ORIGINAL OPEN MEETING AGENDA ITEM

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SOUTHWEST GAS CORPORATION

February 7, 2006

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

Subject: Southwest Gas Corporation
General Rate Case; G-01551A-04-0876
<u>Exceptions to the Recommended Opinion & Order</u>

Please accept for filing the enclosed original and thirteen (13) copies of the Exceptions of Southwest Gas Corporation to the Recommended Opinion and Order of ALJ Nodes in the above-referenced proceeding. An additional copy of this letter is included for Docket Control to date/time stamp and return.

Should you have any questions, please do not hesitate to contact me at (702) 876-7163 or Randy Sable at (702) 364-3079.

Respectfully,

Debra S. Jacobson

Debra S. Jacobson
Director, Government & State Regulatory Affairs

c Jeff Hatch-Miller, Chairman
Marc Spitzer, Commissioner
William Mundell, Commissioner
Kristin Mayes, Commissioner
Mike Gleason, Commissioner
Dwight Nodes, Assistant Chief ALJ

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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

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 THE PROPERTIES OF SOUTHWEST GAS CORPORATION DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.

DOCKET NO. G-01551A-04-0876

EXCEPTIONS OF SOUTHWEST GAS CORPORATION TO THE RECOMMENDED OPINION AND ORDER

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EXCEPTIONS OF SOUTHWEST GAS CORPORATION TO THE RECOMMENDED OPINION AND ORDER

Pursuant to A.A.C. R14-3-110.B and the notice of filing recommended opinion and order of the Assistant Chief Administrative Law Judge Dwight D. Nodes ("ALJ"), filed by the Executive Director of the Arizona Corporation Commission ("Commission") on January 24, 2005, Southwest Gas Corporation ("Southwest" or the "Company") respectfully submits to the Commission for consideration the following exceptions:

I.
BRIEF SUMMARY INTRODUCTION

The overarching theme set forth in Southwest's application for an increase in rates is the Company's inability to recover the Commission-authorized margin, thus negatively impacting its ability to earn the Commission-authorized rate of return.

This general rate case provides the Commission with a unique and timely opportunity to take positive steps, primarily through the determination of a competitive cost of capital and the establishment of a rate structure designed to provide Southwest with a realistic opportunity to recover its fixed costs, to better ensure that Southwest has a reasonable opportunity to earn its authorized rate of return. There was general agreement, if not unanimity, among the parties that the consequence of such actions by the Commission would be to strengthen Southwest's financial profile, which reasonably could be expected to result in a better-leveraged capital structure and, ultimately, lower capital costs for the benefit of Southwest's customers.

Southwest's current credit rating from Standard & Poor's is "BBB-", which is the lowest investment grade rating, and Southwest's credit rating from Fitch and Moody's is only one level above investment grade. On February 27, 2004, Moody's changed its ratings outlook for Southwest from "stable" to "negative". Moody's stated what could be cause for a ratings downgrade to be:

> *Continuing high leverage, continuing earnings volatility on account of weather variations and eroding margins from declining customer consumption, continuing lags in recovery of capital investment costs."*[1]

The ability for the Company to improve its bond rating was also addressed by Standard & Poor's (S&P) in their most recent summary report for the Company (see Rejoinder Exhibit No. A- 38 (TKW-4)), where S&P stated:

> *Ratings improvement hinges on achieving better rates of return and rate design improvements in Arizona, as well as maintaining improved regulatory treatment in Nevada.*

Prominent throughout this case was the acknowledgment that there was a need for a

[1] Moody's Investor Services Credit Opinion: Southwest Gas Corporation, February 27, 2004.

change because Southwest has experienced a chronic and continuing inability to earn the Commission-authorized rate of return and that declining average residential consumption, combined with the existing volumetric rate design, was the primary culprit. Notwithstanding the dire need for a change that stems from the overwhelming amount of evidence and the overall tone of the hearing, the cries for such a change are not heeded in the recommended opinion and order which, not only is silent on these matters but, proposes adoption of rate design proposals that collectively constitute a step backward from the status quo.

Southwest respectfully requests that as the Commissioners review the Company's exceptions, and as they are considering the Company's position on these select items, they ask themselves: does the recommended opinion and order truly reflect an equitable result for Southwest and its customers, as well as all other stakeholders.[2]

The Appendix attached hereto contains proposed amendments that modify the applicable portions of the recommended opinion and order with respect to each item that Southwest addresses below.

II.
RATE BASE

A. Deferred Taxes.

The recommended opinion and order denies the Company's deferred tax adjustment for the following reasons: (1) it is improper to recognize the new Internal Revenue Service ("IRS") regulations; (2) the Company did not quantify the impact of the Energy Policy Act; and (3)

[2] By filing exceptions on select items, Southwest does not waive any claim or potential argument regarding any other procedural or substantive issues that may have arose during this proceeding, and Southwest specifically reserves its right to file any applicable post-order pleading that it deems appropriate.

Southwest did not present the deferred tax adjustment as part of its direct case.

Contrary to the recommended opinion and order, the Company's deferred tax adjustment is proper for the following reasons:

1. The IRS regulations have the full force and effect of law, and Southwest is obligated to comply with the regulations. The new regulation and ruling requires Southwest to include in income, in 2005 and 2006, the cumulative tax deduction taken under the old UNICAP regulations with respect to the simplified service cost method. As such, this change is mandatory and not elective, and it impacts the test year rate base.

2. The IRS regulations prevented the Company from continuing with an election that it made in 2002 that was going to benefit customers by increasing deferred taxes and decreasing rate base. The new IRS regulations closed the door on companies from availing themselves of this election and, as such, required the Company to include in income, in 2005 and 2006, the cumulative tax deduction taken under the old regulations, and putting the Company in a position similar to what it would have been in had the Company not made the election. As such, there is no harm to customers because the Company is in essentially the same position as it would have been had the Company not made the election in 2002. Accordingly, there is no justification for disallowing this adjustment.

