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BEFORE THE ARIZONA CORPORATION COMMISSION

- 1
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- 3 WILLIAM A. MUNDELL
COMMISSIONER
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8 IN THE MATTER OF THE APPLICATION OF
9 SOUTHWEST GAS CORPORATION FOR
10 THE ESTABLISHMENT OF JUST AND
11 REASONABLE RATES AND CHARGES
12 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 REPLY BRIEF

13
14 The Residential Utility Consumer Office ("RUCO") offers this reply to the arguments
15 offered by Southwest Gas Company ("SWG" or "Company") and other parties in their initial
16 post-hearing briefs. Many of the arguments presented by SWG or other parties were already
17 addressed in RUCO's Initial Closing Brief, and will not be repeated here.

18
19 **Pipe Replacements**

20 Regarding the effective date of a change to the pipe replacement write-off schedule
21 required by Decision No. 58693, SWG argues that RUCO witness Diaz Cortez agreed that the
22 Commission is free to determine the ratemaking treatment of all assets placed in service
23 during the period since the last rate case. SWG Br. at 109, citing Diaz Cortez Surrebuttal at
24 12-13. However, SWG ignored the portion of Ms. Diaz Cortez's testimony which distinguished
her initial general statement regarding when ratemaking treatment is determined. She went on

1 to state: "However, the typical treatment of plant additions between rate cases is not applicable
2 to the pipe replacements at issue here." RUCO-4 at 12-13. Ms. Diaz Cortez then explained
3 that the Commission's adoption of the settlement agreement in Decision No. 58693 had
4 determined the ratemaking treatment for these pipe replacements prospectively, and that any
5 application of a different treatment to a prior period would constitute retroactive ratemaking.

6 7 **Deferred Income Taxes**

8 SWG contends that its proposed adjustment to deferred income taxes should be
9 adopted, because it is based on a post-test year change to Internal Revenue Service ("IRS")
10 regulations that became effective in August 2005, before the rates that will result from this
11 proceeding are put in place. However, the change to deferred income taxes that SWG
12 proposes to comply with the regulation is not a known and measurable event, as the regulation
13 was only adopted as a temporary regulation and is subject to amendment after the IRS takes
14 additional review. Exh. A-27 at LEM-1, third page of second document; Tr. at 491-92. This
15 temporary regulation is not a sufficient basis for the Commission to adopt a post-test year
16 change to deferred income taxes.

17 18 **Sales & Marketing Wages**

19 SWG objects to RUCO's proposed adjustment to disallow wages related to sales and
20 marketing, claiming that RUCO proposed its adjustment based on stale information from the
21 Company's last rate case. However, regardless of the job titles of the relevant employees,¹
22 the Company's witness concedes that at least a portion of their responsibilities relate to
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¹ SWG's witness Palacios did confirm that the job titles of the 37 employees addressed by RUCO are the current job titles. Tr. at 91.

1 marketing of gas service. SWG witness Palacios described marketing-related tasks performed
2 by the 37 employees, and outlined how they earn bonuses under the sales incentive program
3 based on their success in persuading customers to take four gas services from the Company,
4 rather than only two or three services. Tr. at 86-93.

5 Further, SWG overlooks the fact that RUCO modified its position by offering to exclude
6 only the portion of these employees' wages related to their marketing activities. RUCO-6 at
7 18. While the data necessary to identify such a portion of their wages was not known to
8 RUCO at the time it filed its surrebuttal testimony, in the course of the hearing further facts
9 were uncovered that makes such a division possible. Tr. at 573-575. As discussed in
10 RUCO's initial brief, the Commission has previously disallowed marketing-related expenses,
11 and should do so again here for the portion of these employees' wages related to their
12 marketing tasks.

13

14 **Post-TY Wage increases**

15 Most of SWG's arguments to include its 2005 wage increase in customers' rates were
16 addressed in RUCO's initial brief, and will not be repeated here. However, RUCO did not
17 address the claim in SWG's initial brief that its proposal here is consistent with the
18 Commission's determination of the issue in SWG's last rate case, Decision No. 64172. While
19 RUCO does not dispute that its position in that proceeding, which is similar to its position here,
20 was not adopted in Decision No. 64172, the Commission's resolution of a matter in one case
21 does not create binding precedent which it is obligated to follow in future cases. The
22 Commission is free to make different policy determinations at different times, even if no

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1 differences in facts are present.² The Company must agree, for it is recommending that the
2 Commission allow full recovery of its Management Incentive Plan expenses, despite a partial
3 disallowance in its last rate case.

