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**Subject: <u>Docket No. G-01551A-07-0504</u>**

Southwest Gas Corporation (Southwest) hereby submits for filing an original and thirteen (13) copies of its Post-Hearing Reply Brief in the above-referenced docket. In addition, a copy will be provided to parties of record.

Respectfully submitted,

Debra S. Gallo By

Debra S. Gallo, Director
Government & State Regulatory Affairs

c ALJ Dwight Nodes, ACC
Ernest Johnson, ACC
Maureen Scott, ACC
Bob Gray, ACC
Stephen Ahearn, RUCO

Arizona Corporation Commission
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SOUTHWEST GAS CORPORATION

Docket No. G-01551A-07-0504

# 2007 ARIZONA GENERAL RATE CASE

## Post-Hearing Reply Brief

August 22, 2008

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**of**
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**of**
**Southwest Gas Corporation**
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**BEFORE THE ARIZONA CORPORATION COMMISSION**

**COMMISSIONERS**

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

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|---|---|
| IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS PROPERTIES THROUGHOUT ARIZONA | DOCKET NO. G-01551A-07-0504<br><br>**BRIEF** |

**POST-HEARING REPLY BRIEF OF SOUTHWEST GAS CORPORATION**

Southwest Gas Corporation ("Southwest" or the "Company") respectfully submits this reply brief in response to the initial closing briefs of the Arizona Corporation Commission Utilities Division Staff ("Staff"), the Residential Utility Consumer Office ("RUCO"), Southwest Energy Efficiency Project ("SWEEP"), and the Arizona Investment Council ("AIC").

## I.
## BRIEF SUMMARY INTRODUCTION

Prominent in the briefs of both Staff and RUCO is the acknowledgment that Southwest historically has been unable to earn its Commission-authorized rate of return. Unfortunately, however, neither Staff nor RUCO supports or advances any effective means of addressing the issues identified by the Company as being the primary causes – declining consumption and sensitivity to weather. On the other hand, Southwest has presented the Commission with a rate design package that includes a Volumetric Rate Design ("VRD"), a Weather Normalization Adjustment Provision ("WNAP"), and a Revenue Decoupling Adjustment Provision ("RDAP"), which will eliminate the Company's reliance on volumetric sales to recover its cost of service which, in turn, will remove the disincentive to promote conservation as well as stabilize the Company's authorized revenues, which ultimately benefits both customers and shareholders.

In addition to approving Southwest's proposed rate design package, Southwest urges the Commission to determine a cost of capital that provides an investor in the Company with a reasonable opportunity to realize a return commensurate with the return the investor would expect to realize from an investment with corresponding risks.

The recommendations of both Staff and RUCO, if adopted by the Commission, would result in an authorized rate of return inferior to all of the proxy groups utilized by Southwest, Staff, and RUCO. The Company urges the Commission to adopt Southwest's recommendation to align the interests of customers and investors by enhancing Southwest's opportunity to improve its financial profile, to the benefit of Southwest's customers in terms of improved earnings and the strengthening of Southwest's capital structure, which should result in higher credit ratings and, as a consequence, lower capital costs that are ultimately passed on to customers.

As more fully explained in this Reply Brief, Southwest contends that, as a matter of law, Southwest should be authorized to recover all operating expenses in the absence of any evidence that the operating expenses are unreasonable.[1] A "50-50 sharing" of an expense is a disallowance of 50 percent of the expense and, consequently, an explicit erosion of Southwest's opportunity to realize the Commission-authorized rate of return. The only relevant and lawful inquiries are whether the operating expense is prudent and reasonable. Inquiries regarding whether the incurrence of any particular expense benefits customers or shareholders [or both]

[1] *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (1978); *West Ohio Gas Company v. Public Utility Commission of Ohio*, 294 U.S. 63 (1935).

leads down a steep slippery, confiscatory slope. If the standard were an analysis of who benefits from the operating expense, one could make an argument, based upon vague and subjective notions of equity, that every operating expense, either directly or indirectly, benefits both the shareholder and the customer.

## II.
## RATE DESIGN

### A. The Commission Should Approve Southwest's Proposed Revenue Decoupling Package.

It is difficult to imagine that anyone observing the hearing would not intuitively come to the same conclusion - Southwest's proposed rate design package, which includes the VRD, WNAP, and the RDAP, provides the greatest degree of revenue and bill stability when compared to those of Staff and RUCO. Notwithstanding the fear provoking rhetoric contained in Staff's and RUCO's initial briefs, both Staff and RUCO are doing nothing more than what they have done historically - proposing rate designs that slightly shift a portion of the authorized margin into the basic service charge and loading the remaining margin into the volumetric charge. In fact, Staff expressly states that it places "emphasis on the volumetric component to encourage conservation choices."[2]

Even more frustrating is that both parties refuse to recognize the tangible benefits to the customers if revenue decoupling is implemented. Just as in Southwest's last general rate case, RUCO's and Staff's proposals put Southwest at greater risk of not recovering its authorized margin due to the associated risk of relying upon consumption levels to recover authorized margin, especially in light of the overwhelming evidence presented by the Company of declining residential use per customer and the proposals to increase conservation and energy efficiency programs. Conservation and energy efficiency are laudable goals, and Southwest would like to assist its customers to embrace them. However, helping a customer to conserve the resource - natural gas - is one thing; having a customer avoid paying for Southwest's fixed costs of providing gas service is another. The latter does something much different than merely conserve the resource – i.e., it encourages conservation at the expense of the Company by inequitably eroding Southwest's opportunity to recover Commission-authorized margin. This approach is unnecessary when there are other available methods of encouraging conservation without inequitably eroding the Company's opportunity to recover the Commission-authorized margin, i.e., the VRD, WNAP, and the RDAP.

1. Southwest's Proposed Volumetric Rate Design.

Both Staff's and RUCO's entire discussion of the Company's proposed VRD is inaccurate, misleading and unsupported by the record. For example, a simple comparison of Staff's and the Company's proposed effective commodity rates, as filed in testimony, applicable to all residential gas consumption, shows the disingenuous nature of Staff's position. Staff's proposed commodity rate is $1.49499. Southwest's proposed rate is $1.49065 – a difference of only $0.00434 per therm or $1.38 per year for an average residential customer using 319 therms. As such, Staff's assertion that its proposed rate design will better promote conservation when the proposed commodity charges are virtually identical is without merit.

In light of the foregoing, Staff's argument that the Company's proposal "does the precise opposite by removing any capacity of the ratepayer to realize any benefit from decreased usage"[3] should be summarily dismissed since Southwest's proposed commodity rate is nearly identical to

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[2] Staff Brief, p. 3, lns. 10-11.
[3] Staff Brief, p. 21, lns. 22-23.

Staff's. The two rate designs result in a price signal that should have the same effect on customers' incentive to decrease their usage. Therefore, Staff's remaining claims that its rate design will do a significantly better job promoting conservation than the Company's proposed VRD are baseless and should be given no weight by the Commission.[4]

Similarly, Staff's contention that "[f]or a customer whose usage remains in the first tier, there is no incentive to invest in reduced commodity usage"[5] is similarly without merit and contravenes the evidence. The reality is that customers will always save the gas cost or commodity cost portion of rates. Such an argument by Staff is tantamount to arguing that just because you purchased a new car and have a car payment means you should not limit the amount of your driving to save on fuel costs.