3. There is no need to quantify the impact of the Energy Policy Act. The provisions of the Energy Policy Act that affect Southwest are only applicable to property placed in service after April 11, 2005, and the act has no effect on property placed in service before that date. Consequently, the Energy Policy Act has no effect on the Company's rate case because its test year ended August 31, 2004.

4. The new IRS regulations were issued on August 3, 2005. Consequently, it was impossible for Southwest to include the net effect of the new IRS regulations in its direct case (the application was filed in December 2004). As a result, the Company included the requested change in its rebuttal testimony that was filed on August 23, 2005. The intervening parties had ample time to address this issue through data requests and pre-filed testimony.

As such, based upon the foregoing, the ALJ's recommended opinion and order should be amended to permit Southwest to recover the proposed deferred tax adjustment.

B. <u>Pipe Replacement – Steel Pipe</u>.

As noted by the ALJ, Decision No. 58693 stated: "In future Southwest rate cases for the Southern Division gas properties, Southwest shall exclude from rate base an additional portion of capitalized expenditures associated with replacements of Aldyl A, Aldyl HD, steel installed in the 1960s, and ABS pipe related to defective materials and/or installation." As such, only if a specific pipe type was found to be a defective material or a defective installation was the Company required to write-off the pipe replacement.

1960s steel pipe was never found to be defective material and was only subject to write-off under Decision No. 58693 because of installation practices (i.e., the lack of cathodic protection). However, by 1998, all of the Company's steel pipe was cathodically protected, and therefore, no longer subject to the terms and conditions of Decision No. 58693, and the Company was no longer required to write off its pipe replacements of 1960s steel pipe. There is no evidence in the record that contradicts the Company's position with respect to its steel pipe replacements. As such, based upon the foregoing, the ALJ's recommended opinion and order should be amended to deny RUCO's proposed disallowance of rate base associated with the write-off of 1960s steel pipe.

III.
OPERATING INCOME

A. An Analysis of Who Benefits From an Expense is an Exercise That Results in Inconsistent and Unlawful Conclusions.

Throughout the operating income portion of the ALJ's recommended opinion and order, the ALJ undertakes an analysis of whether the customer or shareholder benefits from a specific operating expense as a basis for determining whether the Company should recover that particular operating expense. This is an improper analysis because it is an unfocused exercise that leads to inconsistent and unlawful results, insofar as it disallows prudently-incurred operating costs.

The inconsistency in the application of such a nebulous standard can be illustrated by the ALJ's own recommended opinion and order. For example, on page 12, lines 2-4 and page 14, lines 7-9 of the recommended opinion and order the ALJ's justification for permitting the recovery of expenses related to the compensation of 37 employees and American Gas Association dues includes an analysis of whether "shareholders and ratepayers" benefit from the expense. However, on page 15, lines 21-22 and page 17, lines 1-5, the ALJ uses the same rationale, to wit, that the expenses benefit both "shareholders and ratepayers" to support his recommended disallowance of operating expenses related to Sarbanes-Oxley and pipeline safety (TRIMP).

The Commission establishes rates that are supposed to "meet the **overall operating costs of the utility** and produce a reasonable rate of return." (Emphasis added.) *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (1978). As such, a utility is entitled to recover its operating costs, and a disallowance of a prudently incurred operating expense is improper. *Id.* and *Residential Utility Consumer Office v. Arizona Corporation Commission,* 199 Ariz. 588, 20 P.3d 1169 (2001). Accordingly, the proper analysis should be a prudency review of the Company's operating expenses, not who benefits from the expense. As such, the Commission should amend the recommended opinion and order with respect to the following items:

Federally-Mandated Programs

Transmission Integrity Management Program. The Transmission Integrity Management Program ("TRIMP") is the result of federal legislation and regulations prescribing standards for transmission pipeline risk analysis and adopting and implementing a pipeline integrity management program. TRIMP is nothing more than pipeline safety-related costs, similar to those that the Company has been incurring and recovering in rates for the past thirty years. TRIMP is a mandatory cost of doing business as a local distribution company, and there is no justifiable reason to disallow a portion of TRIMP. A disallowance of a prudently incurred operating expense, such as TRIMP, is unlawful. Southwest does not oppose Staff's recommendation that a surcharge mechanism is the appropriate means of recovering the compliance costs associated with TRIMP.

Sarbanes-Oxley Act of 2002. Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") is federal legislation that requires the establishment of an internal control structure and certain procedures for financial reporting. As such, SOX compliance is mandatory and non-compliance would likely result in severe Securities and Exchange Commission penalties and other consequences, including, without limitation, delisting, significant financial penalties, financing costs, and it would also negatively affect Southwest's access to capital markets, and ultimately harm customers. As such, Southwest should be permitted to recover all of its actual SOX costs, and a disallowance of a prudently incurred operating expense, such as SOX compliance, is unlawful.

Reversal of Long-Standing Precedent

Supplemental Executive Retirement Plan. Southwest offers a Supplemental Executive Retirement Plan ("SERP") to its officers to ensure that their retirement and deferred compensation portions of their total compensation are on parity with all other employees of Southwest whose retirement distributions are not impacted by certain IRS regulations. The Commission has allowed full recovery of SERP in every prior Southwest general rate case since the inception of the IRS regulations. Most recently, in the Company's last general rate case, Decision No. 64172, the Commission found: "In arguing that SERP costs should not be borne by ratepayers, RUCO did not focus on the overall compensation package to the company's top executives. There is no evidence that Southwest's overall compensation package is excessive. We will not remove the SERP from allowed expenses absent such showing." The record in the present case is also devoid of any evidence that the overall compensation of the Company's executives is excessive. RUCO never made such a challenge and presented essentially the same evidence it did in Southwest's last general rate case. Furthermore, the SERP is a reasonable operating expense that is common among most publicly held Fortune 1000 company survey respondents. Accordingly, there is simply no basis for a disallowance of SERP, and the recommended opinion and order should be amended to permit the Company to recover the SERP operating expenses.

