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**SOUTHWEST GAS CORPORATION**

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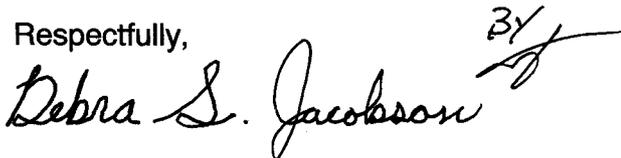
Docket Control  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, Arizona 85007

RE: Docket Nos. E-00000K-07-0052 and G-00000E-07-0052

Please accept the enclosed original and fifteen (15) copies of Southwest Gas Corporation's Additional Response in the Matter of the Use of Hook-Up Fees for Electric and Natural Gas Utilities.

Thank you for your assistance in this matter.

Respectfully,



Debra S. Jacobson  
Director, Government and State Regulatory Affairs

Enclosures

C: Ernest G. Johnson, ACC  
Jerry D. Anderson, ACC  
Bob Gray, ACC

AZ CORP COMMISSION  
DOCKET CONTROL

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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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AZ CORP COMMISSION  
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THE MATTER OF THE USE OF HOOK-UP FEES  
FOR ELECTRIC AND NATURAL GAS UTILITIES.

DOCKET NO. E-00000K-07-0052  
DOCKET NO. G-00000E-07-0052

**ADDITIONAL RESPONSE  
OF  
SOUTHWEST GAS CORPORATION**

On January 17, 2007, the Arizona Corporation Commission (Commission) opened a generic investigation docket into the feasibility of energy utilities assessing an initial amount, referred to as a "hook-up fee," on new customers for their infrastructure requirements in Arizona. Initial comments were provided by Southwest Gas Corporation (Southwest) on April 5, 2007. On October 18, 2007, a special open meeting and workshop was held. At the workshop, Commission Utilities Division Staff (Staff) posed twelve questions for discussion at the workshop. At the close of the workshop, Staff invited workshop participants to provide, by November 1, 2007, written responses to the questions posed during the workshop, in addition to the verbal responses provided during the workshop. As requested, Southwest provides its Additional Response to the workshop questions.

Before providing its responses to the specific questions posed, it may be helpful to first describe Southwest's Arizona natural gas operations and its service and main extension policies and practices contained in Rule No. 6 of its Arizona Gas Tariff,

**BACKGROUND**

Southwest is Arizona's largest local gas distribution company (LDC), serving approximately 950,000 customers in Arizona at year-end 2006. Nearly one-half of these customers (46 percent) were added since 1990.

At December 31, 2006, Southwest's investment in distribution plant was approximately \$1.8 billion (at original cost). Approximately \$1.2 billion, or 67 percent, of the \$1.8 billion total distribution plant investment at December 2006 was added just in the last twelve years. Of the \$1.2 billion, 53 percent was for service to new customers; 5 percent was for system reinforcement as a cumulative result of customer growth; 5 percent was for high pressure distribution mains to extend natural gas service to outlying areas; and 28 percent was required to replace facilities that have outlived their useful lives. The remaining 9 percent was for other distribution plant expenditures.

Southwest must compete with other entities, including other utilities, for raw materials, such as steel, concrete, paving materials, et cetera to build its energy delivery infrastructure. All of these material costs have experienced significant cost increases in the last three to five years. Also, because much of the natural gas distribution piping used by Southwest is petroleum based, the recent extraordinary increases in the costs of oil are also reflected in price increases for finished natural gas piping products.

Besides the need to invest significant capital resources to serve growth due to new customers, replacement of aging infrastructure will continue to be a driving factor in Southwest's costs of service. It has been Southwest's experience that the cost per foot for replacing old facilities (primarily natural gas piping) is between 2 and 3 times greater than the cost of facilities to serve new customers.

Thus, even with a "hook-up" fee for new customers, there will continue to be upward pressure on costs of service and the need for future rate relief as long as rates are set using historic costs while current costs of service escalate and outpace the corresponding revenues that are collected from customers.

