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Janet Napolitano
Governor

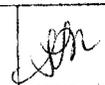
Stephen Ahearn
Director

July 26, 2007

Arizona Corporation Commission
DOCKETED

JUL 26 2007

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

DOCKETED BY 

RE: RUCO's Report on Rate Design Alternatives to Encourage Conservation (Docket No. G-01551A-04-0876, Decision No. 68487)

Pursuant to Decision No. 68487, RUCO, ACC Staff, SWEEP and Southwest Gas met to "... seek rate design alternatives that will truly encourage conservation efforts, while at the same time providing benefits to all affected stakeholders." (Decision, p. 34)

The first several meetings centered around Southwest Gas' presentations on decoupling mechanisms in general and with specific regard to SWG's perceived need for a decoupling mechanism. This included the following SWG arguments:

- 1) A history of declining usage;
- 2) Conservation and efficiency's role in declining usage;
- 3) Inability for SWG to earn its authorized rate of return;
- 4) Desirability of removing any disincentives for SWG to aggressively promote conservation.

Beginning with the third meeting, RUCO expressed its concern that SWG appeared to have reached a solution to a purported "problem", although the purported "problem" and its cause had not been conclusively identified. RUCO stated that it needed certain facts and data so the parties could establish what the problem really was and then seek a solution, rather than the other way around, and supplied the Company with a number of questions to answer.

Data responsive to RUCO's questions yielded a chart that demonstrated how much margin SWG had lost due to conservation and how much was lost due to weather over a three-year period. This chart showed that over the three-year period SWG had under-recovered by \$22.5 million. Of this amount, \$4.5 million, or approximately 20%, was due to conservation, and \$18.1 million, or 80%, was attributable to weather (see Schedules on Attachment 1). The data was conclusive: the real cause for SWG's under-recoveries was not conservation, but weather. None of the actual participants in the meetings disagreed as to the meaning of the data.

The real problem having been identified, subsequent discussions shifted away from decoupling and began to focus on subjects actually germane to SWG's under-recovery problem. These discussions included the following topics:

- 1) The merits of the current 10-year weather normalization for SWG vs. a weather decoupling mechanism;
- 2) Debate on stockholders vs. ratepayers' responsibility to bear the weather risk;
- 3) The appropriate price signals that a conservation rate design should send;
- 4) Potential adjustments to Return on Equity in light of any mechanism that would shift shareholder risk to ratepayers.

No consensus was ultimately reached between the parties on these more relevant topics. However, the meetings proved useful in that the parties were able to identify weather as the true cause of SWG's inability to recover at approved levels, and that conservation efforts are of relatively little significance to the under-recovery phenomenon. In that respect, the Commission's decision to ask the parties to confer on rate design alternatives was fruitful in narrowing the necessary scope of future consideration of possible remedies to the Company's earnings problems.

RUCO is disappointed in the selective nature of the Company's "report" on this matter, and had supplied the Company with language that could have been used to more accurately reflect what actually transpired in the meetings, inclusion of which could possibly have earned our co-sponsorship of the report. That the Company did not accept our language and filed the report in the manner it did—replete with apologia for the very mechanism revealed through the meeting process to be inappropriate to the peculiar circumstances of this Company—has necessitated this more balanced and accurate retelling of the meeting process and its results.

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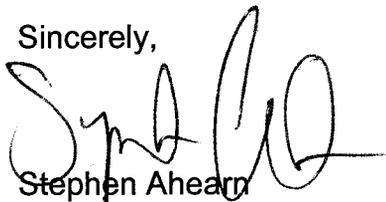
In addition, the Southwest Gas report may have earned greater credibility in RUCO's estimation had it been written by someone from the Company who had actually attended the meetings.

Attached please find materials as counterpoint to the self-serving AGA attachment to the Company's "report," as follows:

- NASUCA's June 2007 Resolution opposing the sort of decoupling mechanism proposed by Southwest Gas in its most recent rate case (Attachment 2), and
- A slide presentation given by LSU's Center for Energy Studies to NASUCA members in June 2007 that covers the topic of incentives and energy efficiency more expansively than does AGA (Attachment 3).

It is my understanding that NASUCA President John Perkins presented this same information at NARUC's Summer Meeting last week.

Sincerely,



Stephen Ahearn
Director

SA:hs

attachments

cc: All Parties of Record

ATTACHMENT 1

**SOUTHWEST GAS CORPORATION
ARIZONA STAKEHOLDER DECOUPLING WORK GROUP
RESPONSES TO RUCO'S QUESTIONS AT 3RD MEETING**

Response 4 (Continued).

Data reflected in Responses 1 and 4 allow us to determine the impact on the recovery of Southwest's fixed cost of providing service of changes in actual use per customer (captures both weather and conservation), weather adjusted use per customer (captures conservation) and actual less conservation (captures weather) from amounts authorized in the last rate case. The calculations are reflected below for 2004, 2005 and 2006.

Description (a)	Change From Revenue at Authorized Margin per Customer		
	Total (d)	Conservation- Related (f)	Weather- Related (h)
2004			
Change in Average Use per Customer	11.7	(4.3)	16.0
Average Commodity Margin	\$ 0.52579	\$ 0.52579	\$ 0.52579
Change in Margin per Customer	\$ 6.15	\$ (2.26)	\$ 8.41
Average Number of Customers	785,673	785,673	785,673
Change in Annual Margin	\$ 4,833,258	\$ (1,776,326)	\$ 6,609,584
Change in Fixed Component of Margin	\$ 4,587,102	\$ (1,685,858)	\$ 6,272,961
Change in Variable Component of Margin	\$ 246,156	\$ (90,468)	\$ 336,623
2005			
Change in Average Use per Customer	(26.3)	(1.8)	(24.5)
Average Commodity Margin	\$ 0.52579	\$ 0.52579	\$ 0.52579
Change in Margin per Customer	\$ (13.83)	\$ (0.95)	\$ (12.88)
Average Number of Customers	825,650	825,650	825,650
Change in Annual Margin	\$ (11,417,317)	\$ (781,413)	\$ (10,635,904)
Change in Fixed Component of Margin	\$ (10,835,838)	\$ (741,616)	\$ (10,094,221)
Change in Variable Component of Margin	\$ (581,479)	\$ (39,797)	\$ (541,682)
2006			
Change in Average Use per Customer	(37.8)	(4.7)	(33.1)
Average Commodity Margin	\$ 0.52579	\$ 0.52579	\$ 0.52579
Change in Margin per Customer	\$ (19.87)	\$ (2.47)	\$ (17.40)
Average Number of Customers	864,201	864,201	864,201
Change in Annual Margin	\$ (17,175,876)	\$ (2,135,625)	\$ (15,040,251)
Change in Fixed Component of Margin	\$ (16,301,115)	\$ (2,026,858)	\$ (14,274,257)
Change in Variable Component of Margin	\$ (874,760)	\$ (108,767)	\$ (765,994)
Three-Year Impact on Fixed Cost Recovery	\$ <u>(22,549,850)</u>	\$ <u>(4,454,333)</u>	\$ <u>(18,095,518)</u>

**SOUTHWEST GAS CORPORATION
ARIZONA STAKEHOLDER DECOUPLING WORK GROUP
RESPONSES TO RUCO'S QUESTIONS AT 3RD MEETING**

Question 1.

