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BEFORE THE ARIZONA CORPORATION COMMISSION

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2011 SEP 23 P 2:11
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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

RUCO'S REPLY BRIEF

The Residential Utility Consumer Office ("RUCO") offers this reply to the arguments offered by the Settling Parties in their initial post-hearing briefs.

RATE DESIGN

Most of the arguments the Settling Parties offer in support of the Settlement (Option A (partial decoupling) and Option B (full revenue decoupling) and RUCO's proposed alternative rate design were addressed by RUCO in its Opening Brief and will not be repeated here. However, there are a few points raised by the Settling Parties to which RUCO must respond.

1 **RUCO's reply to the Company**

2 The tenor of the Company's Opening Brief is that RUCO's testimony is internally
3 inconsistent and "RUCO's entire opposition to the Settlement Agreement rings hollow..."
4 Company Brief at 15-22. Unfortunately for the Company, many of the arguments that RUCO
5 makes in opposition to the Settlement are supported and argued by Staff's rate design witness
6 David Dismukes, in Staff's underlying case. While the Company may not agree with RUCO's
7 evidence, or Staff's for that matter, the whole premise that RUCO has provided "...no
8 meaningful evidence to establish that the Settlement Agreement is unfair, unjust,
9 unreasonable, or not in the public interest" is flawed at its core. The Commission should give
10 little if no consideration to the Company's arguments. RUCO maintains the Settlement is not
11 in the public interest for the many reasons stated in RUCO's Opening Brief.

12 Nonetheless, the Company complains that the record does not support most, if not all of
13 Ms. Jerich's and Dr. Johnson's testimony. For example, the Company complains Director
14 Jerich is mistaken that decoupling shifts risk from the utility to the ratepayer. In fact,
15 Southwest Gas states, "the record clearly establishes that decoupling does not create such a
16 shift." (Southwest Gas Brief at p. 20). Perhaps Southwest Gas has forgotten that, among
17 other things, in its last rate case the Commission found that "revenue decoupling is a means of
18 providing the Company with what is effectively a guaranteed method of recovering authorized
19 revenues, thereby shifting a significant portion of the Company's risk to ratepayers." (Dec. No.
20 70665, p. 41, lines 5-9).

21 Prior to the time Staff signed the Settlement, Staff opposed the Company's full revenue
22 decoupling recommendation – the EEP. Staff's witness David Dismukes' testified that the
23 Company's full revenue decoupling proposal would "...shift revenue recovery risk associated
24 with the changes in the economy, price, and other factors away from the Company and its

1 shareholders and onto ratepayers.” S-3 at 2. This is the problem with full revenue decoupling
2 – it guarantees an increasing stream of revenues to the Company and shifts the risk of the
3 economy and other variables from the utility to the ratepayer. The Company’s argument that
4 there is no evidence in the record to support this proposition is nonsense. The Company, as
5 well as the other Settling Parties would be better served explaining what benefit the ratepayer
6 will get in return for assuming this additional risk. Unfortunately, the record evidence suggests
7 that ratepayers do not get anything of comparable value to compensate for the additional risk
8 and burdens they will assume if the Settlement is approved.

9 Next, the Company criticizes Dr. Johnson’s testimony that decoupling will force
10 customers to pay higher rates – the Company claims it was effectively rebutted. Company
11 Brief at 18. In support of its argument, the Company questions Dr. Johnson’s qualifications,
12 his “admitted lack of experience” and the fact that Dr. Johnson never performed an analysis of
13 the rate per-therm impact of decoupling in this case. Company Brief at 18. Rather, the
14 Company claims the Commission should rely on its argument that decoupling will result in
15 lower bills if the customer uses less. Id. In support of its argument, the Company cites to the
16 testimony of Mr. Hester, the Company’s witness who was asked how a customer could save
17 money under decoupling. Id., Transcript at 89. Mr. Hester responds in relevant part “Under
18 decoupling they can simply use less” a common mantra raised by the proponents of the
19 Agreement. Transcript at 89.

20 RUCO is at a loss to understand how the Company thinks it has rebutted the simple fact
21 that under decoupling rates will go up¹. In fact, the less each customer uses, the more rates
22 will increase. If the Company is arguing that under decoupling rates will either stay the same or

23
24 ¹ RUCO agrees there are some situations where rates will go down under decoupling such as severe weather situations, but that is not what this case is really about – it is about increasing rates to offset revenue loss caused by energy efficiency - i.e. the situation where sales per customer decline, so per-therm rates will increase when the difference is trued-up.

1 decrease, then the Company is wrong. Not only would such an argument be counter-intuitive,
2 it is wrong by the terms of the Settlement as well as being contrary to the entire point of
3 decoupling. Paragraph 3.18 of the Settlement provides in relevant part:

4 Should the Commission select Alternative B, the Company will
5 implement full revenue decoupling mechanism whereby rates will adjust to
6 reflect any differences between authorized revenues per customers and
7 actual revenues per customer-as proposed by the Company in its
8 application.

