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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED

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COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF SOUTHWEST GAS CORPORATION DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-01551A-04-0876 DECISION NO. 68487 **OPINION AND ORDER**

DATES OF HEARING:	October 3, 4, 5, 6, 7 and 11, 2005
PLACE OF HEARING:	Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Dwight D. Nodes
IN ATTENDANCE:	William A. Mundell, Commissioner Marc Spitzer, Commissioner Kristin K. Mayes, Commissioner
APPEARANCES:	Mr. Andrew W. Bettwy, Ms. Karen S. Haller and Mr. Justin Lee Brown, on behalf of Southwest Gas Corporation; Mr. Scott S. Wakefield, on behalf of the Residential Utility Consumer Office; Mr. Walter Meek, on behalf of the Arizona Utility Investors Association; Mr. Peter Q. Nyce, Jr., on behalf of the United States Department of Defense; Mr. Timothy M. Hogan, Arizona Center for Law in the Public Interest, on behalf of Southwest Energy Efficiency Project and Natural Resources Defense Council; Ms. Laura Sixkiller, ROSHKA, DEWULF & PATTEN, PLC, on behalf of Tucson Electric Power Company; and Mr. Jason Gellman and Ms. Diane Targovnik, Staff Attorneys, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

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BY THE COMMISSION:

On December 9, 2004, Southwest Gas Corporation ("Southwest Gas" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for a rate increase.

On January 7, 2005, the Commission's Utilities Division Staff ("Staff") filed a Letter of Insufficiency.

On January 26, 2005, Staff filed a Letter of Sufficiency indicating that Southwest Gas' application met the sufficiency requirements outlined in Arizona Administrative Code ("A.A.C.") R14-2-103, and classifying the Company as a Class A utility.

By Procedural Order issued February 7, 2005, procedural timeframes were established and a hearing was scheduled to commence on October 3, 2005.

Intervention was granted to the Residential Utility Consumer Office ("RUCO"); the Arizona Utility Investors Association ("AUIA"); the United States Department of Defense ("DOD"); Southwest Energy Efficiency Project ("SWEEP") and the Natural Resources Defense Council ("NRDC") (collectively "SWEEP/NRDC"); Yuma Cogeneration Associates ("YCA"); Arizona Community Action Association ("ACAA"); Arizona Public Service Company ("APS"); and Tucson Electric Power Company ("TEP").

With its application, Southwest Gas filed the Direct testimony of Jeffrey W. Shaw, Christina A. Palacios, Steven M. Fetter, Christy M. Berger, James L. Cattanach, Vivian E. Scott, A. Brooks Congdon, Edward B. Gieseking, Randi L. Aldridge, Robert A. Mashas, Frank J. Hanley, and Theodore K. Wood.

Pursuant to the revised procedural schedule established by Procedural Order issued March 10, 2005, on July 26, 2005, RUCO filed the Direct testimony of Marylee Diaz Cortez, William A. Rigsby, and Rodney L. Moore; YCA filed the Direct testimony of Jeffrey L. Hoffman; AUIA filed the Direct testimony of Walter W. Meek; ACAA filed the Direct testimony of Brian Babiars (July 20, 2005); SWEEP/NRDC filed the Direct testimony of Jeff Schlegel; and Staff filed the Direct testimony of Stephen G. Hill, Jim Dorf, Dennis Rogers, Robert Miller, William Gehlen, Prem Bahl, William Musgrove, Bob Gray, and Steve Irvine.

On August 23, 2005, Southwest Gas filed the Rebuttal testimony of Ms. Palacios, Mr. Fetter, Ms. Scott, Mr. Congdon, Mr. Gieseking, Ms. Aldridge, Mr. Mashas, Mr. Hanley, Mr. Wood, William N. Moody, Marti Marek, Robert M. Johnson, and Lisa E. Moses.

On September 13, 2005, RUCO filed the Surrebuttal testimony of Ms. Diaz Cortez, Mr. Rigsby, and Mr. Moore; AUIA filed the Surrebuttal testimony of Mr. Meek; SWEEP/NRDC filed the Surrebuttal testimony of Mr. Schlegel; DOD filed the Surrebuttal testimony of Dan L. Neidlinger; and Staff filed the Surrebuttal testimony of Mr. Hill, Mr. Dorf, Mr. Rogers, Mr. Gehlen, Mr. Musgrove, Mr. Gray and Mr. Irvine.

On September 23, 2005, Southwest Gas filed the Rejoinder testimony of Ms. Palacios, Mr. Fetter, Mr. Cattanach, Ms. Scott, Mr. Congdon, Mr. Gieseking, Mr. Moody, Ms. Marek, Ms. Moses, Ms. Aldridge, Mr. Mashas, Mr. Hanley, and Mr. Wood.

On September 26, 2005, a prehearing procedural conference was conducted to address order of testimony and exhibits.

The evidentiary hearing was commenced as scheduled on October 3, 2005, and additional hearing days were held on October 4, 5, 6, 7, and 11, 2005.

On October 21, 2005, Southwest Gas filed a substitute Exhibit A-50 (Annual Consumption Graph for Low Income and Non-Low Income Residential Customers) and Exhibit A-52 (information regarding the Company's Management Incentive Plan), a portion of which was submitted under seal.

On November 4, 2005, Southwest Gas filed Exhibit A-53 (compilation of regulatory commission orders from other states addressing decoupling mechanisms) and Exhibit A-54 (summary of Southwest Gas' revised position on cost of equity and rate of return).

Initial Post-Hearing Briefs were filed by DOD on October 31, 2005, by RUCO on November 3, 2005, and on November 4, 2005 by Southwest Gas, SWEEP/NRDC, AUIA, and Staff.

Reply Briefs were filed on November 14, 2005 by Southwest Gas, RUCO, SWEEP/NRDC, and Staff.

On November 23, 2005, Southwest Gas filed a Supplement to its Reply Brief.

Rate Application

According to the Company's application, as modified, in the test year ended August 31, 2004 Southwest Gas had adjusted operating income of $46,775,622 on an adjusted Original Cost Rate Base

("OCRB") of $943,110,070, for a 4.96 percent rate of return. Southwest Gas requests a revenue increase of $66,898,342. Staff recommends a rate increase of $51,625,135, and RUCO recommends an increase of $48,506,079. A summary of the parties' positions[1] follows:

	Company Proposed	Staff Proposed	RUCO Proposed
ORIGINAL COST			
Adjusted Rate Base	$943,110,070	$924,927,566	$919,607,846
Rate of Return	9.24%	8.40%	8.64%
Req'd Operating Inc.	87,140,541	77,693,916	79,478,947
Op. Income Available	46,775,622	46,644,274	50,211,496
Operating Inc. Def.	40,364,919	31,049,641	29,267,452
Rev.Conver. Factor	1.6573	1.6627	1.6573
Gross Rev. Increase	66,898,342	51,625,135	48,506,079
FAIR VALUE			
Adjusted Rate Base	$1,189,807,002	$1,418,205,879	$1,164,944,249
Rate of Return	7.32%	6.63%	6.82%
Req'd Operating Inc.	87,140,541	77,693,916	79,478,947
Op. Income Available	46,775,622	46,644,274	50,211,496
Operating Inc. Def.	40,364,919	31,049,641	29,267,452
Rev.Conver. Factor	1.6573	1.6627	1.6573
Gross Rev. Increase	66, 898,342	51,625,135	48,506,079

REVENUE REQUIREMENT

Rate Base Issues

Southwest Gas proposes an OCRB of $943,110,070 in this proceeding. Staff proposes an OCRB of $924,927,566, and RUCO recommends an OCRB of $919,607,846. Each of the disputed issues regarding rate base items is discussed below.

Deferred Income Taxes

Southwest Gas has proposed an adjustment to accumulated deferred income taxes that would result in an increase of more than $21 million to the Company's rate base. According to Southwest Gas, the deferred tax adjustment is necessary due to new regulations enacted by the Internal Revenue Service ("IRS") on August 3, 2005 which now require the Company to include in income in 2005 and

[1] Other intervenors in the proceeding raised non-revenue requirement issues which are discussed below.

2006 the cumulative tax deduction taken under the prior uniform capitalization ("UNICAP") rules (IRS Code Section 263A) with respect to the simplified service cost method ("SSCM") for self-constructed assets (Ex. A-27, at 6). This deferred tax adjustment is necessitated by the Company's voluntary election in 2002 to change from its historical method of accounting to SSCM.

Southwest Gas argues that the deferred tax adjustment is proper because the new IRS regulation is known and measurable, and because the change puts the Company in a similar position to where it would have been had it not made the election in 2002. The Company claims that its position is consistent with Commission precedent granting recognition of post-test year rate base adjustments where the impact is known and measurable, and is comparable to Staff's recommendation to recognize changes to property tax expenses that are required by post-test year legislation.

Staff disputes the Company's contention that the proposed deferred tax adjustment is proper in this proceeding. Staff argues that the deferred income tax adjustment proposed by Southwest Gas is due entirely to the Company's voluntary decision in 2002 to change its accounting methodology to the SSCM (Ex. S-6, at 2; Tr. 499-500). Staff also claims that the IRS regulations cited by Southwest Gas are temporary rules and the 2005 Energy Policy Act is likely to increase the amount of the Company's deferred taxes, thereby reducing rate base and offsetting the new IRS rule.

RUCO also opposes the Company's proposed adjustment, arguing that the IRS rule change occurred nearly a year after the end of the test year. RUCO further contends that Southwest Gas failed to include this proposal in its initial application and waited until Rebuttal testimony to propose the adjustment. RUCO also sides with Staff's argument that the IRS rules are temporary and subject to amendment before being made final. As a result, RUCO asserts that the IRS rule change does not meet the known and measurable standard employed for other post-test year adjustments.

We agree with Staff and RUCO that recognition of the new IRS regulation is not proper in this proceeding. As Staff points out, Southwest Gas made an entirely voluntary decision in 2002 to change its accounting methodology for self-constructed assets to SSCM, and it is that voluntary election that has caused the Company to now make accounting changes due to the new IRS regulation. The Company's witness, Lisa Moses, admitted that the 2005 Energy Policy Act would result in an increase in deferred taxes, and thus a decrease in the Company's rate base, but she indicated that the Company had not quantified the impact of those changes. Although Ms. Moses stated that she does not believe the Energy Policy Act would have a significant impact on Southwest Gas, the Company did not present testimony to show how the Energy Policy Act, which is an equally known and measurable change in law, could have an offsetting effect on the Company's deferred tax liability and rate base (Tr. 495-497). We also believe RUCO's point is well taken, that Southwest Gas could have presented this proposal as part of its direct case to allow other parties more time to analyze the issue prior to the hearing. As a result, we will adopt Staff's position on this issue.

Completed Construction Not Classified

The National Association of Regulatory Utility Commissioners' ("NARUC") Uniform System of Accounts ("USOA"), Section 106, provides the following description of the appropriate regulatory treatment for Completed Construction Not Classified ("CCNC"):

> At the end of the year or such other date as a balance sheet may be required by the Commission, this account shall include 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 accounts. (RUCO Ex. 9)

In its application, Southwest Gas proposed an adjustment to test year rate base to reflect its CCNC balance. Relying on the NARUC USOA section quoted above, RUCO argues that only work orders which have an in-service date that falls within the test year may be included in the adjustment for CCNC (RUCO Ex. 5, at 8). According to RUCO witness Rodney Moore, certain work orders that were included in the Company's CCNC adjustment were not in service by the end of the test year and should, therefore, be disallowed (RUCO Ex. 6, at 7-8).

Through her Rejoinder testimony, Company witness Randi Aldridge explained that "the direct gas plant portion of the CCNC adjustment is plant that was serving test year customers at the end of the test year" and the proposed CCNC adjustment "was made simply to match test year plant with test year customers" (Ex. A-31, at 17-18). Ms. Aldridge also testified on cross-examination that although the Company's work order system may have only a single in-service date for an entire project, projects such as pipe replacements are completed incrementally to minimize customer outages, but all of the plant additions included in the CCNC account reflect pipe that was used and useful during the test year (Tr. 537-538, 589).

We agree with the Company's proposed CCNC adjustment. As Ms. Aldridge's testimony makes clear, only plant that was in service providing service to customers within the test year was included in the proposed CCNC adjustment. There is no evidence contrary to the Company's assertion that such plant was used and useful during the test year and we believe the Company's treatment of these plant accounts is consistent with the NARUC USOA and prior Commission decisions.

Pipe Replacement

RUCO has proposed disallowance of certain requested pipe replacement projects from the Company's rate base pursuant to the terms of a prior Commission Order that addressed regulatory treatment of defective pipe[2] installed in the former Tucson Gas & Electric system, which was subsequently acquired by Southwest Gas. In Decision No. 58693 (July 7, 1994), the Commission adopted a Settlement Agreement between Southwest Gas, Staff, and RUCO which required Southwest Gas to write-off a certain percentage of the replacement cost of defective pipe, and provided that the pipe replacement percentage write-off amounts would decline annually until the amounts reached zero (Decision No. 58693, at 3-4; RUCO Ex. 3, at 5-6). RUCO witness Marylee Diaz Cortez testified that the Company has continued to make the required pipe replacement write-offs since the prior Decision but the Company seeks in this docket to cease certain of the write-offs (RUCO Ex. 3, at 6).

In its application, Southwest Gas is requesting that the pipe write-off schedule required by Decision No. 58693 be modified to allow the affected write-offs to cease when the specific type of pipe reached an average life of 40 years. Thus, under the Company's proposal the 1960s steel pipe and the ABS pipe would no longer be subject to write-off and the scheduled write-offs for the Aldyl A and Aldyl HD pipe would cease in 2013 and 2020, respectively (*Id.*).

[2] The defective pipe was 1960s steel pipe, and plastic pipe known as Aldyl A, Aldyl HD, and ABS.

Although RUCO agrees that Southwest Gas is entitled to seek modification of the prior write-off requirements, RUCO disagrees with the Company's proposal to retroactively modify the write-off schedule starting in 2000. RUCO argues that Southwest Gas is required to comply with the requirements of Decision No. 58693 until such time as a subsequent Commission Order is issued modifying those requirements (*Id.* at 7-8). Ms. Diaz Cortez agreed that the Company's modified pipe replacement schedule, based on a 40-year life, should be permitted on a going-forward basis, but opposes the retroactive treatment proposed by the Company (*Id.*). Based on its position, RUCO recalculated the write-offs required by Decision No. 58693 and determined that the Company's proposed rate base should be reduced by $1,982,686.

Southwest Gas contends that RUCO misinterpreted the data provided by the Company with respect to pipe replacement amounts. The Company cites to Exhibit A-47, a data request response provided to RUCO that shows the amount of Aldyl A, 1960s steel, and ABS pipe replaced between 2000 and 2004. The Company claims the data request response indicates the costs provided for pipe replacement are "not necessarily for pipe replaced due to defective material or faulty installation practices" (*Id.*). However, the data request cited by Southwest Gas does not identify which costs are related to the prior Order's requirements. Company witness Robert Mashas testified that the Company disagrees with RUCO's recommendation because 1960s vintage steel pipe was never considered a defective material and was only included as part of the Settlement Agreement because it lacked cathodic protection, which has been installed on all of the Company's steel pipe since 1998 (Ex. A-33, at 16-17).

Contrary to the Company's assertions, neither the Settlement Agreement nor the Order adopting it mention cathodic protection for 1960s pipe as a distinguishing characteristic that would permit treatment that is different from the other types of pipe that were considered defective and required specific regulatory treatment. Rather, both the Settlement and the Order specifically state that "In future Southwest rate cases for the Southern Division gas properties, Southwest shall exclude from rate base an additional portion of capitalized expenditures associated with replacements of Aldyl A, Aldyl HD, steel installed in the 1960's, and ABS pipe related to defective materials and/or installation" (Decision No. 58693, at 3).

Mr. Mashas also claims that the effective date of the new write-off should be January 1, 2000, the day after the end of the test year in the Company's last rate case. He contends that this retroactive application of the write-off percentages more accurately reflects the determination of the remedial portion of eligible pipe replacement expenditures (*Id.*). Mr. Mashas stated that the Commission has the authority to make the proposed adjustment retroactive to 2000, and that even RUCO agrees that the Commission has such authority.

Although we may have the legal authority to make the retroactive adjustment proposed by Southwest Gas, we are not inclined to exercise such authority if it is not in accordance with a valid binding Commission Order which adopted a Settlement Agreement to which Southwest Gas was a signatory party. The Company may not unilaterally alter the terms of a Settlement Agreement and Commission Order simply because it has an understanding of the terms of the agreement that may differ from the belief of another party. Rather, the Company could seek an amendment to the requirements of the prior Order if it believed the terms are no longer applicable, which it has properly done in this docket. However, we agree with RUCO that Southwest Gas must continue to comply with the requirements of the prior Order until such time as those requirements are modified by the Commission. Therefore, based on the weight of the evidence, and in accordance with the directives set forth in Decision No. 58693, we adopt RUCO's position on this issue and will reduce the Company's proposed rate base accordingly.