Management Incentive Plan

Management Incentive Plan. The Company's Management Incentive Plan ("MIP") represents a portion of management's total overall compensation, which is designed to retain and attract quality management. There is no evidence that Southwest's overall compensation package is excessive and by disallowing a portion of the MIP, Southwest is being penalized for its efforts to retain and attract quality management. Notwithstanding the arguments and analysis for and against the five factors used by the Company to quantify the MIP payout, if the MIP portion of the total overall compensation were included in the management's base salary, there would be no proposed disallowance. The MIP is a reasonable operating expense and should not be disallowed.

IV.
COST OF CAPITAL

For the limited purpose of these exceptions, Southwest takes issue with only the return on common equity ("ROE") of 9.5% that the ALJ proposes in the recommended opinion and order. It is not unusual for there to be differences of opinion among cost of capital witnesses when it comes to estimating the cost of common equity. However, in this proceeding, there is one guiding principle upon which there is unfaltering unanimity – i.e., the *Hope/Bluefield* standards.

At lines 12-14 on page 30 of the recommended opinion and order, the following statement is made: "The oft cited *Hope* and *Bluefield* cases provide that the return determined by the Commission must be equal to an investment with similar risks made at generally the same time . . . ." [Underlining added]. On Exhibit A to these exceptions, the above-quoted language is repeated and superimposed on Exhibit No. A-41.

Exhibit No. A-41 compares Staff witness Hill's recommended 9.5% ROE, relative to a

40% common equity component in the capital structure, with Staff witness Hill's <u>own</u> proxy group results of a 10.93% ROE relative to a 48.85% common equity component in the capital structure. Even Staff witness Hill acknowledged during cross-examination that an investor in Southwest <u>could not</u> expect to realize a return commensurate with a return on an investment in the proxy group companies. [Tr. 898, lns. 8-11].

Following are the recommendations of the parties related to the equity component of the capital structure and return on equity (the recommended opinion and order adopts Staff's proposal):

	Southwest	RUCO	Staff
Equity Component of Capital Structure	42%	42%	40%
Return on Equity	11.42% [w/o CMT] 11.17% [with CMT]	10.15%[3]	9.5%

In addition to the foregoing illustration, the following comparative information, which the Commissioners may find interesting, if not useful, in arriving at is decision in this proceeding, demonstrates that the ALJ's recommendation is woefully low – if the objective is to satisfy the *Hope/Bluefield* standards of reasonableness:

1. Staff, in its November 4, 2005 initial closing brief cites to the most recent Southwest general rate case decision of the Public Utilities Commission of Nevada ("<u>Nevada Commission</u>") to support its position that a hypothetical capital structure of 40% best balances

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[3] RUCO recommends a 42% common equity component in the capital structure as a means of adjusting for the differential between the capital structures of Southwest and RUCO's proxy group companies. [Ln. 26, page 23 through ln. 24 on page 24, recommended Opinion and Order]. Had RUCO not made the adjustment to a 42% common equity component in the capital structure, sound financial theory would support a corresponding increase to the 10.15% ROE recommendation.

the interests of customers and investors. [Page 29, lns. 12-15 of Staff's brief, referring to Exhibit No. S-22, Nevada Commission Order No. 04-3011 at paragraph 31.] At paragraph 86 of that same Nevada Commission Order, which is not mentioned by Staff in its brief, the Nevada Commission determined that a **10.5%** ROE relative to a 40% common equity component was just and reasonable.

2. In Decision No. 67744, dated April 7, 2005, in Docket No. E-01345A-03-0437, the Commission approved a proposed settlement which provided for a **10.25%** ROE relative to a 45% common equity component in the capital structure for Arizona Public Service Company ("APS"). Despite, then-RUCO witness Hill's recommendation of 9.5%.

3. On June 24, 2005, in Docket No. E-01933A-04-0408, Staff witness Dorf recommended a **10.50%** ROE for Tucson Electric Power Company ("TEP") relative to a 40% common equity component in the capital structure.

4. The average regulatory return on common equity awarded for all fully-litigated cases for the period January 2003 through June 2005 was **10.91%** relative to a 47.50% common equity component in the capital structure. [Exhibit No. A-36, page 41 and FJH-24.]

5. Value Line's forecasted ROE for the natural gas distribution industry is **12.0%** relative to a 45% equity component in the capital structure for 2006 and **12.5%** relative to a 45.5% common equity component in the capital structure for the 2008-2010 time frame. [Exhibit No. A-37, page 16 and FJH-33.]

6. Exhibit B to these exceptions is a graphic representation of the regulatory return on common equity awarded for natural gas distribution rate cases for the period January 2003 through June 2005 that was referred to by Southwest witness Hanley in FJH-24. [*See* Exhibit

No. A-36.] Exhibit B illustrates how Staff witness Hill's recommendation, and the ALJ's recommended 9.50% ROE falls outside the zone of reality, let alone reasonableness.

For all of the foregoing reasons, the Commissioners are respectfully urged to reject the recommended 9.50% ROE and, instead, to determine that the 11.42% ROE (11.17% with the CMT) recommended by Southwest aligns better with all of the comparative data and the reality that Southwest, with a BBB- credit rating which is but one step above junk bond status, is considerably weaker financially than the proxy group companies with which Southwest must compete for capital. It is in the public interest that Southwest be afforded an opportunity to earn a competitive risk-adjusted rate of return, in order to maintain its financial integrity and attract the capital necessary to meet its obligations to serve customers.

V.
THE CONSERVATION MARGIN TRACKER AND RESIDENTIAL RATE DESIGN

A. The Conservation Margin Tracker.

What is more equitable than a Commission order that protects customers from variances in usage (due to inefficient building envelopes, colder than normal weather, among others) and that also protects the utility by eliminating its dependency on volumetric sales, therefore reducing the Company's risk associated with variances in customer usage (due to conservation efforts, warmer than normal weather, among others)? These benefits are precisely the equitable result that would accompany the approval of the conservation margin tracker ("CMT"). Additional benefits of the CMT include the following:

1. The CMT protects customers by eliminating the risk that the Company may experience a windfall by recovering more than its Commission-authorized margin per customer,

especially during periods of colder than normal weather.

2. The CMT protects customers by reducing the risk that the Company may earn a rate of return that is more than its Commission-authorized rate of return.

