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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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11 IN THE MATTER OF THE APPLICATION OF  
 12 SOUTHWEST GAS CORPORATION FOR  
 13 THE ESTABLISHMENT OF JUST AND  
 14 REASONABLE RATES AND CHARGES  
 15 DESIGNED TO REALIZE A REASONABLE  
 16 RATE OF RETURN ON THE FAIR VALUE  
 17 OF ITS PROPERTIES THROUGHOUT  
 18 ARIZONA

Docket No. G-01551A-10-0458

**RUCO'S OPENING BRIEF**

The Residential Utility Consumer Office ("RUCO") hereby submits its Opening Brief on the matters raised in Southwest Gas Corporation's ("SWG or Company") recent rate hearing.

**INTRODUCTION**

There are some who will argue that the implementation of decoupling in this case should be a foregone conclusion. The Commission's new policy establishes a preference for decoupling. A preference, however, is not the same as a requirement, which appears to be the position of many in this case. The policy statement itself is instructive. Throughout the statement, the Commission makes clear that revenue decoupling may be preferable to other mechanisms that address disincentives to energy efficiency. But nowhere does it say that

1 decoupling in any form is the best and/or only mechanism to address the Company's  
2 disincentives.

3         This case is the first case with a decoupling proposal since the policy, and is a test case  
4 with wide ranging implications going forward - which is the reason why the Commission must  
5 consider balance and look out, not only for the shareholder, but for the ratepayer's interest.  
6 The proposed settlement ("Settlement") in this case offers a partial decoupling proposal  
7 (Option A) and a full revenue decoupling proposal (Option B). Unfortunately, the timing is bad,  
8 there is significant ratepayer opposition and both decoupling proposals have problems. The  
9 settling parties themselves do not uniformly support both options<sup>1</sup>, and at least one party,  
10 SWEEP, believes that Option A is not in the public interest. SWEEP-2 at 4. RUCO believes  
11 that both Options are not in the public interest and should be rejected.

12             **Past Commission decisions reject decoupling**

13         Remarkably, this Commission has rejected the Company's attempts to secure a  
14 revenue decoupling mechanism in the Company's last two rate cases. In both cases, as in this  
15 case, the Company attempted to secure a revenue decoupling mechanism to address the  
16 effects of declining use. In December, 2004, the Company filed a rate application and sought  
17 a "Conservation Margin Tracker" which was a revenue decoupling mechanism designed to  
18 address declining average use. The Commission, in Decision No. 68487<sup>2</sup>, stated that there  
19 was conflicting evidence in the record as to the cause of the declining use and that neither the  
20 "law nor public policy" supported the Company's request that customers provide the Company

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23 <sup>1</sup> The Settling parties have drawn a distinction between their support for Option A and Option B and their support  
24 for the Settlement Agreement. All of the parties support the Settlement Agreement but the Settlement provides  
that Staff supports both alternatives equally, the Company prefers Option B, and the remaining Signatories will  
support at least one alternative. A-14 at 7, paragraph 3.2.

<sup>2</sup> Decision No. 68487 was docketed on February 23, 2006.

1 with a guaranteed method of recovering revenues through the use of a decoupling mechanism.  
2 Decision No. 68487 at 34. The Commission encouraged the Company to continue to pursue  
3 rate design alternatives with interested parties. Id.

4 In the Company's last rate case, which was filed in August, 2007, the Company made  
5 several decoupling proposals – a full revenue decoupling adjustment provision ("RDAP") and a  
6 weather normalization adjustment provision ("WNAP"). The Commission in Decision No.  
7 70665 rejected the Company's decoupling proposals noting:

8 We remain concerned that the decoupling proposals could provide a  
9 disincentive to customers to undertake conservation efforts, because they  
10 would be required to pay for gas they did not use. It appears that, first and  
11 foremost, revenue decoupling is a means of providing the Company with  
12 what is effectively a guaranteed method of recovering authorized revenues,  
13 thereby shifting a significant portion of the Company's risk to ratepayers.

14 Decision No. 70665 at 41.

#### 15 **Decoupling will increase rates**

16 In the subject case, Staff's witness, David Dismukes, testified that the impact of  
17 decoupling, had it been in place from 2007 through 2010 (the more relevant time period for  
18 purposes of this case) would have allowed the Company to collect an additional \$62.0 million  
19 from residential ratepayers. S-3 at 16-17.<sup>3</sup> The purpose of the additional \$62. million would  
20 presumably be to address the Company's disincentive to promote energy efficiency. However,  
21 it would come at a time when a significant portion of Arizona has felt the pinch of an economy  
22 close to freefall with high unemployment rates, and at a time when many people are just trying  
23 to make ends meet. At this time and at this price, ratepayers deserve to know exactly why

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24 <sup>3</sup> For ease of reference, trial exhibits will be identified similar by their identification in the Transcript of Proceedings. The transcript volume number will identify references to the transcript.

1 they will be paying this kind of additional money to address a problem which arguably does not  
2 exist.

3 There is no doubt that the revenue guarantee from decoupling underlies the  
4 Company's, as well as the industry-oriented parties, favor of full revenue decoupling. After all,  
5 decoupling shifts the risks from the shareholder to the ratepayer – and with a favorable  
6 Commission policy which discourages decoupling-specific adjustments to account for the risk  
7 imbalance (i.e. Cost of Equity adjustments) – utilities like SWG will undoubtedly be lining up  
8 with decoupling proposals.

9 **1) The Settlement is not in the Public Interest**

10 **A) The circumstances of this case support the rejection of the Settlement**

11 Opponents of decoupling would argue that there is never a good time to implement  
12 decoupling. RUCO does not believe that. Nor does RUCO uniformly reject decoupling.  
13 Transcript at 688. RUCO does believe, however, that the Commission favors a policy of  
14 decoupling where the facts and circumstances of the case warrant it. In other words, RUCO  
15 believes that the Commission should reject decoupling where it does not make sense under  
16 the circumstances of the case. The Commission's Policy Statement supports RUCO's view.  
17 "The Commission could also consider alternative methods for addressing utility financial  
18 disincentives." RUCO-1 at 30. Clearly, the Commission's policy does not require that the  
19 Commission approve decoupling in this case.