## **QUESTIONS POSED AND RESPONSES**

### **1. How do we pay for growth?**

- **Rates?**
- **Hook-up fees**
- **Other**

There are many different mechanisms that can be used to help fund the capital required to build the infrastructure necessary to serve new customers. A hook-up fee is only one such mechanism. Other mechanisms, such as including construction work-in-progress in rate base, forecasted test years, or revenue stability mechanisms, are available to the Commission to help

ensure the utility has sufficient cash flows to fund growth-related capital investment.

For many years, Southwest has utilized what is referred to as the Incremental Contribution Method (ICM), contained in the Service and Main Extension Rules of its Arizona gas tariff, to fund growth-related capital investment. The ICM achieves many of the purported benefits of the hook-up fee concept. The ICM also avoids some of the inherent inequities that might result from establishing a system-wide, average cost hook-up fee. Such a flat rate tends to discriminate between in-fill customers and those customers in more outlying areas where longer, more costly line extensions are required to provide service. Conversely, the ICM is a balanced and structured approach that is tailored to consider the unique circumstances of each requested line extension and the incremental costs and associated revenues expected from the new customer or additional load.

The stated goal of the ICM analysis is to ensure that when the incremental costs of providing service to new customers are measured against the new expected margin revenue, the new line extension will produce at least the Commission-authorized rate of return (ROR). The ICM includes the estimated investment in mains and services, meters, and a regulating station, if one is required.

Additional ICM factors include the following: operations expenses; expected margin revenue; depreciation; and taxes. For the operations' cost factor, Southwest periodically reviews and updates the operational expenses associated with new customers, such as metering and billing. Margin revenue is calculated using the Commission-authorized basic service charge and per therm margin rates, multiplied by estimated usage by appliance. Southwest periodically analyzes customer usage patterns and anticipated usage by appliance to derive these estimates. State and federal income taxes, property taxes, and depreciation rates are also included, based on the most recently-approved factors for these items from the Company's last Arizona GRC. The resulting rate of return on incremental rate base is compared to the most recent Commission-authorized ROR to determine the economic feasibility of the extension. Southwest collects a refundable advance equal to the initial investment in the gas facilities required to serve the new customer. If the new line extension does not provide a return at least equal to the Commission-authorized ROR, a contribution-in-aid-of-construction (CIAC) is then required in order to achieve the Commission-authorized ROR.

Southwest's ICM model ensures that new customer growth is self-supporting and

existing customers are not burdened by the incremental investment to serve new customers. A significant amount of investment has been required to nearly double the number of customers served during the last twelve years. Nonetheless, the use of the ICM has allowed Southwest to grow economically, with increases in margin rates less than the Consumer Price Index (CPI). In large part, the ICM enabled Southwest to double the number of customers served, while increasing residential margin rates by only 76 percent (76%) of the CPI.

Southwest believes its ICM approach addresses many of the concerns raised by the Commission in this investigation and further changes to its Arizona gas tariff are unnecessary with respect to infrastructure needs related to customer growth. However, no hook-up fee or ICM can avoid the need for rate relief when overall costs of service escalate faster than the revenues derived from historic cost-based rates.

**2. What are the fairness and equity issues associated with imposing or not imposing hook-up fees?**

- a. Is it more equitable to have current utility customers paying through their rates?**
- b. Is it more equitable to assign those costs to new customers for whom the infrastructure must be built?**

As a general rule of economic efficiency, costs should be assigned to those causing the costs. A properly-designed hook-up fee, or an ICM approach like Southwest's for example, can assign and collect these marginal costs from the appropriate customer or vintage of customers. However, the intergenerational inequities that are the crux of this question are an inevitable part of utility ratesetting.

The traditional form of utility pricing is average cost pricing. In its simplest form, average cost pricing takes the total embedded cost to serve the customer class and divides it by the number of consumption units to develop a rate per unit of consumption. Implicit in this embedded cost of service, however, is a certain amount of "reserve" capacity, given the "lumpiness" of investment in utility infrastructure, the need to plan and build infrastructure to serve projected needs several years into the future, and the presence of the resulting reserve capacity built into a utility system. During the period when new customers can be connected and "grow" into this planned capacity reserve, the marginal cost to serve the new customer is much lower than the rates that are set on the embedded cost of service. The new customers are actually subsidizing the existing customers to the extent the revenues from new customers exceed the

marginal costs to serve the new customer. Conversely, when it is time to add the next increment of capacity, the total cost of the capacity addition is spread to both existing and future customers.