3. The CMT protects all stakeholders by removing the inherent financial disincentive the Company presently has to aggressively promote conservation and energy efficiency.

4. The CMT provides regulators and stakeholders greater flexibility in designing rates because it will permit the Company to recover its authorized margin per customer (no more and no less), and potentially improve its currently weak credit ratings, while at the same time permitting rates to be designed to encourage conservation without jeopardizing the utility's ability to recover its Commission-approved operating costs.

5. The CMT is risk free to all stakeholders. If Southwest's customer usage levels do not vary from the usage levels used in this proceeding to establish rates, then the CMT will not be a factor in customer's bills. However, if the usage varies (for whatever reason – conservation efforts, warmer or colder than normal heating seasons, etc.), then the CMT will result in either a surcharge or a surcredit, as the case may be.

6. Adoption of the CMT would benefit the Company and its customers by minimizing future financing costs as a result of eliminating the Company's reliance upon volumetric sales to recover Commission-authorized margin, thus providing the Company a better opportunity to earn the Commission-authorized rate of return and likely improving the Company's financial position in the view of investment analysts and rating agencies.

7. The CMT is not a drastic or unprecedented concept. In fact, the protection afforded by the CMT is essentially the same as that provided under Southwest's existing purchased gas balancing account. The Company has presented several exhibits and other documentation demonstrating support for decoupling mechanisms, including, without limitation, the following: copies of state public utility commission orders that have approved decoupling mechanisms; a list of over one hundred different state public utility commission decisions that have addressed the concept of decoupling margin recovery from sales for both electric and gas utilities; a copy of the joint statement from the American Gas Association and the National Association of Regulatory Utility Commissioners ("NARUC"); and copies of resolutions from the board of directors of NARUC. [*See* Exhibit A-53; Appendix 1 to Southwest's Post-Hearing Brief; Exhibit A-47 and Exhibits SMF-2 and SMF-3 to Exhibit A-47; appendices A and B to Southwest's Supplement to Post-Hearing Reply Brief.]

For whatever reason, most intervening parties and the ALJ were apprehensive about permitting the Company and its customers the opportunity to experience the equities associated with the implementation of the CMT. The CMT simply ensures that the Company and its customers actually experience what the Commission orders, with respect to the recovery of margin, thus providing the Company with an improved opportunity to actually earn the Commission-authorized rate of return (yet, by no means guaranteeing that return) and to strengthen its capital structure.

As such, the CMT is really a win-win situation for Southwest and its customers, as well as all other stakeholders, and Southwest requests that the Commission amend the recommended opinion and order to permit the implementation of the CMT or some other form of a decoupling mechanism.

B. Residential Rate Design.

In order to demonstrate that the Company's rate design provides greater benefits to customers than the rate design proposed by the ALJ in the recommended opinion and order, the Company calculated its rates using its rate design and the ALJ's proposed revenue requirement and commodity blocks. The following table illustrates the Basic Service Charge (BSC) and commodity rates for the ALJ's and the Company's rate designs, using the ALJ's proposed revenue requirement:

RATES CALCULATED AT ALJ's PROPOSED REVENUE REQUIREMENT

	ALJ RECOMMENDED (STAFF)	SOUTHWEST	
		WITH CMT	WITHOUT CMT
Basic Service Charge	$9.70	$10.50	$13.00
First Tier Rate	0. 54200	0.62157	0.51945
Second Tier Rate	0. 50100	0.30779	0.24545

By establishing rates that more closely reflect its cost of providing service, the Company's proposed rate design: (1) minimizes the impact on customers during the winter months; (2) reduces the intra-class subsidy that wealthier low-volume residential customers receive from large-volume low-income residential customers; (3) provides more stability to customers at a time when gas prices are volatile; (4) reduces the amount of margin customers would be at risk of paying in excess of the Commission-authorized levels; and (5) reduces the risk that the Company will not recover its authorized margin.

1. Winter Bills Are Impacted Less Under Southwest's Rate Design Proposal.

If this Commission is concerned with the impact of rate increases on an individual's ability to pay bills during the winter heating season, it will adopt the Company's rate design. The following table illustrates the January customer bills (excluding gas costs) and the difference in the bills using Southwest's proposed rates and the ALJ's recommended rates:

	January Bill Excluding Gas Cost		
	SWG	**ALJ**	**Difference**
With CMT			
Low Volume Customers	$ 17.34	$ 15.66	($ 1.68)
Mode Volume Customers	$ 39.95	$ 41.20	$ 1.25
High Volume Customers	$ 69.19	$ 88.79	$19.60
Without CMT			
Low Volume Customers	$ 18.71	$ 15.66	($ 3.05)
Mode Volume Customers	$ 37.32	$ 41.20	$ 3.88
High Volume Customers	$ 60.63	$ 88.79	$28.16

The impact to customers during the winter months is minimized with the Company's rate design proposal. The high-volume (including low income) customers pay almost $20.00 more per month under the ALJ's recommendation than under Southwest's with the CMT ($28.00 more per month without the CMT). Contrary to Staff's contention that Southwest's rate design adversely impacts low-volume customers, the difference in the low-volume customers' bills under the ALJ's and the Company's rate design is only $1.68 ($3.05 without the CMT). Additionally, the greatest number of Southwest customers (mode volume customers) pay $1.25 more under the ALJ's recommended rate design than customers under Southwest's proposed rate design with the CMT ($3.88 more without the CMT). Undoubtedly, the impact of higher customer bills during the winter heating season is greater with the ALJ's recommended rate design than if the Commission approved Southwest's rate design proposal.

2. Subsidy to Wealthier Low Volume Customers Is Reduced Under Southwest's Rate Design Proposal.

The Company's proposal also reduces the subsidy that low-volume customers receive under the ALJ's recommended rate designs. Although the Commission may be legitimately concerned that the Company's rate design would more adversely impact low-income customers, the Company clearly demonstrated in Exhibit A-50 (using actual Company data) that low-income customers <u>cannot</u> be equated with low-volume customers. In effect, the ALJ's recommended rate design would require higher-volume low-income customers to pay approximately $20.00 (with CMT) to $28.00 (without CMT) more than low-volume wealthier customers despite the fact that the cost of service to the customers is essentially the same. The ALJ's recommended opinion and order actually penalizes the low-income customer that has high usage.

