ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF SOUTHWEST GAS CORPORATION DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	Docket No. G-01551A-04-0876

RUCO'S INITIAL CLOSING BRIEF

The Residential Utility Consumer Office ("RUCO") offers this Initial Closing Brief on the matters raised at Southwest Gas Corporation's ("SWG") recent rate hearing.

ISSUES RESOLVED BETWEEN RUCO AND SWG

RUCO and SWG have reached agreement on a number of issues which were initially disputed. Those agreements are as follows:

- Pipe Replacement (portions) – SWG has agreed to RUCO's adjustments related to replacement of Aldyl A and Aldyl ABS pipe. Tr. at 614.
- Miscellaneous intangible plant – RUCO and SWG agree on the appropriate adjustments to rate base. RUCO-4 at 3 (the schedule referenced on line 15 should be RLM-3, not RLM-2).
- Working capital – RUCO and SWG are in agreement on the use of 37.5 lag days for income taxes. A-27 at 3 (Moses); RUCO-4 at 4 (Diaz Cortez).
- Sarbanes-Oxley expense – SWG has agreed to update the Company's actual costs. A-30 at 10 (Aldridge). RUCO has agreed with the Company's clarification that it did

not double count certain invoices. A-31 at 12-13 (Aldridge); Tr. at 952, 985 (Diaz Cortez).

- Injuries and damages expense – Upon SWG's agreement to use a 10 year average, RUCO and the Company are now in agreement. Tr. at 928 (Moore).
- TRIMP expense – SWG accepts RUCO's adjustment to reflect actual costs, and amortize the expenses over seven years. A-33 at 11.
- DSM proposal – RUCO and SWG are in agreement regarding the $4.385 million of proposed demand side management ("DSM") programs and the collaborative process for their development, administration and performance assessment. A-14 at 5 (Scott).

RATE BASE OUTSTANDING ISSUES

Construction Completed Not Classified (CCNC)

At the conclusion of an accounting period, work orders for utility plant additions may be complete and in service, but the work order may not have yet been classified for transfer to the detailed utility plant accounts. Such plant is reflected on the utility's balance sheet as Construction Completed Not Classified ("CCNC"). RUCO-9. SWG proposed an adjustment to its test-year rate base for its CCNC balance. A-29 at 11 (Aldridge). However, certain work orders that were included in the Company's CCNC adjustment were not in service by the end of the test year, and therefore should be disallowed. RUCO-6 at 7-8 (Moore); RUCO-10. RUCO's removal of a portion of the Company's CCNC adjustment was based on the Company's response to a data request in which the Company indicated the in-service date for each CCNC work order. Id. At 7-8; RUCO-10. The Company claims that portions of its work orders were in service by the end of the test year, and that those portions of work orders should be included in a CCNC adjustment. However, the National Association of Regulatory Utility Commissioners' Uniform System of Accounts defines the CCNC as including the "total of the balances of *work orders* for utility plant which has been completed and placed in service but which work orders have not been classified for transfer to the detailed utility plant account." Exh. RUCO-9 (emphasis added). The definition focuses on work orders as the relevant measure of what is included in CCNC, not segments of work orders, as the Company proposes.

In addition, the Company failed to reflect retirements related to CCNC projects which it included in rate base. RUCO's adjustment on schedule RLM-4 reflects the retirements for the projects which have an in-service date during the test year and which RUCO believes are appropriate to include in rate base. However, should the Commission determine that other CCNC projects are also appropriate to include in rate base, there may be additional retirements that should also be reflected.

Pipe Replacements

RUCO proposed disallowance of certain pipe replacement projects from rate base, consistent with the terms of an earlier Commission order regarding the pipe replacement projects. After SWG acquired its gas distribution properties in Southern Arizona, it determined that certain types of pipe used in the system were defective. The defective pipe was an issue in several SWG rate cases in the 1980's and 1990's. In Decision No. 58693 (July 7, 1994), the Commission adopted a settlement agreement that resolved the issue of how the pipe would be treated for ratemaking purposes. SWG agreed to write off a certain annual percentage of the replacement costs of the defective pipe types[1]. The write-off percentages would decline annually until they reached zero.

SWG made the required write offs in all other rate cases since 1994, but in this docket the Company proposes to cease making some of the write-offs required by Decision No. 58693. While RUCO agrees with the Company's proposed future treatment of the write-offs

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1 Specifically, the 1960's steel pipe, and plastic pipe known as Aldyl A, Aldyl HD and ABS.

(modifying some of the write-offs and eliminating others), RUCO and the Company disagree over what write-offs should be reflected for the years 2000 through 2004.