Fairness, like beauty, is in the eye of the beholder and who benefits from the subsidization that occurs. In this instance, it can be argued it is unfair and inequitable to "overcharge" new customers for the benefit of existing customers. Yet, it is unlikely existing customers would be willing to forego the benefit of the revenues in excess of marginal costs from these new customers if new customers were only charged the true marginal cost to serve. There are also circumstances, such as system reinforcements that benefit all customers by increased delivery reliability, when it is appropriate to spread those costs to all customers.

In ratesetting, one of the goals is to achieve the delicate balance between protecting the ability of customers to pay the costs of service and preventing undue discrimination in pricing as between similarly-situated customers or between customer classes. Over time, the shifting subsidies between existing and new customers, as increased costs are spread over all customers, tend to balance each other. In this respect, average cost pricing tends to produce a "fair and equitable" solution for utility pricing. As imperfect as it may be, average cost pricing also has certain advantages in terms of simplicity in calculation and administration.

That is not to say that a properly designed hook-up fee or ICM approach should not be included in the possible solutions for the vexing problem of how to fund growth-related capital requirements.

Other matters of fairness and equity include the ability of the relevant market to absorb a large initial capital advance for utility service connections. The resulting affordability of the housing or commercial building is a practical limit as to whether a hook-up fee can be relied upon as the entire source of funding for new infrastructure required to serve the growth in number of customers. Other variables to consider include the fact that areas with lower land costs and lower housing prices may be able to absorb a larger hook-up fee than may be possible in an area experiencing higher land or housing prices.

The experience of Dixie-Escalante Rural Electric Association (Dixie) discussed during the workshop illustrates the potential economic displacement that could occur as a result of imposing dissimilar hook-up fees between jurisdictions. Dixie experienced an influx of homebuyers from Dixie's Utah service territory to its adjacent Arizona service territory when the hook-up fee used by Dixie was \$750 in Arizona, but increased to \$2,950 in Utah and housing

and land prices also increased in the Utah market. Similar displacements could occur within individual utility service territories or between Arizona and neighboring states if a policy of significant hook-up fees for utility service were adopted. Consumers and builders/developers would tend to migrate to areas or utilities not subject to Commission regulation or to other states that did not charge the hook-up fees or that charged lower hook-up fees.

Of course, hook-up fees are only one potential factor or mechanism in the total equation for setting utility rates and recovering sufficient revenues to pay the costs to provide service to new and existing customers. Whether the expected costs imposed on a given utility system are collected entirely up-front from the new customer, or spread over the life of the capital assets devoted to providing utility service through average cost rate making cannot be answered in isolation. The total rate design and the percentage of costs of service that are collected in the form of fixed monthly charges or variable commodity charges, with the corresponding impact on the total customer bill and revenue stability for the utility, are additional factors to consider in protecting customers from frequent rate increases.

During the workshop, APS proposed that hook-up fees be treated as miscellaneous revenue, rather than as an offset to plant-in-service. If treated as revenue instead of a capital offset, there is a danger of over-reliance on hook-up fees for recovery of the total revenue requirements for the utility. If there is a downturn in the economy or housing industry, then the expected revenue stream from hook-up fees will be reduced. Without a corresponding revenue balancing mechanism, the resulting shortfall represents a revenue and earnings deficiency for the utility, which will necessitate a rate increase request. The problem of funding growth is not solved, but new problems of rate design and revenue recovery are created.

Another potential problem with treating hook-up fees as revenues is that the funds collected are used to offset current expenses, rather than used to build plant in the future when needed. For instance, if hook-up fees are intended to pay for incremental costs to serve new customers, including a generation component for electric service, when it is time to build the new generation plant, those funds may not be available.

There may be some benefits to treating hook-up fees as revenues, such as improved funds from operations-to-debt coverage (FFO) ratios. Treating hook-up fees as revenue could also help address the tax liability issue created when treating such contributions as offsets to plant-in-service. However, it is not certain how rating agencies might view or discount this inherently

unstable revenue source. As currently structured, Southwest uses the ICM and resulting CIAC or advance as an offset to plant-in-service and not as revenue.

