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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS PROPERTIES THROUGHOUT ARIZONA.	DOCKET NO. G-01551A-07-0504 **STAFF'S NOTICE OF ERRATA FILING**

On August 25, 2008 Staff of the Arizona Corporation Commission ("Staff") filed its Reply Brief in this matter. Staff has included a substitute Brief which contains the following non-substantive corrections: 1) on page 1, the word "Gas" was inserted on line 13; 3) on page 5, line 6, "$200.00" was changed to "20.00;" 3) on page 12, line 26, "1998" was changed to "1995;" 4) cites which were inadvertently omitted, were added on pages 6, 12, 13, 16, 17, and 21; 5) on page 17, line 10, "Miller" was changed to "Congdon;" and, 6) on page 5, line 23, the word "not" was added.

RESPECTFULLY SUBMITTED this 28th day of August, 2008.

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I. INTRODUCTION.

Staff has already responded in its Post-hearing brief to many of the arguments made by Southwest Gas Corporation ("Southwest," "SWG" or "Company"). SWG has not met its burden of proof with respect to its proposed revenue requirement and rate design in this case, and the Commission should reject them. The Company's proposals are designed to put shareholder interests ahead of ratepayer interests and would end up shifting considerable risk to ratepayers.

The Company's rate design revenue decoupler proposals all come to the Commission under the guise of "conservation," so they appear attractive at first blush. Unfortunately, the Company defines "conservation" so broadly that it includes declines in usage for any reason whatsoever. In the end, the Company's decoupler mechanisms are designed not to promote or encourage conservation due to Company initiated conservation programs, but merely to preserve the Company's authorized margin revenues between rate cases.

The Company and the Southwest Energy Efficiency Project ("SWEEP") ask for a three year pilot program for SWG's proposed revenue decouplers; implying that somehow this lessens the significance of the Commission granting revenue decoupling at this time or suggesting somehow that ratepayers will not be harmed because it is merely a "pilot program" for three years. But giving the Company a pilot program to collect revenues to make up for an undefined and unspecified loss of margin revenues, for reasons which are uncertain at best, using mechanisms the effects of which are unknown, is a dangerous proposition at best.

Before any decoupling mechanisms are adopted by the Commission, their advantages and disadvantages should be the subject of much more expansive evaluation within a recently opened Generic Docket at the Commission.[1] This Docket provides the opportunity for the Commission to consider the merits of revenue decoupling for all Arizona utilities at once, rather than in piecemeal fashion. The Commission also has a mandate from Congress under the Energy Independence and Security Act of 2007 to examine rate designs that encourage energy efficiency for each customer class, further reason to consider this issue in the Generic Docket.. Any pilot programs that are put in place should be as a result of the findings, recommendations and consensus building in that docket. Too many important questions have not been answered in this docket, including the impact of the mechanisms upon customers, to allow decoupling to proceed.

A similar theme is seen in the makeup of the Company's proposed revenue requirement where ratepayers are being asked to pay the price for "shareholder" benefits as well. For instance, the Company seeks full recovery from ratepayers for its incentive compensation plans even though shareholders derive many benefits from those plans. SWG's proposed overall cost of capital, a large part of SWG's case, is much higher than any awarded by the Commission to-date at least in recent times, yet there is nothing that would set SWG apart from others regulated by the Commission in terms of risk.

This case is about striking the appropriate balance between ratepayers and shareholders. SWG has not struck the appropriate balance between its ratepayers and shareholders in this case. The Commission should reject SWG's proposals which the record demonstrates will serve to benefit shareholders at the expense of ratepayers.

. . .

. . .

[1] The electric docket number is E-00000J-08-0314. The gas docket number is G-0000C-08-0314.

II. THE COMPANY'S PROPOSED RATE DESIGN AND REVENUE DECOUPLING MECHANISMS ARE DESIGNED TO BENEFIT THE COMPANY AT THE EXPENSE OF RATEPAYERS.

Company witness Congdon said it best when he stated that there is a lot going on with SWG's rate design proposals in this case. *Tr. 377: 25 and Tr. 378: 1-5.* The Company has proposed a myriad of decoupling mechanisms designed to guarantee that it will recoup its authorized margin revenue. While citing the need to promote conservation, SWG's real reasons for requesting the revenue decoupling mechanisms are sprinkled throughout its testimony. The Company wants to: 1) ensure that it will recoup a certain revenue level, 2) ameliorate the impacts of regulatory lag, and, 3) ensure that any customer usage declines between rate cases are immediately accounted for. It is not hard to understand why the Company, or any Company that the Commission regulates for that matter, would want the types of decoupler mechanisms and rate design SWG has proposed in this case. The mechanisms are designed to greatly reduce any business risk that the Company faces in the ordinary course of doing business. That ordinary business risk and much more would be borne by SWG's ratepayers if the Commission were to adopt the Company's rate design proposals in this case.

A. <u>The Significant Increase in the Basic Service Charge Proposed by the Company is Opposed by all Parties</u>.

As Southwest notes in its post-hearing brief, it is proposing an increase in its residential Basic Service Charge from the existing $9.70 to $12.80. *SWG Post-hearing brief at 8.* That amounts to a 32% increase. Compared to the overall increase being recommended, 2.7%, a 32% increase to the Residential Basic Service Charge is excessive.

No other party is proposing an increase as great as what the Company is proposing. Staff is proposing a much more moderate increase more in line with the overall increase recommended in this case. Staff's suggested increase to the Basic Service Charge is $1.00, or $10.70 per month. RUCO is also proposing a smaller increase to the Basic Service Charge than that proposed by the Company. And, SWEEP proposes no increase at all.

The Commission made clear in its Order in the last SWG rate case that rate design involves a balancing of various factors involving both the shareholder and the ratepayer.[2]

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[2] *Decision No. 70441.*

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

The Company's reasons for this significant increase are unpersuasive. It is true as the Company notes that it now recovers approximately 40% of its fixed costs through the current Basic Service Charge. So it is reasonable that the Basic Service Charge be increased by some amount to recoup a greater percentage of fixed costs. Staff's proposed increase provides more contribution towards the Company's fixed costs but is much more in line with the overall increase in this case.

The Company also argues that its proposed increase continues the "gradual" movement of improving margin stability especially when viewed with all of the other rate design changes it is seeking in this case. Everyone understands the Company's desire to address regulatory lag and variations in weather upon its revenue stream. These were the same reasons cited by the Company in its last rate case wherein it proposed a doubling of its Basic Service Charge for Residential Single Family customers.

In this case, the Company has proposed a less drastic increase in the Basic Service Charge, but increased the Basic Service Charge and First Block Commodity Charge to an extent that all of its authorized margin revenues would be recovered through these two charges alone for the Residential Single Family Class. As Staff Witness Radigan pointed out in his Direct Testimony, what amounts to a 20% change overall equates to $50 million per year under current rates for this one Service Class.

All three forms of decoupling proposed by the Company, when combined would likely end up producing a similar result as the Company's proposal in the last case which combined a full revenue decoupling mechanism with a Basic Service Charge that was double existing rates at the time.

The Company opposes the Staff's (and RUCO's) more "modest" increases to the Basic Service Charge because it claims that such a modest increase does little to ameliorate the "negative impacts of declining consumption per residential customer and the Company's sensitivity to weather variations." *SWG Post-hearing brief at 9.* In support of its claims, the Company presents a table which if Staff's proposed rate design is used purportedly produces an immediate revenue shortfall of $6.7 million. *SWG Post-hearing brief at 10.* But the Company's claim is based upon lost revenues associated with a decline in usage that has not been proven as discussed below. The Company goes so far in its chart as to suggest that if the Staff were to increase its proposed Basic Service Charge to $20.00 (over double the amount of the current charge), SWG would still not be made whole as a result of alleged declines in customer usage.

The Company claims that the need to increase the Basic Service Charge exists only if it does not get full revenue decoupling and graciously states that it will forgo any Basic Service Charge increase if the Commission gives it full revenue decoupling. *SWG Post-hearing brief at 10.* The Company's concession in this regard is illusory. With a full revenue decoupling mechanism, the level of the Basic Service Charge is less important to the Company, because the revenue deoupler will make up for any and all lost margin revenue regardless of cause.

There is nothing "gradual" about any of the Company's proposals in this case. The Company's significant increase in the Residential Basic Service Rate should be rejected. Even Company witness Congdon agreed that "gradualism in terms of how it impacts your customers needs to be considered." *Tr. 355: 15-16.*

B. The Company Should Not be Compensated for Post Test Year Declines in Customer Usage or for Declines Between Rate Cases Based Upon the Current Record.

The Company states in its Brief that the Staff and RUCO do little to address the "negative impacts of declining consumption per residential customer and the Company's sensitivity to weather variations." *SWG Post-hearing brief at 9.* It is this alleged decline in per customer usage that is behind almost all of the Company's rate design proposals and its extensive reliance upon decoupler mechanisms in this case. If the Commission does not approve SWG's full revenue decoupling proposal (RDAP and WNAP), SWG requests that the Commission establish rates based upon a claimed post-test year reduction in residential volumes.

