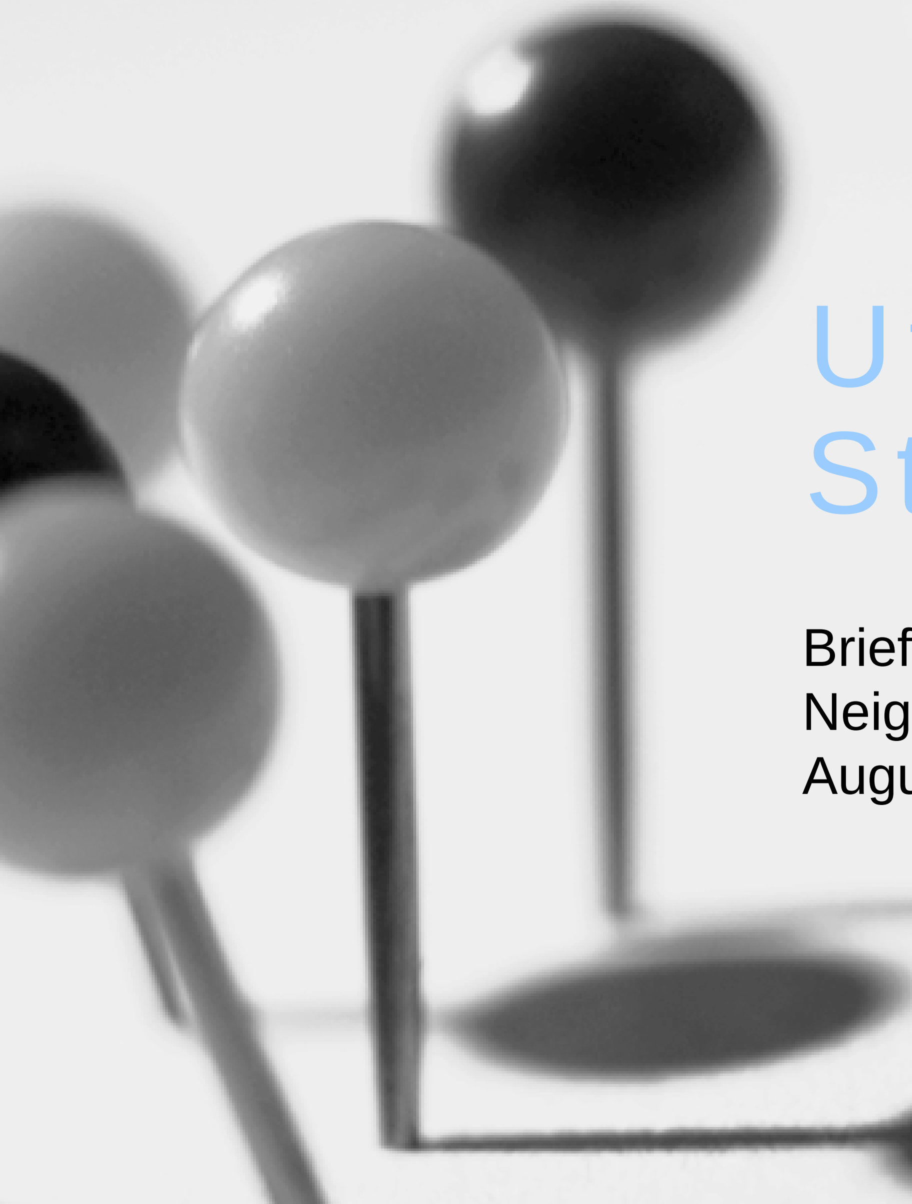
Payday lenders make short-term loans at criminally high interest rates—at least 390%, often more. They prey on people who are desperate for cash, and then wreak havoc with their lives because of the dire consequences of missing their extraordinarily short due dates. Payday lenders are economic predators that consumers should stay away from. But utility companies routinely authorize payday lenders to accept bill payments, giving them easy access to vulnerable consumers.

http://www.turn.org/article.php?id=623

A report by the National Consumer Law Center (NCLC), a long-time TURN ally, urges utility companies to discontinue current practices allowing payday lenders to lure victims by providing a convenient place for consumers to pay essential bills. As the report points out, California's utilities are among those contracting with payday lenders for bill-paying service. Pacific Gas & Electric, for example, includes 71 payday lenders among its neighborhood pay stations.

TURN staff attorney Hayley Goodson says TURN will prioritize putting an end to this anti-consumer practice. "Thanks to the timely NCLC report on utility use of payday lenders as billing agents, TURN has ammunition with which to fight the practice. In the upcoming rate case for San Diego Gas & Electric and Southern California Gas TURN will urge the California Public Utilities Commission (CPUC) not to permit the companies to use payday lenders as utility pay stations," she said.

"To implement this change," Goodson said, "we're suggesting that the Commission prohibit SDG&E and SoCal Gas from contracting with any payday lenders as new payment centers. Additionally, we are recommending that the CPUC order both companies to actively search for alternatives to the existing payment centers at payday lenders, and drop the payday lenders as soon as alternatives are found."



Utility Pay Stations

Briefing to the City Council
Neighborhood Quality of Life Committee
August 29, 2006

Purpose

- To provide an overview of the utility pay stations' functions and operations, as well as the community needs they serve

Background

- Utility Pay Stations (UPS) sites
  - Martin Luther King, Jr. Community Center (MLKCC)
  - West Dallas Multipurpose Center (WDMC)
- In operation since 1987

Martin Luther King Community Center

West Dallas Multipurpose Center

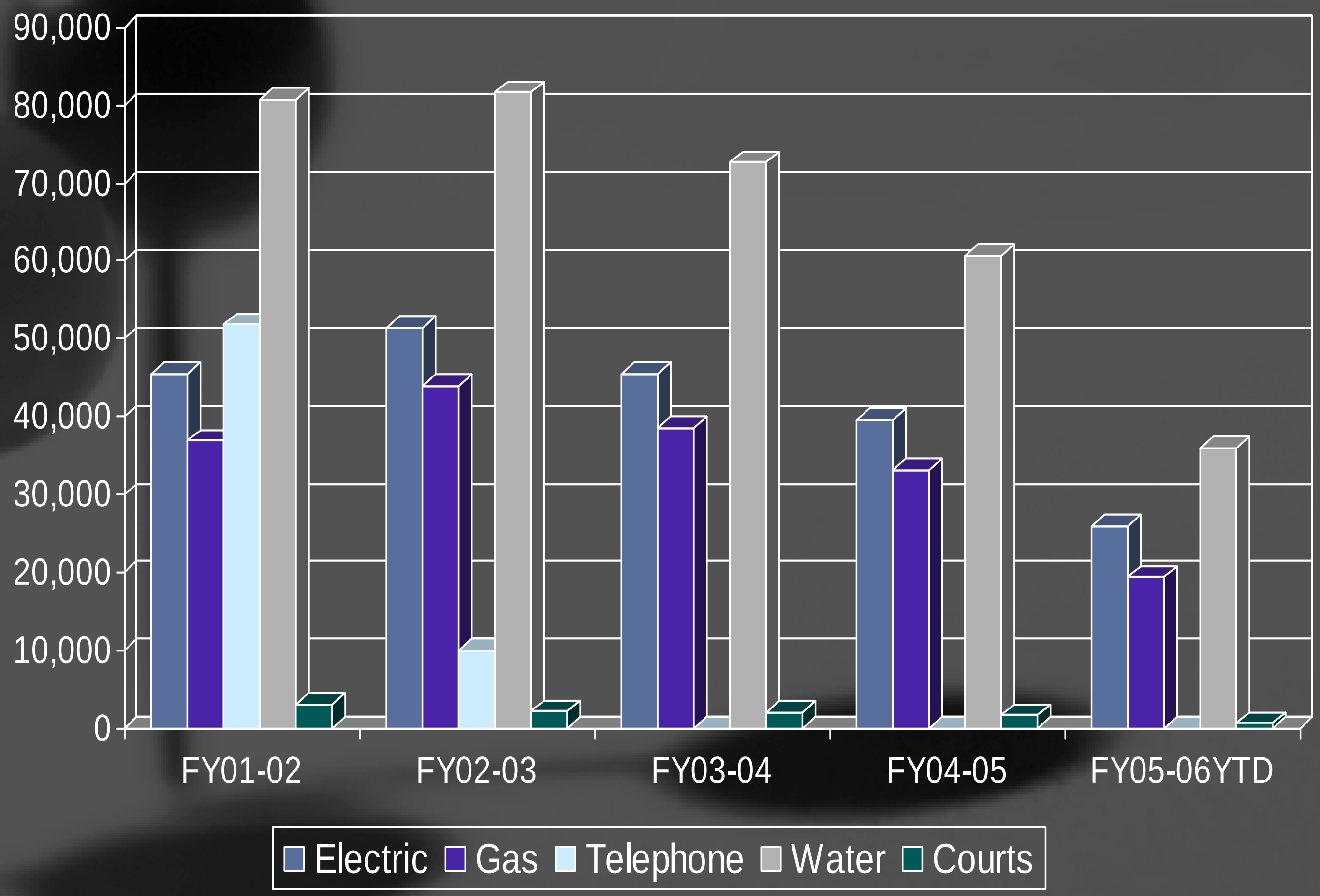
Operations

- Core Services
  - Utility payment processing for TXU, Atmos, Dallas Water Utilities
    - MLK also offers processing for Dallas Courts
    - Telephone utility payments discontinued Dec. 2002
- Transaction Fees
  - No fees to customers until July 2001
  - $1 per transaction for TXU/Atmos payments
    - Registered seniors (60+) and clients with disabilities are exempted
    - $0.45 paid to third-party transaction service; City retains $0.55
    - About $12,000 collected annually in FY05-06 for social service programs
      - City collected about $189,000 annually before fees enacted in July 2001

Operations

- Hours of Operation
  - MLKCC
    - 8 a.m. to 6 p.m., Mondays through Fridays
  - WDMC
    - 8 a.m. to 6:30 p.m., Mondays and Thursdays
    - 8 a.m. to 4 p.m., Tuesdays, Wednesdays, Fridays
- Staffing Levels
  - MLKCC: 3.9 FTEs funded – currently 2 permanent, 3 temporary positions filled
  - WDMC: 1.9 FTEs funded – currently 2 permanent, 1 temporary positions filled

Transaction Counts



Customer Trends

- Reductions in transactions attributed to:
  - Implementation of fees in 2002
  - Loss of telephone payment processing in 2002
  - Reduced hours of service and staffing
  - Alternative payment options

Community Needs

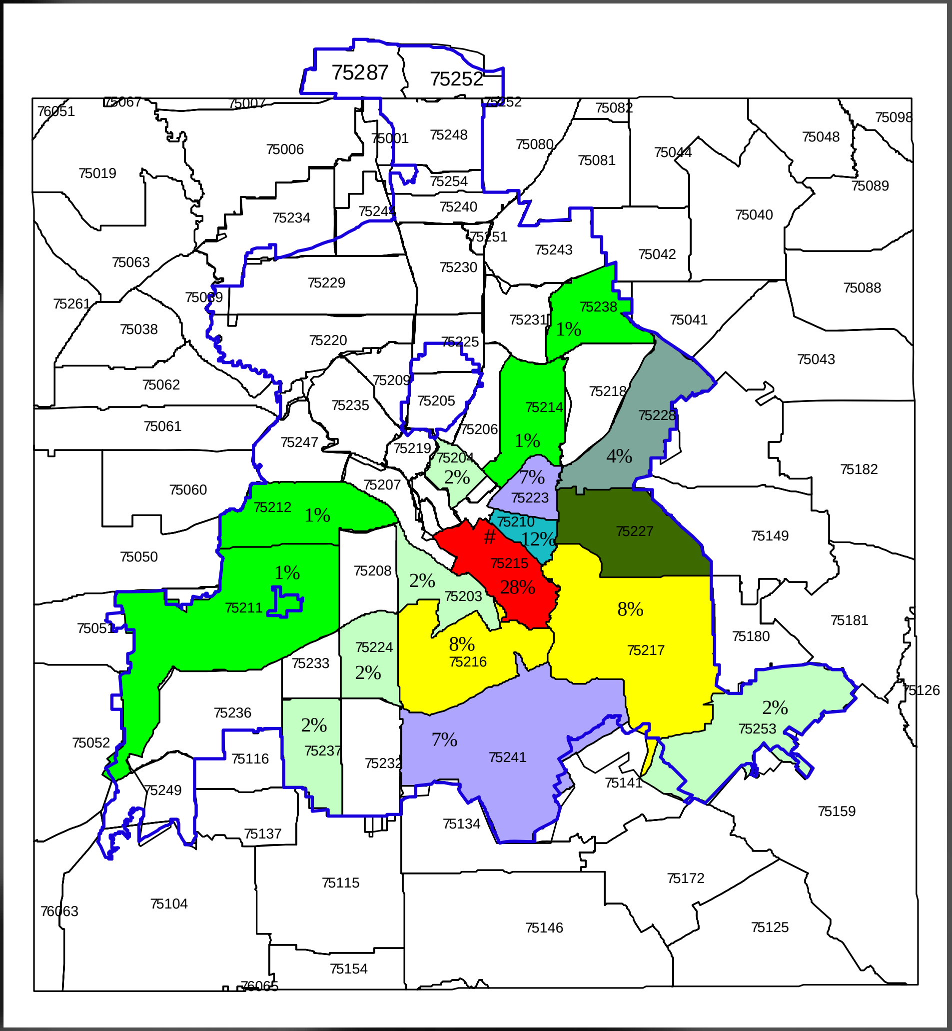
- Customer Service Survey, April 2006

Utility bills paid at this facility	**MLK**	**WDMC**	**Total**	**%**
All three (electric, water, gas)	73	48	121	60.5%
Electric and Water	8	19	27	13.5%
Water	5	15	20	10.0%

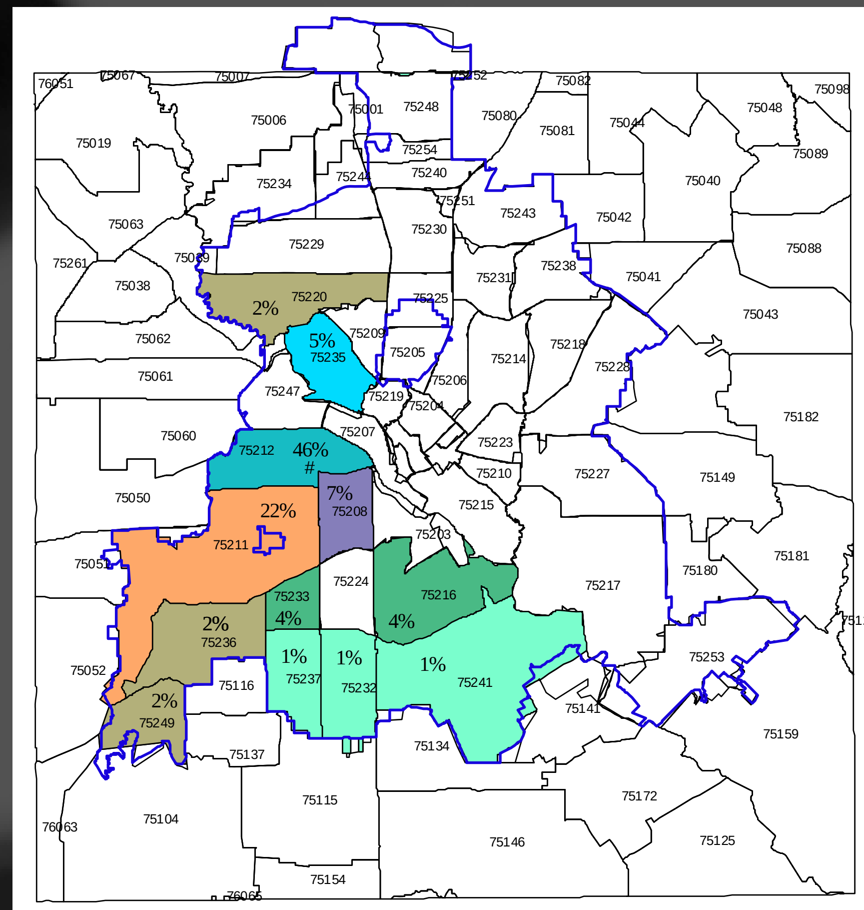
Reasons for paying bills at this facility	**MLK**	**WDMC**	**Total**	**%**
Closer to home/convenient location	49	43	92	46.0%
Easier and faster	20	24	44	22.0%

Level of satisfaction with the UPS	**MLK**	**WDMC**	**Total**	**%**
Extremely satisfied	54	56	110	55.0%
Very satisfied	44	33	77	38.5%

MLKCC Customer Base



WDMC Customer Base



Community Needs

- Customer Service Survey, April 2006

Recommendations to improve services	**MLK**	**WDMC**	**Total**	**%**
Everything is good/excellent service	11	22	33	16.5%
Keep it the way it is/stay here	3	14	17	8.5%
Have more employees	4	4	8	4.0%
Have more tellers	3	6	9	4.5%
Stay open a little later	2	1	3	1.5%
Provide assistance with paying phone bills	10	2	12	6.0%
Provide faster service for older customers	1	1	2	1.0%
Other	0	4	4	2.0%
No response	66	46	112	56.0%

Community Needs

- Customer survey, May 2006
  - What other services would you like offered at the pay stations?
    - 80% Money orders/check cashing
    - 63% Postage stamps
    - 63% Automated teller machine
    - 62% Faxing/copying services
    - 60% Traffic ticket payments
    - 58% Notary services
    - 40% Wire transfer services
    - 37% Long distance calling card sales
    - 34% Child support payments

RFP Process

- Request for Proposals (RFP) issued August 4, 2006
  - Deadline August 25, 2006
- Contractor Role
  - Provide payment processing operations, including staff, equipment, ancillary services
    - Seniors/disabled persons would not pay fees for utility bill payments
  - Provide a City-approved set of other services for fees, e.g. sales of money orders, check cashing, non-utility bill payments
  - Pay the City a specified portion of revenues
- City would provide facilities, utilities and security services

Next Steps

- Proposal evaluation in progress
- Brief Quality of Life committee with recommendation on September 11, 2006
- Council consideration of award of contract September 27, 2006

STAFF DATA REQUEST   Case: AX-2010-0061

Please provide any and all **Missouri-specific** documentation used to support the Petition for Promulgation of Consumer Protection Rules Relating to Billing and Payment, and specifically the explanations under the paraphrased headings: payday loan stores as pay stations; special fees for normal services; consideration of all relevant factors; surcharges and user fees for billing and collection items; restrictions of payday loan and similar lenders as utility paystations; and, customer service centers and fees to make payments, and further used to support the statements, "The proposed rules address significant issues concerning consumers and their utility bills. The proposed rules establish or strengthen the ratepayer's rights." (Petition page 2)

<u>OPC RESPONSE</u>

Data request response

1. Attached are the documents/sources that OPC relied upon as factual background for problems faced by consumers with payday loan stores and utility pay stations. These are in addition to the documents contained as attachments or referenced in Public Counsel's Petition. No one single source with **Missouri-specific** documentation appeared to be available during Public Counsel's reseach. Many sources were reviewed over the last few years, but these are the documents that were recorded and retained as useful information sources.
   Please note that not all of the documents provide are Missouri specific, but are provided as a good faith effort to indicate some of the documentation reviewed by Public Counsel illustrating a problem national in scope or the experiences of other states.