For the last three years, provide weather adjusted and actual average use per residential customer data so we can see both the conservation and weather impacts on usage.

Response 1.

See table below for residential customer average usage and dollar impacts.

Description	2004	2005	2006
<u>Average Usage</u>			
Actual	358.7	320.7	309.2
Weather Adjusted	342.7	345.2	342.3
Last GRC	347.0	347.0	347.0
<u>Difference From Last GRC</u>			
Actual/Weather and Conservation-Related	11.7	(26.3)	(37.8)
Weather Adjusted/Conservation-Related	(4.3)	(1.8)	(4.7)
Weather-Related	16.0	(24.5)	(33.1)
Average No. of Customers	785,673	825,650	864,201
Average Commodity Rate	\$ 0.52579	\$ 0.52579	\$ 0.52579
<u>Dollar Impact of Change in Average Use</u>			
Actual	\$ 4,833,258	\$(11,417,317)	\$(17,175,876)
Conservation-Related	\$ (1,776,326)	\$ (781,413)	\$ (2,135,625)
Weather-Related	\$ 6,609,584	\$(10,635,904)	\$(15,040,251)

Question 2.

Over the same period, provide average use for newly installed customers versus vintage customers.

Response 2.

See table below. Results are based on weather-adjusted data for 12-months ending December 2006, and includes data for all customers installed prior to 2002 (vintage customers) and for customers installed in 2002, 2003 and 2004.

	Vintage	2002	2003	2004
Weather-Adjusted Average Use	343.4	339.2	334.5	334.0
Change From Vintage		(4.2)	(8.9)	(9.4)

ATTACHMENT 2

**THE NATIONAL ASSOCIATION OF
STATE UTILITY CONSUMER ADVOCATES
RESOLUTION 2007-01**

NASUCA ENERGY CONSERVATION AND DECOUPLING RESOLUTION

Whereas, the provision and promotion of energy efficiency measures are increasingly viewed by state commissions as a necessary component of utility service;

Whereas, many states are now encouraging rate-regulated utilities to adopt energy efficiency programs and other demand-side measures to decrease the number of units of energy each utility's customers purchase from the utility;

Whereas NASUCA has long supported the adoption of effective energy efficiency programs;

Whereas recent proposals by rate-regulated public utilities for the initiation or expansion of energy efficiency measures have featured utility rate incentives or revenue "decoupling" mechanisms that guarantee utilities a predetermined amount of revenues regardless of the number of units of energy sold;

Whereas, the utilities proposing decoupling measures seek guarantees from public utilities commissions that they will receive their allowed level of revenues;

Whereas, these utilities justify this departure from traditional rate-making principles on the theory they are being asked to help their customers purchase fewer energy units from them by promoting energy efficiency measures and other demand-side measures, thereby reducing their revenues and, consequently, their returns to their shareholders, and that decoupling mechanisms compensate utilities for revenues lost due to conservation;

Whereas, these utilities contend that because these measures reduce their revenues, they have a disincentive to encourage programs that aid their customers in purchasing fewer units of energy;

Whereas, historically, rates have been set in periodic rate cases by matching test-year revenues with test-year expenses, adding pro forma adjustments and allowing the utilities an opportunity to earn a reasonable rate of return on their investments in exchange for a state-protected monopoly;

Whereas revenue guarantee mechanisms allow rate adjustments to occur based upon one element that affects a utility's revenue requirement, without supervision or review of other factors that may offset the need for such a rate change;

Whereas, historically, rate-regulated utilities were not guaranteed they would earn the allowed return; rather, earnings depended on capable management operating the utilities in an efficient manner;

Whereas, many utilities proposing revenue decoupling request compensation for revenue lost per customer, implying that sales volumes are declining, when in fact these utilities' total energy sales revenues are stable or increasing;

Whereas, there are a number of factors that may cause a utility to sell fewer units of energy over a period of time, including weather, changing economic conditions, shifts in population, loss of large customers and switches to other types of energy, as well as energy efficiency and other demand-side measures;

Whereas many utilities have been offering cost-effective energy efficiency programs and actively marketing these programs for years without proposing or implementing rate incentives or revenue guarantee mechanisms such as decoupling, and have continued to enjoy financial health;

Whereas past experience has shown that revenue guarantee mechanisms such as decoupling may result in significant rate increases to customers;

Whereas some utilities have referenced the benefit of encouraging energy efficiency programs as a justification for revenue guarantee mechanisms without in fact offering any energy efficiency programs, indicating that the revenue guarantee mechanisms are attractive to utilities for reasons other than their interest in promoting energy conservation;

Whereas past experience has shown that rate increases prompted by revenue guarantee mechanisms such as decoupling are often driven not so much by reduced consumption caused by utility energy efficiency programs, as by reduced consumption due to normal business risks such as changes in weather, price sensitivity, or changes in the state of the economy;

Whereas utilities are better situated than are consumers or state regulators to anticipate, plan for, and respond to changes in revenue prompted by normal business risks, and the shifting of normal business risks away from utilities insulates them from business changes and reduces their incentive to operate efficiently and effectively;

Whereas the traditional ratemaking process has historically compensated utilities for experiencing revenue variations associated with normal business risks;

NOW THEREFORE NASUCA RESOLVES:

To continue its long tradition of support for the adoption of effective energy efficiency programs;

And to oppose decoupling mechanisms that would guarantee utilities the recovery of a predetermined level of revenue without regard to the number of energy units sold and the cause of lost revenue between rate cases;

BE IT FURTHER RESOLVED:

NASUCA urges Public Utilities Commissions to disallow revenue true-ups between rate cases that violate the matching principle, the prohibition against retroactive ratemaking, the prohibition against single-issue ratemaking, or that diminish the incentives to control costs that would otherwise apply between rate cases;

NASUCA urges State legislatures and Public Utilities Commissions to, prior to using decoupling as a means to blunt utility opposition to energy efficiency and other demand-side measures, (1) consider alternative measures that more efficiently promote energy efficiency and other demand side measures; (2) evaluate whether a utility proposing the adoption of a revenue decoupling mechanism has demonstrated a commitment to energy efficiency programs in the recent past; and (3) examine whether a utility proposing the adoption of a revenue decoupling mechanism has a history of prudently and reasonably utilizing alternative ratemaking tools;

If decoupling is allowed by any state commission, NASUCA recommends that the mechanism be structured to (1) prevent over-earning and provide a significant downward adjustment to the utilities' ROE in recognition of the significant reduction in risk associated with the use of a decoupling mechanism, (2) ensure the utility engages in incremental conservation efforts, such as including conservation targets and reduced or withheld recovery should the utility fail to meet those targets, and (3) require utilities to demonstrate that the reduced usage reflected in monthly revenue decoupling adjustments are specifically linked to the utility's promotion of energy efficiency programs.