<u>Summary of Rate Base Adjustments</u>

Based on the foregoing discussion, we adopt an adjusted OCRB of $922,944,881 and a Fair Value Rate Base ("FVRB") of $1,169,584,038.

	Commission Approved
ORIGINAL COST:	
Gas Plant in Service - Staff	$1,682,879,492
Less: Accumulated Depreciation	<u>593,408,170</u>
Net Plant in Service	1,089,471,322
<u>Deductions</u>:	
CIAC	7,027,372
Customer Meter Deposits	23,912,141
Deferred Income Tax Credits	136,468,076

Additions:	
Working Capital	881,148
Total OCRB	922,944,881

RCND RATE BASE:

Gas Plant in Service - Staff	$2,439,429,196
Less: Accumulated Depreciation	856,679,561
Net Plant in Service	1,582,749,635
Deductions:	
CIAC	7,027,372
Customer Meter Deposits	23,912,141
Deferred Income Tax Credits	136,468,076
Additions:	
Working Capital	881,148
Total RCND	1,416,223,194

FAIR VALUE RATE BASE:

Gas Plant in Service - Staff	$2,061,154,344
Less: Accumulated Depreciation	725,043,866
Net Plant in Service	1,336,110,479
Deductions:	
CIAC	7,027,372
Customer Meter Deposits	23,912,141
Deferred Income Tax Credits	136,691,328
Additions:	
Working Capital	881,148
Total FVRB	1,169,584,038

Operating Income Issues

In the test year, the Company's adjusted operating revenues were $322,865,978. In its Rebuttal Schedules, Southwest Gas reported adjusted test year operating expenses of $276,090,356, and test year net operating income of $46,775,622. As reported in its Surrebuttal Schedules, Staff's proposed adjusted test year operating expenses are $276,221,704, resulting in test year operating income of $46,644,274. RUCO's Surrebuttal Schedules show proposed adjusted test year total operating expenses of $272,654,482, yielding test year operating income of $50,211,496. The disputed expense adjustments are discussed below.

Sales and Marketing Wages for 37 Employees

RUCO witness Rodney Moore proposed disallowance of salaries and wages for 37 Southwest Gas employees who he claimed were engaged in sales, marketing and promotional activities. He claimed that ratepayers should not be required to fund the cost of such activities and he proposed removal of almost $3 million in salaries from the Company's test year expenses (RUCO Ex. 5, at 15-16). In his Surrebuttal testimony, Mr. Moore modified his recommendation to exclude the entirety of the 37 employees' wages, stating that "RUCO would be willing to explore revisiting its position if a fair and reasonable quantification of the time/costs devoted solely to Customer complaint resolution and Regulatory affairs could be substantiated by the Company" (RUCO Ex. 6, at 18).

In her Rebuttal testimony, Company witness Christina Palacios disputed RUCO's analysis and stated that the Company had previously removed almost $600,000 in promotional and marketing expenses, consistent with prior Commission Decisions. Ms. Palacios testified that the employees' wages that RUCO seeks to disallow are responsible for interacting with individual customers and developers seeking information regarding extension of gas service, as well as maintaining oversight until service is extended to a requesting property (Ex. A-5, at 2-6). Ms. Palacios asserted that the job duties of the employees in question include: advising customers on gas products and availability; coordinating new business processes; working with customers to determine technical needs and specifications; investigating and settling customer complaints; ensuring satisfactory customer service; participating in customer business meetings as consultants/advisors; establishing programs to educate customers; interpreting and applying tariffs to main/service extensions; ensuring adequate and timely coordination of services; negotiating contracts and special agreements; preparing studies and analyses; making presentations to trade allies or potential customers; and staying up to date on government regulations and technology changes within the industry (*Id.* at 4). Southwest Gas cites to Decision No. 64172 wherein the Commission denied RUCO's proposal to remove half of the costs associated with Southwest Gas' sales and marketing employees because "these employees are necessary for processing a request for service" (Decision No. 64172, at 10-11). The Company also cites to a decision by the United States Supreme Court in *West Ohio Gas Co. v. Public Utilities Com'n of Ohio*, 294 U.S. 63, 72 (1935), which held that "[w]ithin the limits of reason, advertising or development expenses to foster normal growth are legitimate charges upon income for rate purposes…."

We agree with RUCO that a portion of the salaries of employees associated with sales, marketing, and promotional activities should be excluded from allowable test year expenses in this proceeding. It appears that the majority of these employees' time is dedicated to duties that enhance service to customers and potential customers, thereby providing benefits to both shareholders and ratepayers. However, by the Company's admission, a certain amount of these same employees' time is devoted to purely marketing or promotional activities that the Commission has previously found are expenses that should not be borne by ratepayers. For example, Ms. Palacios provided an estimate at the hearing that the employees in question devoted approximately 90 percent of their time to non-marketing duties, as described above, and approximately 10 percent to marketing activities (Tr. 109-110). In addition, Company witness Aldridge stated that approximately 17 percent of those same employees' compensation was obtained from the Company's Sales Incentive Plan (Tr. 573-574). Despite the admission by Company witnesses that at least some portion of these employees' time is devoted to sales and marketing activities, no attempt was made to allocate a portion of their wages out of test year expenses. Based on the best information in the record, we believe it is reasonable to perform such an allocation and we will therefore disallow 10 percent of the 37 employees' wages from test year expenses (*i.e.*, $289,243). In addition, we expect Southwest Gas in its next rate case to provide a detailed explanation of employee duties that are associated with sales, marketing, or promotional activities and offer a reasonable allocation of wage expense consistent with those duties.

<u>Labor Annualization and 2005 Wage Increases</u>

In this proceeding, Southwest Gas has included in proposed test year expenses an annualization of wage increases that were given to employees in 2004, as well as wage increases granted in 2005 after the end of the test year. However, the Company included only wage increases for employees who were employed as of the end of the test year to avoid a mismatch (Ex. A-31, at 3-5; Tr. 543-545).

Although RUCO accepts the 2004 wage increase, it disputes the inclusion of the post-test year wage increase because it believes inclusion of the 2005 increase constitutes a double counting of such expenses (RUCO Ex. 6, at 11; Tr. 929-930).

Staff witness Jim Dorf testified that Staff has accepted the reasonableness of including both the 2004 and 2005 wage increases because the costs are known and measurable (Tr. 1085).

We agree with Staff that the 2005 wage increase expense should be allowed because it is a known and measurable expense that is being incurred by the Company on a going-forward basis. Because the post-test year wage increase has been applied only to employees who were employed during the test year, there is no resulting mismatch of revenue and expenses.

American Gas Association Dues

The American Gas Association ("AGA") is a national trade association for natural gas distribution and transmission companies. During 2004, Southwest Gas paid dues to the AGA (Arizona portion) of $211,934 (RUCO Ex. 5, RLM-9). The AGA provides services to its members in the following categories: Public Affairs; Communications; Corporate Affairs and International; General Counsel and Corporate Secretary; Regulatory Affairs; Marketing Development; Operating & Engineering Services; Policy & Analysis; Industry Finance & Administrative Programs; and General & Administrative Expense (Ex. A-30, RLA-3).

Although Southwest Gas claims that it has removed the amount of the dues that are attributable to the AGA's Marketing and Lobbying functions (1.54 percent and 2.10 percent, respectively), RUCO seeks an additional 39.09 percent disallowance ($75,385) for the Public Affairs and Communications functions performed by the AGA (RUCO Ex. 5, RLM-9). According to RUCO witness Moore, the Communications category of AGA operations promotes the use of gas over other fuels, while the Public Affairs category provides members with information on legislative and regulatory developments, provides testimony, comments, and filings regarding legislative and regulatory activities, and lobbies on behalf of the industry (*Id.* at 21-22).

Southwest Gas witness Aldridge countered that the Communications and Public Affairs categories are appropriate AGA functions that should be recovered in test year expenses because the Company removed the amounts specifically associated with marketing and lobbying. Ms. Aldridge testified that the Communications function of the AGA includes developing informational materials for member companies and consumers and coordinating all media activity (Tr. 550). With respect to the Public Affairs function, the AGA described its activities as follows: "The [AGA] monitored and represented the activities of Congress and Federal agencies that affected issues of importance to the natural gas industry and its customers. This division also monitored state and local legislative and regulatory trends. In 2002 its major federal, legislative and regulatory efforts were pipeline safety legislation and regulation, Federal funding for Low Income Home Energy Assistance Program (LIHEAP), federal funding for research, and national energy policy legislation." (Ex. A-30, RLA-3).

We believe that the Company has demonstrated sufficiently that, having removed the portion of its AGA dues directly attributable to marketing and lobbying, the remainder of the AGA dues should be recoverable as legitimate test year expenses. Although the descriptions of AGA activities provided by the Company are somewhat nebulous, we find that Southwest Gas has met its burden of showing that the functions for which RUCO seeks exclusion have a benefit to the Company and its customers and should be allowed. However, in its next rate case filing the Company should provide a clearer picture of AGA functions and how the AGA's activities provide specific benefits to the Company and its Arizona customers.

Transmission Integrity Management Program Expenses

The federal Pipeline Safety Improvement Act of 2002 directed the Office of Pipeline Safety and the Research and Special Programs Administration divisions of the U.S. Department of Transportation to enact regulations creating standards for transmission pipeline risk analysis and adopting a pipeline integrity management program (Ex. A-32, at 19-21). In Arizona, Southwest Gas has identified approximately 335 miles of transmission facilities located in high consequence areas that are subject to the federal legislation (Ex. S-3, at 6-7). The Company's application in this docket includes an expense adjustment to recover costs associated with compliance with this legislation, which Southwest Gas calls its Transmission Integrity Management Program ("TRIMP"). The Company seeks to recover costs incurred prior to the effective date of the rates in this proceeding, as well as a representative level of ongoing costs that it expects to incur due to ongoing TRIMP activities (*Id.*). Although the Company initially sought to recover a higher level of TRIMP expenses, it subsequently agreed to RUCO's recommendation to amortize 2004 and 2005 TRIMP costs over 7 years ($138,365 annually), with an additional test year allowance of $603,677 annually (RUCO Ex. 3, MDC-5).

Staff witness Dorf testified that although Staff encourages Southwest Gas to comply fully with the new pipeline safety regulations, Staff is concerned with the volatility of the Company's estimated compliance costs, as exemplified by a comparison of the Company's original estimate of more than $12 million through 2009 compared to its revised estimate of just over $3 million (Ex. S-4, at 5). Due to this fluctuation in the estimated ongoing compliance costs, as well as Staff's belief that the expenses should be borne jointly by shareholders and ratepayers, Mr. Dorf recommended establishment of a surcharge mechanism that would allow recovery through rates of half of the baseline direct assessment, direct examination, and maintenance and repair TRIMP-related costs (but not capital replacements). Staff proposes that the surcharge be labeled on customer bills as "DOT Pipeline Safety Surcharge." Staff's proposed surcharge would have annual adjustments after the first and second year, and would terminate at the end of the third year (Ex. S-3, at 11-14). Mr. Dorf explained that Staff's rationale for its recommendation is based on the following factors: 1) the Pipeline Safety Act of 2002 has significantly modified pipeline safety regulations; 2) the estimated costs of complying with the new regulations are significant; 3) initial assessments must be performed in a compressed time period; 4) current rates do not provide for recovery of these incremental costs; and 5) the costs are estimated at this time and are therefore inappropriate for inclusion in base rates (*Id.* at 12).

We agree with the reasoning expressed by Staff witness Dorf that TRIMP costs should be borne equally by shareholders and ratepayers, and a surcharge mechanism is the appropriate means of recovery. As Mr. Dorf stated at the hearing, recovery of TRIMP expenses through a surcharge would mitigate potential volatility in the program's costs especially given the long projection period for completing the first cycle of TRIMP costs (Tr. 1082). With respect to the split of TRIMP costs, we also agree with Staff that because the pipeline safety program benefits both shareholders and ratepayers, the TRIMP expenses should be shared equally. We will therefore adopt Staff's recommendation for treatment of TRIMP costs.

<u>Sarbanes-Oxley Compliance Expenses</u>

Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") requires the establishment of an internal control structure and certain procedures for financial reporting, including a requirement that the company's annual report contain an internal control report (Ex. A-29, at 21-22). This legislation created the Public Company Accounting Oversight Board, and requires that publicly traded companies' external auditors attest to and report on management's assessment of the effectiveness of their internal controls and procedures. Companies were required to be in compliance with SOX by December 31, 2004 (Ex. S-3, at 15).

Southwest Gas seeks an adjustment to recover expenses related to the initial assessment and review of the Company's internal controls and additional post-test year expenses that it claims are necessary to fully implement SOX requirements, as well as estimated incremental and recurring compliance costs related to audit fees (Ex. A-30, at 9-13). Subsequent to filing its application, the Company updated its estimated compliance costs to reflect actual expenses, and Ms. Aldridge testified that those costs are reasonable in light of the Company's use of internal labor, including exempt employee labor for which overtime pay was not required (*Id.*).

Staff recommends an equal sharing of ongoing SOX compliance costs between ratepayers and shareholders based on its claim that the improved internal controls required by SOX provide a benefit to both groups. Staff witness Dorf stated that the SOX requirements protect ratepayers with improved compliance and benefits shareholders by protecting them from management impropriety (Staff Ex. 3, at 17). Mr. Dorf also testified that Staff recommends a 25 percent reduction of initial audit costs based on published reports by the American Institute of Certified Public Accountants that original estimates were overstated, and Staff recommends disallowance of the Company's proposed recovery of non-recurring implementation costs (*Id.*; Tr. 1085-1087).

Although it is important for Southwest Gas to comply fully with federally mandated audit and reporting requirements, we believe Staff's recommendation more accurately reflects the actual SOX compliance costs that will be incurred by the Company for the period that the rates set in this proceeding are in effect. As Mr. Dorf points out in his testimony, Staff's recommendation is based on numerous published articles that indicate there will be significant reductions to many companies' first year implementation and audit costs. Mr. Dorf cited to a white paper published by Enterprise Financial Consulting, LLP, which suggests numerous ways to reduce SOX costs in future years, and indicates that use of a compliance software application alone could save a minimum of 30 percent of the initial compliance costs (Ex. S-4, at 6).

We also agree with Staff's equal sharing of ongoing SOX compliance costs given the clear benefit that shareholders will receive in addition to ratepayer benefits. If anything, shareholders are likely to be greater beneficiaries of the SOX legislation because compliance with the new law will provide additional assurance that companies' financial statements have a higher degree of reliability. Indeed, ratepayers are at best only secondary beneficiaries of the SOX compliance procedures. We will therefore adopt Staff's position on this issue.

Management Incentive Program

Southwest Gas provides compensation in addition to base salaries to certain eligible management employees through its Management Incentive Program ("MIP") based on achievement of the following five factors: 1) an improved customer-to-employee ratio when compared to the prior year; 2) a comparison of the Company's customer-to-employee ratio to its peer utilities; 3) the results of customer satisfaction surveys; 4) the achievement of a three-year return on equity ("ROE") target; and 5) a comparison of the Company's ROE to its peer utilities (Ex. A-33, at 7). Company witness Mashas claims that these five factors were designed to align customer and shareholder interests (*Id.*). Southwest Gas contends that achieving these goals increases productivity and helps the Company retain quality employees by deferring 60 percent of the MIP payout for three years (*Id.* at 6-11).

RUCO proposes to reduce MIP expenses by 67 percent to recognize that shareholders receive the majority of benefits through achievement of the MIP performance targets, especially between rate cases. Ms. Diaz Cortez testified that amounts awarded under the MIP could be viewed as bonuses because the eligible individuals also receive wage and salary increases. She also stated that the annual amount of MIP compensation is not known and measurable because the payouts depend on reaching the performance goals (RUCO Ex. 3, at 20-23).

Staff also recommends reducing MIP expenses, but proposes an equal sharing between shareholders and ratepayers. Staff witness Dorf stated that shareholders and ratepayers stand to benefit from the performance goals, but added that there is no assurance that the award levels achieved during the test year will be repeated in future years (Ex. S-4, at 9-10).

Southwest Gas responds that MIP payouts should be considered part of the employees' overall compensation package and no party in the case has suggested that the employees' total pay is unreasonable, and that the Company is penalized by the Staff and RUCO proposals by putting part of its management's compensation at risk. According to Southwest Gas, if the Company put these amounts in the employees' base salary, Staff and RUCO would not claim that there should be a disallowance.