20 Nor should the Commission approve the decoupling proposals in this case. RUCO's  
21 Director, Jodi Jerich testified that during this time of economic unrest, it is not appropriate to  
22 shift all the risk to the ratepayer from the utility. Transcript at 688. Ms. Jerich's testimony is  
23 consistent with Staff's witness, David Dismukes whose opposition to the Company's original  
24 full revenue decoupling mechanism was based on the fact that it "... would shift revenue

1 recovery risk associated with changes in the economy, price, and other factors away from the  
2 Company and its shareholders and onto ratepayers. Such a shifting of risk, without any  
3 corresponding mitigation or ratepayer protection measures will result in rates that are not fair,  
4 just and reasonable.” S-3 at 3. The shifting of risk in this case is likely to be significant - as  
5 mentioned above, over the last four years the additional revenues the Company would have  
6 collected under decoupling would have amounted to approximately \$62 million. S-3 at 16-17.

7 Barring appropriate ratepayer protection measures, which are not provided for in the  
8 Settlement,<sup>4</sup> shifting the risks to ratepayers at this time is counterintuitive. Arizona has the  
9 second highest poverty rate, second highest home foreclosure rate in the nation, and for those  
10 people who are able to make their monthly foreclosure payments, fifty percent owe more than  
11 their house is worth. Transcript at 689. Couple these concerns with Arizona’s high  
12 unemployment rate and the fact that Arizona’s ratepayers already pay more for DSM programs  
13 than any other ratepayers in the Southwest<sup>5</sup>, now is not the right time to be guaranteeing a  
14 utility significant additional revenue in the absence of conclusive proof that ratepayer’s will get  
15 corresponding and at least proportionate benefit.

16 **B) Ratepayer benefits do not outweigh the shifting of risk to ratepayers that**  
17 **result from decoupling.**

18 In spite of the settling parties contention that decoupling provides ratepayers with  
19 benefits that mitigate if not overcompensate for the clear financial benefit of increased revenue  
20 and reduced risk to the Company, the evidence in the record does not support this claim.  
21 Looking at the big picture, there is an honest question whether decoupling is a benefit to  
22 ratepayers where the utility in question, Southwest Gas, is merely a distribution facility. Unlike  
23

24 <sup>4</sup> The lack of sufficient corresponding ratepayer mitigation will be discussed below.

<sup>5</sup> Transcript at 689.

1 an electric utility that generates its own power, energy efficiency and conservation will defer or  
2 delay the need for additional generation and infrastructure that results from increased demand.  
3 The ability to push back the need for new and very costly generation and infrastructure that  
4 would be recovered through future rate increases is a definite ratepayer benefit. But for a  
5 natural gas utility, new infrastructure is connected to new customer growth, not consumer  
6 consumption levels of existing customers. The primary ratepayer benefit of decoupling does  
7 not exist in this case.

8 The perceived ratepayer benefits associated with the Settlement pale in comparison to  
9 the shareholder benefits. Staff's Director, in his Settlement testimony, describes the ratepayer  
10 benefits he perceives the Settlement offers. Among those benefits:

- 11 • Commitments benefiting low income customers
- 12 • Rate stability
- 13 • A company commitment to reduce expenses by at least \$2.5 million per year
- 14 • Continuation of a 20-year plan to replace early vintage plastic pipe
- 15 • The establishment of a COYL replacement program
- 16 • Provisions to address costs incurred by Southwest for development of gas heat  
17 pump technology
- 18 • Energy efficiency initiatives
- 19 • Implementation of a decoupling mechanism
- 20 • Rate Design

21 S-9 at 13-14.

22 Noticeably absent are any substantive financial benefits to ratepayers to offset or  
23 mitigate the revenue windfall that will likely inure to the Company if decoupling is implemented.  
24

1 The chart on page 15 of the Settlement compares Staff and the Company's direct case to the  
2 two Settlement alternatives on the important financial issues. Id. at 15.

3 On the issues of proposed revenue increase and return on equity, Staff's direct position  
4 is identical to Option A<sup>6</sup>. In other words, compared to Staff's direct case, on the substantive  
5 financial issues, in exchange for a lucrative partial decoupling mechanism, ratepayers will get  
6 no benefit. Ratepayers will do even worse under Option B. Again, compared to Staff's direct  
7 case, in exchange for full revenue decoupling – ratepayers will see a \$2.3 million reduction in  
8 revenue requirement and a 25 basis point reduction in the cost of equity. Given the guarantee  
9 of revenue recovery and the amount of revenues at stake, the quid pro quo falls far short of  
10 being fair, proportionate, and appropriate to the ratepayer in this case.

11 The other ratepayer "benefits" hardly make up for the difference. For example, the \$2.5  
12 million in expense reductions - the immediate beneficiaries are the shareholders and not the  
13 ratepayers. Ratepayers will eventually share in the benefit, but that will not happen until a new  
14 set of rates are established in a rate case. Under the terms of the Settlement, for full revenue  
15 decoupling, that will be no sooner than five years. A-14 at 14. The Settlement will  
16 automatically increase per-unit-rates between rate cases, which will bolster the Company's  
17 cash flow and income, which will extend the time between rate cases even in the absence of a  
18 rate moratorium. RUCO-10 at 9. The increased revenue flow will reduce the pressure on the  
19 Company to cut costs. Id. Granted the \$2.5 million per year reduction may ameliorate some  
20 of this problem but to the extent rates are increasing and costs are decreasing, it is difficult to  
21 know when, and even if this provision will benefit ratepayers – at the very least, it will be no  
22 sooner than 2016 under Option B. Id.