NASUCA authorizes its Standing Committees to develop specific positions and to take appropriate actions consistent with the terms of this resolution to secure its implementation, with the approval of the Executive Committee of NASUCA. The Standing Committees or the Executive Committee shall notify the membership of any action taken pursuant to this resolution.

Approved by NASUCA:
Denver, Colorado

Submitted by:
NASUCA Consumer Protection Committee

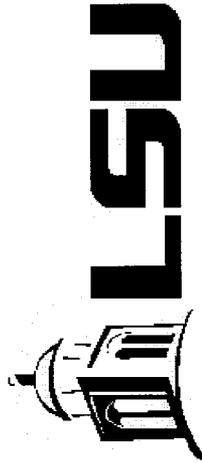
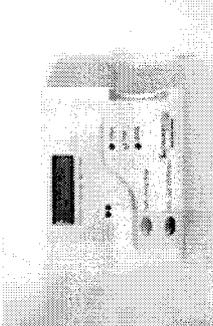
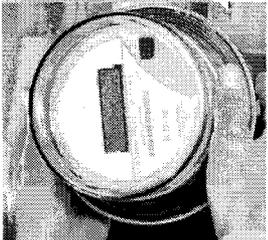
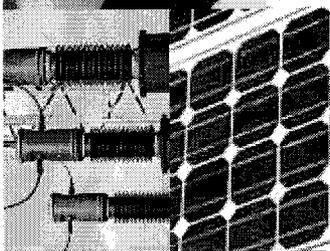
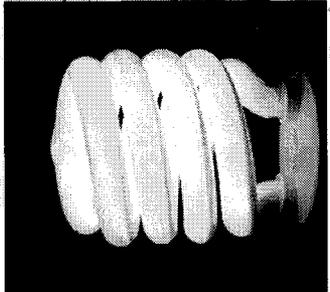
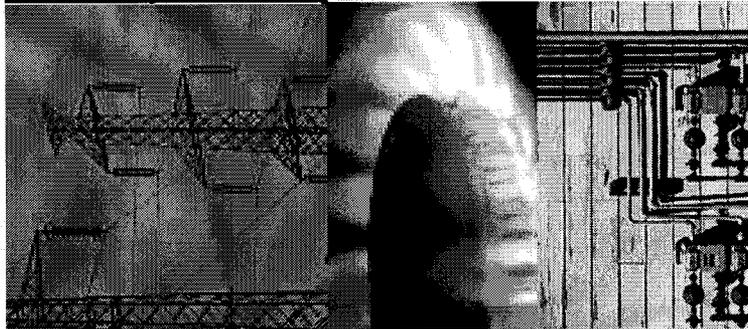
June 12, 2007

June 11, 2007

Opposed:
Ohio
Indiana
Colorado
Wyoming

Abstained:
Massachusetts
California

ATTACHMENT 3



Regulatory Issues for Consumer Advocates in Rate Design, Incentives & Energy Efficiency

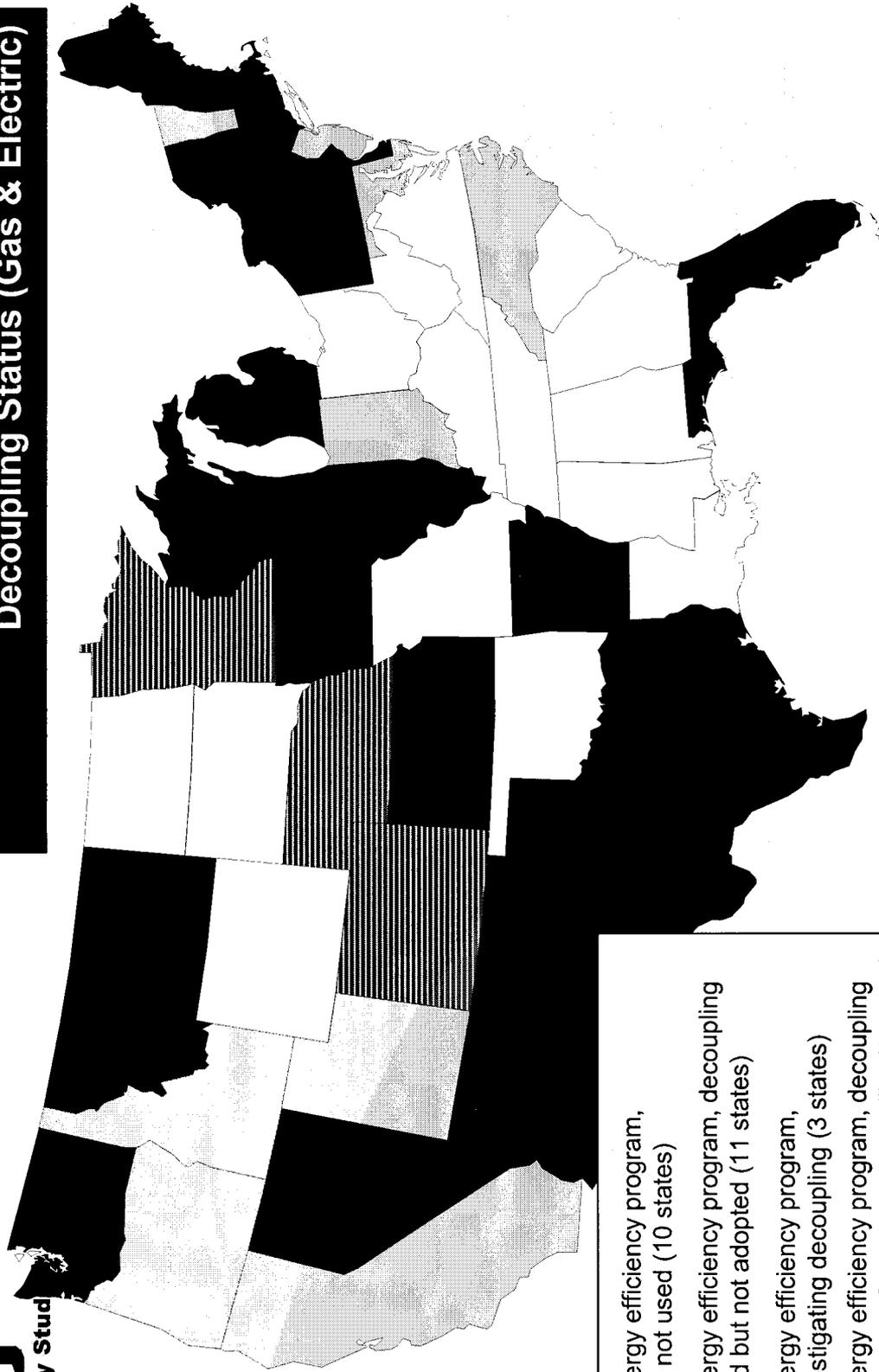
David E. Dismukes, Ph.D.
Professor & Associate Executive Director
Center for Energy Studies
Louisiana State University