In Decision No. 64172, the Commission adopted Staff's recommendation regarding MIP expenses based on Staff's claim that two of the five performance goals were tied to return on equity and thus primarily benefited shareholders. We believe that Staff's recommendation for an equal sharing of the costs associated with MIP compensation provides an appropriate balance between the benefits attained by both shareholders and ratepayers. Although achievement of the performance goals in the MIP, and the benefits attendant thereto, cannot be precisely quantified there is little doubt that both shareholders and ratepayers derive some benefit from incentive goals. Therefore, the costs of the program should be borne by both groups and we find Staff's equal sharing recommendation to be a reasonable resolution.

<u>Supplemental Executive Retirement Plan</u>

Southwest Gas offers a Supplemental Executive Retirement Plan ("SERP") to the Company's officers. Company witness Mashas testified that the SERP is necessary "to ensure that the retirement and deferred compensation portions of [the officers'] total compensation are on parity with all other employees of Southwest whose retirement distribution is not impacted by certain IRS regulations" (Ex. A-33, at 3). Mr. Mashas claims that recovery of the SERP costs is reasonable due to restrictions on these employees' basic retirement plan ("BRP"), exclusion of deferred compensation from the BRP calculation, and the need to ensure attraction and retention of qualified employees. Mr. Mashas explained that IRS regulations place limits on pension plan calculations for salaries exceeding $165,000 and thus salaries in excess of that level are not included in the pension calculation. Mr. Mashas stated that the SERP provides officers with a retirement benefit equal to 50 percent of the average of the last three years salary provided that they are at least 60 years old and have at least 20 years of service (*Id.* at 5-6). In addition, IRS regulations place restrictions on the Company's 401(k) contributions to the extent that "maximum contribution levels represent a significantly smaller percentage of an officer's salary compared to other employees" (*Id.* at 4-5).

RUCO witness Moore proposed a reduction in test year expenses of approximately $2.7

million associated with the SERP. Mr. Moore stated the cost of these supplemental retirement benefits for select executives is not a necessary cost of providing gas service to customers because the Company's officers are already fairly compensated with a wide array of benefits, including a retirement plan. Mr. Moore cited to the Company's most recent rate case before the Nevada Public Utilities Commission[3] where Southwest Gas' SERP expenses were excluded from the Company's operating expenses (RUCO Ex. 5, at 28-29).

We agree with RUCO's position on this issue. Although we rejected RUCO's arguments on this issue in the Company's last rate proceeding, we believe that the record in this case supports a finding that the provision of additional compensation to Southwest Gas' highest paid employees to remedy a perceived deficiency in retirement benefits relative to the Company's other employees is not a reasonable expense that should be recovered in rates. Without the SERP, the Company's officers still enjoy the same retirement benefits available to any other Southwest Gas employee and the attempt to make these executives "whole" in the sense of allowing a greater percentage of retirement benefits does not meet the test of reasonableness. If the Company wishes to provide additional retirement benefits above the level permitted by IRS regulations applicable to all other employees it may do so at the expense of its shareholders. However, it is not reasonable to place this additional burden on ratepayers.

<u>Miscellaneous Expenses</u>

Through her Direct testimony, Company witness Aldridge indicated that the application included an adjustment to remove certain miscellaneous expenses for items such as gym memberships, donations and meals (Ex. A-29, at 23).

Based on his review of data requests, RUCO witness Moore proposed an additional adjustment to remove from test year expenses "payments to chambers of commerce, non-profit organizations, donations, club memberships, gifts, awards, extravagant corporate events and for various meals, lodging and refreshments, which are not necessary in the provisioning of gas service" (RUCO Ex. 5, at 25).

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[3] *Application of Southwest Gas Corporation for Increase in Rates*, Public Utilities Commission of Nevada, Order in Docket No. 04-3011 (August 30, 2004), at 41.

In her Rebuttal testimony, Ms. Aldridge stated that RUCO had failed to justify the exclusion of the various miscellaneous expenses identified by Mr. Moore. Ms. Aldridge claimed that the vast majority of the expenditures are reasonable, recurring, and necessary business expenses and should remain in cost of service. However, after additional review, Ms. Aldridge accepted exclusion of a portion of RUCO's proposed disallowance ($62,165 Arizona jurisdictional), but further testified that accepting RUCO's recommendation would result in exclusion of expenses related to moving expenses for a transferred employee; safety awards and costs related to the Company's Operations Center; alcohol and drug testing; and continuing professional education (Ex. A-30, at 15-16).

In his Surrebuttal testimony, Mr. Moore indicated that there were additional expenses the Company had not removed that RUCO believes should not be recoverable through rates. Examples of expenses that Mr. Moore claims remain in the Company's miscellaneous expenses include: liquor, coffee, water, ice, sodas, smoothies, bagels, donuts, subs, trophies, flowers, gift certificates, photographs, charitable/community service club donations, travel reduction programs, shareholder meetings, recognition events, sports events, club memberships, art work, and barbecues and accessories (RUCO Ex. 6, at 20-21). Mr. Moore stated that RUCO would agree to reduce its proposed disallowance by approximately 20 percent, from $346,299 to $277,039, "to avoid the tedious litigation of line-by-line examination of the 40 pages of workpapers" (*Id.* at 21).

In her Rejoinder testimony, Ms. Aldridge claimed that specific items identified by Mr. Moore (*i.e.*, liquor, club donations, sports events, club memberships, barbecues) were removed by the Company as part of the $62,165 adjustment described above (Ex. A-31, at 14-15). She indicated that certain meal costs and expenses related to employee appreciation and charitable events were not removed because she believes such expenses are reasonable business expenses. Ms. Aldridge also criticized RUCO's analysis of the workpapers provided through data requests as lacking sufficient detail which was "not even enough for the Company to determine whether a transaction should remain in cost of service" (emphasis original) (*Id.* at 16). She therefore concluded that "RUCO has simply presented insufficient evidence to support their proposed disallowance" (*Id.*). On cross-examination, Ms. Aldridge maintained that she had removed expenses related to barbecues, Jeep tours, and balloon rides as part of the $62,165 adjustment, but that other expenses for items such as awards for meter reading accuracy, safe driving awards, shareholder meetings, photographs, sympathy cards and flowers are necessary business expenses that should be recovered through rates (Tr. 353-358, 583-587). She admitted that the exclusion of $62,165 of expenses (for barbecues, Jeep tours etc.) were removed only after RUCO raised the issue through its testimony (Tr. 583).

Although we appreciate Ms. Aldridge's attempt to exclude expenses that are clearly inappropriate for recovery from ratepayers, we do not believe that the Company has met its burden of proving the reasonableness of all of the miscellaneous expenses for which it seeks recovery. It is curious that Southwest Gas seeks to cast the burden of proving the unreasonableness of expenses on RUCO, especially once RUCO has provided some evidence that certain claimed expenses are inappropriate and which evidence, by the Company's own admission, should result in additional exclusions. Given the state of the record, it is unclear precisely which additional miscellaneous expenses should be excluded from cost of service, but we believe that at least a portion of the items that the Company believes are reasonable business expenses should be disallowed (*e.g.*, shareholder meeting expenses). Because the Company failed to sustain its burden of proof on this issue, but also recognizing that many of these miscellaneous expenses may be legitimate and reasonable business expenses, we will disallow half of RUCO's original proposed disallowance ($346,299 x 50% = $173,150 disallowance).

<u>Southwest Gas Legal Arguments</u>

Throughout its legal Briefs, Southwest Gas repeatedly cites the case of *Anaheim, Riverside, Banning, Colton, and Azusa, California v. Federal Energy Regulatory Commission*, 669 F.2d 799, 809 (U.S. App. D.C. 1981), to support its assertion that Staff's recommendations must fail because Staff failed to present sufficient evidence to raise a serious doubt as to the prudence of the Company's proposal. As Staff points out in its Reply Brief, the *Anaheim* case was based on the Federal Power Act which, pursuant to 16 U.S.C. §824d(e), imposes on the utility company the "burden of proof to show that the increased rate of charge is just and reasonable." The *Anaheim* case, while not controlling precedent, also stands for the proposition that once a party challenges the propriety of a particular aspect of the company's application with some credible evidence, it is incumbent upon the utility to demonstrate the reasonableness of its proposals. The evidence presented through sworn testimony and other exhibits has been carefully weighed and a just and reasonable result achieved based on consideration of the competing evidence and arguments. As established by the Arizona Constitution and relevant case law, this Commission has broad discretion in setting just and reasonable rates and we believe our findings herein achieve that goal despite the Company's disagreement.

Southwest Gas also repeatedly cites *West Ohio Gas v. Public Utilities Commission of Ohio*, 294 U.S. 63 (1935), to support its contention that specific expense items, including advertising and promotional costs, must be presumed reasonable. While the *West Ohio Gas* case indicates that "good faith" should be presumed on the part of a company's managers with respect to the prudence of expenditures, we disagree with the position advocated by Southwest Gas that our consideration of the reasonableness of any particular expense may not include recognition of the relative benefits that may be derived from such costs. The test of reasonableness is based on a host of considerations presented in the record and may not be reduced to a simple pass through of costs claimed by the Company in order to pass legal muster. The Commission's ratemaking authority allows precisely the type of analysis that has been conducted with respect to these expense items and is consistent with case law interpreting that authority.

<u>Net Operating Income</u>

Consistent with the foregoing discussion, we will allow adjusted test year operating expenses of $275,031,605, which based on test year revenues of $322,865,978, results in test year adjusted operating income of $47,834,373, a 6.63 percent rate of return on FVRB.

COST OF CAPITAL

As amended at the hearing, Southwest Gas recommends that the Commission determine the Company's cost of common equity to be 11.42 percent if its proposed conservation margin tracker ("CMT") is not adopted and 11.17 percent with adoption of the CMT (see discussion of CMT below). The Company's weighted cost of capital recommendation is 9.24 percent without the CMT and 9.13 percent with the CMT (Tr. 783-784; Ex. A-54). Staff recommends a cost of common equity rate of 9.50 percent with an overall weighted average cost of capital determination of 8.40 percent (Ex. S-1, SGH-1, Sched. 11). RUCO proposes adoption of a cost of common equity of 10.15 percent and a weighted average cost of capital of 8.64 percent (RUCO Ex. 1, WAR-1).

Capital Structure

During the test year, Southwest Gas had an average actual capital structure consisting of 34.5 percent common equity, 5.3 percent preferred stock, and 60.2 percent long-term debt (Ex. A-38, TKW-1). The Company, Staff, and RUCO agree that the Commission should employ a hypothetical capital structure for purposes of setting rates in this proceeding. However, Staff disagrees with the Company and RUCO as to the composition of the hypothetical structure.

Southwest Gas proposes adoption of a hypothetical capital structure of 42 percent common equity, 5 percent preferred equity, and 53 percent long-term debt (Ex. A-38, at 8-33). According to Company witness Theodore Wood, Southwest Gas has improved its actual common equity ratio from 31.1 percent in 1995 to 37.0 percent as of June 30, 2005, despite the financial challenges facing the Company from a combination of rapid customer growth and inability to earn its authorized rate of return (Ex. A-40, at 7). Mr. Wood stated that the Company's requested 42 percent hypothetical structure is consistent with past Commission practice to set the equity ratio above the Company's actual capital structure but below the average of similar risk natural gas distribution companies (*Id.* at 11). Mr. Wood criticizes Staff's proposed 40 percent capital structure and cites to Southwest Gas' issuance of approximately 15.8 million shares of common stock between 1994 and 2004, netting $313.7 million in proceeds, as well as the recent $60 million Equity Shelf Program, as examples of the Company's dedication to improve its equity ratio despite financial hurdles (*Id.* at 16; Ex. A-39, at 20-21). Mr. Wood was also critical of Staff's recommendation to require a formal recapitalization plan because of the dilution effect on existing shares and the potential negative impact on the Company's stock price. According to Mr. Wood, such a requirement would be detrimental to the integrity of existing capital and could hinder the Company's ability to maximize proceeds from subsequent stock offerings (*Id.* at 21-22).

Although, as discussed below, RUCO disagrees with Southwest Gas' overall cost of capital recommendation, it agrees with the Company's hypothetical capital structure proposal. RUCO witness William Rigsby stated that he adopted the Company's hypothetical structure in his analysis because Southwest Gas is close to the average debt and equity percentages in his sample group of local distribution companies ("LDCs"). The capital structures for his sample group averaged 51.2 percent long-term debt, 0.3 percent preferred equity, and 48.5 percent common equity (RUCO Ex. 1, at 44-45). Thus, when Southwest Gas' preferred and common equity are combined under RUCO's proposed hypothetical structure, a 47 percent total equity ratio is achieved for purposes of analyzing the Company's cost of capital.

Staff recommends that the Commission adopt a 40 percent hypothetical structure, with 5 percent preferred stock and 55 percent debt, for purposes of determining Southwest Gas' overall cost of capital in this proceeding. Staff witness Stephen Hill testified that the equity ratio of Southwest Gas has been consistently low for more than a decade and that ratepayers should not be required to, in effect, subsidize the Company's equity return to the extent requested by Southwest Gas (Ex. S-1, at 20-27). Mr. Hill stated that Staff's recommended 40 percent equity ratio provides an appropriate balance between financial safety and economy for Southwest Gas and is consistent with the hypothetical structure adopted in the Company's last rate case (*Id.*). Mr. Hill also recommends that the Commission should require Southwest Gas to submit a re-capitalization plan for how the Company can reach an actual 40 percent equity goal prior to its next rate proceeding. Mr. Hill further proposes that if the Company elects not to increase equity capital to at least 40 percent, the Commission should set rates in the next case using the actual capital structure at that time (*Id.* at 26).

Although it did not present a specific cost of capital recommendation, AUIA criticized Staff's proposai to require Southwest Gas to adopt a recapitalization plan to increase its equity ratio to at least 40 percent by the Company's next rate case. AUIA argues that the cause of the Company's debt-heavy capital structure is its inability to earn its authorized rate of return over a number of years, which it claims is at least as damaging to shareholders as ratepayers. AUIA witness Walter Meek testified that shareholders would support a plan to achieve a 40 percent equity ratio if the Commission would adopt a rate design that would enable Southwest Gas to actually earn its authorized rate of return (AUIA Ex. 2, at 8).

We agree with Staff that use of a 40 percent equity ratio is appropriate in this proceeding. The 40 percent ratio is more than 5 points higher than the ratio in existence at the end of the test year and 3 points higher than the Company's equity at the end of June 2005. This hypothetical capital structure is consistent with our Order in the Company's last rate case (Decision No. 64172, at 17). Although Southwest Gas has made some progress over the past decade to improve its equity position relative to debt, our continuing need to employ an inflated equity ratio for setting rates in case after case highlights the need to encourage even greater efforts to increase the equity ratio. Ultimately, however, the level of equity lies within the control of the Company's management and not with ratepayers who have been asked to shoulder the burden of rates set based on a hypothetical structure that does not actually exist.

As Staff witness Hill pointed out, ratepayers have for many years been burdened with an authorized return set using a hypothetical capital structure far greater than the Company's actual equity ratio. At some point, we must send Southwest Gas a signal that it must improve its capital structure up to the hypothetical level that has been employed for many years or it must live with the results of its actual capital structure. Therefore, we believe it is also appropriate to adopt Staff's recommendation to require Southwest to submit a re-capitalization plan explaining how it intends to achieve a 40 percent equity prior to the Company's next rate case. We do not believe it is necessary, at this time, to determine whether failure to reach the 40 percent goal would result in use of the Company's actual capital structure in its next rate case. However, the possibility of such a determination in the next rate case will depend on the Company's efforts to make progress on this issue based on the plan it develops and implements pursuant to this Order.

<u>Cost of Common Equity</u>

Determining a company's cost of common equity for purposes of setting its overall cost of capital requires an estimation that is both art and science. As evidenced by the competing methodologies employed by the three cost of capital witnesses in this case, there is no clear-cut answer as to which formula should be used for reaching the appropriate outcome. Rather, the three expert witnesses, Messrs. Hanley, Hill, and Rigsby, each rely on various analyses for their recommendations.

<u>Southwest Gas</u>

Southwest Gas' expert witness, Frank Hanley, based his common equity cost recommendation of 11.42 percent (or 11.17 percent with the CMT) on the results of his common equity models, namely, the Discounted Cash Flow ("DCF"), Risk Premium Model ("RPM"), Capital Asset Pricing Model ("CAPM"), and Comparable Earnings Model ("CEM"). According to Mr. Hanley, use of these models is consistent with the Efficient Market Hypothesis ("EMH"), which is based on the premise that investors are aware of all relevant publicly available information in making their investment decisions (Ex. A-35, at 20-24). Mr. Hanley stated that, absent evidence to the contrary, it must be assumed that investors are aware of all of the models he used in his analysis and that those investors take the models into account in making their decisions (*Id.*).