23 \_\_\_\_\_  
24 <sup>6</sup> The FVROR used in the Settlement, however, is based on Staff's alternate method in its direct case as will be discussed further below.

1 The five year stay out provision under traditional ratemaking may be a benefit. To the  
2 extent it is a benefit, it is less of a benefit where decoupling has been implemented. The  
3 Settlement will put into place a mechanism that would tend to greatly reduce the odds that the  
4 Company would need to come in for a rate review. Transcript at 563. The concern then  
5 becomes whether the Company is adequately and appropriately finding ways to spend all the  
6 revenues coming in.

7 The Settlement will also guarantee the Company an opportunity to earn a 9.50%  
8 percent return on equity for at least five years under full revenue decoupling. Looking at the  
9 economic picture prospectively, a guarantee of revenues and a 9.50% return on equity for the  
10 next five years is a wonderful bet. The 9.75% option is also great for shareholders, but with  
11 less guaranteed revenue, it is less of a lock. It is no surprise that the Company and the  
12 shareholder interest groups in this case prefer full revenue decoupling over the partial  
13 decoupling alternative.

14 The same argument applies to the benefit of the "lower" cost of capital associated with  
15 decoupling. Transcript at 566. Ratepayers will not see that benefit for at least another five  
16 years, and in the meanwhile they are paying the price of a mechanism that will cause their  
17 rates to go up.

18 Another touted ratepayer "benefit" is rate stability. Rate stability is a benefit provided  
19 ratepayers are paying fair and reasonable rates. Here, if rates were to stabilize as the result of  
20 decoupling, it is likely that ratepayers will be paying unfair and unreasonable rates. Ratepayers  
21 would be happier paying a lower rate than a higher rate even if it meant forgoing rate stability.

22 RUCO, however, questions how rates will stabilize when rates can go up by as much as  
23 5% every year. Even where rates could actually decrease due to weather patterns, the result  
24 is not a stable rate.

1           There is also testimony that ratepayer's will benefit because the Company will increase  
2 its expenditures on DSM programs. Transcript at 568. Of course, the Company will recover  
3 these costs through the DSM adjuster. In reality, it again becomes the ratepayers who will be  
4 paying for the "benefit". The increased expenditures on DSM are a good thing but separating it  
5 out as a benefit to ratepayers beyond the normal benefits that would be achieved by having  
6 more and/or appropriate DSM programs is disingenuous.

7           In sum, the Settlement will provide some benefit to the ratepayers. However, just how  
8 much benefit is questionable, and under no circumstances commensurate with the benefit that  
9 the shareholders will receive if either option is approved.

10           **C) The public does not support decoupling at this time and decoupling could**  
11 **result in a disincentive for ratepayers to conserve – the very opposite of its intended**  
12 **purpose.**

13           The real hope is that decoupling will provide the Company with incentive to encourage  
14 and promote energy efficiency in a cost effective, fair and well balanced manner. This is a  
15 ratepayer benefit that if achievable, RUCO will not attempt to denigrate or take away. In this  
16 case, however, RUCO is not convinced this goal can be achieved through decoupling in a  
17 meaningful and cost effective way based on the evidence in the record.

18           There is no question that the public does not support decoupling. Groups like the AARP  
19 have been vocal about their opposition. Sun City residents, folks who live on a fixed income,  
20 have sent hundreds of letters to the Commission voicing their dissatisfaction with decoupling.  
21 In response, shareholder aligned groups such as the Arizona Investment Council, choose to  
22 focus on the customer satisfaction levels associated with decoupling in places like New Jersey  
23 and Oregon. Transcript at 267-268. This case is being decided in Arizona, and the  
24

1 Commission should focus its concern on the ratepayers that its decision will affect - those  
2 ratepayers, have overwhelmingly voiced their opposition to decoupling.

3 **The public perception of decoupling in Arizona is valid.**

4 The public's perception is that under decoupling, if they use less they will be forced to  
5 pay more. The Settling parties have suggested that like many things about decoupling, this is  
6 a misconception. In fact, the Settling parties argue that if the ratepayer uses less gas they will  
7 actually experience lower bills. Transcript at 284-285 for example. This is true, but it is beside  
8 the point. Under either option, **if ratepayers conserve, their rates go up.** Transcript at 556-  
9 557. Their bills may go down because they are using less gas, but their rates will still go up  
10 under decoupling.

11 Nonetheless, the Settling parties claim that under decoupling the ratepayers will be  
12 incentivized to conserve. AIC-1 at 16, Transcript at 280. The idea here, according to Dr.  
13 Hansen is that under decoupling, the customer who reduces his usage will have the immediate  
14 financial benefit of a lower bill and would not give up this immediate financial benefit because  
15 of a concern that the utility may recoup a tiny fraction of that lost revenue a year later. AIC-1 at  
16 16. Dr. Hansen likens it to the restaurant diner who goes out to dinner with six friends. Dr.  
17 Hansen claims that there have been published economic studies which show that the diner will  
18 spend more than he would if he paid his own way due to the fact that there are now five other  
19 diners splitting the bill. Transcript at 281.

20 The point the Settling parties appear to be making is that the approved revenue spread  
21 will not be reflected in rates until down the road and will be divided among so many ratepayers  
22 that the actual rate increase will be insignificant and not a disincentive to conserve. As Dr.  
23 Hansen points out, the dessert is a conserved therm, but what the diner is buying under  
24 decoupling is the bill reduction by conserving. Transcript at 283. In dollar terms, under Option

1 B, the largest monthly adjustment that ratepayers will see under the cap is \$1.40 in the first  
2 year. Transcript at 263. Mr. Cavanaugh testified that Option B will not raise the ratepayer bill  
3 over a nickel a day. Transcript at 380.

