**BEFORE THE ARIZONA CORPORATION COMMISSION**



COMMISSIONERS

GARY PIERCE – Chairman
BOB STUMP
SANDRA D. KENNEDY
PAUL NEWMAN
BRENDA BURNS

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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-10-0458 |

**NRDC's NOTICE OF FILING DIRECT TESTIMONY**

The Natural Resources Defense Council (NRDC), by and through its attorney, Laura E. Sanchez, hereby provides notice of filing the Direct Testimony of Ralph Cavanagh in the above-referenced matter.

RESPECTFULLY SUBMITTED this 23rd day of June, 2011.

By ______________________
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ORIGINAL and 13 COPIES of the foregoing filed this 23rd day of June, 2011 to:

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BEFORE THE ARIZONA CORPORATION COMMISSION

DIRECT TESTIMONY

OF

RALPH CAVANAGH

Q. Please state your name, address, and employment.

A. My name is Ralph Cavanagh. I am the Energy Program Co-Director for the Natural Resources Defense Council ("NRDC"), 111 Sutter Street, 20th Floor, San Francisco, CA 94104.

Q. Please outline your educational background and professional experience.

A. I am a graduate of Yale College and Yale Law School, and I joined NRDC in 1979. I am a member of the faculty of the University of Idaho's Utility Executive Course, and I have been a Visiting Professor of Law at Stanford and the University of California. From 1993-2003, I served as a member of the U.S. Secretary of Energy's Advisory Board, and I am now a member of the Department of Energy's Electricity Advisory Board. My current board memberships include the Bipartisan Policy Center, the Bonneville Environmental Foundation, the Center for Energy Efficiency and Renewable Technologies, the Renewable Northwest Project, and the Northwest Energy Coalition. I have received the Mary Kilmarx Award from the National Association of Regulatory Utility Commissioners (2007), the Heinz Award for Public Policy (1996) and the Bonneville Power Administration's Award for Exceptional Public Service (1986). I have not testified before the Arizona

Corporation Commission in at least two decades, but I was an invited participant in the workshops that preceded the Commission's adoption last December of its Final Policy Statement Regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures ("Final Policy Statement").

Q. On whose behalf are you testifying?

A. I am testifying for the Natural Resources Defense Council (NRDC).

Q. What is the purpose of your testimony in this proceeding?

A. My testimony supports the Southwest Gas Corporation's ("Southwest") proposal for a revenue-per-customer decoupling mechanism.

Q. Summarize your conclusions and recommendations.

A. Southwest has proposed an energy efficiency enabling provision (EEP) consisting of "a revenue per customer decoupling mechanism that is designed to eliminate the link between sales and revenues that currently exists with traditional rate designs, so that the existing financial disincentive associated with Southwest Gas's pursuit of cost-effective energy efficiency is eliminated."[1]

[1] Prepared Direct Testimony of Edward B. Gieseking, p. 12: 9-13.

The company's General Rate Case Application appropriately links that proposal to its significant role in achieving the Commission's appropriately ambitious Electric and Gas Energy Efficiency Standards.[2]

I conclude that the Southwest proposal is entirely consistent with the Commission's Final Policy Statement, and I recommend its approval. My testimony summarizes experience with comparable revenue decoupling mechanisms and responds to concerns commonly raised about them. Southwest's proposal would remove a potent disincentive to the company's engagement with all forms of energy efficiency progress, by ensuring that the Company recovers no more and no less than the fixed costs previously authorized by the Commission, notwithstanding any short-term fluctuations in natural gas use. My testimony also shows that efforts to link rate adjustments specifically to energy efficiency program impacts would have perverse consequences and impede statewide progress in achieving cost-effective savings.

My testimony anticipates and rebuts claims that approval of Southwest's proposal should be linked to reductions in its return on equity. I am aware of no evidence that decoupling mechanisms have reduced any

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[2] Southwest Gas Corporation, Application, Docket No. G-01551A-10-0458) (Nov. 12, 2010), pp. 8-9.

utility's cost of capital, and customer benefits from the proposed mechanism are illustrated in the initial returns from a portfolio of proposed Southwest efficiency programs that "have an overall benefit-cost ratio of 1.68, with targeted annual savings of 2,451,00 therms."[3] Reducing the Company's authorized return on equity ("ROE") would undercut a principal rationale for the Commission's Final Policy Statement, which was to "encourage and enable aggressive use of demand side management programs and the achievement of Arizona's Electric and Gas Energy Efficiency Standards, which will benefit ratepayers and minimize utility costs."[4]

Q. What is the basis for your conclusion that Southwest's proposal is consistent with the Commission's Final Policy Statement?