In his analysis, Mr. Hanley developed two proxy groups of comparable gas distribution companies. Based on an historical comparison of financial data for the proxy groups and Southwest Gas, Mr. Hanley found that Southwest Gas has earned returns well below those of the proxy groups (Tr. 680-681). According to Mr. Hanley, during the period of 1997 through 2003, Southwest Gas achieved an average return on actual book common equity of 6.74 percent in Arizona, compared to the 11.62 percent and 12.11 percent average return on equity ("ROE") realized by the proxy groups (Ex. A-35, FJH-1).

The Company argues that there is an even greater disparity with the proxy group ROEs if Southwest Gas' greater level of business risk is taken into account, as evidenced by the Standard & Poor business profile of 3.0 for Southwest Gas compared to the proxy group average profiles of 1.8 and 2.0 (Ex. A-35, at 13-14, FJH-11). The Company also claims its ROE request is reasonable compared to other litigated cases for LDCs across the country the past several years, where the average ROE granted was 10.91 percent, for companies with a common equity ratio of 47.5 percent (Ex. A-36, at 41, FJH-24). The Company argues that these comparisons support the need for a higher ROE because Southwest Gas is more risky, from both a business and financial risk perspective.

Southwest Gas contends that Staff's recommended ROE understates significantly a reasonable return for the Company based on *Value Line* forecasts for other LDCs. Mr. Hanley cited to a *Value Line* survey from June 17, 2005, which reported an expected 12.5 percent ROE for such companies relative to a 45.5 percent common equity ratio (Ex. A-37, at 16). Mr. Hanley criticized Staff's reliance on the DCF method for determining ROE based on his claim that the DCF tends to understate the common equity cost rates when market values exceed book values and when such market-based investors' required rates of return are applied to lower book values (*Id.* at 7).

The Company also cites to the *Hope* and *Bluefield* cases[4], as well as Article 15, §3 of the Arizona Constitution and *Residential Utility Consumer Office v. Arizona Corporation Com'n*, 199 Ariz. 588 (2001), for the proposition that the Commission must consider Southwest Gas' greater risk relative to other LDCs when determining an appropriate common equity cost rate.

<u>RUCO</u>

RUCO contends that its proposed 10.15 percent cost of common equity is appropriate given the Company's actual capital structure, the current environment of relatively low inflation and interest rates, and the Company's relatively higher financial risk compared to other similar LDCs (RUCO Ex. 1, at 43-45). RUCO witness Rigsby employed both a DCF analysis and CAPM to reach his recommendation. His DCF analysis yielded an 8.91 percent COE result, while the CAPM resulted in a range of 8.82 to 10.39 percent (*Id.* at 27). In reaching his 10.15 recommendation, Mr. Rigsby rounded up (to 10.40) the upper end of his CAPM results, and then reduced that result by 25 basis points to achieve RUCO's proposed 10.15 cost of common equity (*Id.*).

Mr. Rigsby acknowledged that his proposal is 124 basis points higher than the 8.91 percent DCF result, but contends Southwest Gas' heavily leveraged position and higher level of financial risk compared to his proxy LDCs warrants a recommendation at the higher end of his results. He also states that his recommendation is close to the 10.50 percent return on common equity adopted by the Nevada Public Utilities Commission in Southwest Gas' most recent rate proceeding (Docket No. 04-3011). Mr. Rigsby indicated that his decision to lower the COE recommendation by 25 basis points from the CAPM upper end was based on RUCO's recommendation to adopt a rate design that mitigates income volatility to Southwest Gas by shifting more of the revenue recovery from the Company's commodity charge to its fixed monthly charge, in lieu of adopting the Company's proposed CMT (*Id.* at 28). On the other end of the spectrum, his recommendation of 124 basis points above the DCF result reflects concern over the Company's inability to achieve higher levels of shareholder equity and the *Value Line* comparison to other proxy LDCs compared to Southwest Gas

[4] *Federal Power Commission et al. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, et al.*, 262 U.S. 679 (1923).

(*Id.* at 29).

Staff

In determining Staff's cost of common equity recommendation in this proceeding, Staff witness Stephen Hill conducted a DCF analysis which resulted in a cost of common equity estimate of 9.20 percent. Mr. Hill stated that, in order to support and temper his DCF results, he used three additional econometric models to estimate the cost of equity capital for a group of firms similar in investment risk to Southwest Gas. The three additional methods used by Mr. Hill are: 1) CAPM; 2) the Modified Earnings-Price Ratio ("MEPR"); and 3) the Market-to-Book Ratio ("MTB"). The sample proxy companies used for these models are the same as those employed by Mr. Hill for his DCF analysis (Ex. S-1, at 36-37). Mr. Hill's CAPM analysis resulted in a cost of capital for the proxy companies ranging from 7.71 to 9.38 percent (*Id.*, Sched. 7). For the MEPR model, the cost of equity capital ranged from 8.68 to 8.78 percent (*Id.*, Sched. 9). Finally, Mr. Hill's MTB analysis resulted in cost of equity capital ranging from 8.84 to 9.46 percent (*Id.*, Sched. 10).

Although Mr. Hill relied primarily on the 9.20 percent DCF result for determining his cost of equity recommendation, he also averaged the corroborative results (*i.e.*, CAPM, MEPR, and MTB) which produced a range of 8.41 to 9.21 percent, which he noted is almost entirely below the DCF result. As a result, Mr. Hill concluded that the DCF was a conservative (*i.e.*, high) estimate of the Company's estimated cost of equity capital and therefore the DCF result should be considered to be in the upper range of equity capital cost for Southwest Gas. However, due to his expectation of higher short-term interest rates in the near term, Mr. Hill stated that it was appropriate to set a range so that his DCF result is near the middle of a reasonable range. He therefore determined that the best estimate of the cost of equity capital for a company facing similar risks as that group of gas distribution companies ranges from 9.00 to 9.50 percent (*Id.* at 37). Because Southwest Gas' capital structure contains less common equity than the proxy group he used to estimate the cost of equity capital, Mr. Hill concluded that the additional risk faced by Southwest Gas warrants an equity return at the high end of his range, or 9.50 percent (*Id.* at 40).

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Conclusion on Cost of Equity

We believe that Staff's recommended cost of equity capital in this proceeding achieves an appropriate result that is supported by the evidence in the record. Staff witness Hill's use of the DCF as the primary basis for determining the Company's reasonable estimated cost of equity capital is a methodology that has been used for many years by this Commission, as well as other regulatory commissions across the country.

As Mr. Hill explained in his testimony, both historical and projected growth rates were calculated for his sample group of gas distribution companies. The companies in Mr. Hill's proxy group possess similar risk characteristics and, based on a sustainable growth rate supported by data published *Value Line* and other financial publications, produced a growth rate estimate of 5.12 percent (Ex. S-1, at 29-34). Although Staff's COE recommendation is based primarily on the DCF analysis, as explained above Mr. Hill also conducted a review of other COE formulas, including CAPM, to corroborate the DCF results.

Mr. Hill also testified that the methods utilized by the Company's witness, which depend heavily on beta (a relative risk measure which is designed to measure investor risk), does not provide an accurate portrayal of actual investment risk (Tr. 877). Staff points out that the Company's witness, Mr. Hanley, excluded 8 of 11 indicated DCF return rates from his proxy group based on his opinion that any result under 9.90 percent did not reflect returns being authorized in other jurisdictions. As Mr. Hill pointed out on the witness stand, if those 8 companies were included in Mr. Hanley's DCF calculation, the result would be approximately 9.2 percent, which is almost identical to Staff's DCF calculation (Tr. 876).

After reviewing the various proposals summarized herein, and as further described in the testimony prepared by the parties' expert witnesses, we believe Staff's cost of equity capital recommendation is an appropriate result for determining the Company's overall cost of capital in this proceeding. Staff's DCF calculation of 9.20 percent, with an upward adjustment of 30 basis points to 9.50 percent, gives recognition to the higher risk faced by Southwest Gas.

We are not persuaded by the Company's legal arguments that adoption of Staff's cost of equity recommendation would result in a violation of the Commission's authority under the Arizona

Constitution, the case law interpreting that authority, or of the *Hope* and *Bluefield* decisions. Article 15, Section 3 of the Arizona Constitution provides in relevant part that the Commission "shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations within the State for service rendered therein." In determining just and reasonable rates, the Commission has broad discretion subject to the obligation to ascertain the fair value of the utility's property, and establishing rates that "meet the overall operating costs of the utility and produce a reasonable rate of return." *Scates, et al. v. Arizona Corp. Com'n*, 118 Ariz. 531, 534, 578 P.2d 612 (Ct. App. 1978). Under the Arizona Constitution, a utility company is entitled to a fair rate of return on the fair value of its properties, "no more and no less." *Litchfield Park Service Co. v. Arizona Corp. Com'n*, 178 Ariz. 431, 434, 874 P.2d 988 (Ct. App. 1994), *citing Arizona Corp. Com'n v. Citizens Utilities Co.*, 120 Ariz. 184 (Ct. App. 1978). The oft cited *Hope* and *Bluefield* cases provide that the return determined by the Commission must be equal to an investment with similar risks made at generally the same time, and should be sufficient under efficient management to enable the Company to maintain its credit standing and raise funds needed for the proper discharge of its duties.

For the reasons described above, we believe that adoption of Staff's recommendation for a 9.50 cost of equity capital, and overall 8.40 percent weighted cost of capital comply with these obligations. Staff's expert witness, although primarily relying on the well-established DCF method for calculating his cost of equity capital, also employed two other tests as a check on the reasonableness of his results. He also pointed out that the Company's witness arbitrarily excluded 8 of the 11 companies in his proxy group because they produced DCF results less than 9.90 percent, and thus skewed downward the overall results on his analysis. Moreover, Staff's witness gave recognition to Southwest Gas' highly leveraged capital structure by adding 30 basis points to his DCF results. We therefore believe that adoption of Staff's recommendation results in a just and reasonable return for Southwest Gas based on the record of this proceeding.

We therefore adopt a cost of equity of 9.50 percent, which results in an overall weighted cost of capital of 8.40 percent.

	Percentage	Cost	Avg.Weighted Cost
Common Equity	40.0%	9.50%	3.80%
Preferred Equity	5.00%	8.20%	0.41%
Total Debt	55.0%	7.61%	4.19%
			8.40%

AUTHORIZED INCREASE

Based on our findings herein, we determine that Southwest Gas is entitled to a gross revenue increase of $49,345,636.

Fair Value Rate Base	$1,169,584,038
Adjusted Operating Income	47,834,373
Required Rate of Return	6.63%
Required Operating Income	77,508,617
Operating Income Deficiency	29,674,244
Gross Revenue Conversion Factor	1.6629
Gross Revenue Increase	49,345,636

RATE DESIGN ISSUES

Conservation Margin Tracker

Southwest Gas has proposed in this proceeding a decoupling mechanism that it calls a Conservation Margin Tracker ("CMT") to address the Company's ongoing inability to achieve its authorized rate of return due, at least in part, to declining per customer usage on its system. The Company has proposed that the CMT be imposed only on the residential class (although it does not oppose broader application). Under the CMT, if Southwest Gas does not achieve its authorized "margin" (*i.e.*, all costs of providing gas less the cost of the gas itself) per customer class, the CMT would track that shortfall and impose a surcharge on customers in that class the following year based on the prior year's revenue shortfall. In effect, the CMT would insulate Southwest Gas from the risk associated with declining gas usage by customers.

The Company claims that the CMT is a reasonable cost recovery mechanism for the following reasons: it would eliminate the Company's financial disincentive associated with promoting Demand Side Management ("DSM") programs; it would not discourage consumers from conserving natural gas because the more a customer conserves the more the customer would save; it would charge customers only the fixed costs of service that the Commission authorized in the rate case; it would protect customers from the Company earning more than its authorized margin per customer during a colder than normal heating season; it would protect the Company from declining residential use per customer; and it would provide the Company with a more consistent revenue stream by reducing its dependency on gas sales to recover the authorized margin per customer, thus having a positive impact on the Company's ratings with credit agencies and reducing borrowing costs needed to fund infrastructure growth (Ex. A-19, at 18-23; Ex. A-20, at 14-22; Ex. A-21, at 5-9). Southwest Gas contends that it is willing to modify the CMT or accept another type of decoupling mechanism to address the declining usage problems that it claims all parties have acknowledged exist.

Staff opposes adoption of the CMT because customers would be charged more for gas that is not used the preceding year. Staff argues that if natural gas is relatively inelastic, as the Company contends, the potential for ongoing conservation would be mitigated and usage levels will stabilize over time, thus minimizing the declining usage that impacts the Company's revenues. However, if the declining usage trend continues, Staff claims that the CMT would result in customers incurring additional charges if their conservation efforts proved successful, thereby discouraging price signals that could lead to conservation. Staff also opposes the CMT on the basis that it could result in sharp increases for residential customers if the Company fails to recover its authorized margin. Staff argues that implementation of the CMT would provide Southwest Gas a guaranteed rate of return, rather than the opportunity to earn a reasonable return as required by law. Staff asserts that the Company's historical inability to earn its authorized return should be addressed through traditional rate design methodologies, such as gradually moving closer to a more cost-based rate design. Staff points out that the Nevada Commission rejected an almost identical decoupling mechanism proposed by Southwest Gas.

RUCO also opposes the Company's CMT proposal. Although RUCO agrees that the Commission should modify the existing rate design to allow greater recovery of fixed costs, it claims that the CMT is too extreme a remedy for addressing declining usage. RUCO argues that the approved rate design should not provide the Company with a guaranteed recovery of margin, and would allow recovery from customers who were not even on the system when the shortfall occurred.

RUCO further opposes the CMT on the basis that it would be applicable only to residential customers, and because the CMT would have the effect of requiring customers to pay the authorized margin for therms they do not consume (RUCO Ex. 3, at 29). RUCO argues that although the Company declined to propose a rate design that would recover all of the margin through the basic service charge, because it believes such a rate design would be inconsistent with the principle of gradualism, it has proposed the CMT which would have the same extreme effect on residential customers.

SWEEP/NRDC expressed understanding of the dilemma faced by Southwest Gas with respect to decreasing usage and revenues. However, SWEEP/NRDC opposes adoption of the CMT in this proceeding. Its witness, Jeff Schlegel, stated that a full analysis of the benefits and drawbacks of decoupling mechanisms for LDCs warrant consideration in a broader context (SWEEP/NRDC Ex. 1, at 7-8). SWEEP/NRDC suggests that the issue of financial disincentives should be addressed through the DSM policy process, via comments and/or workshops. SWEEP/NRDC contends that consideration of the decoupling issues should address questions such as who bears the risk of weather variations and variations in economic growth from forecasted levels and overall demographic and energy usage trends (*Id.*).

AUIA argues that the financial situation faced by Southwest Gas requires adoption of a decoupling mechanism, such as the CMT, or a significant increase in margin recovery through the fixed monthly charge. AUIA contends that the decoupling concept is not radical or drastic, as Staff and RUCO contend, given the adoption of such a mechanism in at least three other states. AUIA cites the testimony of Company witness Steven Fetter, former Chairman of the Michigan Public Service Commission, in support of the CMT. Mr. Fetter indicated that declining margin recovery from volume sales is a national phenomenon and NARUC has passed a resolution urging its members to consider decoupling mechanisms (Ex. A-7, at 6-8).

<u>Conclusion on CMT</u>

Although we recognize that Southwest Gas is facing increased financial pressure due to declining usage on a per customer basis, we do not believe the proposed CMT should be adopted in this proceeding. The Company has suggested that it is open to other decoupling mechanisms as a solution, and we believe that the issue should be fully explored as part of a broader investigation of usage volatility and margin recovery.

There is conflicting evidence in the record as to whether the recent level of declining per customer usage will continue into the foreseeable future, and whether conservation efforts are the direct cause of Southwest Gas' inability to earn its authorized return from such customers. Further, as RUCO points out, the likely effect of adopting the proposed CMT is that residential customers will be required to pay for gas that they have not used in prior years, a phenomenon that could result in disincentives for such customers to undertake conservation efforts. We are also concerned with the dramatic impact that could be experienced by customers faced with a surcharge for not using "enough" gas the prior year. The Company is requesting that customers provide a guaranteed method of recovering authorized revenues, thereby virtually eliminating the Company's attendant risk. Neither the law nor sound public policy requires such a result and we decline to adopt the Company's CMT in this case.

We encourage the parties to this proceeding to seek rate design alternatives that will truly encourage conservation efforts, while at the same time providing benefits to all affected stakeholders. To that end, Southwest Gas should coordinate its efforts to pursue implementation of a decoupling mechanism through discussions with Staff, RUCO, SWEEP/NRDC, and any other interested parties. Such efforts may be pursued through the DSM policy process, as suggested by SWEEP/NRDC, and through a proposal in the Company's next rate case.