3. Southwest's Rate Design Proposal Offers the Greatest Stability to Its Customers.

With a higher BSC and/or lower tail block rates as proposed by Southwest, the customer's bill is largely stabilized throughout the year, despite variations in usage due to warmer or colder than normal weather. The customer is largely shielded from large swings in bills when a higher BSC and/or lower tail block rates are implemented, and by spreading the cost of service throughout the year instead of leaving customer's susceptible to large bill impacts during the heating season, and during the holiday season when customers need money the most. All the parties acknowledge that the rate design proposed by the Company provides greater stability for the customers. This is invaluable during a time when natural gas costs are volatile, and the Commission can protect customers from large swings by approving the Company's rate design.

4. Declining Average Residential Use Per Customer.

If the recommended opinion and order is not amended to approve the CMT, then it is imperative that the Commission reduce the Company's risk associated with its dependency upon volumetric sales to recover authorized margin. In the event of any variance in customer usage, both Southwest and its customers are put at risk. The record is undisputed that the Company has already experienced a decline in average residential use per customer since filing its rate application, which has significantly contributed to the Company's inability to improve its near junk bond status credit rating BBB-. In fact, the Company's test year and weather normalized average residential use per customer was 347 therms. The Company's experienced average residential use per customer for the year ended December 31, 2005 was 325 therms. **This is a difference of 22 therms!**

The recommended opinion and order also increases energy efficiency programs by over 700% (from $600,000 to $4,385,000). It is undeniable that a reasonable person can only conclude that the Company's experienced average use per customer will continue to decline in the near future. The fact is, absent extraordinary circumstances, the Company will not recover the Commission-authorized margin, and not have a reasonable opportunity to earn the Commission-authorized rate of return because of the chronic decline in residential use per customer that the Company will likely continue to experience.

Southwest presently has a second block rate of approximately $.40. The recommended opinion and order proposes a second block rate of approximately $.50. Consequently, the recommended residential rate design actually increases Southwest's risk of not recovering the Commission-authorized margin because approximately an additional $.10 per therm is at risk of non-recovery in the event the customer's usage continues to decline or the weather is warmer than normal. More importantly, the customers are also at risk of having the Company recover more than its authorized margin by approximately the same amount in the event of a customer usage increase (i.e., a colder than normal heating season). A 22 therm decline in usage under the ALJ's recommended rate design with a second tier rate of $.50 results in the non-recovery of approximately $9,000,000 in authorized margin.

There is nothing equitable about increasing the risk the Company and its customers face as a result of variances in customer usage (either increases or decreases) by placing a greater amount of margin recovery in the second block rate. The only way to reduce this risk is to implement the CMT or decrease the second block rate, thus making the proposed second block rate less than the existing second block rate of $.40. In addition, such action will allow the Commission to minimize the impact of the rate increase during the crucial winter months and stabilize customers bills by adopting Southwest's rate design.

5. Impact on Customer Bills.

Based on the G-5 residential rate design proposed by Southwest (assuming the ALJ's recommended revenue requirement), and assuming average seasonal usage of 13 therms during the summer and 46 therms during the winter, single-family residential customers would experience an increase under summer rates of $4.24 ($5.42 without CMT), from $24.40 to $28.64 per month (from $24.40 to $29.82 without CMT), and an increase under winter rates of

$5.72 ($3.96 without CMT), from $65.53 to $71.25 per month (from $65.53 to $69.49 without CMT).

As such, Southwest encourages the Commissioners to amend the recommended opinion and order to reflect a rate design commensurate with the Company's proposal.

VI. MISCELLANEOUS ISSUES

A. Purchased Gas Adjustor.

In light of the recommended opinion and order's increase in the bank balance trigger level of the purchased gas adjustor mechanism ("PGA"), Southwest submits that the increase in the band from $.10 to $.13 is inadequate and respectfully requests that the Commissioners either increase the band to $.20 or, preferably eliminate it entirely, for the following reasons:

1. An increase or elimination of the band will benefit customers by minimizing purchased gas deferrals that incur carrying costs (interest) that are ultimately paid for by customers. An analogy that helps explain the benefits of an increased band is the use of a credit card. If a consumer uses his/her credit card and does not pay off the balance at the end of the month, the customer will likely incur carrying costs (interest) for electing to carry the unpaid balance forward. The larger the balance, the greater the carrying costs. Similarly, if Southwest is carrying a smaller amount of purchased gas deferrals, the lower the carrying costs (interest) that are paid by customers.

2. Increasing or eliminating the band will result in a price signal to customers that better reflects the market price of natural gas. As such, customers will be in a better position to change their usage patterns in response to market signals in natural gas prices. Although customers will receive more accurate price signals, they will not see large swings in their

monthly rates because the 12 month rolling average will continue to ensure that the changes occur on a gradual basis. In light of the highly volatile gas markets the $.20 band or an elimination of the band is more appropriate than the $.13 band proposed by the recommended opinion and order.

3. Increasing or eliminating the band will reduce or possibly eliminate the need for the Commission to repeatedly address the need for surcharges. The Commission's review and determination of whether the gas costs were prudently incurred, however, will remain unchanged. By increasing the band from $.10 to $.20, or by eliminating the band, customers would continue to receive the benefit of the Commission's prudence review, receive a more accurate price signal, and reduce the impact on customers by decreasing carrying costs.

B. Staff Proposals.

Staff included several unilateral proposals in its direct testimony that were adopted by the ALJ in his recommended opinion and order. With regard to these items, the Company simply requests that the Commissioners amend the recommended opinion and order to provide Southwest with some form of cost recovery. Since these items were not proposed by the Company, the incremental costs to implement the proposals are not included in Southwest's cost of service. For instance, Staff proposed that the Company implement a four-hour service window for all service requests; modify customer billing statements to allow for donations to the Energy Share program; modify the bill stock to include an explanation of "Base Tariff Rate" and "Rate Adjustment"; and that the Company implement various purchasing and gas procurement recommendations. Each of these items has an incremental cost associated with the change that is not reflected in the Company's rate application. If the Company is unable to recover the incremental costs associated with Staff's proposals, then the Company is essentially being disallowed cost recovery for expenses that it was ordered to incur. As such, Southwest requests that it be permitted to account for all costs associated with items that Staff unilaterally proposed and to seek cost recovery in its next rate application.