4 The settling parties have a point, at least as pertains to some ratepayers so long as  
5 their bills go down if they conserve. Nonetheless, this cannot hide the fact that a portion of the  
6 savings is illusory in that it will come back in the form of a higher rate later. Transcript at 557.  
7 Nor does this point mitigate in any way the fact that the higher rate will result in ratepayers  
8 paying for not only their conservation but other ratepayer's conservation. Ratepayers as a  
9 whole will get the connection and understand that however it may appear in the end they will  
10 be paying higher rates as a result of their conservation because of decoupling.

11 Other rate payers will understand that decoupling will cost them a nickel a day or a  
12 \$1.40 a month and will question why they will have to pay the Company to do something that  
13 SWG has already been doing and is required to do anyway. Moreover, while these amounts  
14 may be small to some ratepayers, to others, for example, those who are just over the low  
15 income cut off or on a fixed income, an additional \$1.40 a month is significant. Like everything  
16 else, these little "extras" add up, and whether they are warranted or not do become  
17 meaningful. In this case, these little "extras" would have meant \$62 million of additional  
18 revenues to the utility over the last four years to do something they are required to do. This is  
19 a significant amount to every ratepayer which becomes even more difficult to swallow when  
20 the Company has been paying increasing dividends to it shareholders since at least 2007.

21 RUCO-4.

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1           **D) Neither Option A nor Option B of the Settlement is in the public interest.**

2           The Settlement comes down to an agreement between Staff and the parties who  
3 wanted decoupling. Transcript at 552. No party really gave up much, except Staff who gave  
4 up its opposition to decoupling in exchange for very little if any additional benefit to the  
5 ratepayers.

6           Under both options, the more customers conserve, the more rates will go up. The main  
7 difference between Option A and B is that under Option A rates will go up based on a  
8 calculation of lost revenues attributed to specific DSM programs, whereas under Option B  
9 rates will go up based on a calculation of lost usage per customer, regardless of the factors  
10 contributing to that reduction in usage. Neither option is particularly appealing to ratepayers  
11 and could easily result in ratepayer's actually having a disincentive to conserve – the exact  
12 opposite of the intended purpose of the energy efficiency standard. If either option were to  
13 result in a disincentive to conserve, ratepayer's would be better off under Option A, since  
14 Option B guarantees revenue recovery whether ratepayer's conserve or not.

15           **The parties themselves do not uniformly believe Option A is in the public  
16 interest.**

17           Perhaps this potential for the utility not to recover all of its revenues under Option A  
18 explains why most of the parties "prefer" Option B. The Company, AIC and NRDC prefer  
19 Option B over Option A. AIC-2 at 4, A-16 at 9, Transcript at 361 and 362. SWEEP outright  
20 opposes Option A claiming it is "not in the public interest." SWEEP-2 at 4. According to  
21 SWEEP, Option A:

- 22           ▪ Results in a higher base rate increase than Option B
- 23           ▪ Allows the recovery of anticipated lost-based revenues, thereby  
            paying the Company for lost revenues in advance of actually  
            experiencing such losses
- 24           ▪ Would create perverse incentives

- 1           ▪ Will likely result in contentious and protracted technical
- 2           proceedings at the Commission
- 3           ▪ Would not encourage the Company to support energy codes,
- 4           appliance efficiency standards, and state initiatives and
- 5           legislation, and
- 6           ▪ Does not adequately reduce the utility disincentive to energy
- 7           efficiency.

8 SWEEP-2 at 4. The flaws with this Option are apparent and the parties themselves have  
9 adequately explained why this Option is not in the public interest. As an aside, it is equally  
10 perverse that SWEEP could and does support a Settlement which would require it to support  
11 an option which Sweep admits is not in the public interest.

12           **Option B is not in the public interest for numerous reasons**

13           It is not surprising that Option B, the full revenue decoupling provision, is the preferred  
14 Option of most of the parties – at least the parties whose interests are most closely aligned  
15 with the Company’s. In addition to the various reasons explained above, Option B should be  
16 rejected for the following reasons. First, and perhaps foremost, if the Commission adopts  
17 Option B it will send the message to customers that future reduction in usage will automatically  
18 lead to higher rates per therm, RUCO-10 at 7. This is the exact same concern this  
19 Commission had with the Company’s revenue decoupling proposal two rate cases ago. See  
20 Decision No. 68487 at 34. The Commission noted in the Company’s 2005 rate case:

21           Further, as RUCO points out, the likely effect of adopting the proposed  
22 CMT is that residential **customers will be required to pay for gas that**  
23 **they have not used in prior years, a phenomenon that could result in**  
24 **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. 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 and we decline to adopt the Company’s CMT in this case.

1 Id. (Emphasis added). Second, similar to what the Commission found in Decision No. 68487,  
2 Option B would require customers to pay for a level of gas service that they do not actually  
3 use.

4 The third reason why Option B should be rejected is because declining use is a normal  
5 risk caused by normal events that all utilities face. In between rate cases, a Company's  
6 revenues may fluctuate for a variety of reasons – inflation, weather, interest rates, etc.  
7 Transcript at 643-644, 681. These changes result in regulatory lag, which can work in favor of  
8 the company or the ratepayer at different times. Either way, regulatory lag is a factor common  
9 to all utilities. Id. The risks associated with regulatory lag are borne by both the ratepayer and  
10 the shareholder. Option A and Option B are nothing more than an attempt to mitigate the risks  
11 associated with regulatory lag in favor of the shareholders. In other words, Option A and  
12 Option B will shift the shareholder's risks associated with regulatory lag to the ratepayer.

13 This shift of risk is further highlighted by the fact that Option B simply ignores the other  
14 regulatory lag aspects associated with declining consumption which favor the Company–  
15 growth, interest rates – etc. Id. This type of single issue ratemaking is frowned upon by the  
16 courts in Arizona<sup>7</sup>. See for example *Scates v. Arizona Corporation Commission*, 118 Ariz.  
17 531, 534, 578 P.2d 612, 615 (Ariz. App. 1978) (“...such a piecemeal approach is fraught with  
18 potential abuse.”).