National Association of State Utility Consumer Advocates
(NASUCA)
Mid-Year Meeting
June 11, 2007

- Aligns utility incentives with energy efficiency.
- Assists utility in earning its authorized rate of return that is challenged by the decreasing use per customer problem (gas).
- Easier for customers to understand and reduces bill volatility.
- Reduces regulatory costs and the need for frequent rate cases.

- Straight-Fixed Variable Rate Design: eliminates all variable distribution charges and DNG costs are recovered through a fixed delivery services charge or an increase in the fixed customer charge alone (gas LDCs).
- Sales-Revenue Decoupling: separates revenue recovery from sales (sets annual revenues to a “per-customer” target.) Can be done on a full or partial basis.
- Sales-Margin Decoupling: separates margin recovery from sales (sets margin per customer target). Can also be done on a full or partial basis.

**States with Energy Efficiency Programs –
Decoupling Status (Gas & Electric)**

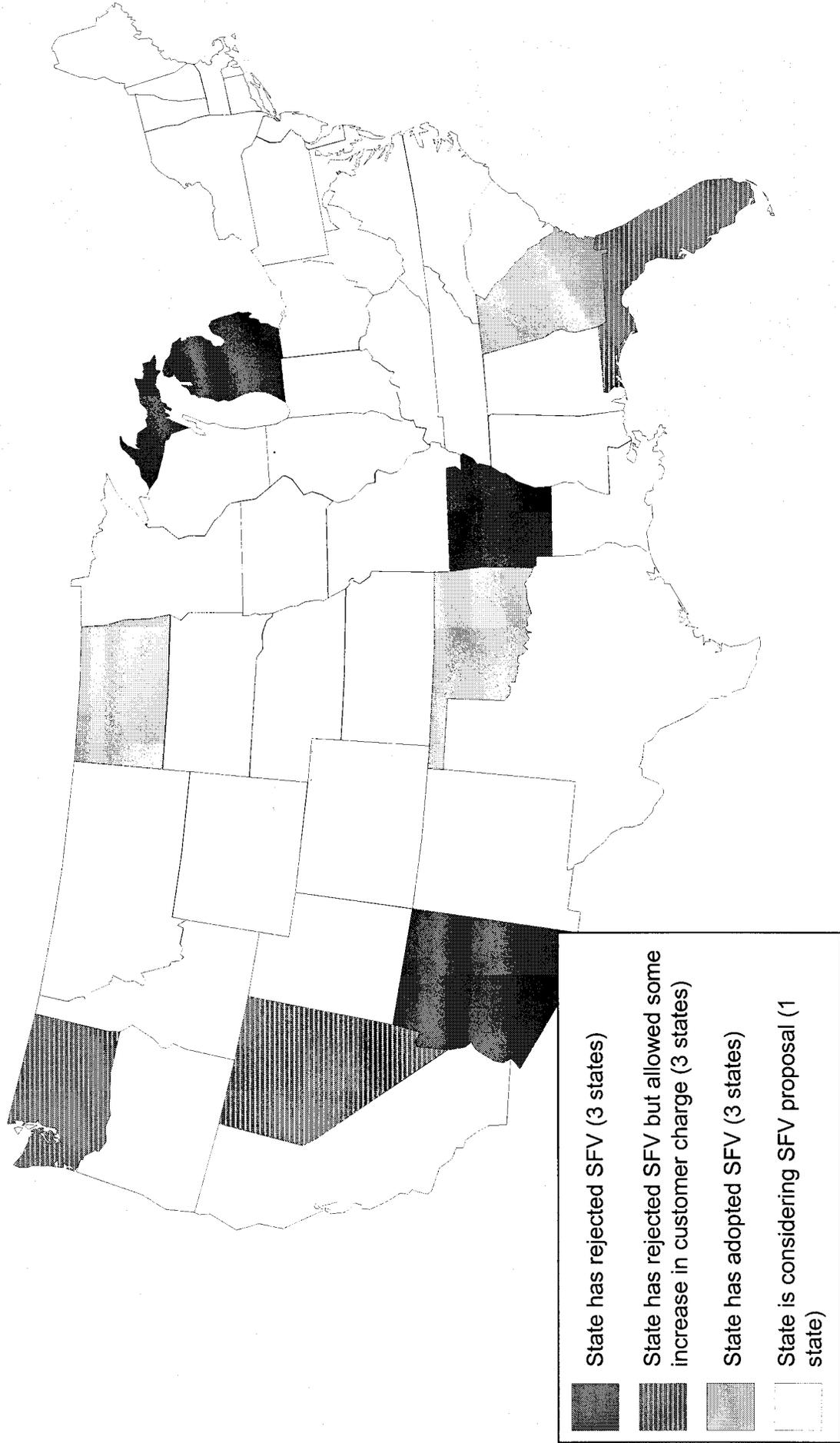


-  State has energy efficiency program, decoupling is not used (10 states)
-  State has energy efficiency program, decoupling was proposed but not adopted (11 states)
-  State has energy efficiency program, currently investigating decoupling (3 states)
-  State has energy efficiency program, decoupling has been approved for at least one utility (9 states)
-  State has no energy efficiency program, decoupling has been approved for at least one utility (1 state)

Note: In Connecticut, the electric utilities do not have decoupling, but two natural gas LDCs have a partial decoupling mechanism in connection with their energy efficiency programs for low-income customers (a conservation adjustment mechanism). Washington has utilities with decoupling, but rejected the most recent utility proposal (January 2007). In Michigan, revenue decoupling was proposed by the Michigan Staff but opposed by the Michigan AG. The MPSC approved a stipulation that excluded revenue decoupling. In Kansas, revenue decoupling was proposed by Aquila. The parties involved agreed to a stipulation that excluded revenue decoupling while the Commission investigates it further in a general docket.