2. No specific documents were used to demonstrate the special fees for normal services other than information relating to telecommunications billing in PSC and FCC rulemakings on Billing standards that showed new line item charges that had developed since the Federal Telecom Act of 1996. It also had a Missouri specific basis in the in- state access surcharge cases PSC Consolidated Case TT-2002-129, et al

3. Public Counsel is not aware of specific written consumer complaints in Missouri regarding payday loan stores acting as pay stations for utilities other than those referenced in the newspaper article attached to Public Counsel's petition for rulemaking. Approximately, 5 years ago, supermarkets in Columbia and in some other areas raised the fee they charged customers to pay utility bills, in particular, LaClede Gas Co.

Public Counsel made an investigation into the customer fee system and had discussions with the utility companies and Staff was involved in these meetings and discussions. At this time, Public Counsel is unable to locate information/files/documents related to this investigation, but will continue to research that matter. Upon information and belief, no action was taken.

List of Documents Included:

<u>Document Title</u> <u>Mike's Title</u>

A Victory Over Predatory Payday Lending…………………Victory Over Payday Loans

Alternative Way to Pay Utility Bills Draws Fire…………………………………..(same)

Arizona PSC Rate Case……………………..Ariz PSC Decision on Payday Loan Stores

Beware of Payday Lenders……………………………………………………..(same)

Blunt, Missouri GOP Aagin Fail to Answer Call…………………..….Payday Loan MO

California Legislature Assembly Bill Number 2511………Ab-2511-bill-ca-payday loan

California Public Utilities Commission 1986 Decision…………………………1986 Cal

Convenient Payments, Killer Loans………………………Utilities and Payday Lenders

Federal Reserve Bank of New York Staff Reports..Payday Lending Fed Reserve Report

Financial Services in Distressed Communities……………Fannie Mai Fin in Distressed

Letter to Governor Blunt……………………………..MO 2005 Payday Lender Survey

Military Service to Get Defense Against Payday Loans………………………….(same)

Missouri Age Consumer Guide Payday Loans……………………………………(same)

Missouri Licenses Online Payday Lenders……………………………………….(same)

MO Payday Loans Company On Line Ads……………………………………….(same)

Payday Lending Facts…………………………………………….Payday Industry Facts

Payday Loan Case Statutes……………………………………………………….(same)

Payday Loans in Missouri……………………………..Payday Loans MO Truman 2008

Payday Loans, a Necessary Product…………………………..Payment + Lending + Info

Payment of Utility Bills: Issues…………………………..Payment of Utility Bills Colton

Regulating Predatory Payday Lending……………………Payday Lending State Survey

Rules of Department of Economic Development………………PSC Utility Billing Rules

Show Me the Money………………………………..………………………(same)

The Growth of Legal Loan Sharking……………A Report on the Payday Loan Industry

The Payday Loan Industry in Missouri…………………MO BBB Payday Loan Report

Unsecured Loans of $500 or Less………………………..MO STTS Loans Under $500

Utility Pay Stations……………………………………………Dallas Pay Station Report

Responses submitted by: Michael F. Dandino,
Chief Legal Advisor
OPC
November 10, 2009

FannieMae
FOUNDATION

Financial Services in Distressed Communities: Issues and Answers

Financial Services in Distressed Communities:
Framing the Issue, Finding Solutions
By James H. Carr and Jenny Schuetz

and

Predatory Lending: An Overview
By James H. Carr and Lopa Kolluri

August 2001

Executive Summary *

The American financial system is arguably the most sophisticated and efficient in the world. The power of our financial services industry derives from the complexity of the nation's financial intermediaries including commercial banks, savings institutions, mortgage banks, credit unions, investment banks, securities firms, insurance companies, specialized credit intermediaries, and a variety of specialized government and government-sponsored or -regulated financial institutions.

But this sophisticated financial services infrastructure differs markedly from the world of finance in lower-income and minority communities. There, the language of finance is increasingly pawnshops, check-cashing outlets, payday lenders, and rent-to-own stores. Largely unregulated in many states, the fees charged by these alternative financial services outlets are frequently excessive and their business practices often differ greatly from the asset-building and wealth-creation services provided by mainstream financial institutions.

In addition, excessive subprime, as well as predatory, lending tend to flourish in communities saturated with check cashers, pawnshops, and related financial services outlets. The heavy concentration of these practices in lower-income and minority communities further erodes the asset-building potential of financially vulnerable households. This concentrated negative impact on households translates into increased financial distress at a community level as households already living on the margin are forced to navigate a minefield of high-cost, unscrupulous, and often fraudulent financial services providers.

The following two articles focus on the financial services infrastructure that typically serves lower-income, minority, and distressed communities. They document how the failure to ensure efficient financial services markets in those areas exposes residents to wealth-stripping financial services activities and greatly contributes to their financial marginalization. The articles offer several policy recommendations to improve the delivery of lower-cost, asset-building financial services to the nation's most financially vulnerable consumers.

The first article, titled "Financial Services in Distressed Communities: Framing the Issue, Finding Solutions," by James H. Carr and Jenny Schuetz, examines the recent explosive growth of alternative financial services outlets in distressed communities and the corresponding growth of subprime and predatory lending in those same markets. Carr and Schuetz document the high costs for households relying primarily or exclusively on those lenders. Recognizing that fringe lenders have filled an important credit gap by developing products and services to meet the unique needs of lower-income consumers, the article cautions that those services, nevertheless, often come at staggering costs. Further, the article explains that because alternative financial services providers do not offer savings products, households that rely exclusively on them to meet their financial services needs have neither the incentive nor opportunity to save.

Carr and Schuetz also highlight the substantial costs to households exploited by excessive subprime and predatory lending. The article notes that while subprime lending is a critical source

* The authors thank Carol Bell, Cate Toups, Isaac Megbolugbe, John Caskey, Jean Hogarth, Bill Senhauser, Michael Seng, Anne Kim, and Bill Wilkins for their thoughtful and insightful comments and suggestions on earlier drafts of these articles. Any remaining errors or inaccuracies are the sole responsibility of the authors.

of credit for millions of families, minority households are disproportionately steered to higher-cost subprime lending. The extreme reliance on subprime lending by minority households raises the question of whether they are steered on the basis of their race or ethnicity rather than due to legitimate creditworthiness issues. The article documents that as much as 35 to 50 percent of the borrowers in the subprime market could have qualified for lower-cost prime market loans and provides examples of the extraordinary costs to households of being unfairly steered to subprime credit. The article notes that steering of borrowers to the subprime market contributes to confusion in the policy-making community in distinguishing between legitimate subprime and predatory lending.

Carr and Schuetz conclude with three policy recommendations to improve the financial services environments of distressed communities. They are: (1) Enhance data collection on finance services transactions and increase enforcement of fair lending, equal credit opportunity, and consumer protection laws and regulations; (2) Create greater competition for financial services in distressed communities by improving the range of available financial products and services and enhancing government's role as a facilitator and supporter of financial services innovation; and (3) Enhance and expand consumer outreach and financial education and awareness.

In the area of enhancing financial innovation, the recommendations include creation of partnerships between mainstream financial services providers and alternative financial services outlets that would leverage the strengths of both sets of institutions. Such partnerships would leverage the economies of scale that could be provided by mainstream firms while leveraging the customized products and outreach techniques perfected by fringe lenders.

The second article, "Predatory Lending: An Overview," by James H. Carr and Lopa Kolluri, examines more closely the issue of predatory lending. It notes that predatory lending represents some of the most abusive lending behavior in the financial services community and highlights the fact that predatory lending is not a simple issue of high-cost lending. Rather, Carr and Kolluri note that predatory lenders structure loans to force borrowers to default for the express purpose of extracting the equity homeowners have accumulated in their properties. But the article also notes that steering households to high-cost subprime loans on the basis of race/ethnicity or other personal characteristics is also a predatory practice that should be considered in the context of debates on predatory lending. A three-part definition for predatory lending is offered to explain how lenders utilize a variety of otherwise legitimate marketing techniques and loan terms to create fraudulent and financially destructive loans. The article concludes with a series of recommendations to directly address predatory lending.

Carr and Kolluri note that because predatory lending thrives in an environment where competition for financial services is limited or lacking, effectively eliminating predatory lending requires the same three-pronged approach recommended by Carr and Schuetz to enhance the efficiency of financial services generally in distressed communities. Carr and Kolluri further point out that as few as five to seven practices constitute the bulk of the most egregious predatory lending behavior and meaningfully addressing those practices would greatly reduce the most blatant forms of predatory lending.

Financial Services in Distressed Communities: Framing the Issue, Finding Solutions*

James H. Carr
Senior Vice President,
Fannie Mae Foundation

Jenny Schuetz
Fannie Mae Foundation Research Intern and
Master of City Planning Candidate, Massachusetts Institute of Technology

Introduction

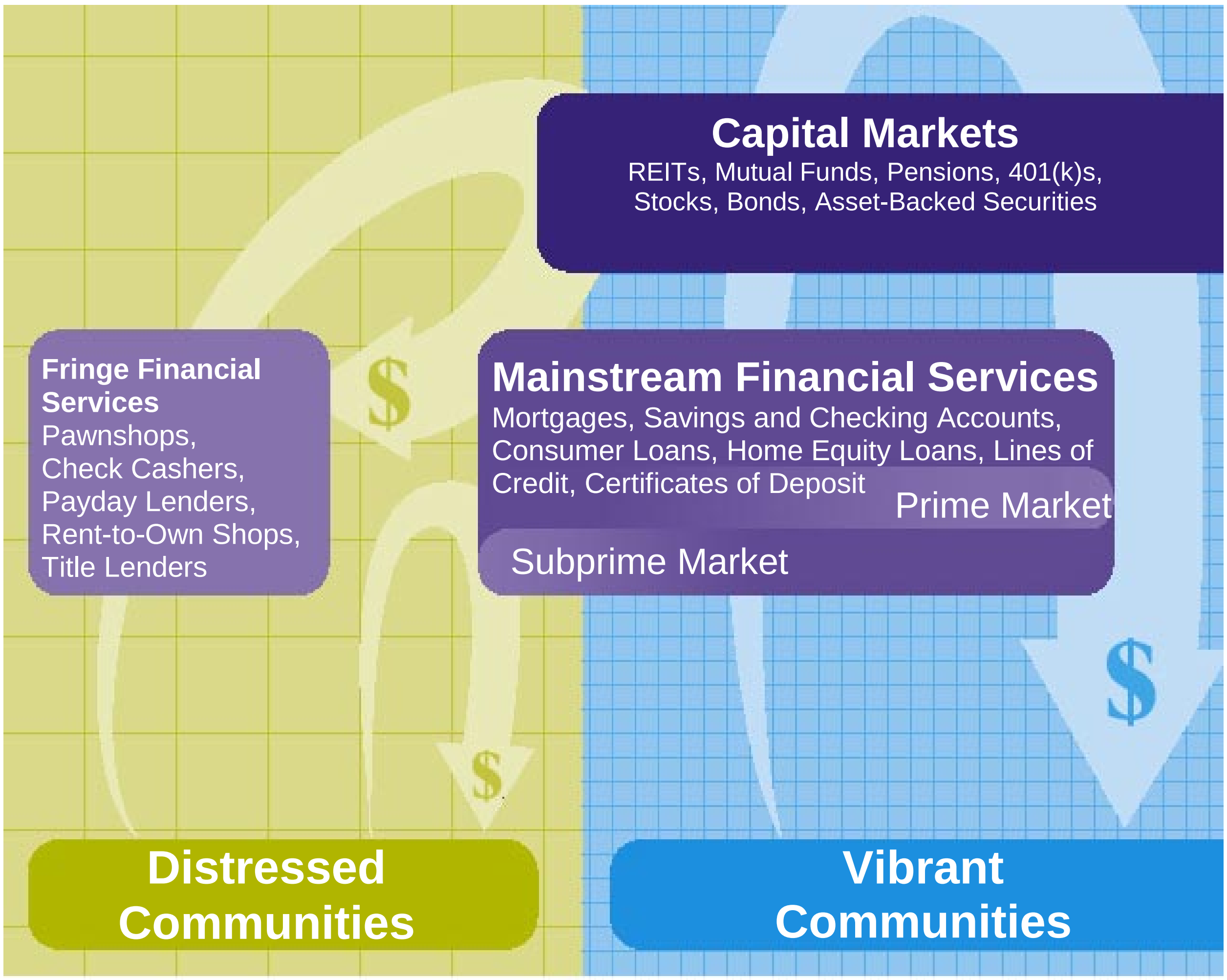
The American financial system is arguably the most sophisticated and efficient in the world. The power of the U.S. financial system comes from the complexity of financial intermediaries that include commercial banks, savings institutions, mortgage banks, investment banks, securities firms, insurance companies, specialized credit intermediaries, and a variety of specialized government and government-sponsored financial institutions.

But this sophisticated financial services infrastructure differs markedly from the world of finance in lower-income and minority communities (see figure 1, Bifurcated U.S. Financial System). There, the language of finance is increasingly pawnshops, check-cashing outlets, payday lenders, and rent-to-own stores. Largely unregulated in many states, the business practices of these financial services outlets differ greatly from the asset-building and wealth-creation services accessed by the majority of Americans.

Further, excessive subprime, as well as predatory, lending tend to flourish in communities saturated with check cashers, pawnshops, and related financial services outlets. Creating greater efficiency in, and competition for, financial services in distressed communities is the key to enabling lower-income and minority residents to maximize their asset-building capabilities and limit the negative influence of excessive high-cost and predatory financial services providers.

This article discusses the recent rapid growth of the alternative or fringe financial sector and highlights how its high-cost fee structure greatly undermines the ability of individual households to accumulate assets and build wealth. The article further notes that, to the extent that fringe financial services providers concentrate in, and are the primary financial services providers for, distressed lower-income and particularly minority communities, the neighborhoods in which they locate are also seriously disadvantaged. The article concludes with a series of recommendations to promote efficient financial markets in lower-income and minority communities. A companion article focuses explicitly on predatory lending (see “Predatory Lending: An Overview”).

Figure 1. **Bifurcated U.S. Financial System**



Financial Services in Distressed Communities

As many as 12 million households in the United States either have no relationship with traditional financial institutions or depend on fringe lenders for financial services. These households are disproportionately poor and minority. Among lower-income families surveyed in a 1995 Federal Reserve Survey of Consumer Finances, 25 percent were unbanked, as well as one-third of African-American households and 29 percent of Hispanic households. Without banks, these households operate largely in a cash economy or resort to fringe banking services that routinely charge significantly higher fees for services than those assessed by mainstream financial institutions. The situation is particularly daunting for African-American households, 60 percent of which have zero or negative net financial assets, according to a report by the Corporation for Enterprise Development.

Lack of physical proximity to mainstream financial institutions is perhaps the most frequently cited reason for the disparity in financial services utilization by low-income and minority populations compared with wealthier households. A 1999 *Harvard Business Review* article, for example, cites extreme disparity in financial services options available to residents of two neighborhoods in Los Angeles—one in South Central and the other in Pacific Palisades. South Central has one depository institution for every 36,000 people, while Pacific Palisades has one for every 1,250 people.

Yet while physical proximity is important, it is not the only—and often not the most significant—barrier to the use of mainstream financial services among lower-income and minority households. There are a variety of complex reasons why many lower-income and minority households do not use traditional financial services even when they have access. Those reasons include unfamiliarity with banking and savings services, a belief by consumers that they do not write enough checks to justify an account, and lack of trust of the mainstream financial services providers. In addition, mainstream financial services can also be very expensive for households that do not have a relationship with those institutions, when customers cannot fulfill minimum balance requirements, or when poor management of an account results in bounced-check or related fees.

