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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
SOUTHWEST GAS CORPORATION FOR
THE ESTABLISHMENT OF JUST AND
REASONABLE RATES AND CHARGES
DESIGNED TO REALIZE A REASONABLE
RATE OF RETURN ON THE FAIR VALUE
OF ITS PROPERTIES THROUGHOUT
ARIZONA.

DOCKET NO. G-01551A-10-0458

STAFF'S OPENING BRIEF

I. INTRODUCTION.

On November 12, 2010, Southwest Gas Corporation ("Southwest Gas" or "Company"), filed an application for an increase in its rates, a request for approval of certain deferred accounting orders and a request for approval of an energy efficiency and renewable energy resource technology portfolio implementation plan.¹ In its application, Southwest Gas requested a revenue increase of \$73.2 million or approximately 9.26 percent over its current revenues using a test year ending June 30, 2010.² The requested revenue increase was based upon an 11.0 percent cost of equity with the Company's capital structure composed of 52.3 percent equity and 47.7 percent long-term debt.³ The Company also requested approval of two deferred accounting orders. The first request was for the deferral of costs to be incurred in a pilot program to replace up to 5,000 customer owned yard lines ("COYL").⁴ The second request was for an accounting order for the expenses and costs associated with the replacement of Aldyl HD pipe, which is being replaced as part of the Company's plan to replace all early vintage plastic pipe.⁵

¹ Ex. A-4.

² *Id.* at 1.

³ *Id.* at 5.

⁴ *Id.* at 5-6.

⁵ *Id.* at 6.

1 The Company also sought approval of its Energy Efficiency (“EE”) and Renewable Energy
2 Resource Technology Portfolio Implementation (“RET”) plan, consisting of an estimated budget of
3 \$14.5 million for the first year.⁶ The EE and RET Plan was submitted prior to the adoption of the
4 Gas Utility Energy Efficiency Standards (“Standards”).⁷

5 Southwest Gas also requested approval of its Energy Efficiency Enabling Provision (“EEP”),
6 which is revenue per customer decoupling mechanism.⁸

7 A number of parties intervened, including the Residential Utility Consumer Office
8 (“RUCO”), the Arizona Investment Council (“AIC”), Tucson Electric Power (“TEP”), Southwest
9 Energy Efficiency Project (“SWEEP”), the National Resource Defense Council (“NRDC”) and
10 Cynthia Zwick. Staff, RUCO, and Cynthia Zwick filed non-rate design direct testimony June 10,
11 2011. Staff, RUCO, NRDC, and SWEEP filed direct rate design testimony June 24, 2011.

12 Staff made several recommendations pertaining to the Company’s proposed rate base,
13 expenses, revenues, and net operating income resulting in a recommended revenue increase of \$54.9
14 million.⁹ Staff agreed with the Company’s capital structure and embedded cost of long-term debt, but
15 recommended a cost of common equity capital of 9.75 percent and a fair value rate of return
16 (“FVROR”) of 7.02 percent using a 1.25 percent inflation-adjusted risk-free return on the fair value
17 increment (differential between fair value rate base and original cost rate base).¹⁰

18 Staff also recommended denial of Southwest Gas’ proposed full revenue decoupling
19 mechanism in favor of a partial decoupling mechanism.¹¹ Staff also noted the lack of customer
20 protections with the Company’s EEP and made several recommendations in the event the
21 Commission elected to approve the proposed EEP.¹² Staff also recommended denial of the proposed
22 EE and RET Plan at this time.¹³ There were other Staff recommendations, including that the
23 Company file a depreciation study in its next general rate case, denial of the Company’s request for

24 ⁶ *Id.* at 6-7.

25 ⁷ A.A.C. R14-2-2501 *et seq.*

26 ⁸ *Id.* at 7.

27 ⁹ Ex. S-1, Ex. Summ. at 1.

28 ¹⁰ Ex. S-8, Ex. Summ. at 2.

¹¹ *Id.* at 16-17.

¹² *Id.*

¹³ Ex. S-7 at 8.

1 deferred accounting orders, that the Company propose an inclining block rate design in its next rate
2 case and denial of cost recovery associated with replacing the distribution pipeline system in the
3 Manors subdivision in Yuma, Arizona. Staff also made several recommendations pertaining to gas
4 procurement, the purchased gas adjustor mechanism, and Southwest Gas' efforts to improve
5 communications with its customers.¹⁴

6 Southwest Gas filed a Notice of Settlement Discussions June 21, 2011. The parties of record
7 subsequently held settlement discussions beginning June 28, 2011 and continuing through July 14
8 2011. The settlement discussions culminated with the production of a term sheet that was circulated
9 among the parties of record July 8, 2011, and ultimately a proposed Settlement Agreement
10 ("Agreement") that was signed by the Company, Staff, AIC, Ms. Zwick, SWEEP and NRDC
11 (collectively the "Signatories"). RUCO and TEP did not sign the Agreement.¹⁵

12 The purpose of the Agreement is to settle all issues presented by Docket No. G-01551A-10-
13 0458 in a manner that will promote the public interest. The Signatories agree that the terms of the
14 Agreement are just, reasonable, fair, and in the public interest in that the Agreement results in a
15 settlement package that addresses Southwest Gas' need for a rate increase and balances this need with
16 terms and conditions that provide for specific customer benefits.

17 **II. BACKGROUND.**

18 Southwest Gas is engaged in the retail distribution, transportation and sale of natural gas for
19 domestic, commercial, agricultural and industrial uses. Southwest Gas currently serves
20 approximately 1.6 million customers in the states of Arizona, California and Nevada.¹⁶
21 Approximately 54 percent of the Company's customers are located in Arizona, including portions of
22 Cochise, Gila, Graham, Greenlee, La Paz, Maricopa, Mohave, Pima Pinal and Yuma counties.¹⁷

23 There are two significant events that occurred after the filing of the Company's rate
24 application. On December 29, 2010, the Commission issued a policy directive on decoupling,
25

26 ¹⁴ Ex. S-5 at 2.

27 ¹⁵ TEP participated in the Settlement discussion and indicated that it did not oppose the Agreement,
see Pre-hearing Transcript at 12.

28 ¹⁶ Ex. A-4 at 12.

¹⁷ *Id.* at 2.

1 “Policy Statement Regarding Utility Disincentives to Energy Efficiency and Decoupled Rate
2 Structures” (“Policy Statement”).¹⁸ In January, 2011, the Standards became final.

3 The Standards require gas utilities to achieve annual energy savings of at least 6 percent by
4 2020, with the savings to increase incrementally as a percent of retail energy sales in each prior
5 calendar year to reach that goal.¹⁹ The utilities will be able to reach this goal through both demand
6 side management (“DSM”) and renewable energy resource technology (“RET”) programs. Up to one-
7 third of the energy savings can result from energy efficient building codes and up to one-third of the
8 savings can come from energy efficient appliance standards. Utilities can also count energy savings
9 from individual customers who adopt efficient home or business practices and technologies. In
10 addition, utilities can count all energy savings resulting from RET projects that displace gas usage by
11 customers.