SWG has made no write-off of the 1960 steel pipe for the years 2000 and later. Since 2000, the Company has written off portions of the Aldyl HD replacements, but not at the levels required by Decision No. 58693.[2]

RUCO does not dispute that the Company has presented an appropriate justification for the Commission to modify the write-offs required under its prior decision. However, until the Commission adopts such modifications, the Company is obligated to adhere to the write-off schedule required by Decision No. 58693. The Commission's adoption of revised write-offs would be effective only from the time the Commission approves those modifications.

In any given rate case, the Commission generally determines the appropriateness for inclusion in rate base of all capital expenditures that have taken place since the end of the test year in the prior rate case. However, the situation is different with respect to these pipe replacements, as the Company had previously agreed to a particular treatment of the replacement plant on a retroactive *and a going-forward basis*, and the Commission approved that treatment in Decision No. 58693. Decision No. 58693 explicitly contemplated the future treatment of these pipe replacements when it described the agreement as requiring the defined treatment "[i]n future Southwest rate cases". Decision No. 58693 at pg. 3, line 22. The entire paragraph beginning at page 3, line 22 of Decision No. 58693 would have no meaning if the decision had no effect on the future rate base treatment of the pipe replacements. Therefore the RUCO's adjustment to reflect the previously required write-offs should be accepted.

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[2] RUCO and the Company have reached agreement on the percentage of disallowances required for the Aldyl A and ABS pipes. Tr. at 614 (Mashas)

Deferred Income Tax

In its rebuttal testimony, SWG proposed for the first time that the Commission reduce its deferred income taxes and increase its rate base by $21 million to reflect provisions of new rules adopted by the Internal Revenue Service ("IRS") on August 3, 2005. Exh. A-27 at 6-7. RUCO opposes the recognition of this post-test year change for several reasons. First, it took place nearly a year after the test year ended on August 31, 2004, and was not included in the Company's initial application and thus not reviewed by RUCO when it filed its direct testimony on July 26, 2005. Further the regulation is only a temporary regulation, and the IRS will be undertaking additional review before adopting final regulations on the matter. Exh. A-27 at LEM-1, third page of the second document. The IRS is free to adopt a final regulation that is different from the temporary regulation on which SWG requests this Commission base its rates. Tr. at 491-92 (Moses). While SWG may be obligated at this time to abide by the temporary regulations, those regulations do not meet the "known and measurable" standard of a post-test year event for recognition by the Commission. The Commission should therefore reject SWG's proposed adjustment to deferred income taxes.

OPERATING EXPENSE OUTSTANDING ISSUES

Sales and Marketing Wages

RUCO has proposed removal of all or a portion of the wages of 37 SWG employees whose tasks include marketing gas and gas products. Those employees' responsibilities include a number of duties relating to increasing the sales of gas, such as monitoring and analyzing competitors' marketing activities, determining the impact of competitive forces in the marketplace, evaluating the effectiveness of advertising programs, designing and implementing new marketing programs, identifying opportunities to increase margin for certain customers, initiating and developing market opportunities, conducting market analysis research and recommend specific market activities based on the results, and other marketing-related tasks. RUCO-6 at 14-16. In addition, all 37 employees participate in a sales incentive program, which awards bonuses for the employee successfully convincing customers to commit to use gas for space heating, water heating, cooking and clothes drying. RUCO-7; Tr. at 92 (Palacios). If customers only use gas for two of those services, the employee does not qualify for the sales incentive. Tr. at 92 (Palacios). Therefore, these 37 employees have an incentive to convince customers to take gas for all possible uses. Id. at 92-93.

In Decision No. 57075, the Commission described its rationale for disallowing marketing related costs. Decision No. 57075 at 54-55. Essentially, the Commission indicated that it was not appropriate to require customers to pay for the costs of both sides of an escalating competition between the gas and electric industries. The Company acknowledges that these types of marketing expenses are not appropriately recovered from customers, as demonstrated by its own removal of a half of a million dollars of other marketing and promotional expenses. RUCO-6 at 16; A-29 at 21 (Aldridge). The Company has removed the costs of marketing when it is performed by an outside company or trade organization. The Commission should likewise disallow the portion of wages of these 37 employees attributable to their marketing-related tasks. That would include the 17 percent of their total wage package that is earned under the sales incentive program, and a percentage of their underlying wages related to the time they spent on sales and marketing activities. Tr. at 945-47 (Moore); Tr. at 549 (Aldridge).

Post-Test Year Wage Increases

SWG has annualized the June 2004 wage increase which became effective in the last quarter of the test year. RUCO agrees with this adjustment by the Company. However, RUCO opposes including in rates of the Company's second wage increase, effective in June 2005, and other within-grade wage increases that took place after the test year.