In fact, fringe lenders attribute their rapid growth to large, unmet consumer financial services needs among many lower-income households. According to the Financial Service Centers of America (FiSCA) (formerly the National Check Cashers Association) alternative sources of credit are filling an important credit gap for “individuals with limited financial means or who may lack the tangible assets to pledge in connection with traditional types of collateralized transactions…” FiSCA further asserts that alternative financial services providers are in higher demand than banks or credit unions in many markets because they provide a wider range of services and more flexible hours of operation tailored to meet the unique needs of their clients.

There is little debate that fringe lenders provide critical services to customers whose extremely low or unreliable incomes, limited tangible assets, or inability to manage credit make them unlikely candidates for mainstream financial services. But the explosive growth of these financial services storefronts over the past decade raises many critical policy issues. First, because fringe lenders do not provide savings accounts, households that rely exclusively on them lack both the incentive and option to save. Second, the heavy concentration of fringe lenders in minority communities means that those areas are disproportionately burdened with second-class financial services options. Finally, reliance on fringe lenders, even to the extent they provide needed financial services, routinely comes at a very high cost.

Consider these examples for check cashers, payday lenders, pawnshops, auto title lenders, and various other fringe financial activity:

- Check cashers—Although the average fee at a check cashing outlet for a government or payroll check ranges from 1.5 to 3 percent of its face value, fees can run as high as 20 percent for personal checks. At least 19 states regulate some aspects of check cashing services.

- Payday lenders—institutions that offer small consumer loans of $100 to $300—routinely charge 15 percent per two-week period. In addition to annualized interest rates of more than 400 percent, such loans encourage households to spend the next paycheck before it arrives, thus encouraging a dangerous cycle that can trap a household in permanent debt.

- Pawnshops offer small, short-term loans using personal items as collateral. State-imposed interest rates are capped as high as 25 percent monthly, which, annualized, can exceed 300 percent. Loopholes in some states allow “lease back” or “roll over” agreements that add fees, sometimes doubling the already high interest rate.

- The rent-to-own industry offers purchasing credit to consumers for a variety of merchandise, such as furniture and home electronics, for weekly or monthly payments that can be applied toward ownership. Leased items are typically priced at two to three times the standard retail amount. No equity builds up in the leased items until the final payment. According to a Federal Trade Commission survey, 60 to 70 percent of customers who initiate leases eventually purchase the items. The Association of Progressive Rental Organizations estimates that the percentage of customers who complete a purchase is less than 25 percent.

- Auto title lending is a variation on traditional pawnbroking. A person with clear title to a vehicle can borrow money from a lender by giving him or her power of attorney to transfer the title should the borrower default. Title loans are typically made for about 25 percent of the car’s value. Interest rates and other service charges vary between 2.5 and 25 percent per month, depending on a state’s pawnshop laws. Title loans are particularly dangerous for working families because defaults can result in the loss of the car and, consequently, the job, if there is no other way to get to work.

- Robert Manning in his book, *Credit Card Nation*, also describes direct marketing campaigns for high-interest “secured” credit cards that are marketed to customers who likely would not qualify for a standard-rate bank-issued credit card. In one example, he cites an offer for a $400 line of credit for which, in return for applying for the credit card, an unsuspecting consumer agrees to pay a variety of fees totaling $369. Such “offers” may be widely distributed, but the people most likely to accept the offer are the most financially vulnerable populations with the least financial sophistication and the fewest credit options.

Compensating for Risk

While the fees charged by fringe lenders are justified on the basis of the perceived high risk of their borrowers, most of these financial services providers have devised creative ways to reduce or protect themselves against borrower default on top of the high fees they charge. Payday lenders, for example, not only require proof of employment, income, and a personal checking account, but the borrower also must provide a postdated personal check. The rent-to-own industry allows no equity to be built up until the final payment, so a customer may meet all weekly payments and default near or at the end of the loan term, losing the item plus all previous cash payments. The retailer can then re-lease the item at the same weekly or monthly rate. Pawnshops provide cash loans in return for collateral left in the possession of the pawnbroker. And “cash leasing,” a cross between payday loans and pawn loans, involves small, short-term cash advances that carry monthly interest charges of up to 30 percent, backed by an active checking account and “pledged” household items, such as a stereo, computer, or television. Some states are better than others in affording consumer protections in these types of transactions.

In fact, Progressive Policy Institute analyst Anne Kim notes that the two largest check-cashing companies in the United States cashed roughly $6.5 billion in checks last year. According to Kim, the majority of those checks were payroll or government benefit payments. The value of bad checks—that is, the checks for which the check cashers could not collect—totaled less than one-fourth of one percent of the total amount of checks cashed. The nation’s two largest check cashers thus realized healthy profits charging on average 2.2 and 3.5 percent, respectively, of the face amount of the checks they cleared.

The Problem Is Growing

As table 1 illustrates, alternative financial services activity is big business. Fringe services engage in at least 280 million transactions each year for gross revenues of more than $168 billion that extract fees of at least $5.5 billion. According to Norman D’Amours, former chairman of the National Credit Union Administration, the number of unregulated and unlicensed financial services providers is growing nationwide, but the increase is exponential in low- and moderate-income and minority communities.

He notes that while the number of credit unions, banks, and thrifts has been steadily decreasing over the past five years in the United States, the number of check-cashing outlets has doubled. An April 2000 report by Dove Consulting for the U.S. Department of the Treasury reveals that about 11,000 check-cashing outlets in the United States cash more than 180 million checks annually, worth roughly $60 billion. D’Amours also estimates that there are between 12,000 and 14,000 pawnshops across the country, outnumbering credit unions and banks. Further, in 1996 there were 8,000 rent-to-own stores that served 3 million customers, according to a recent Federal Trade Commission survey. And in *Savings for the Poor*, Dr. Michael Stegman of the University of North Carolina, Chapel Hill, reported that payday lending grew nationally from 300 stores seven years ago to more than 8,000 in 1999.

Table 1. **Fringe Lending Is Real Money: Estimated Annual Transactions**

Service	Fee/Rate per Transaction	Volume of Transactions	Gross Revenues	Fee Total
Check Cashing	2–3 % payroll and government checks (can exceed 15% for personal)	180 million	$60 billion	$1.5 billion
Payday Loans	15–17% per 2 weeks 400% APR	55–69 million	$10–13.8 billion	$1.6–2.2 billion
Pawnshops	1.5–25% monthly 30-300% APR	42 million	$3.3 billion	N/A
Rent-to-Own	2–3 times retail	3 million	$4.7 billion	$2.35 billion
Auto Title Lenders	1.5–25% monthly 30–300% APR	N/A	N/A	N/A
Total	**N/A**	**280 million**	**$78 billion**	**$5.45 billion**

It Undermines Households and Communities

Even at the most modest levels, alternative financial services fees can greatly undermine the asset-building capacity of lower-income households. According to research cited by the Federal Reserve, fringe services for cash conversion and bill paying would cost an average $20,000-income household between $86 and $500 per year, while the same services at a bank would cost only $30 to $60 (assuming that low-cost banking services are available and the prospective customer is not disqualified for an account by lack of credit). Yet, $500 per year saved for a period of 10 years at a modest interest rate of only 4 percent would grow to more than $6,000. That amount would be sufficient for a down payment on a modestly priced home.

Moreover, the actual costs to many households using fringe banking would be even higher if those same households also resort to payday loans, pawnshops, rent-to-own retail, or auto title pawn loans. An example Manning offers in *Credit Card Nation* is of a $196 Magnavox TV that costs $9.99 a week for 78 weeks from a rent-to-own shop, for a total of $779. Compare it to buying the same television with a credit card at 22.8 percent interest from a national discount electronics store over the same time period for a total of $231. The difference in finance charge would be $548. Assuming a household relied on fringe lenders for only an additional $300 worth of services per year, the new total of $800 of potential savings would grow to nearly $10,000 over a 10-year period, again assuming a modest 4 percent rate of return.

Even if these households actually were able to save some of their earnings, their failure to access mainstream financial services institutions undermines their long-term asset accumulation. To illustrate, table 2 calculates the different investment vehicles. If, in 1989, a family had $3,000 in savings, but saved the money in a shoebox, 10 years later that $3,000 would be still be worth $3,000 in nominal dollars but only $2,233 when adjusted for inflation. However, the same sum invested in a 10-year Treasury note would have grown to more than $5,000 by 1999. Investment in an S&P index fund would have yielded $9,180 over that 10-year period. And if the family had, by prophetic insight, invested their savings in Microsoft Corporation in 1990, their wealth could have grown to a staggering $211,360 by 1999.

Table 2. **The Value of Saving $3,000***

Year	Shoebox	Treasury Note	S&P 500 Index Fund	Microsoft Stock
1989	$3,000	$3,000	$3,000	$3,000
1999	$3,000	$5,072	$9,180	$211,360

* In nominal dollars.

Excessive Subprime Home Mortgage Lending

As with fringe lending, subprime mortgage lending has also experienced tremendous growth in recent years. A recent U.S. Department of Housing and Urban Development (HUD) study indicates that between 1993 and 1998, the dollar volume of subprime loans grew sevenfold, from $20 billion to $150 billion, and the number of subprime refinance loans grew tenfold, from 80,000 loans to 790,000 loans. This growth in subprime lending compares to less than a 40 percent increase in prime lending for home purchases and a 2.5 percent increase in prime refinance loans.

HUD reports that subprime loans are heavily concentrated in lower-income and minority communities—the same communities that are the target for fringe financial outlets. HUD’s analysis indicates that subprime loans are three times more prevalent in lower-income neighborhoods than in high-income areas, and five times more likely in black communities than in white neighborhoods. In fact, in black neighborhoods, high-cost subprime loans accounted for 51 percent of home loans in 1998, compared with 9 percent in white areas. Moreover, homeowners in high-income black communities are six times as likely to have a subprime loan as homeowners in high-income white neighborhoods. Estimates by Fannie Mae, Freddie Mac, and others conclude that many households in the subprime market could reasonably qualify for a prime market loan (see article on Predatory Lending in this report).

The Financial Impact of Excessive Subprime Lending

Subprime loans do not have to be predatory to seriously undermine the financial viability of households. Targeting or referring households to the subprime market in instances in which those loan applicants could reasonably have qualified for prime market loans greatly undermines the long-term asset-building potential of those households. Each additional interest point on a home mortgage totals tens of thousands of dollars on the total cost of a mortgage over the life of the loan. Subprime mortgages are routinely 3 to 4 percentage points or more higher than a comparable prime market loan. Yet, a mere 1 percentage point of additional interest can make a substantial financial impact over the life of a loan (see table 3).

Table 3. **Comparing Mortgage Payments for Different Interest Rates**

30-Year Fixed-Rate Loan				
	House Value	**$85,000**		
	Down Payment	**$4,250 (5%)**		
	Loan Amount	**$80,750**		
Annual Interest Rate	**Monthly Payment**	**Annual Payment**	**Annual Difference from 8%**	**Lifetime Difference from 8%**
8%	592.51	7,110.18	N/A	N/A
9%	649.73	7,796.79	686.61	20,598.43
10%	708.64	8,503.67	1,393.49	41,804.69
11%	769.00	9,228.01	2,117.83	63,535.05
12%	830.60	9,967.26	2,857.08	85,712.32

Take the example of a home modestly priced at $85,000. Assuming a 5 percent down payment, the mortgage is slightly under $81,000. With a base interest rate of 8 percent on a 30-year loan, a loan 1 percentage point higher results in $687 more annually. Over the lifetime of this 9 percent loan, it would be a $21,000 difference. At 2 percentage points—a 10 percent interest rate—the difference from a prime loan of 8 percent would be $42,000, half the original loan amount. Now, take that same $687 a household could save each year by shaving off a percentage point on their mortgage and invest it at 6 percent. At the end of 30 years, that household would have $57,572 instead of having to pay $21,000 in additional interest. The 2-percentage-points savings of $1,393 per year, invested at 6 percent, would total $116,736 at the end of 30 years for the household. And if the subprime loan carried a 12 percent interest rate, the extra interest payment over the base 8 percent loan would be $85,712 over the life of the loan. Invested at 6 percent for 30 years, that $85,712 of additional payments would grow to $239,421 in savings over a 30-year period.

Reasons for Rapid Growth

Three trends in recent years appear to have strengthened the alternative financial services sector: 1) increasing consolidation into large, publicly held firms with standardized business outlets across the nation, 2) increasing involvement by mainstream financial institutions in fringe lending outlets, and 3) enhanced products and services and effective marketing schemes to capitalize on rising consumer debt and the disconnect between low-income households and the mainstream financial system.

Industry Restructuring

Restructuring within both the mainstream and fringe financial services industries are contributing to the growing significance of fringe financial storefronts in disenfranchised communities. Michael Stegman cites consolidation in the banking industry as one reason for the decline in the presence of traditional banks in neighborhoods of all income levels. In *Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor*, John Caskey suggests that banking deregulation and pressure for increased profits have led banks to charge for previously free services and close unprofitable branches (often in low-income and minority areas) as well as eliminate money-losing services, such as small-balance deposit accounts.

Over the same period, several fringe financial outlets, such as pawnshops, check cashers, and payday lenders, have engaged in major consolidations. In the check-cashing industry, for example, six firms owned at least 50 outlets each in 1991. By 1999, one of the largest of these establishments had grown to more than 1,000 company-owned stores with franchises in 30 states. Further, this company has expanded its traditional in-store check-cashing business to include bill payment services as well as automated check cashing using advanced function ATMs with user-friendly touch screen menus.

Pawnshops, too, have grown into national chains. Data from *Fringe Banking* report the existence of at least five large, publicly traded nationwide pawnbroking firms. The largest of these chains went public in 1987, and by 1999 had acquired 414 stores in the United States. The rent-to-own industry has shown similar trends of consolidation. The largest firm was founded in 1986, and by 1999 owned 2,300 stores across the nation, or roughly one-fourth of all rent-to-own stores.

Convergence of Fringe and Mainstream Lenders

Wall Street has also fueled the growth in fringe and subprime activity. A recent *Business Week* article notes, for example, that through securitization—that is, the practice of issuing securities based on a pool of mortgages that can be sold to investors—leading Wall Street firms resold $60 billion of subprime mortgage loans in 1999, up from $3 billion in 1995. Between 1995 and 1998, subprime loan note sales rose from $10 billion to $87 billion. Banks now control 5 of the nation's top 10 subprime lenders and 10 of the top 25 subprime lenders.

Effective Marketing and Customized Services

While many low-income households exhibit reluctance to use traditional banks, fringe financial services providers have well-developed marketing strategies to draw in and retain customers by focusing on the relationship between customers and staff. Pawnshops and rent-to-own stores emphasize treating customers with personal attention and encourage small weekly payments made in person, allowing the retailer to market additional products to existing customers. These types of businesses rely heavily on repeat customers, which they cite as a means of increasing transactions while reducing risk, as Caskey reports in *Lower Income Americans, Higher Cost Financial Services.*

Role of Financial Markets in Community Reinvestment

Creating efficient markets in distressed communities is essential to successful revitalization of those areas. Stated otherwise, building community wealth requires the building of individual wealth. Mainstream financial institutions are the engines of wealth creation and upward financial mobility in America. Improving access to, and utilization of, the mainstream engines of wealth creation would by itself promote significant community investment.

Each dollar that is spent on overpriced financial services by a lower-income household represents potentially important savings that could lead to wealth building. For example, the more than $5.45 billion in fringe financial services fees that are collected from financially vulnerable consumers each year is slightly less than the entire asset base of the more than 460 community development financial institutions (CDFIs) operating in the United States. It is also moderately less than the fiscal year 2000 HUD budget for Community Development Block Grants plus all HOPE VI and Empowerment Zone/Enterprise Community funding.

Moreover, the fees represent an annual funding stream. If only a portion, perhaps 20 percent, of those dollars lost each year to fringe financial services could be captured and redirected to housing, that would represent more than $1 billion for home-buyer assistance or housing rehabilitation in many of the most distressed communities in the nation. And, that funding stream would not require any additional taxpayer contributions. Add to that sum the hundreds of millions of dollars unnecessarily paid each year, by households unfairly and unnecessarily steered into high-cost subprime loans, and it is immediately clear how better organizing the financial markets in distressed communities and connecting households to the engines of wealth creation can provide a major boost to the community revitalization process.

Flowing to a broader range of consumer goods and services, that money could encourage the opening of new business based on market demand for locally desired products or services. Helping to create wealth could reduce the need for complex tax-related government subsidies that encourage businesses to relocate to distressed communities that have no economic rationale for being there other than to benefit from untargeted and questionable tax subsidies. If channeled into savings, money lost to check cashers and similar high-cost services could offer financial institutions and community residents enormous wealth-generating potential.

Fixing the Problem

Enhancing financial services options for lower-income and minority households and communities will require action in three areas:

1. Improving the availability of data on financial services transactions and aggressively enforcing fair lending, equal credit opportunity, and consumer protection laws and regulations.

2. Enhancing availability of products and services designed to meet the unique needs of lower-income and lower-wealth customers.

