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BEFORE THE ARIZONA CORPORATION

COMMISSIONERS
JEFF HATCH-MILLER, Chairman
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AZ CORP 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 **STAFF'S REPLY BRIEF**

I. INTRODUCTION

Southwest Gas Corporation ("Southwest") states throughout its brief that it is entitled to just and reasonable rates and that it must be allowed a reasonable rate of return. This is true. But the determination of what is reasonable is based on the record of a specific-case. The determination of just and reasonable rates is within the Commission's constitutional and plenary authority. By construction and statute, the Commission's determination can only be overturned if it abuses its discretion in reaching its decision.[1] No precise formula is mandated to determine just and reasonable rates, except that fair value must be ascertained as part of the analysis.[2] How to determine fair value for a utility is within the Commission's discretion and is based on the facts presented in the case. One must look to the evidence in the rate proceeding to determine what is reasonable.

The best and substantial evidence supports Staff's recommendations in this case:

- The conservation margin tracker ("CMT") should be rejected because it is a disincentive to conserve, its impact on customers will likely be significant, and because the evidence is insufficient that declining use due to conservation is the sole or predominant cause to why Southwest has not achieved its overall authorized rate of return.

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[1] *Simms v. Round Valley Light & Power, Co.*, 80 Ariz. 145, 154, 194 P.2d 378, 384 (1956).
[2] *Id.* at 151, 294 P.2d at 382; *See also A.R.S. § 40-254.*

- Staff's rate design is fair, just and reasonable, because it balances Southwest's need for greater revenue stability with affordability, gradualism and conservation. Basing rates from test-year usage is appropriate and no mechanism is required to be established for what might happen in the future.
- Staff's recommendations on the purchase gas adjustor ("PGA"), customer-service, billing, demand side management ("DSM"), gas technology institute ("GTI") funding, and other issues exhaustively described in Staff's initial closing brief are supported by the evidence in the record and should be adopted.
- Staff's treatment of transmission integrity management program ("TRIMP"), management incentive program ("MIP") and Sarbanes-Oxley ("SOX") costs should be adopted, because Staff recognizes that those costs benefit both ratepayers and shareholders, and not all of those costs are necessary to provide service to customers. In other words, only a portion of these expenses is reasonably necessary to serve customers. Furthermore, TRIMP costs are projected costs, so those costs are not known and measurable. Staff recognizes that TRIMP is intended to improve pipeline safety. As such, Staff recommends a surcharge to reflect actual costs before a subsequent rate case, while ensuring customers do not pay for more than they have to. Accumulated deferred income taxes ("ADIT") should not be adjusted from the test-year because not all the changes from recently-passed legislation have been incorporated, and because Southwest made no actual payment justifying a $21 million increase to rate base.
- Staff's hypothetical capital structure balances competing interests between Southwest and its customers. The balance is preserved between maintaining Southwest's financial integrity versus ensuring customers do not pay too much in rates for equity the Company does not have.
- The cost of common equity ("COE") in this case should be adopted because Staff's analysis is based on the efficient markets hypothesis, appropriately relies on the DCF method while also incorporating other methods, takes into account Southwest's riskier profile, and does not rely too much on methods that over-rely on beta as a measure of risk.

Clearly, Staff's recommendations should be adopted because ample evidence exists on the record to support these recommendations. Therefore, Staff's proposals are not unreasonable or confiscatory. The substantial and best evidence in the record indicates that – with Staff's proposed revenue requirement, rates and recommendations – Southwest will be able to maintain its financial integrity, attract capital and compensate investors for risks assumed.

Southwest relies on *Anaheim, Riverside, Banning, Colton and Azusa, California v. Federal Energy Regulatory Commission,* 669 F.2d 799 (D.C. Cir. 1981) to support its contention that Staff failed to present sufficient evidence to demonstrate the reasonableness of its position.[3] The *Anaheim* case is based on the Federal Power Act at § 205(e) and 16 U.S.C.A. § 824d(e), which states that the Company has the burden to show its increased rate to be reasonable. In other words, the burden is on the Company to establish the validity and accuracy for each of its cost estimates.[4] Furthermore, even if this were to be more than persuasive authority, Southwest oversimplifies the *Anaheim* holding at several points in its brief. *Anaheim* holds that if a showing of inefficiency or improvidence is made, or if another participant raises serious doubt as to the prudence of an expense or cost, then *the applicant has the burden* of dispelling those doubts and proving that its expenditures are prudent[5].