C. Errors, Omissions, and Inadvertent Mistakes.

The following are items that Southwest believes to be either typographical errors or inadvertent mistakes that appear in the recommended opinion and order, and that should be corrected in the order that is ultimately approved by the Commission.

1. Page 9 and page 10 make reference to Deferred Income Tax Credits of $136,691,328. $136,691,328 is the Company's deferred tax adjustment. [Exhibit A-2, Schedule A-1, sheet 2 of 3.] This number does not reflect the reduction of deferred taxes of $223,252, which RUCO proposed as part of its pipe replacement adjustment. [Schedule MDC-1 to Exhibit R-3.] Therefore, if the Commission does not amend the proposed opinion and order to modify the pipe replacement portion, the following corrections should be made:

   a. Page 9, ln. 28 and page 10, lns. 7 and 15, the reference to Deferred Income Tax Credits of "$136,691,328" should be replaced with "$136,468,076."
   b. Page 9, ln. 20 and page 10, ln. 2, the reference to Total OCRB of "$922,721,629" should be replaced with "$922,944,881."
   c. Page 9, ln. 21, page 10, ln. 17, and page 64, ln. 21, the reference to fair value rate base (or FVRB) of $1,169,360,785; and on page 31, ln. 9, the reference to fair value rate base (or FVRB) of $1,169,360,786 should be replaced with "$1,169,583,580."

d. Page 10, ln. 9, the reference to Total RCND of "$1,415,999,942" should be replaced with "$1,416,223,194."

2. Page 15, ln. 25, "Sarbannes-Oxley" should be changed to "Sarbanes-Oxley."

3. Page 37, ln. 1 and page 38, ln. 12, the recommended opinion and order should be modified to change "35 therms in the summer" to "35 therms in the winter."

4. Page 45, ln. 20, should be modified from "would be required take" to "would be required to take."

5. Page 65, item no. 26 should be corrected to reflect "600" instead of "6,000" and to reflect the body of the recommended opinion and order on lns. 10-14, p. 24, wherein the ALJ rejected the Department of Defenses' proposal and recommended adopting the Company's non-coincident peak measurement recommendation.

6. Page 65, item no. 28 should be corrected to reflect that Staff had no modifications to the Company's billing determinants.

VII.
SUMMARY AND CONCLUSION

Based upon the foregoing, Southwest respectfully requests that the Commission amend the recommended opinion and order to reflect the proposed modifications set forth in the Appendix.

DATED THIS 7th day of February 2006.

RESPECTFULLY SUBMITTED BY
SOUTHWEST GAS CORPORATION,

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Exhibit A

Comparison of Hill Proxy Group Results vs. Hill Recommendations

	Hill Proxy Group Results	Hill Recommendations
Common Equity Ratio [5-Year Average - 2000-2004]	**48.85%***	**40.00%**
Achieved ROE [5-Year Average - 2000-2004]	**10.93%****	**9.50%**

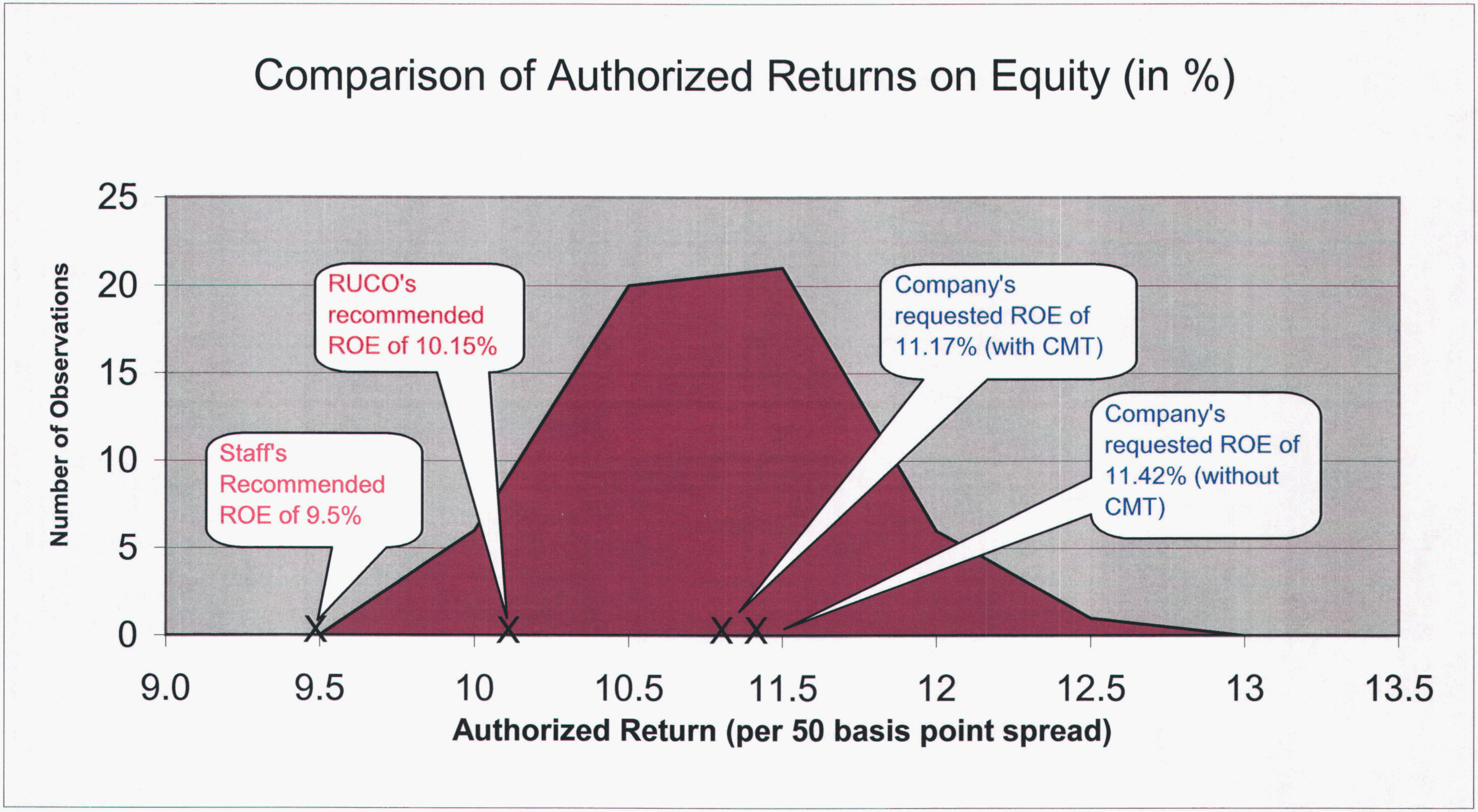
* **Rebuttal Testimony of Theodore K. Wood [Exhibit No. _____ (TKW-2), Sheet 1 of 4**