3. Offering consumer financial education and outreach programs.

Collecting Additional Data and Enforcing Laws

An important missing tool to address the issue of market failure in distressed communities is a robust set of data that could more easily enable policy makers, regulatory agency personnel, researchers, nonprofit community activists, and other interested parties to pinpoint critical areas and issues for examination and possible action. Enhancing data collection is always controversial. But it is simply not possible to resolve a problem that cannot be identified and examined. When the federal government first sought to include borrower race/ethnicity information in the Home Mortgage Disclosure Act database, many argued that added information would be useless because it would answer only *who* was accepted or rejected for mortgage credit but not *why*. Yet that data exposed major and critical areas for concern throughout the mortgage lending industry related to lending to traditionally underserved borrower groups. The net result has been explosive growth in affordable lending to lower-income and minority households over the past decade.

Because alternative financial services providers are regulated at the state level, with widely varying regulatory oversight, a single national reporting requirement could greatly enhance the ability of regulators, community groups, and research institutions to examine the practices of these firms. Data elements might include fee schedules, collateral requirements, number of customers served, and revenue and earnings statements.

The goal of greater regulation with respect to fringe lenders should not be to eliminate those sources of credit. In moderation, they provide important access to credit for a variety of consumers. Rather, enhanced regulation should ensure that to the extent those services are provided, they are offered at costs that more reasonably reflect the real risks presented by consumers. Interest rates, for example, that when annualized can exceed 300 percent or more, are hard to justify under any circumstance. Further, the targeting of high-cost financial services on the basis of personal characteristics such as race or ethnicity, rather than on the basis of income or creditworthiness, should be closely monitored and effectively addressed.

For subprime loans, additional information might include key loan terms such as the inclusion of credit life insurance, balloon payments, prepayment penalties, and related major loan characteristics. Further, interest rates, points, processing fees, and closing costs would also be critical. This data could highlight areas for further investigation and allow for a more aggressive enforcement of fair housing, equal credit opportunity, and a variety of consumer protection laws.

To the greatest extent possible, reporting requirements for similar financial transactions should be the same for the greatest number of institutions possible. Dissimilar reporting requirements across institutions that perform similar services create opportunities for abuse by institutions that are not covered. At the same time, institutions that are covered may be discouraged from attempting to enter emerging markets with new or innovative products. Further, because data collection can be very costly, care should be taken to ensure that any new reporting requirements do not overwhelm financial institutions with requests for insignificant and extraneous information.

Further, an explicit focus on how equal credit opportunity and consumer protection laws are violated in distressed communities would provide financially vulnerable households with the kind of support offered to middle-income and wealthy households in vibrant communities. Each year, millions of dollars are spent on financial system regulation through agencies such as the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Department of the Treasury, and Federal Reserve System, to name a few. But federal institutions can do relatively little to protect the financial interests of households operating in a cash economy or relying on fringe financial services providers whose activities are not covered by those key federal financial regulators.

Enhancing Products to Serve Lower-Income Households

Efforts to promote a wider range of financial products and services for low-income and minority households can be divided into three categories: 1) efforts to connect households receiving government benefits to low-cost access to those funds through electronic transfer accounts (ETAs) and related initiatives; 2) enhanced utilization of technology, such as sophisticated ATMs and the Internet; and 3) innovative products and partnerships designed to meet the unique needs of lower-income, lower-wealth households.

Government Initiatives. The Debt Collection and Improvement Act of 1996 is one of several promising initiatives launched by the federal government to decrease processing costs, reduce fraud, and provide a lower-cost alternative for benefit recipients than sending them paper checks that must be cashed, usually for a fee. The law mandated that, by 1999, all federal benefit payments would be delivered electronically—a measure that is expected to save the federal government an estimated $100 million annually on processing and delivering payments. Since the legislation went into effect, Congress has mandated that states convert food stamp programs to electronic payment by 2002, using point-of-sale (POS) terminals at participating retailers. Additionally, more than 40 states have voluntarily decided to add their emergency cash assistance programs to the plastic food stamp cards so that welfare benefits will be accessible at ATMs and POS networks.

These laws create even more opportunities to link low-income families and people living in underserved areas to banks and other savings institutions. Michael Stegman, in his forthcoming article, “Banking the Unbanked,” says the electronic delivery of government benefits “promotes financial inclusion” and recognizes that “economic opportunity cannot thrive where access is denied.” In fact, an estimated 3 million of the roughly 12 million unbanked individuals in the United States receive federal government benefits—a large market that has gone largely untapped.

Expanding Use of Technology. A Ford Foundation white paper, “Financial Technology and the Lower-Income Consumer” by Steve Davidson et al., notes that new types of ATM and card-based technology have the potential for “turning the unbanked to the self-banked” while lowering costs and increasing access and convenience to financial services and products. The report provides several examples: Umbrella Bank in Illinois plans to put ATM-equipped kiosks in lower-income housing developments; FirstTel is gearing up for similar services in HUD housing in Florida; and Banco Popular offers an all-electronic account to customers without a traditional bank account.

Similar to the federal government’s ETAs is a U.S. Treasury Department pilot initiative that uses ATMs to limit the reliance on fringe lenders and check cashers in traditionally underserved markets. Treasury is piloting a program to put ATMs in post offices to distribute Social Security payments, federal retirement payments, and other government benefits. Consumers use a debit card or credit card to access their benefits with no extra fees. The ATMs would provide safe and convenient access to banking services in traditionally underserved areas. The project, in partnership with the U.S. Postal Service and Key Bank of Cleveland, which owns and operates the ATMs, is testing the use of the free-of-charge ATMs at three urban locations in Baltimore and three rural locations outside Tallahassee, Florida.

Efforts to lower the cost of banking by using technologial advances should be encouraged among the private sector as well, since an estimated half of the country’s private sector employees do not participate in direct deposit. Comptroller of the Currency John D. Hawke Jr. recently told the National Community Reinvestment Coalition that expanding the structure of the direct deposit account to make it more appealing to the unbanked is critical to bringing them into the mainstream banking system. Creating these connections—and adding functions such as transfer of funds to other countries at a lower cost than wire transfer fees—can create links between banks and lower-income residents.

Innovative Products and Services. Mainstream financial services providers can learn from the considerable finesse demonstrated by alternative financial services providers in marketing, packaging, and bundling services. One example is bundling services such as check cashing, money orders, money wiring, utility and cable bill payment, and related services (see the summary of John Caskey's proposed solution following this article). Mainstream financial institutions can take a lesson from and form partnerships with fringe service providers, creating efficient operating structures that lower costs and then pass along savings to clients.

Innovative programs that have recently been introduced or are being test-marketed by institutions such as community development credit unions (CDCUs) and CDFIs should be encouraged and expanded. Woodstock Institute's *Reinvestment Alert No. 16* provides two examples of CDCUs that are offering alternative payday loan products to counter the often-excessive fees charged by fringe payday lenders. The Faith Community United Credit Union in Cleveland and the Louisiana-based ASI Federal Credit Union offer affordable alternatives to their members, and their experiences can show how other mainstream credit unions and financial services providers can establish similar consumer loan products. Both offer interest rates of 17 to 18 percent, with $15 to $30 processing fees and timely repayment requirements. Credit counseling is offered with the service, and a savings plan can be integrated into the loan.

Davidson et al. also provide examples of how some mainstream financial services providers are expanding their reach to lower-income consumers by lowering the cost of those services to help "transition" these customers to mainstream markets. Union Bank of California has created a division called Cash & Save that offers check-cashing services at a lower-than-average 1.0 percent to 1.5 percent fee on payroll checks issued by area employers. Customers are permitted to open Union Bank savings accounts at Cash & Save outlets. Another company, Directo Inc., is serving lower-income customers—many of whom were denied bank accounts—with a payroll debit card, allowing employees to access their pay electronically through an ATM. Directo also has an innovative wire service/ATM feature that enables customers to wire money to foreign bank accounts that can then be accessed through an ATM. The fees are much lower than those for most wire services.

New partnerships between fringe lenders and mainstream financial services providers can also prove to be highly beneficial to residents of distressed communities and the financial institutions that serve them. By moving away from an exploitative model and toward a model that lays the foundation for a long-term, mutually beneficial relationship, mainstream financial institutions can help to build the assets of lower-income consumers that can lead to more valuable and substantial relationships over time.

In *Banking the Unbanked,* Stegman cites the Chicago Community Reinvestment Act Coalition and Bank One as an example of this type of partnership. The organizations teamed up to increase lending, service, and investments in lower-income communities in the Chicago region. They are also piloting a program to promote deposit services to unbanked customers. This pilot, the "Alternative Banking Program," offers a safe, convenient, and inexpensive alternative to check-cashing services and conducts financial literacy workshops to demonstrate the cost savings of using alternatives to check cashers.

The incentive to reform the financial services environment characterized by high-cost and inefficient financial services providers is compelling for policy experts interested in helping to promote the building of wealth among lower-income and minority households. The extraordinary sums of money involved in excessive fringe and subprime lending clearly demonstrate the fact that there is substantial potential for lower- and moderate-income households to build their financial assets. Further, recent research by Hogarth and O'Donnell in the *Journal of Consumer Policy* shows that when low- to moderate-income households are brought into institutions with a transaction account, there is a high probability of moving them "in and up" into other product lines.

Improving Financial Education and Outreach

Even if there is improved enforcement of laws, it is very important to educate consumers about the types of institutions, products, and services they should use, and ones they should avoid. Many lower-income households have limited financial savvy and do not know the most basic aspects of household budgeting. Well-conceived, -designed, and -delivered consumer education programs can be instrumental in helping households more effectively mange their finances.

In addition, consumers need to know how to identify potentially fraudulent or otherwise questionable lenders. They need to know, for example, that when they see ads that read: "No credit, no job, no problem," they should respond with "No thanks!" Financially vulnerable households need help understanding that substantial wealth can be built from relatively small amounts of money. They need support to best understand how to properly and effectively evaluate the financial services options available to them and how to select the options that best meet their needs.

Having said that, caution needs to be exercised with respect to our expectations on the ability of financial education to aid borrowers facing predatory lenders. Households with limited education are little match for sophisticated criminals intent on defrauding a household of their wealth. Loan documents are challenging and complex even for borrowers with masters degrees in business.

Mortgage loan contracts can involve 30 or more separate documents written in the legal prose and not intended to be understood by a lay person. Expecting a poorly educated borrower to defend himself or herself in this type of situation is unrealistic. For borrower education to be most effective, it will need to include education prior to selecting a lender as well as third party review at the time of closing.

Conclusion

Improving the financial services environment for lower-income and minority households is imperative to enabling them to fully benefit from the wealth-building opportunities available to most Americans. With regard specifically to minority households, it is useful to keep in mind that discrimination has played a significant role in creating many of the distressed markets heavily populated by fringe, excessive subprime, and predatory lenders—and that for many years government policies directly supported and even enforced many of the most discriminatory actions. As a result of that history, government has an important role to play in helping eliminate the legacies of those discriminatory actions. Principal among them are the inefficient markets in distressed communities. Improving the markets can be accomplished by supporting financial institutions to reposition themselves to be more effective in meeting the financial services needs of residents of underserved communities.

Rather than acting solely as a policeman—enforcing laws and penalizing institutions that fail to perform—government should work with financial institutions to provide them with the flexibility to test programs or with the funding to pilot innovative financial services approaches that are too expensive for private financial institutions to pursue on their own.

The federal government is constantly engaged in the credit markets to ensure the efficient functioning of those markets as they pertain to middle- and upper-income households. In fact, even today, most households benefit from a substantial infrastructure of government agencies that work to perfect the operation of market mechanisms to ensure the most efficient delivery of financial services possible. But because most of the financial institutions supported or regulated by this infrastructure do not directly serve unbanked households, this elaborate infrastructure does little to promote the financial well-being of the residents of distressed communities.

Greater information and enforcement of relevant laws, combined with increased financial sophistication on the part of consumers, could go a long way toward eliminating in the near term some of the most egregious and abusive financial services practices in struggling, lower-income and minority communities. By combining the private market's innovation with publicly supported initiatives to understand and address market failure, the full range of financial services that serve the majority of Americans can be made accessible in all communities.

Strengthening Financial Services

Five Key Elements in Bridging the Banking Gap[1]

In a paper recently presented at a Federal Reserve System conference on *Changing Financial Markets and Community Development*, John P. Caskey outlined a five-point strategy to bring into the financial mainstream the "unbanked" who, without any type of deposit account, are typically customers of check-cashing outlets (CCOs). He suggests that specially bundled financial programs would help this population build savings and improve credit-risk profiles, qualifying them for lower-cost services and eliminating a common source of stress.

1. Open specialized bank branch "outlets" that provide CCO services.

Banks could provide a range of financial services to unbanked communities by creating bank "outlets" for check cashing. By locating in places convenient to large numbers of low- and moderate-income households that tend to use CCOs, these outlets could initiate banking relationships and build trust among the unbanked. Additional products and services that could be offered include money orders, stamps and envelopes, international and domestic cash wire transfers, phone cards, bus tokens and transit passes, and payment of utility and phone bills. By charging lower fees for check-cashing services than CCOs and offering discounted rates for frequent customers, bank outlets could encourage repeat business, enabling many to "graduate" to banks. The outlets could also work with customers to build savings and address credit problems.

2. Offer "starter" bank accounts with low minimum-balance requirements that cannot be overdrawn, and include access to low-cost money orders for making long-distance payments.

To encourage the unbanked to become traditional bank customers, their accounts could be tailored to their unique situations. Low-cost, low–minimum balance checking and savings accounts could be offered with nontraditional features, such as discounted money orders, stamped envelopes, convenient processing of utility bills, and electronic deposit of wages and government transfers. By blocking the account from being overdrawn, CCO customers can avoid the high costs of bouncing checks that might have dissuaded them from having traditional accounts. ATM and debit-card access could also be given, along with the service of making long-distance payments.

3. *Create accounts specifically designed to build savings.*

"Savings-building" accounts that allow individuals to pledge to save a fixed amount in small increments over a specified time period, usually a year, could also assist the unbanked. Contributions would coincide with receipt of regular income such as a paycheck and, if possible, would be automatically debited. Caskey suggests separating these accounts from a regular checking or savings account to keep a psychological distinction between the two. He also

[1] Material in this section © John P. Caskey. Used with permission.

suggests imposing a penalty for early closure of the account and for failure to make specified deposits at regular intervals.

4. *Offer deposit-secured emergency loans to individuals whose credit histories make them ineligible for traditional mainstream credit.*

With credit-scoring and other cost-saving technologies, bank outlets could find it more feasible to make unsecured non-revolving loans of less than $1,000 to customers with good credit records. This would allow them to compete with payday lenders and pawnbrokers to offer smaller loans often not practical at larger banks because of high risk factors and administrative costs. For customers with impaired credit histories, outlets could offer deposit-secured credit cards, or loans made against the balance of a savings-building account. In addition, outlets could partner with community-based organizations (CBOs) to establish philanthropic deposit accounts to provide collateral for loans to lower-income households without financial savings.

5. Seek community-based partners and offer financial literacy programs.

Banks can benefit in many ways by forming partnerships with carefully chosen nonprofit CBOs. A well-connected CBO can help overcome distrust between community residents and banks. Also, CBOs benefit from increased financial services in the neighborhood, and can initiate and promote financial literacy initiatives.

Caskey also offered two case studies of these strategies:

“Cash & Save” Outlets of Union Bank of California

Union Bank of California began opening “Cash & Save” outlets in 1993 in Los Angeles and San Diego offering check-cashing and banking services. By 2000, there were 12 stores, the most successful of which were stand-alone outlets in large discount stores that catered to middle- and lower-middle-income shoppers. “Check-cashing” is prominently advertised and the hours of operation include evenings and weekends. In addition to traditional banking services, the Cash & Save outlets offer a full range of commercial check-cashing services. A first-time check-cashing customer pays a $3 fee to become a Cash & Save “member” with a digital photo, signature, and employment information on file.

To encourage repeat business, discounts are offered, including a $10 annual “Money Order Plan” that allows six “free” money orders a month and a discounted 1 percent check-cashing fee for the year. Other services include cashing of government checks and paychecks for nondepositors, originating domestic and international wire transfers, handling the payment of utility bills, selling prepaid phone cards, faxing and photocopying, and in some locations selling bus tokens and passes. Basic checking accounts have low minimum-balance requirements. Among nontraditional accounts is a deposit account similar to an Electronic Transfer Account that receives electronic deposits of government benefits payments with a passbook interest rate. Maintenance fees are waived, but all cash withdrawals carry a 1 percent fee. Cash & Save also offers two savings plans: The “Nest Egg” account requires a commitment to deposit at least $25 a month for one year after a $10 initial deposit, and the “Combo” account combines the Nest Egg account with the Money Order Plan. Cash & Save outlets formed partnerships with CBOs to offer personal financial management seminars. The CBOs host the seminars and the banks publicize them. Union Bank reports that about 40 percent of its regular check-cashing customers use at least one traditional bank product within a few years.

"Over-the-Rhine" branch of Cincinnati Central Credit Union

The Cincinnati Central Credit Union (CCCU), realizing the lack of depository financial institutions in the Over-the-Rhine neighborhood, formed a partnership with a local nonprofit organization based there called SmartMoney Community Services. SmartMoney raised the capital to acquire and equip a storefront credit union branch and then provided subsidized office space. The partnership is mutually beneficial: SmartMoney provides one-on-one financial counseling sessions and helps build trust between the community and the CCCU, and the credit union provides the community with convenient, professional depository and credit services. Services include low-cost, low–minimum balance checking and savings accounts, and a small-scale individual development account program.

The branch also sells low-cost money orders, postage stamps, envelopes, and bus passes. To provide small loans to residents with impaired credit histories, the "Smart Loan" program was designed. SmartMoney collected donations from churches and individuals to use as collateral for Smart Loans, with the maximum loan amount being $3,000. SmartMoney requires that recipients enroll in its Smart Change budget counseling course to repair credit records and build savings. CCCU reports that the branch, which is largely self-supporting, has successfully met residents' needs for convenient financial services and support.