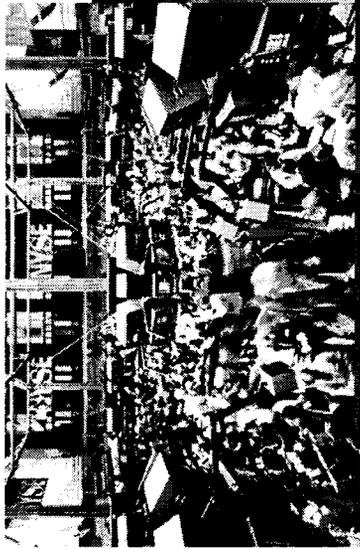
States that have Considered SFV



Note: In Michigan, SFV was proposed by SEMCO Energy but opposed by the Michigan AG. The MPSC approved a stipulation that excluded SFV.

- Represents a significant departure from traditional regulation.
- Shifts sales risks from utilities to customers.
- The impact of changes in use per customer for the gas industry are overstated and address the wrong causes on changes in margins. Power industry faces an entirely different set of usage trends.
- At best, the incentive issue is not resolved and never can be with revenue decoupling.
- Current proposals, offered in conjunction with other “regulatory remedies” diminishes the simplicity argument and raises questions about the purpose of proposal.
- Proportionality issue – changing the rate design for all customers based upon programs for which an exceptionally small percentage of the customers will participate.
- Is actually contrary to “sound economic principles” and well-grounded regulatory policies.

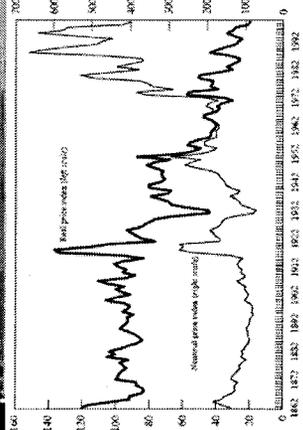
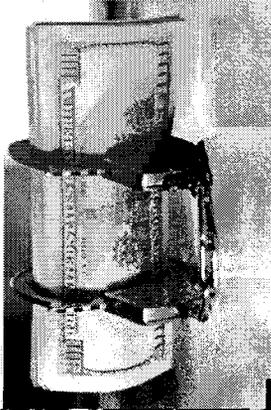
Economy



