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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 **NATURAL RESOURCES DEFENSE COUNCIL'S POST HEARING BRIEF**

The Natural Resources Defense Council (NRDC) hereby files the attached Post-Hearing Brief in the above-referenced matter.

RESPECTFULLY SUBMITTED this 1st day of September, 2011.

NATURAL RESOURCES DEFENSE COUNCIL

By _____
Laura E. Sanchez

ORIGINAL and 13 COPIES of the foregoing filed this 1st day of September, 2011 to:

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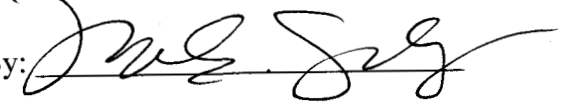
All Parties of Record

By: 

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I. INTRODUCTION AND SUMMARY

On December 29, 2010, the Arizona Corporation Commission unanimously adopted a Final Policy Statement Regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures. All parties to this proceeding except the Residential Utility Consumer Office (RUCO) have now joined in support of a settlement agreement, following Southwest Gas's acceptance of the Commission's invitation to file a proposal for "revenue per customer decoupling," and to "use this policy statement as a guideline in the development of its proposal."

Nothing in the record of this proceeding casts any doubt on the Commission's very recent and well considered conclusions regarding the merits of full decoupling for gas and electric utilities. The Natural Resources Defense Council's (NRDC) testimony demonstrated that Alternative B of that settlement proposal, and only Alternative B, is consistent with the Commission's Policy Statement and its closely linked aspirations for delivering cost-effective energy efficiency benefits to all utility customers. RUCO's concern that the settlement is a "risky" move into "uncharted waters"[1] is contradicted by safeguards built into the settlement itself, along with three decades of experience elsewhere in the U.S. with revenue decoupling (aired fully before the Commission in the hearings in this case and the extensive revenue decoupling workshops that preceded it in 2010).

II. ALTERNATIVE B IN THE SETTLEMENT AGREEMENT IS FULLY CONSISTENT WITH THE COMMISSION'S POLICY STATEMENT AND IS IN THE PUBLIC INTEREST.

Alternative B benefits customers by reducing the company's revenue requirement through a lower authorized return on equity and, more importantly, by removing the company's ability to profit from increased natural gas use and increasing the likelihood of achieving the Commission's energy efficiency targets. Maximum rate impacts are severely constrained to levels equivalent to about five

[1] Testimony in Opposition to Proposed Settlement Agreement of Ben Johnson, p. 6:11.

cents per day for Southwest's average residential customer.[2] NRDC agrees with Arizona Investment Council witness Dan Hansen, moreover, that Alternative B is superior to Alternative A in reducing customers' exposure to high bills from extreme weather events (because Alternative B, unlike Alternative A, ensures that the company will return to customers all revenues received above the authorized per-customer level, in an annual true-up that is missing from Alternative A).

Alternative B incorporates, from Southwest's original filing, a per-customer decoupling mechanism, which includes a monthly adjustment that "provide[s] immediate weather-related rate relief to customers following extreme weather events," followed by an annual adjustment "to true-up the difference between authorized and experienced non-gas revenues."[3] The mechanism is designed to prevent over-earning, because "the Company will not be able to collect more revenue per customer than what the Commission authorizes in this rate case proceeding."[4] The scope of the mechanism is appropriately broad but not over-inclusive, covering "the rate schedules where Southwest Gas has, or expects to have, usage lowered as a result of energy efficiency programs and where a large amount of the fixed cost of service is recovered in variable charges."[5]

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

- "Revenue decoupling may offer significant advantages over alternative mechanisms for addressing utility financial disincentives to energy efficiency . . ." [p. 30, item 3]
- "[N]on-fuel revenue per customer decoupling may be well suited for Arizona as it responds to customer growth and is better suited to address the issues associated with customer growth." [p. 30, item 4]
- "Adoption of decoupling . . . should not occur as a pilot, as this insufficiently supports demand side management efforts, discourages beneficial changes in rate design and is unlikely to encourage financial ratings improvements." [p. 30, item 5]

[2] Tr. Vol 1 (Hester) p. 126:16, Tr. Vol 2 (Hansen) p. 263:15, and Tr. Vol 2 (Schlegel) p. 437:16.
[3] Testimony of Edward B. Gieseking, p. 3:5-9.
[4] Id., pp. 3-4.
[5] Id., p. 7:14-17.