Case Study on Neighborhood Trust Federal Credit Union

Neighborhood Trust Federal Credit Union (NTFCU) in New York City is one of the fastest-growing community development credit unions in the United States. Opened in 1997, it has accumulated $5 million in assets, about double the amount in deposits in most neighborhood credit unions, according to the *New York Times*. Based in an abandoned Chemical Bank branch in the Port Authority Terminal on Fort Washington Avenue and 178th Street, the nonprofit credit union provides services to low-income residents of the Washington Heights and West Harlem communities, where check-cashing outlets and pawnshops are on nearly every corner and predatory lenders proliferate. An estimated 70 percent of NTFCU customers have never had a bank account.

Background/Structure

The idea of creating a nonprofit organization to provide financial and educational services for community development was conceived in 1994 by New York City school teachers Mark Levine and Luis De Los Santos. Recognizing the disparities of service in the Washington Heights community, Levine, a graduate of the Kennedy School at Harvard, conducted a population survey that revealed a desperate need for affordable financial services. He enlisted friends to help him conduct research to determine how to create a community-owned and -run community credit union.

Three years later, the NTFCU was born. A daughter organization of the nonprofit Credit Where Credit is Due organization—which provides outreach, education, and training on financial management, banking services, and homeownership—NTFCU now has a staff of 12 and 3,000 members, each of whom is a shareholder.

Population Served

The two communities served by NTFCU have a total population of about 500,000 with a median household annual income of $10,000 to $12,000. In Washington Heights, 80 percent of the population is Dominican and in West Harlem it is 55 percent African American and Latino. A large proportion of the local businesses are home-based child care, beauty salons, grocery stores and convenience stores, and eateries. Most of the credit union's customers have never used mainstream financial institutions. Instead, they were typically served by pawnshops, check cashers, and predatory lenders.

Services Provided

NTFCU provides a number of financial services, including:

- Personal and business banking: Customers can open a no–minimum balance checking account with $100 and have no limit on the number of checks that can be written for a monthly service fee of $5. Savings accounts require $50 minimums. The credit union also offers ATM cards.

- Lending services in the form of personal loans, securitized credit, and mortgage lending: Personal loans ($500 to $10,000) are offered for personal needs or to start or build micro-businesses. Interest rates are higher on personal loans than for business development. Repayment periods vary by loan and borrower profiles, but generally do not exceed four years. At the time of this writing, the loan portfolio consisted of 700 loans totaling $1.9 million, with a repayment rate of 97 percent. Default rates of 3 percent are consistent with commercial banks serving higher-income populations. Securitized and partially securitized credit cards are also offered. These are basically prepaid credit cards. Mortgage lending is primarily for cooperative housing purchases, normally not exceeding $150,000. Although the majority of owner-occupied housing stock in upper Manhattan is cooperative housing, these mortgages are often viewed as risky loans for commercial banks because they are considered nontraditional.

- Education through financial literacy programs. The Credit Where Credit Is Due (CWCID) organization, the Neighborhood Trust's mother organization, conducts four different educational and outreach programs.

1. The *Personal Financial Literacy Program* focuses on developing basic accounting skills to open and use bank accounts, write checks, draft monthly budgets, save for college, and understand concepts of stock market investment. Graduates of this program can use the pro bono services of the investment company, First Investor.

2. The *Enterprise Training Program* series coaches entrepreneurs on business concepts, how to prepare business plans and budgets, access capital, handle accounting and book-keeping, and better understand the basics of business law and employee management. After completion of the eight-class series, entrepreneurs are entitled to one hour of free consultation with the CWCID education program manager, as well as free consultations with the law firm of Chadbourn and Parke.

3. The *Youth Education Program* or *School Banking* teaches local fourth and fifth graders to use banking services and to save for their futures. Participants open bank accounts and can make deposits with as little as one cent. Withdrawals require parental consent. The program operates in local schools and includes lessons in basic math as applied to banking. More than $23,000 has been saved by the 750 participants.

4. The *Home Ownership Training Program* teaches community members how to obtain a home mortgage loan, assess one's financial capacity to repay it, calculate the terms of an affordable mortgage, and assess the value of a house. Because the majority of housing in the area is cooperative housing, the program also offers specific information about what cooperatives are and about cooperative lending.

Strategies for Success

The credit union's success is attributed to its ability to fine-tune its services to community needs, and its commitment to local economic development. The survey conducted in the beginning of CWCID's project helped identify these needs. The organization is also in a constant mode of self-evaluation and regularly asks clients to fill out evaluation questionnaires. Another strength is Neighborhood Trust's sound business practices and modeling of commercial banking operations, combined with a balance between its commercial approach and nonprofit developmental agenda. Finally, successful fund raising to cover a variety of support activities has also added to the ultimate success of Neighborhood Trust.

Individual Development Accounts

Individual development accounts (IDAs) are matched savings accounts designed to help low-wealth families or individuals build assets. Participants can use the money saved through these accounts to buy a house, develop a business, or increase job skills through education and training.

Similar to other defined contribution plans, such as 401(k)s, IDAs offer a monetary incentive for participation for every dollar saved. Individuals make regular savings deposits in their IDAs that are then matched by funds from the sponsoring bank, foundation, other charitable organization, or local government.

IDA programs often include personal finance literacy counseling and training on such issues as homeownership, household budgeting, record keeping, and long-term economic planning.

Although the main goal of the program is to increase wealth, the accounts also provide opportunities for banks to attract new customers by increasing the comfort level of participants with financial institutions.

Several foundations, community organizations, elected representatives, and government officials have provided crucial support for IDA programs. Both the Corporation for Enterprise Development and the Center for Social Development at the University of Washington at St. Louis have played central roles in the implementation of a national IDA pilot demonstration, research on the effectiveness of IDAs, proliferation of federal and state IDA legislation, and the development and dissemination of program development materials. As a result, a proposed national IDA tax credit, called the Savings for Working Families Act, is expected to come before Congress for a vote this year.

The national demonstration has achieved the goal of proving that low-income and low-wealth individuals can save when given the proper incentives and educational tools. Over a three-year period, the 2,000-plus demonstration participants deposited more than $1.3 million. The success of the national demonstration has generated tremendous interest in and support for IDA programs at the federal, state, and local levels. In considering further initiatives, however, it is important to keep in mind that these early IDA initiatives have been relatively costly to set up. Services such as outreach and consumer education can be costly.

Community Development Financial Institutions

Definition, Structure, and Population Served	Mission	Strengths
Community Development Financial Institutions (CDFIs)		
CDFIs are private-sector financial intermediaries with community development as their primary mission. They are bridge institutions that link unconventional borrowers and conventional financial institutions. There are 6 basic types of CDFIs: 1) community development credit unions, 2) community development banks, 3) community development loan funds, 4) microenterprise funds, 5) community development corporation-based lenders and investors, and 6) community development venture funds. CDFIs target their efforts to distinct geographic	CDFIs bring private-sector capital to bear on problems that have historically required public sector solutions. They all have community development as their primary mission and carry out that mission by: 1) financing businesses and community facilities, job creation and development, and affordable housing in low- and moderate-income communities; 2) providing technical assistance to assist “unbankable” customers; 3) demonstrating that poor urban and rural areas can be profitable markets; 4) helping banks target their	The strength of CDFIs is their flexibility to adapt lending guidelines to the needs of borrowers; to accept unconventional collateral for loans; and to provide education, training, and assistance to potential borrowers. CDFIs attract private investment, they don't substitute for it. They rely on capital-led strategies to address

areas that are economically distressed and/or to distinct demographic populations that are underserved. Some CDFIs, for example, target their efforts to a particular urban, rural, or reservation community. Others lend to particular groups of people (minorities, women, low-income families) or offer specific types of credit products not readily available in the conventional market.	community reinvestment funding; and 5) bringing innovative and trailblazing products and services to disinvested areas. CDFIs make possible loans and investments in community development that conventional financial institutions would consider unbankable.	economic and social problems, and seek to establish capital relationships within their markets that seed sustainability.
CDFI Fund		
The CDFI Fund was established by the U.S. government to facilitate the creation of and capitalize a national network of financial institutions that is dedicated to community development and is committed to serving and improving low-income and low-wealth communities. CDFI Fund supports these organizations with an aim to make the most effective use of limited federal resources. It uses relatively small amounts of federal money to leverage significant amounts of private and nonfederal dollars, promotes private entrepreneurship, and encourages self-help and self-sufficiency.	The Fund bolsters economic development by investing in and assisting CDFIs. By investing in institutions, not just projects, the Fund helps CDFIs better respond to their markets by increasing their ability to manage risk, enhance capacity, and be flexible in their financing. The CDFI Fund provides the following types of assistance: equity investments, credit union shares, loans, grants, and technical assistance (directly, through grants, or by contract with organizations with expertise in community development finance). The Fund supports the following uses of financial assistance: commercial facilities that promote revitalization, community stability, or job creation or retention; businesses that provide jobs for, that are owned by, or that enhance availability of products and services to low-income people; community facilities; basic financial services; housing for low-income people; other businesses and activities deemed appropriate by the Fund; and technical assistance for capacity building, training, and development of programs, investments, or loans.	The CDFI Fund is innovative, investment-oriented, and businesslike in approaching its funding. Recognizing that there are diverse organizational levels, the Fund has established different windows for participants. In addition to the "Core CDFI Program," the Fund has implemented an "Intermediary Program" through which organizations in need of assistance can participate through CDFI intermediaries, and a "Technical Assistance Program" that offers financial support to CDFIs working to build their organizational capacity. Current Initiatives: Core Program—provides financial and technical assistance to CDFIs; Intermediary Program—provides financial assistance to CDFI intermediaries (CDFIs that finance other CDFIs); Bank Enterprise Award Program—provides financial assistance to CDFI and non-CDFI depository institutions; Certification—non-monetary classification recognizing that CDFIs meet Fund eligibility requirements; Microenterprise Awards—non-monetary award program recognizing excellence in microenterprise development; Technical Assistance Component will provide financial assistance to training and technical assistance providers that work with CDFIs; Secondary Market Initiative—financial support to enhance CDFI liquidity.

Case Study of a CDFI: First Bank of the Americas

First Bank of the Americas (FBA) in Chicago is an FDIC-insured bank designated by the U.S. Treasury as a community development financial institution. Since its founding in 1997, FBA has served the predominately Mexican-American communities of Pilsen, Back of the Yards, and Little Village. In a speech in early 2000 to the Chicago Board of Alderman, First Bank of the Americas President and CEO David Voss described the bank's mission of providing reasonably priced financial services to the surrounding community where high-cost fringe bankers do brisk business in "lifeline banking transactions" of check cashing, bill payment, and money transfer.

During a five-month period between September 1999 and February 2000, FBA refinanced more than 150 high-rate mortgages, home equity loans, and consumer loans at market interest rates. Voss estimated that FBA's refinancing will save community members more than $4 million over the next five years.

To overcome neighborhood residents' distrust of traditional financial institutions, FBA, with some outside funding, has launched a community outreach and education campaign. It conducts monthly financial literacy seminars and provides information on local Hispanic TV and radio stations. FBA also has established "school banks" at two schools, Maria Saucedo Scholastic Academy and Cristo Rey High School. The banks, staffed and managed by students, offer savings accounts to students and school staff, serving a dual function of teaching children personal financial management and introducing them to the workings of a bank.

Microfinance for Enterprise Initiatives of Low- and Moderate-Income and Other Disadvantaged Communities

Microfinance is the extension of small loans to small enterpreneurs and households that are too poor to qualify for traditional bank loans or lack assets for collateral. These loans are typically used for income generation, enterprise development, and, in some instances, for community needs such as health and education. Typically microfinance, also called microcredit, loans have a short repayment period and have terms and conditions suited to the local conditions of the community.

The concept of microfinance is not new. Informal systems of credit have existed in societies for centuries, long before modern, commercial banking came into the picture. Many of the current microfinance practices, made popular in developing countries, derive from community-based mutual credit transactions based on trust and peer-based non-collateral borrowing and repayment.

Microcredit in the United States

Microcredit can be an effective program to help empower financially disenfranchised populations, enabling those without access to lending institutions to start small businesses at bank interest rates. In the last five years a surge of interest has spread across the United States to broaden access to credit to lower-income Americans.

In the United States, microlending is centered in community-based banks, credit unions, community loan funds, and other local CDFIs. These institutions provide loans to businesses or households that have one or more of the following characteristics: (1) operate in low- and moderate-income and other disadvantaged communities, (2) are a start-up business or have annual revenues below a specific benchmark, (3) have owners who personally create their product or deliver the service, (4) have fewer than 25 employees, and (5) have a local customer base. The principal amounts of microcredit loans may be as little as $300 or as much as $25,000.

Interest rates are comparable to commercial lending rates and loan repayment rates often exceed those in the commercial sector.

Effective Strategies

According to the OCC study of microcredit practices in the United States, microlending institutions have several common strategies in small business finance. They 1) commit resources, including expert staff, and actively solicit small business customers; 2) learn about small business needs and offer tailored products and services; 3) provide small business customers with easy access; 4) establish streamlined processing for timely credit decisions; 5) offer special handling for flexible loan underwriting; 6) consider partnerships to provide options for small business finance, such as guarantees and credit enhancements, technical assistance, and gap financing; and 7) establish systems to track loan performance and profit.

Microfinance Challenges

Microlending institutions in the United States, such as CDFIs and mainstream banks, face a number of challenges and barriers in providing credit to small businesses in traditionally underserved markets. These include incompatibility of traditional credit evaluation techniques adopted in the banking sector with a need for human subjective review in the decision-making process. It also requires working effectively with government and community-based partners to provide credit enhancements, technical assistance, and other resources. In addition, microcredit providers are often working with a community with information deficits. Many would-be entrepreneurs and small-business owners are unaware of the financial and technical support available to them, and they often have social and language barriers as well. Participation in government programs and with other community development organizations also requires extra time: While banks can make decisions on microcredit loans within three days, loans that involve guarantees from the U.S. Small Business Administration or funds from government agencies often may take much longer.

Rutgers University Research on Organizations as Leaders in Expanding Homeownership

With support from the Fannie Mae Foundation, a team of researchers led by David Listokin and Elvin K. Wyly of Rutgers University conducted case studies of organizations recognized by their peers as leaders in expanding homeownership opportunities for historically underserved households and communities. The case studies describe the efforts of small and large lenders, nonprofit community-based organizations, and lending consortia. The researchers document strategies used by these organizations in the areas of institutional management, attracting and qualifying mortgage applicants, and retaining new homeowners.

The case studies reveal a diverse array of strategies designed to address market imperfections related to information, discrimination, and limited household financial resources. These strategies expand homeownership opportunities, and indicate that a broad spectrum of actors in the housing finance system view historically underserved households and communities as viable markets, not regulatory burdens.

Challenges remain, however, in efforts to use housing finance to promote community development and household wealth accumulation. These challenges reflect inherent tensions between the industry trend toward standardized, efficient business practices and the customized, often expensive programs needed to address multiple obstacles to homeownership and community development faced by underserved households and communities. They also reflect a historically unequal distribution of risks and rewards associated with homeownership in America.

Predatory Lending: An Overview*

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Introduction

Predatory lending has become one of the most critical policy issues facing the financial services industry, particularly mortgage lending. Nearly every federal financial services regulatory agency has publicly denounced predatory lending and called for more effective regulation to address it. Legislation has been proposed in Congress and several states to combat predatory lending, and trade associations and individual financial institutions have declared their concerns. Also, the Federal Reserve Board has proposed a rule to require lenders to report annual percentage rates for all loans, a measure that could help identify predatory lenders.

Despite broad consensus to take action, efforts to end predatory lending have been modest at best. One reason for the slow response is the lack of consensus on what constitutes illegal predatory lending. While there is significant agreement on the key loan terms and lender behavior that generally constitute predatory lending, there is little political consensus at the national level within the housing finance community about how best to address the various areas of concern. Without national consensus on how most effectively to address key predatory lending practices, significant progress in this arena is not likely in the near term.

Predatory loans are characterized by excessively high interest rates or fees, and abusive or unnecessary provisions that do not benefit the borrower, including balloon payments or single-premium credit life insurance, large prepayment penalties, and underwriting that ignores a borrower's repayment ability. Yet, although high interest rates or fees are common characteristics of predatory loans, high-cost loans are not necessarily predatory. And depending on the unique characteristics of an individual loan and specific borrower, loan provisions that may be predatory in one instance, such as a prepayment penalty, may be reasonable and legitimate under others. For this reason, regulatory agencies and other institutions are cautious about instituting broad-based and sweeping regulations that could undermine legitimate sources of financing for credit-impaired households.

Further complicating efforts to stop predatory lending is the fact that there is little, if any, publicly available data regarding loan terms, such as interest rates, origination points, processing or closing fees, and special provisions such as balloon payments, credit life insurance, and prepayment restrictions. Without information on loan terms by borrower and neighborhood race/ethnicity and income, there is no way to effectively monitor or identify questionable lending patterns for further examination. Needless to say, a problem that cannot be identified and examined cannot be eliminated.

As mentioned in the accompanying article (see "Financial Services in Distressed Communities: Framing the Issue"), predatory lending generally does not occur in a vacuum. Rather, it breeds in an environment characterized by little competition for traditional financial services. Specifically, a community flush with "fringe lenders"—check cashing outlets, pawnshops, rent-to-own stores, title lenders, and similar operations—as well as excessive subprime lending, is the environment in which predatory lending activities often flourish.