12 The Commission, in 2008, commenced an investigation of utility financial disincentives to
13 energy efficiency and considered how it could address these issues and maximize energy efficiency
14 efforts at the effected electric and gas utilities. A series of workshops were held, which culminated in
15 the Policy Statement. While the Commission expressed a preference for full revenue decoupling, the
16 Policy Statement also recognized that other alternatives should be proposed as well. The
17 Commission also stated that utilities may file a proposal for decoupling or an alternative mechanism
18 for addressing disincentives, in its next general rate case.²⁰ Southwest Gas was the first utility after
19 the issuance of the Policy Statement that proposed a revenue decoupling mechanism as a part of its
20 rate application.

21 **III. THE SETTLEMENT AGREEMENT IS IN THE PUBLIC INTEREST AND SHOULD**
22 **BE ADOPTED BY THE COMMISSION.**

23 **A. Overview of Settlement Process.**

24 It is no small feat to draft a settlement agreement among diverse parties who represent a range
25 of interests from energy efficiency advocates, to low income advocates, to the investment
26 community. From the outset, all parties were invited to participate. The settlement process took

27 ¹⁸ Docket No. G-00000C-08-0314; Ex. R-1; also *see* Docket No. E-00000J-08-0314.

28 ¹⁹ *Id.*

²⁰ Ex. R-1 at 32.

1 place in a short 3-week period and there was solid participation from the Signatories and also
2 RUCO.²¹ The process was transparent and open. Each participant was given a chance to advance its
3 positions on behalf of its respective client.

4 In its review of the Agreement, the Commission reviews the Agreement to determine whether
5 the terms and conditions of the Agreement are in the public interest. And, because this docket
6 involves a request by Southwest Gas for a rate increase, the Commission reviews the rates produced
7 by the proposed Agreement to determine whether they are just and reasonable.

8 Staff believes that the Agreement is fair, balanced and in the public interest and produces just
9 and reasonable rates.²² Steve Olea, Utilities Director, testified that the Agreement results in a
10 settlement package that addresses Southwest's need for a rate increase while balancing this need with
11 terms and conditions that provide customer benefits, such as:

- 12 • Commitments Benefiting Low Income Customers on the low income rate
13 schedule(s).
 - 14 ○ An increased Low Income Rate Assistance discount from 20 percent
15 to 30 percent for the low income rate schedule(s) for the first 150
16 therms in each winter month.
 - 17 ○ A Company commitment to increase funding for Low Income Energy
18 Conservation Weatherization program with non-ratepayer funds of at
19 least \$1 million over 5 years.
 - 20 ○ A Company commitment to develop enhanced communication
21 programs to increase awareness of low-income programs.
- 22 • Rate Stability.
 - 23 ○ Alternative decoupling mechanisms each of which will improve
24 Southwest's revenue stability, which, in turn, has a positive impact
25 on its financial profile and credit ratings - benefiting customers
26 through keeping future debt costs as low as possible.
 - 27 ○ Alternative decoupling mechanisms, with rate payer protections, each
28 of which will mitigate future rate increases and reduce the frequency
of time consuming and expensive rate cases.
 - A moratorium on general rate case applications for over five years if
the Commission chooses decoupling Alternative B.
- A Company commitment to reduce expenses by at least \$2.5 million per
year.

²¹ Ex. A-14 at 1.6.

²² Ex. S-9 at 12.

- 1 • Continuation of a 20-Year Plan to replace Early Vintage Plastic Pipe.
- 2 • The Establishment of a Customer Owned Yard Line Replacement Program.
- 3
- 4 • Energy efficiency initiatives resulting in customer annual energy savings of
- 5 at least 1,250,000 therms within nine months of the Commission's approval
- 6 of the modified EE and RET plan.
- 7 • Implementation of a decoupling mechanism - either Alternative A or B.
- 8 ○ Aligns utility, customer and societal interests to pursue annual
- 9 customer bill savings through the recently enacted gas energy
- 10 efficiency rules.
- 11 ○ Providing the Company with incentives to support customer energy
- 12 efficiency.
- 13 ○ Providing protection for customers from high winter monthly bills
- 14 following extreme weather events.
- 15 • Rate Design.
- 16 ○ No increase to the monthly basic service charge to enhance customer
- 17 bill savings through energy efficiency and conservation efforts.²³

18 Other Signatories testified that the Agreement is in the public interest. Jeff Schlegel, on
19 behalf of SWEEP, testified that the Agreement is in the public interest, but felt that Alternative A was
20 not in the public interest and urged the Commission to adopt the Agreement within its entirety with
21 the selection of Alternative B.²⁴ AIC witness Gary Yaquinto expressed support for the Agreement,
22 believing that the Agreement with its inclusion of cost recovery mechanisms and its proposed rates
23 are in the public interest.²⁵ Ms. Zwick expressed support for the Agreement and noted that she was in
24 support of the provisions of the Agreement that address the low income customer.²⁶ NRDC witness,
25 Ralph Cavanagh, while expressing a strong preference for Alternative B, testified that the Agreement
26 was in the public interest and the decoupling proposal, Alternative B was in line with the Policy
27 Statement.²⁷

28 ²³ Ex. S-9 at 15-16.

²⁴ Ex. Sweep-2 at 1.

²⁵ Ex. AIC-2 at 2; Tr. at 500:1-5.

²⁶ Tr. at 486:23, 487:1-2.

²⁷ Tr. at 361:22, 362:1-4.

1 Finally, the Company believes the Agreement is fair, reasonable and in the public interest.
2 Company witness John Hester testified that the Agreement provides substantial benefits to Southwest
3 Gas' customers and it allows Southwest Gas to provide its customers a high level of service.²⁸ Mr.
4 Hester further testified that the Agreement also provides its shareholders a period of regulatory
5 certainty and a meaningful opportunity to recover costs and earn a reasonable rate of return on their
6 utility investment.²⁹

7 **B. Decoupling Alternatives A or B are both methodologies to provide meaningful**
8 **alternatives for Commission Consideration.**

9 Because of the unique circumstances of decoupling, the Signatories agreed to present the
10 Commission with two alternative decoupling proposals. Alternative A, is a partial revenue
11 decoupling mechanism consisting of two components: a Lost Fixed Cost Recovery ("LFCR")
12 component and a weather component. It is basically a melding of Staff's original proposal and
13 Staff's understanding of the proposal put forth by RUCO in its direct testimony.³⁰ Alternative A
14 would permit Southwest Gas to recover lost base revenues attributable to achievement of the
15 Commission's required annual energy savings and to adjust customer bills each month when actual
16 weather during the billing cycle differs from the average weather used in the calculation of rates.
17 The Agreement also requires the Company to make a refund to customers for those years where it
18 did not meet the energy efficiency targets. Any party can also petition to have this decoupling
19 mechanism modified or eliminated if Southwest misses the energy efficiency targets two years in a
20 row.

21 Alternative B is a full revenue decoupling mechanism whereby rates will adjust to reflect
22 any differences between authorized revenues per customer and actual revenues per customer, as
23 proposed by the Company in its Application. This full revenue decoupling mechanism also
24 includes a monthly weather component. Alternative B calls for an annual review with an earnings
25 test to ensure that the Company does not earn more than its authorized rate of return resulting from
26 this Docket. This Alternative also contains a rate filing moratorium whereby the Company cannot

27 ²⁸ Ex. A-16 at 20.

28 ²⁹ *Id.* at 22.

³⁰ Ex. S-9 at 17.

1 file for an increase in rates that would take effect prior to May 1, 2017.