** **Direct Testimony of Stephen G. Hill [Exhibit__(SGH-1), Schedule 3, Pages 1-4**

"The oft cited *Hope* and *Bluefield* cases provide that the return determined by the Commission <u>must</u> <u>be</u> <u>equal</u> to an investment with similar risks made at generally the same time . . . ." [Underlining added].

[Lines 12-14, page 30, of Recommended Opinion and Order]

Exhibit B



Comparison of Authorized Returns on Equity (in %)
Number of Observations
25
20
15
10
5
0
Staff's Recommended ROE of 9.5%
RUCO's recommended ROE of 10.15%
Company's requested ROE of 11.17% (with CMT)
Company's requested ROE of 11.42% (without CMT)
9.0
9.5
10
10.5
11.5
12
12.5
13
13.5
Authorized Return (per 50 basis point spread)

APPENDIX

Appendix

Proposed Amendments to Recommended Opinion and Order

RATE BASE

Deferred Taxes

Strike the language from line 24 on page 5 through line 8 on page 6, and substitute with the following language:

> We agree with the Company that recognition of the new IRS regulation is proper in this proceeding. The Company should not be penalized for making a change in 2002 that would have benefited customers had the IRS not issued the new regulations. As a result, we will adopt the Company's position on this issue.

Pipe Replacement

Strike the language from line 21 on page 8 through line 18 on page 9, and substitute with the following language:

> We agree with the Company's position on the issue regarding 1960s steel pipe. 1960s steel pipe was never considered defective material, and it was subject to write-offs only because of the lack of cathodic protection. The record reflects that, by 1998, all steel pipe had been cathodically protected and, therefore, was no longer subject to the terms and conditions of Decision No. 58693. There is no evidence of record that contradicts the Company's assertions that the 1960s steel pipe was not faulty material and that, after 1998, all steel pipe had been cathodically protected.

OPERATING INCOME

Transmission Integrity Management Program

Strike the language from line 16 through line 23 on page 15, and substitute with the following language:

The transmission Integrity Management Program ("TRIMP") is a federally-mandated safety-related program prescribing standards for transmission pipeline risk analysis and providing for the adoption and implementation of a pipeline integrity management program. TRIMP compliance is mandatory, and the costs associated with compliance are nothing more than reasonable costs associated with conducting business. We agree with the Company that all TRIMP compliance costs should be recovered and that no disallowance is warranted. We agree with the reasoning expressed by Staff witness Dorf that a surcharge mechanism is the appropriate means of recovering the compliance costs associated with the Transmission Integrity Management Program ("TRIMP").

Sarbanes-Oxley Act of 2002

Strike the language from line 19 on page 16 through line 5 on page 17, and substitute with the following language:

Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") is federal legislation that requires the establishment of an internal control structure and certain procedures for financial reporting. As such, SOX compliance is mandatory, and the costs associated with compliance are nothing more than reasonable costs associated with conducting business. We agree with the Company on this issue.

Supplemental Executive Retirement Plan

Strike the language from line 7 through line 17 on page 19, and substitute with the following language:

We agree with the Company on this issue. We rejected RUCO's arguments on this issue in the Company's last rate proceeding, and we believe that the record in this case continues to support our finding that the expenses associated with the Supplemental Executive Retirement Plan ("SERP") are reasonable expenses that should be recovered fully in rates. In Decision No. 64172, we stated: "In arguing that SERP costs should not be borne by ratepayers, RUCO did not focus on the overall compensation package to the company's top executives. There is no evidence that Southwest Gas' overall compensation package is excessive. We will not remove the SERP from allowed expenses absent such showing." Once again, the record in this proceeding is devoid of any evidence that the overall compensation of the Company's executives is excessive.

Management Incentive Plan

Strike the language from line 4 through line 12 on page 18, and substitute with the following language:

We agree with the Company on this issue. The Company's Management Incentive Plan ("MIP") represents a portion of management's total overall compensation, and it is designed to retain and attract quality management. No party to the proceeding presented any evidence challenging the reasonableness of the total overall compensation of the MIP participants. A disallowance of any portion of the MIP expenses would result in the disallowance of a prudently-incurred operating expense and effectively would penalize the Company for designing management's compensation in a manner that facilitates the retention of quality personnel.

COST OF CAPITAL

Cost of Common Equity

Strike the language from line 2 on page 29 through the language **for service rendered therein."** in line 5 on page 30. Additionally, strike the language from line 16 on page 30 through line 5 on page 31, and substitute the following language:

Having considered all of the conflicting evidence among the three cost of capital witnesses in this proceeding on the issue of cost of common equity, we find that the appropriate estimate of Southwest Gas' cost of common equity is _____%.