This article provides a working definition of predatory lending and highlights some of the most common characteristics of predatory loans. It distinguishes predatory lending from subprime lending, and highlights the legitimate role that subprime lending plays for households with demonstrated credit problems. The article further points out, however, that despite a clear technical distinction between legitimate subprime lending and predatory lending, there exists a huge gray area between the two, in the form of excessive subprime lending. The article concludes with a series of recommendations and considerations for further action to limit both predatory and excessive subprime lending.

Defining the Problem

A clear definition of predatory lending is difficult due to the complexity of determining the appropriate level of fees for a given level of risk. Generally speaking, three features—alone or in combination—define predatory lending practices. Those features include targeted marketing to households on the basis of their race, ethnicity, age or gender or other personal characteristics unrelated to creditworthiness; unreasonable and unjustifiable loan terms; and outright fraudulent behavior that maximizes the destructive financial impact on consumers of inappropriate marketing strategies and loan provisions. Although a loan involving any one of these tactics might legally be considered predatory, most predatory lenders use some combination of all three to extract the greatest profit and, as a consequence, cause the greatest financial harm to the borrower.

Fraudulent Target Marketing

Predatory lenders use sophisticated technology and numerous sources of publicly available data to identify potential customers. They market their products to customers they identify as financially unsophisticated or vulnerable, and therefore most likely to accept highly unfavorable loan terms. In particular, predatory lenders look for people with limited education who are not adept in financial matters and lack the financial sophistication to scrutinize loans. Such lenders often prey on households that have limited incomes but significant equity in their homes. The elderly are a primary target for predatory lenders.

Marketing techniques include placing “cold calls” to potential borrowers, direct mailings, telephone and door-to-door solicitation, and television commercials. As with many other loan features, these practices by themselves are not predatory. Target marketing is used extensively by all types of mainstream businesses to identify potential customers and customize products to meet their particular needs. Predatory lenders use target marketing not to meet the needs of their customers, but rather to identify households most vulnerable to the lenders’ aggressive or fraudulent behavior.

Predatory lenders’ advertisements claim that easy and affordable home equity loans are a quick way for consumers to pay down credit card debt, take a desired vacation, or pay off other expenses, and still have lower monthly mortgage payments. Predatory lending also often involves fraudulent home improvement scams targeted to elderly homeowners because they are more likely than younger people to live in older homes that need repair, are less likely to undertake the repairs themselves, and may not have the cash to pay for someone else to perform them. Because these homeowners have built up substantial equity in their homes, they are particularly at risk of losing a major share, if not all, of their equity. Predatory lenders also make loans to homeowners who are mentally incapacitated and do not understand the nature of the mortgage transaction or papers to be signed.

Abusive Loan Terms

The second characteristic of a predatory loan is the set of abusive terms it contains. Predatory loan terms are structured to extract the greatest possible return to the lender. For equity stripping purposes, they are also routinely designed to preclude a borrower’s ability to repay the loan. The loan itself may be unnecessarily large, even in excess of a 100 percent loan-to-value ratio. As long as the amount of the loan exceeds the fair market value of the home, it is difficult for the owner to refinance the mortgage or to sell the house to pay off the loan. Negative amortization loans are structured so that interest is not amortized over the life of the loan and the monthly payment is insufficient to pay off the accrued interest. The principal balance therefore increases each month and, at the end of the loan term, the borrower may owe more than the originally borrowed amount.

Aside from the loan itself—typically offered at very high interest rates—loan terms often include inflated and padded costs, such as excessive closing or appraisal charges, high origination and other administrative fees, and exorbitant prepayment penalties that trap lower-income borrowers into the subprime market. While prepayment fees are rarely charged in the prime market—some 2 percent of mortgages carry them—they are included in 80 percent of subprime mortgages, according to the Detroit Alliance for Fair Banking. And, unlike in the prime market, where prepayment fees are a tradeoff for lower interest rates, subprime mortgage holders rarely, if ever, get anything for the added fees, which can cost as much as a 6 percent penalty for early payoff. Consumers are locked into the subprime market even if they demonstrate improving creditworthiness, and are doubly hurt because they are not free to take advantage of lower interest rates as can prime market customers.

There may also be insertion of pre-dispute, mandatory, binding arbitration clauses in contractual documents. Such clauses are not necessarily offensive by themselves. When combined with other predatory loan provisions, however, they can greatly inhibit a borrower from receiving relief from highly unfavorable and unreasonable loan terms and conditions. Other typical predatory loan features include balloon payments that effectively force borrowers to refinance their loans at even higher rates later. Predatory loan terms also commonly feature single-premium credit life insurance that the lender requires as an up-front, lump-sum payment that the borrower must finance. Thus the borrower ends up paying additional interest—on top of the cost of overpriced and often unnecessary insurance. Maintenance provisions may increase the interest rate of a loan as a result of a 30- or 60-day late payment.

Fraudulent Lender Behavior

Fraudulent behavior is the third identifying characteristic of a predatory loan. It refers to illegal management by the lender of the loan transaction to extract the maximum value for the lender. Fraudulent behavior might include: 1) failing to explain the terms of the loan or providing obscure information, 2) using high-pressure tactics to force a prospective borrower to continue through the loan application process in cases in which the customer would prefer to discontinue the process, 3) omitting explanations of credit life insurance or balloon payments, and 4) discouraging borrowers from exploring lower-cost options.

One common tactic is to offer a short-term loan and quote a seemingly reasonable rate, without explaining that the "reasonable" rate becomes astronomical when translated into the annual percentage rate. "Flipping," or repeated refinancing, is another powerful tool of a predatory lender. The lender might offer to refinance a loan on the justification that the borrower can obtain a lower interest rate. But upon signing the new loan documents, the borrower finds out either that the interest rate is not lower or higher processing fees more than overwhelm any offset in interest rates. Or, a balloon payment provision in the original loan might make refinancing unavoidable.

Initiating loans without considering the borrower's ability to repay or structuring loans with payments that a borrower cannot afford can effectively strip the equity from a homeowner. And encouraging borrowers to consolidate consumer debts into a home equity loan with a higher interest rate than the underlying consumer credit debt—thereby also increasing the size of the loan—is a standard predatory lending practice. Further, predatory lenders may refuse to provide modest home equity loans and, instead, use high-pressure tactics to persuade borrowers to fully refinance their homes—again, usually at interest rates that exceed the underlying mortgage.

Other fraudulent behavior includes adding cosigners whom the lender knows have no intention of contributing to the payments, forging loan documents, and using abusive and high-pressure collection practices, such as harassing phone calls, letters, and threats. The combination of abusive loan terms and aggressive and fraudulent lender behavior that characterizes predatory lending illustrates how a loan can financially destroy an individual even in instances in which the loan's interest rate may not be alarmingly high. Because of the many tools in the arsenal of a predatory lender, a request for a relatively modest loan can be transformed into a major financial crisis for an unsuspecting borrower.

A real-life example is useful in understanding how predatory lenders operate: ABC television's "Prime Time Live" in April 1997 featured the story of an elderly man in poor health who could not read or write. The man initially sought a small loan to buy food. Eventually the lender converted his request into a $50,000 home-equity loan. The loan was flipped just 17 days after signing, even before the first payment was due. Subsequently, in less than four years, the lender flipped the loan 11 times, attaching a 10 percent finance fee each time. The lender foreclosed on the house after the man could not make his loan payments. In this case, the man sued and his loans were forgiven. This was a very unusual ending to a predatory lending story—most victims are unable to obtain successful or satisfactory legal redress.

Finally, it is worth noting that some practices of other real estate professionals, such as mortgage brokers and home improvement contractors, could reinforce and further promote predatory lending. Home improvement contractors, for example, sometimes target inner-city neighborhoods where houses are older and often in need of renovation, and where households are cash-poor but have accumulated significant equity in their properties. In these instances, contractors may steer their customers to predatory lenders for loans to pay for the home improvements. Brokers are an important part of the infrastructure of predatory lenders. Checking property deeds and other public records and spending time in a community, brokers identify homeowners who have substantial equity in their properties and encourage those households to refinance with a predatory lender who, in turn, provides the broker with a substantial referral fee. Elderly, black, widowed women are frequent targets.

Predatory Lending as Subset of Subprime Lending

Predatory lending is a subset of subprime lending. The difference between the two is important. By definition, subprime lending is the provision of loans to households that have demonstrated an inability or unwillingness to properly manage credit. By definition, the subprime market is the credit source of last resort for households with poor credit histories, insufficient documentation of requisite financial resources or other important loan application information, and other loan application shortcomings that would limit a prospective borrower's ability to secure credit from the prime market.

Subprime loans carry higher interest rates than prime loans with the justification that borrowers with higher risk factors should pay more to offset their perceived greater risk to the financial institution advancing the loan. Subprime loan rates are also higher, according to Ken Temkin of the Urban Institute, because underwriting guidelines in the subprime market are not standardized across the industry. The lack of standardization causes variation in interest rates offered by different lenders and makes it difficult for borrowers to "shop" for the most favorable rates.

Despite this clear conceptual distinction between predatory lending and legitimate subprime lending, the reality of subprime and predatory lending is much murkier. A loan does not have to be loaded with an excessive number of egregious provisions for it to unfairly undermine the financial solvency of a family. For example, steering minority households to the subprime market on the basis of race/ethnicity, rather than because of a demonstrated inability to properly manage credit, may be a violation of the Fair Housing Act and Equal Credit Opportunity Act—although it is not necessarily an act of "predatory lending."

In fact, even one percentage point unjustifiably added to a mortgage can add substantially to a household's financial burden and greatly undermine its asset-building capabilities. Over the 30-year life of an $81,000 home mortgage, one additional percentage point could add nearly $21,000 to the cost for the home buyer—not including the additional higher processing fees subprime loans typically carry. Note that the typical subprime loan is 300 to 400 basis points higher than a comparable prime market loan.

Concentration in Low-Income and Minority Neighborhoods

Just as fringe-lending activity is increasing, the subprime market has experienced exponential growth in lower-income minority communities. A recent study published by the U.S. Department of Housing and Urban Development (HUD) based on 1998 Home Mortgage Disclosure Act (HMDA) data uncovered striking racial disparities in the subprime market. The report finds that subprime loans are three times more likely in low-income neighborhoods than in high-income areas, and five times more likely in black neighborhoods than in white neighborhoods. In predominantly black communities, high-cost subprime lending accounted for 51 percent of home loans in 1998, compared with only 9 percent in predominantly white areas.

HUD further notes that homeowners in high-income black neighborhoods are six times as likely as homeowners in upper-income white neighborhoods, and twice as likely as homeowners in low-income white neighborhoods, to have subprime loans. Thirty-nine percent of homeowners in upper-income black neighborhoods had subprime loans, compared with 6 percent of homeowners in upper-income white neighborhoods and 18 percent for homeowners living in low-income white neighborhoods.

Does Risk Fully Explain the Size of the Subprime Market?

As noted above, the rationale for disproportionately high levels of subprime lending to lower-income and minority households is that those borrowers represent substantially greater risk than borrowers in the prime mortgage market. Unfortunately, there is little available public data on the credit quality of households that would allow for an examination of the reasonableness of the growth of subprime lending to lower-income minority households. Data that are available, however, do not support the recent explosive growth of this segment of the mortgage market.

First, several financial institutions in the past decade have confirmed that lower-income status is not synonymous with higher credit risk. Stated otherwise, lower-income consumers who receive mainstream credit perform roughly the same as middle- and upper-income households receiving similar credit. As a result, the much greater level of subprime lending to lower-income households relative to higher-income households is not immediately justified by available information on credit quality of these two groups. Second, although black households have been shown in studies to have greater credit problems than non-Hispanic white households, the level of subprime lending to black households and communities far exceeds the measured level of credit problems experienced by those households.

According to a 1999 Freddie Mac study, black households have roughly twice the credit problems of non-Hispanic white households. Yet HUD's data show that blacks rely on subprime refinance lending roughly four times as much for their mortgage credit. Credit quality alone therefore does not fully explain the extreme reliance of black households on the subprime market. Further research by Freddie Mac reports that as much as 35 percent of borrowers in the subprime market could qualify for prime market loans. Fannie Mae estimates that number closer to 50 percent.

If these estimates are accurate, it represents potentially hundreds of millions of dollars wasted each year by the very households that can least afford it.

Credit History Versus Creditworthiness

Although creditworthiness is the measure by which financial institutions determine the type of loan most appropriate for a particular borrower, there is substantial confusion between creditworthiness and credit history. Creditworthiness or credit risk is the measurement of the borrower's ability and willingness to repay a loan. Credit history is the financial transactions data on which a borrower's creditworthiness is determined. Stated otherwise, creditworthiness is the interpretation of an individual's credit history. An evaluation about creditworthiness of a borrower requires, among other things, judgments about the reliability and comparability of the underlying financial transactions data. There are a number of reasons why an individual's credit history may not accurately reflect his or her actual creditworthiness.

Confusion about credit history and creditworthiness inappropriately reinforces the idea that lower-income, and particularly minority, communities are largely bad credit risk environments. Several problems arise from interpreting creditworthiness from existing credit history data for minority households and comparing the data with that for non-Hispanic white households. First, low-income minorities are more likely to be financially unsophisticated, and thus may not attempt to correct poor credit histories before applying for a loan. Two borrowers may have similar credit behavior, but if one has taken steps to improve his or her credit records before applying for a loan, that borrower will be deemed more creditworthy. In fact, many households may be completely unaware of the need to maintain a good credit history, and the role that documentation plays in determining their access to credit.

A related issue is coaching of borrowers at the time of application for loans. Proper counseling at the time of loan application may enable a household to improve its credit score, but there may be substantial differences in the ways in which households receive such coaching along racial and ethnic lines. Third, comparing credit histories of households that have access to and use mainstream financial institutions with individuals that rely primarily on fringe banking services could result in biased assessments of creditworthiness across racial and ethnic groups.

Federal mortgage data, as well as the behavior of fringe and predatory lenders, suggest that minority households are more likely to have used finance companies and other fringe financial services whose terms and practices are more costly and harsh. In some cases, consumers may even have used predatory lending institutions that intentionally structure loans for default. In some instances, loan terms may be so oppressive and unreasonable that repayment is simply unrealistic. Or, some households may have used fringe lenders who might aggressively report even modest credit blemishes in an effort to hold onto their customers by ensuring they remain unattractive to mainstream lending institutions.

Finally, some households may default intentionally because they recognize, albeit after the fact, that the loan terms they have accepted are egregious and unfair if not outright fraudulent. In these instances, financially vulnerable households are penalized with additional credit blemishes for recognizing and acting to defend themselves from unscrupulous or fraudulent lenders.

Unfortunately for underserved households, data that might provide more accurate assessments of borrower creditworthiness are not readily available and therefore not generally used in sophisticated models of credit risk. The result is continued disparate evaluations of credit risk for lower-income, and particularly minority, households and consequently, lower homeownership rates than might be possible.

Recommendations and Solutions

Predatory lending is an outlying consequence of the inefficient financial markets that exist in many lower-income and minority communities. Predatory lending practices thrive in an environment where competition for financial services is limited or lacking, and where excessive marketing of subprime loans and fringe financial services are occurring. For this reason, effectively limiting predatory lending requires the same three-pronged approach recommended to reduce excessive fringe financial services in lower-income, minority, and distressed communities: 1) enhanced enforcement of the relevant federal and state lending and consumer protection laws, 2) increased prime market lending, and 3) improved borrower education and awareness of financial services options and opportunities (see “Financial Services in Distressed Communities”).

Laws that specifically relate to predatory lending and whose greater enforcement must play a key role in eliminating predatory lending include the Fair Housing and Equal Credit Opportunities Acts, the Real Estate Settlement Procedures Act, and the Homeowner’s Equity Protection Act. Some predatory lending practices also might violate various federal and state consumer protection laws, such as the Truth in Lending Act. Together, these laws provide a formidable regulatory infrastructure to make important strides in removing predatory lenders from the nation’s most vulnerable and distressed communities. Together, these laws cover practically every conceivable predatory lending arrangement. (For a more detailed discussion of possible legal strategies to fight predatory lending, see Engel and McCoy 2001.)

Yet, the strength of these federal laws can, nevertheless, be a weakness. Because so many different laws could pertain to various predatory lending practices, determining which law or laws may have been violated in any particular case can be complicated, time-consuming, and costly. Simplifying federal law to target predatory lending directly would greatly enhance the ability of lower-income households and their advocates to combat unfair and illegal lending behavior. Further, outlawing abusive practices would act as a preventive measure and would avoid the need for consumers to be harmed before there could be legal redress.

The North Carolina nonprofit Coalition for Responsible Lending, for example, points out that a handful of provisions account for the overwhelming majority of the most abusive predatory lending activities. The coalition recommends new legislation that focuses on seven loan terms and practices including: 1) credit insurance; 2) excessive fees charged to borrowers; 3) prepayment fees that do not benefit the borrower; 4) mortgage broker abuses including yield-spread premiums; 5) steering of borrowers to subprime loans on the basis of race/ethnicity, age, or gender; 6) mandatory arbitration clauses that restrict the rights of the borrower; and 7) loan flipping or repeated refinancings that do not benefit the borrower.

