



SOUTHWEST GAS CORPORATION

ORIGINAL



2011 JUN 13 P 3:46

AZ CORP COMMISSION
DOCKET CONTROL

Arizona Corporation Commission
DOCKETED

JUN 13 2011



June 10, 2011

Docket Control Office
Arizona Corporation Commission
Utilities Division
1200 West Washington Street
Phoenix, AZ 85007

Re: Docket No. WS-00000A-08-0194

Southwest Gas Corporation (Southwest) herewith submits for filing an original and thirteen (13) copies of its Written Comments in the above-referenced docket.

If you have any questions or comments on the attached Comments, please do not hesitate to contact me at 702-876-7163.

Respectfully submitted,

Debra S. Gallo, Director
Government & State Regulatory Affairs

DSG:pr
Enclosures

c: Service List

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

RECEIVED

2011 JUN 13 P 3:46

AZ CORP COMMISSION
DOCKET CONTROL

2 **COMMISSIONERS**

3 GARY PIERCE, Chairman
4 BRENDA BURNS
5 PAUL NEWMAN
6 SANDRA D. KENNEDY
7 BOB STUMP

6 IN THE MATTER OF THE
7 COMMISSION'S GENERIC
8 INVESTIGATION REGARDING
9 GENERALIZED COST OF EQUITY

DOCKET NO. WS-00000A-08-0194

COMMENTS

9 **WRITTEN COMMENTS OF
10 SOUTHWEST GAS CORPORATION**

10 **I. INTRODUCTION**

11 Southwest Gas Corporation (Southwest Gas) hereby submits written comments in response
12 to Docket No. WS-00000A-08-0194. This docket was opened April 9, 2008, for the purpose of
13 investigating the possible establishment of generalized cost of equity information for potential use
14 in Class A, B, and C water and/or wastewater utility rate cases. While this docket is specific to
15 water utilities, there is merit to considering the establishment of a generic cost of capital proceeding
16 for Class A gas and electric utilities. Therefore, Southwest Gas is providing comments in this
17 proceeding to address important issues in the design of a generic cost of capital proceeding.
18 Properly designed, Southwest Gas believes a generic cost of capital proceeding can provide benefits
19 to the Commission and the participating utilities.

20 **II. BACKGROUND**

21 Several Canadian and U.S. regulatory bodies have developed and employed formulaic
22 approaches to determine an allowed return on common equity (ROE), with the formula approaches
23 used by U.S. regulatory bodies being primarily employed in conjunction with an alternative rate
24

1 making methodology. Southwest Gas does not endorse the use of a generic formula or prescriptive
2 method to replace the current formal method that is used to determine allowed ROEs. However,
3 Southwest Gas does believe the Commission could remove the formal determination of a utility's
4 cost of capital from the rate case process and initiate a process whereby participating utilities have
5 their cost of capital determined as part of a separate consolidated proceeding. A similar approach
6 has been used in California for over 20 years for the major energy utilities and is a useful starting
7 point to review the key issues in establishing a generic cost of capital proceeding.

8 **III. CALIFORNIA GENERIC COST OF CAPITAL PROCEEDING**

9 The California Public Utilities Commission has employed a generic cost of capital
10 proceeding for large energy utilities¹ since 1989 and for large water utilities² since 2008. With the
11 generic cost of capital proceeding, the cost of capital was removed from the general rate case
12 process to a separate cost of capital proceeding. Originally, for the large energy utilities, the generic
13 cost of capital was designed as an annual proceeding. Beginning in 2008, the generic cost of capital
14 proceeding was modified to a multi-year format, with the CPUC opting for a three-year cycle, with
15 complete cost of capital applications being required for every third test year.³

16 **A. CPUC Generic Cost of Capital Process**

17 Under the revised multi-year format, in the year of the generic cost of capital proceeding,
18 utilities and other intervenors submit cost of capital applications by early May of that year. The
19 CPUC processes all the applications concurrently in one proceeding with the objective to provide a
20 decision to adjust the cost of capital embedded in rates by January 1 of the following year. The
21 applications include the recommended capital structure, the embedded costs of debt and preferred
22 securities, the estimated cost of common equity, and the resulting overall cost of capital. The

23 ¹ CPUC Decision 89-01-040

24 ² CPUC Decision 07-05-062

³ CPUC Decision 08-05-035

1 primary models used by the parties in estimating the cost of common equity are the: (1) Discounted
2 Cash Flow (DCF) model; (2) Capital Asset Pricing Model (CAPM); and (3) Risk Premium Model
3 (RPM). The CPUC has not stated a preference for any one model for estimating the cost of
4 common equity, stating:

5
6 “In the final analysis, it is the application of informed judgment, not the
7 precision of financial models, which is the key to selecting a specific ROE
8 estimate. We affirmed this view in D.89-10-031, noting that it is apparent that
9 all these models have their flaws and, as we have routinely stated in past
10 decisions, the models should not be used rigidly or as definitive proxies for the
11 determination of the investor-required ROE. Consistent with that skepticism,
12 we found no reason to adopt the financial modeling of any one party. The
13 models are only helpful as rough gauges of the realm of reasonableness.”⁴

14 The models are used to establish a reasonable range for the cost of common equity capital
15 for the industry and then additional risk factors are reviewed to develop a specific allowed ROE for
16 each utility in the proceeding. The additional factors considered are financial risk and business risk,
17 including regulatory risk.

18 Financial risk is the risk associated with the amount of leverage employed by a utility and
19 the required ROE is positively related to the debt-to-equity ratio of the firm. The CPUC recognizes
20 this fundamental concept, specifically stating that “capital structure and return on common equity
21 should not be addressed independently.”

22 Business risk is a collective term encompassing all of the diversifiable risks of an enterprise
23 except financial risk and is reflected in the variability of operating results. A primary source and
24 special class of business risk for a utility is regulatory risk.

Regulation defines the environment in which a public utility operates. As a result,
regulatory risk is the most significant business risk, as regulation plays a significant factor in

⁴ CPUC Decision 07-12-049, p.28.

1 determining a utility's financial performance. From a cost of capital perspective, "the computation
2 of the allowed rate of return must be consistent with the regulatory risks inherent in the regulatory
3 system used."⁵

4 To summarize, the CPUC generic cost of capital proceeding utilizes multiple methods to
5 determine the required ROE, then reviews additional financial, business and regulatory risk factors
6 to determine a specific allowed ROE for each participating utility. A key point is that a utility-
7 specific allowed ROE and the resulting overall rate of return are developed by analyzing utility-
8 specific factors to support the determination. For example, in the last generic cost of capital
9 proceeding for the major energy utilities, the CPUC decision established utility-specific ROEs for
10 Southern California Edison Company (SCE), San Diego Gas & Electric Company (SDG&E) and
11 Pacific Gas and Electric Company (PG&E).⁶ The test year 2008 ROE for SCE was 11.50%, which
12 resulted in a corresponding 8.75% return on rate base (ROR). The test year 2008 ROE for SDG&E
13 was 11.10%, which resulted in a corresponding 8.40% ROR. The test year 2008 ROE for PG&E
14 was 11.35%, which resulted in a corresponding 8.79% ROR.

15 **B. CPUC Annual Cost of Capital Adjustment Mechanism**

16 With the establishment of a multi-year format for the generic cost of capital proceeding, the
17 CPUC also established an annual cost of capital adjustment mechanism⁷ with the objective to
18 maintain fair and reasonable cost of capital during the time period between formal generic cost of
19 capital proceedings. The mechanism uses an adjustment formula for the allowed ROE based on
20 material changes in an established benchmark of utility bond yields. The established benchmark is

22 ⁵ A. Lawrence Kolbe, William B. Tye, and Stewart Myers, *Regulatory Risk: Economic Principles and Applications to
Natural Gas Pipelines and Other Industries*, Boston: Kluwer Academic Publishers (1993), p. 43.

23 ⁶ Southwest Gas does not currently participate in the generic cost of capital proceeding as Southwest's ratemaking
mechanism adopted in 1994 removed Southwest Gas from the generic proceeding and established an automatic trigger
mechanism (ATM). Under the ATM, Southwest is required to submit a cost of capital case every five years.

24 ⁷ CPUC Decision No. 08-05-035.

1 based on the average yield of utility bonds as reported by Moody's for the time period October
2 through September of the test year. Moody's publishes separate utility bond yield indices based on
3 credit ratings of "AA," "A" and "Baa." The index used is based on the individual utility's bond
4 rating. The adjustment mechanism has the following features:

5 • A utility shall file an annual advice letter by October 15 detailing the results of the cost of
6 capital adjustment mechanism each year, which includes any required changes in rates and
7 revenue requirements that become effective on January 1 of the next year.