Whether customer usage declines have been established, their extent and the source of any declines, and the extent they have already been accounted for, was a subject of much controversy during this proceeding. Insufficient evidence was presented by the Company to support inclusion of its proposed decline in per customer usage. The Company proposes that Commission include a 13 therm per customer usage decline from actual test year levels when determining rates. The Company derived the amount by subtracting levels of usage one year outside of the test year and subtracting them from test year levels. The Company also supports its claims with a chart which purports to show a continuing decline in customer usage from 1995 to 2008. *Tr. 297: 8-11.* The Company claims that this historic data shows that there has been an average 7 therm per customer decline in usage levels.

What the Company does not point out is that these historic per customer usage declines have been trued-up in every rate case that the Company has come in for in Arizona. So, all the Company is really talking about is the effects of any customer decline in usage levels between rate cases, or regulatory lag.

How does one account for the impacts of regulatory lag with any certainty? If one does try to account for it between rate cases, how does one balance the calculation so that it is fair to both ratepayers and shareholders? Is it appropriate and fair to the ratepayer to do a simple subtraction as the Company has done by taking test year therms per customer subtracted from the level of therms for a 12 month post test year period and end the analysis there?

In its Post-hearing brief, the Company states:

> Company witness James Cattanach presented data in his rebuttal testimony and during the hearing as to the known and measurable change in the residential volumes that occurred since the end of the test period – April 30, 2007. This known and measurable change reflects that for the 12 months ended March 31, 2008 an average residential customer uses 319 therms per year which is a decrease of 13 therms per residential customer from the test year volume of 332 therms.[3]

[3] There is conflicting evidence in the record regarding the actual decrease the Company was recommending the Commission include and the period of time the amount was derived. At some places in the record, the Company's witnesses testified that it was derived from the period between the last two rate cases. If this is the case, Staff's comments would still be relevant and applicable to this period of time. *See e.g. Tr. 298: 1-17.*

The Company uses the terms “known” and “measurable,” but how “known” and how “measurable” is the amount when trying to predict the future? Even Company witness James Cattenach expressed uncertainty in the following exchange at the hearing on this matter:

> Q. You also testify that we do not know with 100 percent certainty that residential consumption per customer will continue to decline; is that correct?
>
> A. That’s correct.

Tr. 289: 20-23.

* * * * *

> Q. You also state in your rejoinder that decline in residential consumption per customer can be expected to decelerate or reach equilibrium; isn’t that correct?
>
> A. That is correct.

Tr: 291:2-5.

As Staff witness Radigan testified, the Company has not met its burden of proof with respect to the additional level of customer usage decline it proposes to include in this case. The Company did not do any studies to demonstrate that this level of decline in customer usage would continue into the future. As discussed below there are many factors that need to be considered when attempting to determine future usage levels with any certainty.

Moreover, why should the Commission single out this post-test year event and compensate the Company when the Company has ignored other factors which would tend to offset or mitigate any revenue loss associated with declines in usage. SWG did no studies that would account for post-test events that would tend to mitigate the alleged revenue loss. For instance, between rate cases, the Company has customer growth, investment to serve those customers, and changes in usage patterns and changes in expense levels. While increased investment and energy conservation can decrease the rate of return, increased productivity, efficiency gains and customer growth can increase the rate of return. The issue is not whether the Company has to make investment to connect new customers and whether the revenue growth offsets the carrying charges to support the investment on a penny for penny basis but whether there are offsets.

For instance, Staff witness Radigan noted in his testimony that in the 2005 annual report to stockholders, the Company reported that 35,000 customers were added in Arizona. Based on the Company's latest estimated net margin figures, these customers would provide an additional 9.9 million in net income to the company. This is 57 percent more than the lost net margin due to declining usage.

The Company argues that Mr. Radigan ignores the costs to the Company that go with serving those new customers. *Tr. at 494: 14-19.* But that is not true. Staff witness Radigan pointed out that regulatory lag has both advantages and disadvantages for the Company. But, the Company cannot simply focus on the disadvantages (and completely ignore the advantages it receives) when seeking relief in the form higher rates from customers. The Company offered only anecdotal evidence that growth or other mitigating factors are not enough to offset the alleged declines. This is insufficient when ratepayers are being asked to pay for the alleged declines in usage.

The Commission should reject the Company's proposal to account for regulatory lag by including customer declines in per therm usage occurring outside of the test year. The Company's proposal to account for regulatory lag does not take mitigating factors into account which would act to increase the Company's revenues nor does it establish with any certainty that such trends will continue until the Company's next rate case.

The Company also argues unconvincingly that "no Intervening Party offered substantive analysis, conflicting data, or any other verifiable evidence challenging the information presented by Mr. Cattanach. To the contrary, the only challenge was in the form of opinion testimony from Staff witness Radigan and RUCO witness Rigsby." The Company, not Staff or RUCO, bear the burden of proof in this case. Staff offered considerable testimony through Mr. Radigan which pointed out the flaws in the Company's methodology. There is no requirement, as the Company seems to suggest, that Staff expend considerable resources performing the kind of econometric studies that the Company should have undertook in the first place. To suggest as the Company does, that no party meaningfully challenged the data presented by the Company, because they did not perform a more accurate study for the Company, seems at a minimum to seriously misconstrue the case law on this point.

C. <u>The Company has not Met its Burden of Proof Regarding the Need or Appropriateness of its Various Decoupling Proposals</u>.

1. The impact of and reasons for the Company's proposals in this case are identical to those underlying the Company's proposals in its last rate case which the Commission rejected.

SWG has not addressed the shortfalls with its decoupling mechanism proposals identified by the Commission in its last rate case. The Commission rejected the Conservation Tracker Mechanism ("CMT") proposed by the Company:

> The Company is requesting that customers provide a guaranteed method of recovering authorized revenues, thereby virtually eliminating the Company's attendant risk. Neither the law nor sound public policy requires such a result.

The Company's decoupling mechanism proposals would have virtually the same impact as its proposals in its last rate case. Company witness Congdon confirmed this at the hearing in this case: "[a]nd essentially we took the old CMT and split it into the weather normalization adjustment and the revenue decoupler." *Tr. 378: 13-15.* His stated reason was: "… in terms of revenue, we want to find some way to reduce the negative impacts of declining use per customer." *Tr. 378: 9-12.* So, the Company's decoupling proposals are essentially the same; only the names and number of proposals have changed.

The following passage from the Commission's Order indicates that there are other concerns as well that still have not been adequately addressed in this case:

> There is conflicting evidence in the record as to whether the recent level of declining per customer usage will continue into the foreseeable future, and whether conservation efforts are the direct cause of Southwest Gas' inability to earn its authorized return from such customers. Further, as RUCO points out, the likely effect of adopting the proposed CMT is that residential customers will be required to pay for gas that they have not used in prior years, a phenomenon that could result in disincentives for such customers to undertake conservation efforts. We are also concerned with the dramatic impact that could be experienced by customers faced with a surcharge for not using 'enough' gas the prior year.

Decision No. 68487, 247 P.U.R.4th 243, 268-269.

Indeed, most of the concerns identified by the Commission in Decision No. 68487 were also the subject of debate and conflicting evidence in this case.

2. The Company's Broad-Based Revenue Decoupling Adjustment Provision (RDAP) and Weather Normalization Adjustment Provision (WNAP) are being used to shift normal business risk typically borne by shareholders to the Company's ratepayers.

Like its proposals in the last case, the Company has designed its decoupling mechanisms to compensate it for any declines in customer usage regardless of the cause. In other words, the decoupler mechanisms are not tied to the Company's conservation programs but to any and everything that might end up causing a decline in the Company's authorized revenue streams.

Indeed one of the principal reasons, if not the primary reason, that the Company is seeking relief through its various proposed decoupling mechanisms is to reduce the impact of regulatory lag.

> Q. …Now, it is correct that you agree with RUCO that declining sales per customer is a problem for Southwest only because of regulatory lag?
>
> A. Yes. Well, I am not sure that that's what RUCO says, but I agree that it is a problem only because of regulatory lag.
>
> Q. So without the regulatory lag, we wouldn't be having the discussion now about RDAP or WNAP or this type, new type of volumetric rate design; is that correct?
>
> A. Yes. …..

Tr. 611: 19-25; 612: 1-5.

a. <u>The RDAP</u>.

If the Commission does not accept the Company's arguments with respect to inclusion of the lower per therm customer usage determinants, the Company offers its proposed RDAP as another remedy, which according to the Company is its preferred solution. The RDAP as proposed by the Company would pick up all variance between the actual and Commission-authorized non-gas revenue.

