

OPEN MEETING ITEM



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COMMISSIONERS
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BOB STUMP
SANDRA D. KENNEDY
PAUL NEWMAN
BRENDA BURNS



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Executive Director

ARIZONA CORPORATION COMMISSION

2011 NOV 28 P 3:27

DATE: NOVEMBER 28, 2011

DOCKET NO.: G-01551A-10-0458

AZ CORP COMMISSION
DOCKET CONTROL

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Dwight D. Nodes. The recommendation has been filed in the form of an Opinion and Order on:

SOUTHWEST GAS CORPORATION
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by 4:00 p.m. on or before:

DECEMBER 7, 2011

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Open Meeting to be held on:

DECEMBER 13, 2011 and DECEMBER 14, 2011

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

Arizona Corporation Commission
DOCKETED

NOV 28 2011

DOCKETED BY

ERNEST G. JOHNSON
EXECUTIVE DIRECTOR

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1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

3 GARY PIERCE - Chairman
4 BOB STUMP
5 SANDRA D. KENNEDY
6 PAUL NEWMAN
7 BRENDA BURNS

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

DOCKET NO. G-01551A-10-0458

DECISION NO. _____

OPINION AND ORDER

11 DATE OF HEARINGS:

August 8, 2011 (Pre-hearing conference); August 10, 12 and 15, 2011 (Evidentiary Hearings); October 7, 12, and 24, 2011 (Public Comments).

13 PLACE OF HEARING:

Phoenix, Arizona

14 ADMINISTRATIVE LAW JUDGE:

Dwight D. Nodes

15 APPEARANCES:

Mr. Justin Lee Brown, Mr. Kyle Stephens, and Ms. Cathy Mazzeo, on behalf of Southwest Gas Corporation;

Mr. Timothy Sabo, Roshka, Dewulf & Patten, PLC, on behalf of Tucson Electric Power Company;

Mr. Timothy Hogan, Arizona Center for Law in the Public Interest, on behalf of Southwest Energy Efficiency Project;

Mr. Daniel Pozefksy, on behalf of the Residential Utility Consumer Office;

Mr. Michael M. Grant and Ms. Jennifer A. Cranston, Gallagher & Kennedy, P.A., on behalf of the Arizona Investment Council;

Ms. Cynthia Zwick, in propria persona;

Ms. Laura E. Sanchez, on behalf of the National Resource Defense Council; and

Ms. Robin Mitchell, Mr. Wesley Van Cleve, and Ms. Ayesha Vohra, Staff Attorneys, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

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1 **BY THE COMMISSION:**

2 * * * * *

3 Having considered the entire record herein and being fully advised in the premises, the
4 Arizona Corporation Commission ("Commission") finds, concludes, and orders that:

5 **FINDINGS OF FACT**6 **I. Procedural History**

7 1. On November 12, 2010, Southwest Gas Corporation ("SWG" or "Company") filed
8 with the Commission an application for an increase in rates for service provided in Arizona. With its
9 application, SWG filed supporting schedules and the direct testimony of A. Brooks Congdon, Sandra
10 L. Gaffin, Randi L. Aldridge, Jerome T. Schmitz, Robert A. Mashas, Robert B. Hevert, James L.
11 Cattanach, Theodore K. Wood, Bobbi J. Sterrett, and Edward B. Giesecking.

12 2. On December 13, 2010, the Commission's Utilities Division ("Staff") filed its Letter
13 of Sufficiency indicating that SWG's application satisfied the requirements of Arizona
14 Administrative Code ("A.A.C.") R14-2-103, and classifying the Company as a Class A utility.

15 3. On December 20, 2010, the Residential Utility Consumer Office ("RUCO") filed an
16 Application to Intervene.

17 4. On December 28, 2010, Staff filed a Request for Procedural Order, proposing a
18 bifurcated schedule with alternative hearing dates and filing deadlines that were dependent on
19 whether the parties were able to negotiate a settlement agreement.

20 5. On January 4, 2011, Tucson Electric Power Company ("TEP") filed a Motion to
21 Intervene.

22 6. By Procedural Order issued January 7, 2011, alternative hearing dates and procedural
23 filing dates were established, based on the parties' success in reaching a settlement agreement by July
24 15, 2011. The Procedural Order also granted the intervention requests filed by RUCO and TEP.

25 7. On April 6, 2011, the Arizona Investment Council ("AIC") filed a Motion to
26 Intervene.

27 8. On April 7, 2011, the Southwest Energy Efficiency Project ("SWEEP") filed a
28 Petition for Leave to Intervene.

1 9. By Procedural Order issued April 14, 2011, AIC and SWEEP were granted
2 intervention.

3 10. On April 28, 2011, Cynthia Zwick filed a Request for Leave to Intervene.

4 11. By Procedural Order issued May 11, 2011, Ms. Zwick was granted intervention.

5 12. On May 16, 2011, the National Resources Defense Council ("NRDC") filed a Motion
6 for Leave to Intervene.

7 13. On June 10, 2011, Staff filed the direct testimony of Ralph C. Smith, Julie McNeely-
8 Kirwan, David C. Parcell, Bryan Frye, and Robert G. Gray; RUCO filed the direct testimony of
9 William A. Rigsby and Ben Johnson; and Ms. Zwick filed her direct testimony.

10 14. By Procedural Order issued June 15, 2011, NRDC was granted intervention.

11 15. On June 24, 2011, Staff filed the direct rate design testimony of David E. Dismukes;
12 SWEEP filed the direct rate design testimony of Jeff Schlegel; RUCO filed the direct rate design
13 testimony of Dr. Johnson; and NRDC filed the direct rate design testimony of Ralph Cavanagh.

14 16. On July 12, 2011, SWG filed a motion requesting additional time for filing rebuttal
15 testimony to allow for settlement discussions.

16 17. By Procedural Order issued July 14, 2011, SWG's motion was granted.

17 18. On July 15, 2011, a Settlement Agreement¹ ("Settlement Agreement," "Settlement" or
18 "Agreement") was filed on behalf of SWG, Staff, AIC, SWEEP, NRDC, and Ms. Zwick. RUCO is
19 the only party that did not sign the Settlement.

20 19. By Procedural Order issued July 22, 2011, in accordance with the procedural schedule
21 established by the January 7, 2011, Procedural Order, the evidentiary hearing was scheduled to
22 commence on August 10, 2011; a pre-hearing conference was scheduled for August 8, 2011; and all
23 testimony in support of, or in opposition to, the Settlement Agreement was directed to be filed by
24 July 29, 2011.

25 20. On July 29, 2011, direct testimony in support of the Settlement Agreement was filed
26 by: John P. Hester, on behalf of SWG; Steven M. Olea, Barbara Keene, and Ralph Smith, on behalf
27

28 _____
¹ The Settlement Agreement is attached hereto as "Exhibit A."

1 of Staff; Daniel G. Hansen and Gary Yaquinto, on behalf of AIC; Mr. Schlegel, on behalf of SWEEP;
2 Mr. Cavanagh, on behalf of NRDC; and Ms. Zwick.

3 21. On July 29, 2011, direct testimony in opposition to the Settlement was filed by Jodi A.
4 Jerich, Mr. Rigsby, and Dr. Johnson, on behalf of RUCO.

5 22. On August 1, 2011, a Procedural Order was issued scheduling a local public comment
6 meeting for October 7, 2011, in Sun City.

7 23. On August 10, 2011, the evidentiary hearing commenced,² with additional hearing
8 days conducted on August 12 and 15, 2011.

9 24. On September 2, 2011, initial post-hearing briefs were filed by SWG, Staff, RUCO,
10 AIC, SWEEP, and NRDC.

11 25. On September 23, 2011, reply briefs were filed by SWG, Staff, RUCO, AIC, and
12 SWEEP.

13 26. On September 30, 2011, Staff filed a Staff Report and Recommended Order regarding
14 SWG's Modified Energy Efficiency ("EE") and Renewable Energy Resource Technology ("RET")
15 Portfolio Implementation Plan.

16 27. On October 3, 2011, a Procedural Order was issued scheduling public comment
17 meetings for October 12, 2011, in Phoenix, and for October 24, 2011, in Sierra Vista.

18 28. On October 7, 2011, a public comment meeting was held in Sun City, as scheduled.

19 29. On October 12, 2011, a public comment meeting was held in Phoenix, as scheduled.

20 30. On October 13, 2011, Commissioner Newman filed a statement regarding energy
21 efficiency and revenue decoupling.

22 31. On October 24, 2011, a public comment meeting was held in Sierra Vista, as
23 scheduled.

24 32. On October 26, 2011, Commissioner Kennedy filed a letter requesting that the parties
25 file by November 4, 2011, an "understandable description" of the Settlement, and that SWG post the
26 description on its website.

27 _____
28 ² Also on August 10, 2011, RUCO filed Dr. Johnson's revised schedules, and revised testimony of Dr. Johnson and Ms. Jerich.