Weather

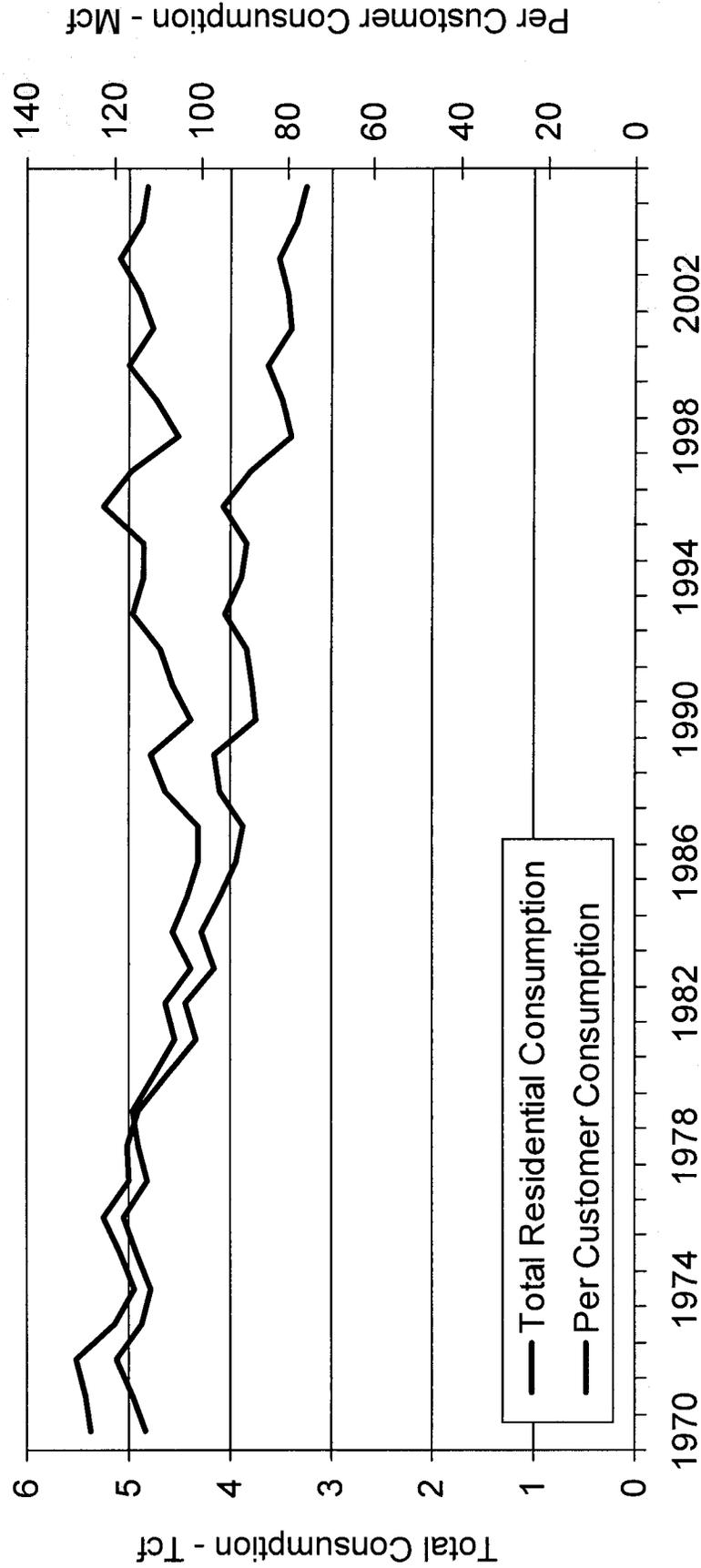


Commodity Prices

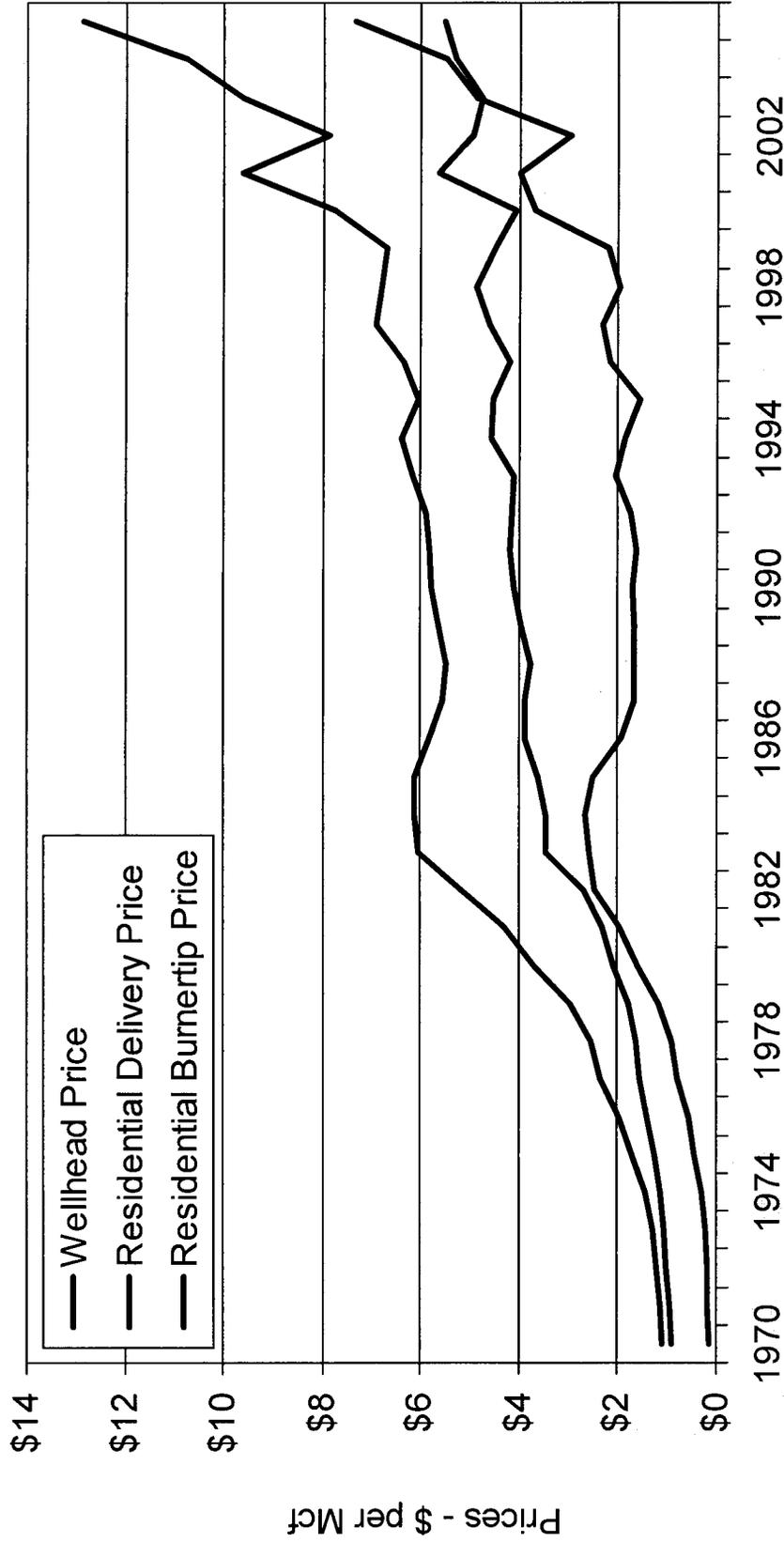


Other Unanticipated Factors

While overall use per customer is decreasing, overall residential natural gas usage is flat to increasing.



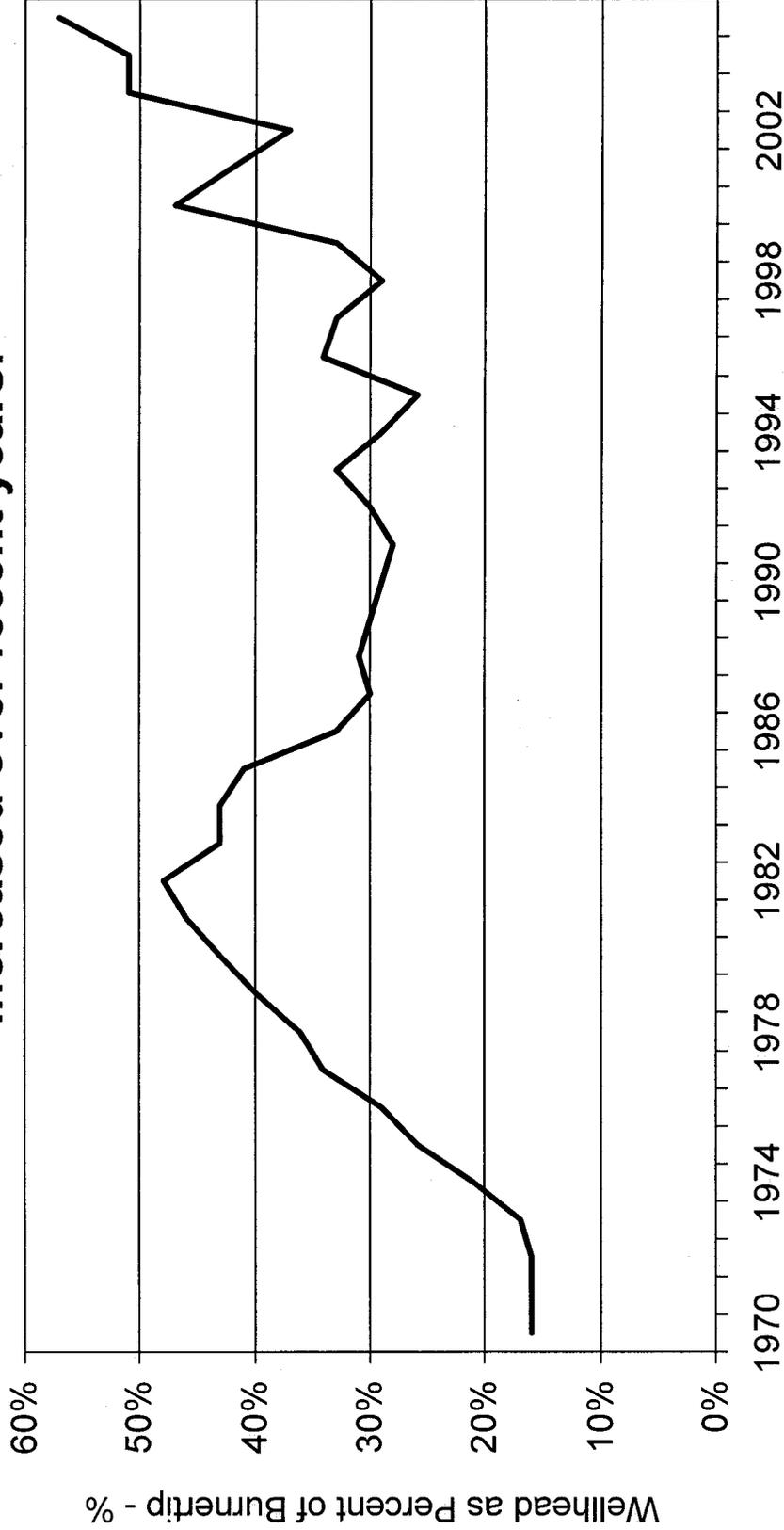
Retail prices have increased significantly since 2000-2001.