4 5 **SERP/MIP**

6 RUCO and the Company propose fundamentally different approaches to determining
7 whether certain labor expenses should be recovered from customers. SWG claims that the
8 standard for recovery of the expenses of the Management Incentive Plan ("MIP") and the
9 Supplemental Executive Retirement Plan ("SERP") is whether the overall compensation
10 package of the affected employees is reasonable. SWG Br. at 97, 99. However, in Decision
11 No. 64172 the Commission endorsed an approach to *evaluate specific components of*
12 *employee compensation* to determine whether they are the type of expenses that customers
13 should be funding.³ The Commission should examine the individual MIP and SERP portions of
14 the compensation package, not only from a quantitative perspective (is the amount
15 excessive?) but also from a qualitative perspective (is this an appropriate type of expense for
16 customers to fund at all?). For the reasons discussed in its initial brief, RUCO believes that all
17 of the SERP expense, and portions of the MIP expense, are not the sort of expenses that
18 should be the responsibility of customers, regardless of the amount of overall compensation.

19 _____
20 ² For example, the Commission recently approved a calculation of income tax lag days for cash working
21 capital that differed from the methodology it had approved just a year before for a different division of the same
22 water company. See Decision No. _____ (Arizona Water Western Division rate case, W-01445A-04-0650,
adopted at Open Meeting on November 9, 2005 with no modifications to the relevant portion of the ROO at page
22. Decision No. not yet available as of the filing of this brief).

23 ³ In Decision No. 64172, page 12, the Commission indicated: "Staff states that the issue is not whether the
24 Company's overall compensation of its management is reasonable, as Southwest asserts, but rather whether
ratepayers should be funding specific components of the MIP that encourages achieving shareholder goals."
The Decision went on to adopt Staff's proposed allocation of MIP expenses. Thus, the Commission rejected
SWG's approach of evaluating overall compensation, and examined an individual piece of compensation for
appropriateness based on qualitative factors other than the amount of such compensation.

1 **AGA Dues**

2 Once again, the Company's constricted focus on the amount of an expense overlooks
3 the fact that the Commission should first consider the nature of an expense to determine
4 whether customers should be required to underwrite it. Surprisingly, with respect to the AGA
5 dues that RUCO is proposing to disallow (promotional-related costs in the Communications
6 and Public Affairs cost centers), the Company acknowledges in its application that similar
7 marketing-type expenses are not appropriate for recovery. A-30 at 13. The Commission
8 should likewise remove the Communications and Public Affairs portions of the AGA dues,
9 especially where the Company offers only speculation regarding the exact purpose of such
10 expenses. Tr. at 552.

11

12 **Miscellaneous Expenses**

13 SWG mistakenly claims in its initial brief that RUCO's proposed disallowance of certain
14 miscellaneous expenses was based solely on a review of the Company's response to DR 11-
15 1. SWG Br. at 100, citing Tr. at 925. SWG further indicates that RUCO's witness indicated
16 that he did not review the additional information on the matter that SWG provided in its rebuttal
17 testimony. SWG Br. at 100, citing Moore Surrebuttal pg. 21. Both of these claims are
18 contradicted in the record.

19 First, RUCO's proposed disallowance was based on a review of many items, including
20 the Company's workpapers and responses to six data requests from RUCO, including DR 11-
21 1. RUCO-5 at 25, lines 9-12. The summary amounts of RUCO's proposed disallowance were
22 reflected on Schedule RLM-11 to RUCO-5, but additional detail was set forth on numerous
23 RUCO workpapers, which were provided to the Company at the time RUCO filed its direct

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1 testimony.⁴ RUCO-5 at 25, lines 19-22 and Schedule RLM-11 footnote for Column A. The
2 statement SWG cited for support of its claim that RUCO witness Moore “simply reviewed the
3 Company’s response to data request number 11-1...as a basis for his disallowance” (Br. at
4 100, citing Tr. at 925) was merely a statement that, in response to Ms. Aldridge’s testimony on
5 the stand, Mr. Moore had once again reviewed the response to DR 11-1 and confirmed a
6 particular aspect of his prefiled testimony. See Tr. at 924, lines 13-16, and at 925 lines 15-21.