The Company historically has granted one wage increase per year. RUCO-5 at 12. RUCO has no objection to annualizing the 2004 wage increase so that expenses may be reflected at the end-of-test year level. However, recognizing the 2005 wage increases, in addition to the 2004 increase, would permit recovery of two wage increases. In addition, recognizing the 2005 wage increases would result in a selective recognition of projected expenses. By annualizing the 2004 wage increases and test year customer and revenue levels to the end-of-test year amounts, a proper matching of revenues, expenses and rate base at the end of the test year results. However, reaching beyond the test year to include an additional wage increase, without also recognizing other post-test year events, produces a mismatch between the various elements of the rate making model. Therefore, the 2005 wage increase and within-grade salary adjustments should be rejected.

Executive Compensation (SERP/MIP)

RUCO proposes disallowing recovery of the costs of two additional compensation programs made available to the Company's management level employees. SWG offers a Supplemental Executive Retirement Plan ("SERP") to a select group of high-ranking officers in the Company, in addition to their regular retirement plan. RUCO-5 at 28. These executives are already fairly compensated for their work, and are provided a wide array of benefits including medical, dental, life and long-term disability insurance, paid absence time, and a retirement plan. RUCO-5 at 28-89. The additional costs of a second retirement plan for executives are not essential for the provision of gas service to customers, and should be borne by shareholders, not customers.

In addition, the Company has a Management Incentive Plan ("MIP") through which key management employees can receive bonuses in addition to their annual salary increases. RUCO-3 at 20-21. Payments under the MIP are based on five performance targets that can be grouped into three areas: return on equity, customers per employee, and customer satisfaction. RUCO-3 at 20. The Company's achievement of these performance targets benefits stockholders primarily, rather than customers. RUCO-3 at 20-21. This is particularly true between rate cases. Id. Further, the plan's incentive to improve the Company's return on equity has failed to significantly improve the Company's capital structure since its last rate case. RUCO-4 at 16; Tr. at 955 (Diaz Cortez).

Additionally, the MIP is not a known and measurable expense on a going forward basis, as MIP awards are contingent on whether or not, and the degree to which, the Company achieves its performance targets. RUCO-3 at 21. Therefore, the amount of MIP expenses incurred during the test year is not necessarily representative of the amount that will be incurred in subsequent years during which new rates will be in effect. Id. at 21-22.

In Decision No. 57745, the Commission disallowed the entire cost of SWG's MIP. RUCO-3 at 22. However, at that time, the MIP's evaluation criteria were based solely on the Company's achieved return on equity. RUCO-3 at 23. With the addition of the customer satisfaction criteria in the current MIP, RUCO recommends that shareholders should be held responsible for two-thirds of the costs of the MIP. Id. at 22.

Shareholders, not ratepayers, are the primary beneficiaries of the program, and the MIP awards can be viewed as bonuses, as they are in addition to regular wages and salaries which increase each year. Furthermore, the MIP expenses that the Company will incur are not known and measurable, and could be as little as zero. Therefore, a sharing of MIP costs is appropriate.

AGA Dues

During the test year, the Company paid $384,566 in dues for membership in the American Gas Association ("AGA"). RUCO-5 at 20. The Company removed from its application a portion of those dues related to marketing and lobbying (A-30 at 13), but it has left in the portion of the dues related to the AGA's Communications and Public Affairs[3] functional cost centers. RUCO-5 at 21.

The Company's belief that the Communications and Public Affairs portions of the dues should be recovered from ratepayers is based exclusively on the descriptions of those classifications that the AGA provided and that Company witness Aldridge attached to her rejoinder testimony. Tr. at 581, 593 (Aldridge). Though RUCO challenged the inclusion of the Communications and Public Affairs items as expenses that customers should pay, the Company provided no additional support demonstrating that those expense categories are in fact for items that benefit customers rather than shareholders. The Company has not reviewed the particular communications that were the subject of the AGA's Communications expenses (Tr. at 552), and can therefore only speculate as to the nature of those communications. The Company acknowledges that the communications could include items that attempt to encourage additional gas usage. Tr. at 581 (Aldridge). For example, though Communications

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[3] Public Affairs represents over 23% of the AGA dues. A-30 at RLA-3 Sheet 1. The lobbying expenses that the Company has removed were part of the Public Affairs category, but only represents 2.1% of the overall AGA dues. A-30 at 14 and at RLA-3 Sheet 2.

expenses includes communications related to pipeline safety, the Company cannot say whether those communications are directed at alleviating potential customers' concerns about safety, thereby promoting the use of gas as a safe energy alternative. Tr. at 551-52 (Aldridge).

Once RUCO has raised an objection to the inclusion of these expenses in customers' rates, the Company has a burden to demonstrate their suitability for inclusion in rates by something more than its speculation of what the costs are for. Because the Company has not provided any additional evidence to demonstrate that the Communications and Public Affairs portions of the AGA dues do not principally benefit shareholders, the Commission should adopt RUCO's adjustment to disallow this portion of the expense.