19 Another less significant reason why both Option A and Option B should be rejected at  
20 this time is, it is unclear which is preferred under the Commission's policy and the Settlement  
21 does not conform to all of the directives of the Commission's policy. Paragraph 8 of the policy  
22  
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24 <sup>7</sup> A complete legal analysis will be provided below.

1 states a preference for full decoupling over partial decoupling. RUCO-1 at 31. Option B would  
2 be the choice under paragraph 8 of the policy. Whereas, paragraph 13 of the policy states a  
3 preference for decoupling applied in a manner to encourage energy efficiency. Of the two  
4 options, paragraph 13 of the policy would favor Option A which provides for the recovery of lost  
5 base revenues attributed to achievement of the Commission's required energy efficiency  
6 standard. A-14 at 7. Both options have a weather normalization component which, under  
7 paragraph 9 of the policy is "discouraged" because such normalization would reduce the size  
8 of decoupling surcredits to customers following an extreme weather event. Id.

9 The policy also requires caps be designed to encourage gradualism. RUCO-1 at 31,  
10 pp. 14. The Settlement Cap is higher than the 3 % minimum discussed in the workshops and  
11 does not appear to be designed with "gradualism" in mind. RUCO-1. Nor does the Settlement  
12 address whether new customers should be treated distinctly from existing customers as  
13 proscribed under paragraph 4 of the policy. Id. at 30, pp. 4. The Settlement does not appear  
14 to distinguish existing customers from new customers. The stakeholders in the decoupling  
15 workshops noted that one approach tried in Washington was to leave new customers entirely  
16 out and apply adjustments solely to existing customers. Id. at 13. The parties in Arizona's  
17 workshop concluded, as did the Commission in its policy, that further analysis was needed to  
18 examine whether there existed a difference between old and new customers and whether that  
19 difference required different treatment. Id. It does not appear that analysis has been done in  
20 this case. These relatively small inconsistencies add to the confusion associated with a very  
21 difficult and complex subject. The inconsistencies and the confusion provide further reason  
22 why this is not the appropriate time to implement either of the proposed decoupling proposals.

23 In summary, the implementation of a decoupling mechanism is one way to address the  
24 disincentive associated with energy efficiency. It is an extreme solution which has ample risks

1 associated with it and turns on its head the regulatory paradigm as we know it. In the absence  
2 of supporting evidence, it should not be assumed that declining sales are caused by  
3 conservation. Nor should it be assumed that the Company needs an incentive to do something  
4 it is already obligated to do. In other words, the Commission should be assured in every case  
5 where decoupling is being considered that there is a "problem" before finding a solution. In  
6 this case, the evidence has been almost exclusively centered on the solution and not the  
7 problem. But assuming for the sake of argument a problem exists, it is wise to consider other,  
8 less extreme measures as solutions to deal with the problem in this case. RUCO believes, for  
9 all of the reasons explained above that neither Option A nor Option B is the answer in this  
10 case. The Commission should reject the Settlement.

11 **2) RUCO recommends that the Commission adopt its rate design alternative.**  
12 **RUCO's proposal is fair and balanced, and should be adopted by the**  
13 **Commission.**

14 RUCO has offered another alternative for the Commission to consider in this case.  
15 RUCO's proposal is in the nature of a compromise –in other words, RUCO is by no means  
16 convinced that there is a "problem," and if there is a "problem", that the solution in this case is  
17 one of the alternatives offered in the Settlement. However, out of respect for the  
18 Commission's policy, and the positive goal of the policy, RUCO has set forth an alternative  
19 which will clearly address the disincentive that the Company claims is associated with energy  
20 efficiency without up-ending the traditional regulatory process.

21 RUCO in an effort to compromise has given up more from its direct position than any  
22 other party except Staff (who gave up its opposition to decoupling). In terms of revenue  
23 requirement, RUCO's compromise position is over \$19 million more than its direct position for  
24 a total recommended revenue increase \$47.6 million. RUCO-14, RUCO-15. RUCO's

1 recommended return on equity increased 50 basis points from 9 percent to 9.5 percent. Id. In  
2 lieu of decoupling, RUCO's compromise position would also increase the Company's flat  
3 monthly customer charges from \$10.70 to \$11.85. RUCO-14 at 10. RUCO is also  
4 recommending that the Commission calculate the FVROR using the methodology adopted in  
5 the recent UNS Electric case (Decision No. 71914 at 49-50) as well as normalize weather  
6 based on the unadjusted 30 year average. RUCO-10 at 18. RUCO agrees to all of the other  
7 provisions in the Settlement.

8 By any standard, RUCO's recommendation is fair, and if anything, arguably over-  
9 generous. Surprisingly, RUCO's proposal sits poorly with the Settling parties – no doubt,  
10 because nothing short of full revenue decoupling will truly satisfy the Company and its aligned  
11 interests – which in itself is indicative of how much money is at stake. Mr. Cavanaugh claims  
12 that shifting more into the fixed rate is a bad idea and will only make things worse. Transcript  
13 at 410. AIC and the Company also agree that RUCO's proposal is a bad idea. Transcript at  
14 92-93, 270-271.