**3. Should hook-up fees be limited to extraordinary growth areas only? How do we define extraordinary growth?**

Economic efficiency suggests that cost causation principles should be used to limit application of hook-up fees to those areas responsible for imposing increased costs on the utility system. However, the difficulties of defining what is extraordinary growth and potential discrimination between similarly-situated customers suggests that a system-wide approach, consistently applied, will simplify administration of such a tool.

**4. What are the economic development implications?**

- Who is helped?
- Who is hurt?

The primary economic impacts of hook-up fees on homebuilders would be the initial up-front capital payment of the fees, plus the carrying costs (interest) associated with the up-front capital outlay. These increased costs to the builder are then passed on to the ultimate homebuyer. Currently, the builders provide for the cost of natural gas facilities in their projects either through a refundable advance and/or a non-refundable contribution.

Since the hook-up fees are typically passed along to the homebuyer from the homebuilder, the primary economic impact to the homebuyer is increasing the cost of the home. A recent study of the burden of municipal impact fees on housing prices by the Southern Arizona Home Builders Association (SAHBA) estimates that current municipal impact fees and taxes can add between \$21,000 to more than \$30,000 to the price of a new home in southern Arizona.<sup>1</sup> This translates into an additional \$133 to \$190 per month in mortgage costs to the homebuyer.<sup>2</sup> Whether refundable or not, a hook-up fee for utility service would have a similar negative economic impact to the homebuyer by increasing the cost of the house and resulting mortgage payment.

In central Arizona, existing municipal impact fees range from approximately \$3,300 to over \$17,000. These impact fees are ultimately reflected in the price of the new home subject to

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<sup>1</sup> Southern Arizona Home Builders Association, *Special Report: Government Fees & Taxes on New Homes*, Aug. 2006

<sup>2</sup> *Id.*

the impact fees. Many of the central Arizona municipalities recently adopted significant increases for impact fees, with many of these increases becoming effective in March 2007. In several municipalities, these new impact fees are more than double the previous level. The long-term effect of these increased impact fees on housing prices and affordability, especially for moderate- and middle-income households, are yet to be seen, but are likely to parallel the cost impacts estimated by the SAHBA study for southern Arizona. These increased municipal impact fees, even without a utility service hook-up fee, certainly tend to diminish the availability of affordable housing for moderate- to middle-income families.

The foregoing response describes economic impacts from hook-up fees in general terms. If hook-up fees were adopted only in an individual utility's service territory, these impacts would be concentrated in its specific service areas. However, if hook-up fees were substantial enough and could be avoided by building or buying in an area that was not subject to the hook-up fees, there could be a migration away from that utility's service territory, particularly on the periphery of the service territory boundaries. As noted in response to Question 2, the customer migration between Utah and Arizona service territories for Dixie-Escalante illustrates this effect when dissimilar hook-up fees were assessed between adjacent jurisdictions.

At the regional level, the implementation of hook-up fees could affect the location decision of residents and businesses considering Arizona compared to other states, such as Utah and New Mexico. This could put government entities and regulated utilities at a competitive disadvantage in terms of attracting or maintaining economic development in Arizona. This, in turn, could have a negative impact on tax revenue growth in Arizona.

In the current housing climate in Arizona, an increase to the cost of housing due to hook-up fees charged by energy utilities to developers, and then passed on to homebuyers, could further depress the residential housing market. Consequently, the increased cost of housing may result in builders experiencing a further decrease in sales and revenue from new homes, on top of an already weakening construction industry. Other trade-offs for the homebuyer may include developers building smaller-size homes or increasing housing density to compensate for decreased margin to the developer because of increased initial costs. According to the Arizona Real Estate Center for Arizona State University (ASU), median income is a primary factor for

determining housing affordability.<sup>3</sup> If the increase in the price of the house due to the hook-up fees is greater than the increase in median income, then, all other things being equal, fewer persons can afford a given house.<sup>4</sup>

New customers may generally see higher new home prices and depressed affordability, both in the short-term and in the long-term. There may also be less customer choice in energy sources and reduced aggregate energy efficiency, as noted in response to Question 6.