2 Staff supports Alternative A and Alternative B equally. The Company supports the
3 inclusion of both Alternatives, but has expressed a preference for Alternative B. The remaining
4 Signatories agreed to support at least one Alternative (either Alternative A or B), and were not
5 precluded from expressing their respective positions on the Alternatives during the hearing or other
6 Commission proceeding, up through the Open Meeting , involving this Agreement.

7 **1. Alternative A.**

8 Under Alternative A, the proposed revenue requirement is \$54.9 million, with a return on
9 equity of 9.75 percent and fair value rate of return (“FVROR”) of 7.02 percent.³¹ For purposes of
10 the Agreement, the fair value rate base (“FVRB”) is \$1,452,932,391. The LCFR mechanism will
11 allow the Company to recover, through a per unit surcharge, the total amount of the anticipated lost
12 base revenues, assuming it achieves 100 percent of the Commission’s required annual energy
13 savings. This amount will be adjusted to reflect actual lost base revenue during an annual
14 reconciliation process each April.³² Under the Agreement, the initial LFCR surcharge will be set at
15 \$0.00213 per therm.³³ This surcharge amount is based on the Commission’s 2011 energy
16 efficiency savings targets and the anticipated lost base revenue associated with achieving those
17 targets.

18 If the Company does not meet 100 percent of the Commission’s standards, the difference
19 between the 100 percent it was allowed to collect and the actual lost revenue will be refunded to
20 customers during the next annual reconciliation process.³⁴ If Southwest Gas exceeds its energy
21 efficiency goals, the Company will not be allowed to recover in the following year the difference
22 between the 100 percent collected and the actual amount of the lost base revenues associated with
23 attaining energy savings greater than 100 percent of the year’s goal.

24 The weather component will be incorporated through a monthly true-up to winter
25

26 _____
27 ³¹ Ex. A-14 at 6.

28 ³² *Id.* at 7-8.

³³ *Id.* at 7; Ex. S-3 at 26.

³⁴ *Id.* at 7.

1 (November through April) bills.³⁵ When actual weather during the billing cycle differs from the
2 average weather used in the calculation of rates there will be either an upward or downward
3 adjustment to the customers' bill.³⁶ In the event of an extreme cold weather event, customers will
4 receive an immediate real-time benefit as there will be a downward adjustment to their bill.³⁷

5 Southwest Gas will be required to make an annual filing, commencing April 2013, to allow
6 the Commission and the parties to the docket to review the performance of the LFCR mechanism
7 and to reset the surcharge.³⁸ The Company must also submit, for Staff review, a communication
8 plan on explaining decoupling to its customers.

9 Other customer protections include the ability of any party to petition the Commission to
10 have Alternative A modified or eliminated if Southwest Gas misses the energy efficiency targets
11 for two consecutive years.³⁹

12 Staff believes that if the Commission is going to require Southwest Gas to achieve specific
13 energy efficiency goals, which results in the sale of less natural gas, there should be some type of
14 accounting for reduced sales. Alternative A preserves the traditional performance/rate relationship by
15 tying any lost fixed cost recovery amounts to energy efficiency savings. As stated by Staff witness
16 Dismukes, if Southwest is correct, that the deployment of cost-effective energy efficiency results in
17 stranding its fixed costs (and capacity), then the only time in which this fixed cost recovery problem
18 should arise is when the Company has met real, meaningful, and measurable energy efficiency
19 goals.⁴⁰ Under Alternative A, the Company would attain greater amounts of fixed cost recovery as it
20 meets its Commission-defined energy efficiency goals.

21 Several of the Signatories, while expressing a clear preference for Alternative B, testified to
22 some perceived deficiencies in Alternative A. SWEEP witness Schlegel, testified that it was the
23 lost fixed recovery mechanism that caused SWEEP to oppose Alternative A.⁴¹ Mr. Schlegel also
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25 ³⁵ *Id.* at 8.

26 ³⁶ *Id.* at 8-9.

27 ³⁷ *Id.*

28 ³⁸ *Id.* at 9.

³⁹ Ex. S-9 at 18.

⁴⁰ Ex. A-12 at 7.

⁴¹ Tr. at 428:6-8.

1 testified that Alternative A was not as attractive because it proposes a higher rate increase because
2 of the higher revenue requirement and the higher ROE.⁴² NRDC witness Ralph Cavanagh, who
3 had participated in the Commission's workshop on decoupling, stated a preference for Alternative
4 B, but testified that Alternative A, would result in an annual increase,⁴³ but that Alternative A
5 would be preferable to the status quo.⁴⁴ Dr. Hansen testifying on behalf of AIC, testified that he
6 believes Alternative A would continue to be a disincentive for the Company to support
7 conservation measures whose benefits are hard to quantify,⁴⁵ although he later testified that a
8 customer would be encouraged to conserve under Alternative A.⁴⁶

9 Another reason that some Signatories expressed a strong preference for Alternative B over
10 Alternative A, was the notion that the annual reconciliation process to determine the actual lost
11 base revenue due to energy efficiency would be contentious and protracted.⁴⁷ Staff witness Barbara
12 Keene testified that in her experience involving lost revenue calculations for electric utilities'
13 energy efficiency programs were not very contentious.⁴⁸ She further testified that regardless of the
14 Agreement, the Company is required to submit annual filings, detailing the costs incurred and the
15 savings realized from its energy efficiency programs and measures.⁴⁹

16 Alternative A, is consistent with the Policy Statement⁵⁰ and offers the Company the ability
17 to recover revenue lost because of energy efficiency. Alternative A is a viable alternative means
18 for addressing the disincentive for the Company to pursue energy efficiency.

19 **2. Alternative B.**

20 Under Alternative B, the proposed revenue requirement is \$52.6 million, with a return on
21 equity of 9.50 percent and a FVROR of 6.92 percent. The return on equity is 25 basis points lower
22
23

24 ⁴² Tr. at 429:10-12.

25 ⁴³ Tr. at 386:19-22.

26 ⁴⁴ Tr. at 410:13-17.

27 ⁴⁵ Tr. at 285:6-17.

28 ⁴⁶ Tr. at 290:21-25.

⁴⁷ Ex. AIC-1 at 10; Tr. at 307-08; 430; 435-36.

⁴⁸ Tr. 519:2-13.

⁴⁹ Tr. 519:14-19.

⁵⁰ Ex. R-1 at 5, 30.

1 than what was recommended by Staff in its Direct Testimony.⁵¹ For purposes of the Agreement,
2 the FVRB is \$1,452,932,391. Alternative B is a full revenue decoupling mechanism where rates
3 will adjust to reflect any differences between authorized revenues per customer and actual revenues
4 per customer. Alternative B also has a weather component that will operate in the same manner as
5 it does under Alternative A.

6 To determine the authorized revenue per customer, the authorized revenue requirement is
7 divided by the total number of test year customers to arrive at the authorized revenue per customer.
8 At the annual true up, the actual revenue per customer (actual revenues collected per the actual
9 number of customers in the preceding 12 month) to authorized revenue per customer to determine a
10 per customer revenue deficiency or surplus.⁵² This per customer difference is then multiplied by
11 the number of actual customers in the reconciliation period to arrive at a total revenue deficiency or
12 surplus. This amount will be placed in a deferral account.⁵³ This deficiency or surplus is divided
13 by the previous 12 months sales volume for the affected rate schedules to develop a per therm
14 surcharge or credit that will be applied to the upcoming twelve-month recovery period.⁵⁴

15 There are a number conditions associated with Alternative B. Southwest Gas must file
16 quarterly and annual reports to allow the Commission the opportunity to review the performance of
17 the decoupling mechanism. The quarterly reports, filed each April, July, October and January, will
18 commence April 30, 2012. The annual reporting requirement will consist of both a review of the
19 performance of the full decoupling mechanism and an annual earnings test. According to AIC
20 witness Hansen, the annual reporting requirement is unique; in his experience, the review occurs
21 after multiple years of having the program being implemented.⁵⁵

22 The annual earnings test will be used to ensure that Southwest Gas does not earn more than
23 its authorized rate of return and a decoupling surcharge will not be implemented, regardless of how
24 successful Southwest Gas is in achieving the energy efficiency targets, if the earnings test indicates
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26 ⁵¹ Ex. S-9 at 20.