1 33. On November 1, 2011, SWEEP and NRDC separately filed Comments to Staff's
2 September 30, 2011, Recommended Order.

3 34. On November 4, 2011, SWG filed a response to Commissioner Kennedy's letter in the
4 form of a document entitled Proposed Settlement Agreement Overview.

5 **II. Summary of Settlement Agreement Terms And Conditions**

6 35. The Settlement Agreement states that the discussions leading up to the Agreement
7 were open, transparent, and included all parties to the proceeding that chose to participate, and that all
8 parties were provided an opportunity to participate in settlement discussions. The signatory parties to
9 the Agreement, SWG, Staff, SWEEP, NRDC, AIC, and Ms. Zwick, assert that the Settlement
10 represents a compromise of all issues in the case, and they believe the terms and conditions of the
11 Settlement "are just, reasonable, and fair, and that the Agreement promotes the public interest."
12 (SWG Ex.14, at 4.)

13 36. The Settlement states that the Agreement balances the Company's need for a rate
14 increase with a number of other customer benefits that would likely not have been accomplished
15 through litigation. Benefits cited by the signatories include: an increased low-income discount;
16 additional low-income weatherization funds; an enhanced communications commitment for low-
17 income customers; added revenue rate stability through implementation of a decoupling mechanism;
18 mitigation of the size and frequency of future rate increases; and a moratorium on rate applications
19 (under the Alternative B decoupling proposal). Other benefits cited by the Settlement are: an annual
20 \$2.5 million expense reduction commitment by SWG; continuation of the Company's plan to replace
21 early vintage plastic pipe; creation of a customer-owned yard line replacement program; increased
22 energy efficiency programs; no increase to the current basic monthly charge; and implementation of a
23 revenue decoupling mechanism that will reduce disincentives for SWG to promote energy efficiency
24 programs, and includes a mechanism to protect customers from high winter monthly bills following
25 extreme weather events. (*Id.* at 4-5.)

26 37. The Settlement Agreement requests that the Commission: approve the Settlement in its
27 entirety (including adoption of either the Alternative A or B decoupling mechanism); find that the
28 terms of the Agreement are just and reasonable, and in the public interest; make any other findings

1 that are deemed necessary; and issue an Order with an effective date for new rates no later than
2 January 1, 2012. (*Id.* at 5-6.)

3 **A. Revenue Requirement**

4 38. As reflected in SWG's application and supporting testimony, the Company requested
5 a revenue increase of approximately \$73.2 million, based on a proposed capital structure consisting
6 of 52.30 percent common equity and 47.70 percent long-term debt, an 8.34 percent embedded cost of
7 long-term debt and 11.0 percent cost of common equity, and a fair value rate of return ("FVROR") of
8 7.50 percent. (*Id.* at 6.)

9 39. Through its direct testimony, Staff made a number of adjustments to SWG's proposed
10 rate base, revenues, and expenses, resulting in a recommended revenue increase of approximately
11 \$54.9 million, including a cost of equity of 9.75 percent and a FVROR of 7.02 percent. (*Id.*)

12 40. In its direct testimony, RUCO proposed a revenue increase for SWG of approximately
13 \$29.2 million,³ including a capital structure consisting of 50.15 percent common equity and 49.85
14 percent long-term debt, with a 9.00 percent cost of common equity and 7.35 percent cost of long-term
15 debt. (*Id.*)

16 41. In the Settlement Agreement, the signatory parties propose that Staff's recommended
17 \$54.9 million revenue increase be adopted if the Commission approves the Alternative A decoupling
18 mechanism, or a lower \$52.6 million revenue increase if the Commission adopts the Alternative B
19 decoupling mechanism. (*Id.* at 15.) The alternative decoupling proposals are discussed below.

20 **B. Alternative Decoupling Mechanisms**

21 42. According to the Settlement, the signatory parties agreed to present two alternative
22 revenue decoupling options for the Commission's consideration. Staff supports both Alternative A
23 and Alternative B equally, and SWG also supports both alternatives, with the caveat that it is
24 permitted to express its preference for either option before the Commission. The Settlement provides
25 that the other signatories are permitted to support at least one of the alternatives, but may express
26 their positions about either option before the Commission. (*Id.* at 7.) The signatory parties assert that

27 _____
28 ³ In response to the Settlement Agreement, RUCO proposed an alternative revenue increase of approximately \$44.6 million, which was subsequently revised to \$47.6 million. (Ex. R-10, at 18; Ex. R-15; Tr. 613.)

1 the Settlement, with adoption of either Alternative A or B in its entirety, is in the public interest and
2 the rates produced thereby are just and reasonable. The signatories also state that if any of the
3 components of Alternative A or B are changed, including the other components of the Agreement, the
4 signatory parties may not consider the rates and charges to be just and reasonable. (*Id.* at 14-15.)

5 **1. Alternative A**

6 43. Alternative A consists of a “partial revenue decoupling mechanism,” a monthly
7 weather adjustor, an overall revenue increase of \$54,927,101, a return on equity of 9.75 percent, and
8 a FVROR of 7.02 percent (based on Staff’s original fair value methodology and valuation). (*Id.*)

9 44. If the Commission adopts Alternative A under the Settlement, SWG would implement
10 a decoupling mechanism consisting of a lost fixed cost recovery (“LFCR”) component and a weather
11 component. The LFCR component would allow the Company “to recover lost base revenues
12 attributable to achievement of the Commission’s required annual energy savings,”⁴ and the weather
13 component would “adjust customer bills each month when actual weather during the billing cycle
14 differs from the average weather used in the calculation of rates.” (*Id.*)

15 45. The Agreement states that the LFCR would allow SWG to recover through a per unit
16 surcharge “the total amount of the anticipated lost base revenues, assuming it achieves 100 percent of
17 the Commission’s required annual energy savings.” The anticipated lost base revenues would be
18 trued-up annually to actual lost base revenues attributable to the Company’s achieved energy
19 efficiency results. (*Id.* at 7-8.) However, if SWG fails to meet 100 percent of the Commission’s
20 required annual energy savings, the difference between the 100 percent and actual lost revenue would
21 be refunded to customers during the following year’s annual reconciliation. (*Id.* at 8.) On the other
22 hand, if SWG exceeds 100 percent of the energy efficiency goals in a given year, it would be
23 permitted to recover lost base revenues only up to the 100 percent level in that year; but would be
24 entitled to recover those lost revenues during the following year’s reconciliation adjustment. (*Id.*)

25 46. Under the Settlement, the initial LFCR surcharge would be set at \$0.00213 per therm,
26

27 ⁴ In Decision No. 72042 (December 10, 2012), the Commission adopted the Gas Utility Energy Efficiency Standards
28 (A.A.C. R14-2-2501 et seq.), which require gas utilities to achieve, by December 31, 2020, cumulative annual energy
savings, expressed as therms or therm equivalents, equal to at least 6 percent of the affected utility’s retail gas energy
sales for calendar year 2019.

1 based on the Commission's 2011 energy efficiency savings goal. The Agreement also provides that
 2 the Company will make an annual filing to allow a review of the performance of the LFCR, and
 3 permit SWG an opportunity to recover lost base revenues attributable to the annual energy savings.

4 (*Id.*)

5 47. With respect to the weather-related component of Alternative A, the Settlement would
 6 implement a monthly true-up (upward or downward) to the non-fuel portion of winter bills
 7 (November through April), when actual weather during the billing cycle differs from the average
 8 weather used in the calculation of rates. Thus, in the event of an extreme cold weather event,
 9 customers would receive an immediate benefit on the following month's bills through a downward
 10 adjustment. (*Id.* at 8-9.)⁵

11 Other terms and conditions applicable for Alternative A include:

- 12 • \$50,000 provided by SWG for hiring of an independent consultant to perform the annual
 13 Staff review of the Company's required annual energy savings. (*Id.* at 9.)
- 14 • The LFCR mechanism would not be modified or terminated prior to SWG's next general rate
 15 case unless the Company fails to achieve the required annual energy savings for two
 16 consecutive years, and prior to any such modification of the LFCR a hearing would be
 17 conducted to allow the signatory parties due process and an opportunity to be heard. (*Id.*)
- 18 • No rate case moratorium would be imposed under Alternative A. (*Id.*)
- 19 • SWG would be required to submit a proposed customer outreach/education plan for Staff's
 20 review and approval, to explain how the Company plans to explain decoupling to customers.
 21 (*Id.*)

22 **2. Alternative B**

23 48. Alternative B consists of a "full revenue decoupling mechanism," a monthly weather
 24 adjustor, and an overall revenue increase of \$52,607,414, a return on equity of 9.50 percent, and a
 25 FVROR of 6.92 percent (based on Staff's original fair value methodology and valuation). (*Id.* at 9-
 26 10.)