15 The Company seeks decoupling to help boost its cash flows and income in the face of a  
16 trend toward energy conservation. RUCO-10 at 17. The Company also argues that  
17 decoupling will help reduce the volatility of its revenues and income in the face of wide  
18 fluctuations in weather conditions. Id. RUCO's rate design addresses these Company  
19 concerns without decoupling. RUCO's proposed rate design mirrors the Company's current  
20 rate design, except for the percentages of revenues that are being generated by the fixed  
21 monthly basic service charge. Id. RUCO recommends a slight shift in the residential revenue  
22 recovery from the variable to the fixed rates, even though RUCO does not believe it is cost  
23 justified in an effort to help the Company boost its revenues lost to conservation and weather  
24 fluctuations. Id. RUCO's proposal is designed to mitigate the Company's risk of not

1 recovering its authorized revenue requirement, while at the same time sending appropriate  
2 signals to ratepayers regarding gas consumption. While it may not be as lucrative as  
3 decoupling to the Company, RUCO's proposal addresses the "problem" and is fair to the  
4 Company. The Commission should approve RUCO's recommendation.

5  
6 **3) RUCO has not concluded that decoupling violates Arizona's Fair Value  
7 Requirement but does believe that both Options present constitutional challenges.**

8 The debate on the application of decoupling in this case, and all cases in Arizona for  
9 that matter, may well be academic if decoupling violates Arizona's fair value requirement.  
10 Undoubtedly, no other single factor distinguishes Arizona from other states that have adopted  
11 decoupling than Arizona's fair value requirement.

12 The Arizona Constitution vests the Arizona Corporation Commission with full and  
13 exclusive power to fix rates, charges, and classifications for public utilities. State v. TEP, 15  
14 Ariz. 294 (1914). The Commission's authority over ratemaking is plenary and cannot be  
15 interfered with by the legislature, the courts, or the executive branch.<sup>8</sup> This authority includes  
16 "all powers which may be necessary or essential in connection with the performance of its  
17 duties."<sup>9</sup>

18 The Arizona Constitution provides:

19 The Corporation Commission shall have full power to, and shall, prescribe  
20 just and reasonable classifications to be used and just and reasonable rates

21  
22 <sup>8</sup> See Ethington, 66 Ariz. at 392, 189 P.2d at 216; Morris v. Arizona Corp. Comm'n, 24 Ariz. App. 454, 457, 539 P.  
23 2d 928, 931 (1975) ("Given that it has complete and exclusive power to set rates, the Commission clearly has the  
24 authority to enter into rate contracts, including those specifying rates for a definite period of time, where it believes  
it necessary to fulfill its ratemaking function. No further grant of authority is necessary.")

<sup>9</sup> See Garvey v. Trew, 64 Ariz. 342, 346-47, 170 P.2d 845, 848 (1946) (noting that Commission has constitutional  
power to enter into contracts with the Federal Power Commission for co-operation under the Federal Power Act).

1 and charges to be made and collected, by public service corporations<sup>10</sup>  
2 within the State for service rendered therein, and make such reasonable  
3 rules, regulations, and orders, by which such corporations shall be  
4 governed in the transaction of business within the State, and may prescribe  
5 the forms of contracts and the systems of keeping accounts to be used by  
such corporations; ... Provided ... that classifications, rates, charges, rules,  
regulations, orders, and forms or systems prescribed or made by said  
Corporation Commission may from time to time be amended or repealed by  
such Commission.

6 See Arizona Constitution, Article 15, Sec. 3.

7 In determining just and reasonable rates, the Arizona Constitution protects consumers  
8 by generally requiring that the Commission only change a utility's rates in conjunction with  
9 making a finding of the fair value of the utility's property.<sup>11</sup> The Arizona Constitution further  
10 provides:

11 §14. Value of property of public service corporations

12 Section 14. The corporation commission shall, to aid it in the proper  
13 discharge of its duties, ascertain the fair value of the property within the  
14 state of every public service corporation doing business therein; and every  
15 public service corporation doing business within the state shall furnish to  
16 the commission all evidence in its possession, and all assistance in its  
17 power, requested by the commission in aid of the determination of the value  
18 of the property within the state of such public service corporation.

---

19  
20  
21 <sup>10</sup> The definition of "public service corporation," embodied in Arizona Constitution, Article 15, Sec. 2 is  
broad:

22 All corporations other than municipal engaged in furnishing gas, oil, or electricity for light, fuel, or  
23 power; or in furnishing water for irrigation, fire protection, or other public purposes; or in  
furnishing, for profit, hot or cold air or steam for heating or cooling purposes; or engaged in  
collecting, transporting, treating, purifying and disposing of sewage through a system, for profit; or  
in transmitting messages or furnishing public telegraph or telephone service, and all corporations  
other than municipal, operating as common carriers, shall be deemed public service corporations.

24 <sup>11</sup> A.R.S. Const. Art. XV, § 14; *Simms*; see also *State v. Tucson Gas*, 15 Ariz. 294, 308; 138 P. 781, 786  
(1914); *ACC v. State ex rel. Woods*, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992).

1           However, Arizona's courts recognize that, "in limited circumstances," the Commission  
2 may engage in rate making without ascertaining a utility's rate base.<sup>12</sup> The two limited  
3 circumstances identified by the courts are the changing of rates pursuant to a previously-  
4 established adjustor mechanism, and the establishment of interim rates when an emergency  
5 exists.<sup>13</sup>

6           The provisions of Arizona's Constitution should be liberally construed to carry out the  
7 purposes for which they were adopted.<sup>14</sup> Conversely, exceptions to a constitutional  
8 requirement should be narrowly construed.<sup>15</sup> Therefore, the protection to consumers afforded  
9 by the fair value requirement should be liberally construed, and exceptions for adjustor  
10 mechanisms and interim emergency rates should be narrowly construed.

11           On its face, trying to fit either Option A or Option B of the Settlement into Arizona's fair  
12 value requirement would be challenging. Option A would allow the Company to increase rates  
13 by imposing a per unit surcharge based on a calculation related to "lost revenues." A-16 at 5,  
14 RUCO-10 at 3-4. Option B would allow the Company to adjust its per-therm rates based on a  
15 calculation related to actual revenues per customer vs. approved revenues per customer. Id.  
16 at 7, RUCO-10 at 4-5. In both cases, rates would be adjusted on a streamlined, formulaic  
17 basis, without a Commission determination that the resulting rates are "just and reasonable"  
18 based upon a full evaluation of all relevant facts, including a determination of the current "fair  
19 value" of SWG's property.