9 Paragraph 3.20 provides in relevant part as follows:

10 There will also be an annual true-up reflecting the difference
11 between the non-gas revenues authorized by the Commission and the
12 actual non-gas revenues experienced by Southwest Gas. At the end of
13 each year, a per-therm rate adjustment will be computed by dividing the
14 balance in the deferred account by the pervious 12 months sales volume.
15 The resulting rate will remain in effect for a 12-month period to refund or
16 collect the deferred account balance.

17 A-14 at 10.

18 The language is clear – when the Company has not recovered its authorized revenues
19 from sales, rates will adjust upward. Option A immediately places a \$0.00213 per therm
20 surcharge on rates. A-14 at 8, Section 3.8. Option B limits rate increases to 5% per year. Id.
21 at 13 – 14, Section 3.29. This rate increase will occur regardless of whether a particular
22 ratepayer uses less gas. In that situation, all other things equal, rates will not stay the same
23 and they will not decrease. Dr. Johnson, a PhD in economics, has ample qualifications to
24 understand that decoupling will result in higher rates per therm when usage per customer
decreases – and these higher rates will translate into higher revenues than the amounts
initially authorized in this case when the number of customers increases. These points were
explained at length by Dr. Johnson and similar points were made by Staff witness Dismukes.
RUCO-7 at 9-10. No attempt was made by the Company to rebut these basic points.

1 Moreover, it is not necessary for Dr. Johnson to perform an independent analysis of the rate-
2 per-therm impact of decoupling to prove a conclusion that can easily be reached by reading
3 and understanding the terms of the Settlement.

4 Perhaps the Company misunderstood or mis-stated the issue, and it was simply trying
5 to argue that if ratepayers use less their bills will be less because their savings will exceed the
6 increase in cost caused by the rate increase. This is an entirely different concept which by no
7 means rebuts RUCO's position that under decoupling the customer's rates will go up under
8 circumstances when they should not. It is a sleight of hand to market the Settlement and
9 decoupling to the public in a way that gives ratepayers the false impression that their bills will
10 go down because of the Settlement or because of decoupling. Any reduction in bills will be
11 attributable to their decision to use less gas, and the bill reduction will be less than normal due
12 to the impact of the increase in rates. The obvious implication of this misleading marketing is
13 that customer's bills are going down because their rates are going down. In truth, if ratepayers
14 use the same amount of gas their bills will increase because their rates will be increasing as a
15 result of the decoupling mechanism. Even for ratepayers who use less gas, under decoupling
16 their bills will be higher than they otherwise would be in the absence of decoupling.

17 The Company's misleading or incorrect arguments in its brief strengthen the case for
18 RUCO's concern about the customer outreach aspect of the Settlement. This outreach will
19 take place after the Settlement is approved – in other words, once the horse is out of the barn.
20 It is clear from the Company's case that it does not intend to convey to customers a fair and
21 accurate explanation that under decoupling, rates will go up. Most likely, the Company will
22 market decoupling as it is doing in this case – as a conservation tool, without revealing that the
23 customer's rates will go up and that bills would be even lower in the absence of decoupling.

24

1 That is not to say that customers are not already aware of the proposed decoupling
2 options. To date, there have been approximately 2,000 emails and letters received by the
3 Commission through August 9, 2011. Company Brief at 12. Of those, according to the
4 Company less than 2% reference decoupling. Id. But to assume that most people are not
5 aware of decoupling or have some idea of how it works would be a mistake, regardless of
6 whether or not they use the term "decoupling" in their email or letter. Attached hereto as
7 Attachment 1 is a letter to the docket dated August 15, 2011. The author of this letter is Janet
8 M. Ek, the General Manager of the Recreation Centers of Sun City, Inc. Ms. Ek, on behalf of
9 her organization, explains the reasons for her organization's opposition to the decoupling
10 options set forth in the Settlement. Among other things, she notes:

11 "It is our understanding that the decoupling options laid out in the
12 proposed settlement have no benefit for the customer, and only serve the
13 best interests of the utility. We wholeheartedly object to either of these
14 provisions, and hope that the Commission acknowledges decoupling can
be used as a tool to reduce the need for new infrastructure and encourage
conservation that in this case, it has the exact opposite effect."

15 The AARP has also been very vocal about its opposition to decoupling. Transcript at 16.
16 These are large organizations that represent a lot of the Company's customers, not just 40
17 (2% of 2000) customers, as the Company implies. These people are not ignorant and it would
18 be a grave mistake to ignore them merely because they failed to use precise terminology in
19 their emails and letters.