RUCO's analysis and discussion regarding the Company's VRD continues to be flawed, as demonstrated during the hearing by RUCO's failed attempt to explain its understanding of how the VRD functions.[6] As noted in Southwest's initial post-hearing brief, RUCO continues to ignore the difference in gas costs and non-gas costs, and the inverse relationship between the two.[7] For example, small users pay a smaller portion of gas costs, but a higher portion of non-gas costs, and as customer usage increases, the allocation of gas costs and non-gas costs changes so that larger users pay a higher portion of gas costs as compared to non-gas costs.[8]

Despite RUCO's arguments, Southwest has clearly demonstrated throughout the course of this proceeding that the VRD is indeed revenue neutral and does not shift revenue recovery from large users to small users. RUCO's opposition is without merit and should be disregarded.

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[4] Staff Brief, p, 22, lines 3-5
[5] Staff Brief, p. 21, lines 25-26
[6] Tr. p. pp. 1306-131366, lns. 20-22, Vol. VII.
[7] Congdon Rejoinder Exhibit ____ (ABC-1) and Tr. pp. 1309-1311.

2. Full Revenue Decoupling - Southwest's Revenue Decoupling Adjustment Provision and Weather Normalization Adjustment Provision.

Staff opposes the adoption of the Company's proposed full revenue decoupling (RDAP/WNAP) based upon the inaccurate and misleading argument that such rate designs will "guarantee an authorized rate of return".[9] This statement is patently false and the record is replete with evidence that Southwest's full revenue decoupling proposal (WNAP and RDAP) only assures that the Company will recover its authorized margin per customer for the number of customers actually receiving service. Southwest's proposed decoupling mechanisms, particularly the RDAP, does not "prevent downward movement in our earned rate of return."[10] Revenue decoupling only stabilizes revenues per customer.

Similarly, Staff's statement that "[f]inancial protection via the revenue decoupling mechanisms is unwarranted as Staff's proposed rate design permits the relief that the Company is entitled to, an opportunity to earn a reasonable return on its fair value rate base"[11] rings hollow in light of the continued financial pressure experienced by Southwest due to declining consumption per residential consumption and the fact that Staff's current proposal offers nothing different than its proposal in the Company's last rate case.

Contrary to the implications that have been made by both Staff and RUCO, there is nothing wrong with providing Southwest greater assurance of recovering its Commission-authorized margin. Commission-authorized margin is different from the Commission-authorized rate of return, and one should not lose sight of this difference. A rate design is supposed to

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[8] Congdon Rejoinder Exhibit_(ABC-1)
[9] Staff Brief, p 24, lns. 14-15.
[10] Staff Brief, p. 3, ln. 20
[11] Staff Brief, p 22, lns. 27-28; p. 23, lns. 1-2.

permit the Company to recover its Commission-authorized margin.[12] Once the Commission establishes the revenue requirement, the Commission must establish rates to permit the recovery of the Commission-authorized revenue requirement; anything less is confiscatory.[13]

*a. Staff's and RUCO's Risk Shifting Argument.*

Staff and RUCO both contend that the Company's full revenue decoupling proposals result in shifting almost all risk that shareholders now bear onto the shoulders of the ratepayer.[14] AIC witness Dr. Hansen took issue with this characterization: "[t]hey make this claim repeatedly and without any support or justification. It seems to be based on a view that risk is a zero sum game, so that if risk is reduced for one party, it must be increased for another."[15] As Dr. Hansen further explained, "[p]rior to the adjustment, both the utility and the customer faced weather risk. After the adjustment, neither the utility nor the customer face weather risk. This demonstrates that a weather adjustment mechanism reduces risk for both the utility and the ratepayers."[16] The WNAP will reduce the variability of the non-gas portion of the bill for customers and reduces the variability of non-gas revenues for the Company."[17]

Even with full revenue decoupling, customers still save the gas costs, which coincidentally make up the majority of volumetric rate costs. Customers also pay no more than the Commission-authorized margin, which is coincidentally the same customers would pay under Staff's and RUCO's proposed rate design if customers actually consumed the level of gas used to establish rates. As such, these are not the effects of shifting risk to customers, but rather

[12] *Scates v. Arizona Corporation Commission,* 118 Ariz. 531, 578 P.2d 612 (1978); *see also, Peoples Organization for Washington Energy Resources v. Washington Utilities and Transportation Commission,* 711 P.2d 319 (Wash. 1985).
[13] *Id.*
[14] Staff Brief, p. 22, lns. 14-15.
[15] Hansen Rejoinder [sic], p. 7, lns. 5-7.
[16] *Id.* at lns. 19-21.

mitigating risk to the Company and customers.

*b. RUCO's and Staff's Argument That Full Revenue Decoupling Will Deter Conservation.*

Contrary to Staff's and RUCO's contentions, full revenue decoupling will not create a disincentive to conserve for the simple reason that the more a customer conserves the more a customer saves. As explained by Mr. Congdon, the RDAP actually sends a better price signal between rate cases to encourage conservation:

> We want to have processes and rate designs in place that will provide a greater reward to customers who conserve, and also tell people or send a price signal to customers that don't conserve, maybe I am paying a little more than I otherwise would be because I am not conserving here.[18]
>
> and:
>
> And what we are trying to do, as I said a moment ago, is figure out a process or a rate design that will encourage customers to use less gas. And the RDAP adds a little bit to that price signal encouraging customers to conserve, because it adds just a little bit to their conservation related savings. And at the same time, it forces people who don't conserve to pay just a little bit more. So in both examples, it is sending an appropriate price signal to promote conservation.[19]

Rather than creating a disincentive to engage in conservation, full revenue decoupling provides both a greater reward, i.e., savings to customers who do conserve and, importantly, a greater penalty, i.e. increased cost for gas service, to customers who do not conserve. The advantage of the RDAP is that it provides for gradual increases in rates, which sends an improved price signal between rate cases, and allows much more freedom in designing rates than would otherwise be the case.

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[17] Hansen Rejoinder [sic], p. 8, lns. 8-10.
[18] Tr. p. 800, lns. 1-6.
[19] Tr. p. 802, lns. 3-12.

c. *Staff's Argument That Decoupling is Not Needed Due to Experienced Customer Growth.*

Staff's allegation that the Company could actually overearn in a high growth climate such as it is presently experiencing contradicts the evidence presented in this proceeding. The additional net income from new customers does not come without the investment in significant new infrastructure[20]. Staff's suggestion that the additional margin from customer growth "is 57 percent more than the lost net margin due to declining usage" is completely without merit and especially damaging to its case because it clearly shows that in its zeal to defeat decoupling, Staff has lost its ability to perform the type of objective analysis required to assist the Commission in reaching correct and sound decisions. The $9.9 million referenced by Staff is indeed 57 percent greater than the lost net margin of $6.3 million related to declining usage. However, Staff fails to recognize the fallacy in such a position because of the failure to consider the costs incurred by the Company to serve new customers.[21]

Company witness Robert. Mashas testified that the margin from new customers requesting service since the last rate case was $38 million and the cost of adding those new customers was $33.4 million.[22] Therefore, the Company had a sufficiency of $4.6 million (the difference between $38 million and $33.4 million) to be applied to the $6.3 million of lost margin Southwest experienced from declining consumption per customer. Stated another way, if you apply the 12.1 percent sufficiency ($4.6 million divided by $38.0 million) that results from the $38.0 million of margin from new customers to the margin from new customers referred to by Staff of $9.9 million, it yields only $1.2 million in margin from customer growth to offset the

[20] Staff Brief, p. 30, lns. 15-22.
[21] Congdon Rejoinder, pp. 9-10.
[22] Mashas Direct, pp. 16-17.