8 • If, in any year, the difference between the current average and the benchmark yields exceeds
9 100 basis points, then an automatic adjustment in the utility's authorized rate of return will
10 result. The Company will update its cost of capital and compute a new rate of return as
11 follows:

12 1. The authorized ROE in effect at the time of adjustment is adjusted by one-half of the
13 change in the average utility bond yields that triggered the adjustment.

14 2. The embedded costs of long-term debt and preferred equity are updated to reflect
15 actual August month-end embedded costs in that year and forecasted interest rates
16 for variable long-term debt and new long-term debt and preferred securities
17 scheduled to be issued.

18 3. The capital structure authorized in the last generic cost of capital proceeding will be
19 used to compute the updated rate of return.

20 • In any year that the change in average bond yields triggers an automatic adjustment, that
21 average becomes the new benchmark until another automatic adjustment is triggered.

22 • In addition, utilities may file a cost of capital application outside of the adjustment process
23 upon an extraordinary or catastrophic event that materially impacts their respective cost of
24

1 capital and/or capital structure and affects them differently than the overall financial
2 markets.

3 **IV. RECOMMENDATIONS FOR ESTABLISHING A GENERIC COST OF CAPITAL**
4 **PROCEEDING**

5 The generic cost of capital proceeding in California has evolved over a long-period of time
6 and provides a valuable starting point in the examination of a similar procedure for Arizona.
7 Specific recommendations from Southwest Gas for the development of a generic cost of capital
8 proceeding in Arizona include:

- 9 • The use of a generic or prescriptive formula approach should not replace the informed
10 judgment of the Commission in determining required rates of returns nor should a single
11 benchmark ROE be established to be applied to all utilities, as utility-specific risk factors
12 should be considered to determine the allowed rate of return for each individual utility.
- 13 • Generic cost of capital proceedings should be set on a multi-year basis, with the time frame
14 selected based on balancing the need to meet the fair rate of return standard consistent with
15 capital market conditions and maximizing the regulatory efficiency of the process.
- 16 • Generic cost of capital proceedings should be conducted by industry rather than
17 encompassing all utilities. This will ensure utilities in the proceeding would have similar
18 business risks.
- 19 • Multiple methods should be used to estimate the cost of common equity. While the
20 Commission has predominantly relied on the DCF model in the past, the Commission
21 should consider the results of alternative models and apply informed judgment when
22 considering the results. The use of several methods will compensate for the limitations of
23 any single model. In addition, when capital market conditions are substantially different
24

1 from normal, the Commission should incorporate that in selecting a rate of return to ensure
2 it remains reasonable beyond the test year.

- 3 • The capital structures used to determine the overall allowed rates of return should be
4 reflective of the expected capital structures that will exist during the time period the rate will
5 be in place until the next generic cost of capital proceeding.
- 6 • Any annual cost of capital adjustment mechanism between formal generic cost of capital
7 proceedings should be a function of utility bond yields and not U.S. Treasury rates.
- 8 • Utilities should be allowed to file a cost of capital application outside of the adjustment
9 process upon experiencing an extraordinary or catastrophic event that materially impacts
10 their respective cost of capital and/or capital structure and affects them differently than the
11 overall financial markets.

12 **V. ADVANTAGES OF A GENERIC COST OF CAPITAL PROCEEDING**

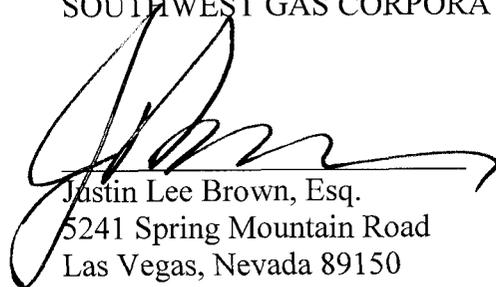
13 The establishment of a generic cost of capital proceeding will allow the Commission to set
14 an appropriate utility-specific allowed rate of return for all participating utilities in a single docket.
15 A key advantage of this approach is that it provides the Commission the ability to take a consistent
16 approach in establishing allowed rates of return. The proceeding could be conducted in a manner
17 very similar to the existing rate case process, but could be handled on a more expedited basis since
18 it is limited to the formal determination of utility cost of capital. Additional advantages of a generic
19 cost of capital proceeding is that it removes the increasingly complex nature of estimating the cost
20 of common equity from the general rate case process and consolidates the results for the benefit of
21 the Commission and all participating utilities. Such a process should reduce the Commission's
22 existing administrative burdens associated with the formal determination of cost of capital on an
23 individual utility basis.