7 Second, Mr. Moore never indicated that he did not review the additional information
8 provided by SWG in its rebuttal testimony, as SWG’s brief asserts. To the contrary, Mr.
9 Moore’s surrebuttal testimony clearly indicates that he analyzed the Company’s rebuttal
10 testimony. RUCO-6 at 21, line 17-20. Mr. Moore’s use of the phrase “without further analysis”
11 on line 23 does not indicate that he undertook no analysis of the Company’s rebuttal testimony
12 (in which the Company made a further reduction in miscellaneous expenses of \$62,165), but
13 that, in order to avoid a line-by-line examination of 40 pages of workpapers substantiating the
14 adjustment, RUCO was offering to further reduce its proposed adjustment. Mr. Moore then
15 proposed to reduce RUCO’s adjustment by \$69,260, from \$346,299 to \$277,039. RUCO-6 at
16 22 lines 1-2. It is disingenuous of SWG to suggest that RUCO failed to consider the
17 Company’s responsive testimony.

18 Additionally, SWG contends that its workpapers are insufficient to make a determination
19 regarding the reasonableness of the Miscellaneous expenses. SWG Br. at 100. However, as
20 discussed above, RUCO reviewed more than just workpapers prior to proposing its
21 adjustment. The Company’s response to DR 11-1 included the invoices for all the items that
22 were the subject of RUCO’s originally proposed disallowance with which the Company
23 disagreed. The basis for RUCO’s proposed disallowance was descriptions on those invoices,
24

⁴ SWG’s rebuttal testimony acknowledged that it had reviewed these workpapers. A-30 at 15, line 21.

1 not merely line items on a workpaper. Further, SWG's own summary of the applicable
2 invoices reveals that the Company is seeking recovery of expenses for coffee, water, tea and
3 soda; employee recognition; food service; ice machines; lodging; memberships; and
4 photography, among other items not necessary to provide gas service. A-30 at Exh. RLA-6.
5 As such, RUCO's adjustment should be adopted.

7 **Cost of Capital**

8 The Company complains that RUCO's recommended returns are "woefully inadequate
9 and contrary to the standards set forth by the United States Supreme Court in *Bluefield*
10 *Waterworks & Improvement Co. v. Public Service Commission of West Virginia et al*, 262 U.S.
11 679 (1923) and *Federal Power Commission et al. v. Hope Natural Gas Co. City of Cleveland*,
12 320 U.S. 591 (1944). SWG Br. at 84. The Company provides little support for its sweeping
13 conclusion other than to note that RUCO's recommended cost of equity ("COE") is 76 basis
14 points less than the 10.91% average COE for the local distribution companies used in the
15 Company's proxy group and that RUCO's recommended common equity ratio of 42% is 5.5
16 percentage points less than the average authorized common equity ratio of 47.5%. *Id* at 83.

17 RUCO, in its initial brief, discusses at length how it arrived at its recommended returns,
18 why they are fair and consistent with the *Hope* and *Bluefield* decisions. RUCO recommends
19 the Commission stand by its tried and true historical approach of determining a utility's COE by
20 applying the discounted cash flow ("DCF") and/or the capital asset pricing model ("CAPM")
21 equity estimation methodologies. There is nothing special about this case that warrants a
22 change in the Commission's practice, which is clearly not as extreme as the Company
23 proposes. The Company's proposal of taking the average COE calculation of the four
24 methodologies the Company considered in its COE analysis has the intended effect of inflating
the COE. The Company's DCF analysis places its intent beyond question. The Company

1 arbitrarily drew the line on what it believed was the minimum COE it should consider among
2 the companies it considered in its proxy, and eliminated from consideration any COE that was
3 below this minimum. A-38 at 32, FJH-7. The Commission should reject the Company's
4 recommended COE.

5 Commission Staff's argument's regarding RUCO witness Rigsby's use of a six-week
6 average of the 91-day Treasury Bill rate to arrive at the market risk premium component used
7 in his CAPM analysis should have no bearing on the weight given to Mr. Rigsby's 10.15
8 percent COE estimate. Although Mr. Rigsby conceded during the hearing that the use of the
9 risk premium provided in Ibbotson Associates' Stocks, Bonds, Bills and Inflation: 2005
10 Yearbook publication is one way of arriving at a risk premium component for the CAPM model,
11 the fact is that there is no obvious distinction between what risk free rate should be utilized in
12 the two instances in which the risk free rate is used in the Sharpe Litner version of the CAPM
13 used by Mr. Rigsby, which is stated as $k = r_f + [\beta (r_m - r_f)]$ (where r_f represents the risk free
14 rate or return). RUCO-1 at 23; Tr. at 838. Mr. Rigsby used the same inputs in the CAPM
15 model for this proceeding that he has used for every other proceeding that he has testified in
16 before the Commission. Tr. at 834-35.