27 ⁵² Ex. A-4 at 3.

28 ⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ Tr. at 355:7-13.

1 that Southwest is earning its authorized rate of return. According to AIC witness Dr. Hansen, the
2 earnings test is a rarity among states that have adopted decoupling.⁵⁶

3 There is a cap on any upward adjustment as a result of the decoupling mechanism. Each
4 year any increase in non-gas revenue that is to be collected through the any decoupling surcharge
5 will be capped at 5 percent.⁵⁷ There will be no cap on annual surcharge decreases. As explained by
6 SWEEP witness Schlegel, during the decoupling workshops, the focus was on the cap as a
7 percentage of the bill.⁵⁸ The cap proposed under the Agreement applies solely to the non-gas
8 revenue; its application to less than half the bill. He estimated the cap to be in actuality less than 2
9 ½ percent of a full gas bill.⁵⁹ Dr. Hansen testified that the cap on the amount of the annual
10 adjustment is rare among states that have adopted decoupling.⁶⁰ Also of significance is the rate
11 case moratorium. Should the Commission select Alternative B, Southwest Gas may not file a rate
12 application prior to May 1, 1017.⁶¹ The moratorium provides a measure of rate stability. However,
13 if unforeseen problems develop with the decoupling mechanism, the Commission has the ability to
14 stop it and in that event, the rate moratorium ceases.

15 The Signatories, with the exception of Staff, stated a clear preference for Alternative B.
16 Those Signatories expressed the belief that Alternative B was consistent with the Policy
17 Statement⁶² Because the Signatories believe so strongly in the importance of decoupling, each has
18 pledged their support of the Agreement even if their preferred option is not selected and has waived
19 their rights to rehearing and appeal. In sum, the two alternatives are both responsive to the Policy
20 Statement and provide the Commission with the ability to address the disincentives to energy
21 efficiency faced by the utility.

22

23

24

25 ⁵⁶ Tr. at 355:5-7.

26 ⁵⁷ Ex. A-14 at 13-14.

27 ⁵⁸ Tr. at 437:1-19.

28 ⁵⁹ *Id.*

⁶⁰ Tr. at 355:5-7.

⁶¹ Ex. S-9 at 13.

⁶² Ex. A-16 at 9; Exs. AIC-2 at 5; Ex. SWEEP-2 at ; Ex NRDC-2 at 2.

1 **IV. THE COMMISSION HAS THE AUTHORITY TO ADOPT A DECOUPLING**
2 **MECHANISM.**

3 During the hearing RUCO witness, Dr. Ben Johnson expressed a veiled concern regarding
4 the constitutionality of the decoupling mechanisms proposed by the Agreement, indicating that
5 perhaps, the rates were being set without a finding of fair value.⁶³ Until his testimony at the
6 hearing, no party had raised an issue with the constitutionality under Arizona law of the decoupling
7 proposals. Administrative Law Judge Dwight Nodes requested the parties address those issues on
8 brief.

9 **A. The setting of just and reasonable rates.**

10 **1. The Commission's Constitutional Ratemaking Authority and Fair Value.**

11 Article 15, Section 3, of the Arizona Constitution provides, in relevant part, that the
12 Commission "shall have full power to, and shall, prescribe just and reasonable classifications to be
13 used and just and reasonable rates and charges to be made and collected by public service
14 corporations within the State for service rendered therein." In determining just and reasonable rates,
15 the Commission has broad discretion, subject to the obligation to ascertain the fair value of the
16 utility's property and to establish rates that "meet the overall operating costs of the utility and
17 produce a reasonable rate of return."⁶⁴ Under the Arizona Constitution, a utility company is entitled
18 to a fair rate of return on the fair value of its properties, "no more and no less."⁶⁵ Arizona law does
19 not mandate that the Commission (1) follow a particular method in its rate making determinations or
20 (2) exclude consideration of relevant factors.⁶⁶ The Commission's ratemaking authority involves
21 more than merely determining rates and indeed extends to every necessary step in ratemaking.⁶⁷

22 Article 15 Section 14 of the Arizona Constitution provides that: "The corporation
23 commission shall, to aid it in the proper discharge of its duties, ascertain the fair value of the property
24

25 ⁶³ Tr. at 664-65.
26 ⁶⁴ *Scates, et al. v. Arizona Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 612 (App. 1978).
27 ⁶⁵ *Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz.45 I, 434, 854 P.2d 988 (App.
28 ⁶⁶ *Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).
⁶⁷ *Arizona Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 294, 830 P.2d 807, 815 (1992).

1 within the state of every public service corporation doing business therein....” The court in
2 construing these provisions of the constitution said:

3 ‘In order that the Corporation Commission might act intelligently, justly, and fairly
4 between the public service corporations doing business in the state and the general public,
5 section 14 was written into the Constitution. The ‘fair value of the property’ of public
6 service corporations is the recognized basis upon which rates and charges for services
7 rendered should be made, and it is made the duty of the Commission to ascertain such
8 value, not for legislative use, but for its own use, in arriving at just and reasonable rates
9 and charges, and to that end the public service corporations are required to furnish the
10 Commission all the assistance in their power.’⁶⁸

11 Thus, the two constitutional provisions have been interpreted as requiring the Commission to find the
12 “fair value” of the utility’s property and use that as a rate base in calculating just and reasonable
13 rates.⁶⁹ The purpose of the fair value requirement is to provide a fair return on the fair value of the
14 property that a utility devotes to public use.⁷⁰

15 Subsequent Arizona decisions have followed *Simms* in affirming that fair value is the
16 exclusive means of determining a utility’s rate base.⁷¹ However, the court in *U.S. West
17 Communications v. Arizona Corp. Comm’n*, (“U.S. West II”) stated that while the constitution plainly
18 required the Commission to ascertain fair value, only the jurisprudence of the courts required that the
19 Commission establish rates based on fair value finding.⁷²

20 Despite the requirement that the “fair value” of a utility’s property be found and used in
21 setting rates (at least in a monopolistic setting),⁷³ the Commission nevertheless has substantial
22 discretion to adopt methodologies and approaches to address particular problems, such as significant
23 capital investment and additional operating expenses. As the Arizona Supreme Court explained:

24 ⁶⁸*State v. Tucson Gas, Electric Light & Power Co.*, 15 Ariz. 294, 138 P. 781, 784 (1914).

25 ⁶⁹ *Simms* at 382.

26 ⁷⁰ *Ariz. Corp. Comm’n v. Arizona Water Co.* 85 Ariz. 198, 203, 335 P.2d 412, 415.