Company witness Miller explained how the RDAP would work in the following passage from his testimony at the hearing:

> …[E]ach year the company will look at average sales per customer in each customer class and determine how that compares to the test year level. It will

> multiply the difference between different types, the number of the customer to determine an amount to charge or credit to the balancing account, divide it by projected annual sales, and that result will be a surcharge or credit to the commodity charge rate." (*Tr. 615: 10-21*).

As such the RDAP would accomplish full revenue decoupling irrespective of whether any of the other decoupler proposals are adopted.

> Q. Now, if the Commission just adopted the RDAP, would that have the effect of full revenue decoupling in this case?
>
> A. Yes. But with the lag inherent in the RDAP, that is, it would, the RDAP would, if it were adopted in full as proposed by the company, with no other restrictions such as an earning cap or something like that, the RDAP would pick up changes in revenue per customer due to weather fluctuations as well as any other changes in sales and revenue per customer and that would thereby be full revenue decoupling." (*Tr. 438: 14-24*).

When questioned about what variances would be picked up by the RDAP, Company witness Congdon responded those due to "conservation." *Tr. 392: 5-6.* But as demonstrated by the following exchange, the Company defines "conservation" very broadly.

> A. That would be conservation related changes in usage. It could result from people simply deciding they want to change the adjustment on their thermostat. It could result from people, you know, purchasing more efficient appliances. It could stem from a variety of causes.
>
> Q. So you don't believe that there's anything other than conservation that would -
>
> A. I am sorry. Go ahead.
>
> Q. You don't believe, then, that there's any other factors than conservation that would be non-weather related and that could affect the difference between the actual and authorized non-gas revenue for the company. Is that what you're saying?
>
> A. Well, I guess now that you have made me think a little harder, there could be other causes that might influence this. For example, people could not be having children and larger families, but I think essentially we're looking at conservation versus an event such as larger or smaller household size.
>
> Q. How about the economy? Could that affect usage?
>
> A. Well, I think in terms of residential customers it could have an indirect effect. And how that, I think, would play out would be customers determining that they can no longer set their thermostats on 68. They might have to turn them down to 65 or whatever. But that type of a decision could be driven by income. …

Q. Did you consider the other factors, economic factors, including income levels in determining how that could impact customer usage and affect what you might collect under this RDAP?

A. Actually, not directly. .....

Tr. 392: 3-25; 393: 1-13.

Q. And I appreciate that point, but I don't think you answered my question. I'm trying to pinpoint what this revenue decoupling adjustment mechanism actually looks at and adjusts for. And given the testimony that I have read and the testimony that I have listened to by the company, it appears to me that the mechanism is broader than making adjustments for just conservation related usage changes, but it also results in adjustments due to other factors as well that result in declining usage. Would that be correct?

A. It would capture the difference between the authorized margin per customer times the number of customers that we serve, and our weather adjusted non-gas revenue, irrespective of exactly what led to that difference.

Tr. 395: 1-5.

So, for instance, if economic conditions cause residential customers to use less gas, this would fall under the Company's definition of "conservation". *Tr. 620: 17-19.* If a customer loses his job and a month later he weatherstrips his home and turns his thermostat down, that would also fall within the Company's definition of "conservation". *Tr. 620: 17-25.*

This demonstrates how overly-broad the Company's proposals actually are. The real intent of its proposals is to shift normal business risk to the ratepayer associated with declines in usage between rate cases, without any consideration of mitigating or offsetting factors. This is inappropriate and the Commission should reject the Company's proposals.

Company witness Congdon also acknowledged that the RDAP would result in ratepayers as a class paying a portion of their bill for gas service that they do not actually use. *Tr. 346: 5-25; 347: 1-12.* He also stated at one point that the conservation impact over a 10 year span from 1995 to 2007, was a negative $118,200,000. *Tr. 336: 1-2.* All of these concerns taken together, many of which were also identified by the Commission in the Company's last rate case, weigh against adoption of the RDAP in this proceeding. These are too many important questions which remain unanswered with respect to the Company's proposals at this time and their ultimate impact upon the customer is not known. When asked if the Company had performed any studies showing the impact of the decoupling mechanisms upon customer rates in this case, Mr. Congdon replied no. *Tr. 337:24-25; 338:1-11.*

b. The WNAP.

SWG states that "[i]t is nothing less than shocking that all parties to this proceeding have not fully embraced the Company's proposed WNAP." *SWG Post-hearing brief at 15.* SWG argues that the net effect of SWG's current rate design structure is that "customers are harmed during colder-than-normal heating seasons and Southwest is harmed in warmer-than-normal heating seasons." *Id,* Southwest also argues that Staff and RUCO have provided "nonsensical" testimony that WNAP shifts risks to ratepayers, when in fact, "WNAP eliminates, not shifts, risk for both Southwest and its customers equally." *Id.* SWG contends that those who do not support WNAP simply do not understand how it operates. *Id.* To the contrary, Staff's opposes WNAP precisely because Staff *does* understand how the WNAP operates and the fundamental flaws underlying it.

Staff does not dispute that SWG's current rate structure results in higher energy bills (and thus "harms" customers) when winter weather is colder than normal. Nor does Staff dispute that SWG loses revenue (and is thus "harmed") during periods in which winter weather is warmer than expected. But SWG's assertion that WNAP results in an "equal elimination" of risk to both SWG and its customers strains credibility. It implies a "zero sum game". A colder winter results from colder temperatures and/or longer duration than a "normal" winter. Likewise, a "warmer" winter is one in which the temperatures are warmer and/or last for a shorter period than in a "normal" winter. In order for SWG's statement that WNAP eliminates risk equally, the added revenue from ratepayers for every colder winter would have to be offset by the equivalent savings to ratepayers during a corresponding warmer winter. For every dollar SWG loses during a warmer winter, it must gain that same dollar back during a colder winter, otherwise, there is no "equality" of result from the implementation of WNAP.

SWG initially cited a loss in revenue as a result of these inconsistent weather patterns, but later stated that over the ten year period from 1995 through 2007, it actually benefited in the amount of \$5.8 Million. *Tr. 335:19-25.* SWG now claims that the reason it seeks the WNAP is to reduce volatility in revenues caused by variations in weather. There is enough uncertainty in the record on the impact of weather on the Company's revenues and the WNAP on both the Company and customers that Staff believes the issue should be explored more in the Generic Docket.

The Company acknowledges that it already has a 10-year normalization procedure to calculate the volumes in each general rate case upon which rates are established. *SWG Post-hearing brief at 16.* Thus, as with its other decoupler mechanisms, the Company states that its real concern is "...between rate cases, there is no mechanism to protect customers and the Company from weather variations that deviate from the weather normalized volumes used to establish rates in the most recent general rate case." *Id.* But, in that the Company typically comes in for a rate case every three years, the Company really has not demonstrated the need for the WNAP between rate cases. A 10-year normalization procedure would appear adequate given the Company's regularly filed rate case applications.

There was also considerable dispute during the course of the proceeding regarding the portion of the alleged deficiency in actual margin revenues and authorized margin revenues due to weather versus conservation (in the broad sense). During the collaborative process, the Company attributed approximately 80% of the deficiency to weather related variations. However, the Company changed its position subsequent to the collaborative, saying that it had erred and that actually 70% of the deficiency was due to conservation (in the broad sense) related variations. *Tr. 334: 17-19.*

Again, Staff believes that this issue needs to be examined more in the Generic Docket on performance based plans for gas and electric companies.

In sum, if the Commission implements WNAP, it will take away the advantage ratepayers may occasionally receive from a warmer than normal winter, and replace it with a guarantee that SWG will receive a set amount of revenue, no matter what the weather may be. It will also result in ratepayers paying more for energy in warmer winters than they otherwise would if there were no WNAP. Essentially, the Company is still asking the customer to pay for service he or she is not receiving. Whether this would equal out over time as the Company claims, is an open question which has not been satisfactorily answered in Staff's opinion.

3. The Company's Volumetric Rates Are Also a Form of Revenue Decoupling and are not Supported by the Record.

As discussed above in conjunction with the Basic Service Charge increase proposed by the Company, SWG has also proposed significant changes to its rate design with its proposed Volumetric Rates. The Company has designed its rates so as to collect 100% of its authorized non-gas margin revenues through the Basic Service Charge and the First Commodity Block for the Single Family Residential Class.

The following discussion is illuminating as to the workings of SWG's proposed Volumetric Rate Design:

> Q. So wouldn't it be true that the rate design would shift the cost from the second block to the first block?
>
> A It doesn't shift costs. It shifts cost – the recovery of costs. And there's also an offsetting shifting in the recovery of the gas cost from the first block to the second block. And we offered this proposal as another way that the Commission could help improve our revenue stability if it does not see fit to adopt our weather normalization adjustment and revenue decoupling adjustment proposals.
>
> Q. Let me state it another way. So under the non-gas charge, wouldn't it be fair to say that this shifts the recovery of the costs from the second block to the first block?
>
> A. Yes. And it has an effect of smoothing out the recovery of our non-gas cost of service across various sizes of residential customers.