20 **RUCO's reply to Staff and the Settling Parties**

21 RUCO in its Opening Brief as well as in its pre-filed testimony made the point, based on
22 Staff's witness David Dismukes, that the Company would have collected an additional \$62
23 million from residential customers if its rates were decoupled from 2007-2010. R-14 at 5,
24 RUCO Brief at 11. Now Staff's own testimony works against Staff's interests. Staff attempts to

1 impeach its significance as well as its own witness by pointing to the Company's testimony that
2 those numbers were based on volumes of therms which during the 2007-2010 period ranged
3 from 347 to 332 therms. Staff Brief at 26. Whereas, the impact would be less in the future,
4 since the rates designed in the subject case are based on 297 therms. Id. Even accepting this
5 as true, the amount of additional revenues that would have been collected under decoupling
6 during this time period would have been significant – which nobody can deny.

7 Next, Staff takes issue with RUCO's assertion that the approval of the Settlement's
8 decoupling proposals will be embarking into "unchartered waters". Staff Brief at 27, RUCO-10
9 at 6. Even though no Arizona utility has a decoupling mechanism, Staff believes that
10 decoupling is not "unchartered waters" because 22 other states have utilities with natural gas
11 decoupling. Staff Brief at 27. However, the Settlement is not being proposed in 22 other
12 states. It is being proposed in Arizona where the facts and circumstances of this utility, the law
13 and the Commission are different. Moreover, 22 states are not even a majority. The 28 states
14 that have not ventured into gas revenue decoupling are a majority, so without question, the
15 touted "experience" is from a minority of jurisdictions.

16 Regardless of the numbers, the simple fact is that this Commission does not know
17 enough about the experience in those other states for it to offer much comfort or assurance
18 about decoupling. Dr. Johnson points out that there is not a lot of detail in this record on the
19 experience of those 22 other states and cautions against drawing too many conclusions from
20 what little is known about these other states. Transcript at 657.

21 Ms. Jerich also testified on this issue. A further review of other states and how
22 decoupling has been addressed is very revealing. Ms. Jerich's research revealed that
23 decoupling mechanisms come in several shapes and sizes other than the two proposed in this
24

1 docket. Specifically, Ms. Jerich pointed out that the New Jersey decoupling mechanism
2 lauded by NRDC's Mr. Kavanagh is not the same as either Option A or Option B.

3 Ms. Jerich addressed the assertion that without decoupling Southwest Gas may face a
4 rating downgrade. She referenced the Nevada PUC Decision where that Commission noted
5 that Southwest Gas had been given other beneficial ratemaking treatment that also helped
6 improve its rating. Transcript at 703-704. Additionally, she points to a number of other states
7 where decoupling has been denied and the credit ratings for those utilities remained the same
8 or actually went up thereafter. For example, in Nebraska, Aquila's credit rating improved after
9 decoupling was denied. RUCO-16. Likewise, utilities in Montana, Connecticut and Rhode
10 Island experienced the same phenomenon when decoupling was rejected by their Public Utility
11 Commissions. Id.

12 The Virginia legislature mandated decoupling. Transcript at 706, RUCO-17. Virginia's
13 Public Utility Commission subsequently prepared a report to the legislature on the subject. Id.
14 The Virginia Commission noted that since the inception of decoupling authorized for three
15 utilities, each utility recovered far more through their decoupling mechanism than they lost due
16 to their energy efficiency efforts. Virginia Natural Gas' decoupling mechanism compensated
17 the company for approximately \$7.7 million for forecasted energy reductions of approximately
18 18 million Ccfs. However, the gas company's own estimates indicate that its efforts have
19 generated actual reductions of less than 491,000 Ccfs. Consumers are paying for a level of
20 energy reductions that far exceeds the amount of foregone revenue attributable to decoupling.
21 RUCO-17, Virginia report at v.

22 The revenue decoupling experience in Maine also suggests that the Commission
23 exercise caution. In Maine during the early 90's Central Maine Power had a decoupled rate
24 design. The decoupled rate design created a crisis due to the sudden and sharp downturn in

1 the Maine economy. The downturn reduced consumption to a much greater degree than the
2 utility's efficiency efforts which created the view that the decoupling mechanism shifted the
3 economic impact of the recession from the utility to consumers, rather than providing the
4 intended energy efficiency and conservation incentive impact. Maine ended decoupling. See
5 the Maine Public Utility Commission's Report of January 31, 2008 at pages 12-13, a copy of
6 which is attached hereto as Attachment 2. RUCO notes that, like Maine, Arizona and its
7 residents are suffering under the financial stresses of a weak economy and a volatile market.

8 During the hearing, Mr. Cavanaugh was asked questions about the Maine experience.
9 Mr. Cavanaugh assured that such an experience could not occur here because of all of the
10 rate impact protections that are made a part of the Settlement. Transcript at 393. Certainly,
11 however, neither Mr. Cavanaugh nor the Company controls the economy. As the economy
12 gets worse, like in Maine, gas consumption in Arizona is likely to decrease – more as the result
13 of the economic conditions than the Company's efficiency efforts. The Company, under
14 decoupling, will be protected, thereby shifting the economic risk from the utility to the ratepayer
15 as Ms. Jerich described. Rates will go up at a time when ratepayers are least prepared to pay,
16 just like in Maine.