27 _____
 28 ⁵ Company witness Hester and Staff witness Olea agreed that SWG would not recover the foregone revenues related to the cold weather bill adjustments. (Tr. 144-145, 238.)

1 49. If the Commission adopts Alternative B under the Settlement, SWG would implement
2 a full revenue decoupling mechanism “whereby rates will adjust to reflect any differences between
3 authorized revenues per customer and actual revenues per customer,” as well as the same weather
4 component included under Alternative A. (*Id.* at 10.)

5 50. As described in the Settlement Agreement, the full revenue decoupling mechanism
6 would enable SWG to annually true-up “the difference between the non-gas revenues authorized by
7 the Commission and the actual non-gas revenues experienced by [SWG].” The term “revenues
8 authorized by the Commission” is defined in the Settlement as the “authorized monthly revenue per
9 customer [in this Decision] multiplied by the total number of customers billed for service during the
10 month.” The “revenues experienced” by SWG is defined as “the billed revenue for the month.”
11 Under this provision of the Agreement, a per-therm rate adjustment would be calculated at the end of
12 each year by dividing the balance in the deferred account by the previous 12 months’ sales volume.
13 The rate resulting from that calculation would remain in effect for the following 12-month period in
14 order to refund or collect the deferred account balance. (*Id.*)

15 51. Alternative B would also impose a number of other terms and conditions, including
16 detailed reporting requirements related to the decoupling mechanism. Among other things,
17 Alternative B would require SWG to:

- 18 • File quarterly reports, starting April 30, 2012, regarding the performance of the
19 decoupling mechanism that would address monthly bill impacts for the residential and
20 non-residential sectors, comparing pre- and post-decoupling bills, and monthly bill
21 impacts by individual tariff, based on average therm usage, with comparisons of pre-
22 and post-decoupling bills. (*Id.* at 10-11.)
- 23 • File annual reports, beginning April 2013, to permit the Commission and all parties an
24 opportunity to review the performance of the decoupling mechanism. The annual
25 reports would include a listing of customer complaints related to decoupling, a
26 showing that energy efficiency disincentives have been removed by the end of 2012,
27 compliance with the Commission’s required annual energy savings, analysis of
28 differences between new and existing customers, comparison of new and existing

1 usage per customer (“UPC”), analysis of overall customer usage, UPC, and customer
2 growth pre- and post-decoupling, analysis of customer migration to tariffs not subject
3 to decoupling,⁶ analysis of Company activities supporting new customer growth, and
4 encouragement of new and economic uses of natural gas. (*Id.* at 11.)

- 5 • SWG’s annual filing would be placed on an Open Meeting agenda for the
6 Commission’s consideration of the performance of the full revenue decoupling
7 mechanism, and if the Commission determines that good cause exists to suspend,
8 terminate, or modify the mechanism, a hearing would be conducted to allow the
9 parties due process and an opportunity to be heard. (*Id.* at 11-12.)
- 10 • SWG would be subject to an annual earnings test that would prohibit the Company
11 from recovering any decoupling deferral amounts to the extent that the deferral
12 recovery would increase its earnings above the authorized return on common equity.
13 The details of the earnings test calculation are contained in an attachment to the
14 Settlement, but the following criteria would serve as the baseline for the test: reporting
15 period based on a calendar year; FVRB held constant at \$1,452,933,391; FVROR held
16 constant at 6.92 percent, and all other cost of capital components held constant,
17 including an 8.34 percent cost of debt and 9.50 percent cost of equity; non-gas revenue
18 experienced for the reporting period; recorded operating expenses for the reporting
19 period, as adjusted for certain ratemaking adjustments recommended by Staff; interest
20 expense held constant for purposes of calculating income taxes; and surcharge
21 revenues are not included in the earnings test. (*Id.* at 12-13.)
- 22 • \$75,000 provided by SWG for hiring of an independent consultant to conduct the
23 annual Staff review of the Company’s annual filing. (*Id.* at 13.)
- 24 • Any surcharge developed through the decoupling mechanism that would result in a

25
26 ⁶ The decoupling mechanism would be applicable to the residential, and small, medium and large general service class
27 customers, but would not be applied to: Transportation Eligible General service and Street Lighting (because the rate
28 structure has effectively decoupled their allocated revenue requirement); Small essential Agricultural, Air-Conditioning,
Water Pumping, Electric Generation and Gas Service for Compression (because there are only a small number of
customers served in these classes); and customers served under negotiated rates and contract terms (or special contract
customers). (SWG Ex. 12, at 7-8.)

1 non-gas revenue surcharge of greater than 5 percent, will be capped at 5 percent; and
2 SWG will carry the deferral account balance forward for recovery in the following and
3 subsequent years with no carrying charges. However, there will be no cap on annual
4 surcharge decreases. (*Id.* at 13-14.)

- 5 • SWG agrees not to file a general rate application prior to April 30, 2016, with a test
6 year ending no earlier than November 30, 2015, and the signatories will not request a
7 change to the Company's base rates to take effect prior to May 1, 2017. SWG would
8 not be precluded from filing other interim rate applications as necessary, including
9 demand side management ("DSM") surcharge resets or requests for accounting
10 deferral orders to comply with new or revised pipeline safety requirements or other
11 unfunded state or federal mandates. (*Id.* at 14.)

- 12 • SWG will submit a proposed customer outreach/education plan to Staff for review and
13 approval, to outline how the Company intends to explain decoupling to customers.
14 (*Id.*)

15 **C. Low Income Programs**

16 52. Under both decoupling options, the Settlement includes commitments for low-income
17 customers. SWG is required to improve its education and outreach efforts for the Low Income
18 Energy Conservation ("LIEC") weatherization program, and to provide a total of \$1 million of non-
19 ratepayer funds for the program over the next five years. The Agreement also provides that the DSM
20 adjustor rate for low-income residential customers will not be increased above the current rate of
21 \$0.00200 per therm; the Customer Owned Yard Line cost recovery mechanism (see discussion
22 below) will not be applied to low-income tariff customers; and customers served under the low-
23 income tariff will be subject to a lower rate increase than other customers, because the current 20
24 percent discount for the first 150 therms of usage in winter months (November through April) will be
25 increased to a 30 percent discount. (*Id.* at 15-16.)

26 **D. Other Terms and Conditions**

27 1. Cost of Capital

28 53. The Settlement states that SWG's capital structure will be comprised of 47.70 percent

1 long-term debt and 52.30 percent common equity, with an embedded cost of debt of 8.34 percent,
2 which will be used for ratemaking purposes in this proceeding. (*Id.* at 16.)

3 2. Rate Base

4 54. The Settlement provides that, for ratemaking purposes, SWG's jurisdictional original
5 cost rate base ("OCRB") for the test year ending June 30, 2010, is \$1,070,115,558; its jurisdictional
6 reconstruction cost new depreciated ("RCND") rate base is \$1,835,749,225; and its jurisdictional fair
7 value rate base ("FVRB") is \$1,452,932,391. (*Id.*)

8 3. Energy Efficiency and Renewable Energy Resource Technology

9 55. SWG included in its application a request for approval of its EE and RET plan,
10 pursuant to A.A.C. R14-2-2501 *et seq.* (*Id.*) Under the Settlement, SWG agreed to submit modified
11 EE and RET plans that would exceed the current approved portfolio budget of \$4.4 million, and that
12 would result in customer annual energy savings of at least 1,250,000 therms within 9 months of
13 Commission approval. (*Id.* at 16-17.) In accordance with the terms of the Settlement, SWG filed on
14 September 13, 2011, in Docket No. G-01551A-11-0344, a new application for approval of its revised
15 EE and RET plan.⁷ The Settlement also requires SWG to achieve customer annual energy savings
16 equivalent to the 2011 requirement of the gas energy savings goals within 12 months of Commission
17 approval of the implementation plan. SWG further agrees that in 2012 and beyond, it will comply
18 with the cumulative annual energy savings requirements set forth in A.A.C. R14-2-2501 *et seq.*, and
19 that at least 75 percent of the cumulative annual energy savings shall be achieved through EE
20 programs. (*Id.* at 17-18.)

21 4. Customer Owned Yard Line Replacement Program

22 56. The Settlement provides for implementation of the Customer Owned Yard Line
23 ("COYL") program which will protect customers that do not have a typical meter and service line
24 configuration from potentially costly repair expenses. A normal line configuration is comprised of a
25 meter located adjacent to the housing structure, and the service line from the meter to the gas main is

26 _____
27 ⁷ On September 30, 2011, Staff filed a Staff Report and Recommended Order regarding SWG's Modified Energy
28 Efficiency and Renewable Resource Technology Portfolio Implementation Plan. The modified plan is being considered
by the Commission concurrently with this Decision.