$6.3 million deficiency from declining consumption calculated by Southwest.

Staff's argument misleads the Commission to think that margin from new customer growth more than offsets margin lost to declining use per customer. This argument is without merit and should serve to diminish the value of Staff's case as it further illustrates Staff's purported desire to deliberately ignore the facts in this case in an attempt to win the arguments at all costs.

*d. The Impact of Full Revenue Decoupling on Low Income Customers.*

In its quest to defeat decoupling at all costs, Staff also throws out several other imaginary barriers to refute the benefits of full revenue decoupling to Southwest's Arizona customers. For example, Staff points to the impact of decoupling on the Company's low-income customers as a reason to reject its adoption.[23] Such a contention is a red herring, as Southwest has agreed to hold such customers harmless if the Commission so desires.[24]

Further, if one looks beyond the politically-charged rhetoric, Staff's concern can be deconstructed. The Company has four components to its decoupling proposal. The first, a proposed $12.70 basic service charge for Schedule G-5 (Residential Gas Service), does not apply to low-income customers. The second component, a volumetric rate with margin collected in the first block, cannot result in an "automatic bill increase"; nor does it discriminate against low-income customers, who will receive a 20-23% discount to the rate. The third component, the WNAP, is a symmetric mechanism that is equally likely to produce decreases as increases; the decreases would occur during colder-than-normal winters--the time low-income customers would likely be in greatest need of a downward bill adjustment. Finally, the RDAP may benefit

[23] Staff Brief, p. 23, lns. 3-4.
[24] Tr. p. 434.

low-income customers particularly. During hearing, Commissioners Hatch-Miller and Mayes suggested in cross-examining Company witness Mr. Congdon, that low-income customers may reside in less-efficient, poorly insulated homes; the very homes likely stand to gain the greatest relative benefit of Southwest's ongoing DSM commitment, and Southwest's increased motivation to encourage increased energy efficiency and conservation should the Commission approve the RDAP.

*e. Miscellaneous Unavailing Arguments.*

In further effort to defeat decoupling at all costs, Staff and RUCO throw out additional unsupported, incorrect, or specious arguments that are misleading, purportedly in hopes of discouraging any sincere consideration for the approval of full revenue decoupling for the benefit of Southwest and its Arizona customers.

- **RUCO's Argument That Customers Pay for Gas Service They Do Not Use.**[25] Full revenue decoupling does not require customers to pay for a level of gas service they do not use. In fact, the mechanisms do exactly the opposite by ensuring that customers, in total, pay only for the level of gas service they receive. As Southwest has repeatedly explained and no one has presented evidence to the contrary, neither the cost nor level of Southwest's non-gas service changes when a customer reduces his or her usage. As such, it is a fallacy for RUCO to claim that full revenue decoupling makes customers pay for gas service they do not use.
- **Full Revenue Decoupling Negatively Impacts the PGA.**[26] This inquiry is merely more hand-wringing and unnecessary supposition. Southwest demonstrated in this proceeding that neither the WNAP, RDAP, nor the VRD have any effect on the PGA mechanism. Contrary to Staff's contention, there is no disagreement as to what adjustments would be necessary because Staff never took a position on what adjustments it believes are necessary to the PGA. To the contrary, the Company demonstrated on the record both in prefiled written testimony and at hearing that no such adjustments are needed.
- **Equal Payment Plan ("<u>EPP</u>") Eliminates the Need for the WNAP.**[27] The Company never contended that the WNAP would "result in 'levelized' bills throughout the year." This was another imaginary barrier thrown up by Staff. To the contrary, the WNAP

[25] RUCO Brief, p. 3, lns. 11-13.
[26] Staff Brief, p. 23, lns. 17-18.
[27] Staff Brief, p. 24, lns. 20-25.

moderates fluctuations in customer bills – it does not levelize them. The WNAP adjusts customer bills up and down on a real-time (monthly) basis to account for variations in usage related to weather. The EPP only takes actual weather-sensitive bills and averages them over a 12-month period. A particularly harsh winter will ultimately result in an upward annual adjustment to customers' bills under the EPP. Unlike the EPP, the WNAP will prevent customers from having to pay more than the Commission-authorized margin per customer as a result of colder-than-normal weather.

- **Lack of Sufficient Detail.** Staff's contention that the Company's decoupling mechanisms "have not been submitted with sufficient detail to implement as proposed" is another unfounded statement and contravenes the evidence presented.[28] The parties have had ample opportunity to vet these proposals, request additional explanations, calculations and analysis over the past 12 months. Not to mention the fact Southwest requested a form of revenue decoupling in its last general rate case and the parties had the same opportunities in that proceeding to vet the issues, and the parties participated in decoupling collaboratives following the last general rate case to further study decoupling. Staff's argument is simply a desperate attempt to avoid implementation of revenue decoupling at all costs. There should be no more postponing of this issue, the time for implementation is now.
- **Examples of Failed Decoupling for Electric Utilities.** Staff's examples of failed revenue decoupling with the "Washington experience" is irrelevant to the determination in this proceeding.[29] The Washington experience involved an electric utility and it failed because of the addition of new power plants and extended drought. Southwest is a natural gas company – not an electric company. Therefore, such comparisons are misplaced. Contrary to the misleading information proffered by Staff, there are Washington gas distribution companies that currently have decoupling mechanisms in Washington –Avista and Cascade Natural Gas. Furthermore, contrary to the information presented by Staff, in late 2007, the New York Public Service Commission approved decoupling mechanisms for both Consolidated Edison Company of New York and National Fuel Gas Distribution Company. The only cases to which Staff references in support of its effort to defeat decoupling relate to old electric company decisions that are irrelevant here and merely provide further evidence of Staff's zeal to win its arguments at all costs.

3. The Time Is Right – For Increased Energy Efficiency/Conservation Concurrent with Approval of Full Revenue Decoupling.

Staff goes to great lengths to make the argument that adoption or approval of the Company's proposed decoupling mechanisms is premature.[30] Southwest believes the exact

[28] Staff Brief, p. 25, lns. 9-10.
[29] Staff Brief, p. 22,
[30] Staff Brief, pp. 23-24.

opposite to be true. Adoption of Southwest's proposed decoupling mechanisms is not premature and given that there is an investigatory docket open, now is the ideal time to implement Southwest's revenue decoupling mechanisms so they can be studied as part of the investigatory docket. SWEEP agrees:[31]

> Also, a pilot of the RDAP and WNAP decoupling mechanisms in the Southwest Gas territory could provide useful, real-world information for review and consideration during the generic investigation.