Allocation of Margin Among Customer Classes

As a means of allocating margin costs between the various classes of customers it serves, Southwest Gas presented a cost of service study to support its rate design proposal. Company witness Congdon stated that the Company's allocation of margin methodology is based on this cost of service study, and the proposed allocation would move each class' rate of return closer to cost of service (Ex. A-17, at 22-24). The Company argues that its cost of service study was not challenged by any party and, because its proposed allocation is directly based on the cost of service study, the Company's allocation of margin should be adopted.

RUCO and Staff argue that cost of service is merely the starting point for designing appropriate rates. They contend that in addition to affording the Company revenue stability, other factors must also be considered in designing rates, such as affordability, gradualism, sending appropriate price signals, and conservation goals.

We agree with Staff and RUCO that designing rates is not an exact science that may be achieved by the application of a formula tied directly to a cost of service study. Rather, the formulation of just and reasonable rates is accomplished only through consideration of multiple factors that balances the desire of the Company to recover as much of its margin as possible with recognition of the legitimate interests of customers in paying rates that are affordable, as well as advancing societal goals. As discussed below, we have attempted to determine just and reasonable rates based on these competing principles and interests.

<u>Single-Family Residential Gas Service (G-5)</u>

The residential rate class encompasses the vast majority of Southwest Gas customers and, not surprisingly, residential rate design garnered the most discussion and debate. Southwest Gas, Staff, and RUCO each proposed separate residential rate design recommendations.

<u>Southwest Gas Proposal</u>

Currently, Southwest Gas' single-family residential gas rates include an $8 basic monthly charge and a two-tier declining block rate of approximately $0.49 and $0.40 per therm, respectively. The break point between the first and second blocks is currently at 8 therms of usage in the summer (May-October) and 40 therms in the winter (November-April).

The Company has proposed an increase in the basic monthly charge from $8 to $16, and an increase in the first block volumetric charge from $0.49 to $0.66 per therm and a reduction in the second block from $0.40 to $0.25 per therm[5] (Tr. 283-287). Under the Company's proposal, the break point between blocks would remain at 8 therms during the summer months but would be reduced to 30 therms per month in winter months.

Southwest Gas is critical of RUCO's rate design proposal because, in the Company's view, it

[5] Southwest Gas proposed that if the CMT were adopted, the basic monthly charge should be increased from $8 to $12 per month, and the commodity charge would increase from $0.49 to $0.84 in the first block, and would decrease from $0.40 to $0.15 in the second block. Because we have not adopted the CMT, the rate design proposal described above is recommended by the Company.

does not shift enough of the volumetric charges to the fixed monthly charge and, by eliminating the declining block rate structure, it puts the Company at greater risk of not recovering its authorized margin (*See, e.g.*, Ex. A-51). With respect to Staff's recommendation, Southwest Gas concedes that low volume users will experience a significant increase in rates (Tr. 286-287). However, the Company contends that under either Staff's or RUCO's proposals, higher usage residential customers would fare substantially better under Southwest Gas' rate design because its second block rates would be reduced substantially compared to either current rates or the Staff and RUCO rates. Southwest Gas argues that its rate recommendation would be more beneficial to high volume residential customers, regardless of income, as evidenced by a chart in Mr. Congdon's testimony that shows substantial savings under the Company's plan for customers with usage over 100 therms in a given month (Ex. A-18, at 5). Based on its Exhibit A-50, which shows that usage by low income customers tracks closely the usage seen by non-low income customers, the Company argues that high use, low income customers may be affected even more dramatically because of an inability to pay increased costs associated with the higher second block rates under either the Staff or RUCO recommendations.

RUCO's Proposal

RUCO proposes an increase in the basic customer charge from $8 to $10.09 per month, and a flat volumetric rate of approximately $0.49 for all usage. According to RUCO, its rate design proposal gives recognition to the Company's concerns regarding revenue stability (*i.e.*, the Company's inability to recover margin costs due to declining per customer usage) by placing more cost recovery into the basic customer charge[6], while also flattening the current two-tier volumetric structure to send appropriate price signals regarding gas consumption. RUCO witness Diaz Cortez indicated that RUCO's rate design proposal would mitigate the Company's risk of not recovering its authorized revenue requirement due to declining usage (RUCO Ex. 4, at 7).

Staff's Proposal

Based on its revenue requirement recommendation, Staff proposes an increase in the basic monthly charge from $8 to $9.70, accompanied by a two-tier commodity rate of approximately $0.54

[6] RUCO claims that its recommendation would shift approximately $23 million per year from commodity charges to the basic service charge under current revenues and over $26 million under RUCO's proposed revenues in this case (Tr. 1003-1004).

for the first 15 therms in the summer and the first 35 therms in the winter, and $0.50 for usage in the second block. Staff claims that its proposed rate design moves significantly towards cost-based rates and properly balances the Company's revenue stability concerns with the concepts of gradualism, affordability, and conservation. Staff witness Bob Gray conceded that the Company's rate design recommendation provides greater rate stability than either Staff's or RUCO's proposals. He pointed out, however, that by "front-loading costs in the customer charge and the first usage block," the Company has offered a design that is inconsistent with Staff's goal of balancing stability with other important factors (Ex. S-15, at 9). Mr. Gray indicated it is "mathematically impossible for a customer with low usage, paying a much higher customer charge and a much higher first block rate to not see a large rate increase" (*Id.* at 8).

Conclusion

Although we are cognizant of Southwest Gas' desire to recover as much of its margin as possible through the monthly customer charge, it is simply untenable to saddle a substantial number of the Company's residential customers with rate increases in excess of 100 percent. Under the Company's recommendation, low usage residential customers would incur not only a doubling of their basic monthly charge (from $8 to $16 per month), but would pay a substantial commodity charge increase for usage up to 30 therms per month in the winter (from $0.49 to $0.66 per therm). While high usage customers may realize lesser overall increases under the Company's plan, relative to the Staff and RUCO proposals, the Southwest Gas rate design would have the effect of encouraging greater usage of natural gas at a time when, by all accounts, an increase in demand for natural gas is coupled with shortages in supply. We do not believe that it is appropriate to send a signal to customers of "the more you use, the more you save."

We are also aware that customers will likely face additional cost increases associated with the Company's purchased gas adjustor ("PGA"). Southwest Gas expected to reach its ten cent PGA cap in January 2006, thus increasing customer bills associated with the cost of gas for a customer using 105 therms a month by approximately $10.50 per month, regardless of the rate design adopted in this proceeding (Tr. 297-298). The Company will also likely in the near future seek Commission approval for imposition of a surcharge to recover its $30 million bank balance, adding an additional

$0.055 per therm (*i.e.*, an additional $5.50 per month for the same customer using 105 therms per month). Although the cost of gas may be largely beyond the Company's control, this additional rate impact must be considered as part of the overall rate impact on customers.

We agree with all parties that movement closer to cost-based rates is in principle a laudable goal. However, that goal must be balanced with consideration of the principles of gradualism, fairness, and encouragement of conservation. Based on consideration of competing interests and concerns, we agree that Staff's rate design recommendation appropriately makes significant movement towards cost based rates while providing a measure of protection for customers who will incur substantial rate increases as a result of this base rate case increase. Accordingly, we will adopt Staff's recommended basic monthly charge of $9.70 and, as adjusted for the revenue requirement adopted herein, a two-tier commodity rate of $0.54200 for the first 15 therms in the summer and the first 35 therms in the winter, and $0.50100 for usage in the second block.

Based on the G-5 residential rate design adopted in this case, and assuming an average monthly usage of 29 therms, single-family residential customers would experience an increase under summer rates of 8.9 percent, from $38.96 to $42.42 per month, and an increase under winter rates of 8.3 percent, from $39.71 to $42.99[7].

<u>Multi-Family Residential Gas Service (G-6)</u>

Southwest Gas proposes creation of a new multi-family residential rate schedule (G-6) that would, under the Company's revenue requirement recommendation, grant customers in multi-family residences a $1 per month reduction to the basic monthly charge compared to single-family residence customers (*See*, Ex. A-2, Sched. H-3). Mr. Congdon stated that creating this separate rate schedule for multi-family residence customers would allow the Commission to moderate the effect on the Company's smallest residential customer class as residential service rates are moved gradually towards cost of service (Ex. A-17, at 26-27). RUCO does not oppose this recommendation.

Staff witness Gray testified, however, that although Staff is not strongly opposed to creation

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[7] An estimate of the seasonal impact of the increase can best be seen by viewing an average customer's summer usage in August (10 therms), where an average bill would increase by 11.8 percent, from $18.94 to $21.18; and an average customer's winter usage in January (72 therms), where an average bill would increase by 8.1 percent, from $84.04 to $90.83.

of a multi-family residential rate class, Staff does not believe it is advisable to create a separate rate structure for a small segment of the general rate class. Mr. Gray stated that while there are likely other segments of the residential class that have different characteristics, "a Balkanization of the residential rate class absent a compelling need to do so is not something Staff will support" (Ex. S-15, at 10).

We agree with Southwest Gas that customers in multi-family dwellings deserve a separate rate categorization to reflect their lower usage characteristics and relatively lower cost to serve as a class. Therefore, we will approve creation of a separate rate schedule for this residential customer class and, consistent with the Company's proposal, impose a basic monthly service charge of $8.70, plus the commodity charges applicable to Schedule G-5 customers.

Based on the rate design adopted in this case, and assuming an average monthly usage of 29 therms, customers in the new multi-family residential class would experience an increase under summer rates of 5.5 percent, from $38.96 to $41.09 per month, and an increase under winter rates of 8.3 percent, from $39.71 to $41.54[8].

<u>Low-Income Residential Gas Service (G-10)</u>

Southwest Gas proposed elimination of its low-income residential gas service tariff (G-10), with such customers being incorporated into the other residential classes (G-5 and G-6), and the current volumetric discount would be extended to the entire year rather than the current applicability to only winter months (Ex. A-17, at 27-29). However, the Company's proposal would lessen the amount of the discount applicable to low-income customers based on its assertion that there would be less of a need to shield such customers from high winter bills because the Company's rate design proposal, if adopted, would shift a portion of the margin recovery from the winter season to the summer season. Under the Southwest Gas recommendation, the existing $7.00 per month basic customer charge would be retained for low-income customers, and the current 20 percent discount on the first 150 therms of usage during winter months would be replaced with a year-round 15 percent

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[8] An estimate of the seasonal impact of the increase can best be seen by viewing an average customer's summer usage in August (10 therms), where an average bill would increase by 5.9 percent, from $18.94 to $20.06; and an average customer's winter usage in January (72 therms), where an average bill would increase by 6.1 percent, from $84.04 to $89.14.

discount with no usage limit. RUCO does not oppose the proposal and the Company indicates that it has not received any opposition to the proposal from local community action advocates after explaining the plan to those representatives (*Id.* at 28-29). Mr. Congdon testified that, if the Commission does not accept the Company's rate design proposal, the current 20 percent low-income discount should not be modified (*Id.*).

Staff opposes the Company's proposal to eliminate Schedule G-10 and modify the low-income residential rate as described above. Staff witness Gray stated that Arizona utilities that offer such a discount typically have a separate, stand-alone tariff and Staff believes maintaining the existing tariff allows a higher profile for the tariff and advances ease of understanding. Mr. Gray agreed with the Company that the $7.00 customer charge for Schedule G-10 should be maintained at that level, and further indicated that the existing 20 percent discount for the first 150 therms of usage during winter months should be maintained because bills incurred for high winter usage is the critical element for low-income customers (Ex. S-15, at 36-38).

Given our adoption of Staff's residential rate design proposal, it appears Southwest Gas does not advocate adoption of its proposed modification of the low-income tariff. We agree with Staff's recommendation that the current Schedule G-10 should be maintained at its current level and we therefore adopt Staff's proposal to maintain the $7.00 customer charge and apply a 20 percent discount to the first 150 therms of consumption during winter months.

<u>Special Residential Gas Service for Air Conditioning (G-15)</u>

Southwest Gas recommended that its special residential service tariff for gas air conditioning (G-15) should be eliminated and the small number of customers covered under the tariff folded into the general residential tariff (G-5). Company witness Congdon explained that there is currently only a small difference in the second block rate between the two schedules and the Company's proposal would eliminate the need to administer a separate schedule for this small number of customers. Mr. Congdon added, however, that if the Commission adopts the rate designs proposed by either Staff or RUCO, the G-15 schedule should remain intact and the summer air conditioning margin rate should be set at $0.25 per therm (Ex. A-17, at 29).

Staff witness Gray opposes elimination of the G-15 tariff because typical usage by customers under this schedule is significantly higher than general residential usage. Given this usage pattern differential, Mr. Gray indicated that it is reasonable to continue the separate tariff. Staff recommends that the G-15 tariff should continue to reflect the G-5 tariff rates, with the exception that the G-15 second summer usage block should be increased from approximately $0.19125 to $0.28200 per therm (Ex. S-15, at 41-42; Ex. S-16).

Given our adoption of Staff's residential rate design proposal, it appears Southwest Gas does not advocate adoption of its proposed modification of the residential air conditioning tariff. We agree with Staff's recommendation that the current Schedule G-15 should be maintained at its current level, with the exception of an increase to the summer second block.

Master Metered Mobile Home Park Gas Service (G-20)

In its application, Southwest Gas proposed increasing the basic monthly charge for master metered mobile home park service customers from $50 to $100, and increasing the commodity charge from approximately $0.314 to approximately $0.323 per therm (Ex. A-1, Sched. H-3). The Company did not present testimony on this issue, but argues that its recommendation better reflects its cost of service for this customer class, compared to Staff's proposal (*Id.*, Sched. H-6).

Staff witness Gray stated that Staff's recommendation is to increase the basic monthly charge from $50 to $60, and to increase the volumetric charge from $0.31415 to $0.38400 per therm (Ex. S-16).

Consistent with principles of gradualism and fairness, we will adopt Staff's recommendation on this issue so as not to impose such an abrupt and significant rate increase on customers taking service under this tariff.

General Gas Service (G-25)

With respect to the Company's recommendations regarding this rate schedule, which includes various sizes of commercial customers, the following issues are addressed below: moving current Armed Forces customers on Schedule G-35 into Schedule G-25; appropriateness of creating a new sub-class for small use customers in the class and relative basic customer charge increase recommendations for different size customers within the class; and use of coincident peak or non-coincident peak for determining the demand charge for large G-25 customers.

Elimination of Armed Forces Rate Schedule (G-35)

In its application, Southwest Gas recommended elimination of Armed Forces Rate Schedule G-35, and movement of existing customers under that schedule into the large general gas service rate under Schedule G-25. The basis of the Company's proposal is that if G-35 customers were permitted to choose to take service under either G-25 or G-35, the Company would experience a shortfall in margins.

DOD witness Dan Neidlinger filed testimony supporting Southwest Gas' recommendation, stating that DOD customers should logically be classified with other large gas users for ratemaking purposes. Mr. Neidlinger's testimony indicates that if the overall revenue requirements are established near the levels recommended by Staff or RUCO, DOD recommends adoption of RUCO's proposed G-25 rates (DOD Ex. 1, at 2-3).

Although Staff initially suggested that Schedule G-35 should be maintained and customers should be able to choose between G-25 or G-35 (Ex. S-15, at 43-47), Mr. Gray subsequently withdrew Staff's opposition based on DOD's agreement with the Company's proposal (Tr. 1097-1098).

Given Staff's acquiescence on this issue, we will adopt the Company's proposal to eliminate Rate Schedule G-35 for Armed Services customers and to include those customers under the large general gas service tariff, Schedule G-25.

New Sub-Class for Small Use Customers and Basic Service Charge Recommendations

Southwest Gas' Schedule G-25 currently includes discrete prices for small (annual 0-7,200 therms), medium (annual 7,201-180,000 therms), and large (annual usage greater than 180,000 therms). The Company proposed the creation of a new sub-class within the small customer category, so that commercial customers with very low usage (*i.e.*, less than 600 therms annually) would be separated for rate design purposes from other small group customers that use between 601 and 7,200 therms annually (Ex. A-16, at 17-18). Mr. Congdon testified that the Company's proposal would allow pricing that more closely matches its cost of service while also mitigating the impact of the rate increase on the smallest customers within the class. He claimed that the Company's proposed tariff adjustments were made to minimize the differences in monthly bills at the cross-over volumes between general service rate schedules (*Id.* at 19).

RUCO does not oppose creation of this sub-class category, but Staff contends that the members of the new sub-class "would see a much larger rate increase than if they had remained part of the current small commercial class presently in existence" (Ex. S-15, at 43). Therefore, Staff witness Gray recommends retaining the current usage levels for small, medium and large G-25 customers (*Id.* at 44).