**5. What are the implementation issues?**

- **Is a phase-in period necessary?**
- **How should the phase-in be properly done?**

Depending on the magnitude of any hook-up fee that is adopted, if any, there may be a period of time necessary to educate all relevant stakeholders about the mechanism established. Southwest suggests a sufficient period, perhaps six to twelve months, be permitted to conduct such educational outreach prior to actual imposition of the mechanism.

Another implementation issue is whether the Commission has the authority under ARS 40-250 to increase rates charged to customers outside of a general rate case or without hearings that the increase is justified and reasonable. Imposition of a significant hook-up fee would affect a utility's rate of return on its investment. The effect on a utility's rate of return necessitates that hook-up fees can only be implemented in the context of a general rate case and the Commission would have to address imposition of hook-up fees on a case-by-case basis for each regulated utility. Thus, an appropriate process must be established so that all relevant stakeholders have adequate notice and opportunity to be heard on setting the level of the hook-up fee for the individual utility.

In terms of administration, a determination is needed as to whether to apply the hook-up fees to applications for utility service that were received prior to the effective date of the fee, but not yet processed. Consequently, some transition period is advised.

**6. What are the unique implications of assessing hook-up fees to gas companies?**

Southwest reiterates that consistent application of its ICM and line extension CIAC and advance rules already address concerns related to funding growth-related capital expenditures.

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<sup>3</sup> Prof. Jay Q. Butler, *Higher Home Prices Impact Affordability in 2005* (Ariz. Real Estate Center, Ariz. St. Univ., 2006) at <http://www.poly.asu.edu/realty/studies/annual/2005Affordability.doc>. Last accessed Mar. 9, 2007.

<sup>4</sup> *Id.*

Southwest has significantly improved the level of internally-generated funds available for growth-related construction since its 2004 Arizona general rate case.

During the workshop, Commissioner Mayes asked whether Southwest would benefit from both its ICM approach and a hook-up fee in terms of generating additional cash flow for growth-related capital expenditures. Southwest has insufficient data to assess the potential impacts of imposing both mechanisms for natural gas service.

The primary concern would be the magnitude of any hook-up fee or combination of fees. This includes the magnitude of the initial fees charged just for natural gas service, the magnitude of initial fees charged just for electric service, or the combined magnitude of initial fees for both electric and natural gas service and the ability of a developer or builder to pass through such fees without negatively affecting profitability. Other concerns include unintended consequences that might occur from adopting a program of mandatory charges for utility service connections.

Care also must be taken to avoid unintended consequences and to consider the effects of imposing hook-up fees in combination with continued use of the ICM for a natural gas utility. More is not necessarily better if the perceived initial investment to provide natural gas service is not offset by the greater source efficiencies or consumer demand for natural gas as an energy choice.

Every building must have electric service, but not all buildings need natural gas service. If the initial fees charged for electric service connections are too high, a builder may avoid the initial fees for natural gas service connections and choose electric-only service for the building. Likewise, if the initial fees for natural gas service connections are too high, the builder may seek to avoid those fees and again choose electric-only service.

Because it is typically much more expensive to retrofit a building for natural gas plumbing than it is to install dual energy systems during the construction phase, it is unlikely that the ultimate home buyer or commercial building owner will later install natural gas to the structure. This raises obvious competitive concerns if the natural gas utility is effectively shut out of the new construction marketplace. More importantly, energy consumers would be effectively precluded from choosing between energy sources for those applications where natural gas is the most efficient energy choice or preferred by the energy consumer. This will lower the aggregate energy efficiency of the stock of housing and commercial buildings in Arizona.

There are other unintended consequences of imposing hook-up fees. Since the builder or

developer typically does not have to live with the long-term energy costs of a given home or building, they are more likely to focus on short-term profitability at the expense of the long-term costs of utility service for the ultimate home buyer or business in the case of commercial buildings. If the magnitude of the up-front fees required for gas and/or elective service is too great, a builder or developer could install electric-only service and avoid the hook-up fee or additional costs for natural gas service. The builder would save money, but the ultimate consumer may face much higher energy costs over the life of the building because they are precluded from access to the greater source efficiencies offered by natural gas for space heating, water heating, cooking, and other applications where natural gas is a more efficient energy source.