17 Finally, RUCO addresses Staff's argument that the weather component of the
18 Settlement's decoupling proposals is a consumer benefit. Staff Brief at 6, 8, and 9. This
19 again raises a concern alluded to above – how easy it is to confuse the issues when it comes
20 to decoupling and make a benefit from something your own witness earlier argued was a flaw.
21 When Staff opposed decoupling in its direct case, Staff's witness David Dismukes testified that
22 the weather component of the Company's decoupling proposal (which is also in the two
23 Settlement Options) "...would be a net shifting of risk away from itself and onto customers."
24

1 S-3 at 23. Now that Staff is a signatory to the Settlement, the weather component is
2 supposedly a big benefit to ratepayers.

3 Mr. Dismukes testified that a close examination of the past weather trends shows that
4 the Company and its shareholders would have had greater relief from this mechanism than
5 ratepayers. S-3 at 20. These mechanisms are not symmetrical and it is quite possible that
6 these mechanisms "... can be pure risk-shifting mechanisms placing greater weather-related
7 sales risks on customers and away from utilities and their shareholders." S-3 at 21. In fact,
8 according to Mr. Dismukes the Connecticut DPUC revised its approval of a weather related
9 decoupling clause because of the asymmetry. Id. at 22.

10 RUCO has addressed all of the issues raised on rate design by the other Settling
11 parties either in its Opening Brief or in this reply. The Commission should reject the
12 Settlement Agreement.

13 **The Settlement Options present constitutional challenges.**

14 RUCO has reviewed the legal arguments made by the Settling Parties addressing the
15 Judge's inquiry on the constitutionality of decoupling as an automatic adjustor. RUCO is not
16 persuaded that decoupling comports with the parameters of an automatic adjustor clause or
17 that it adequately complies with Arizona's fair value requirement. The Settling Parties
18 themselves are not aligned on the law except for their legal conclusion that decoupling does
19 not offend Arizona's fair value requirement. Staff, AIC and Sweep argue that the decoupling
20 options in the Settlement meet the requirements set forth in *Scates* for an automatic
21 adjustment clause. Staff at 18, AIC Brief at 12-13, Sweep at 9 – 11, The Company and
22 NRDC argue that the decoupling options in the Settlement do not meet the requirements of an
23 automatic adjustment clause. Company Brief at 13, NRDC Brief at 7. The fact that there is
24 such a critical disagreement on a key aspect of the law, even among the Settling Parties,

1 supports RUCO's contention that now is not the time to approve the decoupling proposals in
2 the Settlement.

3 **1. A decoupling mechanism is not an adjustor mechanism as permitted**
4 **under Scates.**

5 The Arizona Constitution requires the Commission to set utility rates that are "just and
6 reasonable." To do this, the Commission must determine the "fair value" of the utility's
7 property, determine a rate of return and apply that rate of return to the rate base Scates v.
8 Arizona Corporation Commission, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App.1978). "The
9 reasonableness and justness of the rates must be related to this finding of fair value." Simms
10 v. Round Valley Light & Power, 80 Ariz. 145 (1956).

11 Scates found that an adjustment clause set within a rate case where fair value findings
12 were made to be permissible. Scates defined such an adjustment clause as:

13 "A device to permit rates to adjust automatically, either up or down, in
14 relation to fluctuations in *certain narrowly defined, operating expenses.*"
(Scates at 535) (Emphasis added)

15 A decoupling mechanism recovers lost **revenues** (including lost profit) – not dollar for
16 dollar **expenses**. The reasoning to allow adjuster clauses is that timely recovery of such
17 expenses do not violate the Constitution's parameters because when the costs are passed on
18 to the consumer, the utility neither benefits from the decreased cost nor suffers a diminished
19 return as a result of costs recovered by the adjustment clause. 71-15 Op. Atty. Gen. (1971)

20 Clearly, the exception for automatic adjustment clauses that has been carved out by the
21 courts applies only to a narrowly defined mechanism focused on passing through specific
22 operating expenses. The decoupling proposals in the subject case are fundamentally different.
23 They are tied to changes in revenues affecting operating income that will allow the Company to
24

1 recover its fixed costs – not operating expenses or operating costs². Expenses and revenues
2 are completely different, and this difference comes with fair value implications. The NRDC,
3 one of the Settling Parties, noted as much in its Closing Brief. Decoupling “... is a completely
4 different animal from the automatic adjustment clause defined by *Scates*, which is tied to
5 fluctuations in variable operating costs that are then passed along to customers. The proposed
6 decoupling mechanism relies on, and does not readjust over time, per-customer revenue
7 requirement: adopted by the Commission in this proceeding.” NRDC Brief at 7. The Company
8 also reaches the same legal conclusion:

9 Mechanically, decoupling is not an automatic adjustment clause, as
10 defined by Arizona law. Automatic adjustment clauses have been defined
11 as mechanisms that track specific costs and then adjust to reflect market
12 fluctuations in those costs to offset any cost increases and decreases
13 following a rate case. To the contrary, decoupling mechanisms simply true-
up any differences between any under or over recovery of Commission
approved fixed costs - regardless of market fluctuations in those costs, to
ensure the utility recovers no more and no less than what the Commission
authorized in this rate case.