27 ⁷¹ *See Consolidated Water Utilities, Ltd. v. Ariz. Corp Comm’n* 178 Ariz. 478, 875 P.2d 137 (1993);
28 *Ariz. Corp. Comm’n v. Arizona Water Co.* 85 Ariz. 198, 335 P.2d 412 (1959).

⁷² 201 Ariz. 242, 34 P.3d 351 (2001).

⁷³ *Id.* at 583, the court noted: where a fair value finding that there is no need to rigidly link the fair
value determination to the establishment of rates in a competitive environment. While the
Commission cannot ignore fair value, in a competitive environment it can be used in conjunction
with other information and given the proper weight at the Commission’s discretion. See also *Phelps
Dodge Corp. v. Ariz. Corp. Comm’n*, 207 Ariz. 95, 83 P.3d 573 (2004), quoting *U.S. West II*.

1 The Corporation Commission in its discretion can adopt any of the various approaches
2 used by public utility regulative bodies in considering plant under construction as long
3 as the method complies with the constitutional mandate [of finding fair value] and is
4 not arbitrary and unreasonable.⁷⁴

5 In *Arizona Public Service*, the Commission in a special action appealed a superior court
6 decision which vacated an order of the Commission in a rate-making proceeding. In that case, the
7 court criticized an opinion issued by the Arizona Attorney General stating that the Commission may
8 not consider plant under construction at the close of the historic test year in setting rates. In rejecting
9 that opinion, the court stated:

10 From the foregoing, it is obvious that the Commission in its discretion can consider
11 matters subsequent to the historic year, bearing in mind that all parties are entitled to a
12 reasonable opportunity to rebut evidence presented... We would not presume to
13 instruct the Commission as to how it should exercise its legislative functions. . . .
14 However, it appears to be in the public interest to have stability in the rate structure
15 within the bounds of fairness and equity rather than a constant series of rate hearings.⁷⁵

16 In a subsequent decision involving Arizona Public Service Co. ("APS"), *Arizona Community
17 Action Ass'n v. Arizona Corporation Commission*,⁷⁶ the court addressed "step increases." The
18 Commission had granted APS a 6 percent rate increase in August 1977, which took effect
19 immediately. In addition, APS was authorized to increase its rates in 1978 and again in 1979
20 provided that certain conditions were satisfied.⁷⁷ Under the Commission's decision, if the return on
21 APS' common stock fell below 13.75 percent, APS was entitled to increase its rates by an amount
22 equal to 5 percent of its gross operating revenue or by a "revenue deficiency," whichever is less.

23 On appeal, the Arizona Supreme Court quoted extensively from its previous *Arizona Public
24 Service* decision, again emphasizing that the Commission may consider plant under construction and
25 placed in service at a future date in determining a utility's "fair value" rate base.⁷⁸ The court then
26 discussed the step increases authorized by the Commission, holding that this methodology comported

27 ⁷⁴ *ACC v Arizona Public Service*, 113 Ariz. at 371, 555 P.2d at 329.

28 ⁷⁵ *Id.* (citations omitted).

⁷⁶ 123 Ariz. 228, 559 P.2d 184 (1979).

⁷⁷ *Id.* at 229, 599 P.2d at 185.

⁷⁸ *Id.* at 230, 599 P.2d at 186.

1 with the Commission's constitutional requirements and noting that the Commission had established
2 fair value:

3 In view of *Arizona Corporation Commission v Arizona Public Service, supra*, we find
4 entirely reasonable that portion of the Commission's decision allowing the inclusion
5 of construction work in progress to go on line within two years from the effective date
6 of the Step II increase. Nor do we find fault with the Commission's attempt to comply
7 with our indication in *Arizona Corporation Commission v. Arizona Public Service, supra*,
8 that a constant series of extended rate hearings are not necessary to protect the
9 public interest. The hearing culminating in the order of August 1, 1977, resulted in a
10 determination of fair value. The adjustments ordered by the Commission in adding the
11 CWIP to that determination of fair value were adequate to maintain a reasonable
12 compliance with the constitutional requirements if used only for a limited period of
13 time. Adjustments would obviously be made after a full hearing [using] a test year
14 ending December 31, 1978, as provided in the contested order.⁷⁹

15 Also instructive is *Scates*.⁸⁰ In that case, the utility was granted increases in its statewide
16 charges for the installation, moving and changing of telephones, which amounted to an annual
17 increase in revenues of nearly \$5 million. In approving this increase, the Commission refused to
18 allow the utility to submit summary data showing the effect of the proposed increases on its rate of
19 return, and "all references to the affect of this increase on the company's overall financial condition
20 were stricken."⁸¹ Instead, the Commission "took the view that this increase should be considered
21 solely on the basis of evidence reflecting the cost of these particular services."⁸² As summarized by
22 the appellate court:

23 The resulting net increase in revenue to the utility was accomplished without any
24 inquiry whatsoever into whether the increased revenues resulted in a rate of return
25 greater or lesser than that established in the rate hearings some ten months before. All
26 evidence bearing on the subject was expressly rejected.⁸³

27 On appeal, the court held that the Commission lacked authority to increase rates without any
28 consideration of the impact on the overall rate of return on the utility's rate base.⁸⁴ The court was

24 ⁷⁹ *Id.* at 230-3 1, 599 P.2d at 186-87. While the step increase methodology was upheld, the court also
25 held that the Commission erred in relying solely on the return on common equity as the trigger for the
26 increase, based on "the potential danger of tying rates to one factor over which APS exercises total
27 control." *Id.* at 231, 599 P.2d at 187.

26 ⁸⁰ 118 Ariz. 531, 578 P.2d 612 (App. 1978).

27 ⁸¹ *Id.* at 533, 578 P.2d at 614.

27 ⁸² *Id.*

28 ⁸³ *Id.* at 534, 578 P.2d at 615.

28 ⁸⁴ *Id.* at 537:578 P.2d at 618.

1 careful to note, however, that the Commission may adjust rates without requiring a general rate case
2 to be filed where exceptional circumstances exist:

3 The Commission here . . . failed to make any examination whatsoever of the
4 company's financial condition, and to make any determination of whether the increase
5 would affect the utility's rate of return. There may well be exceptional situations in
6 which the Commission may authorize partial rate increases without requiring entirely
7 new submissions. We do not decide in this case, for example, whether the
8 Commission could have referred to previous submissions with some updating or
9 whether it could have accepted summary financial information.⁸⁵

10 This discussion is consistent with the Arizona Supreme Court's discussion in *Arizona*
11 *Community Action* and *Arizona Public Service Co.*, which, as discussed above, clearly indicate that
12 the Commission does have considerable flexibility in complying with the requirements in Article 15
13 of the Arizona Constitution.

14 The Commission in its Policy Statement addressed a critical problem, the state's need for
15 increased energy efficiency in the face of population growth and the corresponding increases in the
16 demand for energy.⁸⁶ The Commission recognized, under the traditional ratemaking, utilities have
17 been disincented to vigorously utilize demand-side management program to meet their resource
18 needs. Utilities may struggle to recover their fixed costs through volumetric sales because of the
19 pressure to achieve energy savings pursuant to Commission rule. Southwest Gas testified to its
20 chronic decline in customer usage.⁸⁷ The Commission thus began considering alternate approaches it
21 could adopt to spur the use of demand side programs, commencing workshops on decoupling. The
22 ability to address resource issues, while providing utilities with a means to recover fixed costs with
23 declining sales, falls within the Commission's ratemaking authority.