Loss of these energy efficiencies and substitute sources of energy for end-uses actually further concentrates the monopoly for electric utility service. The ability to easily substitute natural gas for electricity for a given end-use, and vice-versa, serves as an important curb on the monopoly powers of the energy utilities. Consumer choice is more limited if a builder or developer eschews dual energy construction and goes electric-only as an unintended consequence of imposition of hook-up fees.

If precluded from natural gas as an energy source, total electric energy consumption in Arizona would likely increase, not decrease, if large hook-up fees were imposed for either electric service or natural gas service or the combined effect of both electric and natural gas hook-up fees. This would only aggravate the need for additional electric generation and transmission resources and further large capital outlays by Arizona electric utilities. If adopted, any mechanism requiring large amounts of initial capital outlay to connect to essential utilities must be constrained by these impacts and potential consequences.

## **7. Effectiveness of hook-up fees**

### **- Full or limited benefit? *e.g.*, tax implications**

Consistent application of Southwest's ICM and CIAC and construction advance rules has improved Southwest's internal generation of funds for capital expenditures. While a properly designed hook-up fee might achieve a similar benefit for electric utilities, its ultimate effectiveness remains limited by the tax implications of such contributions to capital. Under current IRS rules, the utility must book the monies received as an offset to the capital plant

account and recognize the monies received as taxable income. The utility must pay the current taxes on the monies received, so current tax payments due are increased, but the utility does not have additional revenues, per se, to pay the increased taxes, so there is a diminished cash flow to the extent of the increased tax obligations. Additionally, because the utility records a lower amount for plant-in-service, there is less rate base upon which to apply the rate of return, further diminishing potential cash flows. So, under current accounting and IRS rules, imposition of a hook-up fee would be of only limited benefit.

There is also considerable question on how imposition of hook-up fees would be perceived by the rating agencies. If used as plant offsets, it is unlikely to be perceived as improving funds from operations in calculating debt coverage ratios. Nor is it certain if adding an unstable revenue source would be perceived any more favorably.

Southwest has observed that jurisdictions that utilize revenue stabilization mechanisms and more forward-looking measurements of plant-in-service are viewed more favorably by rating agencies in assessing the financial outlook for regulated utilities. These mechanisms are also available to the Commission to address the question of how to pay for growth-related capital expenditures while minimizing impacts to customers, reducing the need for frequent general rate cases, and improving the financial stability of the utilities.

#### **8. What are the competitive issues or concerns?**

Since all homes require electric service by necessity, but not natural gas service, builders may choose to incur only the hook-up fee for electric service and avoid the cost to provide natural gas service. The builder would utilize all electric appliances, rather than build a dual-energy home. Consumers would be essentially denied meaningful choice for appliance purchases, energy efficiency, and home comfort.

Also, because electric appliances typically have much lower source-to-end-use efficiencies compared to natural gas applications, total electric energy demands in the state may actually increase if such a single utility service choice was inadvertently incited. More electric generation and transmission would need to be installed and possibly more natural gas burned in the generation process, with commensurate increases in electric rates and the overall cost of natural gas to all consumers. There could also be a potential negative competitive impact for the natural gas service provider, as builders may opt to reduce their costs and provide only one

energy source (electricity) for the homebuyer.

If consumers bear the majority of the financial burden of hook-up fees, housing prices will increase. Under an assumption that consumers are freely mobile, consumers may refuse to pay higher prices in regulated utility service territories subject to hook-up fees (or simply be unable to afford the higher prices). Therefore, regulated utilities may be at a competitive disadvantage with non-regulated utilities with respect to customer growth.

**9. Would hook-up fees create customer confusion?**

**- What customer education would be necessary?**

Whether there would be customer confusion is more of a function of who bears the incidence of the hook-up fee. If assessed against the residential housing developer or commercial builder, the hook-up fee would most likely simply be passed through in the form of higher prices for the house or commercial structure. The hook-up fee is masked, in effect, and more than likely paid for over time in the form of higher mortgage payments or costs of financing the construction. Customer confusion could exist for random, individual line extensions, however. In those cases, the utility customer bears the entire burden of the hook-up fee, probably without the ability to spread such costs over time.