14 Company Brief at 13.

15 In keeping with the NRDC “animal” reference, comparing an adjuster clause to a
16 decoupling mechanism is like comparing a horse to a pig. The automatic adjustment clause
17 allows rates to adjust automatically with changes in operating costs. This is fundamentally
18 different from what is being sought in this case, which is permission to increase rates (boost
19 revenues) and recover lost profit after the conclusion of a rate case and without a further
20 determination of fair value for reasons that are attributable to changes in usage per customer.
21 Decoupling is dealing with a fundamentally different issue than “fluctuations in certain, narrowly
22

23 ² The *Scates* Court cited to the following cases for examples of adjuster clauses; *Consumers Organization for Fair*
24 *Energy Equality, Inc. v. Department of Pub. Utilities*, 335 N.E.2d 341, 343 (Mass.Sup.Jud.Ct.1975) – fuel adjuster
clause, *City of Norfolk v. Virginia Electric & Power Co.*, 197 Va. 505, 90 S.E.2d 140, 148 (1955) - a purchased gas
adjustment provision, and *Maestas v. New Mexico Pub. Serv. Comm'n*, 85 N.M. 571, 514 P.2d 847 (1973) - gas
adjustment clause.

1 defined, operating expenses”, and the potential impact of decoupling on the Company's
2 income and return on fair value are fundamentally different than is the case with an automatic
3 adjustment clause.

4 In order to fit within the exception for automatic adjustors, the Commission would have
5 to greatly expand upon the Arizona’s Court’s definition of automatic adjustment clauses to
6 include changes in revenues. The Company seems to realize this would be necessary when
7 it urges the Commission to expand beyond “specific cost adjustments” to include the recovery
8 of the approved revenues. Company Brief at 13. That is arguable, but regardless, the
9 Commission cannot get there without first greatly expanding upon the Court’s existing
10 definition of what an adjustor clause is. For the following reasons, such an expansion may be
11 contrary to the fair value requirement and, at the very least, bad public policy.

12 **2. Absent an Earnings Test, a decoupling mechanism violates the fair**
13 **value requirement.**

14 Absent the earnings test, decoupling poses significant constitutional challenges. The fair
15 value provision in the Arizona Constitution is not a one way street. This provision not only
16 protects investors, it also protects customers. The Constitution protects investors by ensuring
17 they have an opportunity to earn a fair return on fair value. The Constitution protects
18 customers by ensuring that they are not required to pay rates that exceed a reasonable level --
19 that level which is necessary to provide investors with an opportunity to earn a fair return on
20 fair value. See Arizona Constitution, Article 15, Section 3.

21 The proposed decoupling options violate the latter requirement by creating a one way
22 street that tips the balance too far in favor of investors and against customers. Decoupling
23 puts per-therm rates on autopilot, potentially increasing these rates above the level which is
24 necessary to provide a fair return on fair value. In this regard, decoupling fails to protect

1 customers on two fronts. First, decoupling fails to protect against the possibility that fair value
2 may decline over time (e.g. if depreciation is reducing fair value at a faster pace than inflation
3 and new investments are boosting fair value). Second, decoupling fails to protect against
4 profits (achieved return on fair value) increasing to excessive levels as a result of the
5 combined impact of increased rates per therm (due to decoupling) and increased volume of
6 gas sold (due to increased numbers of customers). Total profits may increase to excessive
7 levels due to rate increases years after the conclusion of the rate case, and there is no
8 assurance that the resulting increase in profits will be limited to a reasonable level consistent
9 with a fair return on fair value. To illustrate this point, RUCO returns to Staff witness David
10 Dismukes' testimony that Southwest Gas would have received an additional \$62 million if
11 revenue decoupling had been in place from 2007-2010.

12 In other words, due to decoupling and conservation, rates will be increasing, but at the
13 same time the number of customers will be increasing. The net result will be more customers
14 paying higher rates per therm, which will translate into more and more total dollars flowing to
15 the Company -- and the resulting increase in operating income and total profits may result in
16 an excessive return on fair value.