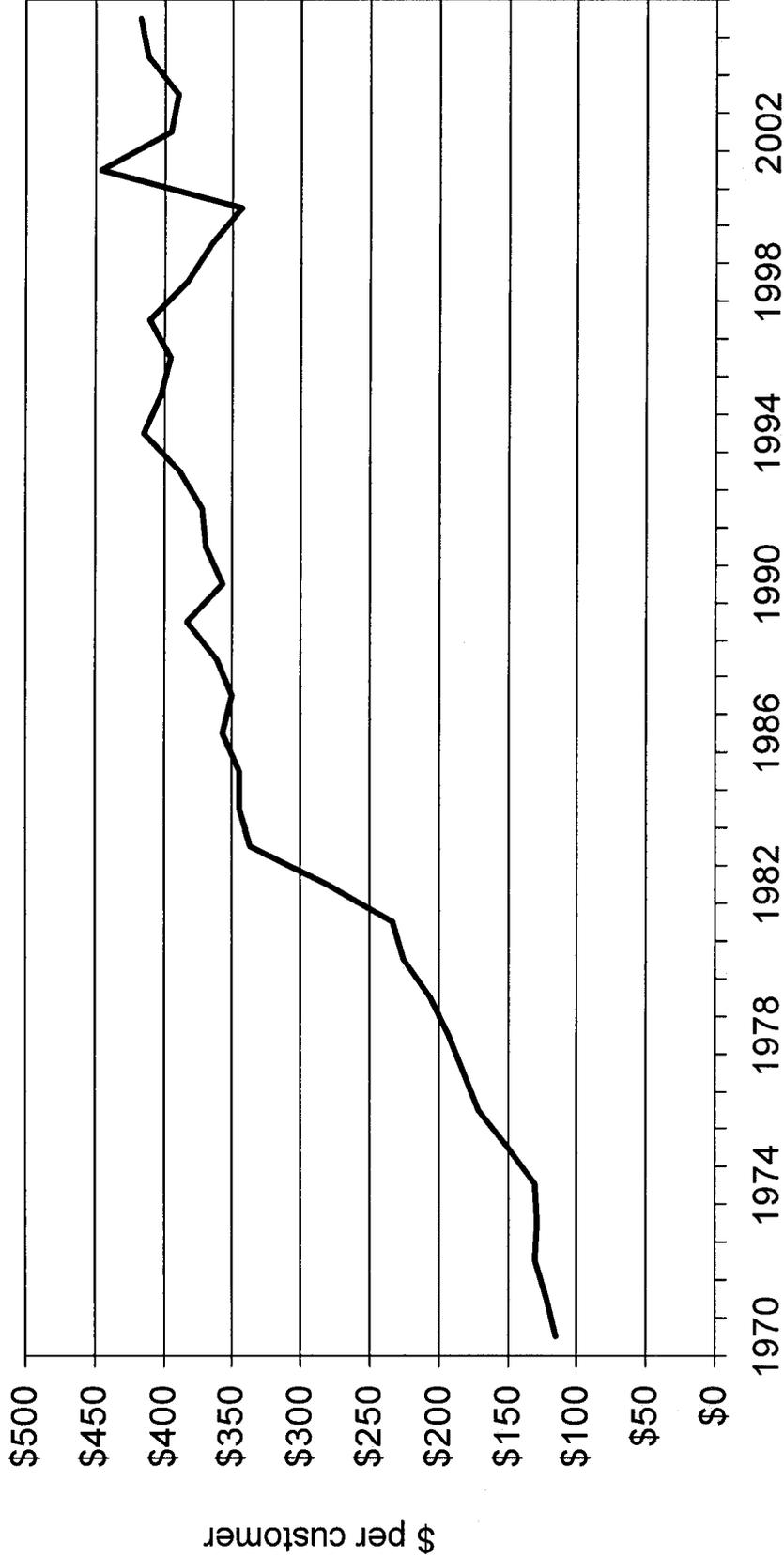


US Natural Gas Price Trends Wellhead as a Percent of Burner-Tip Price

The commodity share of overall natural gas rate has increased over recent years.



Yet despite high prices, and decreases in use per customer, overall DNG revenues per customer are at close to historic highs.



Wild West LDC is facing significant growth challenges – ROE impacts of decreases in use per customer pale in comparison to change in rate base and new customer capital expenses.

	2001	2002	2003	2004	2005	2006
Return on Equity						
Allowed ROE	11.00%	11.00%	11.20%	11.20%	11.20%	11.20%
ROE Impact of Change in Use per Customer	0.00%	-0.60%	1.99%	-0.41%	-0.87%	-0.41%
ROE Impact Change in Customers	0.00%	1.04%	1.66%	1.17%	1.51%	1.51%
ROE Impact Change in Expenses Rate Base and Capital Elements	-0.54%	-2.38%	-3.76%	-1.92%	-1.16%	-2.08%
Actual Achieved ROE	10.46%	9.06%	11.09%	10.05%	10.68%	10.22%

Is decoupling a solution to the “use per customer problem” or an “end-run” on a rate case?

Significant change in rate design for a very small change in overall sales and very limited number of customers.

	Program Spending (million \$)	Percent of Retail Revenues (%)	Gas Savings (Mcf/year)	Percent of Gas Sales Saved (%)	Volume saved per million \$ (Mcf/year)	Benefit-Cost Ratio
Aquila	\$ 2.10	1.4%	146,000	0.5%	69,000	-
Centerpoint	\$ 5.60	0.5%	720,000	0.5%	128,600	2.60
Keyspan	\$ 12.00	1.0%	490,000	0.4%	41,000	3.00
Northwest Natural Gas	\$ 4.70	0.7%	85,000	0.1%	18,000	-
NSTAR	\$ 3.90	0.8%	71,500	0.2%	18,000	2.29
PG&E	\$ 13.50	0.4%	2,000,000	0.7%	148,000	2.10
PSE	\$ 3.80	0.4%	311,000	0.5%	82,275	1.93
SoCal Gas	\$ 21.00	0.6%	1,100,000	0.3%	52,000	2.67
Vermont Gas	\$ 1.10	1.6%	57,000	1.0%	52,000	5.60
Xcel Energy (MN)	\$ 4.00	0.7%	663,000	0.9%	166,000	1.56

Generally, less than one-half of one percent.