1 **VI. CONCLUSION**

2 The foregoing comments represent Southwest Gas' initial comments in response to the
3 generic investigation regarding a generalized cost of equity for water and/or wastewater utilities.
4 Southwest Gas looks forward to participating in this docket and working with the Commission and
5 all other interested parties to provide additional ideas and concepts that address the issues with
6 establishing a generic cost of capital proceeding and to further explore the concepts identified
7 herein.

8 DATED this 10th day of June 2011.

9 SOUTHWEST GAS CORPORATION

10 

11 Justin Lee Brown, Esq.
12 5241 Spring Mountain Road
13 Las Vegas, Nevada 89150
14 Tel: (702) 876-7183
15 Fax: (702) 252-7283
16 E-mail: Justin.Brown@swgas.com

1 ORIGINAL and 13 COPIES of
2 the foregoing filed this 10th day
3 of June 2011, with:
4 Docket Control
5 Arizona Corporation Commission
6 1200 W. Washington
7 Phoenix, Arizona 85007

8 COPIES of the foregoing
9 served by e-mail
10 this 10th day of June
11 2011 on:

12 Steve Olea
13 Elijah Abinah
14 solea@azcc.gov
15 sabinah@azcc.gov
16 Utilities Division
17 Arizona Corporation Commission
18 1200 West Washington Street
19 Phoenix, AZ 85007

20 Dan Pozefsky, Esq.
21 Dpozefsky@azruco.gov
22 Residential Utility Consumer Office
23 1110 W. Washington, Suite 220
24 Phoenix, Arizona 85007

Bryan O'Reilly
bor@snrllc.net
50 South Jones Blvd., Ste 1
Las Vegas, NV 89107

Michael T. Hallam
mhallam@lrlaw.com
Thomas Campbell
tcampbell@lrlaw.com
Lewis and Roca, LLP
40 N. Central Ave., Ste 1900
Phoenix, Arizona 85004-4429

Janice Alward, Esq.
jalward@azcc.gov
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

Gary Yaquinto
GYaquinto@Arizonaic.org
Arizona Investment Council
2100 N. Central Ave., Suite 201
Phoenix, Arizona 85004

Garry Hays
ghays@lawgdh.com
1702 E. Highland Ave, Ste 204
Phoenix, AZ 85016

Michael W. Patten
mpatten@rdp-law.com
Timothy Sabo
tasbo@rdp-law.com
Roshka, DeWulf & Patten, PLC
One Arizona Center
400 East Van Buren Street, Suite 800
Phoenix, Arizona 85004

1 Michele Van Quathem
mvg@rcalaw.com
2 Ryley Carlock & Applewhite
One North Central Ave., Suite 1200
3 Phoenix, AZ 85004-4417

4 Mr. John Hackney
John.hackney@wellsfargo.com
5 Wells Fargo Securities
301 South College Street
6 MACD 1053-056
Charlotte, NC 28288

7 Court S. Rich
crich@roselawgroup.com
8 M. Ryan Hurley
rhurley@roselawgroup.com
9 Rose Law Group pc
10 6613 N. Scottsdale Road, Ste 200
Scottsdale, AZ 85250

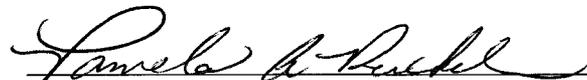
11 Thomas Broderick
Thomas.broderick@amwater.com
12 Arizona American Water Co.
2355 West Pinnacle Peak Road, Suite 300
13 Phoenix, AZ 85027

Jeffrey Crockett, Esq.
jcrockett@bhfs.com
Brownstein Hyatt Farber Schreck, LLP
40 N. Central Ave., 14th Floor
Phoenix, AZ 85004

Joseph D. Harris
Vice President and Treasurer
jharris@azwater.com
Arizona Water Company
PO Box 29006
Phoenix, AZ 85035-9006

Brian Tompsett
Executive Vice President
btompsett@qwest.net
Johnson Utilities, LLC
5230 E. Shea Blvd., Ste 200
Phoenix, AZ 85284

Graham Symmonds
Graham.symmonds@gwresources.com
Global Water
21410 N. 19th Ave., Ste 201
Phoenix, AZ 85027

14
15 
16 an employee of Southwest Gas Corporation
17
18
19
20
21
22
23
24