17 The likelihood of customer growth over the next decade is a very real factor which must
18 be considered in weighing the constitutionality of this proposed mechanism for repeatedly
19 increasing rates after the conclusion of the rate case. RUCO-7 at 21. As Dr. Johnson
20 testified, "SWG has experienced an upward trend in the number of customers it serves". It
21 experienced high growth during the boom years." While growth has slowed in the last few
22 years, Southwest Gas has not had a decrease in customers. RUCO-7 at pp. 18-19.

23 Article 15, Section 3 of Arizona's Constitution is not just concerned with fairness in the
24 allowed rate of return, but it is also concerned with fairness in the rates charged. The

1 Commission shall have the power to prescribe "...just and reasonable rates..." Arizona
2 Constitution, Article 15, Section 3. Rates should not exceed the level which is reasonably
3 necessary to provide an opportunity to earn a fair return on fair value. If the effect of
4 decoupling is to increase rates (prices) and profits (earned returns) to an excessive level
5 (relative to fair value), decoupling would have the effect of violating the constitutional
6 requirement that customers be protected from being forced to pay excessive prices -- rates
7 that are excessive in that they generate profits that exceed a fair return on fair value.

8 In this regard, decoupling is fundamentally different from a typical automatic adjustment
9 clause, which merely passes through increases and decreases in specific operating costs. A
10 typical adjustor passes through changes in narrowly defined operating expenses, and it does
11 not have the potential to increase profits per unit of service sold. Since the typical adjustor
12 doesn't boost per-unit profitability, it doesn't have the potential for increasing profits to an
13 unreasonably high level -- one which exceeds a fair return on fair value. In contrast, the
14 decoupling mechanism is designed to boost profitability by increasing rates and profit per unit
15 of gas sold above the level that would occur in the absence of decoupling. While the goal of
16 the decoupling mechanism is to offset the loss of revenues which occurs when customer use
17 less gas, the decoupling mechanism fails to take into account the impact of increases in the
18 number of customers -- growth which tends to boost the Company's income, and tends to
19 offset declining per-customer usage. In a rate case these offsetting factors can be fully
20 evaluated, along with all other relevant facts, to protect customers from excessive rates and
21 charges. In contrast, decoupling does not offer the needed protections, and it fails to protect
22 against the possibility that rates and profits will be increased too much -- pushing rates (and
23 the Company's profits) above the level that is fair, just and reasonable.

24

1 **3. The Earnings Test in Option B provides only a superficial limitation**
2 **to prevent rates that exceed a fair rate of return.**

3 The Settlement attempts to partially address this concern through the annual earnings
4 test. However, the earnings test is subject to its own limitations. First, the earnings test is only
5 applicable to the full revenue decoupling proposal – Option B. A-14, pp 3.25, Transcript at
6 541. There is nothing analogous to mitigate excessive future rates under Option A. Second,
7 the earnings test may not be adequate because it will be looking at changes up to one year
8 after they occur. Third, if decoupling is boosting rates to the point where they will likely “fail”
9 the earnings test, the Company can avoid this result by increasing its expenditures. Transcript
10 at 678-682. The Company will monitor its earnings and know in advance whether they are
11 likely to fall in the range where it will fail the earnings test. Id. At that point, the Company will
12 not have the normal incentive to control costs or operate efficiently. By spending more money
13 it can push its earnings back below the level associated with the earnings test. RUCO is not
14 saying the Company will necessarily spend money inappropriately – the point is that the
15 pressure to control costs that is normally present will be greatly diminished, and the result will
16 be a different mind-set than the typical utility that is subject to regulatory lag. Id. The end result
17 may be profits that fall within the constraint of the earnings test – yet rates which exceed a just
18 and reasonable level. This result would be contrary to the intent of the Arizona Constitution,
19 and it clearly would not be in the public interest.

20 Putting aside the automatic adjustment clause, the Commission should also give little
21 concern to the Company’s threat that a decision that denies decoupling altogether could be
22 deemed a failure of the Commission to set rates sufficient to meet the Company’s operating
23 costs and produce a reasonable rate of return. Company Brief at 15. Nor should the
24 Commission be concerned that the Company has not earned its authorized rate of return.
First, it can always be argued that the Commission’s action in denying some aspect of a

1 Company's rate filing could prevent the Company from earning a reasonable rate of return.
2 There is nothing unique about this case to suggest a need to venture beyond the
3 Commission's standard ratemaking practice. Second, setting rates does not and should not
4 guarantee that a Company will earn its rate of return. Furthermore, if the Company does not
5 earn its rate of return, it always has the option of coming to the Commission and applying for
6 another rate increase – an option not available to the unregulated counterpart that is not
7 earning a reasonable rate of return due to weak demand, declining usage, bad business
8 judgment or poor economic conditions. Finally, the shift in risks to the ratepayer that would
9 result under either Settlement option is unwarranted and not justified by the mere fact that the
10 Company has not been able to earn its authorized return. The record has established that this
11 Company is financially healthy, has been paying steady and increasing dividends, and will
12 always have the recourse of filing another rate case if it does not earn its authorized rate of
13 return.