24 The decoupling mechanisms, as proposed in the Agreement, represent an alternative rate
25 design. One of the main goals of rate design is the recovery of the authorized revenue requirement.
26 The decoupling mechanism is designed to allow Southwest Gas to recover its authorized revenue per
27 customer. The constitutional directive of finding the fair value rate base and establishing rates using

27 ⁸⁵ *Id.*

28 ⁸⁶ Ex. R-1 at 1.

⁸⁷ Tr. at 81: 3-4.

1 that rate base has been meet in the Agreement. The Agreement proposes a fair value rate base of
2 \$1,452,932,391.⁸⁸ The rates found in Exhibit C and D to the Agreement are set using the fair value
3 rate base.

4 Unlike the scenario in *Scates*, the revenue requirement is set and remains constant, as does
5 FVRB and FVROR and with the earnings test that provides updated financial information,
6 Southwest Gas will not achieve more than its authorized fair value rate of return as set in this
7 docket.⁸⁹ Thus, the procedures that will govern future rate adjustments avoid the problems identified
8 in *Scates*. Unlike *Arizona Community Action*, the rate adjustments contemplated by the decoupling
9 mechanism are not based on the Company's return on common equity falling below a certain
10 percentage.

11 The decoupling mechanism identifies Southwest Gas' fixed costs as appropriate for recovery
12 through the mechanism. The mechanism under Alternative B is designed to ensure that Southwest
13 Gas' net income is unaffected by a change in usage per customer.⁹⁰

14 Even assuming that the decoupling mechanisms are not rate design, the mechanisms comport
15 with the jurisprudence of this state for the establishment of an automatic adjustment clause.

16 In reviewing the LFCR mechanism of Alternative A as well as full revenue decoupling under
17 Alternative B, both Alternatives comport with the jurisprudence of this state for the lawful
18 establishment of an automatic adjustment clause. Either Alternative will be established in a rate
19 proceeding. In *Scates*, the court noted that when adjustors are initially adopted as part of the utility's
20 rate structure in accordance with all statutory and constitutional requirements and, further, because
21 they are designed to insure that, through the adoption of a set formula geared to a specific readily
22 identifiable cost, the utility's profit or rate of return does not change.⁹¹

23 In *Residential Utility Consumer Office v. Arizona Corporation Commission*, the Commission
24 attempted to establish a surcharge to allow Rio Verde Utilities, Inc. to recover expenses incurred for
25

26 _____
27 ⁸⁸ Ex. A-14, ¶ 5.6.

⁸⁹ Tr. at 541:5-11.

⁹⁰ See Ex. A-14 at Exhibit A.

⁹¹ *Scates*, 118 Ariz. 531, 578 P.2d 612

1 Central Arizona Project water expenses.⁹² The court found that the Commission had exceeded its
2 constitutional ratemaking authority by approving a surcharge to recover expenses without
3 determining the fair value of the utility's property. In discussing automatic adjustment clauses, the
4 court stated:

5 Automatic adjustment clauses are designed to ensure that utilities maintain a relatively
6 constant profit despite an increase in a specific cost anticipated by the adjustment
7 clause. An automatic increase allows a utility to recoup cost increases by passing the
8 costs onto the customer while at the same time maintaining the utility's net income.
9 *Id.* The same is true in the converse situation, that of an automatic decrease. The
decrease in cost is passed onto the customer without disturbing a utility's profit. In
essence, an automatic adjustment clause is designed to offset increases or decreases,
leaving the utility's ultimate net income unchanged.⁹³

10 The Commission will establish rates based upon the fair value of the utility's property. The
11 Agreement, with its alternative decoupling proposals, contemplates the recovery by Southwest Gas of
12 its fixed cost through a mechanism, while leaving its net income unchanged. Even under the law
13 regarding the establishment of an adjustor, the decoupling proposals are lawful.

14 **V. OTHER KEY PROVISIONS OF THE AGREEMENT.**

15 **A. Rate Design.**

16 The Agreement provides that Southwest Gas will retain a monthly basic service charge of
17 \$10.70 and a single commodity charge, adjusted to reflect the proposed revenue requirement.⁹⁴ The
18 Signatories also agreed to a revenue allocation that will be an equal percentage increase across all
19 rate classes, with the exception of the low income rate schedules. As Company witness John Hester
20 testified, an equal percentage revenue allocation mitigates the bill impact to any particular customer
21 class and spreads the rate increase evenly among all customer classes.⁹⁵

22 **B. Low Income.**

23 There are a number of benefits for low income customers. The Agreement provides for an
24 increase in the low income rate assistance discount ("LIRA") discount from 20 percent to 30 percent
25

26 _____
27 ⁹² 199 Ariz. 588, 20 P.3d 1169 (2001).

28 ⁹³ 199 Ariz. 588, 591-592, 20 P.3d 1169, 1172-1173.

⁹⁴ Ex. A-14 at 5.

⁹⁵ Ex. A-16 at 17.

1 for the first 150 therms during the winter months (November-April).⁹⁶ Southwest Gas has also
2 committed to increase the funding for the Low Income Energy Conservation (“LIEC”) weatherization
3 program with shareholder funds of at least \$1 million over 5 years. The Company has agreed to meet
4 with the parties to this docket within 45 days of the effective date of a decision approving this
5 Agreement, to develop a plan to enhance customer education and outreach for its LIEC program.
6 The Agreement provides that the demand side management adjustor rate for the low income
7 residential rate schedules will not be increased above the current rate.⁹⁷ The COYL cost recovery
8 mechanism will not apply to the low income rate schedules. Ms. Zwick testified that she was fully
9 supportive of the Agreement, in part, because of the benefits to low income customers.⁹⁸ Even
10 RUCO appears to accept the low income protections of the Agreement.⁹⁹

11 **C. Energy Efficiency Programs.**

12 The energy efficiency provisions of the Agreement require the Company to provide
13 supplemental energy efficiency information to support a modified energy efficiency and renewable
14 energy technology plan.¹⁰⁰ Under the Agreement, Staff has agreed to provide recommendations on as
15 many energy efficiency measures a possible in a report filed prior to the Open Meeting where the
16 Commission intends to vote on the Recommended Opinion and Order approving the Agreement. The
17 Agreement also requires the Company to file in a new docket, a new and revised EE & RET
18 Implementation Plan pursuant to the Gas Energy Efficiency Rule, within sixty days of this
19 Agreement’s approval by the Commission.¹⁰¹ This new and revised Plan will be incremental to the
20 modified EE & RET Plan measures that the Company was not committed to as part of the
21 Agreement.¹⁰²

22 In the Agreement, the Company has also committed to achieving customer annual energy
23 savings equivalent to the 2011 requirement of the gas energy savings goals within twelve months of
24

25 ⁹⁶ Ex. A-14 at 4.

26 ⁹⁷ *Id.* at 15.

27 ⁹⁸ Ex. Zwick-2 at 4.

28 ⁹⁹ Ex. R-10 at 18.

¹⁰⁰ Ex. A-14 at 16-17.

¹⁰¹ *Id.* at 17.