Q. Wouldn't it also be true that, again, stated another way, this shifts the recovery of costs from the high-end users to the low-end users in the non-gas?

A. It does, and that reflects our cost of providing service. So in that sense, this rate design is more cost of service based rate design than what we currently have in effect, or what Staff or RUCO has proposed.

Q. Isn't this rate design on the non-gas side biased against the low-end user?

R. I think if there were not an offsetting effect in the gas cost portion of the rate, in which case this would be a true declining block rate, that there would be some validity to what you-re saying, because then small users would be paying relatively more than large users.

Witness Congdon went on to state that under the Company's proposed rate design, regardless of how much gas you use, you're going to pay $1.49 per therm. *Tr. 362: 21-25; 363: 1-15.* While he did concede that there would be a greater potential for conservation among large users, it is difficult to see how the Company's proposed rate design would incent conservation among any class of users.

Company witness Congdon also described the operation of the Volumetric Rate Design in relation to the other decoupling mechanisms the Company is proposing in the following passage:

> Q. So is it fair to say that the volumetric rate design in and of itself produces an effect similar to what the two decoupling mechanisms would produce?
>
> A. I believe that that is fair to say, particularly in terms of the protection from changes in weather more so than from the declining use per customer, but I do think it benefits us in those regards.

The Commission should reject the Company's proposed Volumetric Rate Design as it is apparent that it was structured solely to benefit shareholders. As Staff stated in its Post-hearing brief:

> Rather than providing an incentive to 'invest in conservation,' the rate design does the precise opposite by removing any capacity of the ratepayer to realize any benefit from decreased usage. By placing an undo emphasis on the fixed minimum charge, the variable commodity charge plays a diminished role in the customer bill. Id. For a customer whose usage remains in the first tier there is no incentive to invest in reduced commodity usage. The implications of full recovery of margin from minimum use customers extends beyond conservation choices and impacts the bases for the Company's desired revenue decoupling mechanisms as well. 'It is obvious that the true intent behind the Company's proposed rate design is to substantially eliminate all risk from variation in sales due to weather.'

Staff Post-hearing brief at 21-22.

4. The Record Does Not Demonstrate That The Company's Proposed Decoupler Mechanisms Are Necessary To Incent the Company to Engage in More DSM or Energy Efficiency Projects or that Such Mechanisms will Promote Conservation.

As discussed below, decoupler mechanisms are typically used to compensate a company for revenues lost from lower usage related to company sponsored conservation programs. But the Company has not narrowed its proposals in this case to address revenues lost due solely to DSM or energy efficiency projects. The Company's proposed mechanisms are designed to capture revenues lost due to declines in customer usage for any reason.

When questioned about this, Company witness Congdon indicated that it would be too difficult or burdensome for SWG to actually structure its decoupling mechanisms to try to account for usage declines due solely to Company-sponsored conservation or DSM programs. *Tr. 825: 2-25; 826: 1-8.*

In addition, the Company argues that its programs are designed to incent conservation by customers. SWG states on page 18 of its Brief that under the RDAP and the Company's proposed volumetric rate design, customer will receive a price signal that encourages conservation because those customers who conserve will save more than those customers who do not conserve. Certainly it is correct that the customer who wishes to conserve does not need the RDAP or volumetric rate design to save money, all they need to do is conserve. In fact, for a customer that intends to conserve, when faced with the choice of having an RDAP or not an RDAP the customer would choose not to have an RDAP because an RDAP would actually cost more because the customer will be paying the Company back for the net lost margin.

In addition, Company witness Miller, conceded at the hearing that with the RDAP, residential customers as a group cannot reduce their aggregate non-gas revenue by conserving.

> So the real question is, if everybody conserves, yes I would agree that Southwest's residential customers, as a group, cannot reduce their aggregate non-gas revenue by conserving. That's the same thing that would happen in the next base rate case in any event. The RDAP simply makes it happen on a year-by-year basis instead of waiting for the next rate case.

Tr. 478: 9-16.

Perhaps most interesting, is the fact that the Company presented very little evidence on what additional DSM or conservation programs it intends to undertake if Commission approved its proposed decoupler mechanisms in this case. It is unusual that if the purpose behind the decoupling mechanisms, is to break the link between customer usage declines due to Company sponsored conservation programs and Company revenues that SWG would not have at least offered more evidence on DSM program opportunities in Arizona.

5. This is Not a Suitable Case for a Decoupler Pilot Program.

Both Southwest and SWEEP propose that the Commission implement full revenue decoupling on a pilot basis for at least three years or until Southwest's next general rate case. *Southwest Post-hearing brief at 16.* SWG states that a pilot period would allow the parties to study the impacts of the RDAP and WNAP and that the Company can provide Staff with reports detailing the dollar amounts collected/refunded by the respective provisions. *Id.* at 17. SWG also offers to engage the services of an independent third party to conduct a review of the decoupling mechanisms and provide the Commission with a copy of the consultant's report. *Id.*

All of the Company's respective proposals may be fine if it were actually a suitable candidate for revenue decoupling at this time. But, at most, the record demonstrates that Companies' proposals are overly-broad, that the Company is experiencing regulatory lag which has both pros and cons associated with it for both shareholders and ratepayers, and that the Company has not even met its authorized $4.4 Million DSM budget at the time of the hearing in this case. Many of SWG's DSM programs are still in their infancy or in the process of being ramped up. The record in this case does not support handing the Company a blank check to simply undertake more DSM or energy efficiency related programs, when the success of its existing programs is not yet known, and when the opportunities for more programs has not been sufficiently vetted.

Moreover, other companies that the Commission regulates have more experience with DSM and energy efficiency programs, and the Commission should examine the more extensive experience and history of these companies in the Generic Docket, before implementing extensive decoupling mechanisms in this case when they are not supported by the record. A generic proceeding with involvement from all industry participants will allow the Commission to make its decision on the basis of a much broader, more developed record. It also presents another opportunity for consensus building with respect to how to best encourage or incent companies to promote conservation programs to their customers.

6. The Absence of Decoupling Mechanisms Are Not the Cause of the Company's Secured Debt Ratings.

In its post-hearing brief, SWG states that "no party disputes that Southwest's risk is greater than its peers when compared to the proxy groups utilized by the return on common equity experts in this proceeding." *SWG Post-hearing brief*, 4. SWG has repeatedly pointed to its Moody's and S&P ratings as "proof" of this proposition. SWG then argues that the source of the increased risk is the fact that many of the proxy groups have revenue decoupling mechanisms that SWG lacks, and has therefore requested in this case.

However, as Staff stated in its post-hearing brief, Staff does not believe that the Moody's and S&P ratings reflect a need for SWG to have revenue decoupling. In truth SWG's low bond ratings are result of years of operating with a highly leveraged capital structure.

Staff reiterates the responses provided in its Post-hearing brief:

> "Staff does not dispute that SWG has a poorer bond rating than those of similar LDCs. Staff disputes SWG's reasoning for the rating. As previously noted, SWG has a lengthy history of low equity. A lower equity ratio means insufficient cash has been generated by investor funds. Without enough cash, SWG must borrow more money than similar LDCs. It therefore must spend more than similar LDCs to service that debt. SWG has a higher "overhead" than a similar LDC. Therefore, assuming all other aspects of the LDCs remain equal, SWG is already at a competitive disadvantage because greater debt service equates to higher overhead, which results in less profit, comparatively speaking. Reduced profit means fewer funds available to reinvest in the company and to provide dividends. EMH assumes that rational investors will have access to this knowledge, and given the choice between SWG and a similar LDC, rational investors are much more likely to choose the investment with the greatest chance to appreciate in value and to provide a dividend. In that scenario, SWG is a greater investment risk because the business model it has chosen over the years has placed it at a competitive disadvantage. Moody's and S&P have recognized this.
>
> Assuming, *arguendo*, that SWG does have a greater growth rate than similar LDCs, it stands to reason that SWG needs greater capital investment to build infrastructure. If that is also true, then SWG, being short on cash, must borrow still more money than a similar LDC, which in turn leads to still greater debt service, to which investors are likely to assign still greater risk. In this respect, SWG has

> become a victim of its own failure to reinvest profits and build equity, as ordered so often by this Commission. Staff does not believe SWG is more risky simply because it has a low Moody's and S&P rating. Staff believes SWG is no more and no less risky than any similar LDC. The Moody's and S&P ratings simply reflect the risk that would be present in any similar LDC that was consistently undercapitalized and thus failed for years to earn its authorized return in the manner that SWG has done.
>
> This misplaced belief that SWG is faced with greater risk than comparable LDCs caused SWG to "utilize the same procedures to select the 34 non-price regulated companies similar in total risk to the proxy group of LDCs." *Hanley* Direct, 51, 3-4. Thus, the results of its CEM are skewed."

Staff's Post-hearing brief at 37-38.