17 RUCO's COE analysis, in addition to using both the DCF and CAPM models, also took
18 into consideration the current outlook on the direction of interest rates, which are directly
19 related to expectations regarding inflation in the economy. RUCO-1 at 39-45. Moreover, in
20 determining its final recommended average cost of capital of 8.64%, RUCO adopted the
21 Company's proposed hypothetical capital structure. RUCO-1 at 5. RUCO's recommended
22 return on equity capital represents a balance of considerations, each analyzed with the notion
23 of providing the Company with a reasonable rate of return, which is fair to the Company and
24 fair to the ratepayers. The Commission should adopt RUCO's recommended rate of return of
8.64%.

1 **Billing Determinants**

2 SWG claims that, regardless of whether it properly understood the detail underlying
3 RUCO's calculation of billing determinants as presented in RUCO's surrebuttal testimony,
4 those billing determinants reflect overstated bills and volumes. SWG Br. at 62. However, the
5 Company has no way of knowing the accuracy of that statement, because it has not provided a
6 reliable starting point on which it could compute the adjusted billing determinants. SWG's
7 argument that RUCO's billing determinants are wrong because they do not match the
8 Company's billing determinants is merely circular reasoning, because the Company has not
9 provided the actual recorded billing determinants for the test year, and thus cannot know
10 whether its adjusted test year billing determinants are accurate. See RUCO's initial brief at 14-
11 15.

12 The Company further argues that it is more likely that its billing determinants are
13 accurate than it is that RUCO's determinants are, because the Company "identified numerous
14 errors" in RUCO's calculations. However, RUCO corrected those errors in its surrebuttal
15 testimony. RUCO-6 at 24; Tr. at 924. SWG's criticisms of RUCO's surrebuttal billing
16 determinants are unfounded, because SWG overlooked the fact that RUCO made additional
17 revisions in its surrebuttal beyond those that were the subject of certain workpapers RUCO
18 provided to SWG before RUCO filed its surrebuttal position. Tr. at 269, 925, 1289.

19 The Company agrees that the identification of a fixed starting point of actual test year
20 billing determinants is an essential step in computing the adjusted billing determinants used to
21 set rates. Tr. at 249, 264-65. The Company was never able to provide this crucial starting
22 point, and thus cannot claim with any assurance that its revised determinants are any more
23 accurate than those proposed by RUCO.

24

1 Conservation Margin Tracker

2 Most of the arguments SWG offers in support of its Conservation Margin Tracker
3 ("CMT") were addressed by RUCO in its initial brief. However, there are a few points SWG
4 raises to which RUCO has not yet responded. First, SWG argues that its CMT proposal
5 should be adopted since no party produced evidence that the historic pattern of declining
6 usage will wane, and that failing to address ongoing declining usage may violate the "just and
7 reasonable" standard of Art. XV § 3 of the Arizona Constitution. However, SWG's own witness
8 testified that it is inevitable that consumption patterns will flatten out at some point, and he
9 could not predict when that would be. *Tr. at 162-64. It could occur tomorrow or at some later*
10 *point in time—no one knows. The "just and reasonable" rate requirement of Art. XV, § 3 does*
11 *not require the Commission to establish rates based on future events that are not known and*
12 *measurable. Normalization of the billing determinants to year-end consumption levels*
13 *(reflecting both customer growth and average usage reductions that SWG experienced during*
14 *the test year) results in tariff rates that would result in collection of the required operating*
15 *income from the end-of-test year customers. The "just and reasonable" requirement does not*
16 *mandate that the Commission project potential declining average usage when designing rates*
17 *any more than it would mandate that the Commission project potential increases in numbers of*
18 *customers beyond the end of the test year. When the Company believes its rates have*
19 *become insufficient due to continued decreased usage, it can file another rate application and*
20 *ask the Commission to set new rates based on the then-known and measurable consumption*
21 *levels.*

22 Second, SWG claims that its CMT proposal provides customers a greater incentive to
23 conserve than would a rate design that recovers all the margin requirement through the basic
24 service charge. SWG Br. at 35. While that may be true (because a non-conserving customer
could be required to pay a greater portion of the unrecovered margin resulting from other

1 customers' conservation), it is an irrelevant comparison, as no party is proposing a rate design
2 that recovers all the margin through the basic service charge. It would be more meaningful to
3 compare the CMT proposal's conservation incentives to the rate designs actually proposed in
4 this proceeding. As for RUCO's proposed rate design, its flat rate structure sends a stronger
5 conservation signal than the Company's declining block rate proposals, either with or without
6 the CMT.