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21           <sup>12</sup> Residential Util. Consumer Office v. Arizona Corp. Comm'n ("*RUCO v. ACC or Rio Verde*"), 199 Ariz. 588,  
22 591 ¶ 11, 20 P.3d 1169, 1172.

23           <sup>13</sup> *RUCO v. ACC*, supra, *Scates*, supra.

24           <sup>14</sup> *Laos v. Arnold*, 141 Ariz. 46, 685 P.2d 111 (1984).

<sup>15</sup> See *Spokane & I.E.R. Co. v. U.S.*, 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary rule" that  
exceptions from a general policy embodied in the law should be strictly construed); *Piedmont & N. Ry. Co. v.*  
*Interstate Commerce Commission*, 286 U.S. 299, 311-12, 52 S.Ct. 541, 545 (1932); *International Broth. of*  
*Teamsters v. U.S.*, 431 U.S. 324, 381, 97 S.Ct. 1843, 1878 (1977).

1 While the rates initially established under the Settlement would be based upon the  
2 Commission's determination of the "fair value" of SWG's property, the same cannot be said for  
3 the future rate levels that will be established pursuant to Option A or Option B. Those future  
4 rate levels will be established on a streamlined, formulaic basis, without the full set of  
5 protections that occur when rates are found to be just and reasonable, taking into account all  
6 relevant facts, including the current fair value of SWG's property.

7 There is no question that under either proposal, future rates will be tied back to rates the  
8 Commission will establish based on fair value. But the future rates will not be the same as the  
9 initial rates that will have been based on fair value. There will be a disconnect between the  
10 rates established using fair value and the future rates which will not be based on fair value  
11 under both options and unless that fair value connection is made, RUCO believes both  
12 proposals would be constitutionally challenged.

13 As mentioned above, there are two situations which Arizona's courts have considered  
14 exceptions to the fair value requirement. The interim rate exception is not applicable here.  
15 The other exception is the automatic adjustor mechanism.<sup>16</sup> An automatic adjustor mechanism  
16 permits rates to adjust up or down "in relation to fluctuations in certain, narrowly defined,  
17 operating expenses."<sup>17</sup> An automatic adjustor permits a utility's rate of return to remain  
18 relatively constant despite fluctuations in the relevant cost. An automatic adjustor clause can  
19 only be implemented as part of a full rate hearing.<sup>18</sup>

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22  
23 <sup>16</sup> *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616; *Residential Util. Consumer Office v. Arizona Corp. Comm'n ("Rio Verde")*, 199 Ariz. 588, 591 ¶ 11, 20 P.3d 1169, 1172.

24 <sup>17</sup> *Scates* at 535, 616

<sup>18</sup> *Rio Verde* at 592 ¶ 19, 1173, *citing Scates* at 535, 616.

1 The Commission has also defined adjustment mechanisms as applying to expenses  
2 that routinely fluctuate widely. In a prior decision in which it eliminated APS' fuel and power  
3 adjustor, the Commission stated:

4 The principle justification for a fuel adjustor is volatility in fuel prices. A fuel  
5 adjustor allows the Commission to approve changes in rates for a utility in  
6 response to volatile changes in fuel or purchased power prices without having to  
7 conduct a rate case.

8 (Decision No. 56450, page 6, April 13, 1989). The Commission went on to discuss the  
9 undesirability of such adjustors because they can cause piecemeal regulation that is inefficient  
10 and undesirable<sup>19</sup>.

11 An adjustor mechanism is an extraordinary ratemaking tool which is appropriate only for  
12 narrowly-defined operating expenses that fluctuate widely and have a significant impact on a  
13 company's return<sup>20</sup>. The consideration of either Option A or Option B as an adjustor  
14 mechanism, would at the very least, be a stretch, which runs afoul of the Arizona Court's  
15 interpretation that exceptions to the fair value requirement should be narrowly construed.<sup>21</sup>

16 The rate setting mechanisms contemplated under Options A and B in the Settlement  
17 may superficially appear to be similar to the purchased gas and similar streamlined rate  
18 adjustment processes which have been historically used by the Commission. However, there  
19 are important distinctions between those pass-through rate adjustments and the approach  
20 contemplated with respect to Options A and B. The purchased gas adjustment mechanism  
21 and similar adjustors are narrowly crafted to simply "pass-through" to customer's changes in  
22 certain out of pocket operating costs, without any intent to increase or decrease the return on  
23 fair value that will be earned by the utility. In contrast, the provisions in Options A and B are

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24 <sup>19</sup> *Id.* at 8. See also *Scates* at 534, 615.

<sup>20</sup> *Scates* at 535, 616

<sup>21</sup> See *Spokane & I.E.R. Co. v. U.S.*, 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916)

1 designed to serve a very different purpose. Both options are tied to changes in revenues – **not**  
2 **costs** – and the purpose is to adjust the Company's earnings relative to the level that would  
3 otherwise be achieved in the absence of the rate adjustment. In this regard, the Settlement  
4 would break entirely new ground should the Commission attempt to classify either option an  
5 automatic adjustment mechanism. An automatic adjustment mechanism attempts to  
6 accomplish a similar purpose to what would normally be achieved through a full rate case, but  
7 without examining all the facts that would normally be analyzed in a rate case. Thus, it  
8 effectively short circuits the process that has historically been used by the Commission to  
9 evaluate claims that rates need to be increased because they are no longer fair and  
10 reasonable – a process which has involved a full evaluation of all relevant facts, including a  
11 finding of fair value.

