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OPEN MEETING AGENDA ITEM



ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

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2006 FEB -7 P 4: 28

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

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**AUIA'S EXCEPTIONS TO THE  
RECOMMENDED OPINION AND ORDER**

The ARIZONA UTILITY INVESTORS ASSOCIATION (AUIA) hereby submits its exceptions to the Recommended Opinion and Order (Recommended Order or Order) filed in this proceeding on January 24, 2006, by Administrative Law Judge (ALJ) Dwight Nodes.

**Introduction**

The Recommended Order in this case deserves a grade of C+. On many issues, the ALJ has chosen to occupy safe ground and that is largely what the Order stands for. It is risk-free, like a cup of decaffeinated coffee with non-fat milk.

Unfortunately, the Southwest Gas income statement requires a stiff shot of caffeine -- more like double espresso.

It is clear that the ALJ has given this case careful, detailed scrutiny and AUIA finds that much of the Recommended Order

1 is fair and commendable, even though the company's needs are not fully met.  
2 Nevertheless, AUIA's overriding concern is that the rate design proposed in the  
3 Order makes no movement toward freeing SWG from the tyranny of weather  
4 and declining per-capita consumption. We fear that we will see the company  
5 back here soon, still looking for a formula to earn its authorized rate of return.

#### 6 Rate Design

7 AUIA is disappointed that the Recommended Order punts on the issue of  
8 the Conservation Margin Tracker (CMT). We believe the company proved  
9 beyond doubt the need for a decoupling mechanism to free its earning capability  
10 from the treacherous effects of warm weather and declining consumption.

11 In the Order, the ALJ refers to the CMT as "a guaranteed method of  
12 recovering authorized revenues, thereby virtually eliminating the company's  
13 attendant risk." (ROO @ 34, L. 10) AUIA disagrees that the CMT, or some  
14 similar decoupling mechanism, would guarantee the company's earnings. It  
15 would simply help to close the gap between actual and authorized earnings that  
16 has existed for more than a decade. Management would still own the risk of  
17 providing reliable service and operating the business profitably.

18 AUIA applauds the language in the order that encourages the company  
19 and other parties to explore the issues of decoupling mechanisms and  
20 conservation efforts that don't penalize stakeholders. (ROO @ 34, L. 1 & 14) In  
21 fact, we recommend that the language in the ordering paragraph (ROO @ 67, L.  
22 14) should be amended to require a workshop that could include other providers  
23 in addition to SWG.

24 If a decoupling mechanism is too novel as a means of stabilizing SWG's  
25 revenues, the obvious alternative is to increase the proportion of revenue that is  
26 collected through the fixed monthly charge. Furthermore, every party in this  
27 case gave lip service to the concept of moving SWG closer to cost-based rates and  
28 the fixed charge is the device for doing that.

29 SWG urged that, without the CMT, the fixed charge should be doubled,  
30 from \$8.00 to \$16.00. RUCO recommended a 26 % increase to \$10.09 and Staff  
31 recommended a 21 % increase to \$9.70. Here, the ALJ took the safest road,  
32 adopting Staff's rate design proposal, including the fixed charge amount.

1 AUIA concedes that the prospect of doubling the fixed charge may be  
2 intimidating, especially for low-income customers, but we contend that the  
3 recommendation in the Order is too anemic in the absence of a decoupling  
4 mechanism. In order to have a significant impact on SWG's revenue deficiency,  
5 the monthly charge should be at least \$12.00.

6 **Cap Structure, ROE, Revenue Requirement**

7 The ALJ made the appropriate decision in recommending a hypothetical  
8 capital structure for SWG including a 40 % equity component. He also followed  
9 Staff's recommendation in requiring SWG to produce a plan for improving its  
10 actual cap structure to 40 % equity, but without ordering that the company's next  
11 rate case be based on that ratio.

12 AUIA does not disagree with the ALJ's recommendation. SWG has  
13 testified to its strong desire to improve its capital structure. However, AUIA  
14 cannot envision a suitable plan that wouldn't rely primarily on increased  
15 retained earnings to build equity. This case is all about the company's inability  
16 to earn and there is little in the Recommended Order that will change that  
17 condition.