- "Full decoupling is preferable to partial decoupling ..." [p. 31, item 8]
- "Decoupling adjustments should occur at least on an annual basis; however, parties may propose more current adjustments as this may provide ratepayers with weather related relief following extreme events." [p. 31, item 10]
- "Broad participation in decoupling is preferred; however, the unique characteristics of each utility may merit different treatment of some customer classes." [p. 31, item 11]

RUCO witness Johnson referred at one point to the settlement as a move into "risky, uncharted waters,"[6] but the testimony of witnesses Cavanagh, Hansen and Schlegel demonstrates the contrary. NRDC's witness Cavanagh noted, for example, that 22 states have experience with decoupling for natural gas utilities, and that a comprehensive assessment of rate impacts from such mechanisms found that "adjustments...go in both directions" and "[t]ypical adjustments in utility bills amount[ed] to less than $1.50 per month in higher or lower charges for residential gas customers and less than $2.00 per month . . . for residential electricity customers."[7]

III. ALTERNATIVE A OF THE SETTLEMENT AGREEMENT IS NOT CONSISTENT WITH THE COMMISSION'S POLICY STATEMENT AND IS CLEARLY INFERIOR TO ALTERNATIVE B.

Following Commission workshops in which NRDC and many others participated, which canvassed partial decoupling options at length, the Commission's Policy Statement concluded (p. 31, item 8) that "full decoupling is preferable to partial decoupling as it contributes to greater rate stability which would encourage improvements in financial ratings, is administratively more manageable, and offers opportunity for rate relief following extreme weather events."

In his testimony in support of the settlement agreement, NRDC witness Cavanagh "agree[d] strongly with the Commission's conclusion to endorse full decoupling over 'partial'

[6] Direct Testimony of Ben Johnson, p. 6: 10-11.
[7] Direct Testimony of Ralph Cavanagh, p. 7: 7&12-16.

variants, including the lost revenue recovery approach that is the centerpiece of Alternative A."[8] He demonstrated that "partial decoupling like that of Alternative A would undercut the whole purpose of the mechanism, while creating perverse incentives. It would reintroduce automatic penalties, in the form of reduced fixed-cost recovery, for all cost-effective natural gas savings not directly associated with savings determined to have been 'achieved' by the Company, even when the Company by action or inaction could make a material difference in prospects for those savings."[9] Cavanagh went on to describe cost-effective savings that would not be directly associated with "achieved" savings but would still be important toward achieving the overall Energy Efficiency Standard, including "efficiency standards administered by government agencies, which can benefit greatly from utility support; informal intervention by utility staff to encourage customer patronage of independent energy efficiency contractors; and effective public education campaigns with multiple participants, including utilities." Cavanagh also explained that "Alternative A would also create a powerful and perverse new incentive for the Company to promote programs that looked good on paper but delivered little or no savings in practice (because then Alternative A would deliver double recovery)."[10] For example, poorly designed efficiency measures that customers later replaced or disconnected might well result initially in lost revenue recovery, while allowing the utility also to gain later from higher energy sales after the measures ceased to function. Alternative B removes any prospect of that wholly inappropriate upside opportunity for the utility when efficiency measures fall short for any reason.