Incredibly Staff also contends that "[m]ost importantly, there is absolutely no evidence in the record that any purported declines in customer usage are the result of the Company's DSM programs. It is simply impossible to say at this time that the existing rate design is creating a disincentive for Company initiated conservation programs."[32] This statement is nonsensical and entirely contrary to the evidence presented in this proceeding. Under Staff's and RUCO's proposed volumetric rate designs, if the Company were to cut its sales, it does not generate revenue and cannot recover its fixed costs. Query: Why would any company purposely endeavor to reduce its revenues when the end result will be a resulting deficiency?

Even more incredibly, Staff questions whether there is additional opportunity for conservation in the state of Arizona[33]: "However, since it is unclear if conditions permit extensive additional conservation in this circumstance, Staff is unable to support a decoupling mechanism on this basis."[34] Is Staff stating that there is little or no opportunity for conservation in the state of Arizona? How does Staff reconcile this position with its recommendation to increase DSM funding or its support of DSM programs? Apparently, in Staff's opinion, these

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[31] SWEEP Brief, p. 7, lns. 21-23.
[32] Staff Brief, p. 26, lns. 22-25.
[33] Staff Brief, p. 29, lns. 25-26.

irrational and unsupported suppositions are additional reasons why the Commission should reject decoupling for Southwest's Arizona customers. Southwest is concerned that remarks of this nature reflect callousness for Southwest's customers rather than concern for customers, much less a fair balance of customer and investor interests.

Staff's heightened concern that "purported" declines in customer usage be the result only of the Company's own programs is sadly misplaced. All reductions in customer usage, whether from the Company's own efforts or not, are good for customers and the state of Arizona, because reductions in usage result in dollar savings for Southwest's customers, reductions in greenhouse gases, and reductions in the demand for natural gas. Staff's concern that it is "unclear"[35] how much more conservation can occur also demonstrates a similar disregard for the best interests of Southwest's customers, and raises the concern that Staff is more focused on "winning" its argument against decoupling at all costs than doing what is best for Southwest's Arizona customers. If Staff truly believes that there is little additional conservation to be gained, what possible harm is there to implement the WNAP and RDAP on a pilot basis as proposed by Southwest, SWEEP and AIC because there would be no surcharge.

Further, Southwest has provided evidence demonstrating that decoupling would position the Company to undertake greater effort to promote conservation, per its attachment to its Opening Brief, <u>to the benefit of its customers</u>. Southwest finds it perplexing that Staff and RUCO are so vehemently opposed to, without foundation, solutions that clearly can provide substantial benefits to Southwest's customers without imposing an additional undue burden.

Staff's and RUCO's proposals do little more than maintain the status quo – to the

[34] Staff Brief, p. 30, lns. 4-5.
[35] Staff Brief, p. 29, ln. 25.

detriment of both Southwest's customers and its shareholders. Southwest submits, and the record in this case supports, that the Commission should implement Southwest's proposed full decoupling mechanisms (WNAP and RDAP), require the Company to aggressively promote conservation as proposed in the Company's Attachment 3 to its Opening Brief, and study the effectiveness of the program in the Commission's investigatory docket to determine if customers are indeed better served by taking proactive measures than simply maintaining the status quo, as Staff and RUCO suggest.

The Company presented ALJ Nodes and this Commission with a variety of rate design options and regulatory mechanisms which, when implemented, would produce a win-win for both the Company's customers and shareholders. With its proposed revenue decoupling mechanisms, the Company would realize its Commission-authorized margin levels, customers would be protected against an over-recovery of margin and all stakeholders could embrace conservation and energy efficiency to make the best use of the resource and maximize customer savings – without harm to any of the affected interests.

## III.
## COST OF CAPITAL

### A. Capital Structure.

Staff presented no novel arguments in its initial post-hearing brief to support its use of a capital structure consisting of 43.44 percent common equity, 4.48 percent preferred equity, and 52.08 percent long-term debt.[36] Furthermore, Staff is incorrect and mischaracterizes the evidence when it claims that Southwest provided no documentation to support its claim that the

[36] Parcell Direct, p. 2, lns. 20-26, p. 3, lns. 1-4.

Company has already exceeded its target capital structure.[37] Company witness Theodore Wood included in his Rejoinder testimony Exhibit No. ___ (TKW-1), which is from the Company's Monthly Operating Report[38] and demonstrates that Southwest has achieved a 45.1 percent common equity ratio, which is slightly higher than the equity component in Southwest's recommended capital structure. In addition, the Company's first and second quarter Form 10-Q filed with the Securities and Exchange Commission (SEC) also verify this contention.

As explained in more detail in Southwest's post-hearing brief, the reasonableness of Southwest's proposed capital structure is demonstrated by the following unrebutted points:

- Southwest has a lower common equity ratio (45.1 percent) than the average expected capital structure of Staff's proxy group of 58.3 percent during the expected rate effective period.[39]
- Southwest's common equity ratio at year end March 31, 2008 was 45.1 percent, which is greater than the requested target of 45 percent.
- Southwest's proposed capital structure contains less common equity (45 percent) than the average expected common equity ratio of the proxy groups used by Southwest and RUCO (57.5 percent).[40]
- Southwest has made significant improvement and continues to improve its common equity ratio, and there is no evidence to suggest that this improvement will not continue.[41]
- Use of a target capital structure or a capital structure that best reflects the conditions Southwest will experience during the rate effective period is consistent with other recent Commission decisions.[42]

Based upon the foregoing, Southwest's recommended capital structure is reasonable and best reflects the conditions Southwest will experience during the rate effective period.

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[37] Staff Brief, p. 33, ln. 24.
[38] In compliance with the Commission's Decision No. 54716 issued in Docket No. U-1551-85-267, Southwest provides the Commission a copy of the Company's Monthly Operating Report on a monthly basis.
[39] Parcell Surrebuttal, Exhibit DCP-5; Tr. p. 1207, lns. 21-25; p.1208, lns. 1-2.
[40] Wood Rebuttal p. 3; Wood Rejoinder, p. 3; Wood Rebuttal Exhibit No.__(TKW-4), Sheet 1 of 2.
[41] Wood Rejoinder, pp 6-7.

Consequently, the Commission should adopt the capital structure recommended by RUCO and Southwest.