Many states have recently enacted or have begun to debate streamlining their state statutes to focus directly on predatory lending. The state of North Carolina enacted a comprehensive predatory lending law in July 1999. The North Carolina law defines two types of loans—"home loans" and "high-cost home loans." For all home loans, the law prohibits lending abuses such as requiring credit life, disability, or unemployment insurance, and loan flipping. With regard to high-cost home loans, it imposes expanded protections against excessive balloon payments, high interest rates and fees, negative amortization, and predatory home improvement contractors. In addition, loan counseling is required and a borrower's ability to repay must be taken into consideration.

Using the North Carolina model, the states of New York, Illinois, South Carolina, Minnesota, West Virginia, Utah, Maryland, and California are all considering predatory lending legislation. Another example of local action is Washington, DC's, new "Predatory Lending Protections and Mortgage Foreclosure Improvements Act of 2000" that provides additional protections for District residents who might find themselves at risk of losing their homes through foreclosure as a result of corrupt lending practices. Among other features, this law attacks predatory activity by defining a subset of loans that might be predatory and providing homeowners with a quick judicial review prior to a foreclosure sale. Philadelphia is another city that has recently enacted a predatory lending law.

Perhaps the most comprehensive federal examination of predatory lending performed to date was pursued jointly by the U.S. Department of the Treasury and HUD. Their report, "Curbing Predatory Home Mortgage Lending," included extensive discussion of predatory lending tactics and a wide range of recommendations to limit fraudulent lending behavior (see the full report at www.huduser.org/publications/hsgfin/curbing.html). The study highlighted and discussed practices ranging from loan flipping, targeting minority and low-income borrowers, and lending to borrowers based on the value of their home rather than the ability to repay a loan. Expanding borrowers' access to the prime market by awarding banks and thrifts Community Reinvestment Act credit and amending many existing laws were among the recommended solutions. Additionally, the study revealed that the Federal Housing Administration is developing tools to help borrowers who have been victimized by predatory lenders to avoid foreclosure, retain their homes with a reasonable level of debt, and, if necessary, repair their credit.

The National Community Reinvestment Coalition has outlined a multipart strategy to address predatory lending. Among its recommendations are for the Federal Reserve Board to use its existing authority to prohibit unfair and deceptive mortgage lending practices, to step up its oversight of subprime lenders, and to improve data disclosure to more effectively track subprime and predatory lending.

Conclusion

The issue of predatory lending is, for good reason, an issue of national concern. Yet, while there is strong consensus to act, there is enormous inertia in taking definitive action that might impact lending of any type. Part of the failure to aggressively address predatory lending is based on a legitimate concern that price controls and blanket prohibitions of individual loan features could negatively impact market segments in unintended ways.

Moreover, as this article and the previous one on *Financial Markets in Distressed Communities* highlights, predatory lending is merely the extreme end of a spectrum of abusive, unscrupulous, and costly financial services practices that dominate lower-income and minority communities. Placing caps on certain practices and eliminating certain other behaviors would go a long way to removing some of the most destructive wealth-stripping activities from the mortgage markets in distressed communities. But limitations, restrictions, and caps on various financial services practices are not sufficient to address the broader issue of market failure that plagues these communities. That broader challenge requires positive action and initiative. Lower-income and minority communities need high-quality, low-cost financial services tailored to their low-income and low-wealth circumstances. Further, those households need access to savings vehicles that would enable them to build their assets to the greatest extent possible.

Assisting households to better understand how to make informed choices about the financial services and providers they choose is an important aspect of a comprehensive anti–predatory lending program. At the same time, however, there are real limits on the extent to which consumer financial education can help vulnerable households who are the focus of fraudulent professionals.

Mortgage loan documents can consist of dozens of provisions written in extremely complex, confusing, and technical legal language. Predatory lenders target lower-income and minority borrowers with limited education and vulnerable elderly consumers specifically because they cannot reasonably protect themselves. To expect that financially vulnerable consumers can reasonably review, understand, and challenge specific provisions in the dozens of legal documents that are routinely involved in the mortgage lending process is a highly unreasonable expectation.

Despite the inability to achieve consensus on the perfect response to predatory lending, some immediate intervention is needed and should be forthcoming at a national level. Failure to successfully remove predatory lenders from the financial services markets could, over a relatively short time, undermine much of the success that has been achieved over the past decade in enhancing the number of historically underserved households that are now homeowners. And it could further exacerbate the tenuous financial positions of many vulnerable, lower-income, elderly homeowners, many of whom reside in older, inner-city, and distressed communities.

Principles for Responsible Lending[1]

Coalition for Responsible Lending

Homeownership not only supplies families with shelter, it also provides a way to build wealth and economic security. Unfortunately, too many American homeowners are losing their homes, as well as the wealth they spent a lifetime building, because of harmful home equity lending practices. Some lenders target elderly and poor or uneducated borrowers to strip the equity from their homes, which traps borrowers in bad loans and creates a high risk of foreclosure. Subprime lending has increased 1,000% in the last five years, and abusive lending is up commensurately.

Seven principles should govern attempts to eliminate predatory lending and protect family wealth:

- Prohibit the financing of up-front credit insurance for all loans.
- Limit fees charged borrowers, direct and indirect, to 3% of the loan amount.
- Prohibit back-end prepayment penalties on subprime loans, since they act in an anti-competitive manner by keeping lenders from remedying abusive situations.
- Take sufficient steps to address mortgage broker abuses on purchased loans, including prohibiting yield-spread premiums.
- Address steering by making sure that borrowers receive the lowest-cost loan they qualify for.
- Avoid mandatory arbitration clauses in any home loans.
- Prohibit "flipping" of borrowers through repeated fee-loaded refinancings.

1. Credit insurance premiums should not be financed into the loan up-front in a lump-sum payment. One type of credit insurance, credit life, is paid by the borrower to repay the lender should the borrower die. The product can be useful when paid for on a monthly basis. When it is paid for up-front, however, it does nothing more than strip equity from homeowners, which is why Fannie Mae and Freddie Mac have both agreed not to purchase any loan that includes financed credit insurance. Conventional loans almost never include, much less finance, credit insurance.

2. The borrower should not be charged fees greater than 3% of the loan amount (4% for FHA or VA loans). Points and fees (as defined by HOEPA) that exceed this amount (not including third party fees like appraisals or attorney fees) take more equity from borrowers than the cost or risk of subprime lending can justify. By contrast, conventional borrowers generally pay at most a 1% origination fee.

3. Subprime loans (defined as interest rates above conventional) should not include prepayment penalties, for the following reasons:

    - Prepayment penalties trap borrowers in high-rate loans, which too often leads to foreclosure. The subprime sector serves an important role for borrowers who encounter temporary credit problems that keep them from receiving low-rate conventional loans. This sector should provide borrowers a bridge to conventional financing as soon as the

[1] "Principles for Responsible Lending" are from the Coalition for Responsible Lending and are used with permission. For more information, see www.responsiblelending.org.

borrower is ready to make the transition, though prepayment penalties are designed to prevent this from happening. Why should any borrower be penalized for doing just what they are supposed to do—namely, pay off a debt?

- Prepayment penalties are hidden, deferred fees that strip significant equity from over half of subprime borrowers. Prepayment penalties of 5% are common. For a $150,000 loan, this fee is $7,500, more than the total net wealth built up over a lifetime for the median African American family. According to Lehman Brothers' prepayment assumptions, over half of subprime borrowers will be forced to prepay their loans—and pay the 4% to 5% in penalties—during the typical five-year lock-out period. And borrowers in predominantly African-American neighborhoods are five times more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods. Prepayment penalties are therefore merely deferred fees that investors fully expect to receive and borrowers never expect to pay.

- Borrower choice cannot explain the prevalence of prepayment penalties in subprime loans. Only 2% of borrowers accept prepayment penalties in the competitive conventional market, while, according to Duff and Phelps, 80% in subprime do.

4. Lenders should take sufficient steps to address mortgage broker abuses, including prohibiting yield-spread premiums. Brokers originate over half of all mortgage loans and a relatively small number of brokers are responsible for a large percentage of predatory loans. Lenders should identif—and avoid—these brokers through comprehensive due diligence. In addition, lenders should refuse to pay "yield-spread premiums"—fees lenders rebate to brokers in exchange for placing a borrower in a higher interest rate than the borrower qualifies for. These lender kickbacks violate fair lending principles since they provide brokers with a direct economic incentive to steer black borrowers into costly loans.

5. To address steering, lenders should make sure that borrowers get the lowest-cost loan they qualify for. As Fannie Mae and Freddie Mac have shown, subprime lenders charge prime borrowers who meet conventional underwriting standards higher rates than necessary. This is particularly troubling for lenders with prime affiliates–the very same "A" borrower who would receive the lender's lowest-rate loan from its prime affiliate pays substantially more from the subprime affiliate. HUD has shown that steering has a racial impact since borrowers in African-American neighborhoods are five times more likely to get a loan from a subprime lender–and therefore pay extra–than borrowers in white neighborhoods. A minority borrower with the same credit profile as a white borrower simply should not pay more for the same loan. Therefore, lenders should either:

   - offer "A" borrowers loans with "A" rates, or
   - refer such borrowers to an affiliated or outside lender that offers these rates.

6. Lenders should not impose mandatory arbitration clauses in any home loans. Increasingly, lenders are placing pre-dispute, mandatory binding arbitration clauses in their loan contracts. These clauses insulate unfair and deceptive practices from effective review and relegate consumers to a forum where they cannot obtain injunctive relief against wrongful practices, proceed on behalf of a class, or obtain punitive damages. Arbitration can also involve costly

fees, be required to take place at a distant site, or designate a pro-lender arbitrator. Arbitration will always take time the consumer may not have if they are facing foreclosure. Such clauses are unfair to borrowers, who generally do not understand what rights they are giving up; if an informed consumer thinks that arbitration is a helpful step in resolving a dispute with a lender, the consumer and lender should be permitted to agree to arbitration then.

7. Lenders should prohibit “flipping” of borrowers through repeated fee-loaded refinancings. One of the worst practices is for lenders to refinance subprime loans over and over, taking out home equity wealth in the form of high fees each time, without providing the borrower with a net tangible benefit. Some lenders originate balloon or adjustable rate mortgages only to inform the borrowers of this fact soon after closing to convince them to get a new loan that will pay off the entire balance at a fixed rate. Others require borrowers to refinance in order to catch up if the loan goes delinquent.

Combating Predatory Lending Practices

Federal Banking Regulatory Agencies Call for Greater Oversight

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision in January issued a directive that strengthens the examination and supervision of institutions with significant subprime lending programs.

The "expanded guidance" decree specifies borrower characteristics that indicate an institution is targeting the subprime lending market, clarifies the standards to use when evaluating loss allowances, and identifies potentially predatory lending practices that safety and soundness examiners will criticize, among other features.

The expanded guidance is expected to help banks and thrifts engaging in subprime lending activities be more aware of the banking agencies' expectations regarding risk management processes.

Responses to Predatory Lending by the U.S. Department of Housing and Urban Development (HUD) and U.S. Treasury Department

A joint U.S. Department of Housing and Urban Development and U.S. Treasury Department Task Force on Predatory Lending has conducted five field forums around the country and, based on its findings, proposed a four-point plan to address predatory lending practices. The plan is detailed in the report, "Curbing Predatory Home Mortgage Lending," summarized below. The full report is available at: www.huduser.org/publications/hsgfin/curbing.html.

1. Provide improved disclosures to borrowers and enhance consumer literacy. Require creditors to recommend that high-cost loan applicants seek home mortgage counseling, disclose credit scores on request, and provide better information on loan costs and terms.

2. Prohibit damaging or unfair lending practices. Loan flipping and lending to borrowers without regard to their ability to repay should be prohibited, and brokers and lenders should be required to provide greater documentation of loan and payment history.

3. Restrict abusive terms and conditions on high-cost loans, including balloon payments, prepayment penalties, and the financing of points and fees; prohibit mandatory arbitration agreements on high-cost loans; and ban single-premium credit life insurance.

4. Use Community Reinvestment Act (CRA) credit to create a positive incentive structure for banks and thrifts. Grant CRA credit to institutions that promote borrowers from the subprime to prime mortgage market, and deny CRA credit to institutions that originate or purchase loans that violate applicable lending laws.

Proposals by the Federal Reserve Board to Strengthen Predatory Lending Prohibitions

The Federal Reserve Board has proposed amending two of its regulations to crack down on predatory lending:

The first proposal is to require additional disclosure of mortgage applications and loans under the Home Mortgage Disclosure Act (HMDA). The revision, which would mandate reporting of requests for mortgage preapprovals and home-equity lines of credit, is designed to track the level, trend, and underwriting characteristics of high-cost mortgage loans. It would help identify institutions engaged in subprime lending, make high-volume nondepository lenders subject to HMDA reporting requirements, and simplify the definition for “refinance” and “home improvement loan” to ensure more complete and consistent data.

The second proposed amendment broadens the scope of loans subject to the Home Ownership and Equity Protection Act (HOEPA) of 1994 by adjusting price triggers that determine coverage under the act. Interest rate triggers would be lowered by two percentage points (from 10 points to 8 points above current Treasury bill rates), and the fee-based triggers would include optional insurance premiums and similar credit protection products paid at closing.

The proposed amendment also prohibits certain practices, such as repeated refinancing of HOEPA-regulated loans over a short time when transactions are not in the borrower’s interest, and making loans without verification of a consumer’s repayment ability.

It is important to note that HOEPA still does not cover all home equity lenders and all home equity loans, and there are loopholes that allow room for abuse.

Calls for Additional Federal Action

The National Community Reinvestment Coalition (NCRC) has made several recommendations for additional federal anti–predatory lending action.

It recommends calling for federal banking regulations to increase their oversight of subprime lenders during CRA exams and accompanying fair-lending reviews. The NCRC suggests that regulatory agencies issue an interagency advisory letter saying that predatory lending will not receive credit under CRA exams and will be penalized through lower CRA ratings and fair lending referrals to the Department of Justice. It calls for the Federal Reserve Board to use its authority to conduct regular fair lending reviews of subprime affiliates of bank holding companies, as recommended by the General Accounting Office.

Secondly, the NCRC has called for Congress to pass more comprehensive anti–predatory lending legislation.

The NCRC is a national community reinvestment and fair lending trade association of more than 700 community-based organizations and local public agencies dedicated to increasing access to credit and capital for traditionally underserved urban and rural areas.

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MEMORANDUM

FROM: Meghan McClowry
TO: Kevin Thompson
DATE: January 15, 2010
RE: Litigation involving Payday Lenders in Missouri

Question: Research the cases referred to in Public Counsel's Petition to determine whether there is anything relevant to Staff's investigation of payday lenders and utility payments.

My understanding of your question is whether the cases mentioned in the article entitled, "A Study of the Payday Loan Industry in Missouri,"[1] discuss anything relevant to the Staff's investigation of payday lenders and utility payments. Although the article neither specifically names nor cites to the cases it mentions, my research indicates that the St. Louis County case is *Woods v. QC Financial Services*[2], and the federal case is, *Hooper v. Advance America*[3]. Neither case has yet to be decided on the merits, but both have recently been decided on procedural matters regarding whether the mandatory arbitration clause of their respective loan contracts were binding. Further neither case mentions the relationship between payday lenders and utility bills.

In the *Woods* case, Ms. Woods entered into a loan contract with the payday lender on several occasions.[4] Woods filed a petition alleging that the lender had committed several violations of Missouri statutes governing payday lenders, and seeking class certification on behalf of those similarly situated to herself.[5] QC Financial sought dismissal of Woods' petition and asked the trial court to compel Woods to engage in individual arbitration as provided for in the mandatory arbitration clause contained in the loan contract.[6] The trial court granted, in part, a declaratory judgment that QC Financial's arbitration clause was unconscionable, and denied QC's motion to dismiss Wood's case.[7] The Court of Appeals for the Eastern District of Missouri affirmed.[8]

In *Hooper* the Plaintiffs filed a seven-count, putative class-action complaint against Advance America.[10] The complaint alleged that Advance America was engaged in unfair, deceptive, and illegal lending practices to the detriment of its Missouri borrowers.[11] Advance America, invoked a clause in Plaintiffs' loan contracts, attempting to stay all litigation and compel Plaintiffs to binding arbitration.[12] The district court held Advance America waived its right to arbitration when it filed an extensive motion to dismiss.[13] The U.S Court of Appeals for the 8th Circuit affirmed.[14] Similarly, this case makes no mention of the relationship between utility bills and payday lenders.

In conclusion, as stated above, there was no mention of the relationship between payday lenders and utility bills mentioned in the above stated cases. I have attached the decisions for your further review.

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[1] http://stlouis.org/Storage/142/Documents/PaydayLoanReport09color.pdf
[2] 280 S.W.3d 90 (Mo.App. E.D.,2008).
[3] 589 F..3d 917 (8th Cir. 2009).
[4] Woods *supra* n. 2.
[5] *Id*.
[6] *Id*.
[7] *Id*.
[8] *Id*.
[10] Hooper v. Advance America, **2008 WL 4371360 (W.D. Mo. 2008).**
[11] *Id*.
[12] *Id*.
[13] *Id*.
[14] *Id*.

Military Service to Get Defense Against Payday Lenders, But It's Slow in Coming

03/27/2007

The John Warner National Defense Authorization Act for Fiscal Year 2007 became law this last October. One small section of this Act, Section 670 under "Subtitle F--Other Matters," gives marching orders to the practices of creditors who prey upon military service members and their dependents. (A "predatory lending practice" is one considered to be "an unfair or abusive loan or credit sale transaction or collection practice.") Among those affected are businesses that offer military personnel deferred deposit transactions--small, short-term loans better known as "payday loans--without regard for their ability to repay and with excessive charges packed into the loan and terms requiring, for example, balloon payments and waiver of legal rights. Loans such as these have proven to be a source of spiraling debt for many military families.