A. Southwest has proposed a per-customer decoupling mechanism, which includes a monthly adjustment that "provide[s] immediate weather-related rate relief to customers following extreme weather events," followed by an annual adjustment "to true-up the difference between authorized and experienced non-gas revenues."[5] The

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[3] Application, note 2 above, at p. 8:16-17.
[4] Final ACC Policy Statement Regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures, Docket Nos. E-00000J-08-0314 and G-00000C-08-0314, p. 30 (Dec. 29, 2010).
[5] Testimony of Edward B. Gieseking, p. 3:5-9.

mechanism is designed to prevent over-earning, because "the Company will not be able to collect more revenue per customer than what the Commission authorizes in this rate case proceeding."[6] The scope of the mechanism is appropriately broad but not over-inclusive, covering "the rate schedules where Southwest Gas has, or expects to have, usage lowered as a result of energy efficiency programs and where a large amount of the fixed cost of service is recovered in variable charges."[7]

The Commission anticipated and encouraged all of these decoupling elements in its Final Policy Statement:

- "Revenue decoupling may offer significant advantages over alternative mechanisms for addressing utility financial disincentives to energy efficiency . . ." [p. 30, item 3]

- "[N]on-fuel revenue per customer decoupling may be well suited for Arizona as it responds to customer growth and is better suited to address the issues associated with customer growth." [p. 30, item 4]

- "Adoption of decoupling . . . should not occur as a pilot, as this insufficiently supports demand side management efforts, discourages beneficial changes in rate design and is unlikely to encourage financial ratings improvements." [p. 30, item 5]

- "Full decoupling is preferable to partial decoupling ..." [p. 31, item 8]

- "Decoupling adjustments should occur at least on an annual basis; however, parties may propose more current adjustments as this may provide ratepayers

[6] Id., pp. 3-4.
[7] Id., p. 7:14-17.

with weather related relief following extreme events." [p. 31, item 10]

- "Broad participation in decoupling is preferred; however, the unique characteristics of each utility may merit different treatment of some customer classes." [p. 31, item 11]

Q. Describe experience with revenue decoupling elsewhere in the country.

A. Nationally, the count of states with decoupling for at least one utility stands at 14 for electricity and 22 for natural gas. In the West, Hawaii, California, Idaho and Oregon have adopted decoupling for at least one electric utility. California, Utah, Oregon, Washington and Wyoming have adopted natural gas decoupling mechanisms. New Mexico's Public Service Commission has left open "the determination of whether a decoupling mechanism should be approved or required for any utility," and the New Mexico Legislature has acknowledged the need to "identify regulatory disincentives or barriers for public utility expenditures on energy efficiency and load management measures and ensure that they are removed in a manner that balances the public interest, consumers' interests and investors' interests."[8]

Q. What about rate impacts of revenue decoupling?

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[8] See Case No. 08-00024-UT, Final Order Repealing and Replacing 17.7.2 NMAC (2010), p. 10; Efficient Use of Energy Act, Section 62-17-5.F.

A. Neither revenue decoupling in general nor the Southwest proposal in particular add any additional costs to utility bills; they simply ensure that previously approved fixed costs are neither over- nor under-recovered. In terms of rate adjustments to achieve this objective, industry experience shows that effects are minimal in practice, with adjustments that go in both directions. A comprehensive industry-wide assessment (attached) found that, of 88 gas and electric rate adjustments from 2000-2009 under decoupling mechanisms, less than one-seventh involved increases exceeding 3 percent. (Refunds accounted for a much larger fraction.) Typical adjustments in utility bills "amount[ed] to less than $1.50 per month in higher or lower charges for residential gas customers and less than $2.00 per month . . . for residential electric customers."[9] That represents about a dime a day for the average household, which hardly seems like dangerous rate volatility, particularly since it sometimes comes in the form of a rebate - and serves only to ensure that the utility recovers no more and no less than the fixed costs of service that regulators have reviewed and approved.

Q. What do you say to those who are concerned that revenue decoupling reduces incentives to save energy,

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[9] See Pamela Lesh, Rate Impacts and Key Design Elements of Gas and Electric Utility Decoupling: A Comprehensive Review, Electricity Journal (October 2009), p. 67.

by raising rates and depriving customers of rewards from consumption reductions?