**B. <u>Southwest's Increased Financial and Investment Risk as Compared to Peer Utilities</u>.**

Staff repeatedly contradicts itself with respect to its position regarding whether Southwest is a greater financial and investment risk compared to the proxy group. Staff states several times in its initial brief that Southwest is no more and no less risky than any similar LDC and that Southwest has failed to produce substantive proof to support its contention that it is a greater investment risk than other similar LDCs.[43] Staff then contradicts itself by recognizing that Southwest's lower equity ratio makes it more of an investment risk because of its need to borrow capital.[44] Similarly, one of Staff's arguments against revenue decoupling is that "[b]y all accounts, the Company is growing rapidly in Arizona and will continue to grow."[45] Yet, with respect to determining a proper cost of capital, Staff is not nearly as aggressive in describing the Company's growth and instead only states that "assuming, *arguendo,* that Southwest does have a greater growth rate than similar LDCs, it stands to reason that Southwest needs greater capital investment to build infrastructure."[46] Staff continues by acknowledging that with the greater growth, the Company has greater capital needs and a greater demand to borrow money, which results in an assignment of greater risk from investors.[47]

Notwithstanding Staff's inconsistencies on this issue, Southwest's greater financial and investment risk is demonstrated by the following uncontroverted points:

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[42] UNS Gas Decision No. 70011; *see also*, UNS Electric Decision No. 70360.
[43] Staff Brief, p. 37, ln. 5 and p. 38, lns. 3-4, 7-8.
[44] Staff Brief, p. 37, lns. 12-24.
[45] Staff Brief, p. 30, lns. 17-18.
[46] Staff Brief, p. 37, lns. 25-26.
[47] Staff Brief, p. 37, lns. 25-28.

- Staff witness Parcell acknowledges that Southwest presents a greater financial and investment risk than the proxy group.[48]

- Staff's proxy groups have higher bond ratings from Moody's (A3) and S&P (A) than Southwest (Baa3 and BBB-, respectively).[49]

- Staff's proxy groups have stronger business and financial risk profiles (excellent and intermediate) than Southwest (strong and aggressive).[50]

- Standard & Poor's Ratings Direct, Issuer Ranking: U.S. Natural Gas Distributors and Integrated Gas Companies, Strongest to Weakest, dated June 13, 2008, which ranks the U.S. natural gas distributors and integrated gas companies in terms of credit rating outlooks, business risk profile, and financial risk profile lists Southwest near the bottom of that list as number forty-four out of forty-nine.[51]

- Southwest has a lower equity ratio than the proxy groups utilized by the parties, including Staff's proxy groups.[52]

Staff also incorrectly assigns blame for the Company's investment risk and financial performance solely on Southwest based upon a specious argument that higher leverage has led to the Company's inability to earn its authorized rate of return.[53] Staff fails to recognize that the Company's financial performance and bond ratings are significantly impacted by the end-result of the regulatory process. The reality is that the rate-making paradigm in Arizona for Southwest has not provided a reasonable opportunity for the Company to earn its authorized rate of return, primarily due to the lack of regulatory support in improving revenue stability due to declining consumption per customer and susceptibility to variations in weather. This problem is further compounded by significant historic customer growth, which has further negatively impacted the Company's ability to improve its capital structure and bond rating.

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48 Parcell Direct, p. 34 and Tr. p. 1168, lns. 1-4.
49 Hanley Exhibit ___ (FJH-15) Sheet 1 of 3.
50 *Id.*
51 Exhibit A-40.
52 Wood Rebuttal Exhibit No. ____ (TKW-4).
53 Staff Brief, p. 37, lns. 22-23.

The importance of regulation in the overall creditworthiness of a utility can be found in the following statement from S&P[54]:

> Indeed, Standard & Poor's views the regulatory and political environment in which a utility operates as one of the most significant factors in assessing the creditworthiness of regulated utilities... For regulated entities, however, the ability to generate revenues almost entirely depends on regulatory decisions.

The U.S. Supreme Court has also recognized the importance of regulation in *Duquesne Light Co. v. Barasch*:

> The risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks.[55]

Indeed, despite Staff's unsupported and contradictory remarks in its brief, Southwest is more of an investment and financial risk than the proxy group. Furthermore, the rate-making paradigm in Arizona is also a risk factor that investors will consider. Accordingly, the return on equity must be commensurate with this heightened risk associated with Southwest.

**C. <u>Return on Equity</u>.**

Staff describes in its initial brief the purpose of establishing an appropriate cost of common equity and the consideration to investor expectations. Specifically, Staff notes that "[t]he cost of common equity is an attempt to estimate the return on investment in a company's stock that investors will require once they take into consideration the associated risks and the available alternatives."[56] Staff then cites Roger Morin stating that "[a] rational investor is maximizing the performance of his or her portfolio only if returns expected on investments of

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[54] Standard & Poor's, Criteria: Influence of Regulatory and Policy Decisions on Utility Credit Quality Deepens, Demanding Timely Assessments From Standard & Poor's, May 15, 2007. Rejoinder Exhibit No.__(TKW-4)
[55] *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 315 (1989).

comparable risk are the same. If not, the investor will switch out those investments yielding low returns at a given risk level in favor of those investments offering higher returns for the same degree of risk."[57] Yet, Staff never explains why it believes an investor would make an investment in Southwest at Staff's recommended return on equity of 10.0 percent relative to its recommended 43.44 percent common equity ratio.

To this point, Staff relies upon a proxy group of what it believes to be similarly situated gas distribution companies to predict the return investors will expect in order to invest in Southwest's common stock.[58] In other words, the companies Southwest will compete against for common equity capital. However, Staff recommends an authorized return on equity of 10.0 percent relative to a 43.44 percent common equity ratio for Southwest, yet Staff's proxy group reflects the following characteristics:

| **Average Actual Equity Ratio[59]** | **Average Projected Equity Ratio[60]** | **Average Actual Returns[61]** | **Average Projected Returns[62]** |
|---|---|---|---|
| **50.4%** | **58.3%** | **13.2%** | **12.2%** |

In light of the above, one must ask the question: why would an investor choose to invest in Southwest? Staff never answers this question.

The Company submits that no rational investor would make the switch from a proxy group company, and that is why its recommendation of a return on equity of 11.25 percent

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[56] Staff Brief, p. 34, lns. 11-13.
[57] Staff Brief, p. 34, lns. 19-22 (citing Morin, Roger A., "New Regulatory Finance", Public Utilities Reports, Inc., 1994, p. 21).
[58] Staff Brief, p. 35, lns. 13-15.
[59] Parcell Surrebuttal, Exhibit DCP-5.
[60] *Id.*
[61] Parcell Surrebuttal, Exhibit DCP-9.
[62] *Id.*

relative to a 45 percent common equity ratio best reflects the return that investors will require to make the switch from a proxy group company to Southwest.

**D. <u>Impact of Revenue Decoupling</u>.**

Staff's assertion that if the Commission adopts any of the decoupling proposals that a further downward adjustment to the ROE is necessary is logically incomprehensible. As noted in the post-hearing brief, seven of the eight gas distribution companies that make up the proxy group relied upon by Southwest and RUCO, and that make up one of the two proxy groups relied upon by Staff, already have revenue stabilization in the form of revenue decoupling, performance based rates, or weather normalization.[63] At present, Southwest has no revenue stabilization tariff mechanisms.