As Staff has pointed out, SWG has incorrectly attributed its low bond ratings to the fact that it does not have decoupling. The truth is, SWG began with the assumption of greater risk, used it to select other proxy companies similarly risky, and then argued that revenue decoupling would remedy the risk. At the same time, SWG argues that revenue decoupling is *not* reducing risk, and therefore the Commission should not lower it authorized rate of return if decoupling is authorized. SWG can not have it both ways.

SWG is not riskier than other LDC's due to an absence of decoupling. SWG has chosen for years to operate with a highly leveraged capital structure and has been paying the price for its choice, as the Commission repeatedly warned it ultimately would. As Staff has shown, if Staff's recommendations are approved, SWG will have no trouble attracting equity capital. At that point, it will up to SWG to use it wisely. As the Commission pointed out, the ratepayers should not be burdened by an artificially-inflated equity structure, and now that SWG has finally achieved the 43.44% that Staff has shown, that equity structure should be used in setting SWG's return.

SWG has argued that the Commission should institute a revenue decoupling "pilot program" for three years, and have the results independently analyzed to verify the effectiveness of decoupling and determine if it should continue. Staff opposes this. Instead, the Commission should adopt Staff's proposals, deny the authorization of decoupling, and wait three years. Now that SWG has finally achieved the equity ratio the Commission has been directing it to achieve for so many years, the Commission should give the new equity structure a chance to provide the benefits that derive from that structure before it seeks to add new variables to the equation. The appropriate time to judge the effectiveness of those measures would be during SWG's next rate case.

III. THE COMPANY'S COST OF CAPITAL

A. <u>The Company's Proposed ROE is Inflated</u>.

The Company's proposal for a return on common equity capital of 11.25 percent is excessive compared to recent rates of return set by the Commission for comparable companies. The Company claims that the 11.25% is actually the floor, and that if the Commission does not adopt its revenue decoupling proposals, it should be awarded an even higher rate of return on equity. *SWG Post-hearing brief at 27.*

In its post-hearing brief, the Company focuses much attention upon the fact that that the proxy group of companies it selected had some form of revenue stabilizing mechanism. *SWG Post-hearing brief at 28 – 30.* The Company argues that it is more of a risk than the proxy group it selected because "the majority of the Proxy Group enjoy the benefits of stabilized revenues and earnings attributable to weather normalization clauses, revenue decoupling provisions, or some other form of innovative rate design, something Southwest is currently lacking." *SWG Post-hearing brief at 29.* But, as Staff witness Parcell pointed out, it is not appropriate to consider the reduction to risks from this perspective. *Ex. S-18, p. 6.*

> To put risk reduction in proper perspective for SWG, we need to consider the extent to which any new rate design mechanisms are risk-reducing to SWG in relation to its previous position. Clearly, these rate design proposals are new to SWG and, should they be approved by the Commission, they would be risk-reducing to the Company relative to its historic and present situation.

Ex. S-18, p. 7.

Southwest also argues that the Company is more of a business risk in comparison to the Proxy Group, "because Standard & Poor's has assigned SWG a business risk profile of "strong" versus an average business risk profile of "excellent" for the Proxy Group." But, as Staff witness Parcell pointed out:

> It is noteworthy that Standard & Poor's recently published a report on SWG on April 24, 2008. In this report, attached as Exhibit DCP-16, S&P noted that the Company's outlook is "positive" and "reflects Standard & Poor's Rating Services' expectation that the Company's

> improved financial performance could lead to a higher rating over the near term.
>
> S&P also noted the "strong business risk profile" of SWG as a positive factor in the rating process. In this regard, S&P noted the Company's "large, stable, residential, and commercial customer base", the "absence of competition", and "relatively lower operating risks."

Ex. S-18, p. 7.

Southwest also tries to draw a comparison to APS and suggests that the Staff's and RUCO's ROE recommendations are far too low because the Commission awarded APS a 10.75% authorized last year in Decision No. 69663. But, a more appropriate comparison would be to the Commission's recent decision in the UNS Gas case.[4] In that case the Commission authorized a return on common equity of 10.0%.

B. <u>Fair Value Rate of Return</u>.

Moreover, for the first time in its Reply Brief, the Company claims that it is asking for a requested increase of $57.5 Million, rather than the $50.2 Million contained in its Application and in its testimony that was filed in this Docket. The Company states in this regard that its recommended return on the Fair Value Increment "results in approximately an incremental $11.1 Million in revenues, thereby resulting in a net requested increase of $57.5 Million. The Commission should reject the Company's new revenue requirement number since it is inconsistent with its Application in this Docket. It is Staff's understanding that the Company's $50.2 Million contained the Company's recommended return on the Fair Value Increment.

The Company also attacks Staff's position in the *Chaparral* case which presented the Commission with two options for determining the Fair Value Rate of Return ("FVROR"). *SWG Post-hearing brief at p. 38.* The Company argues that Staff's first option completely obviates any purpose of the Fair Value Increment. Id. The Staff's first option recognizes that shareholders have not financed the FV increment and therefore a zero cost rate is appropriate. Thus, from a financial perspective, it should not be necessary to provide for any costs associated with the FV Increment of the capital structure.

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[4] Docket No. G-04204A-06-0463 et al.

But, Staff offered a second option should the Commission choose from a policy perspective to provide for a return on the FV Increment. In that event, Staff witness Parcell recommended the cost be no larger than the real risk-free rate of return. If the Commission selected Option 2, Staff's recommendation in both Chaparral and in this case was that the ROE awarded not exceed 1.25%of the risk free rate, to the FV Increment to determine FVROR.

The Company argues that Staff's position in arguing that any ROE award not exceed 1.25% of the risk free rate is arbitrary. However, Staff's proposed rate of return n common equity for SWG fell at the low end of the range produced by these two options after consideration of all of the facts in this case, so in this case the cap of 1.25% under option 2 did not even come into play. In any event, it is not arbitrary because Staff's primary position is that since the FV Increment is not financed by shareholder or investor funds, a zero value is appropriate. But Staff also recognizes that circumstances may be such that the Commission may feel it appropriate to award an ROE that attributes some cost to the FV Increment based upon the facts and circumstances of each particular case.

C. *Chaparral* – Decision No. 70441.

The Company notes in its post-hearing brief that "there are several methods the Commission can use to determine an appropriate FVROR..." *Company Post-hearing brief at p. 40.* Both Southwest and Staff have proposed different methodologies in this case. The Commission should choose a methodology, such as Staff's, which results in a reasonable rate of return for the Company. This is consistent with Decision 70441:

> Both Staff's and RUCO's methods adjust the WACC derived from the OCRB to develop a rate of return that can be applied to the FVRB. Staff's method adjusts the cost of capital to reflect the cost of the portion of the capital structure that is funded by neither debt nor equity, but exists due to inflation. RUCO's method analyzes the inflation contained in the estimates of cost of equity and adjusts the cost of capital to eliminate the inflation component. Neither method modifies the FVRB we found in Decision No. 68176, and both methods apply a FVROR derived from a financial analysis of the Company's cost of capital directly to that FVRB to determine required operating income.
>
> Accordingly, while we find that either Staff's or RUCO's method would result in a fair rate of return on FVRB, in this case we will use RUCO's method, with modifications as discussed below to reduce the

> inflation embedded in the cost of capital in order to determine a fiar return on FVRB.

Decision No. 70441 at 34.

The Commission should adopt Staff's recommendation in this case on the appropriate FVROR.

IV. THE RECORD DOES NOT SUPPORT ADOPTION OF CERTAIN OF THE COMPANY'S OPERATING EXPENSES.

A. AGA Dues.

In its Post-hearing brief, Southwest continued to request recovery of 94.52 percent of its AGA dues with a 5.48 percent exclusion, which the Company contends is related to AGA's marketing and lobbying functions. Staff agrees with excluding these portions of AGA dues, but still believes that an additional adjustment should be made. Staff continues to recommend that a total of 40% of Southwest's AGA membership dues be removed from the Company's cost of service.

Staff witness Smith acknowledges that the Commission approved AGA membership dues with an exclusion for only lobbying and marketing functions in the Company's last rate proceeding in Decision No. 68487. However, Decision No. 68487 at page 14 provided a clear directive which stated that: "in its next rate case filing the Company should provide a clearer picture of AGA functions and how the AGA's activities provide specific benefits to the Company and its Arizona ratepayers."

In its post hearing brief, Southwest goes on at length about information it provided in the form of testimony, exhibits and responses to discovery in order to meet the Commission's directive from Decision No. 68487. *SWG Post-hearing brief at 51.* However, the documentation that Southwest provided throughout this proceeding contains selective self-serving material, some of which was prepared by the AGA, and none of which was independently verifiable by Staff, despite diligent efforts through discovery to obtain support for AGA's claims. For example, Southwest witness Randi Aldridge stated in her direct testimony at page 24 that the AGA's efforts resulted in $479 million in member savings in comparison with $18 million in membership dues for the year 2006. However, Southwest did not provide any work papers or other verifiable documentation whatsoever to substantiate this claim. Southwest provided no calculations showing how the $479 million was produced by AGA functions. Nor did Southwest identify which AGA functions were allegedly producing the outsized benefits that AGA claimed. Consequently, the unsubstantiated claims of AGA benefits must be discounted.