12 In sum, the Settlement contemplates using rates that have been found to be just and  
13 reasonable, and allows those rates to be increased on a formulaic basis. The purpose of this  
14 streamlined process is not to pass through changes in operating expenses, but to bolster or  
15 maintain the Company's earnings. This formulaic change in rates will occur on an expedited,  
16 streamlined basis, without the benefit of an opportunity to examine all relevant facts, including  
17 a determination of the fair value of the utility's property, as called for under the Arizona  
18 Constitution.

19 With all of that said, RUCO acknowledges that there may be a fair value connection that  
20 RUCO has not contemplated. RUCO hesitates to draw any legal conclusions at this time until  
21 it has a chance to exhaust its legal research and consider the arguments raised by other  
22 parties. At this point in time, however, RUCO does see the constitutional challenges raised  
23 above as another reason why approving the Settlement at this time as not being in the public  
24 interest.

1           **4) Other Issues**

2                           **Fair Value Rate of Return**

3           Under the terms of the Settlement, both options establish a Fair Value Rate of Return  
4 (“FVROR”) using Staff’s fair value methodology and valuation. A-14 at 7, 10. In fact, the  
5 Settlement did not adopt Staff’s preferred FVROR methodology. Transcript at 775. Instead,  
6 the Settlement adopted Staff’s alternate methodology where Staff’s witness subtracted the  
7 inflation factor from an estimated risk-free rate of return to arrive at the real risk free rate of  
8 return. Id. Admittedly, not as risky as RUCO originally thought, it is still an inferior  
9 methodology than RUCO’s proposal. Id. at 775-776.

10           RUCO’s FVROR proposal subtracts the rate of inflation component from the cost of  
11 equity and the cost of debt. RUCO-10 at 12. RUCO’s proposed methodology is the same  
12 methodology that the Commission approved in the recent UNS Electric case. See Decision  
13 No. 71914 at 49-50. In UNS Electric the Commission concluded:

14           In the Chaparral City Rate Case, we found that an inflation element exists in  
15 both the debt and equity components of the capital structure and,  
16 accordingly, the inflation adjustment was made to the entire cost of capital.  
17 In that Decision, we reiterated that “the most basic tenet of rate regulation  
18 ... is that a utility should be provided with rates that will allow it an  
19 opportunity to earn a return that is comparable to those of similarly situated  
20 enterprises.” However, as we recently found in the UNS Gas rate decision,  
21 we do not believe the inflation factor should be reduced by 50 percent,  
22 because such a methodology would fail to recognize that RCND  
23 estimations are based on estimates of the cost to reconstruct the entirety of  
24 the Company’s system at current prices, and do not take into account in the  
RCND estimation efficiencies and cost savings that may exist due to factors  
such as technological advances. We note that the Chaparral City Remand  
Decision did not apply a 50 percent weighting factor to the inflation  
estimate, although inflation was calculated only on the equity component in  
that case due to a lack of sufficient evidence in the record concerning  
inflation in the cost of debt. **In this proceeding, we find that an  
unadjusted inflation factor should be subtracted from the entire  
WACC, to afford appropriate recognition to the fact that inflation  
exists in both the debt and equity components of the Company’s**

1           **capital structure**, and that reconstruction cost estimates likely exceed the  
2 rate of inflation based on the factors cited above.

3 Decision No. 71914, docketed September 30, 2010, at pp. 49-50 (Em phasis added and  
4 footnotes omitted).

5           In the subject case, similar to the UNS Electric case, the unadjusted inflation factor  
6 should be subtracted from the entire WACC "...to afford appropriate recognition to the fact that  
7 inflation exists in both the debt and equity components of the Company's capital structure."

8 The reasoning behind this methodology is solid, and consistent with how the Commission has  
9 handled this issue since the Chaparral decision. Decision No. 71308. The fact that there is a  
10 Settlement is not a sound reason for changing the methodology. A change in this  
11 methodology should not be made because parties have compromised their positions in order  
12 to get something of greater value to them.

13           Since Chaparral, the methodology for determining the FVROR has been in flux. Where  
14 the Commission goes with it will have wide implications for future proceedings. The  
15 Commission, for theoretically sound reasoning, has said that the inflation component should be  
16 subtracted from both the debt and the equity components of the capital structure. It would be a  
17 setback to this sound methodology to adopt Staff's alternative approach in this case. The  
18 Commission should reject the Settlement.

19 **CONCLUSION**

20           RUCO supports the Commission's decoupling policy. However, as Director Hill of the  
21 Tennessee Regulatory Authority noted regarding the fact that other states have adopted  
22 decoupling, when it concerns the states conservation policy, the regulator is required to look  
23  
24

1 beyond a one size fits all answer<sup>22</sup>. In the present case, neither Option A nor Option B of the  
2 Settlement is the solution to declining use. The time is not right, the decoupling proposals are  
3 not right, there is far too much public opposition, and it would not be in the ratepayers' interest.  
4 By no means should the Commission consider this as a knock against its policy. It is a good  
5 policy with the right intention. But the facts are the facts, and now is not the right time for the  
6 implementation of either Option A or Option B. RUCO recommends the Commission adopt  
7 RUCO's proposal as it is a superior proposal under the circumstance of this case.

8 RESPECTFULLY SUBMITTED this 2<sup>nd</sup> day of September, 2011.

9  
10   
11 Daniel W. Pozefsky  
12 Chief Counsel

13  
14  
15  
16  
17 AN ORIGINAL AND THIRTEEN COPIES  
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19 of September, 2011 with:

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-26-  
<sup>22</sup> See *Petition of Piedmont Natural Gas Company before the Tennessee Regulatory Authority*; Docket No. 09-00104 at 17.

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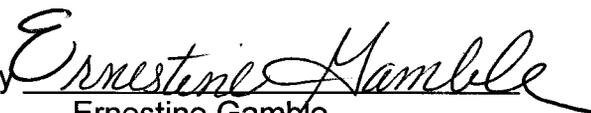
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