14 If anything, the answering briefs of the other parties have further shown that RUCO's
15 legal concerns regarding the Settlement options are justified. The constitutional concerns are
16 another reason why the circumstances are not right for the approval of either option in the
17 Settlement.

18

19 **The Fair Value Rate of Return**

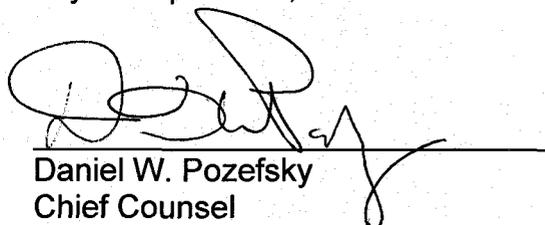
20 RUCO believes that its FVROR methodology is superior and more in line with the
21 Commission's recent approach than the alternate Staff approach adopted in the Settlement.
22 RUCO explained its reasons behind its objections to the alternate Staff approach in its Closing
23 Brief as well as in the testimony of Dr. Ben Johnson on the subject. It was pointed out to Dr.
24 Johnson, during the hearing that his assumptions on Staff's risk free rate of return was wrong
and that the effect on Staff's methodology in the event of rapid inflation would not be as severe

1 as Dr. Johnson originally thought. Transcript at 775. Dr. Johnson acknowledged the mistake
2 but by no means did Dr. Johnson's admission "effectively" disprove RUCO's objection to the
3 use of Staff's alternate approach. Company Brief at 16. RUCO's FVROR methodology is still
4 the superior methodology as it subtracts the inflation component from both the debt and the
5 equity components of the capital structure which is exactly what the Commission did in the
6 recent UNS Electric case. Decision No. 71914 at 49-50, September 30, 2010.

7
8
9 **CONCLUSION**

10 It is not difficult to rebut the arguments raised in the Settling parties Briefs because it is
11 so clear that now is not the time to adopt the Settlement Agreement. There are far too many
12 unresolved concerns, including the general public's opposition to decoupling and the legal
13 issues to merit adoption of decoupling in this case. RUCO's alternate proposal is generous,
14 fair and in the public interest. The Commission should reject the Settlement and adopt
15 RUCO's recommendation in this case.

16
17 RESPECTFULLY SUBMITTED this 23rd day of September, 2011.

18
19 
20 Daniel W. Pozefsky
21 Chief Counsel

22 AN ORIGINAL AND THIRTEEN COPIES
23 of the foregoing filed this 23rd day
24 of September, 2011 with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

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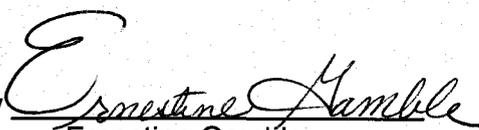
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ATTACHMENT 1

ORIGINAL



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August 15, 2011

Southwest Gas
G-01551A-10-0458
In Opposition

Chairman Gary Pierce
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Arizona Corporation Commission
DOCKETED

AUG 24 2011

Re: Southwest Gas Corporation
Docket No. G-01551A-10-0458

DOCKETED BY 

RECEIVED
2011 AUG 24 A 11:08
AZ CORP COMMISSION
DOCKET CONTROL

Dear Chairman Pierce,

The Recreation Centers of Sun City, Inc. (RCSC) would like to express our opposition to both decoupling options in the proposed settlement agreement of Southwest Gas Corporation, Docket No. G-01551A-10-0458.

We believe that the purpose of decoupling is for energy efficiency and conservation. Those who conserve should be rewarded through savings on their monthly bill for using less energy. When implemented correctly decoupling can be a conservation mechanism that allows ratepayers to benefit from the reduction of his/her consumption while holding the utility harmless. It can be beneficial in situations where new infrastructure is needed to meet the demands of existing growth. However, in this case new infrastructure is not needed to meet the demands of existing customers in our area, and reduced consumption will not delay the need for new infrastructure.

It is our understanding that the decoupling options laid out in the proposed settlement agreement have no benefit for the customer, and only serves the best interest of the utility. We wholeheartedly object to either of these provisions, and hope that the Commission acknowledges that although decoupling can be used as a tool to reduce the need for new infrastructure and encourage conservation that in this case it has the exact opposite effect.

Our residents understand the need to be good stewards of our resources. However, the majority of our residents are on fixed incomes, and without the benefits that come with conservation (i.e. lower utility bill) we do not understand the desire of those who propose a mechanism that would lead to higher rates even with decreased use.

We respectfully ask the Commission to reject any option of decoupling in this case. The residents of Sun City should not be the test subjects for such a drastic policy change in rate design.