NRDC's witness Cavanagh went on to testify that Alternative A "would ensure adversarial discord over every savings calculation, since significant financial stakes would then hinge on the results. Unlike full decoupling, Alternative A would leave unimpaired strong utility incentives to promote increased natural gas use, since (unlike Alternative B) Southwest would keep any per-customer fixed cost recovery in excess of that authorized by the Commission. Paying a utility

[8] Testimony of Ralph Cavanagh on the Settlement Agreement Filed with the Commission, p. 4:10-13.
[9] Id., lines 16-24.
[10] Id., p.5:5:9.

bonuses for both increases in its per-customer natural gas sales and its 'achieved' natural gas savings is the metaphorical equivalent of encouraging the CEO to drive with one foot on the brake and the other on the accelerator."[11] This outcome would be inconsistent with the purpose of the Commission's Policy Statement on Decoupling and the goals of its Energy Efficiency Standard. Finally, "adjustments keyed solely to adjudicated savings would lead to annual rate increases (unless the company was wholly ineffective), whereas rate adjustments under full decoupling can be either positive or negative (Southwest notes, for example, that its most recent Nevada decoupling adjustment 'will return approximately $2 million to its customers.'[12]) This point is worth underscoring: in sharp contrast to Alternative B, Alternative A virtually guarantees annual rate increases."[13]

The most telling rationale for choosing Alternative B, of course, is the inclusion in the Commission's own policy statement of an apt critique of the very "lost margin recovery mechanisms" that form the core of Alternative A:

> Lost margin recovery mechanisms allow for recovery of margins attributable to decreased sales from energy efficiency programs; however, this mechanism may be subject to prolonged litigation, and would not allow for other beneficial actions on rate design or contribute to improved costs of capital.[14]

For these reasons, NRDC strongly urges the Commission to adopt Alternative B in the Settlement Agreement.

IV. RUCO'S PROPOSED INCREASE IN FIXED CHARGES ON UTILITY BILLS SHOULD BE REJECTED.

RUCO witness Johnson, "in the spirit of compromise," proposed "a modestly higher customer charge" in order to "maintain or boost" Southwest Gas's "cash flows and income in the face

[11] Id., lines 9-21.
[12] Prepared Direct Testimony of Edward B. Gieseking, p. 9:5.
[13] Testimony of Ralph Cavanagh on the Settlement Agreement Filed with the Commission, pp. 4-6.
[14] Final ACC Policy Statement Regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures, Docket Nos. E-00000J-08-0314 and G-00000C-08-0314, p. 28.

of a trend towards energy conservation, and to reduce the volatility of its revenues and income in the face of wide fluctuations in weather conditions." Witness Johnson acknowledged that this proposal "is not cost-justified," but contended that it is "less objectionable than the decoupling provisions included in the proposed settlement."[15]

But the Commission rightly reached the opposite conclusion in its own recent Policy Statement on decoupling:

> Other proposals discussed in the workshops included fixed cost/variable cost pricing . . . Though these and other proposals may be appropriate for some utilities, the Commission believes that they have limited application. Fixed cost/variable pricing would result in larger customer charges, which impact low-income customers, and reduced variable charges, which discourages efficient energy use.[16]

Witness Johnson's proposal to raise customer charges did not acknowledge, let alone attempt to rebut, these concerns.

V. ALTERNATIVE B OF THE SETTLEMENT AGREEMENT IS FULLY CONSISTENT WITH ARIZONA LAW.

In the hearing on this matter, Judge Nodes requested that all parties address the authority of the Commission under Arizona Law to adopt decoupling in post-hearing briefs. The issue is whether the Commission would exceed its constitutional rate-making authority by approving decoupling in this matter. NRDC denies this, and is unaware of a finding by any court in the U.S. that adoption of a decoupling mechanism runs counter to any fundamentals of ratemaking.