Miscellaneous Expenses

The Company's application included an adjustment to remove certain Miscellaneous expenses such as gym memberships, donations and certain meals. A-29 at 33. However, RUCO determined that the Company had not removed other expenses related to payments to chambers of commerce, donations to non-profit organizations, club memberships, gifts, awards, extravagant corporate events and for various meals, lodging and refreshments not necessary to providing gas service. RUCO-5 at 25. In its rebuttal testimony, the Company agreed to a small portion of RUCO's proposed adjustment. A-30 at 16. However, RUCO continues to object to the inclusion of expenses for liquor, coffee, water, ice, sodas, smoothies, bagels, trophies, flowers, gift certificates, photography, donations, travel reduction programs, shareholder meetings, recognition events, art work, barbeques, and the like. RUCO-6 at 21; Tr. at 925 (Moore).

In today's environment of wildly escalating gas costs that will impact all customers' bills, the Commission should be even more critical of the Company's attempt to burden customers with the costs of luxury items. Tr at 956-57 (Diaz Cortez). Therefore, these extravagant expenditures that are unnecessary to the provision of gas service should not be included in customers' rates.

COST OF CAPITAL

The Commission should adopt RUCO's recommended rate of return of 8.64 percent, which is the weighted cost of RUCO's recommended costs of debt and equity capital. RUCO-1 at 5. A 10.15 percent cost of common equity is appropriate given the Company's capital structure, the current environment of low inflation and low interest rates, and the Company's higher financial risk (as compared to other similar gas utility distribution companies). RUCO-1 at 43-45.

The Company's actual capital structure as of August 31, 2004 is 60.8 percent long-term debt, 5.1 percent preferred equity and 34.1 percent common stock. A-38 at 9. The Company is proposing a capital structure comprised of approximately 53 percent long-term debt, five percent preferred equity and 42 percent common stock. A-38 at 8. The Company's hypothetical capital structure is close to the average debt and equity percentages of the local distribution companies ("LDC") that RUCO used in its proxy of companies to determine a fair rate of return. RUCO-1 at 44. RUCO supports the Company's proposed hypothetical structure.

RUCO recommends, however, that the Commission reject the Company's proposed cost of equity ("COE"). The Company is proposing a COE of 11.92 percent (without the conservation margin tracker ("CMT")) or 11.67% (with the CMT). Transcript at 780. In calculating its COE the Company deviates from the normal method the Commission uses when determining COE and proposes a unique methodology which has the effect of inflating the COE. Moreover, the Company's proposed COE is not representative of the proxy of LDC's the Company uses in its COE analyses and should be rejected by the Commission.

The Company relied on the following market-based models in calculating its COE—the Discounted Cash Flow ("DCF") model, the Comparable Earnings Model ("CEM"), the Capital Asset Pricing Model ("CAPM") and the Risk Premium Model ("RPM"). The Company calculated its COE by averaging the results of these four models. Tr. at 692. Historically, admits the Company, the Commission determines a utility's COE by applying the DCF and/or the CAPM model. Tr. at 692. There is nothing unusual or extraordinary about this case that requires or justifies the Commission adopting the Company's approach. The Commission should reject the Company's methodology for determining its proposed COE.

Regardless of the methodology, the Company has skewed the results of its DCF and CEM analysis to arrive at an inflated COE. In its DCF analysis the Company utilized two proxy groups consisting of gas distribution companies. Id. at 695.[4] One proxy consisted of five distribution companies, and the other proxy consisted of eleven distribution companies. Id. at 695. The Company considered each proxy company's regulatory awarded returns on equity and chose the proxy companies with the five highest returns on equity to arrive at its final recommendations. A-38 at 32, FJH-7. The Company arbitrarily eliminated the other companies from consideration based on the lowest regulatory approved COE (9.90%) in the period from January 1, 2003 through September 30, 2004[5]. Id. The Company established the 9.90% benchmark based on its belief that a lower COE is not indicative of any reasonable expected COE. Id. The Company's method of arbitrarily assigning a benchmark COE and

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[4] The companies used in the two proxy groups, with the exception of one, are the same companies RUCO used in its proxy group. Id. at 702

[5] During the hearing, the Company changed its DCF analysis based on the 9.45% COE awarded by the Arkansas Public Utility Commission in Order No. 16 dated September 19, 2005. S-20 at 45. Transcript 779-781.

ignoring in its DCF analysis the COE of other proxy companies below the benchmark results in a skewed analysis towards the high end. Thus, unlike RUCO's DCF analysis which considers the COE of all its proxy companies, the Company's analysis is not representative of the entire proxy group it utilizes as a whole. The Commission should reject the Company's DCF analysis.