Southwest has failed to demonstrate that ratepayers should fund activities and functions conducted through an industry organization that would be subject to disallowance if conducted directly by the utility.

Southwest stated in its post-hearing brief that Staff witness Smith "merely relies on a nearly five year old Florida Public Service Commission decision, an outdated National Association of Regulatory Utility Commissioners (NARUC) audit, as well as reference to California and Michigan public service commission decisions." *SWG Post-hearing brief at 51-52.* This accusation is inaccurate and fails to acknowledge the evidence presented by Staff. First, the Commission should consider all available information in determining the appropriate percentage of AGA dues that should be excluded from Southwest's operating expenses in this proceeding. Secondly, Southwest neglected to mention that Mr. Smith also based his 40% disallowance on data taken from the March 2005 NARUC Audit Report as well as the AGA's 2007 and 2008 budgets. The evaluation of AGA's 2007 and 2008 budgets supported a somewhat higher disallowance. Staff Exhibit S-12, attachment RCS-2, Schedule C-6, page 2 and Tr. 931:13-24. Staff's recommendation that a 40% disallowance of AGA dues from operating expenses is appropriate was based on an analysis of all of these sources.

A review of the March 2005 NARUC audit materials with respect to the categories of AGA expenditures demonstrates that Staff's estimated 40% disallowance would appear to be a reasonable exclusion percentage. Staff reached that conclusion by excluding amounts associated with activities that should not reasonably be the responsibility of ratepayers. These categories include: a 24.13% disallowance for Public Affairs; a 10.54% disallowance for Corporate Affairs and International; a 50% disallowance of General Counsel & Corp Secretary, i.e., a 2.60% disallowance from total AGA dues of 5.20% total assigned by AGA to this category; and a 2.37% disallowance for Marketing Department. This data was presented in attachment Staff Exhibit S-12, attachment RCS-2, Schedule

C-6 page 2 of 2. These disallowance percentages combined produce an overall disallowance of 39.64% which nearly equals Staff's recommended disallowance of 40%.

Applying the same methodology with respect to the categories described above from the March 2005 NARUC audit report to the budget materials provided by the AGA for the years 2007 and 2008 results in an even greater disallowance. For example, if the 2007 AGA budget amounts were used to calculate a disallowance percentage, approximately 43.29% of AGA dues would be removed from Southwest's operating expenses. Furthermore, if the 2008 AGA budget information was used, approximately 46.19% of AGA dues would be appropriately disallowed. See Staff Exhibit; attachment RCS-2, Schedule C-6, page 2 of 2. Tr. 931:13-24.

Based on the foregoing, Staff recommends that a total of 40% of Southwest's AGA membership dues be removed from the Company's cost of service.

B. MIP/SIP/SERP.

In is Post-hearing brief, Southwest continues to request 100% inclusion of its MIP, SIP and SERP programs in the Company's operating expenses. Staff believes that the arguments offered by Southwest miss the point and fail to apply the analytical framework articulated by the Commission in a series of recent rate Orders concerning whether or not these types of expenses are allowable for ratemaking purposes. Consistent with Commission precedent on these issues and based on an analysis of the facts in the record, Staff recommends a 50% disallowance of the MIP program and 100% disallowance of the SIP and SERP programs.

Southwest continues to argue that its overall total compensation is prudent and reasonable by citing the compensation study (Peer Proxy Group) the Company conducted, whereby the Company compared its five highest paid employees total compensation to the five highest paid employees of each Proxy Peer Group company, as originally discussed by Company witness Hobbs in her direct testimony. *SWG Post-hearing brief at 58.* Southwest claims that Staff witness Smith acknowledged that he did not conduct any compensation studies similar to the Company's Peer Proxy Group study in support of his recommendations with respect to the MIP, SIP and SERP, and that he solely relied upon the Commission's decision in Southwest's last rate case and other recent Commission decisions. *SWG Post-hearing brief* at 59. However, these statements by Southwest miss the point. The Commission has articulated the analytical framework in recent Orders. The Commission focuses on the components of utility compensation. The Commission has consistently determined that certain components (e.g. incentive compensation) should be shared by ratepayers and shareholders. Other components (e.g. SERP and stock-based compensation) are the responsibility of shareholders. In contrast, Southwest is basing its request for 100% inclusion in operating expenses of the MIP, SIP and SERP solely on the basis of the alleged reasonableness of the Company's overall compensation as indicated by its Peer Proxy Group study. However, Southwest's analysis should not be determinative of the ratemaking treatment for incentive compensation in this case because it fails to apply the Commission's analytical framework to these individual components of compensation.

In its Post-hearing brief, Southwest stated that: "Staff witness Smith acknowledged that he did not conduct an independent review or analysis of the MIP as there was really no need to do so because of prior Commission precedent and based upon his belief that the present Commission is the same Commission that presided over the Company's last general rate case. Contrary to Mr. Smith's testimony, this is a different Commission and indeed, a different case." *SWG Post-hearing brief at 59.* First of all, this *is* the same Commission that presided over the recent UNS Gas, Inc. and UNS Electric, Inc., rate cases, in which Staff's recommendations regarding a 50/50 sharing of incentive compensation and a 100% disallowance of SERP and stock-based compensation (SBC) were adopted by the Commission per Decision Nos. 70011 and 70360, respectively, as noted in Staff's initial hearing brief. *Staff Post-hearing brief at 25.* Secondly, while the instant proceeding may be indeed be a different case, the facts and circumstances surrounding Southwest's MIP and SERP programs (the SIP program was implemented in May 2007) appear to be consistent with the Commission's findings concerning incentive compensation in Decision No. 68487, in which a 50/50 sharing of MIP and 100% disallowance of SERP was adopted. In addition, Staff's rationale for its recommendations regarding incentive compensation was discussed extensively during the hearings in the UNS Gas and UNS Electric rate cases. Furthermore, Southwest contends that Staff did not conduct any substantive analysis of the MIP program. *SWG Post-hearing brief at 59.* However, one need only review Staff witness Smith's direct testimony at pages 25-35 and his surrebuttal testimony at pages 21-28 to see that this contention is untrue. A detailed analysis of the components of Southwest's MIP was in fact presented by Staff, and used as the basis for the recommendation for 50/50 sharing. Southwest had not recorded an expense for stock expense in that case; Southwest adopted expense accounting for stock options pursuant to Statement of Financial Accounting Standards SFAS 123R. Exhibit S-12 at 36:13-19 and RCS-5 at pages 33-49. Prior to expensing stock options for financial accounting purposes, the dilution of common equity that resulted from issuing stock options was a "cost" to shareholders only, and was not an expense borne by Southwest's ratepayers. The exclusion of SIP expense in the current Southwest rate case is consistent with keeping the responsibility for stock options with shareholders, where it properly belongs.

With respect to the MIP, Staff maintains that only 50% of such expense should be charged to Southwest's ratepayers. As noted in Staff's initial closing brief, incentive compensation programs generally provide benefits to both ratepayers and shareholders. *Staff Post-hearing brief at 5.* At hearing, Company witness Hobbs acknowledged that all stakeholders benefit from the MIP, with stakeholders defined as shareholders, ratepayers, customers and government agencies. *Tr. 140:4-19.* In addition, on the issue of whether shareholders and customers benefit from the MIP, Company witness Hobbs stated in her direct testimony at page 5, lines 4-8, that: "The longer term performance shares act as a retention tool while aligning the interests of management/executive employees, <u>shareholders</u> and customers for continued financial and customer-oriented performance." (Emphasis supplied)

The benefit to shareholders from incentive compensation justifies the allocation of an appropriate portion of such expense to shareholders. Based on Staff's analysis of the specifics of Southwest's MIP, the appropriate allocation to shareholders in the current case is 50%.

Similar to the MIP, Southwest states in its Post-hearing brief that Staff's rationale for its recommendation to disallow 100% of the Company's SERP and SIP expense is based solely on prior Commission decisions. *SWG Post-hearing brief at 60.* As noted above, the rationale for Staff's recommendation was discussed extensively during the UNS Gas and UNS Electric hearings. In both decisions in those rate cases (Decision Nos. 70011 and 70360, respectively), the Commission ordered that 100% of SERP be disallowed. In fact, in Decision No. 70360 at page 22, the Commission stated:

> As was clearly stated in the passage cited above, and which passage was quoted in the UNS Gas case (Decision No. 70011, at 28) the issue is not whether UNSE may provide compensation to select executives in excess of the retirement limits allowed by the IRS, but whether ratepayers should be saddled with costs of executive benefits that exceed the treatment allowed for all other employees. If the Company chooses to do so, shareholders rather than ratepayers should be responsible for the retirement benefits afforded only to those executives. We see no reason to depart from the rationale on this issue in the most recent UNS Gas rate case, and we therefore adopt the recommendations of Staff and RUCO and disallow the requested SERP costs.