18 AUIA did not offer testimony on cost of equity (COE). Nevertheless, we  
19 are compelled to say that in a period of rising interest rates and rapidly  
20 increasing capital needs, the ALJ's recommendation of 9.5 % is well below what  
21 would reflect market conditions. If the company's recommendation is too rich  
22 for the Commission's taste, it should give consideration to a COE within the  
23 10.15 % to 10.4% range developed by RUCO witness William Rigsby.

24 Having said all of that, AUIA will not fall on its sword over the ALJ's  
25 recommendation of a revenue requirement increase of \$49.35 million, even  
26 though the company initially requested nearly \$67 million. We continue to be  
27 more concerned that structural impediments in rate design will prevent the  
28 company from realizing its authorized income, whatever the amount. This  
29 Order does little to cure that concern.

30 **Expense Adjustments**

31 Staff and RUCO advocated various adjustments to six categories of  
32 expense. The ALJ's recommendations are a mixed bag of judgment calls:

1           The ALJ arrived at a 10 % disallowance -- \$289,243 -- from the cost of 37  
2 marketing and sales employees, a reasonable judgment, given the evidence.

3           The ALJ recommended no deduction for American Gas Association dues,  
4 but the Order proposes more specific information on the distribution of those  
5 funds in SWG's next rate case. This is another reasonable conclusion.

6           The ALJ proposes to split the cost of four expense areas between  
7 customers and shareholders: Transmission Integrity Management Program  
8 (TRIMP); Sarbannes-Oxley compliance (SOX); the Management Incentive Plan  
9 (MIP); and certain miscellaneous expenses.

10           AUIA is disturbed by these disallowances for two reasons. First, there is a  
11 strong aspect of nickel-and-diming the company to death. For example, 40 pages  
12 of work papers detailing miscellaneous expenses resulted in disagreements  
13 between the company and RUCO over moving expenses, safety awards, alcohol  
14 and drug testing, professional education, barbecues, charitable donations, water,  
15 ice, sodas, smoothies, bagels, donuts (sic) and on and on. The ALJ's resolution of  
16 this dispute was a 50% disallowance of \$173,150.

17           Second and more important, these cost-splits demonstrate an explicit  
18 rejection of the fact that some expenses are necessary just to stay in business,  
19 even if they are not precisely required to provide gas service.

20           The ALJ concluded that it is the company's burden to demonstrate that all  
21 of the miscellaneous costs are necessary business expenses. Translation: that  
22 they benefit ratepayers. The same rationale is behind the dictum requiring more  
23 details about the use of AGA dues.

24           Perhaps the company should expect to provide more justification for these  
25 expenses, but some common sense should operate here. Today, no utility can  
26 function on behalf of its shareholders and ratepayers without representation in  
27 Washington, D.C. and without a cost-effective window on the industry as a  
28 whole. That's what AGA provides, but how do you prove that it's necessary to  
29 provide gas service, as RUCO insists?

30           Still more egregious is the split between shareholders and ratepayers of  
31 the costs of TRIMP and SOX. These are federally mandated programs. The  
32 company has no choice but to follow these mandates or go out of business. It is  
33 irrelevant whether shareholders or ratepayers derive some benefit from them.

1 Specifically, with regard to SOX, the ALJ postulated that shareholders are  
2 the chief beneficiaries because they get the assurance that the company's reports  
3 are accurate and not inflated or misstated. Yet, there is no evidence that  
4 shareholders really receive any benefit from SOX because there is no reason to  
5 believe that SWG or its outside auditors would falsify data. SOX and TRIMP are  
6 simply costs of doing business that should be recovered in rates.

7 MIP has been debated in each of SWG's last two rate cases, with similar  
8 results. The ALJ's equal-sharing recommendation is a compromise which  
9 recognizes that some potential ratepayer benefit is embodied in the MIP  
10 program. AUIA believes that any disallowance is an unnecessary intrusion into  
11 the company's compensation decisions. We will suggest, one more time, that  
12 this Commission should be embarrassed by a position that says, essentially, it's  
13 OK to pay executives for simply showing up at work, but don't pay a premium  
14 for performance unless it directly benefits ratepayers.