Likewise the Commission should reject the Company's CEM. Here, the Company, in an effort to avoid circularity, used as its proxy group 87 non-price regulated firms which the company argues is comparable in total risk to the regulated utilities used in the Company's DCF proxies. A-38 at 49-50. The flaw in the Company's logic is that SWG is a regulated utility and comparing non-regulated companies to regulated utilities is not, and cannot be, an apples-to-apples comparison. The market determines price and thus the customer base with the non-regulated companies, whereas, regulatory bodies determines the price of regulated utilities. Consumers of monopoly utility services have no service provider alternatives and therefore the financial risk the regulated utilities face is much different than the non-regulated companies. The Commission should reject the Company's CEM results.

The 10.15 percent cost of common equity estimated by RUCO witness Rigsby is very reasonable when the Company's hypothetical capital structure is compared with the capital structures of other publicly traded gas distribution companies. RUCO-1 at 4. RUCO's 10.15 percent COE reflects an upward adjustment of 124 basis points to the results of RUCO's DCF analysis and is 25 basis points lower than the upper range of its estimates obtained from both the DCF and CAPM methodologies. Id.

In arriving at RUCO's final 10.15 percent COE estimate, Mr. Rigsby took into account not only the additional financial risks that the Company faces, but also the current economic environment. Mr. Rigsby's final recommendation takes into consideration anticipated interest rate increases by the Federal Reserve and the impact that these increases could have on utility stocks. RUCO-1 at 41. The observations presented in Mr. Rigsby's direct testimony on the effect of interest rates on utility stocks and his opinions on how investors view utility stocks (RUCO-2 at 8-9) were confirmed in an article, which appeared in the Wall Street Journal (Attachment A) on October 10, 2005. RUCO believes that Mr. Rigsby has produced a COE estimate that is fair to both the Company and the Company's ratepayers. The Commission should adopt RUCO's 8.64 percent rate of return.

RATE DESIGN OUTSTANDING ISSUES

Billing Determinants

A critical step in the process of setting utility rates is the determination of the billing determinants over which required revenues will be spread. Tr. at 242 (Congdon). Billing determinants, including the number of bills issued for the various tariffs, the consumption levels reflected on those bills, and the billed demand levels for tariffs with demand components, that underlie the Company's adjusted test year revenues must be determined. Id. at 241-42. If too few billing determinants are used, tariff prices would be set unnecessarily high. Tr. at 243. While the actual test year billing determinants are not the ones ultimately used to set rates (Tr. at 244-45), a fixed starting point of actual billing determinants is an essential first step in computing the adjusted determinants for use in setting rates. Tr. at 249, 264-65; RUCO-6 at 6 (Moore).

Despite the fact that the Company agrees that the actual billing determinants are necessary to begin the process of discerning the adjusted billing determinants, it was unable to provide actual recorded billing determinants. Tr. at 265; RUCO-6 at 5 (Moore); Tr. at 935

(Moore). Instead the Company supplied billing determinants that were based on a bill frequency analysis ("BFA") that already included certain adjustments. Tr. at 259-60 (Congdon).

Because the Company did not provide billing determinants that RUCO could verify actually produced the test year recorded revenues, it was necessary for RUCO to impute revised billing determinants as the fixed starting point in designing rates. RUCO-5 at 5. Appropriate adjustments were then made to that starting point, to produce a normalized set of billing determinants to develop final rates. RUCO-6 at 6.

In the Company's rejoinder testimony, it disputed some of RUCO's calculations in its surrebuttal testimony related to the billing determinant starting point. However, the Company's adjustment to RUCO's bills and volumes referred to numbers other than those relied on by RUCO in its surrebuttal testimony. Tr. at 269 (Congdon), at 924-25 (Moore).

As a result, RUCO's billing determinants are the most reliable determinants over which the required revenues can be spread.

Conservation Margin Tracker

Over at least the past 20 years, the Company has experienced a notable decrease in average consumption per customer. Tr. at 154 (Cattanach). This decreasing consumption is a major factor in SWG's difficulty in earning its authorized returns in recent years. A-3 at 7-8 (Shaw). Because the Company's costs are largely fixed per customer, recovery of an excessive portion of revenues from commodity-related charges can result in underearnings when consumption levels decrease. A-3 at 7-8 (Shaw); A-19 at 4 (Geisking); RUCO-3 at 34 (Diaz Cortez).

In anticipation of a continuation of the trend of decreasing consumption, SWG proposed a Conservation Margin Tracker ("CMT"), a relatively novel rate design device to stabilize its margin revenues in the event of continued decrease in average consumption. The cornerstone of the CMT proposal is the establishment of an authorized margin per customer to which actual margins per customer will be compared. A-19 at 17 (Geisking). The difference between total authorized margin (authorized margin per customer multiplied by the actual number of customers during the relevant time period) and the total actual billed margin will be recovered from or returned to customers in the following year. A-19 at 17; Tr. at 368. The CMT is only proposed to be applicable to residential customers. Tr. at 339.