The amount of customer education (or resistance) is also dependent on the magnitude of the hook-up fee. If sufficiently low and generally affordable, especially relative to the resulting price of the home or building, customers are less likely to question the imposition of the hook-up fee than if the fee were set much higher.

Given the prevalence of impact fees charged by municipalities on new construction, customers may be aware of such fees and less education may be necessary. The issue of how best to educate customers on the topic of hook-up fees presents an opportunity for cooperation between the utilities, the Commission and the building industry to develop appropriate informational outreach prior to implementation.

**10. What types of infrastructure should be included in a hook-up fee?**

**11. Should hook-up fees attempt to pay for a new customer's full incremental cost?**

Questions 10 and 11 are closely related and therefore the responses combined. It is generally appropriate to utilize a marginal, or incremental, cost in determining the cost responsibility for adding new customers. Southwest utilizes this concept in its ICM analysis.

The ICM is a marginal cost model used to determine the economic feasibility of adding new customers; thereby ensuring the amount of investment for new customers is justified by the expected margin revenue from those customers and, in turn, protecting the interests of existing customers. Southwest currently includes operational expenses that are customer-sensitive in its ICM analysis, as well as the incremental capital expenditures for distribution mains and services. Similar costs should be included in any hook-up fee calculation. System reinforcement costs that benefit all customers, such as installing larger-sized mains and regulating stations, are typically excluded from ICM analysis. Maintenance expense should not be included in the analysis, since new facilities require less maintenance for a number of years.

During the workshop, questions were specifically posed to electric utilities about including generation as a component of an electric hook-up fee. The magnitude of an electric hook-up fee that includes generation as a component is likely to be substantial. Such a substantial electric hook-up fee very likely would result in the unintended consequences described earlier and displace opportunity for natural gas in the construction marketplace, thus limiting customer choice and decreasing aggregate energy efficiency throughout Arizona.

## **12. Should different sized customers pay different hook-up fees?**

Yes. If marginal costs principles are used to establish hook-up fees, then it is appropriate to charge fees based on customer size and demands expected to be placed on the utility system. Southwest's ICM utilizes this marginal cost approach. The ICM analysis is tailored to the individual circumstances for each line extension. The ICM recognizes the expected revenues from the new customer and the incremental costs to extend service to the customer. A similar approach can be used to develop hook-up fees.

## **CONCLUSION**

If the Commission decides to adopt hook-up fees as part of the range of options available to address the question on how best to fund growth-related capital expenditures, in an effort to protect customers from double-digit electric utility rate increases, then care must be taken to ensure the magnitude of such charges does not create competitive concerns or unintended consequences. Southwest believes that application of its existing main and service extension rules, through the use of the ICM, effectively shields existing customers from the costs of

growth, and obviates the need for natural gas hook-up fees throughout its Arizona service territory. There are additional mechanisms that may be more effective in providing more stable revenue streams for utilities to meet the challenges of growth and to fund the replacement of aging infrastructure.

Southwest looks forward to additional opportunities to work with the Commission, other energy utilities, and the other stakeholders in Arizona on this topic.

DATED at Las Vegas, Nevada this 1<sup>st</sup> day of November, 2007.

SOUTHWEST GAS CORPORATION



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Ajo Improvement Company  
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P.O. Box 631  
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Dixie-Escalante Rural Electric Assn., Inc.  
71 E. Highway 56  
Beryl, UT 84714-5197

Duncan Valley Electric Cooperative, Inc.  
P.O. Box 440  
Duncan, AZ 85334

Garkane Energy Cooperative, Inc.  
P.O. Box 465  
Loa, UT 84747

Morenci Water and Electric Company  
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Graham County Electric Cooperative, Inc.  
P.O. Drawer B  
Pima, AZ 85543

Mohave Electric Cooperative, Inc.  
P.O. Box 1045  
Bullhead City, AZ 86430

Navopache Electric Cooperative, Inc.  
1878 W. White Mountain Blvd.  
Lakeside, AZ 85929

Sulphur Springs Valley Electric Cooperative  
P.O. Box 820  
Willcox, AZ 85644

Trico Electric Cooperative Inc.  
P.O. Box 930  
Marana, AZ 85653

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By:   
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