1 owned by SWG. However, in the Tucson area primarily, there are more than 100,000 service lines
2 where the meter is located at or near the customer's property line, and the service line from the meter
3 to the residence is owned by the customer or property owner, similar to the configuration for most
4 water systems. In those instances, responsibility for leak repairs is borne by the customers. When
5 leaks occur, the Company must turn off service until the line is repaired or replaced, and a
6 disproportionate number of COYL configurations are located on older homes for which customers
7 may not be able to afford the necessary repairs. Under the terms of the Settlement, SWG will
8 purchase leak detection devices and set up a program to check COYLs for leaks, and if leaks are
9 found, the Company will replace the COYL with a normal service line configuration. Subject to an
10 annual reporting requirement, SWG will be permitted to add a surcharge to all bills to recover an
11 amount approximately equal to the amount that would have been assessed if the additional plant had
12 been in rate base during the test year. (*Id.* at 18-20.)

13 5. Expense Reduction Plan

14 57. The Settlement requires SWG to identify cost reduction initiatives to reduce its
15 expenses on an annual basis by an average of \$2.5 million per year, beginning in 2012, and that the
16 reduction commitment will continue through the end of the test year in the Company's next rate case.
17 (*Id.* at 20.)

18 6. Customer Communication Improvements

19 58. Another condition of the Settlement requires SWG to file a report in this docket every
20 6 months, beginning March 31, 2012, detailing developments in its efforts to improve
21 communications with customers, including a section on whether the Company can use texting to
22 communicate with customers, or an explanation as to why it is unable to do so. (*Id.*)

23 7. Gas Procurement

24 59. The Settlement requires SWG to create a new section in its Annual Gas Procurement
25 Plan to document the use of financial instruments; and to provide an explanation in any future
26 purchased gas adjustor ("PGA") reports when it begins to recover compressed natural gas costs
27 through the PGA, including an indication of the reasons for such service, the expected length of time
28 such service will be necessary, and the estimated cost and volume of such service. (*Id.*)

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8. Purchased Gas Adjustor

60. The Settlement requires SWG to file, within 60 days of this Decision, documentation defining all current line items in its monthly PGA report; and for the Company to include in the cover letters for future monthly PGA reports an explanation of any additions, deletions, or changes in the terms used in the report. (*Id.* at 21.)

9. Yuma Manors

61. The Settlement precludes SWG from recovering in base rates the remaining \$225,445 associated with the Yuma Manors pipe replacement project in 2006, which was discussed in Decision No. 70665. (*Id.*)

10. Early Vintage Plastic Pipe

62. The Settlement requires SWG to continue its 20-year plan for replacing early vintage plastic pipe (“EVPP”), and provide documentation in future rate cases of progress and money spent on EVPP replacement. The Company is prohibited from establishing a deferral account for EVPP replacement, and may not modify or discontinue the write-off requirements associated with Aldyl HD pipe. (*Id.*)

11. Development of Gas Heat Pump Technology

63. According to the Settlement Agreement, gas heat pump technology development costs will be removed from the Company’s operating expenses; no new gas heat pump projects will be funded through SWG’s research and development (“R&D”) surcharge; SWG is required to prepare an accounting of the development costs funded by Arizona ratepayers through base rates and the R&D surcharge, prepare a plan to reimburse ratepayers for their proportionate level of funding of gas heat pump technology development costs, and file the plan within 90 days of the Decision in this case to be followed by a Staff recommendation to the Commission within 120 days thereafter. The reimbursement plan will include a methodology for how the benefits of any commercialization revenues and royalties associated with the gas-fueled air conditioning units are to be shared with SWG’s Arizona ratepayers, to ensure that customers receive credit for any investment that contributed to the development of the technology. (*Id.* at 21-22.)

...

1 12. Incremental Contribution Method

2 64. The Settlement requires SWG to continue use of the incremental contribution model
3 (“ICM”) and submit, within 30 days of the effective date of this Decision, a revised ICM model that
4 prevents the Company from collecting contributions in aid of construction (“CIAC”) that result in an
5 expected ROE, as generated through the ICM model, that is more than 50 basis points above the
6 return on common equity authorized by this Decision. Staff is required to submit a recommendation
7 to the Commission within 90 days of SWG’s filing of the revised ICM model. (*Id.* at 22.)

8 13. Depreciation Study

9 65. The Settlement requires SWG to file a comprehensive depreciation study in its next
10 general rate case that addresses depreciation and amortization rates for all of the Company’s
11 jurisdictional Direct and System Allocable depreciable and amortizable plant accounts. (*Id.* at 23.)

12 14. Rate Design and Revenue Allocation

13 66. With respect to the base rate revenue allocation, the Settlement provides that revenue
14 responsibility will be allocated among all classes equally, with the exception of the low-income rate
15 schedules. A comparison of the residential rate impacts based on the Company’s original application,
16 Staff’s direct testimony, and the Settlement Agreement under Alternative A and B, is set forth in the
17 Table below.

	Company Direct	Staff Direct	Settlement Alternative A	Settlement Alternative B
Overall Average Rate Increase (%)	9.26%	6.95%	6.95%	6.66%
Average Rate Increase (%) – RESIDENTIAL	13.55%	10.31%	8.11%	7.77%
Average Monthly Bill Impact RESIDENTIAL	\$5.81	\$4.42	\$3.48	\$3.33
Average Rate Increase LOW INCOME	16.08%	11.61%	2.16%	1.81%
Average Monthly Bill Impact – LOW INCOME	\$5.20	\$4.04	\$0.70	\$0.59

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26 The Agreement also requires SWG to include in its next general rate case a proposal for an inclining
27 block rate design. (*Id.*)
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1 15. Miscellaneous Tariff Changes

2 67. The Settlement provides that the miscellaneous changes included in SWG's proposed
3 tariffs will be approved, except as otherwise indicated. The Company is required to modify its
4 Arizona Gas Tariff in accordance with Staff's recommendation supporting metering configurations
5 where a sub-meter is installed by SWG downstream of the primary meter. (*Id.* at 24.)

6 E. Force Majeure

7 68. The Settlement Agreement provides that SWG will not be prohibited from seeking a
8 change to base rates in the event of an emergency, which is defined as "an extraordinary event that is
9 beyond [the Company's] control and that, in the Commission's judgment, requires base rate relief in
10 order to protect the public interest." (*Id.*)

11 F. Commission Evaluation of Settlement

12 69. The Settlement indicates that if the Commission issues an Order adopting all material
13 terms of the Agreement, the signatory parties will be bound by the terms approved by the
14 Commission. The signatories, except Staff, are permitted to advocate their respective positions
15 regarding Alternatives A or B, but if either of the decoupling options are approved in their entirety,
16 the signatories must support the Settlement and may not request rehearing under A.R.S. § 40-253, or
17 modification under A.R.S. § 40-252. If the Commission makes material modifications to the
18 Agreement, including to Alternative A or B, any or all of the signatory parties may withdraw from
19 the Settlement. (*Id.* at 24-26.)

20 G. Miscellaneous Provisions

21 70. The Settlement indicates, among other things, that the Settlement Agreement
22 represents a compromise of disputed issues by parties with diverse interests, in a manner consistent
23 with the public interest; that the Agreement may not be construed as an admission by any party as to
24 the reasonableness or unreasonableness of any position previously taken; may not be used or cited as
25 precedent in any other proceeding or forum; and each of the terms is in consideration of all other
26 terms of the Settlement, and is therefore not severable from the other terms. (*Id.* at 26-27.)

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1 **III. Arguments in Support of and Opposition to Settlement**

2 **A. Opposition to Settlement Agreement**

3 1. RUCO

4 71. RUCO argues that neither of the decoupling alternatives included in the Settlement
5 Agreement should be adopted by the Commission because, among other things, “the timing is
6 bad...[and] there is significant ratepayer opposition...” (RUCO Initial Brief, at 2.) RUCO cites to
7 the denial of decoupling proposals in SWG’s prior two rate cases, and asserted that the Commission
8 should do so again.

9 72. In Decision No. 68487 (February 23, 2006), the Commission declined to adopt SWG’s
10 proposed “conservation margin tracker” finding that the issue of revenue decoupling “should be fully
11 explored as part of a broader investigation of usage volatility and margin recovery.” (Decision No.
12 68487, at 34.) The Commission directed the Company to pursue discussions of the decoupling issue
13 with other parties “through the DSM policy process...and through a proposal in the Company’s next
14 rate case.” (*Id.*) In Decision No. 70665 (December 24, 2008), the Commission again denied SWG’s
15 decoupling proposals, which it separated into two mechanisms, a “weather normalization adjustment
16 provision” and a “revenue decoupling adjustment provision.” (Decision No. 70665, at 40-41.)
17 However, the Commission pointed out that the issue of revenue decoupling was being addressed in
18 generic investigations (Docket Nos. G-00000C-08-0314 and E-00000J-08-0314) for both gas and
19 electric utilities, and indicated that the generic docket was the most appropriate forum to address
20 decoupling.⁸ (*Id.*)

21 73. Ms. Jerich testified that a decoupling mechanism should not be adopted, at this time,
22 given current economic factors including Arizona’s high poverty rate, high foreclosure rates, and the
23 “underwater” mortgage situation faced by many residents. (Tr. 688-689.) RUCO also argues that the
24 ratepayer benefits that would be gained by implementing decoupling under the Settlement would not
25 outweigh the shifting of risk from SWG to customers. According to RUCO, unlike an electric utility
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27 ⁸ See, *Final ACC Policy Statement Regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures*
28 (December 29, 2010) (Docket Nos. G-00000C-08-0314 and E-00000J-08-0314) (“Policy Statement”). The Policy
Statement Conclusions (pages 30-32) are attached hereto as “Exhibit B.”