There is no standard of sufficiency that intervening parties must conquer and the burden does not shift to any other parties from the utility making the request to increase rates. The burden rests with Southwest. *Anaheim* only states that some costs can be presumed to be prudently incurred, if unchallenged[6]. Since Staff has raised serious doubt as to several of Southwest's requests, Southwest must then justify those requests. Southwest bears the burden to show its costs and expenses to be reasonable.

Absent an abuse of discretion, the Commission has broad authority to set rates. Unless arbitrarily set, any Commission-approved rates should withstand appellate scrutiny. Here, Staff has presented evidence justifying its recommended rates as just and reasonable. Staff has ascertained fair value in accordance with Arizona law. If the Commission decides to adopt Staff's recommendations, it is adopting rates supported by the evidence in the record. Staff has already highlighted that

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[3] Southwest cites this case abundantly in its brief.
[4] 669 F.2d at 803. *quoting* Village of Chatham v. FERC, 662 F.2d 23, 28 (D.C. Cir. 1981)
[5] 669 F.2d at 809. *See also* Ohio Gas Co. v Public Utilities Comm'n 294 U.S. 63, 55 S.Ct. 316 (1935).
[6] Id.

evidence in its Initial Closing Brief supporting its recommendations.

This reply brief will not rehash every point made in Staff's Initial Closing Brief, nor will it refute every single item raised in Southwest's brief. Staff's recommendations and positions have been described in Staff's Initial Closing Brief, with extensive citations to the evidence in the record. Staff will, however, highlight some of the major flaws in Southwest's arguments in this brief.

II. THE EVIDENCE DOES NOT SUPPORT ADOPTION OF THE CONSERVATION MARGIN TRACKER.

Southwest's arguments against Staff are particularly inflammatory on this issue. Southwest accuses Staff's position of being filled with rhetoric, hyperbole, and delusion as to how drastic and inequitable the CMT is. But as Staff pointed out, the evidence shows that several problems exist with the underlying basis for the adoption of an experimental mechanism like the CMT should not be adopted. For example, while declining per customer use has been a phenomenon that has occurred, there is evidence disputing that this trend will continue. In fact, Southwest's own witness, Mr. Cattanach, testifies to the relative inelasticity of natural gas, suggesting that declining per customer usage will not continue as it has. No one can attest to how much elasticity, if any, truly remains for natural gas, but common sense dictates that *some* amount of natural gas is going to be needed for the foreseeable future.

But even with some elasticity in natural gas, the CMT is still a bad move. The causal link or nexus between declining usage because of conservation and Southwest not achieving its overall authorized rate of return has not been shown. Southwest cannot convincingly explain away the evidence that Southwest is meeting its rate of return through new customer growth and that economies of scale do not apply. Furthermore, no evidence has been presented that existing or vintage customers are entirely or predominantly responsible for Southwest only achieving 2.29 percent return on margin for this customer class. Thus, the evidence is insufficient to justify the CMT's adoption.

Also, the evidence provided by Staff and the Residential Utility Consumer Office ("RUCO") makes it clear that the CMT will charge people for not using enough natural gas, which is logically a major disincentive to conserve. Even though customers will save money by not using as much gas, the CMT would offset those savings if Southwest cannot collect its authorized margin. Staff does not believe that is the message the Commission wants to send. Finally, the evidence shows that the CMT's impact could be significant, especially if it imposes another surcharge for not using "enough" gas on top of a colder than normal winter.

Southwest states that the CMT will protect customers from high winter bills. But that is only if Southwest over-recovers above its authorized margin. According to the evidence, that only happened once in the last 11 years, in 1998, when winter temperatures were colder than normal. But even mild winters lead to high winter bills and the CMT will not protect customers in those circumstances. Furthermore, customers would not receive the benefit of the "over-recovery" until the following year. The impact of weather is dubious in any event, since according to Southwest, it is conservation and increased efficiencies and not weather that is the culprit.