RUCO agrees that the Commission ought to modify the Company's existing rate design in recognition of the fact that its margins are at risk if consumption continues to decrease. RUCO-3 at 34. However, the Company's CMT proposal is too extreme a solution to the dilemma that could arise from further conservation by customers. There are a multitude of reasons to reject the CMT proposal.

First, the CMT's approach of viewing authorized margin on a per customer basis is contrary to the Commission's historic approach to setting rates. In the past, the Commission has determined a utility's authorized revenues on an overall company basis. SWG, however, proposes that the Commission now authorize margin on a per customer basis, essentially guaranteeing that the Company will receive the predetermined revenue levels for each customer. Tr. at 362 (Geisking).

A second reason to reject the CMT is that it would provide the Company with greater assurances of revenue recovery than the Commission usually affords. Tr. at 998. Generally, the Commission provides no guarantee of revenues to insure that a utility collects a certain amount even if customer consumption decreases. However, the CMT would insulate the

Company's earnings from all changes in average usage, regardless of the cause. Tr. at 348-349, 362 (Geisking)[6]. For example, the CMT allows the Company to "true up" its revenues for consumption decreases due to warm weather. Tr. at 347. Likewise, the CMT attempts to overcome the Company's perceived shortcomings of using a historic test year. Tr. at 49-52 (Shaw). It does so by insuring that the Company earn the authorized margin per customer not just from the customers who were on the system during the test year, but also from new customers who come onto the system in later years. Id.

A third objection is that the CMT is being proposed at a point when the decreasing consumption problem is likely to be slowing. SWG's economist Mr. Cattanach testified that he expects to see the rates of conservation slowing in the future. Tr. at 161-164. If the predicament of decreasing consumption tempers, there may be less of a need to address the Company's earnings concerns.

A fourth reason to disapprove of the CMT is that it would have imbalanced impacts on customers. When evaluating a rate design proposal such as the CMT, the Commission ought to consider its impacts on individual customers as well as its impacts on customer classes as a whole. Tr. at 232 (Congdon).

The Company's CMT proposal is imbalanced in several respects. First, it is only applicable to residential customers. Tr. at 339. However, the residential customer class is not the only class for which declining consumptions are possible. Tr. at 338. In fact, the Company's DSM proposal includes a significant expansion of resources devoted to commercial and industrial customers. A-13 at 13-14. The Company expects to observe

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[6] RUCO believes there is a typographical error in the transcript. At page 348, beginning at line 17, the question should read "Q. Okay. Now, Southwest Gas's proposal here would insulate the company's earnings from all changes in use per customer regardless of cause, correct?" The transcript erroneously substituted the word "cost" for "cause" on line 19.

conservation by the nonresidential customers as a result of the additional DSM programs. Tr. at 182 (Scott). There is no reason to penalize residential customers for their conservation efforts, but allow larger customers to receive the full benefit of their similar accomplishments.

The CMT would produce additional inequities affecting individual customers. Most notably, the CMT would have the effect of requiring customers to pay the authorized margin for therms they do not consume. RUCO-3 at 29 (Diaz Cortez); RUCO-8. Further, *customers who contribute the full authorized margin, and those who contribute more than the authorized margin, would be burdened with a CMT charge* if customers as a whole continue to conserve. Tr. at 350-352, 357 (Geisking). Also, new customers, who come onto the system in a subsequent year would be required to subsidize any under-recovery of margin from the prior year. Tr. at 358 (Geisking). Finally, if those new customers use less gas due to more efficient housing stock and appliances, and thus contribute less than the pre-authorized margin levels, the pre-existing customers will have to share the burden of reimbursing the Company for the new customers' under-contributions. Tr. at 360-61 (Geisking). In light of these numerous inequities, the CMT is an inappropriate device to address decreasing consumption's impact on decreasing revenues.

A fifth factor evidencing the inappropriateness of the CMT is that it is an excessive modification to the existing rate design. The Company declined to propose a rate design that recovers all margin through the basic service charge, because the Company believes such a rate design is too extreme and inconsistent with the principle of gradualism. Tr. at 336-37, 607-08, 206. However, by guaranteeing that the Company will recover its authorized margin per customer, the CMT's impact is similar to recovering all margin revenues through the basic service charge. Tr. at 361, 369; RUCO-7. It is puzzling that the Company would propose the CMT when it has rejected an essentially equivalent rate structure because it was too radical.

The CMT is an extreme, imbalanced and overcompensating solution to the Company's concerns about decreasing future consumptions. Rather than adopting it, the Commission should adopt RUCO's rate design proposal, which appropriately balances the Company's concerns of decreasing margins and the public interest in promoting conservation of increasingly scarce gas resources.