1 that generates its own power and which could potentially defer additional generation facilities
2 through increased energy efficiency measures, SWG is a gas distribution company that could not
3 similarly delay infrastructure investment due to conservation. RUCO claims that there are no
4 substantive financial benefits that would be realized by ratepayers from decoupling, compared to the
5 revenue windfall that would be gained by SWG if decoupling is approved.

6 74. RUCO points to the direct testimony filed by Staff witness David Dismukes prior to
7 negotiation of the Settlement Agreement, in which Mr. Dismukes stated that SWG would have
8 collected an additional \$62 million if decoupling had been in place from 2007 through 2010. (Ex. S-
9 3, at 16-17.) RUCO contends that in exchange for the additional revenue SWG is likely to receive if
10 decoupling is approved, the Settlement Agreement provides for a revenue requirement that is the
11 same as Staff's direct case recommendation if Alternative A is adopted (\$54.9 million increase/9.75
12 percent ROE), and only \$2.3 million less than Staff's direct case recommendation if Alternative B is
13 adopted (\$52.6 million increase/9.50 percent ROE). RUCO argues that the other ratepayer benefits
14 included in the Settlement, such as the annual \$2.5 million expense reduction requirement, will
15 actually benefit shareholders by reducing SWG's costs, and that ratepayers would not realize any
16 benefit from the expense reductions until the Company's next rate case which, under Alternative B,
17 would be at least five years in the future. (RUCO Ex. 10, at 9.) RUCO further contends that other
18 claimed ratepayer benefits under Alternative B, such as the five-year stay out provision, the lower
19 ROE and capital costs, and rate stability, will provide as much of a benefit to the Company's
20 shareholders by virtue of the assured revenue stream that would exist under decoupling.

21 75. RUCO next asserts that the public does not support decoupling, and cites to organized
22 efforts by American Association of Retired Persons ("AARP") and Sun City residents as examples of
23 public opposition.⁹ According to RUCO, the public perception that decoupling is not beneficial to
24 customers is valid because even if individual customers are able to conserve gas, and thereby lower
25 their overall bills, the rate that is paid for the non-gas portion of the bill will increase, assuming
26 declining usage and revenues on a customer class basis. (Tr. 556-559.) RUCO argues that with

27 ⁹ We note that the Commission has received hundreds of public comment letters, emails and phone calls in opposition to
28 decoupling and SWG's proposed rate increase through filings with Docket Control, and contacts made with Consumer
Services and Commissioners' offices.

1 decoupling, even if customers are able to reduce their total bills through reduced usage, they will still
2 end paying more than they otherwise would have paid.

3 76. RUCO claims that neither of the proposed decoupling alternatives is in the public
4 interest because customer rates will increase more as usage and revenues decline on a per customer
5 basis. RUCO asserts that even the settling parties themselves are not in agreement regarding the
6 preferred decoupling option. RUCO cites to the testimony of witnesses for SWG, AIC, and NRDC,
7 who prefer adoption of Alternative B, and to the testimony of Mr. Schlegel on behalf of SWEEP,
8 who testified that Alternative A is not in the public interest. (Ex. A-16, at 9; AIC Ex. 2, at 4; Tr. 361-
9 62; SWEEP Ex. 2, at 4.) RUCO criticizes SWEEP's joinder in the Settlement Agreement given
10 SWEEP's opposition to one of the options being presented to the Commission (Alternative A).

11 77. With respect to Alternative B, specifically, RUCO contends that it would send a signal
12 to customers that usage reductions as a class will result in automatic per therm rate increases in the
13 future, thus providing a disincentive for customers to conserve. (RUCO Ex. 10, at 7.) RUCO cites to
14 concerns expressed in a prior SWG case, in which the Commission stated:

15 Further, as RUCO points out, the likely effect of adopting the proposed
16 CMT is that residential customers will be required to pay for gas that they
17 have not used in prior years, a phenomenon that could result in
18 disincentives for such customers to undertake conservation efforts. We
19 are also concerned with the dramatic impact that could be experienced by
20 customers faced with a surcharge for not using "enough" gas the prior
21 year. The Company is requesting that customers provide a guaranteed
22 method of recovering authorized revenues, thereby virtually eliminating
23 the Company's attendant risk. Neither the law nor sound public policy
24 requires such a result and we decline to adopt the Company's CMT in this
25 case.¹⁰

26 78. RUCO also argues that decoupling should be rejected because declining customer
27 usage is a normal risk faced by all utilities, and between rate cases a company's revenues may
28 fluctuate due to various factors such as inflation and weather. RUCO asserts that decoupling is
29 simply a means to enable companies to shift risks associated with regulatory lag from customers to
30 shareholders. In addition, RUCO contends that Alternative B would ignore other regulatory lag
31 factors associated with declining usage, such as growth and declining interest rates. RUCO argues

¹⁰ Decision No. 68487, at 34.

1 that adoption of decoupling would effectively constitute a form of single issue ratemaking, which is
2 contrary to court decisions such as *Scates*.¹¹

3 79. RUCO also makes the argument that the Settlement is inconsistent with the
4 Commission's Policy Statement which expresses a preference for full decoupling (such as Alternative
5 B), but also encourages applying decoupling in a manner that encourages energy efficiency. RUCO
6 asserts that both decoupling options include a weather normalization component, which is
7 discouraged under the Policy Statement because normalization would reduce the size of decoupling
8 surcredits to customers following an extreme weather event. (RUCO Ex. 1, at 31.) RUCO also
9 claims that the Policy Statement requires decoupling "cap adjustments" to be designed to encourage
10 gradualism, and that the proposed Settlement Agreement cap exceeds the 3 percent adjustment
11 amounts discussed during the decoupling workshops. (*Id.* at 16-17.) Another criticism raised by
12 RUCO is that the Settlement Agreement does not address whether new customers should be treated
13 differently from existing customers. RUCO contends that the Settlement includes new and existing
14 customers, although the parties in the decoupling workshops suggested that "further analysis was
15 needed" to determine whether a separate treatment was necessary. (*Id.* at 13.)

16 80. RUCO concluded that decoupling is an extreme solution to the issue of declining
17 usage and revenues, and that it would be advisable for the Commission to consider other less extreme
18 measures to addressing declining sales. RUCO recommends that the Commission reject the
19 Settlement and adopt RUCO's rate design "alternative."

20 a. RUCO's "Alternative" Proposal

21 81. RUCO presented through its testimony in opposition to the Settlement an alternative
22 rate design proposal "in the spirit of compromise." (RUCO Ex. 10, at 18.) Under this proposal,
23 RUCO recommends that the Commission approve a total revenue increase of \$47.6 million, based on
24 a cost of equity of 9.50 percent, and use the FVROR methodology adopted in Decision No. 71914
25 (for UNS Electric), and weather normalization using an unadjusted 30-year average. (*Id.* at 18;
26 RUCO Ex. 14, at 10; RUCO Ex. 15.) RUCO's alternative rate design proposal would increase the
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¹¹ *Scates v. Arizona Corporation Commission*, 118 Ariz. 531 (App. 1978).

1 basic monthly customer charge from \$10.70 to \$11.85, compared to the Settlement Agreement which
2 would retain the customer charge at the current rate of \$10.70. With these components, RUCO does
3 not oppose the other terms of the Settlement Agreement.

4 82. RUCO contends that its alternative proposal would help mitigate the declining usage
5 problem by allowing SWG to recover more of its fixed costs through the fixed monthly charge. (Ex.
6 R-10, at 16.) RUCO also asserts that this alternative approach would help boost the Company's cash
7 flows; reduce revenue volatility; and reduce the risk that SWG would not be able to recover its
8 authorized revenue requirement. (*Id.* at 17.)

9 **B. Settlement Agreement Proponents**

10 83. All of the signatory parties to the Settlement Agreement support the full decoupling
11 option, Alternative B, with only Staff being equally supportive of either option.