7 Finally, SWG contends that RUCO has failed to raise any serious doubt as to the
8 prudence of the CMT proposal. SWG Br. at 36. RUCO's initial brief demonstrated numerous
9 inequities that would result from the CMT (e.g. between new customers and longer-term
10 customers, between customers who contribute to the under recovery of margin and those who
11 do not), and several other reasons why the CMT is not an appropriate rate design feature.
12 RUCO Br. at 16-18.

14 **RUCO's Rate Design**

15 SWG claims that RUCO offered no basis for its allocation of cost recovery from the non-
16 residential classes. SWG Br. at 16. However, Ms. Diaz Cortez' testimony clearly indicates
17 that RUCO's proposed rate design recovers costs from the various classes in the exact same
18 proportions as rates are currently recovered from those classes. RUCO-4 at 10. The only
19 shifting of revenues RUCO proposes from the current rate design is a movement within each
20 class from the volumetric to the fixed monthly service charges. Id. The Company
21 acknowledges that its method of allocating margin is based on its cost of service study (SWG
22 Br. at 43), but it overlooks the fact that a cost of service study is only a starting point in
23 designing rates. Numerous other factors, such as fairness, gradualism, and appropriate price
24 signals can also influence what is a reasonable rate design.

1 SWG further contends that its rate design proposal provides the best *economic* price
2 signal regarding the actual market price of natural gas. SWG Br. at 45 (emphasis added).
3 However, providing the best economic price signal of the actual market price of gas is not the
4 overriding objective in rate design. In fact, certain aspects of the Company's purchase gas
5 adjustor mechanism that minimize the amount of volatility customers experience under the
6 PGA (and which no party is proposing be changed) already suppress the signal of the true
7 market price of gas that customers actually will experience. For example, the PGA rate is
8 based on a rolling 12-month average cost of gas, and adjustments to the PGA rate are subject
9 to a \$0.10 per therm cap over any 12 month period. Both of these features limit the volatility of
10 the monthly PGA adjustment, and thereby skew to some degree the customers' perception of
11 the true cost of gas. See A-1, Current and Proposed Tariff Sheet No. 87. Other rate design
12 goals, such as conservation, may overshadow the value of providing a purely economic price
13 signal. RUCO's rate design more appropriately balances the various aims of a proper rate
14 design for the Company.

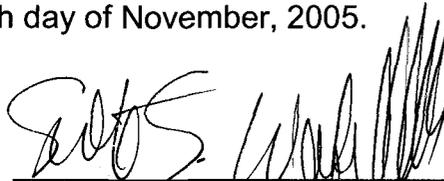
15 Finally, SWG complains that RUCO's rate design places more of its revenue at risk
16 because of its single tier commodity rate than the Company's existing rate design which
17 includes a lower margin price for consumption in the higher tier. However, the Company
18 overlooks the fact that increased risk due to a higher commodity rate for the last therm
19 consumed is offset by a shifting of recovery from the commodity to the fixed charges. RUCO's
20 proposed rate design, if applied to the Company's existing revenue level, would shift \$23
21 million from the commodity charges (where the Company faces a risk of under recovery if
22 consumption decreases) to the basic service charge. Tr. at 1003. When RUCO's proposed
23 rates are factored in, RUCO's proposal assures recovery of \$26 million more than today's
24 rates. Id. Additionally, maintaining a declining block rate structure for higher consumption of
gas would undermine the goal of promoting additional conservation. RUCO-3 at 35. The

1 Commission should not require a declining block rate structure when it is ordering the
2 Company to increase its spending on demand side management programs.

3
4 **Conclusion**

5 SWG's objections to RUCO's proposals regarding revenue requirements and rate
6 design are all refuted in either RUCO's initial brief, or in this reply brief. The Commission
7 should adopt RUCO's revenue requirement adjustments, reject the Company's CMT proposal,
8 and design rates based on RUCO's proposed flat commodity charge proposal.

9
10 RESPECTFULLY SUBMITTED this 14th day of November, 2005.

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12 
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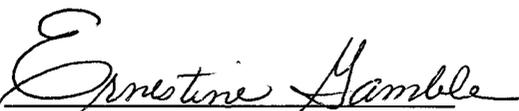
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