Sincerely,



Janet M. Ek, CMCA, AMS, CPFM
General Manager

ATTACHMENT 2

Report on Revenue Decoupling for Transmission & Distribution Utilities

**Presented to the Utilities & Energy
Committee by the MPUC, OPA and OEIS**

January 31, 2008

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on rates. Therefore, decoupling may not completely neutralize a utility's efforts to maximize sales or avoid significant decreases in load.

In the event that a decoupling mechanism does completely neutralize a utility's interest in sale levels as intended, there are a variety of implications outside the context of energy efficiency and conservation. A utility that is completely neutral to sales would have less interest in promoting economic development within its service territory.¹⁴ Similarly, a utility would have little interest in offering a larger customer a special discount rate as an incentive to remain on the grid (as opposed to self-generation) or to otherwise act to ensure that customer decisions to leave the grid are based on sound economic analysis. The result could be higher than necessary electricity rates and uneconomic decisions by individual customers to cease or reduce purchases through the electricity grid.

For the reader who would like additional information about the attributes of revenue decoupling, we have attached several documents to this report. Attachment C was published by the National Association of Regulatory Utility Commissions (NARUC) in September 2007 and titled *Decoupling for Electric and Gas Utilities: Frequently Asked Questions (NARUC FAQ document)*, provides useful background information and includes a detailed bibliography of current resources on the subject. Attachment D, which was adopted by the National Association of State Utility Consumer Advocates (NASUCA) in June 2007, is captioned *NASUCA Energy Conservation and Decoupling Resolution*. Attachment E is *A Response to the NASUCA "Decoupling" Resolution*, which was published in August 2007 by 11 separately named organizations. Attachment F is a PowerPoint presentation made by RAP in April 2007 and titled *Energy Efficiency and Utility Profits: Aligning Incentives with Public Policy*. Attachment G, a document titled *Revenue Decoupling*, is a policy brief prepared by the Electricity Consumers Resource Council (ELCON) in January 2007.

V. MAINE'S EXPERIENCE WITH REVENUE DECOUPLING

As mentioned above, Maine has experience with revenue decoupling that is generally considered a failure. In 1991, the Commission adopted, on a three-year trial basis, a revenue decoupling mechanism for CMP (referred to as "Electric Revenue Adjustment Mechanism" or "ERAM").¹⁵ The "allowed" revenue was determined in a traditional rate case proceeding and adjusted annually

¹⁴ If a "per-customer" decoupling mechanism is in place (see section VII, below), a utility would have the financial incentive to encourage new business to enter the State, but would not have the incentive to encourage increased production.

¹⁵ *Investigation of Chapter 382 Filing of Central Maine Power Company, Order, Docket No. 90-085 (May 7, 1991).*

based on changes in the utility's number of customers (as a result the mechanism was also referred to as "ERAM per customer"). Analyses before the Commission at the time indicated that changes in the number of customers were at least as good an indicator of CMP's costs as changes in sales levels. CMP's ERAM was not, however, a multi-year plan, so CMP was free to file a rate case at any time to adjust its "allowed" revenues.

CMP's ERAM quickly became controversial. Around the time of its adoption, Maine, as well as the rest of New England, was experiencing the start of a serious recession that resulted in lower sales levels. The lower sales levels caused substantial revenue deferrals that CMP was ultimately entitled to recover. CMP filed a rate case in October 1991 that would have increased rates at the time, and resulted in lower amounts of revenue deferrals. However, the rate case was withdrawn by agreement of the parties to avoid immediate rate increases during bad economic times.¹⁶

By the end of 1992, CMP's ERAM deferral had reached \$52 million. The consensus was that only a very small portion of this amount was due to CMP's conservation efforts and that the vast majority of the deferral resulted from the economic recession. Thus, ERAM was increasingly viewed as a mechanism that was shielding CMP against the economic impact of the recession, rather than providing the intended energy efficiency and conservation incentive impact. The situation was exacerbated by a change in the financial accounting rules that limited the amount of time that utilities could carry deferrals on their books.

Maine's experiment with revenue cap regulation came to an end on November 30, 1993 when ERAM was terminated by stipulation of the parties.¹⁷

VI. ACTIVITIES IN OTHER STATES

As discussed above, decoupling is not a new concept. It was developed over 15 years ago and was implemented in Maine and in other states in the 1990s. However, there has been a renewed interest in revenue decoupling in recent years. In the last few years, several states have adopted decoupling mechanisms, including Maryland, Delaware, California, New York and Idaho.

¹⁶ *Proposed Increase in Rates, Order Granting Motion to Withdraw Proceeding*, Docket No. 91-174 (Jan. 10, 1992).

¹⁷ *Consideration of Issues Concerning ERAM-Per-Customer for Central Maine Power Company, Order Approving Stipulation*, Docket No. 90-085-A (February 5, 1993). After the termination of ERAM, the Commission's efforts regarding incentive regulation moved to the development of rate cap regulation.