Southwest's comparisons to the PGA are only applicable to the extent that the CMT would be another adjustor mechanism. But while the PGA tracks a rapidly-fluctuating expense – the price for natural gas – the CMT would track no such rapidly-fluctuating expense. Usually an adjustor recovers certain narrowly-defined expenses.[7] Furthermore, Southwest's proposed CMT applies only to residential customers, has no bandwidths, and suffers from several other mechanical deficiencies. These deficiencies could perhaps be tailored to be a mirror-image to the PGA, but the evidence to justify the CMT is still lacking.

Southwest is requesting, essentially, that risk to it be reduced through the CMT. Not all risk because the CMT will likely still not allow Southwest to achieve its overall authorized rate of return, as alleged by Southwest. Southwest's two positions appear to contradict each other, and the question must be asked as to why this adjustor should be adopted – even if declining customer usage due to conservation were the problem – when it is likely to be unsuccessful anyway.

DSM and other conservation programs should not be held hostage to the CMT. Staff supports Southwest recovering its costs for DSM, and is supporting $4.335 million being recovered through Southwest's DSM adjustor mechanism. Conserving and efficiently-using a precious and finite

[7] See RUCO v. Arizona Corp. Comm'n, 199 Ariz. 588, 592, 20 P.3d 1169, 1172 (App. 2001)

commodity is an important policy goal and Staff applauds Southwest's support to do so. But such support should not be dependent on adoption of a mechanism as troubling as the CMT.

In short, Southwest has failed to meet its burden justifying the CMT. It should not be adopted. The problem of Southwest's inability to earn its authorized rate of return should be addressed through modifying its rate design, which is exactly what Staff has done.

III. STAFF'S RATE DESIGN APPROPRIATELY BALANCES MULTIPLE FACTORS.

Southwest leaves no doubt that it seeks to recover the vast majority of its margin in the basic service charge and the first block. This is why its rate design achieves greater revenue stability and if that were the only factor to consider, then Southwest's rate design may win the day. But clearly, revenue stability is not the only factor to consider when designing rates. Staff provides ample evidence that multiple factors should be weighed more evenly when designing rates. Staff's rate design, therefore, is more justifiable than the rate design proffered by Southwest.

Southwest also contends that marginal cost of natural gas provides the best economic price signal, and that the most efficient natural gas use occurs when price reflects marginal cost. Even so, customers need a certain amount of gas for things like heating homes, running laundry and providing hot water. Each customer will need a certain amount of natural gas, although that amount may be different for each customer. So, regardless of the price signal, people will have to use some natural gas.

When natural gas use is more discretionary, however, the price signal to conserve can actually lead to conservation. More discretionary use occurs at higher levels, or within the second rate block, than at lower levels. A second block rate of $0.50 per therm (Staff's recommendation) is going to send a message to customers that gas is a precious and finite commodity. A second block rate of $0.25 per therm or $0.15 per therm (Southwest's proposals with and without the CMT respectively) will not send that message. In fact, the message will likely be sent that natural gas is cheaper at higher usage levels, which is clearly not the case. Staff's rate design sends more of a price signal to conserve at these discretionary levels.

Southwest further contends that Staff's position about declining-block rates is contradictory.[8] But Staff merely indicates that declining rate blocks are relatively more difficult to understand versus a single flat rate, not that customers could not understand the impacts of declining blocks to their bills[9]. But customers always understand the bottom-line, and will likely look for ways to save money, especially given the rising costs of natural gas. If conserving natural gas will result in savings, then customers will likely conserve. While not eliminating this incentive, customers looking at the bottom-line and seeing a twenty-five or fifteen cents per therm savings will not be nearly as incented to conserve as seeing a fifty cents per therm savings. Since more discretionary use obviously occurs in the second block than the first block, Staff's rate design is better geared toward sending this price signal to conserve and for conservation actually occurring.