Accordingly, if the Commission adopts Southwest's proposal the Company would then be on par with the proxy group and no ROE adjustment would be necessary – as any purported risk reduction is already reflected in the proxy group. However, if the Commission does not approve any of the Company's proposed tariff mechanisms to help with revenue stability, then Southwest would be at a disadvantage vis-à-vis the proxy group and a 25 basis point upward adjustment to the ROE would be warranted to reflect the continued increased risk Southwest would face compared to the proxy group.[64]

**E. <u>Fair Value Rate of Return</u>.**

As explained by Southwest in its initial post-hearing brief, Staff's recommendation is arbitrary and unreasonable as it results in less operating income than under a strictly original cost rate base approach. To the contrary, Southwest's proposal is well founded, reasonable, and

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[63] Hanley Rebuttal, pp. 5-6 and Hanley Rebuttal Exhibit No. ____ (FJH-16), Sheet 2 of 2.
[64] Hanley Rejoinder, pp. 10-11.

consistent with the Arizona Appeals Court decision in Chaparral. Southwest's recommendation to assign a 2.05 percent net of inflation risk free rate to the fair value increment is appropriate.

## IV.
## REVENUE REQUIREMENT

With the exception of the expenses associated with the Management Incentive Plan ("MIP") Supplemental Executive Retirement Plan ("SERP") and the stock-based incentive plan ("SIP"), to which both Staff and RUCO take issue, there is no other issue associated with the Company's revenue requirement that is shared by both Staff and RUCO. Accordingly, Staff's and RUCO's issues are addressed separately, except for compensation-related expenses.

**A. Reply to Staff's Positions.**

1. American Gas Association Dues.

Despite the fact that the Company provided numerous supporting exhibits and testimony pertaining to member savings in relation to member dues and responded to approximately thirteen data requests that included multiple subparts pertaining to the American Gas Association ("AGA") costs, functions, activities, and benefits the Company receives from the AGA,[65] Staff asserts that "Southwest has not provided any work papers or other documentation that would substantiate the claim."[66] To the contrary, in addition to all the information identified by Southwest in its initial post-hearing brief that was provided to the parties in this case, this information was furnished by the AGA. Contrary to the implications by Staff regarding the veracity of the information, there is no better source for this information. Furthermore, Staff contends that the Company "has failed to demonstrate that ratepayers should fund activities

[65] Aldridge Rebuttal Exhibit No. ____(RLA-1) and (RLA-2); Aldridge Direct Exhibit No. ____ (RLA-2); *See also* Southwest Brief p. 51.
[66] Staff Brief, p. 8, lns. 23-24.

conducted through an industry organization that would be subject to disallowance if conducted directly by the utility."[67] However, Staff has never identified the activities or components it finds objectionable if it were Southwest engaging directly in the functions being conducted by the AGA. Southwest gains multiple efficiencies by being a member of AGA and having the AGA's resources available to it. This was confirmed by Company witness Randi Aldridge. AGA member benefits amount to $479 million of annual savings or avoided costs, in comparison to only $18 million in total membership dues.[68] Accordingly, Staffs proposed disallowance should be rejected, and these benefits should not be disallowed.

2. <u>Injuries and Damages</u>.

In its initial brief, Staff continues to take exception to the Company's proposed methodology for deriving the self-insured portion of injuries and damages expense.[69] As discussed in the Company's initial brief, Staff deviates from the methodology agreed to by the parties in Southwest's last general rate case and proposes a new methodology for calculating the level of self-insured retention. Staff's methodology fails to recognize that the present level of aggregate insurance has not been in place for a period of 10-years and because Southwest does not have <u>recorded amounts</u> for 10 years using the current aggregate amount, Staff's calculation does not accurately reflect the level of self-insurance the Company expects to experience during the rate effective period. Staff's calculation also fails to recognize that the parties in the last general rate case agreed to record the aggregate level of insurance as a system allocable expense.

Staff's characterization of the 2005 incident as unprecedented and non-recurring is unfair and misleading. As discussed in Southwest's initial brief, the reason it is larger than all other

[67] Staff Brief, p. 8, lns.:26-27; 9,:lns. 1-2.
[68] Aldridge Rebuttal, p. 9.

system-allocable amounts is that it is the first of its kind under the methodology employed by the parties in the last general rate case.[70] Southwest's methodology utilizes the anticipated amounts based upon actual incidents as if the current aggregate level of insurance had been in place for the past 10 years. In a ten-year average it is highly likely that any one year will be significantly higher or lower than the average, thus there is a need to use a ten-year average. During this ten year period, the Company had two incidents that met or exceeded the aggregate limit and had eight years with little or no activity. Given the ten year period, it is not surprising that there were two years with "overstatement" and one year with a significant "understatement". Below are two tables demonstrating two different treatments of the Company's injuries and damages expense. Table A demonstrates the Company's accounting for the Tucson Arizona accident as a System Allocable Common expense (as proposed in this case).

**Table A**

| Line No. | Year | | Arizona Direct | | Total Common | | Common Allocated to Arizona | | Total Arizona | | Over/(Under) Statement |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | 2005 | $ | 1,360,224 | $ | 10,367,500 | $ | 5,655,471 | $ | 7,015,695 | $ | (5,284,383) |
| 2 | 2006 | | (975,540) | | 200,000 | | 108,909 | | (866,631) | | 2,597,943 |
| 3 | 2007 | | 713,629 | | (25,500) | | (13,886) | | 699,743 | | 1,031,569 |

**Source:**
**Lines 1 - 3: Docket No. G-01551A-07-0504 ACC Staff Attachment RCS-5 Page 148 of 155**

69 Staff Brief, p. 2, lns. 10-13.
70 Mashas Rejoinder, p. 7, lns. 15-23.

Table B reflects the 2005 incident as if it were recorded as an Arizona expense.

**Table B**

| Line No. | Year | | Arizona Direct | | Total Common | | Common Allocated to Arizona | | Total Arizona | | Over/(Under) Statement |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | 2005 | $ | 10,360,224 | $ | 367,500 | $ | 200,471 | $ | 10,560,695 | $ | (8,829,383) |
| 2 | 2006 | | (975,540) | | 200,000 | | 108,909 | | (866,631) | | 2,597,943 |
| 3 | 2007 | | 713,629 | | (25,500) | | (13,886) | | 699,743 | | 1,031,569 |

**Source:**
**Lines 1 - 3: Docket No. G-01551A-07-0504 ACC Staff Attachment RCS-5 Page 148 of 155**

It is interesting to compare the Tables above to Staff's table on p. 11 of Staff's initial post-hearing brief. Staff chose to limit its table to the years 2006-2007 to support its contention that the Company's methodology overstates the actual recorded amounts. Indeed, when you focus solely on years 2006-07 it could lead one to believe that the amounts were overstated. However, when you include the recorded amounts in 2005 with the 2006-07 recorded amounts (as noted in the Tables above), this inclusion completely undermines Staff's argument and it becomes obvious why Staff did not include the 2005 recorded amounts in its table.

The Company's methodology for calculating its level of self-insurance is consistent with its last general rate case as is the dollar amount proposed by the Company. As set forth in Southwest's initial brief, the Company's proposed level of self-insurance is $1,762,000, which is roughly $31,000 or only one percent different from the approved level in the last general rate case[71] and Southwest has adequately demonstrated the reasonableness of the Company's requested level of self-insured retention expense. As such, the Commission should adopt its proposed methodology with respect to its Injuries and Damages expense.