12 1. Southwest Gas

13 84. As described by SWG witness Hester, Alternative B includes a number of
14 characteristics that are not part of the partial decoupling option, Alternative A. He gave the following
15 examples of benefits that are unique to Alternative B: quarterly and annual reporting requirements,
16 including a decoupling performance review; an earnings test requirement that would limit recovery of
17 decoupling deferral amounts in excess of the Company's authorized return on common equity
18 ("ROE"); an annual cap of 5 percent per year of non-gas revenue that would be collected through the
19 decoupling annual adjustment; a five-year rate case moratorium; and a communication plan
20 requirement for outreach and education to explain decoupling to customers. (SWG Ex. 16, at 8-9.)

21 85. Mr. Hester testified that although SWG agreed to support either decoupling option, the
22 Company strongly supports Alternative B as the superior decoupling mechanism. He gave the
23 following reasons for the Company's preference for the full decoupling option: prevents utility profit
24 from increased sales; ensures customers pay no more than costs authorized by the Commission;
25 enhances SWG's focus on cost controls; includes customer protection from high winter bills due to a
26 severe weather event; would not require additional complex contested proceedings that may occur
27 under Alternative A; decreases the frequency of rate cases; greater acceptance of decoupling
28 nationally by regulatory commissions; allows for both upward and downward rate adjustments;

1 addresses the long-term declining usage issue for SWG; and retains immediate permanent customer
2 savings on commodity costs. (*Id.* at 9-10.)

3 86. Other provisions cited by SWG as being in the public interest include: the COYL
4 replacement program; a commitment by SWG of \$1 million of non-ratepayer funds to the LIEC
5 weatherization program over five years; an increase in the discount provided to Low Income Rate
6 Assistance (“LIRA”) customers, from 20 percent to 30 percent; an expense reduction requirement of
7 \$2.5 million per year for SWG; a modified energy efficiency/renewable energy tariff plan
8 requirement to improve SWG’s program offerings; and no increase in the residential monthly
9 customer charge. (SWG Ex. 14, at 4-5, 15-20.)

10 87. SWG makes several arguments as to why the Settlement Agreement is fair, just, and
11 reasonable, and in the public interest. The Company claims that it has been unable to achieve its
12 Commission-authorized ROE for at least 15 years due to declining customer usage, and that the
13 Commission’s adoption of the EE standards will further exacerbate the issue as customers achieve
14 even greater gas conservation. (Tr. 86-87, 97-98.) The Company contends that adoption of a revenue
15 decoupling mechanism would provide customer bill stability, as well as revenue stability for SWG
16 which will benefit customers in the long-term through higher credit ratings and lower costs of debt.
17 (Tr. 139-141, 154-155, 354, 371-375, 507-508.)

18 88. SWG states that it is cognizant of the numerous letters and emails received by the
19 Commission, but claims that such correspondence should not be construed as overwhelming
20 opposition to the Settlement, or the decoupling proposals. The Company asserts that many of the
21 letters reference the original request for a \$73.2 million increase, rather than the substantially lower
22 amount included in the Settlement (either \$54.9 million or \$52.6 million). SWG also contends that,
23 with respect to development of its decoupling proposal, the Company carefully considered comments
24 made during the decoupling workshops, as well as statements made by organizations such as AARP.
25 The Company claims that it recognizes there are ongoing questions about how decoupling works,
26 which is why the Settlement requires SWG to work with Staff to develop customer education and
27 outreach materials related to decoupling. (See, SWG Ex. 14, at 9, 14.)

28 89. SWG asserts that RUCO’s arguments in opposition to the Settlement are without

1 merit. First, with respect to RUCO's claim that the FVROR methodology proposed by Staff and
2 included in the Agreement is unsound, the Company points out that the same methodology was
3 approved by the Commission in SWG's prior rate case, and that RUCO's own witness conceded that
4 his criticism of the methodology was misplaced based on his misunderstanding of Staff's testimony.
5 (Tr. 79, 775-776.) Next, SWG disputes RUCO's concern with the Settlement's use of a 10-year
6 weather normalization for determining the revenue requirement. Although Dr. Johnson advocated the
7 use of a 30-year normalization period, SWG witness Hester testified that the Commission has
8 consistently adopted a 10-year normalization period since at least the early 1990's, and that RUCO's
9 proposal would ignore the long-term warming trend that exists in SWG's service area. (Tr. 79-80.)

10 90. RUCO's final, and primary, point of opposition to the Settlement Agreement is related
11 to the inclusion of a decoupling mechanism. SWG asserts that Dr. Johnson's claims that decoupling
12 is a highly controversial issue, and represents risky and uncharted territory, are unfounded and not
13 supported by the record. SWG cites to the following testimony of NRDC witness Cavanagh,
14 addressing the history of the decoupling workshops, to support its argument:

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

23 (Tr. 370-371.) With respect to RUCO's argument that decoupling would discourage energy
24 conservation, SWG points to SWEEP witness Schlegel's testimony at the hearing that "under
25 decoupling, there is still a significant incentive to conserve," (because overall customer bills would
26 still be less due to lower gas costs associated with conservation) and that RUCO's recommendation to
27 increase the basic monthly customer charge "is a much more impactful disincentive to efficiency than
28 decoupling could ever be." (Tr. 417-418, 431.)

91. SWG also disputes RUCO's claim that there are no current disincentives to the
Company pursuing energy efficiency goals. SWG cites RUCO witness Jerich's admission that under

1 the existing regulatory model a financial disincentive exists for aggressively pursuing DSM and
2 energy efficiency programs (Tr. 716-717), and the Company argues that the Commission's Policy
3 Statement acknowledges that utilities currently face financial disincentives to promoting energy
4 efficiency. (RUCO Ex. 1, at 2, 4, 27, 30.) The Company claims that, contrary to RUCO's assertions,
5 the Settlement Agreement provides real benefits to customers that would likely not have been
6 achievable in a fully litigated proceeding (under Alternative B), including winter bill adjustments due
7 to severe weather, a five percent cap on non-gas revenue increases, rate case moratorium, earnings
8 test, and ongoing Commission oversight of the decoupling mechanism. Nor, according to SWG, has
9 RUCO presented any evidence that the 25 basis point reduction in the ROE (under Alternative B) is
10 not sufficient recognition of a perceived shifting of risk from the Company to ratepayers.

11 92. Regarding RUCO's argument that decoupling is not justified because infrastructure
12 construction would not be delayed or avoided, SWG contends that revenue decoupling, as stated in
13 the Policy Statement, "achieves the primary purpose of reducing utility disincentives to implementing
14 demand side programs and reducing energy consumption." (RUCO Ex. 1, at 4.) Moreover, according
15 to SWG, deferral of infrastructure is not of paramount importance for gas distribution companies with
16 decoupling, as evidenced by the testimony of various witnesses in support of the Settlement,
17 including Mr. Hester, Mr. Hansen, Mr. Cavanagh, and Mr. Schlegel. (Tr. 134-137, 266-267, 320-321,
18 402-403, 472-474.) Mr. Hester stated that customers will experience immediate savings through
19 conservation efforts because "if a customer uses one less therm today, we will have to buy from our
20 supplier one less therm of gas. We will never incur that cost. We will never pass that on to
21 customers." (Tr. 135.)

22 93. The Company also criticizes RUCO's contention that SWG is not deserving of
23 decoupling because it is not in poor financial health. SWG claims the Policy Statement makes clear
24 that the purpose of implementing decoupling is to encourage conservation through DSM programs
25 and to enable Arizona utilities to meet the standards set forth in the EE rules. The Company contends
26 that although it has recently received upgraded credit ratings, those ratings were based in part on the
27 request for decoupling in this case. SWG also points out that it has not been able to earn its
28 authorized return for many years, a fact not disputed by any party.

1 94. SWG contends that RUCO's opposition in this case is not based on any concerns that
2 were not already addressed during the decoupling workshops, and that the four specific requirements
3 identified by Ms. Jerich during the workshops as being necessary for RUCO's support (i.e., cost
4 effectiveness, commitment to energy efficiency with identified goals, a high degree of accountability,
5 and a cap on amounts that will be recovered) are all satisfied by the Settlement Agreement, by Ms.
6 Jerich's own admission. (SWG Ex. 17; Tr. 726-728.)

7 95. SWG asserts that despite RUCO's opposition, it has failed to present any viable
8 alternatives to the Settlement's decoupling options. The Company points out that RUCO initially
9 proposed a weather adjustment mechanism through Dr. Johnson's testimony, but later abandoned that
10 position after seeing that the Settlement included a weather component under both decoupling
11 options. (RUCO Ex. 7, at 26-27; Tr. 589-590.) SWG argues that the Policy Statement allows for
12 "...alternative methods for addressing utility financial disincentives...to encourage and enable
13 aggressive use of demand side management programs and the achievement of Arizona's Electric and
14 Gas Energy Efficiency Standards...." (RUCO Ex. 1, at 30.)