15 Finally, there is the Supplemental Executive Retirement Plan (SERP),  
16 which the ALJ concluded is a shareholder obligation, supporting RUCO's  
17 contention. SERP may be a judgment call, but AUIA disagrees with the ALJ's  
18 conclusion because it amounts to second-guessing the SWG compensation  
19 committee about what is necessary to attract and retain top executives.

20 All told, the treatment of these adjustments adds up to the death of 1,000  
21 cuts. It represents a serious deterioration in the regulatory compact, which  
22 asserts, in a mountain of Arizona case law, that a utility must be allowed to  
23 recover its prudently incurred expenses in determining the appropriate return it  
24 is allowed to recover on the value of its assets devoted to public service.

### 25 Officer Certification

26 Staff recommended that an officer of SWG should be required to certify,  
27 under oath, that all information included in the monthly PGA report is true and  
28 accurate. In reaching his recommendation supporting Staff's position, the ALJ  
29 asserted: "Indeed, it is surprising that AUIA has not taken a position in support  
30 of Staff's recommendation given the inherent interest of shareholders in  
31 transparency and accountability for a publicly filed report regarding the  
32 Company's purchased gas costs. We will therefore adopt Staff's  
33 recommendation." (ROO @ 56, L. 10)

1 AUIA must confess that its reason for taking no position on this issue is  
2 that it simply escaped our notice. However, we will cure that oversight  
3 herewith. We are willing to take credit for the ALJ's decision.

4 Since it is AUIA's position that SWG officers should be paid for more than  
5 simply showing up at the office, we think it is appropriate that SWG vice  
6 president William Moody should be required to do a little extra, such as signing  
7 off on the PGA reports. Perhaps Mr. Moody would then qualify for his own  
8 ratepayer-funded MIP.

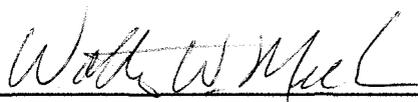
9 **Conclusion**

10 In some important respects, this Recommended Order treats the financial  
11 condition of Southwest Gas as business as usual, which, over the past 11 years,  
12 has meant that the company has been unable to earn its authorized rate of return,  
13 accumulate retained earnings or improve its capital structure.

14 If the Commission approves this order without modifying the rate design  
15 component, Southwest Gas will simply continue to live on the edge financially,  
16 imposing ongoing hidden costs on its customers and producing underwhelming  
17 financial performance for its shareholders. It will also be an invitation for the  
18 company to return to the Commission prematurely to seek rate relief.

19 If the Commission is unwilling to cure the structural deficiencies in the  
20 company's rate design at this juncture, it should, at a minimum, create a forum in  
21 which the parties to this case and other gas distribution companies can begin to  
22 address these defects without the attendant pressures of a rate case.

23 Respectfully submitted, this 7th day of February, 2006

24 

25 \_\_\_\_\_  
26 Walter W. Meek, President

27  
28 **CERTIFICATE OF SERVICE**

29  
30 An original and 13 copies of the foregoing exceptions  
31 filed this 7th day of February, 2006, with:

32  
33 Docket Control  
34 Arizona Corporation Commission  
35 1200 W. Washington Street  
36 Phoenix, AZ 85007  
37

1 Copies of the foregoing exceptions hand delivered  
2 this 7th day of February, 2006, to:

- 3  
4 Jeff Hatch-Miller, Chairman  
5 Dean Miller, Executive Assistant  
6 William A. Mundell, Commissioner  
7 Adam Stafford, Executive Assistant  
8 Marc Spitzer, Commissioner  
9 Philip Dion, Executive Assistant  
10 Mike Gleason, Commissioner  
11 Kenneth Rozen, Executive Assistant  
12 Kristin Mayes, Commissioner  
13 Matt Derr, Executive Assistant  
14 Christopher Kempley, Esq., Legal Division  
15 Dwight Nodes, Esq., Hearing Division  
16 Ernest Johnson, Esq., Utilities Division

17  
18 A copy of the foregoing exceptions was  
19 mailed this 7th day of February, 2006, to:

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30 Walter W. Meek

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