In addition, with respect to Staff's recommendation to disallow 100% of stock-based compensation, the Commission also stated on page 22 of Decision No. 70360 that:

> "For these same reasons, we agree with Staff that test year expenses should be reduced to remove stock-based compensation to officers and employees. As Staff witness Ralph Smith stated, the expense of providing stock options and other stock-based compensation beyond normal levels of compensation should be borne by shareholders rather than ratepayers (Ex. S-58, at 34). The disallowance of stock-based compensation is consistent with the most recent rate case for Arizona Public Service Company (Decision No. 69663)."

Staff's treatment of MIP, SIP and SERP is based on an analysis of the facts presented in the current case and is also fully consistent with the analysis and results of the Commission's Order in Southwest's last rate case and with other recent Commission decisions on similar or identical issues for other utilities, including UNS Gas and UNS Electric. Additionally, while not presented, the parties recent settlement in TEP's rate case, Docket No. E-01933A-07-0402, also reflected consistent treatment of that utility's incentive compensation, stock-based compensation and SERP.

Based on the foregoing, Staff still believes that the Commission should reject Southwest's position with respect to its request to include 100% of its MIP, SIP and SERP expense. The Company did not provide any compelling reasons for the Commission to deviate from its recent decisions on similar or identical issues. Staff's recommendation of a 50/50 sharing of incentive compensation and a 100% disallowance of SERP and SBC should be adopted for Southwest for the reasons described in Staff's testimony and briefs.

C. **<u>Injuries and Damages</u>.**

In its Post-hearing brief, Southwest disputed the pro forma amount of injuries and damages expense that Staff witness Smith calculated in this proceeding. The main point of contention is that Mr. Smith deviated from the methodology agreed to by the parties in the Company's last general rate case in favor of a different methodology for calculating the level of self-insurance expense. *SWG Post-hearing brief at 53.* Staff acknowledges that it used a different method to derive a reasonable pro forma adjusted level of the self-insurance component of injuries and damages expense. This was done for good reason: an evaluation of the results produced by the method in Southwest's last rate case clearly demonstrated that the method seriously overstated the amount of actual expense in each subsequent year for which information was available. *Staff Exhibit S-14:41.* Additionally, there is no single "right" method for determining an allowance for self-insurance. Other Arizona utilities, including UNS Gas, UNS Electric and TEP, use a method that differs significantly from the method used by Southwest. The objective is to determine a reasonable going forward allowance for self-insurance expense. Staff's proposal best accomplishes that in the current rate case.

Staff's calculation for self-insurance uses a 10-year average of recorded amounts as shown on attachment Staff Exhibit S-14, attachment RCS-7, Schedule C-12, page 2. The Company contends that the problem with Staff's calculation is that "the present level of aggregate insurance has not been in place for a period of 10-years. Therefore, Southwest does not have <u>recorded amounts</u> for 10 years using the current aggregate amount, and a result, Staff's calculation does not accurately reflect the level of self-insurance the Company expects to experience during the rate effective period." *SWG Post-hearing brief at 53.* This statement is ostensibly based on the fact that prior to August 1, 2004, Southwest's insurance carriers covered claims in excess of $1 million. As of that date, the Company implemented a second level of self-insurance (in addition to its self-insurance expense of up to $1 million per claim) that initially had a $10 million aggregate level, but as of August 1, 2005, Southwest purchased additional insurance covering $5 million of the $10 million referenced above and that resulted in a $5 million aggregate level going forward. It is on this basis that the Company contends that "in order to properly normalize self-insurance expense based upon a 10-year history, Southwest restated the claims prior to August 1, 2005 as if the $5 million aggregate had existed for all ten years." *SWG Post-hearing brief at 54.* The result of the Company's restatement, however, is to substantially increase its test year recorded amount to the point of being unreasonable.

Southwest made a similar assertion with respect to its system allocable amounts as it related to the May 2005 leaking gas line fire where it stated: "As noted above, beginning with the agreement among the parties in the last general rate case, the Company began recording the aggregate levels of self-insured retention as system allocable. Therefore, there is no history of system allocable recorded amounts at this level because prior to the last general rate case, the Company recorded these expenses directly to the jurisdiction where the incident occurred." *SWG Post-hearing brief at 55.*

The problem with Southwest's methodology for calculating its going forward injuries and damages expense is that, despite the fact that it was agreed to by the parties in the Company's last rate case, it clearly has significantly overstated Southwest's actual self-insurance expense in 2006 and 2007. As explained in the surrebuttal testimony of Staff witness Smith and reproduced in Staff's initial closing brief at pages 10-11:

> The method used by Southwest in its last rate case would have significantly overstated the expense amounts recorded in 2006 and 2007, respectively. In Southwest's last rate case, Docket No. G-0551A-04-0876, a test year ending August 31, 2004 was used. Based on the estimating method used in that docket, as shown on Southwest's response to Staff data request, STF-13-14, a pro forma expense for Arizona operations of $1,731,312 was allowed. As shown in the following table, however, this allowed amount has substantially exceeded Southwest's recorded expenses for self insurance in each year, 2006 and 2007 (from Staff Schedule C-12, page 2):

Reserve for Self-Insurance Expense
Amount allowed in last SWG rate case (G-01551A-04-0876) $ 1,731,312 (2)

Arizona and Common Actual Recorded Expense Amounts

Year	Arizona Direct	Total Common	Common Allocated to Arizona (1)	Total Arizona	Overstatement of Actual
	(A)	(B)	(C)	(D) A + C	(E) Above - Col.D
2006	$ (975,540)	$ 200,000	$ 108,909	$ (866,631)	$ 2,597,943
2007	$ 713,629	$ (25,500)	$ (13,886)	$ 699,743	$ 1,031,569

Notes and Source
(1) Based on the Paiute and AZ percentages shown on Sch C-12, p.2
(2) SWG response to STF-13-14, sheet 4 of 6

> Southwest is proposing to use a similar estimation method in the current case. The concern that such an estimation method would continue to significantly overstate Southwest's actual recorded expense for self-insurance thus persists."

The methodology used by Staff to calculate Southwest's injuries and damages expense started with a 10 year average using actual recorded amounts. Staff removed $10 million amount related to a May 2005 leaking gas line fire as this amount represented an extreme and unprecedented expense that is totally out-of-line with the expense in all other years of the period 1998 through 2007 where the "common" expense ranged from a high of $500,000 in 1998 to a low of a negative $300,000 in 2003. The $10 million related to this extremely abnormal event should be excluded in the calculation of Southwest's going forward injuries and damages expense. As explained by Staff witness Smith in his direct testimony and reproduced in Staff's Post-hearing brief at pages 11-12:

> That expense is abnormal and was incurred in a prior period. Rates in the current case are being established for prospective application. While historical information may be useful to address normalized expenses, an extremely abnormal event like the May 2005 leaking gas line fire-related settlement expense, is not expected to reoccur and should therefore not be built into pro forma operating expenses. Second the Company has not demonstrated that the May 2005 leaking gas line fire was not due to its own negligence. Ratepayers should not be burdened with extra costs that may have been incurred as the result of negligence by the utility. Exhibit S-12 at 62:17-24.

Staff believes that the methodology it used produces a reasonable going forward allowance for injuries and damages expense. Staff's recommended normalized allowance is $7.317 million, which represents an increase of $1.638 million or 29 percent, over Southwest's test year amount of $5.679 million. Staff acknowledges that this methodology differs from the one agreed to by the parties in the Company's last rate case. The fact that a method was used in one rate case, however, does not mean that there is no other reasonable way of estimating Southwest's self-insured expense for ratemaking purposes. The Company also agreed with this assertion at hearing. *Tr. at 263:14-23.* Staff would not have proposed a different method if the method used in the prior rate case was thoroughly sound and was producing reasonable results. However, the evidence shows that method had inherent flaws, was based on "restating" prior year actual results, and was producing unrealistically high estimates of pro forma expenses that were far in excess of subsequent actual recorded amounts.

In its Post-hearing brief, Southwest points out that its proposed level of self-insurance is $1,762,000 or approximately $31,000 more than the approved level in its last rate case, thus demonstrating the reasonableness of the Company's requested level of self-insurance expense in this proceeding. However, as noted above, the amount approved in the last rate case overstated Southwest's actual recorded amounts by approximately $2.6 million in 2006 and $1 million in 2007. In other words, it caused ratepayers to significantly over-pay for this expense component.

In summary, Southwest has proposed a pro forma Injuries and Damages expense for Arizona of $8.259 million. This represents an increase of $2.580 million or 45 percent, over the test year recorded amount. In contrast, Staff recommends a normalized allowance for Injuries and Damages expense for Arizona of $7.317 million. As noted above, this represents an increase of $1.638 million or 29 percent, over the test year recorded amount of $5.679 million. For the reasons described above, Staff's going-forward injuries and damages allowance is reasonable. The Company's filed amount should be decreased by $851,717 as shown on Staff Exhibit S-14, attachment RCS-7, Schedule C-12, revised, page 1, columns D and E.