The proposals for customers within the G-25 rate schedule, including the Company's claimed cost of serving the customer classes (Ex. A-1, Sched H-6), are as follows (Ex. A-17, at 30-32):

Proposed Schedule	Current	Staff	RUCO	SWG	Cost of Serv.
Small GS	$20.00	$24.00	$34.57	$25.00	$74.86
Medium GS	20.00	24.00	48.39	35.00	79.02
Large GS	90.00	105.00	207.00	150.00	145.81
Transport Elig.	500.00	540.00	1,037.00	750.00	754.99

Based on our review of the record, we find the Company's recommendation to create a separate sub-class of very small customers is reasonable and should be adopted. However, in order to mitigate the severity of the customer charge increases on customers in this class, we will adopt a modified increase in the customer charges as follows: customers in the new small use segment - $25.00; customers in the medium class - $33.00; customers in the large class - $145.00; and customers in the transportation eligible class - $720.00. We believe these approved customer charges move the customers in this rate schedule closer to the Company's cost of service while, at the same time, protecting customers from dramatic increases in rates.

<u>Demand Charge Determination</u>

Southwest Gas also proposed to change its method of measuring a large customer's peak demand from a coincident peak method (*i.e., system* peak month) to a non-coincident peak method (*i.e., customer* peak month). The Company claims that its non-coincident peak measurement would take some of the risk of revenue recovery out of rates while, at the same time, reflecting value to customers on an annual basis (Ex. A-17, at 33).

Staff opposes changing the demand charge calculation formula from use of coincident peak due to the potential that "some customers may have structured their consumption and operations such that they reduce consumption on what is likely to be [the Company's] peak month" and, therefore, the change could have a significant rate impact on customers who have very different coincident and non-coincident peaks (Ex. S-15, at 44).

DOD agreed with the Company's recommendation, in part. DOD witness Neidlinger stated support for a modified non-coincident peak method "whereby a customer's billing demand would be based on the highest monthly demand experienced during any winter month" (DOD Ex. 1, at 3). DOD would exclude from the calculation demands during the summer months of May through September.

Although we believe DOD's proposed modification of the non-coincident peak method for determining the demand charge has merit, there is not sufficient data in the record to support its adoption. We will therefore adopt the Company's non-coincident peak measurement recommendation as a means of taking some of the risk of revenue recovery out of rates while, at the same time, reflecting value to customers on an annual basis.

Air Conditioning Gas Service (G-40)

Southwest Gas proposed the imposition of a single basic service charge of $25 for customers taking service under this tariff, rather than the Company's otherwise applicable basic service charge (Ex. A-16, at 14). However, the Company offered no testimony explaining the need for a distinct basic service charge for this tariff.

Staff witness Gray stated that the Company has a number of tariffs where the basic service charge is set by what it would be on the customer's otherwise applicable tariff, and this is the only tariff where Southwest Gas is proposing such a change (Ex. S-15, at 48).

We agree with Staff that there does not appear to be any reasonable justification for why the current tariff should be changed and it is more reasonable to have a larger basic service charge for a large commercial customer under the tariff compared to a small commercial customer taking service under the tariff (*Id.*). We therefore adopt Staff's recommendation on this issue.

Gas Service for Compression on Customer's Premises (G-55)

Southwest Gas proposes increasing the basic monthly charge for customers taking service under Schedule G-55, gas service for compression on customer premises, from $8.00 to $12.00 for residential customers; from $20.00 to $25.00 for small customers; and from $170.00 to $350.00 for large customers. The Company also proposes increasing the commodity charge from $0.13305 to $0.13669 per therm for all customers served under the G-55 tariff (Ex. A-1, Sched. H-3). Although Southwest Gas offered no specific testimony explaining the level of proposed increases, the Company claims that its proposal for increasing rates under the tariff reflect the Company's cost to serve this class of customers.

Staff witness Gray filed testimony recommending lesser rate increases. Mr. Gray recommended increasing the basic monthly charge for residential customers under this tariff from $8.00 to $9.70; small customers from $20.00 to $24.00; and large customers from $170.00 to $190.00 (Ex. S-13, at 49; Ex. S-16). He also proposed increasing the commodity charge from the current $0.13305 to $0.17000 per therm (*Id.*).

Consistent with principles of gradualism and fairness, we will adopt Staff's recommendation on this issue so as not to impose such an abrupt and significant rate increase on customers taking service under this tariff. However, since the small customer service charge is tied to Schedule G-25 (*i.e.*, $25.00), the customer charge for such customers shall be set accordingly.

<u>Cogeneration Gas Service (G-60)</u>

Southwest Gas proposes that its cogeneration gas service tariff (G-60) be made available to all electric generation customers, with the exception that customers whose facilities exceed 5 megawatts ("MW") would be required to take transportation service at the Schedule G-60 rates. Company witness Congdon stated that this exclusion is necessary to eliminate "the risk to Southwest Gas' sales customers associated with the procurement of the upstream gas supply and interstate pipeline requirements for these large customers" (Ex. A-17, at 35-36).

Staff witness Gray testified that, although the Company expressed legitimate concerns regarding the possibility of significant new electric generation loads straining its system, Staff recommends that Southwest Gas should develop provisions of the G-60 tariff that would provide sufficient protections for the system and other core customers (Ex. S-13, at 50-51). Mr. Gray indicated that, in his opinion, it would be unfair to impose a provision that has the effect of potentially barring certain customers from taking service under this tariff due to the customer's size (*Id.*). Staff therefore proposes that the otherwise applicable general service and essential agricultural basic service charges should continue to be applied to G-60 customers, and that the per therm rate should be increased from $0.08934 to $0.11400 (*Id.* at 51; Ex. S-16).

We agree with Staff's recommendation regarding the Schedule G-60 tariff. We see no valid reason for restricting the Schedule G-60 tariff in the manner suggested by Southwest Gas. However, to the extent Southwest Gas believes additional protection for its system and core sales customers is necessary, the Company may separately propose in a tariff amendment filing, language that it believes would provide necessary safeguards.

Small Essential Agricultural User Gas Service (G-75)

Southwest Gas proposed increasing the basic monthly charge for customers taking service under the small essential agricultural user gas service tariff (G-75) from the current $75 per month to $150 per month, and increasing the Schedule G-75 commodity charge from $0.19468 to $0.22186 per therm (Ex. A-1, Sched. H-3). The Company also recommends freezing Schedule G-75 so no new customers could take service under the tariff and would instead be required to be served under the general service tariff, Schedule G-25. Currently, customers may choose to be served under either Schedule G-75 or the general service tariff, G-25. According to Southwest Gas, its request to reclassify customers on the G-75 tariff is consistent with Decision No. 58377 (August 12, 1993) in which, according to the Company, the Commission suggested that customers under this schedule be moved to the general service tariff "and to gradually eliminate Schedule G-75"[9] (Southwest Gas Initial Brief at 60).

Staff witness Gray testified that Staff opposes closing Schedule G-75 because elimination of the tariff would remove the option that currently exists for eligible agricultural customers to choose between general service and the G-75 tariff. Mr. Gray stated that "absent a powerful reason to take

[9] Decision No. 58377 concurred with Staff's recommendation "to retain the current SEA [small essential agriculture] rate schedule" (Decision No. 58377, at 42-43). Although the Decision directed Southwest Gas to "gradually move the SEA schedule to the general service level," the Commission specifically rejected Southwest Gas' request to close the small essential agriculture tariff to new customers because "closure may unfairly treat identical customers" (*Id.* at 43). Contrary to the Company's assertion in its Brief, the Commission did not state in Decision No. 58377 that Schedule G-75 should be eliminated.

this service option away" the G-75 tariff should be retained (Ex. S-13, at 52). In his surrebuttal testimony, Mr. Gray indicated his belief that the Company has not presented a compelling reason why eligible new customers should be precluded from exercising the same option that currently exists (Ex. S-15, at 12). With respect to the applicable charges, Mr. Gray recommended that the basic service charge should be increased from $75.00 to $90.00, and the per therm rate should be increased from $0.19468 to $0.22300 (Ex. S-13, at 52; Ex. S-16).

Consistent with principles of gradualism and fairness, we will adopt Staff's recommendation on this issue so as not to impose such an abrupt and significant rate increase on customers taking service under this tariff. We agree with the principles stated in Decision No. 58377, that charges for this agricultural tariff should continue to move *gradually* closer to cost of service and the general service rate. However, we do not believe the Company's proposal to double the basic monthly charge for such customers, and to freeze new customers from taking service under the G-75 tariff, is consistent with the goals set forth in that prior Decision or with principles of fundamental fairness.

<u>Natural Gas Engine Gas Service (G-80)</u>

As described by Company witness Congdon, customers served under the natural gas engine gas service tariff (G-80), use natural gas engines to pump water for agricultural irrigation (Ex. A-17, at 36-38). Mr. Congdon stated that the G-80 tariff serves customers in a very price sensitive market in which the customers may decide, based on the cost of gas service, to either switch to electricity to operate their pumps or simply not to irrigate and produce crops at all (*Id.*). In its application, Southwest Gas proposes to increase the basic monthly charge in the peak season (April-September) from $80 to $100, but reduce the commodity margin from the current rate of $0.16189 to $0.15848 per therm (Ex. A-1, Sched. H-3). No customer charge applies during off-peak months (*Id.*). In support of its proposal, Mr. Congdon stated that it did not assign an increase in margin to this class of customers because the Company is concerned that it may lose some of the G-80 tariff customers due solely to increases in the price of gas, which gas cost is reset for this class semi-annually, on April 1st and October 1st (Ex. A-17, at 37). Due to these competitive concerns, Southwest Gas opposes Staff's recommendation to increase the margin recovery associated with the G-80 tariff class (*Id.*).

Staff witness Gray agrees that the off-peak basic service charge should remain at zero.

However, he recommends that the on-peak customer charge should be increased from $80 to $95 per month, and the per therm rate should be increased from $0.16189 to $0.17700 (Ex. S-13, at 53; Ex. S-16). In his surrebuttal testimony, Mr. Gray stated that Staff took into account the Company's competitive concerns concerning the G-80 rate class, but "Staff does not believe the potential for customers leaving a given rate class should totally exempt that rate class from bearing some, albeit small, portion of the overall rate increase" (Ex. S-15, at 12-13). He pointed out that, under Staff's recommendation, the Schedule G-80 customers would receive the smallest revenue increase (approximately 2.77 percent under Staff's revenue requirement proposal) of any rate class under Staff's recommended rate design (*Id.*).

We agree with Staff that the relatively small margin increase assigned to the G-80 tariff class is a reasonable outcome based on the competing concerns of all customers affected by this proceeding. Although we recognize that retention of customers on Southwest Gas' system may provide benefits to all customers, we are not inclined to broker prices between competing sources of energy by limiting increases that may otherwise be applicable to a given class of customers based on cost of service principles and other factors that are weighed in determining rates for all classes of customers. We will therefore adopt Staff's recommendation on this issue.

MISCELLANEOUS ISSUES

Billing Determinants

Billing determinants are established by developing an annualized number of bills and volumes for the test period under the Company's current rate schedules (Ex. A-16, at 3). Accurate billing determinants are important because if too few determinants are used, tariff prices would be set unnecessarily high and, likewise, too many billing determinants would result in tariff prices that are too low to capture the established revenue requirement (Tr. 241-244).

Company witness Congdon testified that the proposed billing determinants were compiled by taking the monthly recorded number of bills and therms, by rate schedule, for the 12-month test year period, with the following adjustments to the recorded bills and therms: (1) billing adjustments (to remove anomalies); (2) volume annualizations (customer specific adjustments to reflect a full year's consumption for each customer, excluding the residential and small commercial classes); (3)

customer reclassifications (to move customers and volumes between tariff schedules to reflect end of test year composition); (4) weather normalization (to accurately depict monthly volumes under normal weather conditions); (5) customer annualizations (for residential and small commercial classes, captures seasonal nature of test year customer growth); and (6) reclassification of full margin transportation customers to present rate schedules (to reflect pricing at present rate schedules) (Ex. A-16, at 3-8).

Although Staff does not oppose the Company's proposed billing determinants[10], RUCO witness Moore filed testimony reflecting modifications that RUCO believes are necessary to obtain accurate determinants. Mr. Moore initially revised the billing determinants to reflect updated bill frequency analyses, and imputed revised billing determinants into the Company's proposed rate design, and, finally, annualized the imputed billing determinants using the Company's pro forma adjustments (RUCO Ex. 5, at 5).

In his Rebuttal testimony, Mr. Congdon identified several errors he believes were made in RUCO's calculation. He stated that RUCO improperly attempted to utilize the Company's actual recorded bills and failed to utilize the residential bill frequency analyses ("BFAs") which are necessary to correctly price the first and second block volumes of the existing rates. Mr. Congdon indicated that RUCO's analysis understated first block revenues by approximately 88 million therms, which resulted in those therms being priced at the lower second block rate, thereby understating residential revenues by $7.4 million (Ex. A-17, at 24-25). Mr. Congdon also claimed that RUCO improperly used ratios to distribute the Company's total proposed adjustments to bills and volumes.

In his Surrebuttal testimony, Mr. Moore stated that following review of a data request response and several telephone conversations with Southwest Gas, the Company was unable to provide a set of test year billing determinants that generate its test year recorded revenues. Mr. Moore claims that RUCO analyzed the BFAs provided by the Company and determined a set of determinants that accurately reflect the size of the test year customer base, its usage patterns, and that

[10] Mr. Congdon stated that Staff accepted the Company's proposed test year bills and volumes, but not all of the Company's proposed reclassifications of customers to new rate schedules. The Company agreed that, to the extent Southwest Gas' proposed rate schedules and customer reclassifications are not adopted, use of Staff's bills and volumes would be appropriate (Ex. A-17, at 26). To the extent we have adopted Staff's recommendations on the various rate schedule issues, as discussed above, Staff's bills and volumes will be employed accordingly.

generate the test year recorded revenue. RUCO then added pro forma adjustments to create a normalized set of test year determinants to design a rate structure that would produce RUCO's recommended revenue requirement (RUCO Ex. 6, at 4-7). RUCO argues that it corrected whatever errors existed in its initial calculation through its surrebuttal testimony and that the workpapers for those calculations were provided to the Company. RUCO claims that there is no assurance that the Company's proposal is any more accurate than RUCO's revised calculations.

The Company provided a response to a RUCO data request to clarify the alleged errors, but Mr. Congdon claimed in his Rejoinder testimony that RUCO's continued insistence on adjustments to bills and volumes reflected several computational errors including: improper calculation of the Company's average test year cost of gas; incorrect pricing of bills and volumes for the Company's former Black Mountain Gas Company customers; and improperly pricing the gas cost and basic service charge revenue applicable to Schedule G-60 and G-80 (Ex. A-18, at 9-13). Despite attempting to reconcile RUCO's adjustments through data requests and telephone conversations, Mr. Congdon believed that RUCO's proposal continued to understate residential gas cost by $6 million, and overstated residential margin by the same amount (*Id.* at 12). On cross-examination, Mr. Congdon testified that the billing determinants proposal in RUCO's Surrebuttal testimony was closer than its original calculation, but RUCO's number of bills was still approximately 22,000 higher than the Company's calculation and RUCO's volumes were overstated by approximately 5 million therms (Tr. 244).

It is fairly clear that Southwest Gas and RUCO never achieved a meeting of the minds regarding the appropriate billing determinant methodology. There is little doubt that RUCO's initial calculations were flawed and, although subsequent amendments were made to its proposal, for the reasons identified by Mr. Congdon we believe that the billing determinant recommendation presented by Southwest Gas is the most reliable proposal and should be adopted in this proceeding (subject to the Staff modifications discussed above). In future cases, the parties would be wise to initiate discovery regarding complex issues such as this at an early stage in order to avoid the necessity of amendments to their recommendations at a later stage in the process.

Purchased Gas Adjustor

All of Southwest Gas' core customers are served under a purchased gas adjustor ("PGA") mechanism[11]. The PGA mechanism uses a 12-month rolling average, whereby a new PGA rate is calculated each month. Each month the Company calculates its average cost of natural gas, on a per therm basis, for the most recent 12 months. The monthly PGA rate is then determined by subtracting the base cost of gas[12] from the 12-month average cost of gas. As explained by Staff witness Gray, the PGA rate is "banded," which means each month when the PGA rate is set it cannot be set at a rate that is more then $0.10 per therm different than the rate that was in place in any of the previous 12 months (Ex. S-13, at 8). The PGA currently has a $22.4 million bank balance "trigger," such that if the balance becomes over-collected by $22.4 million or more, the Company is required to take certain actions to address the under-collected balance (*Id.* at 18).

Staff made several recommendations regarding the PGA mechanism. Staff proposed that the base cost of gas should be set at zero and the full commodity cost of gas incorporated into the PGA. Staff also recommended that the current $22.4 million bank balance trigger should be increased to $29.2 million and an officer of Southwest Gas should be required certify each PGA report. Each of these issues is discussed below. Staff further recommended that the bank balance interest rate should be set based on the one-year nominal Treasury constant maturities rate, and that the PGA report should identify certain additional details regarding purchases and usage[13]. These issues are not in dispute and are not addressed further. The reporting details recommended by Staff are in addition to all current reporting requirements. Further, the Company's PGA monthly reports to the Commission should continue to comply with all current reporting requirements and include the beginning bank balance, any offsets, and the ending bank balance.