Southwest also complains that Staff offers no way to compensate Southwest under its proposed rate structure if per customer usage continues to decline. But the Commission is not obligated to design mechanisms to compensate Southwest for what might occur, or to guarantee Southwest that it recover its rate of return. Use of a historical test-year to base rates is lawful and appropriate in Arizona. The Commission is not under any obligation to design rates based on projected declines since any projections are speculative. Furthermore, Southwest predicts that usage will go down but also states that natural gas is a relatively inelastic commodity. RUCO has indicated that natural gas elasticity is declining. Staff's rate design offers Southwest the opportunity to earn its overall authorized rate of return based on historical test-year usage. That is all the law requires. Furthermore, Staff has recognized Southwest's problem and proposes a rate design that does move toward revenue stability and cost-based rates. The best and substantial evidence supports Staff's rate design.

Finally, Southwest has a remedy available to it if it cannot achieve its overall authorized rate of return, and that is to file another rate case. A rate application adjudicated before the Commission is the traditional, accepted and appropriate process to ensure a Company does receive a reasonable rate

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[8] Southwest Post-Hearing Brief at 50.

[9] See Direct Testimony of Robert G. Gray, Exhibit S-13, at 34:3-7. "By nature using a declining block rate structure is more complicated than the more commonly used flat rate structure. For a residential customer, it makes their bill more difficult to understand, as instead of having a single tariff multiplied by their therm consumption, the bill reflects the different rates in each block, each applied to the applicable portion of the usage."

of return. Southwest has not been bashful about applying for increased rates when needed. Staff agrees that increased rates are justified here. But the law does not mandate the Commission to authorize rates anticipating any number of possible scenarios. The law also does not obligate the Commission to authorize experimental mechanisms because Southwest has failed for any number of reasons, to achieve its rate of return.

Staff discussed its recommendations regarding proposed tariff modifications and/or eliminations extensively in its Initial Closing Brief. Staff disagrees with Southwest's assertions that Staff did not present evidence justifying its positions regarding modification or elimination of tariffs. Southwest, however, bears the burden to justify its proposed changes, and failed to meet its burden on several occasions. Staff's recommendations on tariff modifications and eliminations are fair, supported by the evidence, and should be adopted over Southwest's position.

The PGA is also implicated whenever there is a discussion about rate impacts to customers. Southwest claims Staff does not have any evidence to back up its recommendations. But the significant increased cost of natural gas is really all that Staff needs to support establishing a higher trigger balance of $29.2 million and requiring officer certification of PGA reports. Adoption of Staff's recommendations will better protect customers from price volatility, as well as ensuring the veracity of the information contained in PGA reports. Southwest's response is that it does not believe officer certification is necessary and wants quid pro quo in the form of a higher bandwidth, from $0.10 per therm to $0.20 per therm. A $6.8 million increase to the trigger bank balance hardly seems to justify a doubling of the adjustor cap from $0.10 per therm to $0.20 per therm. Southwest's proposals do not seem to recognize the importance of protecting and ensuring ratepayer interests.

IV. STAFF'S REVENUE REQUIREMENT INCREASE ADOPTS THE MAJORITY OF WHAT SOUTHWEST PROPOSES, BUT DOES NOT ADOPT ALL OF THOSE ITEMS WHEN THE EVIDENCE JUSTIFIES OTHERWISE.

Staff accepted the significant majority of Southwest's requested revenue increase as prudent. In other words, Southwest met its burden for the bulk of its requested increase. But Staff contends Southwest failed to meet its burden on TRIMP, SOX, MIP and ADIT. The record and the evidence does not support Southwest's requests in these areas.

The standard is not just whether the operating expenses are prudently incurred. Rather, the standard also includes whether the expenses are to the benefit of ratepayers and whether expenses incurred outside the test-year are known and measurable. Staff has provided evidence that not all of Southwest's costs for MIP, TRIMP and SOX are to serve customers, even if all costs were reasonable for Southwest to incur. Staff provided specific evidentiary justification – through James J. Dorf's testimony – for splitting costs between shareholders and ratepayers for MIP, TRIMP and SOX that was summarized in Staff's Initial Closing Brief. Staff's position is not merely buttressed by some general policy justification. This contrasts with the facts in the *West Ohio Gas* case, where the Supreme Court found that no evidence was presented to justify reducing marketing costs from $12,000 to $5,000.[10] Here, Staff provided expert testimony that:

- some MIP performance targets are specifically geared to meeting return on equity goals, but all five targets benefit shareholders;
- Not all TRIMP costs are geared to benefit customers, but instead benefit shareholders, improve the ability to site pipelines and reduce damages from unexpected interruptions of gas service; and
- SOX costs have some benefit to ratepayers but the main aim was for shareholder benefit.