¹⁰² *Id.*

1 Commission approval of the new and revised EE & RET Implementation Plan.¹⁰³ In addition,
2 Commission Staff has committed to use its best effort to review the Company's new and revised Plan
3 and file recommendations for Commission approval on a schedule that contributes to the timely
4 implementation of energy savings programs that are necessary to achieve the 2011 energy savings
5 requirement.¹⁰⁴ Finally in 2012 and beyond, the Company has agreed to comply with the cumulative
6 annual energy savings requirements set forth in the Standards; to achieve at least seventy-five percent
7 of the cumulative annual energy savings through energy efficiency programs; to file its
8 implementation plans on a schedule consistent with the requirement of the Rule; and to work with
9 SWEEP and Commission Staff to avoid the need to file a request for a waiver during any plan year
10 from 2011 through 2015.¹⁰⁵

11 Staff's witness, Barbara Keene testified at the hearing that Staff was almost finished with its
12 review of the Company's submitted measures and has found that 18 out of 23 to be cost effective.¹⁰⁶
13 She further testified that Staff's review would be complete by the time the Commission votes on this
14 matter.¹⁰⁷

15 **D. Customer Owned Yard Lines.**

16 In its application, Southwest had proposed a pilot program to spend \$10,000,000 to replace a
17 portion of these lines and eventually replace all these lines with a cost of over \$200,000,000.¹⁰⁸
18 Staff's recommendation was to deny the Company's pilot program request, but instead have
19 Southwest Gas perform a leak survey to determine the extent of the COYL leak problem and then
20 come up with a replacement program.¹⁰⁹

21 A COYL results from residential service that is not provided by the "normal" meter and
22 service line configuration. The normal configuration is one where the meter serving the residence is
23 located immediately adjacent to the housing structure and the service line from the gas main to the
24

25 ¹⁰³ *Id.*

26 ¹⁰⁴ *Id.*

27 ¹⁰⁵ Ex. A-14, ¶ 5.10-5.11.

28 ¹⁰⁶ Tr. at 527:1-11.

¹⁰⁷ *Id.*

¹⁰⁸ Ex. S-1 at 72.

¹⁰⁹ Ex. S-1 at 77.

1 meter is owned by Southwest Gas. Southwest Gas' service territory there are over 100,000 services
2 that are provided where the meter is at or near the property line of the residence and the service line
3 from the meter to the residence is owned by the customer or property owner (vary similar to a water
4 system), hence the term Customer Owned Yard Line. Because Southwest Gas does not own this
5 piping, the customer is solely responsible for maintaining the COYL.

6 In cases where these COYLs develop leaks, the responsibility for repairing these leaks falls on
7 the customer.¹¹⁰ When Southwest Gas becomes aware of such a leak, the Company notifies the
8 customer that the leak must be repaired and turns off service to that customer until the leaking line is
9 repaired or replaced. Many of these COYLs are on older homes where the customer may have
10 difficulty (financially) in replacing or repairing the COYL.

11 Paragraph 5.14 of the Agreement requires the Company to purchase Remote Methane Leak
12 Detection (RMLD) devices to conduct leak surveys of these COYLs. As a leak is discovered (either
13 through the Company's leak survey program or through a customer call to Southwest), Southwest
14 Gas will replace these COYLs with a normal service configuration.

15 Paragraphs 5.14-5.17 detail the mechanics of COYL Cost Recovery Mechanism (CCRM).
16 Southwest Gas will account for these replacements on an annual basis and submit this accounting to
17 the Commission on an annual basis. Based on the amount of plant installed each year, Southwest Gas
18 will be allowed to add a surcharge to its bills that would basically be equal to the amount that would
19 have been assessed had this additional plant been in rate base during the test year. The COYL Cost
20 Recovery mechanism ("CCRM") will be capped annually to increase no more that \$0.01 per therm in
21 any given year. Within six months of commencing the survey, Southwest Gas shall file a report
22 detailing its findings and recommendations regarding the leak survey. Using this method will allow
23 Southwest Gas to maintain a system free of COYL leaks without requiring customers that may not be
24 able to fix such leaks from having their gas service terminated. Mr. Hester testified that the COYL
25 program will mitigate the financial burden on customers who need to replace their COYL by
26 replacing the COYL with a Southwest Gas owned and maintained service extension line.¹¹¹

27
28 ¹¹⁰ Ex. S-6 at 5.

¹¹¹ Ex A-16 at 16.

1 According to Mr. Hester, the program provides a least cost alternative, which will result in a minimal
2 cost to other customers, and replaces aging customer-owned natural gas delivery infrastructure to the
3 benefit of all customers.¹¹²

4 **E. Gas Heat Pump Technology.**

5 In Decision No. 68487, the Commission approved a surcharge that allowed the Company to
6 fund research projects relating to pipeline safety and energy efficiency.¹¹³ The per therm surcharge
7 was estimated to be \$0.00113, which would increase an average residential customer's bill by
8 approximately three cents per month.¹¹⁴ In accordance with that decision, the Company files annual
9 reports with the Commission, detailing projects that are funded with surcharge dollars. The
10 Company asserts that it has used the surcharge dollars for a variety of projects, primarily in the
11 pipeline safety area and for gas heat pump projects as well.

12 The Company formed an unregulated subsidiary, IntelliChoice Energy, to engage in the
13 marketing and sales and commercialization of the gas fired heat pumps. The Company provided a
14 notice of intent letter advising Staff and the Commission of the formation of IntelliChoice Energy in
15 October 2009.¹¹⁵

16 Staff became concerned that the funding has gone toward the development of gas-fired
17 equipment that will be sold in a competitive market to compete with non-regulated electric
18 equipment. Ratepayer funding for gas-on-electric competition or commercial development of
19 competitive products has generally been disfavored.¹¹⁶ Additionally, and perhaps more importantly
20 in this instance, under Southwest's recent arrangements, the GHP equipment will be commercialized
21 and sold by a non-regulated subsidiary, without any apparent compensation to Southwest Gas or its
22 ratepayers for the significant development funding incurred to date.¹¹⁷

23
24
25 ¹¹² *Id.*

¹¹³ Docket No. G-01551A-04-0876.

¹¹⁴ Decision No. 68487 at 60-61.

¹¹⁵ Docket No. G-01551A-96-0008. Staff determined that no further action was required by the
27 Commission.

¹¹⁶ Ex. S-1 at 48-49.

¹¹⁷ *Id.* at 49.

1 Paragraphs 5.29-5.32 of the Agreement provides that the Company remove all gas heat pump
2 technology development cost from operating expenses and that no new gas heat pump projects will
3 be funded through the surcharge. In addition, Southwest Gas will identify and track the Arizona
4 customer funding of the gas heat pump technology and propose a plan to reimburse Arizona
5 customers for their proportionate level of funding to be returned to customers to the extent
6 commercial development occurs and revenues and royalties are received by Southwest Gas by any
7 other entities that are affiliated with Southwest Gas.

8 **F. Other Key Provisions.**

9 As part of the Agreement, Southwest Gas agreed to many of Staff's recommendations found
10 in Staff's direct testimony, such as tariff changes to address submetering, the Yuma Manors pipe
11 replacement project,¹¹⁸ the 20 year plan to replace EVPP,¹¹⁹ the Company's annual gas procurement
12 plan and purchased gas adjustor report.¹²⁰ Additionally, the Company agreed to conduct a
13 comprehensive depreciation study and an updated depreciation study for System Allocable plant in its
14 next Arizona rate case.¹²¹ Southwest Gas may continue the use of its Incremental Contribution
15 Method ("ICM") and its ICM model, but will revise the model to ensure that the Company does not
16 collect contributions in aid of construction that will result in a rate of return that is more than 50 basis
17 points above the authorized return on equity.¹²² As part of its next rate application, Southwest Gas
18 shall propose an inclining block rate design as part of its rate design proposal.¹²³

19 The Company has committed to improve its communications with its customers. The
20 Company shall file a report in this docket every six months, beginning March 31, 2012, detailing
21 developments in its efforts to improve communications with customers. The Company will include
22 in its initial report to the Commission a section on whether the Company can use texting to
23 communicate with its customers, or if it cannot, provide an explanation as to why not.¹²⁴

24
25 ¹¹⁸ Ex. A-14 at 24, ¶ 5.41.