Setting Base Cost of Gas at Zero

The base cost of gas is currently included along with the margin within the tariffed rate per

[11] Customers under Schedules G-60 and G-80 are served under a separate cost of gas which is reset twice annually, on April 1st and October 1st (Ex. A-13, at 8).
[12] The base cost of gas includes both the commodity cost and the cost of transport from its source to the Southwest Gas distribution system.
[13] Specifically, Staff recommends that Southwest Gas' report include a breakdown of "purchases" into fixed price and variable (such as index) contracts, and that the Company begin identifying in its monthly PGA reports average and median usage levels for G-5 and G-10 rate schedules (Ex. A-13, at 25).

therm for each rate class, with the monthly PGA listed as a separate line item on customer bills. Mr. Gray explained that in a rate case the Commission traditionally addresses all costs aside from the cost of gas component, which is treated separately through the PGA function. Because the margin rate recovers all of the other costs, such as metering, billing, customer service, personnel, and facility costs, the rates established in a proceeding such as this affect only the margin rate component, consisting of the tariffed rates and the basic service charge. As a result, the margin rate change for a given customer class is always much higher than the percentage increase on customer bills, given the treatment of the cost of gas component as a constant in the rate proceeding. Mr. Gray pointed out that including both a margin component and a base cost of gas in the tariffed (commodity) rate can result in significant confusion for customers who are trying to understand their bills, especially after rate increases are granted (Ex. S-13, at 8-16).

Southwest Gas' current base cost of gas is $0.37034 per therm, as established in the Company's last rate case (Decision No. 64172). In its application, Southwest Gas proposed increasing the base cost of gas to $0.53436 per therm, which Staff found to be reasonable. However, Staff witness Gray recommended, as an alternative, that the base cost of gas be set at zero as a means of minimizing customer confusion. Under Mr. Gray's recommendation, setting the base cost of gas at zero would effectively eliminate the base cost of gas component so that the PGA rate would include the previously separate base cost of gas amount. Thus, a single line item on customer bills would include the full commodity cost (absent a temporary surcharge or credit), allowing customers to easily see the changing cost of gas component separate from the margin component (Ex. S-13, at 13).

In order to alleviate short-term customer confusion from such a change, Staff further recommends that Southwest Gas should create specific customer education materials to explain the change (including, *e.g.*, a side-by-side bill comparison under the old and new rate structures) (*Id.* at 14-15). Mr. Gray also points out that setting the base cost of gas at zero would cause the monthly PGA rate component to significantly increase, and well beyond what a typical application of the $0.10 therm band would enable the monthly PGA rate to reflect. To remedy this problem, Staff recommends that, when applying the $0.10 per therm band for the first 12 months after this Decision, Southwest Gas should compare the new monthly PGA rate to the sum of the base cost of gas and the monthly PGA in prior months. Taking this approach would, according to Mr. Gray, provide a consistent benchmark for applying the $0.10 per therm band while transitioning to a base cost of gas of zero (*Id.* at 15-16).

Southwest Gas indicated that it does not oppose Staff's recommendation to set the base cost of gas to zero (*Id.* at 14; Tr. 270). Mr. Congdon also testified at the hearing that the Company does not oppose Staff's recommendation to create specific customer education materials, "like a bill stuffer" that would go out in customer bills to explain the change (Tr. 270).

We believe Staff's recommendation to set the base cost of gas at zero is appropriate and, once fully implemented, should enhance customer understanding of their bills. This proposal will allow customers to more easily track the separate components that go into the provision of gas service, especially the gas component during periods of volatility. We appreciate Staff's effort in devising this recommendation, as well as the Company's agreement with a proposal that should minimize customer confusion, while at the same time allowing the Company to recover its costs. As a final matter on this issue, we direct the Company to submit to Staff for its review a copy of all customer education materials related to this issue prior to the materials being distributed to customers.

<u>PGA Mechanism Trigger Level</u>

Southwest Gas' current PGA mechanism was implemented in June 1999, at a time when natural gas prices had remained relatively stable for a number of years. Staff witness Gray testified that, although no PGA structure can change or mitigate the fact that natural gas prices have increased dramatically in recent years, Staff believes the current PGA mechanism reasonably balances the protection of customers from wildly fluctuating gas prices with the goal of sending, to a certain extent, price signals to customers regarding gas prices (Ex. S-13, at 17). Therefore, Staff recommends that the existing PGA mechanism should be retained, subject to the limited modifications discussed below.

Mr. Gray explained that when the rolling average PGA mechanism was established by Decision No. 61225 (October 30, 1998), the $22.4 million trigger level was set on the basis of consumption levels for Southwest Gas in 1996 and 1997 (approximately 447 million therms annually). For 2003 and 2004, the Company had an average annual consumption of 516 million therms (*Id.* at 18). Mr. Gray stated that although there is not necessarily one right trigger level, given the increasing annual cost of gas (among other relevant considerations regarding the impact on customers and the Company), Staff believes the trigger level for the PGA bank balance should be increased from $22.4 million to $29.2 million. According to Staff, the proposed trigger level increase should provide a level of flexibility to absorb higher usage and higher natural gas costs in the PGA bank balance, while also providing a measure of protection for customers and the Company if a positive or negative balance were to be carried within the balance for a period of time (*Id.* at 19-21).

Company witness Gieseking testified that while Southwest Gas is not necessarily opposed to an increase in the PGA bank balance trigger level, to the extent such an increase were to be adopted the Company believes the current $0.10 per therm PGA adjustment rate band should also be increased to $0.20 per therm[14] (Ex. A-21, at 10-11). Company witness Congdon stated that an increase in the bank balance trigger level would potentially increase the amount of money carried in the balancing account, thereby increasing the Company's business risk in the eyes of the financial community (Ex. A-17, at 40). Southwest argues that an increase in the adjustment cap would save customers in the long-term by minimizing deferrals to the balancing account, thereby reducing carrying costs on the PGA balance, and resulting in less cost to customers in a future period (*Id.*). Southwest Gas also contends that leaving the current $0.10 band in place would hinder the adjustment of gas rates that are used to reflect the 12-month average cost and would distort the true marginal cost of natural gas, thus failing to send appropriate price signals to customers (Ex. A-21, at 10-11).

We agree with Staff that the PGA bank balance trigger level should be increased to $29.2 million for the reasons set forth in Staff witness Gray's testimony. As stated above, the Company is not opposed to the trigger level increase as long as the change is accompanied by a corresponding increase in the $0.10 per therm adjustment band. We believe that an increase in the trigger amount is a reasonable adjustment based on various factors, including the significant increase in gas

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[14] Southwest Gas initially proposed a corresponding increase in the adjustment band of only three cents, from $0.10 to $0.13 (Ex. A-17, at 40).

consumption levels since the trigger was originally established.

Given the current volatility in the price of gas we believe a slight adjustment of the current adjustment band is appropriate. According to Mr. Gray, the purpose of the band is to limit the amount by which the monthly PGA rate could adjust automatically within a 12 month period, without further action by the Commission (Ex. A-15, at 5-6). Staff does not oppose an increase of the band in principle, but does not believe there is a need to link what it considers a moderate trigger level increase with an expansion of the adjustment band, as proposed by the Company (*Id.*). Although the trigger level and the adjustment band are not inextricably intertwined, limiting the band to its current level could result in greater long-term costs for the Company's customers. Mr. Gieseking testified that the Company's rolling 12-month average cost was expected to exceed the $0.10 upper band by January 2006, an indication that an increase in the band is warranted at this time. As Mr. Gray stated in his Rebuttal testimony, the band was expanded once before by the Commission, from $0.07 per therm to $0.10 per therm, and "Staff is not conceptually opposed to a possible expansion of the band" (Ex. A-15, at 5). However, we believe the Company's proposed increase to $0.20 is excessive. We find that an increase to $0.13 per therm reflects a more reasonable balance between the interests of the Company and its customers.

<u>Officer Certification of Monthly PGA Reports</u>

Staff recommends that an officer of Southwest Gas be required to certify, under oath, through an affidavit attached to each adjustor report, that all information provided in the adjustor report is true and accurate to the best of his or her information and belief. Mr. Gray stated that this recommendation is consistent with action taken by the Commission in other gas and electric cases dealing with adjustor mechanisms (Ex. A-13, at 24-25). Staff does not believe there is any basis for Southwest Gas to be treated differently than the other companies that are required to provide such certification (Ex. A-15, at 5).

Southwest Gas opposes Staff's recommendation to require officer certification of the monthly PGA reports. Company witness Moody testified that although Southwest Gas is committed to providing the Commission with accurate information, the Company does not believe the certification requirement is necessary. Southwest Gas believes the person most knowledgeable regarding the report should sign it, as opposed to an officer (Ex. A-22, at 7; Tr. 454-455).

We do not believe it is an undue burden for an officer of Southwest Gas to be required to familiarize herself or himself with the workings of the PGA mechanism and the monthly reports that are filed to support the required information. While Southwest Gas argues that Staff failed to provide a valid reason for why this requirement is necessary, the underlying basis of the Company's opposition rings hollow. The officer certification requirement would not only put Southwest Gas in a position that is comparable to other companies for which the issue has been addressed, but will provide a measure of assurance to the Commission, as well as the Company's customers and shareholders, that a level of oversight exists that reaches to the Company's highest ranks. Although we are not suggesting that Southwest Gas' prior PGA reports have been deficient, given the financial accounting scandals that have been exposed in the recent past, certification of a report that deals with millions of dollars of gas costs on a monthly basis seems a small price to pay for a higher level of oversight. Indeed, it is surprising that AUIA has not taken a position in support of Staff's recommendation given the inherent interest of shareholders in transparency and accountability for a publicly filed report regarding the Company's purchased gas costs. We will therefore adopt Staff's recommendation.

<u>Gas Procurement Practices</u>

Staff witness Gray and William Gehlen conducted a detailed review of Southwest Gas' procurement practices during the test year, and offered several recommendations with respect to those practices. Mr. Gray identified price stability as one of the Commission's goals of the gas procurement process for Arizona LDCs, including Southwest Gas (*See*, Decision No. 61225).

Staff witness William Gehlen testified regarding the Company's procurement practices and indicated that having a mix of spot market gas and long-term fixed price contracts enhances price stability (Ex. S-8). Staff recommended that Southwest Gas further explore procurement opportunities in order to enhance greater price stability for customers. According to Staff, the Company has agreed to a number of recommendations, including: conducting a fuel and procurement practice best practices review; separating the contract award group from the invoice approval authority within the Company; reviewing the Company's portfolio evaluation software; eliminating the use of cell phones in term bidding and negotiating activities; and having a neutral party observe these activities (Tr. 433-434).

It is also Staff's position that employees involved in gas procurement should not have "substantial" stock ownership in companies with which it is dealing (Tr. 1108). Company witness Moody agreed that Southwest Gas would review its definition of stock ownership rules for employees involved in gas procurement and meet with Staff within 60 days of the Decision in this case (Tr. 434).

Mr. Moody also agreed Southwest Gas shares Staff's concerns regarding El Paso, shortfall of service, and other lateral issues. It is Staff's recommendation that Southwest Gas should construct and own its laterals absent a compelling reason to do otherwise. However, Mr. Moody indicated that the best course of action is to take a look at a cost-effective and reasonable means for the Company to either own its system or own access to supplies that come onto its system. He explained that the Company has a long history of trying to purchase laterals from El Paso, but to do so would often require also purchasing undesirable lateral facilities (Tr. 455-456).

Although there does not appear to be any dispute between the Company and Staff regarding these gas procurement issues, we direct the Company to initiate discussions with Staff, within 60 days of this Decision, regarding the stock ownership issues discussed above, and to continue to cooperate with Staff regarding other procurement issues, including issues pertaining to El Paso and construction and ownership of laterals on the Company's system. Staff shall file within 180 days of the effective date of this Decision, as a compliance item in this docket, a report or reports regarding the stock ownership issues, procurement practices, benchmarking, and El Paso laterals issues discussed above.

Interest on Customer Deposits

In its Application, Southwest Gas proposed a reduction of the interest rate applied to customer deposits from 6 percent to 3 percent (Ex. A-29, at 31-32). As noted above, Staff proposed that the interest rate on PGA balances be set based on a monthly one-year nominal Treasury constant maturity rate (Ex. S-13, at 22). Staff also recommends that the same interest rate be applied to the Company's other balancing accounts (*i.e.*, DSM and LIRA) (*Id.* at 54). Company witness Congdon testified on rebuttal that an equitable approach to the customer deposit interest rate issue would be to synchronize the interest rates on both customer deposits and the balancing accounts maintained by Southwest Gas

(Ex. A-17, at 39).

Staff witness Gray testified that Staff recommends maintaining the customer deposit interest rate at 6 percent consistent with the rate in effect for a wide variety of other utilities. Mr. Gray stated that although interest rates are currently relatively low, a significant rise in rates would not be equitable to customers if the customer deposit interest rate were reduced to 3 percent as requested by the Company (Ex. S-13, at 57).

We agree with Staff that the customer deposit interest rate should be maintained at the current level of 6 percent. We believe that subjecting such deposits to a constantly varying interest rate could lead to customer confusion and would be inconsistent with the practices in effect for other utilities in the State. We therefore adopt Staff's recommendation on this issue. We also agree with Staff that maintaining the 12-month customer deposit period is appropriate.

Four-Hour Service Window

In his Direct testimony, Staff witness Gray indicated that the Commission's Consumer Services Division has received a number of customer contacts expressing concern that Southwest Gas asks customers to be available at the service location for most or all of a day when a technician is scheduled for service. Mr. Gray stated that the Company's policy imposed a burden on customers and is inconsistent with the practices of other gas and electric utilities, which provide a four-hour window for service calls. Mr. Gray pointed out that the service window length is not established by Commission rule, but is set according to each company's practice. Mr. Gray recommended that Southwest Gas be required to establish a company practice of giving customers a four-hour window, in accordance with the policies in effect for other similar utility companies (Ex. A-13, at 54-55). Mr. Gray stated that there is no compelling reason why Southwest Gas cannot adopt the four-hour standard and he recommends that the Commission order the Company to adopt such a standard within 6 months from the date of this Decision (Ex. A-15, at 14).

Company witness Palacios responded that a directive from the Commission is not necessary because Southwest Gas currently offers several service options including two-hour, four-hour, and eight-hour service windows "based on the customer's request" (Ex. A-6, at 5). She indicated that only 10 to 15 percent of customers requesting service establishment (which requires entry into the premises) request service appointments of four hours or less. Ms. Palacios claims that if Staff's recommendation were adopted, Southwest Gas would likely have to increase its workforce to provide every customer, regardless of need, a four-hour service window (*Id.* at 4-5). She stated that such a mandate would also likely require significant restructuring of existing work practices and replacement of or major modification to the Company's customer appointment software. Ms. Palacios noted that gas utilities differ from electric companies because, for safety reasons, an employee must always enter the premises when service is established, and because service technicians must give their highest priority to emergencies which may interfere with their ability to meet four-hour window requirements (*Id.* at 6-7).

We do not believe that the four hour service window requirement recommended by Staff would place an onerous burden on the Company's customer service capabilities. Mr. Gray testified that the Commission's Consumer Services Division has received comments regarding the lack of such a window being offered, and Staff's proposal to allow Southwest Gas 6 months to develop a program to meet this requirement is a reasonable length of time for compliance. Although the Company's witness attempted to distinguish electric from gas service providers to support the Company's position, she failed to recognize that UNS Gas, Inc. ("UNS") has a tariff in effect that requires appointments to be scheduled "within a maximum range of four (4) hours during normal working hours" unless another time frame is established that is mutually agreeable to both UNS and the customer (Ex. S-27). Consistent with the tariff in effect for UNS, we agree with Staff that Southwest Gas should adopt a tariff which requires customers to be offered a maximum four-hour service window. Staff's recommendation is therefore adopted.

<u>Energy Share Contributions</u>

Southwest Gas currently participates in the Energy Share program, which allows customers the opportunity to make voluntary contributions to help other customers with financial difficulties pay their utility bills. Other companies, such as APS and Salt River Project, also participate in the program, which is administered by the Salvation Army.

Staff witness Gray stated that Southwest Gas currently provides customers with a separate bill insert that can be returned with donations for Energy Share. In comparison, APS provides a box on its actual bills that can be checked and an amount indicated for donation. Staff recommends that, at the time the new rates from this proceeding are reflected on customer bills, Southwest Gas should provide a place on its customer bills to allow donations to the Energy Share program (Ex. S-13, at 55-56).