15 96. As discussed above, RUCO's alternative consists of a proposal to increase the basic
16 residential customer charge from \$10.70 to \$11.85 per month. According to SWG, RUCO's
17 alternative recommendation is flawed because its own witnesses conceded that increasing the basic
18 customer charge would cause low-volume customers to pay a higher average rate per therm than
19 higher volume users, and would create a disincentive to conserve compared to a lower customer
20 charge. (Tr. 592-593, 741-742.) Accordingly, SWG contends that RUCO's alternative proposal
21 should be denied as being inconsistent with the goals set forth in the Commission's Policy Statement.

22 2. Arizona Investment Council

23 97. AIC argues that traditional rate design creates an inherent conflict between DSM and
24 energy efficiency goals because currently the Company is allowed to recover less than half of its
25 fixed costs through the monthly customer charge, with the remainder of fixed costs incorporated into
26 the non-gas per-therm rate. According to AIC, this type of rate structure, combined with declining
27 usage trends, results in a situation in which companies such as SWG are not able to achieve their
28 Commission authorized rates of return. (Tr. 87.)

1 98. AIC points out that the Commission's adoption of aggressive energy efficiency
2 standards will exacerbate the current trend in declining usage, and therefore the Company must be
3 allowed to have a reasonable opportunity to recover its fixed operating costs through a revenue
4 decoupling mechanism. AIC cites the hearing testimony of several witnesses to support its argument,
5 including Staff's Utilities Division Director, Steve Olea, who testified that:

6 [T]he company is being mandated to conserve a certain amount. And if
7 we assume that they are going to comply with the [EE] rules, which I
8 assume all companies try to comply with the rules, then they are going to
9 sell that amount of gas less. And if you know that, then they need to get
10 compensated for that.

11 (Tr. 213-214.) Staff witness Barbara Keene added:

12 [T]here is a disincentive for a utility to be required not to sell its
13 product...So, you know, although they always try to comply with
14 Commission rules to the best of their ability, it becomes difficult when the
15 [EE] requirement is so high.

16 (Tr. 524.)

17 99. AIC raises arguments similar to those made by SWG and the other parties to the
18 Settlement. AIC points out that efforts leading to the Agreement occurred over a number of years,
19 through discussions, analysis and collaboration, and that adoption of a decoupling mechanism was
20 eventually supported in this case by all interested parties, including Staff, with the exception of
21 RUCO. AIC contends: the Settlement Agreement is consistent with the Commission's Policy
22 Statement; that decoupling is no longer a novel concept, having been adopted in at least 22 states for
23 gas utilities (NRDC Ex. 1, at 6); the number of customer complaints has decreased and customer
24 satisfaction has increased where decoupling has been adopted (Tr. 267-269); and adoption of
25 decoupling in Nevada, and the prospect of approval in Arizona, has improved SWG's credit ratings.

26 (AIC Ex. 2, at 3.)

27 100. AIC also makes many of the same points raised by the Company with respect to the
28 customer benefits and protections included in the Settlement. AIC points out that the Agreement
satisfies all the elements identified by Ms. Jerich during the decoupling workshops, that the
Settlement contains numerous reporting requirements, as well as an earnings test to prevent returns

1 above the authorized ROE, and imposes substantial expense reduction obligations by SWG. AIC
2 cites to Mr. Olea's testimony at the hearing that the Settlement Agreement's annual review of the
3 merits of the decoupling for SWG "is actually more stringent than any other in the nation." (Tr. 205.)

4 101. AIC also responded to the public comments made by AARP's state director in
5 Arizona, David Mitchell. AIC contends that although AARP opposes either of the proposed
6 decoupling mechanisms, as well as RUCO's alternative rate design, Mr. Mitchell conceded that
7 Alternative B in the Settlement "comes closest to including the consumer protections we believe are
8 essential if decoupling is to be adopted." (Tr. 16.) With respect to AARP's criticism of the 5 percent
9 cap on increases under Alternative B, AIC points out that because the 5 percent cap applies only to
10 non-gas revenue, it is actually a 2.5 (or less) percent cap on the full bill or revenue amount. (Tr. 437.)
11 Finally, AIC asserts that AARP's concern with the length of the five-year rate moratorium is
12 misplaced, given the Settlement's ongoing annual reporting requirement that would allow
13 modification or elimination of the decoupling mechanism by the Commission. AIC contends that the
14 Settlement Agreement, especially with adoption of the Alternative B decoupling mechanism,
15 provides substantial customer benefits, removes the disincentive for SWG to promote conservation
16 programs, and therefore should be approved by the Commission.

17 3. Southwest Energy Efficiency Project

18 102. SWEEP, as a signatory party, supports adoption of the Settlement Agreement and
19 advocates strongly for approval of Alternative B as the decoupling option that would better align the
20 interests of SWG and its customers, and would reduce the Company's disincentive to promote energy
21 efficiency while offering customers more opportunities to reduce their energy bills. (SWEEP Ex. 2, at
22 2.) Mr. Schlegel testified that the Settlement, with Alternative B, would, among other things: result
23 in a lower revenue requirement (relative to Alternative A); provide a number of customer protections
24 including a yearly 5 percent cap on non-gas revenue adjustments, impose annual reporting and review
25 requirements and an earnings test, and includes a severe weather adjustment mechanism for winter
26 bills. (*Id.* at 2-4.)

27 103. SWEEP contends that only under Alternative B would revenues be fully decoupled
28 from sales, thereby removing the Company's financial disincentive to pursue energy efficiency

1 programs, including advocating for more efficient building codes and appliance standards, for which
 2 the Company would receive partial credit towards meeting the EE standards. (Tr. 480-481.) Finally,
 3 SWEEP argues that the Commission should not adopt RUCO's alternative proposal to increase the
 4 basic customer charge because it would have a negative impact on low- and fixed-income customers,
 5 as well as lower usage customers.

6 4. Natural Resources Defense Council

7 104. Similar to the points made in support of the Settlement Agreement by SWG, AIC, and
 8 SWEEP, NRDC contends that Alternative B should be adopted by the Commission because it is
 9 consistent with the goals of the Commission's Policy Statement, removes SWG's ability to profit
 10 from increased gas sales, increases the likelihood that the Company will be able to meet the EE
 11 standards, and offers a number of customer benefits such as a lower revenue requirement, a cap on
 12 annual non-gas adjustments, and a five-year rate moratorium. NRDC witness Ralph Cavanagh
 13 testified that some form of gas decoupling has been approved in at least 22 other states, and that
 14 based on findings obtained through a national study, adjustments "go in both directions" and
 15 "[t]ypical adjustments in utility bills 'amount[ed] to less than \$1.50 per month in higher or lower
 16 charges for residential gas customers and less than \$2.00 per month...for residential electric
 17 customers.'"¹² Mr. Cavanagh stated that full revenue decoupling, like that offered by Alternative B,
 18 should be approved because:

19 [P]artial decoupling like that of Alternative A would undercut the whole
 20 process of the mechanism, while creating perverse incentives. It would
 21 reintroduce automatic penalties, in the form of reduced fixed-cost
 22 recovery, for all cost-effective natural gas savings not directly associated
 23 with savings determined to have been 'achieved' by the Company, even
 24 when the Company by action or inaction could make a material difference
 25 in prospects for those savings....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...[and] would ensure adversarial discord over every savings
 calculation, since significant financial stakes would hinge on the results.

26 (NRDC Ex. 2, at 4-5.) He added that under Alternative A, SWG would retain strong incentives to

27 _____
 28 ¹² NRDC Ex. 1, at 7, citing Pamela Lesh, Rate Impacts and Key Design Elements of Gas and Electric Utility Decoupling:
 A Comprehensive Review, *Electricity Journal* (October 2009), at 67.

1 promote higher gas sales because, unlike Alternative B, the Company would retain fixed cost
2 recovery in excess of that authorized by the Commission. (*Id.* at 5.)

3 105. Regarding RUCO's alternative proposal, which it calls a form of fixed cost/variable
4 pricing, NRDC points out that the Commission's Policy Statement indicates that such proposals
5 "have limited application" and "would result in larger customer charges, which impact low-income
6 customers, and reduced variable charges, which discourages efficient energy use." (RUCO Ex. 1, at
7 28.)

8 5. Cynthia Zwick

9 106. In her testimony in support of the Settlement, Ms. Zwick indicates that she did not
10 participate in discussions on, nor is she taking a position on, the issue of decoupling or the relative
11 merit of Alternative A or B. However, she supports adoption of the Agreement as a signatory party,
12 and points to the benefits set forth in the Settlement on behalf of low-income customers, as described
13 above. (Zwick Ex. 2, at 2-4.)

14 6. Staff

15 107. Staff contends that the Settlement Agreement is in the public interest and should be
16 adopted by the Commission. Staff points out that the Agreement addresses the interests and concerns
17 raised by a wide and divergent group of parties, and that the negotiation process was open and
18 transparent.