26 ¹¹⁹ *Id.* at 21, ¶ 5.25.

27 ¹²⁰ *Id.*, ¶ 5.24.

28 ¹²¹ *Id.* at 23, ¶ 5.35.

¹²² *Id.* at 22, ¶ 5.33-5.34.

¹²³ *Id.* at 23, ¶ 5.39.

¹²⁴ *Id.* at 20, ¶ 5.21.

1 Southwest Gas has committed to identify cost reduction initiatives to reduce its expenses on
2 an annual basis by an average of \$2.5 million per year beginning in 2012. This commitment will
3 continue through the end of the test year in the Company's next general rate case.¹²⁵

4 **VI. RUCO PROPOSAL.**

5 RUCO was not a signatory to the Agreement. RUCO has however, indicated support of the
6 low income programs and the commitment to energy efficiency contained in the Agreement.¹²⁶
7 Further, RUCO offered an "alternative proposal". As described by RUCO witness Jodi Jerich, RUCO
8 recommends shifting a portion of the revenue requirement into the fixed monthly rate.¹²⁷ The fixed
9 monthly rate would increase from \$10.50 to \$11.85.

10 All Signatories opposed the RUCO alternative. AIC witness Dr. Hansen testified that the
11 RUCO proposal is not an option to decoupling. According to Dr. Hansen, the customer charge would
12 need to be in excess of \$28 per month in order for all non-gas costs to be recovered through the
13 customer charge.¹²⁸ Mr. Cavanagh for NRDC testified that the unfortunate thing about that proposal
14 is that by putting more of the customer's bill in a fixed charge and less in the variable charge, you are
15 reducing every customer's reward for saving energy, at a time when this Commission is rightly
16 pressing for more progress on energy efficiency.¹²⁹ Mr. Schlegel testified that by increasing the
17 monthly minimum sends the wrong message regarding conservation; that raising the basic service
18 charge is a much more impactful disincentive to efficiency than decoupling could ever be. And under
19 decoupling there is still a significant incentive to conserve.¹³⁰ Even during public comment, David
20 Mitchell, on behalf of the AARP opposed the increase in the monthly minimum as being regressive
21 and noted: "that increasing the customer charge has a relatively greater impact on those customers
22 who use the least gas, those who live in smaller homes and/or are trying hard to keep their bills down.

23
24
25

¹²⁵ *Id.*, ¶ 5.20.

26 ¹²⁶ Ex. R-14 at 11.

27 ¹²⁷ *Id.* at 10.

28 ¹²⁸ Tr. at 270:1-4.

¹²⁹ Tr. at 364:10-15.

¹³⁰ Tr. at 431:2-12.

1 That group includes many low income customers and seniors on fixed incomes.”¹³¹ Mr. Olea on
2 behalf of Staff testified:

3 But when you shift more of the costs onto the monthly minimum charge, that is going
4 to adversely impact the low users, which could be actually the low-income users. And
5 because -- regardless if you use any gas or not, your bill is going to go up. You could
6 use zero, and your bill is going to go up. And, in fact, if you are going to promote
conservation, more of the cost should go into the commodity, which gives customers
more control over their bill, because the less they use the less they pay.¹³²

7 RUCO witness Ben Johnson also testified that decoupling will discourage conservation. As
8 seen in the discussion above, it is the increase in the monthly minimum that will have the effect of
9 discouraging conservation, not decoupling.

10 RUCO asserts that decoupling is not necessary for the company because it is not in poor
11 financial health.¹³³ According to AIC witness Gary Yaquinto, the credit markets looked favorably
12 on Southwest Gas because of the approval of decoupling mechanisms in Nevada and the anticipation
13 that decoupling may be approved in Arizona.¹³⁴ Staff witness David Parcell noted that Southwest
14 Gas’ debt rating was recently upgraded in response to the approval of decoupling in Nevada, stating:

15 The rating upgrade also recognizes signs of improvements in Southwest’s regulatory
16 environment where we remain cautiously optimistic about...potentially Arizona (55%
of operating margins).¹³⁵

17 RUCO stated that one of the reasons it did not support the Agreement was the testimony of
18 Staff witness David Dismukes that Southwest Gas would have collected an additional \$62 million
19 from residential customers if decoupling had been in place.¹³⁶ Mr. Hester testified that in recasting
20 those results for the period of 2007-2010, the volumes of the rates designed during that period were
21 based on 347 to 332 therms, whereas the rates designed in the instant case are based on 297 therms.¹³⁷
22 He further noted that the Company would only have recovered the revenues that were authorized by
23 the Commission. As explained by Mr. Hester, in a report filed by Southwest Gas on April 3, 2009 in

24
25 ¹³¹ Tr. at 17:10-15.

26 ¹³² Tr. at 176: 9-18.

27 ¹³³ Ex. R-14 at 5.

28 ¹³⁴ Ex. AIC-2 at 3; Tr. 497:7-20.

¹³⁵ Ex. S-8 at 15, quoting Moody’s May 27, 2010 upgrade report.

¹³⁶ Ex. R-14 at 5, quoting Ex. S-3 at 16-17.

¹³⁷ Tr. at 77-78.

1 compliance with Decision No. 70665, the effects of decoupling over 6 years (2003-2008), showed
2 that the largest impact would have resulted in a 5.4 percent decrease.¹³⁸

3 Contrary to the assertions of RUCO, decoupling is not “unchartered waters.” As noted by
4 counsel for AIC, Michael Grant, the Commission has considered and vetted decoupling for the past
5 six years.¹³⁹ As noted by Mr. Cavanagh, 22 other states have experience with natural gas
6 decoupling,¹⁴⁰ including California and Nevada, which are in Southwest Gas’ service territories. Mr.
7 Cavanagh, who participated in the Commission’s workshops on decoupling, testified:

8 I do not recall a more thorough evaluation of the alternatives, of the skeptical
9 arguments, a more thorough financial analysis commissioned by one of the
10 nation's top federal research laboratories, the engagement of the Regulatory
11 Assistance Project, which is the gold standard for regulatory experience, and at a
12 time when we had the record of 22 states with natural gas decoupling and with
13 electric decoupling to draw upon. If after all of that someone thinks we need
14 more study, all I can say is [I] fear they will never be satisfied.¹⁴¹

13 VII. CONCLUSION.

14 The Agreement contains substantial benefits for ratepayers. It also provides to the
15 Commission for its consideration, two proposals on decoupling that are responsive to the Policy
16 Statement. There are also certain benefits for Southwest Gas that will allow the Company sufficient
17 revenue to operate in a safe and reliable manner. Staff would urge the Commission to adopt the
18 Agreement.

19 RESPECTFULLY SUBMITTED this 2nd day of September, 2011.

20
21 

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138 Tr. at 87-88.

139 Tr. at 37-38.

140 Tr. at 365:1-8.

141 Tr. at 370-71.

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