RUCO's Rate Design Proposal

In recognition of the realities of decreasing consumption and its effects on SWG's ability to earn its authorized return, RUCO has proposed a rate design that addresses the Company's concerns in a less drastic manner than either the CMT or the Company's alternative rate design proposal. RUCO's proposed rate design has two principal characteristics.

First, RUCO proposes to increase the percentage of revenue that the Company collects through the basic service charge. In the test year, SWG recovered 37% of its residential revenues from the fixed monthly service charges, and 25% of its commercial revenues from fixed monthly charges. RUCO's proposed rate design would increase those percentages to 41% and 32%, respectively. The impact would be to increase recovery through the basic service charges from 33% in the test year to 38%. RUCO-4 at 7 (Diaz Cortez). On a dollar basis, RUCO's proposal shifts $23 million of *existing* revenues from commodity rates to the basic service charge, even before considering the additional revenues resulting from this proceeding. Tr. at 953, 1004 (Diaz Cortez). By shifting revenue recovery from the commodity-based rates to the fixed portion of the rates, SWG's risk of not recovering its revenue requirement in a period of declining usage would be diminished. RUCO-4 at 7. Even the

Company acknowledges that this feature of RUCO's rate design proposal is a movement in the right direction. Tr. at 53 (Shaw).

Secondly, RUCO proposes to flatten the existing two-tier declining commodity rate structure for residential customers. Retaining the declining rate structure is counterintuitive to the goal of promoting energy efficient consumption. RUCO-3 at 35 (Diaz Cortez). It would be counterproductive to, on the one hand, promote increased spending on DSM, and on the other hand continue to utilize a rate structure that provides lower commodity rates for larger consumption levels. Id. The existing distinction between summer and winter rates disappears when a flat commodity rate is used, because the only difference between the current summer and winter rates is where the break-over point is between the two tiers. Id. at 37. Intervenor Southwest Energy Efficiency Project supports this aspect of RUCO's rate design proposal, and Staff does not oppose it. SWEEP-2 at 1 (Schlegel); S-15 at 7 (Gray).

CONCLUSION

RUCO has proposed a rate design that more appropriately balances SWG's concerns about its decreasing margins and the public interest in inciting customers to conserve natural gas resources. However, in light of current energy costs the Commission should protect customers from being forced to absorb the costs of items that are not essential to the provision of gas service. Further, the Commission should continue to rely on its established approaches to determine a fair return on equity. Today's era of rapidly increasing energy costs is not the time for the Commission to experiment with rate design mechanisms or return on equity approaches, nor to permit extravagant costs that are not necessary to serve customers.

RESPECTFULLY SUBMITTED this 3rd day of November, 2005.

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EXHIBIT A

THE WALL STREET JOURNAL. ONLINE

October 10, 2005

MARKET MOVERS

Utilities Might Face Ugly Reality

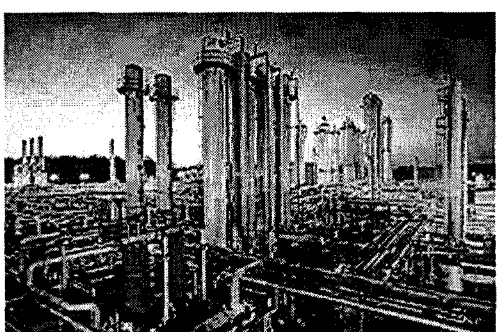
Sector Has Gleamed Recently, But Worries About Energy Prices And Interest Rates Spur Concern

By IAN MCDONALD and E.S. BROWNING
Staff Reporters of THE WALL STREET JOURNAL
October 10, 2005; Page C1

Called the big uglies on Wall Street, utility stocks have been a sight for sore eyes lately. But some fear they might soon live up to their name.

Shares of utilities are about 15% higher so far this year, second only to energy stocks, which are up 32%, according to Dow Jones Indexes. Health-care stocks are the only other sector in the black -- up 3%. Broadly, stocks -- as measured by the Dow Jones Industrial Average and Standard & Poor's 500-stock index -- are in the red by 4.6% and 1.3%, respectively.

There's not much mystery as to what's driving energy and health care. Energy shares usually soar with skyrocketing crude-oil prices. Health-care stocks often fare well in doldrums years, because demand for medicine and hospitals remains fairly constant no matter how the economy is doing.



ConocoPhillips
Duke Energy Field Services in Carthage, Texas.

Utilities are more of a puzzle. Grouped together by professional investors with other grimy and unglamorous -- or ugly -- industries, they usually don't offer much growth potential. Yet the Dow Jones Utility Average hit a record last week, capping a nearly 45% gain during the past two years.

In the past several trading sessions, however, the sector has slipped amid worries that inflation and interest rates are headed up, that the economy will slow and that energy prices have peaked. That skittishness after such a long run-up reflects marketwide concern over the same issues. Major stock indexes suffered one of the year's worst weeks, and the price of crude oil fell sharply.