[71] Southwest Brief, p. 56.

3. Yuma Manors.

Staff's recommendation regarding Yuma Manors is based upon a mere "belief" and not on the evidence.[72] Staff's brief attempts to support its "belief" by making careless and unsupported statements regarding negligence, characterizing the purported incident as a substantial contributing cause, claiming the Company did not conduct CP monitoring correctly in 2006, and claiming the Company examined the pipe when it replaced the ground bed.[73] Staff carelessly assigns negligence to the Company without demonstrating the necessary elements to support a claim of negligence, let alone citing to evidence in the record to factually support this contention.[74] Staff's leap to this conclusion overlooks the fact there is no evidence that the Company had knowledge of this employee purportedly making an error, that the Company failed to properly supervise or failed to properly train the employee, or that the Company was otherwise negligent in any respect with regard to the Yuma Manor pipe replacement project or the events leading up to the replacement.

Staff's initial brief also incorrectly states that Southwest did not conduct cathodic protection monitoring correctly in 2006.[75] To the contrary, Company witness Jerry Schmitz testified that Southwest conducted cathodic protection monitoring of the Yuma Manors system in 2006 and provided documents verifying this contention as part of Rebuttal Exhibit No. ___ (JTS-3).[76] Furthermore, Staff contends that the Company conducted a visual inspection in 2006 and cites to pages 224 and 225 of the hearing transcript to support this assertion.[77] Yuma Manors is

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[72] Staff Brief, p. 15, lns. 26-27.
[73] Staff Brief, p. 14, lns. 17-18; p. 15, lns. 16-17, p. 16, ln. 27.
[74] *Id.* at p. 14, ln 10; p. 18, ln 11; p. 19, ln 3.
[75] Staff Brief, p. 15, lns. 16-17.
[76] Schmitz Rebuttal, p. 10, lns. 3-4.
[77] Staff Brief, p. 16, ln. 27.

an underground distribution system and Southwest never even intimated that it engaged in a visual inspection of the underground distribution system at Yuma Manors in 2006. To the contrary, Company witness Schmitz specifically testified that when the ground bed was installed in January 2006 "it was not known what condition the pipe was in at that time."[78] This example further demonstrates Staff's carelessness in its conclusions and statements regarding the Yuma Manors issue throughout the course of this proceeding.

Contrary to Staff's incorrect and conclusory remarks that the Company intended to extend the life of the distribution by twenty years with the installation of the new ground bed, Southwest installed the $11,000 ground bed anode because it "was the most cost-effective way to maintain the safety of the system and comply with those regulations."[79] Other than Staff's own witnesses' incorrect conclusory remarks, there is no evidence the Company intended to extend the life of the Yuma Manors distribution system by twenty years.[80]

Staff's assertion that the Company should not benefit from negligent conduct and that customers have somehow lost the benefit of this pipe is equally egregious and without merit.[81] To the contrary, customers received an unintended benefit from this distribution system since it far exceeded the 43 year average useful life of steel pipe in Arizona, and, as a result, was eligible for retirement in the normal course of business.[82] Furthermore, customers will benefit from the new pipe through "betterment to the distribution system that should extend the useful life of the system for 40 or more years."[83]

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[78] Schmitz Rebuttal p. 10, lns. 8-9.
[79] Tr. p. 226, lns. 10-13 and Schmitz Rebuttal, p. 6.
[80] *Id.*
[81] Staff Brief p. 19, lns. 14-15.
[82] Tr. p. 226, lns. 16-18; Schmitz Rebuttal, p. 12, ln 5.
[83] Schmitz Rejoinder, p. 12, lns. 16-18.

As noted by the Company in its post-hearing brief, there are multiple factors that should be considered when determining the cause of pipe corrosion.[84] Staff expressly states in its brief that it does not dispute this point, but then chooses to ignore it as being "besides the point" or "not a relevant issue".[85] This is likely because a review of these factors results in a reasonable conclusion that is contrary to Staff's recommendation.

Staff's recommendation is also inconsistent with past Commission precedent where the Commission has recognized a betterment associated with pipe replacement projects.[86] It is also inappropriate for Staff to suggest that, in addition to the costs associated with the expedited replacement of the Yuma Manors system, some "further penalty" be included.[87] The Office of Pipeline Safety has purportedly determined that the incident did not rise to a level that justified a citation or fine.[88] Accordingly, such a suggestion by Staff in a general rate case is procedurally improper as the Commission has certain procedural rules and guidelines for handling purported pipeline safety violations that afford the utility due process and provide for certain standards and limits within that proper forum for determining pipeline safety violations. For Staff to suggest that the Commission treat this as a penalty, when the appropriate division already concluded there was no basis for a citation or a fine, is entirely misplaced and improper.

Based upon the foregoing, the evidence overwhelming supports a finding that Southwest is entitled to rate base the betterment associated with the Yuma Manors distribution system.

[84] Southwest Brief, pp. 47-48.
[85] Staff Brief, p. 15, lns. 6-7; p. 16, lns, 3-6, 16-18; 20-21.
[86] Mashas Rebuttal, pp. 9-14.
[87] Staff Brief, p. 19, lns. 12-15.
[88] Tr. p. 996, lns. 22-25 and p. 997, lns. 2-5.

**B. Reply to RUCO's Positions.**

1. Miscellaneous Expenses.

Regarding Miscellaneous Expenses, RUCO continues to ignore the Company's rebuttal testimony and, consequently, RUCO's brief is not representative of the evidence.[89] As reflected in Southwest's initial brief, Southwest exhaustively addressed RUCO's concerns regarding the reasonableness of expenses identified in a RUCO data request and, in fact, Southwest voluntarily removed expenses totaling $13,904 after a more thorough review of the questioned expenses.[90] RUCO's continued opposition to the Company's revised request is devoid of any evidentiary basis other than its reliance on a "philosophical difference" and its reliance upon suspicion or speculation. For example, RUCO appears to recommend the disallowance of certain hotel meeting room expenses merely based upon the name of the hotel, e.g., exclusion of hotels with "golf" in the name.[91] In fact, RUCO witness Mr. Moore testified at hearing that his recommended disallowance of these particular expenses was based upon "the hotel name" and "the dollar amount."[92] To the contrary, Southwest explained that rather than own and maintain these facilities that are needed from time to time, i.e. board and shareholder meetings, it is more economical to hold them offsite.[93] Without more to justify the cherry-picking of disallowances, RUCO's recommended disallowance of miscellaneous expenses should be disregarded.

2. 2008 Wage Increase.

While accepting the Company's 2007 general wage increase, RUCO continues to oppose the Company's proposed 2008 wage increase because it would allegedly result in a mismatch

[89] RUCO Brief, p. 10.
[90] Aldridge Rebuttal, pp. 13-14; Aldridge Rebuttal Exhibit RLA-5.
[91] Moore Direct, p. 28.
[92] Tr. p. 753, lns 22-25; 754, lns. 1-2.

between rate base, revenues, and expenses.[94] Yet, as Company witness Ms. Aldridge testified, the 2008 wage increase post-test year adjustment does not violate the matching principal because it only applies to employees on the payroll at the end of the test period (April 30, 2007).[95] The 2008 wage increase does not apply to any employees hired after April 30, 2007, to meet customer growth, changes to work requirements, etc.[96] Therefore, the number of employees at the end of the test year is synchronized with test period customers that they serve and there is no mismatch.