TRIMP also suffers from being mostly projected costs (i.e. not known and measurable). Most of the actual TRIMP costs will not be spent until after this rate case is decided. Staff would be perfectly justified to not recommend any recovery of any costs not incurred during the test-year, but Staff's recommendation recognizes the importance of the TRIMP program to preserve the public's safety and ensure the integrity of pipelines. At the same time, the surcharge mechanism ensures that customers pay only for TRIMP costs actually incurred. Staff's TRIMP surcharge recommendation balances these interests and is supported by the evidence.

For ADIT, the evidence is that: (1) not all of ADIT adjustments are known and measurable (the impact of the 2005 Energy Policy Act on ADIT has not been factored into the adjustment, for example); (2) Southwest did not have to make any actual payments due to the changes in Internal

[10] 294 U.S. at 72, 55 S.Ct. at 321.

Revenue regulations; (3) the regulations are still temporary; and (4) Southwest voluntarily changed methods in 2002. Staff does not think Southwest has shown why its customers should bear the burden of a $21 million increase to rate base for all of the reasons presented in Staff's testimony and summarized in its Initial Closing Brief.

V. STAFF'S COST OF CAPITAL RECOMMENDATION IS AMPLY SUPPORTED BY SUBSTANTIAL EVIDENCE IN THE RECORD.

Southwest wrongly alleges that Staff's recommendations are illegal and violate the Supreme Court decisions in *Federal Power Commission, et. al. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) and *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia et al*, 262 U.S. 679 (1923). But Arizona is a fair value state and a utility is only entitled to the fair rate of return on the fair value of its property.[11] Fair value must be found, but how fair value is found and the fair rate of return is a matter of discretion for the Commission. A 6.63 percent rate of return on fair value rate base that is Staff's recommendation is fair and reasonable and amply supported in the record. Staff's cost of capital ("COC") recommendation also allows shareholders a reasonable rate of return on investment, in accordance with Arizona law.[12]

Staff presents substantial evidence justifying its 8.40 weighted COC recommendation – based on a hypothetical capital structure of 40 percent equity, 5 percent preferred stock and 55 percent debt; a cost of debt of 7.61 percent; and a cost of common equity of 9.50 percent. In ascertaining a reasonable cost of capital, there is no required formula; rather, if the Commission has considered relevant factors, then its finding would withstand scrutiny.[13] Staff's testimony and analysis incorporated all of the factors in the *Litchfield Park* decision to come to its ultimate COC recommendation. Because Southwest challenges the legality of Staff's recommendation, Staff's analysis is summarized below:

- <u>Comparisons with other companies having corresponding risks</u>: Staff's analysis, specifically its Discounted Cash Flow ("DCF") analysis, scrutinizes sustainable growth, earnings,

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[11] *Litchfield Park Service Co v. Arizona Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994) *quoting Arizona Corporation Comm'n v. Citizens Utilities Co.*, 120 Ariz. 184, 190, n. 5, 584 P.2d 1175, 1181 n. 5 (App. 1978).
[12] *See Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978).
[13] *Id.* at 435, n. 3, 874 P.2d at 992, n. 3.

dividends and book value growth, both historical and projected, for eleven local gas distribution companies ("LDCs"). These LDCs were specifically selected because of their similarity to Southwest.[14] Staff's comparison included external growth that factors in a market to book ratio greater than one.[15] LDCs also serve as the basis for the Capital Asset Pricing Model ("CAPM"), Modified Earnings-Price Ratio ("MEPR") and Market-to-Book ("MTB") analyses.