D. <u>Outside Services and Injuries and Damages Error Correction</u>.

In its Post-hearing brief, Southwest discusses an error correction resulting from the Company failing to reclassify a credit booked to the wrong account during the test year. Specifically, Southwest erroneously booked a $300,000 credit to Account 923 – Outside Services during the test year when it should have been booked to Account 925 – Injuries and Damages. *SWG Post-hearing brief at 64*. Southwest stated that this error correction did not zero out, but instead increased the Company's revenue requirement by $283,664 due to the self-insurance component of injuries and damages being based on a 10 year average and allocated system-wide using the four-factor methodology. *SWG Post-hearing brief at 64.*

At hearing, Staff witness Smith stated that Staff presented its case in terms of the Company's original filing and all of his adjustments were calculated based on Southwest's original filing. *Tr. 900:4-6.* As a result, when looking at the error correction discussed above from a test year accounting perspective, one expense account would be increased by $300,000 (Account 923) and the other account (Account 925) decreased by $300,000 and the impact on recorded test year amounts should net to zero. *Tr. 900:11-14.* Southwest is reflecting this adjustment for ratemaking purposes and therefore calculated a substantial pro forma expense increase due to the methodology the Company proposes to use for its pro forma injuries and damages expense discussed above.

Based strictly on the recorded test year amounts, the impact on expenses of this Southwest error correction should net to zero. If the Commission adopts Staff's recommended injuries and damages expense, no separate adjustment is necessary. If the Commission adopts Southwest's injuries and damages proposal, the result including this error correction is an increase to Staff's recommended test year expense of $1,135,381 as shown on Staff Exhibit S-14 at 40. Staff recommends that the Commission adopts Staff's Injuries and Damages expense, as explained above.

E. <u>Depreciation Expense and Property Tax Associated with Yuma Manors</u>.

In its Post-hearing brief, Southwest maintains that the maximum adjustment for depreciation and property tax expense related to the $320,779 the Company agreed to remove related to the replacement of the Yuma Manors pipeline system is $15,175 and $8,499, respectively.

Staff's position on this issue is that that offer by Southwest is the absolute <u>minimum</u> adjustment for Yuma Manors and the appropriate amounts to remove for depreciation and property tax expense related to its adjustment to remove 100% of the cost associated with the premature replacement of Yuma Manors pipe is $54,370 and $28,945, respectively.

F. <u>Yuma Manors Pipeline Replacement</u>.

In its Post-hearing brief, Southwest disputes Staff's recommendation to remove 100% of the costs associated with the premature Yuma Manors pipeline replacement project from the Company's rate base. Southwest disagrees with Staff witness Hansen's assessment that the circumstances surrounding the need to replace the pipeline system was the direct result of the negligence of a Southwest employee. *SWG Post-hearing brief at 46-47.* The Company has agreed to remove $320,779 of costs related to overtime, shift premiums and other related costs incurred by the Company pursuant to the replacement of the system over a short period of time. However, Staff contends that the $320,779 represents the absolute <u>minimum</u> adjustment that should be made. Staff recommends that the entire cost of the premature replacement of Yuma Manors pipe caused by Southwest employee errors of $1,092,448 should be removed from the Company's rate base.

In its Post-hearing brief, Southwest listed several factors which the Company stated were indicators that the pipeline system *may* have already been reaching the end of its useful life regardless of the employee error. *SWG Post-hearing brief at 47-48.* With respect to the incorrect taken by the Southwest employee, the Company stated that: "…it is reasonable to conclude that this system would need replacement sometime in the near future, and the effect of any purported employee error simply identified the weak links in the system." The Company went on to say that: "the employee's purported mistake did nothing more than expose this potential issue sooner than Southwest may have otherwise have learned about it, which then resulted in a pipe replacement project that occurred sooner than otherwise would have. Nothing more, nothing less." *SWG Post-hearing brief at 48.*

The recorded evidence shows that the chief cause of the pipeline's failure and the need for an urgent replacement of such pipe was a direct result of the Southwest employee incorrectly installing the Cathodic Protection (CP) system to the pipeline and the resultant gas leakage. The incorrect installation of the CP system, i.e., the reverse wiring of the CP, caused the accelerated corrosion of the pipeline, and was the direct result of negligent maintenance and errors by a Southwest employee.

In fact, as noted in Staff's initial closing brief, according to the Company's witness, there were no immediate plans to replace the pipeline, even after a visual inspection was conducted in 2006. *Staff Post-hearing brief at 16 and Tr. at 224-225.*

In its Post-hearing brief, Southwest cites Company witness Mashas' rebuttal testimony where he stated that Staff's recommendation for 100% disallowance of the Yuma Manors pipeline project costs from rate base is inconsistent with past Commission precedent. Southwest claims that in the five Commission proceedings that Mr. Mashas has testified in since 1986, the Commission never disallowed 100% of a pipeline system's replacement costs, regardless of a purported error by the gas utility necessitating the pipe replacement. *SWG Post-hearing brief at 43.* Mr. Mashas cited four prior Commission Orders in his rebuttal testimony. At pages 9-10 of his rebuttal testimony, Mr. Mashsas stated:

> Beginning in Commission Decision No. 57075 and in every subsequent Commission rate case decision for Southwest, the remedial portion of pipe replacement was shared equally between customers and shareholders, if the original installation of the pipe was buy a gas company other than Southwest. This was the case regarding Arizona Public Service (APS) installed ABS pipe. This was also the Commission ruling in regards to Tucson Gas and Electric (TG&E), now Tucson Electric Power (TEP), installed Aldyl A, ABS and 1960s vintage steel pipe. In the one instance where pipe replacement was the result of Southwest installed Aldyl HD pipe, the remedial portion of pipe replacement was the sole responsibility of Southwest's shareholders. (Emphasis supplied)

As indicated in the last sentence of the above quoted portion of Mr. Mashas' rebuttal testimony, the Commission has found that, in certain circumstances, the remedial portion of pipe replacement costs are the sole responsibility of Southwest's shareholders. Based upon the circumstances surrounding the Yuma Manors pipeline failure as described by Staff witness Hansen, the responsibility for the costs of premature pipe replacement associated with that project be borne by Southwest's shareholders. In his rebuttal testimony, Mr. Mashas also cited Decision No. 58693 whereby the Commission adopted and approved a settlement that addressed the appropriate level of steel pipe replacement that would be included in rate base. Page 5, paragraph F of Decision No. 58693 provides that:

> ...nothing in this Agreement shall be construed as prohibiting Staff or any other party from pursuing new issues related to expenditures made or actions taken after June 30, 1993, except for the treatment of pipe replacement and repair costs, which will be governed by paragraph B. However, Staff or any other party shall not be precluded from pursuing issues related to pipe replacement, pipe repair, leak surveys or any other matter related to pipe replacement, pipe repair, or leak surveys not specifically covered by Paragraph B.

Staff's position is that Southwest's incorrect installation of the CP system in the Yuma Manors pipeline falls under the provisions of Paragraph F in Decision No. 58693 described above. Nothing about the specific facts of the Yuma Manors pipe replacement, which came to light for the first time in the current Southwest rate case, or Staff's recommended adjustment to hold Southwest's shareholders responsible for the cost related to the negligent maintenance is barred by prior Commission decisions.

In its Post-hearing brief, Southwest stated that Staff agrees that the new pipeline is a betterment to the system and that the Company acted prudently in its decision to replace the ground bed to maintain a safe and reliable system and in replacing the Yuma Manors pipeline system. Company Brief at 49. While this may be true, it is not the issue. The issue is that the primary cause of the pipeline system's failure and the incurrence of cost to replace it prematurely was a direct result of a Southwest employee's error installing the CP system on the Yuma Manors pipeline system.

Therefore, rate base should be reduced by $1,092,448 to remove the costs related to the replacement of the Yuma Manors pipeline system. Those costs should be borne by Southwest's shareholders and should be disallowed in this proceeding.

Staff acknowledges that the evidence would support a rate base disallowance between the absolute minimum amount of $320,779 offered by Southwest and the $1,092,448 full cost disallowance recommended by Staff. Tr. 958:5-25. Because the costs resulting from negligent maintenance should be borne by shareholders, not ratepayers, Staff recommends the full cost of $1,092,448 be disallowed. However, if the Commission chooses an "in-between" amount, Staff believes it should be in the higher end of the range, i.e., closer to the $1.1 million.

V. CONCLUSION

The Commission should adopt the Staff's recommendations as discussed herein and in the Staff's Post-hearing Brief as the rates produced thereby are just and reasonable and in the public interest.

RESPECTFULLY SUBMITTED this 25th day of August, 2008.

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