As discussed in Southwest's initial brief, the methodology employed by the Company for this pro forma adjustment is consistent with the 2007 wage increase, to which RUCO does not object, and consistent with the methodology utilized by the Company in its last general rate case.[97]

### C. Recovery of the Company's Management Incentive Plan, Supplemental Executive Retirement Plan, and Stock Based Compensation Expenses is Proper.

As discussed at length in Southwest's initial brief, there has been no showing in this proceeding that the Company's total compensation expense is unreasonable.[98] Both Staff and RUCO propose partial disallowances of the MIP expense based on some notion that a portion of the expenses benefit shareholders.[99] However, a "sharing" of an expense is a partial disallowance of the expense and, if a reasonable, ongoing operating expense is disallowed, there is an explicit erosion of Southwest's opportunity to realize the Commission-authorized rate of

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[93] Aldridge Rebuttal, p. 13, lns. 18-23.
[94] Moore Direct, p. 23, lns. 7-23.
[95] Aldridge Direct, pp. 6-7.
[96] Aldridge Direct, p. 7, lns. 1-3.
[97] Docket No. G-01551A-04-0876.
[98] Southwest Brief, pp. 57-63.
[99] Staff Brief, pp. 5-8; RUCO Brief, p. 11.

return. Sharing is not the test for whether an item of expense should be recognized for ratemaking purposes. *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (1978); *West Ohio Gas Company v. Public Utility Commission of Ohio*, 294 U.S. 63 (1935). The test is whether the expense is reasonable and ongoing. *Id*) The Company's MIP expenses <u>are</u> reasonable and ongoing and neither RUCO nor Staff have presented any evidence to the contrary in this proceeding.

RUCO argues that because two of the five MIP performance targets are related to the achieved return on equity, the primary beneficiaries of the MIP are the Company's shareholders.[100] As such, the incentive to reach those two targets should be borne at least in part, if not in total, by the shareholders.[101] The abstract rhetoric ignores reality. Subsumed in the revenue requirement determined in this proceeding is the cost of capital. Actually earning the cost of equity allowed by the Commission is not a <u>bonus</u> for the shareholders – it is simply another cost of doing business for the Company. Unless and until Southwest over-earns [i.e., earns more than the Commission authorizes], there is no discrete shareholder benefit. Viewed more dramatically, the shareholder is actually punished unless and until Southwest recovers 100% of the costs [including the cost of equity] allowed by the Commission.

If one were to follow the logic that the shareholders benefit when the MIP participants strive to achieve a performance target associated with the return on equity, then every dollar Southwest realizes benefits the shareholder because it is one more dollar toward achieving the target – even though Southwest is not recovering fully the <u>cost</u> allowed by the Commission. The logic is flawed and the result of incorrect application. Further, no party has presented any

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[100] RUCO Brief, p. 11.
[101] RUCO Brief, p. 11, lns. 15-16.

evidence demonstrating that customers are harmed by the MIP factors. Just because the shareholders derive some benefits, does not necessarily mean it is a negative result for the customer; a financially healthy company benefits customers. Both Staff and RUCO ignore the fact that the interest of customers and shareholders can be aligned.

Furthermore, since no party challenges the total compensation of these management employees, Southwest is actually being penalized by placing a portion of the management's compensation at risk. If the MIP portion of the total compensation were included in the base salary of these employees, Staff and RUCO would have no argument to disallow any portion of the total compensation. As such, the ALJ and the Commissioners should not fall prey to the proposed disallowance of a reasonable operating expense simply because the Company's compensation is structured in a manner that has prompted Staff and RUCO to propose a disallowance when neither party has presented any evidence or analysis beyond citation to past proceedings based upon the record developed therein.

Accordingly, Staff's and RUCO's proposed 50% disallowance of MIP expense and 100% disallowance of SBC and SERP should be rejected.

## V.
## ISSUES NOT SPECIFICALLY ADDRESSED

There are several issues and arguments that were addressed in Southwest's Post-Hearing Brief and, with respect to which, neither Staff nor RUCO has presented anything new. As such, Southwest's commentary would be redundant. Accordingly, Southwest refers the ALJ and the Commissioners to Southwest's Post-Hearing Brief for its argument and position on all issues and arguments not specifically addressed herein.

## VI.
## CONCLUSION

This case is about providing Southwest with a reasonable opportunity to realize the Commission-authorized rate of return. The achievement of such a result depends on (1) the recovery of all reasonable, ongoing operating expenses and (2) a rate design and decoupling mechanism that best ensures that factors outside the control of Southwest do not jeopardize the opportunity to realize the Commission-authorized margin.

The interests of both Southwest investors and customers are aligned when it comes to realizing the Commission-authorized rate of return because the Company's capital structure would likely strengthen, resulting in credit ratings improvement and, thus, lower capital costs. Southwest's inability to earn its authorized rate of return has negatively impacted both the Company and its customers.

Based on the record as a whole, and for all the reasons set forth in Southwest's Post-hearing Brief and this Reply Brief, ALJ Nodes is respectfully urged to recommend, and the Commissioners are respectfully urged to approve, Southwest's recommended revenue requirements, including the embedded cost of capital recommendations, and a full revenue decoupling mechanism that best ensures a reasonable opportunity to recover the Commission-authorized level of margin as well as promotes conservation and energy efficiency for the benefit of all Arizona citizens.

DATED this 22nd day of August 2008.

Respectfully Submitted by:
SOUTHWEST GAS CORPORATION

Karen S. Haller, Esq.
Justin Lee Brown, Esq.
Meridith Strand, Esq.
Legal Department
5241 Spring Mountain Road
Las Vegas, Nevada 89102
Telephone No. (702) 364-3191

**ORIGINAL and 13 COPIES of the foregoing filed this 25th day of August 2008, with:**

Docket Supervisor
Docket Control
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

**COPIES of the foregoing served by regular mail and/or electronic mail this 25th day of August 2008, on:**

Maureen Scott, Esq.
Charles Hains, Esq.
Legal Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, AZ 85007
mscott@azcc.gov
chains@azcc.gov

Timothy M. Hogan, Esq.
Arizona Center for Law in the Public Interest
202 East McDowell Road, Suite 153
Phoenix, AZ 85004
thogan@aclpi.org
Attorneys for SWEEP

Dan Pozefsky
Residential Utility Consumer Office
1110 West Washington, Suite 220
Phoenix, AZ 85007
dpozefsky@azruco.com

Michael Grant, Esq.
2575 East Camelback Road
Phoenix, Arizona 85016
mmg@gknet.com
Attorneys for Arizona Investment Council

Joseph Banchy
The Meadows HOA
6644 East Calle Alegria
Tucson, Arizona 85715

Dwight D. Nodes
Assistant Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
dnodes@azcc.gov

an employee of Southwest Gas Corporation