- Current financial and economic conditions: Staff witness Stephen G. Hill highlights numerous economic conditions that factors into his analysis. Mr. Hill describes long-term interest rates as being relatively stable at historically low levels, with some upward movement in short-term rates.[16] Mr. Hill cites an A.G. Edwards study indicating that market expectations are below historical returns.[17] Market risk premiums for stocks are lower than Ibbotson historical data and Southwest's own retirement portfolio expects about an 8.75 percent return.[18] Moody's bond yields are also considered and all those market indicators suggest that Staff's 9.50 percent COE recommendation is reasonable compared to the market-at-large as well as to other utility distribution companies of similar risk.
- Risks of the enterprise and the Company's financial history: Staff recognizes the difficulty Southwest has had in earning its authorized rate of return and in its increased financial risk. This is precisely why Staff recommends a hypothetical capital structure with a 40 percent equity ratio and a 9.50 percent COE that is at the high end of Staff's range. Staff realizes that Southwest's financial integrity must be preserved, even if ratepayers will pay more in the short-run. Contrary to Southwest's arguments, the evidence also shows that with Staff's recommendations, Southwest's financial integrity will be preserved, because the Company pre-tax coverage of its debt costs will improve over what it has been historically.
- Financial Policy and Capital Structure: Mr. Hill points out that Southwest's actual capital

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[14] Direct Testimony of Stephen G. Hill, Exhibit S-1, at 30:2-17.
[15] Id. at 32:16 – 33:26 and Schedules 3 – 4.
[16] Id. at 6:17-19.
[17] Id. at 7:4-9.
[18] Id. at 8:23 – 9:15.

structure has ranged from 33.11 percent to 37.31 percent from 1995 to 2004.[19] The industry average is a 41.7 percent equity ratio and the similar-risk sample average is a 43.7 percent equity ratio, when appropriately factoring in short-term debt into capital structure.[20] Staff balances the need to preserve Southwest's financial integrity with the reality that customers will pay for plant as if it were funded with equity when it was actually funded with debt. Even though short-term debt may have been excluded from the capital-structure determination in the past, Mr. Hill articulates a more than adequate justification to include it here.[21] Including short-term debt, therefore, is reasonable and legal.[22] Furthermore, a 40 percent equity ratio has been accepted in Southwest's hypothetical capital structure in past Commission orders and Southwest fails to provide the justification to alter that determination here.

- Management competence: Staff is *not* alleging management is incompetent. But Staff is saying that management *is* making the decisions as to how to fund plant. Southwest management chose to leverage Southwest and fund plant with more debt than equity. It is not an unconscious decision and that recognition factors into Staff's capital structure recommendation and in its recommending that Southwest provide a recapitalization plan with notice that actual capital structure may be used if Southwest does not achieve 40 percent equity by the next rate case.
- Attraction of capital: Mr. Hill testifies that an 8.40 percent cost of capital allows the Company a pre-tax interest coverage ratio of 2.38, which is higher than what the Company has realized over the past three years.[23] Staff's cost of equity recommendation compares favorably with rates of return awarded to other distribution companies.[24] An 8.40 percent COC compares favorably with the larger economy, looking at the current economic climate, the prognosis for interest rates, and including recent actual bond yields.[25] Combine this with

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[19] Id. at Schedule 2, Sheets 1,3.
[20] Id. at Schedule 2, Sheet 4.
[21] Tr. at 907 – 908.
[22] *See Litchfield Park,* 178 Ariz. at 436, 874 P.2d at 993 (so long as a reasonable, non-arbitrary basis for switching methodologies is articulated, the Commission's decision to do so is upheld)
[23] See Hill Direct Testimony at Schedule 11.
[24] Id. at 4, FN 4.
[25] Id. at 6 – 10. An extensive discussion of interest rates occurs at 10 – 13.

the fact that Staff also recommends a rate design that moves towards cost of service and revenue stability, the best and substantial evidence shows the ability for Southwest to attract capital if Staff's recommendations were to be adopted.