The recommended Opinion and Order adopts Staff's position that a 9.50% return on common equity is appropriate for Southwest Gas. We disagree. The evidence reflects that Staff witness Hill's own proxy group achieved on average a 10.93% return on common equity relative to an average 48.85% common equity component in the capital structure. In this decision, we are adopting a 40% common equity component for Southwest Gas' capital structure, and Southwest Gas is a far riskier financial investment than an investment in the proxy group companies. It is intuitive that, if we were to abide strictly to the *Hope/Bluefield* standards articulated above [i.e., provide an investor in Southwest Gas with a return on common equity equal to an investment with similar risks], we would authorize a return on common equity higher, perhaps substantially higher, than the 10.93% enjoyed by investors in the proxy group companies.

A further check on the reasonableness of our determination that Staff's recommendation is inadequate is the evidence that Value Line's forecasted return on common equity for the natural gas distribution industry for 2006 is 12% relative to a 45% common equity component in the capital structure and, for 2008-2010, the forecasted return on common equity for the natural gas distribution industry is 12.5% relative to a 45.5% common equity component in the capital structure.

In this decision, we are strongly urging Southwest Gas to attempt to achieve an actual 40% equity component in its capital structure and, for the variety of reasons discussed during the hearing – in particular the steady, chronic decline in average consumption among residential customers –

Southwest Gas has been unable to realize the margins authorized by this Commission. We believe that an authorized return on common equity of _____ % provides Southwest Gas with a reasonable opportunity to realize the Commission-authorized margin and, as a consequence, an improved opportunity to strengthen its capital structure.

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

	Percentage	Cost	Average Weighted Cost
Common Equity	40.0%	_____%	_____%
Preferred Equity	5.00%	8.20%	0.41%
Total Debt	55.0%	7.61%	4.19%
			____%

RATE DESIGN ISSUES

Conservation Margin Tracker

Strike the language from line 26 on page 33 through line 19 on page 34, and substitute with the following language:

The record is replete with evidence that Southwest Gas has experienced and is likely to continue to experience increased financial pressure due to a steady, chronic decline in average consumption among residential customers. The consequence for Southwest Gas has been an inability to realize the margin authorized by this Commission in general rate cases. In that regard, the evidence discloses that over 50% of the earnings shortfall is directly attributable to declining average residential consumption. The evidence discloses further that the margin shortfall due solely to declining average residential consumption from 1987 through the end of the test year in this proceeding was $122.4 million. The proposed Conservation Margin Tracker ("CMT") is a mechanism that would address the declining average consumption phenomenon and, as well, shield Southwest Gas' customers from the risk that Southwest Gas could realize more margin than authorized by the Commission in any given year. Therefore, we adopt the CMT in this decision.

A compelling reason to adopt the CMT is that the Company is being ordered in this decision to implement additional demand side management/energy efficiency programs at a funding level of $4,385,000, which is $3,785,000 more than the current funding level. It would be counterintuitive to suppose that the additional expenditures will not result in a further decline in average residential consumption, exacerbating the already steady decline. While we do not doubt that Southwest Gas will conscientiously promote the programs, it certainly is the case that the CMT would remove any disincentive to do otherwise.

Finally, to the extent opposition to adoption of the CMT was voiced on the basis that the issue should be explored later, we note that a very thorough record was developed during the hearing in this proceeding. We think the time is now for its adoption. It is simple and straightforward, and it is fair to all stakeholders.

In Finding of Fact No. 19 at lines 24 and 25 on page 64, strike the word **not.**

Strike the Ordering paragraph at lines 14-18 on page 67, and substitute with the following language:

IT IS FURTHER ORDERED that, prior to the Company's next rate case, Southwest Gas should coordinate efforts with Staff, RUCO and SWEEP/NRDC and any other interested parties to explore refinements or improvements to the CMT, as authorized in this decision.

Single-Family Residential Gas Service (G-5)

Strike the language from line 12 on page 37 through line 3 on page 38. At line 7 on page 38 strike the word "Staff's" and insert the words "the Company's." Strike the language from line 9 on page 38 beginning with "Accordingly" through line 16 on page 38 (including footnote 7) and substitute with the following language:

In particular, the Company's rate design minimizes the impact on customers during the winter months, reduces intra-class subsidies, provides more stability to customers, reduces the amount customers will overpay or underpay for the cost of gas service due to changes in usage patterns (due to inefficient building envelopes, colder than normal weather, among others), and reduces the risk to the Company due to changes in usage patterns. Accordingly, we will adopt a basic monthly service charge of $____ and, a two-tier commodity rate of $______ for the first 15 therms in the summer and the first 35 therms in the winter, and $______ for usage in the second block.

In Finding of Fact No. 21 at line 1 on page 65, strike the amount "$9.70" and insert "$____." At line 1 on page 65 insert a period after the word "appropriate" and strike line 2 on page 65.

MISCELLANEOUS ISSUES

Purchased Gas Adjustor

PGA Mechanism Trigger Level

At line 25 on page 54, strike the words **a slight** and insert **"an."** At line 11 on page 55, strike the word **However** and the comma that follows; and capitalize the **w** that follows the comma, and strike the word **excessive** and insert **"appropriate."** At line 12 on page 55, substitute the number **20** for the number **13**. Further, in Finding of Fact No. 29 at line 24 on page 65, substitute the number **20** for the number **13**.

STAFF PROPOSALS

Add the following Ordering paragraph by inserting after line 8 on page 68:

IT IS FURTHER ORDERED that, commencing on the effective date of this decision and continuing through the end of the test year in Southwest Gas' next general rate case, Southwest Gas is authorized to make entries into a deferral account reflecting only readily-identifiable incremental expenses associated with complying with the unfunded Commission mandates identified in this paragraph, and Southwest Gas may seek recovery, subject to audit, of the deferred amounts in the Company's next general rate case. The unfunded mandates, include, without limitation, the following: (1) implementation of a four-hour service window for all service requests;(2) implementation of modifications to customer billing statements to allow for donations to the Energy Share program; (3) modifications to bill stock to include explanation of "Base Tariff Rate" and "Rate Adjustment"; (4) the various purchasing and gas procurement recommendations; and (5) all other Staff approved proposals.

ORIGINAL and 13 COPIES of the foregoing filed this 7th day of February 2006, with:

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COPIES of the foregoing served by regular mail and e-mail this 7th day of February 2006, on:

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