**Incremental Impact of DSM Implementation
on Shareholders, Wild West Utility**

	Change in Revenue			Income Impact			Shareholders Equity	Impact on ROE
	Use per Customer	DSM Customers	New Customers	Use per Customer	DSM Customers	New Customers		
2007	\$(1,971,361)	\$(288,537)	\$7,052,203	\$(1,221,185)	\$(178,738)	\$4,368,579	\$313,071,056	0.95%
2008	\$(2,905,519)	\$(608,826)	\$6,391,367	\$(1,799,862)	\$(377,145)	\$3,959,215	\$339,501,229	0.52%
2009	\$(4,485,340)	\$(943,652)	\$6,213,829	\$(2,778,502)	\$(584,557)	\$3,849,237	\$363,965,179	0.13%
Total	\$(9,362,220)	\$(1,841,015)	\$19,657,399	\$(5,799,549)	\$(1,140,440)	\$12,177,031	Net Impact: \$5,237,041.80	1.61%

**Exaggerated
Example**

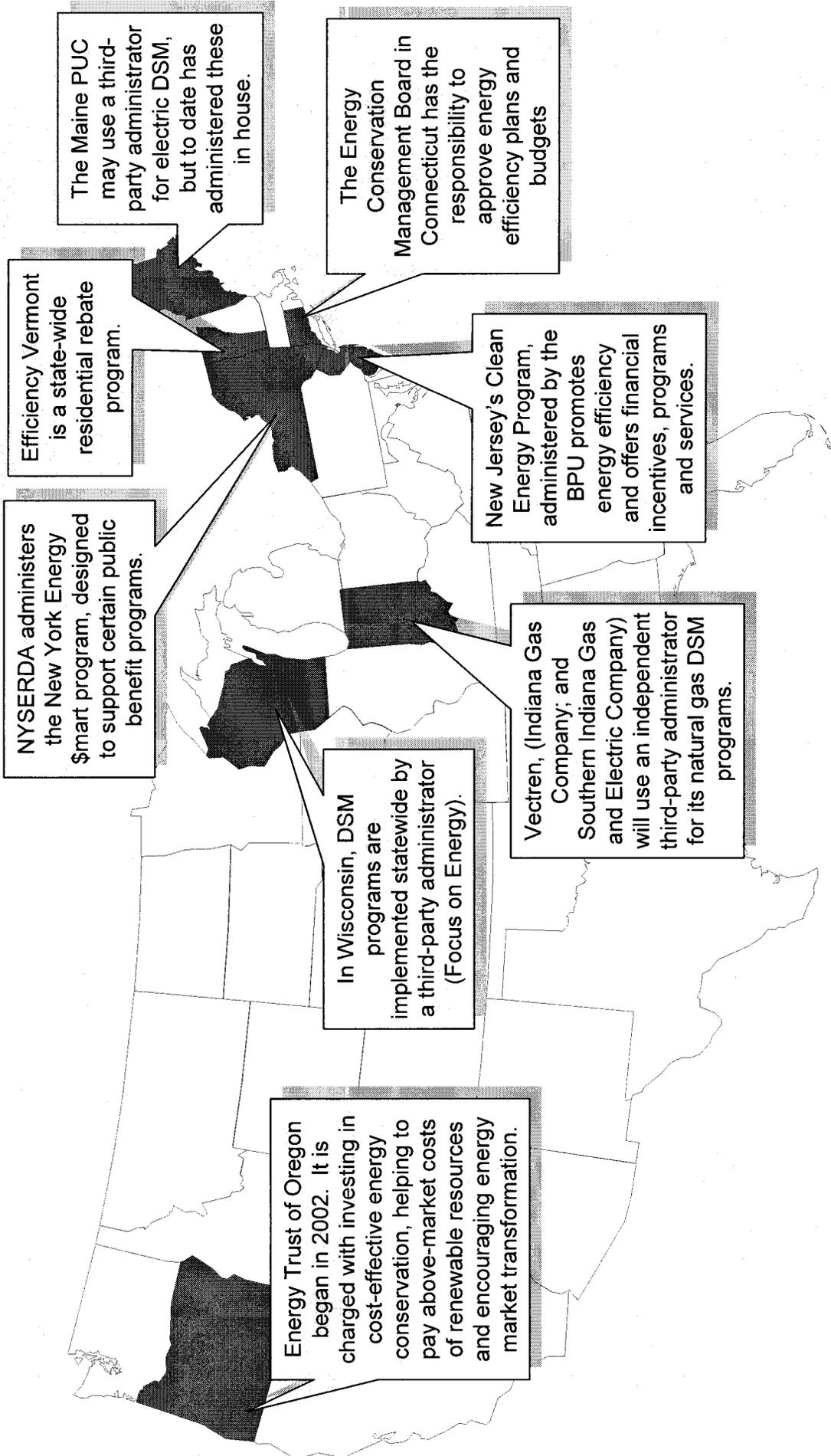


- Reduced revenues/income reduces overall taxes and needs to be considered.
- A one percent per year (3 percent cumulative) reduction is beyond current experience.
- The additional income created by customer growth from the test year is completely ignored (and its corresponding income effects).
- Net impact for a growing LDC is moderate – the net income impact is still positive, not negative.

- Reduces customers' ability to have full control of their energy savings. Reduces, in part, incentive to conserve particularly with SFV.
- If successful in reducing sales incentive, then also reduces incentive to measure sales losses and savings. You have "decoupled" DSM performance to any form of measurement.
- If successful in reducing sales incentive, then reduces incentive to promote efficient natural gas use and economic development.
- Revenues more difficult to estimate than costs, creating revenue certainty reduces incentive to push cost efficiency.

George A. Schreiber, Jr., SEMCO Company President and Chief Executive Officer, said, "I am very pleased with the Company's results for 2006. We achieved these results, despite warmer-than-normal temperatures and continued customer conservation, which, when combined, adversely impacted 2006 earnings by an estimated \$3.5 million." Schreiber added, "One way we overcame the impact of the weather and customer conservation was to keep spending under control."

States with Third-Party Administrators



- **Projected test years:** forecasts could account for anticipated energy efficiency savings.
- **Cost-effectiveness tests:** screening on RIM-passing measures only.
- **Lost Revenues (ex post):** periodic filings on proven, *ex post* lost revenues/sales.
- **Rate design (inclining blocks):** higher rates in upper blocks.
- **Repression adjustments:** usage adjustment to correct of DSM-related reductions in usage.
- **Direct Incentives:** performance-based incentives for programs.
- **Risk Management:** if volatility is an issue, then manage it.
- **More frequent rate cases:** traditional approach at correcting rates that get out of balance.

Questions, Comments, & Discussion

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