In response, Company witness Congdon testified that Southwest Gas strongly supports retention of allowing customer contributions via bill inserts. He stated that the current practice should be maintained "unless Staff presents clear and convincing evidence that a change in the program notification process would result in a greater benefit than its cost" (Ex. A-17, at 38).

We believe Staff's recommendation should be adopted. We appreciate Southwest Gas' participation in the Energy Share program. However, we agree with Staff that inclusion of a line on customer bills is preferable to a bill insert, which may be discarded when customers open their bills. We do not believe that a cost/benefit analysis is necessary to recognize that contributions are likely to be enhanced if, at the time customers sit down to write out their monthly checks, the opportunity to donate is clearly shown on the billing statements alongside the amount due. We believe Staff's recommendation represents a common sense approach to encouraging contributions to the program. The Company should implement this change within 60 days of the effective date of this Decision.

<u>Gas Technology Institute</u>

The Gas Technology Institute ("GTI"), which was formerly known as the Gas Research Institute, is a non-profit entity that does research, development and training regarding energy markets. GTI's Operations Technology Development ("OTD") programs focus on projects pertaining to pipe and leak locating and detection, reduced construction costs, gas main integrity and safety, while its Utilization Technology Development ("UTD") program focuses on developing increased-efficiency and safety end-use equipment for residential, commercial, and industrial gas customers. Although GTI was previously funded through a FERC surcharge, it now must solicit donations via state public utilities commissions and the LDCs they regulate (Ex. S-13, at 2-8).

Staff recommends that Southwest Gas participate in funding GTI's OTD and UTD programs at a level of $688,712 annually, which amount would be recovered on a per therm basis from the Company's sales customers, excluding G-30 and B-1 customers. Mr. Gray stated that the per therm surcharge would amount to approximately $0.00113, which would increase an average residential customer's bill by approximately three cents per month (*Id.*).

Southwest Gas witness Marti Marek testified that the Company supports funding gas research but opposes Staff's mandatory contribution of all research funding to a single entity. She indicated that, although the Company is pleased with the projects it has participated in with GTI, there are other competing research organizations that perform equally valuable work (Ex. A-24, at 2-6).

We agree with Southwest Gas that the funding provided for research should not be allocated to a single entity. The Company should have flexibility to tailor the research funds to the projects and organizations best suited for a specific need, subject to oversight by the Commission (*Id.* at 7). We will therefore adopt the recommended level of research funding, which would be collected through a surcharge, and held and disbursed through a balancing account. Adoption of Southwest Gas' proposal will allow the Company flexibility to select specific projects on a case-by-case basis, but will permit Staff to have input and oversight regarding the program expenditures.

Demand Side Management/Energy Efficiency Programs

Southwest Gas proposed increasing its current level of demand side management ("DSM") funding of $600,000 per year to $4,385,000 annually[15], subject to the Commission's approval of a decoupling mechanism. The DSM programs would be directed at all classes of customers instead of just residential customers as currently exists. The specific programs, and the associated funding proposed by Southwest Gas are as follows: Low-Income Energy Conservation ("LIEC") ($500,000); Energy Star Home Certification ($250,000); Multi-Family New Construction ($1,200,000); Residential Energy Construction ($200,000); Energy Star Appliances ($800,000); Food Service Equipment ($500,000); Efficient Commercial Building Design ($500,000); Technology Information Center ($35,000); and Distributed Generation ($400,000).

Staff, RUCO, and SWEEP/NRDC all support the DSM programs proposed by the Company, with a few minor exceptions. SWEEP/NRDC witness Schlegel recommended that an additional $750,000 should be added to the Energy Star Home Certification program, and that Southwest should

[15] The DSM funds are collected through a DSM surcharge and held and disbursed through a balancing account.

be allowed to impose a performance incentive mechanism to recover up to 10 percent of DSM funding if minimum goals are met (SWEEP Ex. 1, at 6). Company witness Vivian Scott testified in support of SWEEP/NRDC's proposals because she believes increasing funding for the Energy Star Home Certification program would enable the Company to expand the program to larger parts of its service territory (currently offered only in the Tucson area) (Ex. A-15, at 3). She also supports the performance incentive mechanism proposal which is comparable to a program in effect for APS (*Id.*).

Staff witness Steve Irvine supports the Company's initial proposed DSM funding level, with the exception of $50,000 included in the LIEC program that is specifically allocated for rate assistance to low-income customers. Mr. Irvine stated that such rate assistance is not DSM-related and should therefore be considered as a separate and distinct program (Ex. S-19, at 3). He acknowledged that a similar program was included in a recent APS case, but points out that the rate assistance component of that case was part of a settlement agreement involving a number of diverse parties. Mr. Irvine also opposes the SWEEP/NRDC proposal to increase the Energy Star Home Certification program by $750,000 on the basis that Southwest Gas previously indicated that "the market has sufficiently transformed and that incentives are no longer necessary to ensure more energy-efficient construction" (*Id.* at 6) (*See also*, Decision No. 67878, June 1, 2005, granting Southwest Gas' request to reduce the annual Energy Advantage Plus program funding from $900,000 to $250,000). In addition to these adjustments to proposed DSM revenues, Staff recommends the following with respect to the Company's DSM programs: semi-annual DSM reports certified by an officer of the Company; requirement that Company docket within 120 days of this Decision, in a separate docket, detailed descriptions of the DSM programs that would be subject to Commission approval; requirement that the Company implement and maintain the collaborative DSM working group to solicit and facilitate input from any interested party (prior to submission to Commission of specific programs); responsibility of Southwest Gas to demonstrate appropriateness of specific DSM programs; and no performance incentive mechanism should be approved (*Id.* at 9-10).

With one exception, we agree with Staff's recommendations regarding DSM. Despite Staff's concerns, we believe the $50,000 currently included in the LIEC program for rate assistance funding should be maintained. Although such funding may not in a strict sense be considered DSM-related, we agree with Mr. Schlegel that it represents a relatively small percentage of the overall DSM budget and is to be used for emergency situations for low-income customers. To the extent any portion of this $50,000 is not spent yearly on bill assistance emergencies, the balance should be allocated to general LIEC programs. With respect to SWEEP/NRDC's proposal to increase by $750,000 funding for Energy Star Home Certification, we share Staff's concern that the Company has previously offered conflicting views of whether such an increase in such funding would be cost effective. As Mr. Irvine pointed out, through data request responses the Company indicated that it could offer the program throughout its service area at the initial funding level and specifically requested a reduction in funding for a similar program in the Tucson area due to market transformation (Ex. S-19, at 6-7). We also agree with Staff that the performance incentive mechanism, which was suggested for the first time in Mr. Schlegel's testimony, is not sufficiently developed for approval at this time. The parties to the DSM collaborative process may wish to pursue this issue through further discussions but the proposal contained in the record of this proceeding lacks sufficient detail to determine whether it is appropriate at this time. In all other respects, we agree with and adopt Staff's recommendations as described above.

* * * * * * * * * *

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

FINDINGS OF FACT

1. On December 9, 2004, Southwest Gas filed an application with the Commission for an increase in rates.

2. On January 7, 2005, the Commission's Utilities Division Staff filed a Letter of Insufficiency.

3. On January 26, 2005, Staff filed a Letter of Sufficiency, notifying the Company that its application met the sufficiency requirements and classifying Southwest Gas as a Class A utility.

4. By Procedural Order issued February 7, 2005, procedural timeframes were established and a hearing was scheduled to commence on October 3, 2005.

5. Intervention was granted to RUCO, AUIA, DOD, SWEEP/NRDC, YCA, ACAA,

APS, and TEP.

6. Southwest Gas filed Direct testimony with its application on December 9, 2004. Pursuant to Procedural Order issued March 10, 2005, Direct testimony was filed on July 26, 2005 by Staff, RUCO, YCA, AUIA, ACAA, and SWEEP/NCRA.

7. Rebuttal testimony was filed by Southwest Gas on August 23, 2005. Surrebuttal testimony was filed on September 13, 2005 by Staff, RUCO, AUIA, SWEEP/NRDC, and DOD. Rejoinder testimony was filed by the Company on September 23, 2005.

8. An evidentiary hearing was conducted at the Commission's offices in Phoenix, Arizona commencing on October 3, 2005 and concluding on October 11, 2005.

9. Late-filed exhibits were filed by Southwest Gas on October 21, 2005 and November 4, 2005.

10. Initial Post-Hearing Briefs were filed by DOD on October 31, 2005, by RUCO on November 3, 2005, and on November 4, 2005 by Southwest Gas, SWEEP/NRDC, AUIA, and Staff.

11. Reply Briefs were filed on November 14, 2005 by Southwest Gas, RUCO, SWEEP/NRDC, AUIA, and Staff. Southwest Gas filed a Supplement to its Reply Brief on November 23, 2005.

12. According to the Company's application, as modified, in the test year Southwest Gas had adjusted operating income of $46,775,622 on an adjusted Original Cost Rate Base of $943,110,070, for a 4.96 percent rate of return.

13. In its application, as modified, the Company requested a revenue increase of $66,898,342, based on OCRB of $943,110,070, and rate of return of 9.24 percent.

14. Staff recommends a rate increase of $51,625,135, based on OCRB of $924,927,566, and a recommended rate of return of 8.40 percent.

15. RUCO recommends a revenue increase of $48,506,079, based on OCRB of $919,607,846, and recommended rate of return of 8.64.

16. For purposes of this proceeding, we determine that Southwest Gas has an Arizona Fair Value Rate Base of $1,169,584,038.

17. A rate of return on FVRB of 6.63 percent is reasonable and appropriate.

18. Southwest Gas is entitled to a gross revenue increase of $49,345,636.

19. The Company's proposed Conservation Margin Tracker decoupling mechanism proposal is not adopted in this proceeding.

20. The class responsibility for the revenue requirement should be allocated using the methodology of Staff's rate design expert witness.

21. For residential customers under Schedule G-5, the basic monthly customer charge should be increased from $8.00 to $9.70, and a two-tier declining block structure remains appropriate in accordance with Staff's recommendation.

22. A separate multi-family residential basic monthly customer charge of $8.70 is appropriate under the new Schedule G-6 rate.

23. The low-income residential rate (G-10) should be maintained at its current $7.00 per month with the current commodity discount of 20 percent for the first 150 therms of winter usage.

24. Staff's rate design recommendations for Special Residential Gas Service for Air Conditioning (G-15) and Master Metered Mobile Home Park Gas Service (G-20) should be adopted.

25. The current Armed Forces Rate Schedule G-35 should be eliminated and customers currently on that schedule would receive service under Schedule G-25.

26. For General Gas Service customers on Schedule G-25, a new sub-class should be created for small customers using less than 600 therms annually, and the demand charge for large G-25 customers should be calculated based on DOD's recommendation of using a modified non-coincident peak during any winter month.

27. For Air Conditioning Gas Service (G-40); Gas Service for Compression on Customer's Premises (G-55); Cogeneration Gas Service (G-60); Small Essential Agricultural User Gas Service (G-75); and Natural Gas Engine Gas Service (G-80), Staff's recommended rate design should be adopted.

28. The billing determinants proposed by the Company should be employed for setting rates in this proceeding.

29. With respect to the Company's Purchased Gas Adjustor mechanism, the base cost of gas should be set at zero in accordance with Staff's recommendation; the trigger level for the PGA

bank balance should be increased from $22.4 million to $29.2 million as recommended by Staff; and the current $0.10 per therm adjustment band should be increased to $0.13 per therm.

30. The interest rate for the Company's PGA, DSM, and LIRA balancing accounts should be based on the one-year nominal Treasury constant maturities rate, in accordance with Staff's recommendation.

31. The Company's PGA monthly reports to the Commission should continue to comply with all current reporting requirements and include the beginning bank balance, any offsets, and the ending bank balance.

32. Staff's recommendation to require an officer of Southwest Gas to provide certification of the accuracy of the monthly PGA reports is reasonable and should be adopted.

33. Southwest Gas should initiate discussion with Staff within 60 days regarding gas procurement issues identified by Staff, including issues pertaining to El Paso and construction and ownership of laterals on the Company's system.

34. The current interest rate of 6 percent on customer deposits should be maintained in accordance with Staff's recommendation. The 12-month customer deposit period should also be maintained.

35. Southwest Gas should develop within 6 months a tariff proposal that would require that customers be offered a four-hour window for service calls.

36. Southwest Gas should implement, within 60 days of the effective date of this Decision, Staff's recommendation to allow donations to the Energy Share program by an indication on the Company's billing statements.

37. Gas research should be funded at the level recommended by Staff, but Southwest Gas should have the flexibility, subject to Staff oversight, to select appropriate entities for use of the research funds.

38. DSM programs should be funded at the level initially recommended by Southwest Gas ($4,385,000) and the Company should comply with the recommendations made by Staff regarding, among other things, compliance filings and working with the DSM collaborative group.

39. Arizona customer bills should contain information relevant to Arizona customers.

Information specific only to Nevada and/or California customers should be removed from the back of Arizona customer bills. Furthermore, the back of Arizona customer bills should contain explanations for two billing line items "Base Tariff Rate" and "Rate Adjustment."

40. We also agree with Staff that anytime Southwest Gas initiates participation in a new natural gas docket at the FERC which relates to its service in Arizona, the Company should be required to provide Staff with a copy of Southwest Gas' initial filing in that FERC docket.

CONCLUSIONS OF LAW

1. Southwest Gas is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§40-250, 40-251 and 40-367.

2. The Commission has jurisdiction over Southwest Gas and the subject matter contained in the Company's rate application.

3. The rates, charges and conditions of service established herein are just and reasonable and in the public interest.

ORDER

IT IS THEREFORE ORDERED that Southwest Gas Corporation is hereby authorized and directed to file with the Commission, on or before February 28, 2006, revised schedules of rates and charges consistent with the discussion herein and a proof of revenues showing that, based on the adjusted test year level of sales, the revised rates will produce no more than the authorized increase in gross revenues.

IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective for all service rendered on and after March 1, 2006.

IT IS FURTHER ORDERED that Southwest Gas Corporation shall notify its customers of the revised schedules or rates and charges authorized herein by means of an insert in its next regularly scheduled billing, in a form acceptable to Staff.

IT IS FURTHER ORDERED that, in its next rate case, Southwest Gas Corporation shall provide a detailed explanation of employee duties that are associated with sales, marketing, or promotional activities and offer a reasonable allocation of wage expense consistent with those duties.

IT IS FURTHER ORDERED that, in its next rate case, Southwest Gas Corporation shall provide a clearer picture of AGA functions and how the AGA's activities provide specific benefits to the Company and its customers.

IT IS FURTHER ORDERED that Southwest Gas Corporation should coordinate its efforts to pursue implementation of a decoupling mechanism through discussions with Staff, RUCO, SWEEP/NRDC, and any other interested parties. Such efforts may be pursued through the DSM policy process, as suggested by SWEEP/NRDC, and through a proposal in the Company's next rate case.

IT IS FURTHER ORDERED that Southwest Gas Corporation shall submit to Staff for its review a copy of all customer education materials related to setting the base cost of gas at zero prior to the materials being distributed to customers.

IT IS FURTHER ORDERED that the Company's PGA monthly reports to the Commission shall continue to comply with all current reporting requirements and include the beginning bank balance, any offsets, and the ending bank balance.

IT IS FURTHER ORDERED that, for all future PGA monthly reports, an officer of Southwest Gas shall be required to certify, under oath, through an affidavit attached to each adjustor report, that all information provided in the adjustor report is true and accurate to the best of his or her information and belief.

IT IS FURTHER ORDERED that Southwest Gas Corporation shall initiate discussions with Staff, within 60 days of this Decision, regarding the stock ownership issues discussed herein, and to continue to cooperate with Staff regarding other procurement issues, including issues pertaining to El Paso and construction and ownership of laterals on the Company's system.

IT IS FURTHER ORDERED that Staff shall file within 180 days of the effective date of this Decision, as a compliance item in this docket, a report or reports regarding the stock ownership issues, procurement practices, benchmarking, and El Paso laterals issues discussed above.

IT IS FURTHER ORDERED that Southwest Gas Corporation shall, within 6 months of the effective date of this Decision, propose a tariff which requires customers to be offered a maximum four-hour service window.

IT IS FURTHER ORDERED that Southwest Gas Corporation shall implement, within 60 days of the effective date of this Decision and in a form acceptable to Staff, Staff's recommendation to allow donations to the Energy Share program by an indication on the Company's billing statements.

IT IS FURTHER ORDERED that Southwest Gas Corporation shall comply with the recommendations made by Staff regarding, among other things, DSM compliance filings and working with the DSM collaborative group.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

Jeffrey M. Hatch-Miller
~~CHAIRMAN~~

COMMISSIONER

COMMISSIONER

COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 23rd day of Feb., 2006.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT ____________________

DISSENT ____________________

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