The Arizona Corporation Commission has plenary powers to prescribe rates.[17] The Commission must also comply with the Constitution's requirement that the rates be "just and reasonable."[18] However, a court will not overturn an order of the Commission unless the appealing

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[15] Testimony of Ben Johnson in Opposition to Proposed Settlement Agreement, p. 17: 13-16 & 23-24. The proposal also is summarized in the Settlement Testimony of Jodi A. Jerich, p. 10: 7-14.
[16] Policy Statement, p. 28.
[17] *RUCO v. Arizona Corp. Comm'n*, 199 Ariz. 588, 20 P.3d 1169 (2001) at 591, citing *Tucson Elec. Power Co. v. Arizona Corp. Comm'n,* 132 Ariz. At 242 (1996), and Article 15, Section 3 of the Arizona Constitution.
[18] Id., quoting *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 294 P.2d 378 (1956) at 151.

party presents "a clear and convincing showing that the Commission's actions are unlawful or unreasonable."[19]

Any claim that the Commission lacks constitutional authority to approve the settlement would have to frame decoupling as a fluctuating rate of some sort, akin to an automatic adjustment clause, which is not tied to a fair value finding (as RUCO's witness suggested in his testimony).[20] The decoupling mechanism here is neither an interim rate, as contemplated in *RUCO v. Arizona Corp. Comm'n*, nor an automatic adjustment clause as defined in that case and other Arizona case law:

> "The automatic adjustment clause is a device to permit rates to adjust automatically, either up or down, in relation to fluctuations in certain, narrowly defined, operating expenses....Such clauses normally embody a formula established during a rate hearing to permit adjustment of rates in the future to reflect changes in specific operating costs, such as wholesale cost of gas or electricity."[21]

The decoupling mechanism in Alternative B of the proposed settlement is clearly distinguishable from an automatic adjustment clause. The decoupling mechanism does not seek to reflect potential changes to the company in operating costs, such as wholesale commodity costs. Instead, decoupling incorporates the company's fair value, after a full hearing, and simply seeks to remove the linkage between retail gas sales and the recovery of costs that do not fluctuate with those sales. This is a completely different animal from the automatic adjustment clause defined by *Scates*, which is tied to fluctuations in variable operating costs that are then passed along to customers. The proposed decoupling mechanism relies on, and does not readjust over time, per-customer revenue requirements adopted by the Commission in this proceeding.

As stated earlier, we are unaware of a holding by any court in the U.S. that decoupling is outside utility commissions' regulatory authority. This is hardly surprising, since revenue decoupling

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[19] *RUCO v. Arizona Corp. Comm'n at* 591.
[20] Tr. Vol. III (Johnson) at 664-665.
[21] *Scates v, Arizona Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (1978) at 535.

represents no departure whatsoever from traditional cost-of-service ratemaking. Decoupling simply ensures that unexpected fluctuations in retail sales do not affect a company's ability to recover the fixed-cost revenue requirement that its utility commission has reviewed and approved after a full hearing for all interested parties. In this respect, decoupling is exactly like straight fixed-variable rate design (adoption of which has seldom if ever been questioned on legal grounds), except that unlike this flawed alternative, decoupling leaves undisturbed customers' rewards for saving energy.

VI. CONCLUSION

As of October 2010, NRDC had more than 11,000 members and 18,000 online activists in Arizona. On behalf of these constituents, NRDC has intervened in this matter to pursue its long-standing goal of reducing the environmental and economic cost of reliable energy services. NRDC applauds the Arizona Corporation Commission for its leadership in establishing one of the nation's most ambitious Energy Efficiency Standards, based on well justified findings that net benefits to customers will be measured in the billion of dollars. In addition, the Commission's recent Policy Statement on Decoupling was a major step toward achieving significant energy and cost savings that will benefit all Arizonans. NRDC urges the Commission to adopt the full decoupling proposal in Alternative B of the settlement, in order to realize its energy efficiency goals, provide reasonable financial stability for this utility, and ensure customer benefits through steadily increasing and highly cost-effective energy savings.

RESPECTFULLY SUBMITTED this 1st day of September, 2011.

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