Why should military service men and women need the protection from these lenders that Section 670 adds? In its August 2006 report on Predatory Lending Practices Directed at Members of the Armed Forces and their Dependents, the U.S. Department of Defense presents some eye-opening facts that answer that question.

At the outset, we should say that while the Department of Defense's report deals, in part, with predatory payday lenders, many payday lenders in California do not seek out military borrowers in particular and do comply with the law.

First, then, according to the report, the enlisted military personnel preyed upon by payday lenders are--at least 48 percent of them--under 25 years of age. They generally have little experience in managing finances, no savings cushion, and no family assistance close by. What they do have that makes them attractive to payday lenders is a regular paycheck, whatever its size, and no likelihood of quitting their employment or being downsized or laid off.

The likelihood is, rather, that these military personnel will need a small loan at some point. Thus some payday lenders concentrate near the front gates of military bases in states (including California) where payday loans are legal. One study found 161 payday lenders and 217 banks in San Bernardino County--home to several military facilities--alone, making it the highest payday lender-to-bank ratio in the State. Indeed, California's payday loans totaled almost $2.5 billion in 2005; the average annual percentage rate was 426.

Some estimates are that abusive fees associated with payday lending cost military families over $80 million every year. This figure does not include Internet payday loans, which are estimated to bring in $500 million annually.

As we've pointed out in our special report, noted at the end of this article, in California, a family (military or not) could face a formidable APR by, for example, borrowing $300 (the maximum allowable) for a week at 15 percent interest (the maximum allowable), which would result in a 780 percent APR. Although not the norm, this would be within California law.

The effects upon the military family can be dire when they must take out loan after loan, each with equally high APRs and fees, to repay the first and subsequent loans, yet end up owing much more than the initial loan and still not able repay it. (Although California law prohibits both entering into another deferred deposit agreement while a previous one is in effect and paying off one payday loan with the proceeds of another, these laws can be circumvented by both lender and borrower.)

The effects upon the military branches and the nation can be significant as well. An Associated Press article last September quoted a Point Loma Navy official as saying that under Navy rules, sailors with debts of more than 30 percent of their income cannot be sent overseas because their financial problems could distract them from their duties or, worse, make them vulnerable to bribery. Between 2000 and 2005, he said, Sailors' and Marines' security clearance revocations and denials increased by 1600 percent because of their financial problems. And, "'Almost every case of espionage in our military has in some way had ties to financial greed or need on the part of the individual.'"

In April 2006, California Assembly members Ted Lieu (D-Torrance) and Lori Saldana authored a bill to allow military members and their spouses to defer payday loan payments for a number of months and to prohibit the lenders from garnishing their pay or contacting their superiors to collect. Already amended a number of times, this bill, late in August, was again amended to add a 36 percent APR cap on payday loans, which rate would include in its calculation charges for any ancillary products and services sold by the lender and included in the amount financed.

Although this bill, Lieu said, was the first in the country to implement the Defense Department's recommendations, it did not pass. According to David Ford, Lieu's Chief of Staff, the inclusion of the interest rate cap amendment so late required an urgency clause, which required a two-thirds vote to pass. Some legislative members' concern about the restriction on military payday loans that would result, as well as the effects it might have on the poor and other segments of the population, discouraged them from supporting the bill. "The 36 percent was the crux," Ford says. But, he adds, "the real crux is that we don't pay our military young men enough."

Ford also says that many programs already exist to help military personnel, so they do not need payday loans.

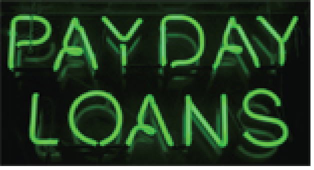
Lieu and Saldana introduced a new bill in December. In committee at this writing, AB 7 provides that any violation of Section 670 of John Warner's Defense Authorization Act (which, although enacted last October, does not go into effect until next October) is also a violation of California law. Section 670 provides for the 36 percent APR rate cap and generally preempts other laws that may allow a higher rate. This cap is to include not only interest, but the total of any and all other costs or fees associated with the extension of credit. Although several states already have 36 percent rate limits, Georgia, for example, caps rates at 60 percent, and Nevada, where many Internet loans originate, has no rate cap.

Section 670, in addition to its many other protective provisions, also disallows violation or waiver of any State consumer lending protections on the basis of nonresident or military status of a person or dependent, regardless of where their permanent home is. Nor may the borrower be prohibited from or charged a penalty or fee for prepaying their loan. And if a creditor's contract contains any provisions prohibited by the section, it is void.

How is a law that doesn't even become effective until next October going to help service men and women now? Lieu's bill refers to the provisions of Warner's Act. Thus, if passage of AB 7 occurs earlier, California lenders will have to comply earlier.

While most Americans would hope that these protections for our service members will be enacted soon, still more will undoubtedly hope that the very need for them, as well as the additional deployment they will enable, will disappear even sooner. So far we're still waiting for both.

For information on current California law affecting payday transactions, access our report no. 57,



Missouri Licenses Online Payday Lenders; Other States Are Clamping Down On Them

9/8/2009

Contact: Michelle L. Corey at 314-645-3300 or mcorey@stlouisbbb.org or Chris Thetford at 314-645-3300 or communications@stlouisbbb.org

St. Louis, Mo., Sept. 8, 2009 - While Missouri has issued licenses to 33 online payday loan operators, other states and the federal government are clamping down on such operations, state records show.

A recent Better Business Bureau (BBB) study pointed out the hazards of payday lending for consumers at nursing homes and other brick-and-mortar payday loan outlets. However, the potential pitfalls for consumers who patronize *online* payday lenders are even greater.

“Internet payday loan providers are the loan sharks of today,” said Darrell McGraw, West Virginia’s attorney general. He has waged a four-year battle against such companies.

“Due to the nature of these lenders operating over the Internet and across the globe, they are difficult to track and verify, consequently increasing the risk of identity theft for consumers,” noted the Massachusetts Division of Banks.

“It’s very difficult for Missouri to pursue unscrupulous lenders when the state allows such abnormally high interest rates for payday loans,” said Michelle L. Corey, president and CEO of the BBB in St. Louis.

Missouri's lax payday lending laws appear to be attractive to out-of-state online payday lenders. Of the 33 online payday lenders licensed by the state, only one is physically located in Missouri. Loan Shack of Missouri LLC, located in South Dakota, operates in states without an annual percentage rate cap – and in Missouri, where the cap is high. The company appears to comply with federal and state laws, but charges 521% APR on a two-week loan.

A twist in the online lending business involves "brokers" who solicit personal information, including bank account numbers, from consumers, promising to place the consumer with a payday loan company.

Money is subsequently deposited in the consumer's bank account, sometimes without the consumer's knowledge, complainants have told the BBB. When the consumer refuses to pay, the account is turned over to a collection agency.

"The potential for ID theft and unauthorized bank withdrawals is great in operations such as online payday lending," said Corey. "We urge consumers to be extremely cautious when considering giving personal information to a firm with which they are unfamiliar."

An example of a "broker" payday loan operation is **Debt Doctors**, a company using a Wentzville, Mo., post office box address. In response to consumer complaints to the BBB, manager Dennis Best said that Debt Doctors is only a data processing company and loans actually were made by a company called Magnum Z LLC. However, a now-defunct Nevada limited liability company lists Dennis Best of Wentzville as manager. Often, Debt Doctors tells the BBB that the complainant should contact Magnum Z or that the account is out of Debt Doctors' hands and the account has been or will be turned over to a collection agency. Neither Debt Doctors nor Magnum Z LLC is licensed as a payday lender in Missouri.

Since November 2006, the BBB has received 25 complaints or reports filed by consumers in 13 states against Debt Doctors.

A Pennsylvania man told the BBB that he had applied for a loan online and that he received a call from Debt Doctors saying he would receive a $300 loan. The customer said he didn't want the loan and the company said it was canceled, "but they still put the money in my account." He said he couldn't return the money unless he paid $90.

A potential borrower from Texas told the BBB, "I applied online for a payday loan with a Web site that would send my information to several different companies." She said she decided against the loan and declined offers from lenders. Debt Doctor, however, "just deposited $200 in my bank. I know I have never spoken to anyone from their company authorizing this loan. They have since turned me over to collections."

A Florida woman said she applied for a payday loan and turned down offers from three companies. She also declined an offer from Debt Doctors but the company deposited $300 into her account without her authorization.

In respsonse to consumer complaints that the company made unauthorized loans, Debt Doctors said that the customers did authorize the loans and that Debt Doctors processed the loans for the actual lender, Magnum Z.

In 2007, the Maryland commissioner of financial regulation issued a cease-and-desist order against "Magnum Z, d/b/a Debt Doctor" of Wentzville alleging the company made loans in Maryland without a license and at interest rates in excess of the legal limit.

Debt Doctors was among several online payday loan operations sued recently by McGraw, the West Virginia attorney general. In May 2009, Debt Doctors agreed not to participate in payday lending in West Virginia and to repay one consumer $1,480.

Since 2005, West Virginia has settled 68 suits against online payday loan companies and their collection agencies, bringing 5,246 West Virginia consumers $1,223,473 in refunds or canceled debts. The allowable APR in West Virginia is 18%.

Another state that is aggressively pursuing online payday lenders is Massachusetts, which last month issued cease-activity directives to 95 online payday loan companies that operated nearly 400 Web sites. More than 120 Web sites were listed at one address. Massachusetts law limits payday loan APRs to 23%.

A Pennsylvania court ruled in mid-July that the state could require online payday loan companies to be licensed even if they have no physical presence in the state.

The Federal Trade Commission (FTC) also has taken recent actions against online companies soliciting payday loans. Last month, the FTC announced a settlement with a debit card company that charged consumers a fee for a prepaid debit card with a zero balance when the consumers thought they were applying for a payday loan. Thousands of consumers were hit with an enrollment fee of up to $54.95, the FTC said.

In another settlement reached last June, the FTC accused two online payday loan companies of violations of federal law by not disclosing the APR in their advertising. The companies only stated fees in such phrases as $20 per $100 borrowed. Actually, the FTC said, borrowers would pay up to 782% APR.

Before shopping for a payday loan the BBB suggests that you consider these alternatives:

- Check your bank or credit union to determine the availability of short-term loans. There you can interact with their representatives if you have questions.
- Contact your creditors or loan service company as quickly as possible if you are having trouble with your payments, and ask for more time.
- Use a credit card for emergencies. Although this is generally a costly way to borrow money, it is still less costly than payday lending.
- Determine if you can delay paying a non-interest bill such as a utility bill and make payment arrangements with the company.

For more information, call the BBB at 314-645-3300 or go online to www.bbb.org.

About the BBB

The BBB is a non-profit organization that sets and upholds high standards for fair and honest business behavior. The BBB provides objective advice, free business Reliability Reports, charity wise-giving reports, and educational information on topics affecting marketplace trust. Please visit www.bbb.org for more information.

MISSOURI
DEPARTMENT OF ECONOMIC DEVELOPMENT

Matt Blunt
Governor

DIVISION OF FINANCE

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D. Eric McClure
Commissioner

January 18, 2005

The Honorable Matt Blunt, Governor
State Capitol Building
Room 218
Jefferson City, Missouri 65102

Re: Report to General Assembly pursuant to section 408.506, RSMo

Dear Governor Blunt:

The Division of Finance has, in accordance with section 408.506, RSMo, conducted a survey by mail of the so-called "payday lenders" operating pursuant to section 408.500. The reporting timeframe was October 1, 2003 through September 30, 2004. The summary which follows presents a picture of the Missouri payday loan industry as calendar year 2005 began based on a 94.1% return of surveys by the industry. We have preserved the survey forms which were filed by the individual lenders, and we have attached a blank copy of the survey form.

1,198 payday loan licenses were issued during calendar year 2004. Lenders closed and opened locations throughout the year with 1,100 being the approximate average number active at a given time, a 37.5% increase over the previous survey dated January 8, 2003 (hereafter “previous survey”). These licenses were widely dispersed with some active in very small communities.

The total number of payday loans made during the reporting period approached 2.6 million, an increase of 30% from the previous survey. For purposes of this survey, a renewal was treated as a separate loan.

The average loan was $241.11 (an increase of nearly $20 from the previous survey) with the most commonly occurring loan amount being $300 (up from the previous survey’s $200).

The average of renewals was 2.2 with 3 being the most commonly occurring number. The 2.2 average was a drop from 2.8 noted in the previous survey. This drop may be attributed to the trend toward companies allowing fewer renewals in order to stay within the 75% cap on interest and fees on a loan and all related renewals; this cap was effective August 28, 2002.

The most common APR --- 391.07% --- was reported by 66% of the respondents; 22% of the lenders charged more and 12% charged less. The 391.07 APR rate represents $15 per $100 for 14 days. Another commonly reported APR was 469.29% which is $18 per $100 for 14 days. Several lenders reported charging 365%, i.e., a dollar a day per $100 borrowed. One company charges 730% or two dollars per day per $100 borrowed. By far the highest reported rate was 1277.5%; the lowest reported was 100%. The mean average APR was 408.03%.

Lenders reported that charge-offs have totaled about 5.4% of the number of loans made. This compares to 6.15% reported at the previous survey.

820 lenders reported charging an NSF fee, 226 charged a late fee, and 7 collected origination fees.

During the reporting period, there were approximately 350 complaints about payday loans or payday lenders. Most of these were from citizens who, after taking out the loan, saw the triple digit APR and believed the rate to be unlawful. In such cases, we explained the law and closed the file. On a number of occasions, the "complaint" was that the borrower had made a loan with each of several lenders and, the rates being what they were, the borrower simply could no longer pay the interest. In those cases, we contacted the various lenders to see if any modification was possible. Other complaints involved a multitude of areas which include such things as checks being deposited early, collection tactics, proper crediting of payments, and customers being unable to make payments as the location was closed. In most cases, resolution was had by telephone contact with the licensee. Examiners made a few on site visits and any necessary corrections were made by recasting accounts and/or refunding.

As section 408.506 also requires the Division to summarize the payday loan laws from contiguous states, we conducted a survey of such states' laws by telephone. We invite your attention to the attached chart.

We believe the foregoing satisfies the requirements of section 408.506.

Very truly yours,

D. Eric McClure
Commissioner of Finance

DEM:tkp
Enclosure

October 27, 2004

[«License_Type»-«License_Year»-«Location_ID»]

To: «Licensee_Name_including_DBA» «Store»
«Location_Address1»
«Location_Address2»
«City», «State» «Zip»

Re: Section 408.500 Lender Survey

Section 408.506 requires that the Division of Finance report certain information from the section 408.500 lenders to the General Assembly. This will require your cooperation. PLEASE RETURN THIS FORM TO OUR OFFICE WITH THE REQUESTED INF ORMATION **NOT LATER THAN NOVEMBER 22, 2004**. ALL DATA SHOULD BE FOR THE PREVIOUS 12 MONTHS THAT ENDED SEPTEMBER 30, 2004. For questions, please call Tammy Prater at 573-751-3463.

Number of loans made in the previous 12 months that ended 9/30/04: _______________

Average principal amount of such loans: $________________

Circle the average number of renewals per loan: 0 1 2 3 5 6

Number of defaulted loans in the previous 12 months that ended 9/30/04: ____________

What annual percentage rate or rates do you typically charge? Example: 391.07% APR

____

What other fees do you charge: NSF fee ____________
Late fee ____________
Origination fee ____________

If offered and for an additional convenience fee payable by the licensee, would you be interested in making your licensing fee payment via credit or debit card? Yes or No
If yes, would you prefer making your payment via: Internet or Telephone

STATEMENT: The undersigned states that (s)he is a(n) (officer) (principal) (partner) (authorized representative) of the company above named and that the facts contained in the foregoing are true.

____
Signature/Title – Phone: _______________

PAYDAY LOANS IN CONTIGUOUS STATES

	Licenses	Maximum Loan	Rate	Term	Renewals	Complaints
Missouri	1,198	$500	A loan and all renewals thereof may not earn more interest than 75% of the original principal	14 day minimum 31 day maximum	Limited to 6	Approximately one per working day
Arkansas	173 deferred presentment licensees	$400	10% of the check + $10	6 day minimum 31 day maximum	Forbidden	Rare
Kansas	207	$500	$5.50 on a loan of $50 or less; $50.01-$100 10% + $5 fee; $100.01-$250 7%(minimum $10) + $5 fee; $250.01 to $500 6% (min $17.50) + $5 fee	7 day minimum 30 day maximum	Forbidden No more than 3 loans in 30 days	Rare
Iowa	210	$500	$15 on the first $100 and $10/$100 thereafter	Minimum 1 day Maximum 31 days	Forbidden	Rare
Tennessee	1,300	$500	$15 per $100 but maximum $30	No minimum but 31 day maximum	Forbidden	Rare
Kentucky	400	$500	$15 per hundred	14 days	Forbidden	Rare
Nebraska	159	$500	$15 per $100	No minimum but a 31 day maximum	Forbidden	Rare
Illinois	1,097	None (may be any amount)	No limit	No maximum or minimum	Limited to 2	Rare
Oklahoma	355	$760	240 % APR	Minimum 1 month Maximum 10	Available without limit	Occasionally Received

MO AGE CONSUMER GUIDE PAYDAY LOANS
http://ago.mo.gov/publications/knowyourrights.pdf