- The Cost of Capital: COE is usually the main point of dissention between parties when discussion the cost of capital. Southwest criticizes Staff's focus on the DCF model. While the Commission is never irrevocably bound to particular method, the Commission has relied on recommendations where the DCF model was a key determinant of COE for many years. No evidence here indicates that the DCF should be torn from its mantel and tossed into the incinerator. Other Commissions still rely on evidence derived from the DCF model. Multiple learned sources still justify the DCF as a reliable method to determine COE.[26] Many factors were utilized to determine the growth or "g" variable in Staff's DCF analysis, in accordance with the efficiency market hypothesis. Mr. Hill incorporates a wide array of data to determine a long-term DCF growth rate, which is in accordance with modern finance theory that all public information is incorporated into stock prices. In addition, Mr. Hill also used the CAPM, MTB and MEPR methods to temper his DCF result.[27] Furthermore, Mr. Hill recommends a higher COE than his DCF result, taking into account other factors such as Southwest's leveraged capital structure and greater financial risk.

Clearly, Staff has presented substantial evidence justifying its COC recommendations. By contrast, Southwest's COE recommendation suffers from many weaknesses that are described in Staff's Initial Closing Brief. Staff contends that the analysis and results it presents is the best evidence and justifies an 8.40 percent COC and a 9.50 percent COE.

Southwest criticizes Staff's COE recommendation in its initial brief by attempting to compare it to multiple accounting equity returns on book value. But Staff's COE recommendation is a market-based determination incorporating all publicly-available data in accordance with the efficient markets hypothesis. Southwest's brief compares Staff's market-based COE to accounting returns on equity

[26] Hill Direct Testimony at 42 – 45; Surrebuttal Testimony of Stephen G. Hill, Exhibit S-2, at 18:15 – 19:15.
[27] Hill Direct Testimony at 36:2-4.

such as 12.5 and 10.91 percent.[28] Determining a proper and reasonable COE going forward cannot just be limited to comparing historical accounting returns or past authorized returns, for that violates the efficient markets hypothesis. While these historical figures should be part of the analysis, they are not the result of the analysis itself. Staff incorporated historical accounting returns to reach its COE determination. But Southwest's references to those historical accounting returns in its brief distorts the picture of what a proper COE should be.

Southwest also criticizes the requirement that it file a plan to recapitalize and achieve an actual 40 percent equity ratio in its capital structure, even though this will be the fifth rate case since 1990 likely allowing a higher equity ratio in a hypothetical capital structure. Staff presents its justification in Mr. Hill's Surrebuttal Testimony stating that this recommendation can only be a good message to send to investors:

> Finally, it is difficult to believe that the Company is testifying that increasing its common equity ratio from 36 percent to 40 percent would, somehow be detrimental to investors. [A Southwest] with a 40 percent common equity ratio would have lower financial risk, possibly a higher bond rating and lower marginal debt costs. A more financially secure company can only be good for investors. For the benefit of both consumers as well as investors, this Commission should adopt Staff's recapitalization proposal for [Southwest].[29]

The time has come for the Commission to send notice to Southwest that customers should not have to support the Company's leveraged financial position through a hypothetical capital structure in perpetuity. The recapitalization plan simply puts the Company on notice that an actual capital structure may be adopted in the future, even if the actual equity ratio is less than 40 percent. The evidence supports and justifies adoption of this requirement.

In short, the best and substantial evidence shows that an 8.40 percent COC with a 9.50 percent COE will allow investors a fair return and will also allow Southwest to attract capital and while preserving its ability to maintain its financial integrity.

VI. CONCLUSION

The Commission as the trier of fact faces the difficult task of weighing the credibility of the

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[28] Id. at 76, 83.

[29] Surrebuttal Testimony of Stephen G. Hill, Exhibit S-2, at 11:9-14.

voluminous amount of evidence presented in this case. The record can – as a matter of law – support a variety of results. To put it another way, Staff's arguments are not that its recommendations are the *only* legal determination the Commission can make. Rather, the factual and evidentiary record in this case best justifies Staff's recommendations. But the burden to justify increased rates rests with Southwest. Significant doubt is raised as to several of Southwest's proposals, and Southwest has failed to meet its burden. Staff's recommendations are fair, reasonable, justifiable and lawful.

RESPECTFULLY SUMITTED this 14th day of November, 2005.

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Deborah Amaral, Secretary to
Jason D. Gellman