A. Experience proves the opposite: revenue decoupling results in trivial rate adjustments that go both ways, and do not materially affect rewards for saving electricity and natural gas. As the Oregon Public Utility Commission found when it adopted a decoupling mechanism for Portland General Electric in January 2009, responding to analogous claims that decoupling would rob customers of the rewards of conservation: "We believe the opposite is true: an individual customer's action to reduce usage will have no perceptible effect on the decoupling adjustment, and the prospect of a higher rate because of actions by others may actually provide more incentive for an individual customer to become more energy efficient." Oregon PUC Order No. 09-020, p. 28 (Jan. 2009). Finally, note that unlike so-called "fixed-variable rate designs" that load fixed costs into monthly customer charges, Southwest's proposal "does not establish a 'fixed bill' that would make customers indifferent to the amount of gas they use."[10]

Q. Explain your conclusion that approving Southwest's proposal should not result in an adjustment in its authorized return on equity.

[10] See Direct Testimony of Edward B. Gieseking, p. 6:17-18.

A. In this I am of course in part just echoing the Commission's conclusion in the Final Policy Statement: "Commitment to and early implementation of decoupling should precede significant decoupling-specific adjustments to cost of capital if a revenue per customer decoupling mechanism is approved for a utility."[11] The data that I just presented provide additional support for my recommendation: rate impacts this modest simply do not imply appreciable consequences for company-wide cost of capital, and I have seen no empirical evidence to the contrary. Indeed, in the specific context of natural gas utility decoupling, a March 2011 investigation by the Brattle Group reached the opposite conclusion:

> The findings of our analysis do <u>not</u> support the belief that utilities with decoupling have a lower cost of capital than utilities <u>without</u> decoupling. Contrary to what some might expect to find, at least on the basis of the opinions of certain intervenors and the (minority set of) judgments where commissions reduced allowed rates of return because of decoupling, we found that the estimated cost of capital for decoupled utilities was <u>higher</u> by a <u>small but statistically significant</u> amount (emphasis in original).[12]

Q. Why shouldn't the Commission amend the proposal so that adjustments track only natural gas savings attributable to the Company's energy efficiency programs?

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[11] Final ACC Policy Statement, note 4 above, p. 31 [item 6].
[12] J. Wharton, M. Vilbert, R. Goldberg & T. Brown, <u>The Impact of Decoupling on the Cost of Capital</u> (Discussion Paper, The Brattle Group, March 2011), p. 2.

A. This would undercut the whole purpose of the mechanism, while introducing a whole new set of perverse incentives. It would reintroduce automatic penalties, in the form of reduced fixed-cost recovery, for all cost-effective natural gas savings not directly associated with Southwest's programs, even when the Company by action or inaction could make a material difference in prospects for those savings. It would create a powerful and perverse new incentive for the Company to promote programs that looked good on paper but delivered little or no savings in practice. And it would ensure adversarial discord over every savings calculation, since significant financial stakes would then hinge on the results. Finally, and most tellingly, adjustments keyed solely to adjudicated savings would mean automatic annual rate increases (unless the company was wholly ineffective), whereas decoupling adjustments can be either positive or negative (Southwest notes, for example, that its most recent Nevada decoupling adjustment "will return approximately $2 million to its customers."[13])

Q. But doesn't your recommendation mean paying Southwest for savings that it didn't help achieve?

A. No, because the proposed EEP doesn't "pay" Southwest any incremental amount for anything; it is simply

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[13] Prepared Direct Testimony of Edward B. Gieseking, p. 9:5.

a mechanism that allows the company to receive no more and no less than the fixed-cost revenue requirement per customer that the Commission has reviewed and approved.

Q. Revenue decoupling has been criticized as "use less, pay more" and shifting risk to customers; do you believe those are valid concerns regarding Southwest's proposal?

A. No. As indicated earlier in my testimony, customers who find ways to use significantly less energy will not be appreciably affected by decoupling-induced rate adjustments, and of course a principal justification for the Commission's Energy Efficiency Standards is to reduce the costs of providing reliable energy services, with long-term savings to Southwest customers (in the form of reductions in the company's revenue requirements and fuel purchases) that revenue decoupling will not affect. As regards risk shifting, an appealing feature of Southwest's proposal is that it reduces risks for *both* customers and Southwest; customers get prompt relief from cost increases driven by extreme weather events, and Southwest avoids downside risk on recovery of its authorized fixed costs (although, as noted earlier, I do not view this as justification for a reduction in the company's ROE). Risk reduction is not a zero sum enterprise here.

Q. Does this conclude your testimony?

A. Yes.