WALL STREET JOURNAL VIDEO

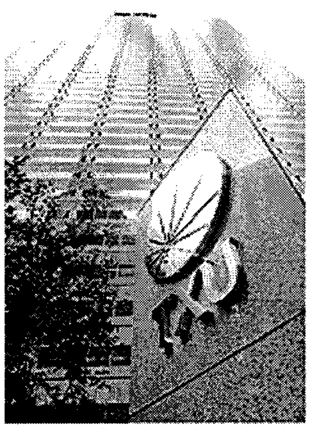
1
WSJ's Ian McDonald comments[2] on the utilities sector.

Utilities' earlier gains resulted from a trio of profitable coincidences.

Historically, interest-rate increases have pushed utilities stocks down because such reliable dividend payers long have been used as a bond substitute by income-seeking investors. Rising rates make newly issued bonds with higher yields more attractive than existing income-producing stocks and bonds with lower payouts. Despite 11 consecutive rate raises by the Federal Reserve, however, long-term bond yields remain low, allowing dividend-paying utilities to retain their edge.

Then there's deregulation, an echo of the story that last pushed the sector up in 2000 after the stock-bubble burst. Thanks to loosened U.S. rules, some utilities that churn out excess power from relatively low-cost sources like coal or nuclear plants can sell that extra capacity in high-cost markets, making a bundle.

Companies like **TXU**, **Duke Energy**, **FPL Group** and Exelon are in this camp and appear poised to report strong third-quarter results in coming weeks. These stocks are well up on the year.


Bloomberg News/Landov
TXU headquarters in Dallas.

"These are hidden energy plays," says Judy Saryan, portfolio manager of the $762 million Eaton Vance Utilities Fund, speaking about Exelon and TXU. "Utilities investors are in a different time."

Strong demand for power has helped, too. The U.S. Gulf Coast hurricanes, which have crimped energy supplies from the region, are expected to keep the price of power high.

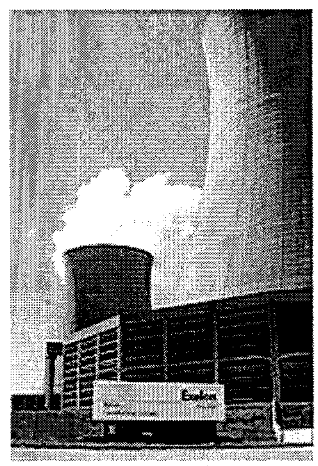
All this has generated extra cash, which utilities have used to slash debt, boost dividend checks and repurchase stock -- which helps drive up share prices.

The sector's fall after last Monday's peak was triggered by worries about all three of the legs that have supported utilities for the past two years -- low bond yields, high prices in the unregulated part of the power market, and high demand for power in a booming economy.

Moreover, the run-up has caused utility stocks to become pricier in relation to their earnings. The higher stock prices also have pushed down their dividend yields -- the amount of income they produce per dollar invested.

"If something bad happens in the utilities world, you could have a material downside," says John Meara, president of St. Louis money-management firm Argent Capital Management, who has steered clear of the sector. "The risk side of the equation is definitely higher than it was five years ago."

Investors don't have to look far back to see a time when a spurt of enthusiasm in the sector ended badly. Utility stocks last soared in 2000, powered by the likes of Enron, as investors fell in love with companies that traded energy like other commodities. The stocks fell hard as the promise of big profits from that business model unraveled ahead of Enron's collapse.


Jeff Haynes/AFP/Getty Images
An Exelon nuclear plant in Bryon, Ill.

There are some significant differences between then and now. This run-up has lasted longer. The stocks that have been gaining are more stable than the ones that soared ahead of the Enron disaster.

Still, a bet on utilities today is an implicit bet that the "conundrum" of low interest rates on long-term bonds will persist. It's also a bet that the economy will chug through the destruction of property and confidence from this year's hurricanes.

And whether your yardstick is stock valuations -- share prices relative to earnings -- or dividend yields, utilities don't look all that inexpensive. Mr. Meara looks at the dividend yield of utilities compared with that of the 10-year Treasury note. Five years ago, utilities were yielding as high as 10%, well above the almost 6% yield of the 10-year note. Today utilities have average yields of 3.4%, compared with more than 4.3% for the note. That makes the Treasury security a better deal, even taking into account lower taxes on dividends.

Some people fear that, even after the fundamental reasons for holding utility stocks have dissipated, investors may hold them, waiting for one last rebound. "Our concerns are mainly about valuations," says Sam Stovall, chief investment strategist at Standard & Poor's. "One reason for the run might have more to do with psychology than fundamentals. Why unload something that has been so good to you?"

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