19 108. As described by Staff witness Steve Olea, the Settlement balances SWG's need for a
20 revenue increase with a number of customer benefits, including: an increased low-income customer
21 discount; a commitment by SWG to increase funding for low-income weatherization to \$1 million
22 over 5 years; a Company commitment to develop enhanced communication programs for low-income
23 programs; alternative decoupling mechanisms which will have a positive impact on SWG's financial
24 profile and credit ratings, which will benefit customers by reducing the Company's capital costs; a
25 number of ratepayer protection terms that will mitigate the size and frequency of future rate cases; a
26 five-year rate case moratorium; a \$2.5 million per year expense reduction requirement for SWG;
27 continuation of SWG's 20-year plan to replace problematic early vintage plastic pipe; establishment
28 of the COYL program; energy efficiency initiatives that will result in annual customer energy savings

1 of at least 1,250,000 therms within nine months of approval of the Company's modified EE and RET
2 plan; alternative decoupling mechanisms that align Company, customer, and societal interests to
3 pursue customer bill savings through the EE rules, providing SWG with incentives to support
4 customer energy efficiency; protection for customers from high monthly winter bills following
5 extreme weather events; and no increase to the monthly service charge, which will enhance customer
6 bill savings through energy efficiency and conservation efforts. (Staff Ex. 9, at 12-14.)

7 109. With respect to the alternative decoupling proposals included in the Agreement, Staff
8 states that it supports Alternatives A and B equally. Staff claims that Alternative A would preserve
9 the traditional performance/rate relationship by tying SWG's lost fixed cost recovery to energy
10 efficiency savings. Staff asserts that the LFCR mechanism of Alternative A would provide a
11 meaningful incentive for the Company to meet energy efficiency goals, and Staff witness Barbara
12 Keene downplayed the potential contentiousness of proceedings devoted to determining lost revenue
13 calculations under the LFCR. (Tr. 519.) Ms. Keene testified that Alternative A would require SWG
14 to submit annual filings detailing costs incurred, and savings realized, from energy efficiency
15 programs. Staff also argues that Alternative A is consistent with the Policy Statement, would offer
16 the Company the ability to recover revenue lost due to implementation of energy efficiency measures,
17 and therefore represents a viable means of addressing the disincentive that currently exists for SWG
18 to pursue energy efficiency measures.

19 110. Staff notes that under Alternative B, SWG's revenue increase would be \$2.3 million
20 lower compared to Alternative A (\$52.6 million v. \$54.9 million), and that Alternative B includes a
21 reduced ROE of 9.50 percent, 25 basis points lower than under Alternative A. (Staff Ex. 9, at 20.)
22 Staff points out that Alternative B also includes a number of conditions, including quarterly and
23 annual reporting requirements, an annual review process of the decoupling mechanism, an annual
24 earnings test, and a 5 percent cap on recovery of annual non-gas rate adjustments. Staff asserts that,
25 according to AIC witness Dr. Hansen, the Alternative B conditions are more stringent than in many
26 other states, where annual reviews typically do not occur for several years and do not include an
27 earnings test. (Tr. 355.) Staff claims that these conditions and restrictions are in addition to the
28 multiple additional customer benefits and protections discussed above.

1 111. Staff is critical of RUCO's alternative, and noted that even AARP opposes RUCO's
2 alternative. (Tr. 17.) Mr. Olea testified that shifting more cost recovery into the fixed monthly charge
3 would have a negative impact on low use customers who would be unable to reduce their bills no
4 matter how much they conserve. (Tr. 176.) With respect to RUCO's citation to the pre-Settlement
5 testimony filed by Mr. Dismukes, and the claim that SWG would have recovered an additional \$62
6 million from customers if decoupling had been in place from 2007-2010, Staff points to the testimony
7 of Mr. Hester who stated that the rates during that period were based on gas volumes ranging from
8 347 to 332 therms, rather than the 297 therm assumption used in this case. (Tr. 78.) Mr. Hester
9 indicated that if the volumes used in that exercise were based on the volumes being proposed in this
10 case, customers would have been refunded \$66 million in revenues during that same period if
11 decoupling had been in place. (*Id.* at 78-79.)

12 **IV. Constitutional Arguments Regarding Decoupling**

13 112. At the conclusion of the hearing, the parties were asked to address in their briefs
14 whether adoption of a decoupling mechanism, as contained in the Settlement Agreement, would be
15 contrary to the fair value ratemaking constraints imposed by the Arizona Constitution.

16 **A. Summary of Arguments**

17 1 RUCO

18 113. RUCO argues that both decoupling options present constitutional challenges, claiming
19 that decoupling violates the fair value requirement of Article 15, Section 14, of the Arizona
20 Constitution. RUCO asserts that under Alternative A or B, there would not be a determination by the
21 Commission that the annual rate adjustments were just and reasonable, nor a current fair value
22 determination of SWG's property. RUCO claims that there would be a "disconnect" between the
23 rates established during the rate case and the time when any future rate adjustments were made.
24 (RUCO Initial Brief, at 21.) RUCO argues that there are only two situations where courts have
25 permitted deviations from the fair value requirement, for interim rates or automatic adjustment
26 mechanisms. RUCO states that the interim rate exception is not applicable, and automatic adjustment
27 mechanisms are only permitted "in relation to fluctuations in certain, narrowly defined, operating
28

1 expenses.”¹³

2 114. According to RUCO, there are important distinctions between the types of adjustors
3 that have typically been approved by the Commission (*i.e.*, for purchased gas or power) because
4 purchased power adjustments are simple pass-throughs of fluctuating operating expenses, whereas
5 the decoupling adjustments are tied to changes in revenues for which the purpose is to adjust the
6 Company’s earnings relative to the level that would otherwise be achieved absent the rate adjustment.
7 RUCO claims that the annual decoupling adjustments would circumvent the Commission’s historical
8 ratemaking process without examining all facts that would normally be analyzed in a full rate case,
9 including the then-current fair value of the Company’s property.

10 2. Southwest Gas

11 115. SWG argues that although the Constitution requires the Commission to set rates based
12 on the fair value of a company’s property within Arizona, there is no constitutionally prescribed
13 formula for doing so, other than the requirement that the Commission determine the fair value of the
14 utility’s property and use that determination in setting rates.¹⁴ SWG contends that, mechanically,
15 decoupling is not an automatic adjustment clause under Arizona law. According to SWG, automatic
16 adjustment clauses are mechanisms that track specific costs and adjust those costs to reflect market
17 fluctuations between rate cases. The Company claims that decoupling mechanisms simply true-up
18 differences between under- or over-recovery of Commission-approved fixed costs, without regard to
19 fluctuation in those costs, to ensure that the utility recovers no more or less than authorized in the rate
20 case.

21 116. The Company contends that even if decoupling is considered an adjustment clause, as
22 defined by the courts, both decoupling options presented in the Settlement satisfy the requirements of
23 *Scates* and its progeny because the future adjustments flow from a full rate case and simply reconcile
24 revenues to the Company’s rate structure established in the rate case.

25 3. AIC

26 117. AIC makes similar arguments regarding the constitutionality of decoupling, claiming

27 ¹³ *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 535, 578 P.2d. 612, 616 (App. 1978).

28 ¹⁴ *Scates*, 118 Ariz. 531, 534; *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151 (1956); *Residential Utility Consumer Office v. Arizona Corporation Commission*, 199 Ariz. 588, 591 (App. 2001) (hereafter “RUCO”).

1 that *Scates* looks favorably on adjustment mechanisms, which would include the decoupling options
2 contained in the Settlement, as long as those adjustors are adopted as part of a utility's rate structure
3 as part of a full rate case. AIC asserts that the Settlement options satisfy the court's guidelines
4 because: the decoupling mechanisms are proposed as part of SWG's rate case, based on the
5 Company's fixed costs; Alternative B prohibits the Company from earning in excess of the
6 Commission authorized ROE on a going-forward basis, until the following rate case; and both
7 options require customer refunds in certain circumstances.

8 118. AIC points out that SWG has not earned its authorized return since its last rate case, or
9 for more than 15 years, despite regular rate case filings. AIC argues that the adoption of the EE
10 standards will require SWG to sell less gas, making it likely that the Company will have even less
11 opportunity to recover its fixed costs under a traditional rate design format. Thus, according to AIC,
12 a strong argument exists that failure to adopt a decoupling mechanism would be violative of *Scates*
13 and other case law because SWG would effectively have no reasonable opportunity meet its
14 operating costs and earn a reasonable rate of return.

15 4. SWEEP

16 119. SWEEP also argues that the decoupling mechanism included in the Settlement is
17 consistent with legal precedent because, under *Scates* and *RUCO*, the legal foundation for
18 implementing an adjustment mechanism is satisfied by the Commission's determination in this case
19 of the fair value dedicated to utility service. SWEEP asserts that adoption of the Settlement
20 Agreement's revenue requirement, and SWG's underlying revenues and expenses, provides the type
21 of protection that *Scates* and *RUCO* indicated were a necessary element for approval of an adjustment
22 mechanism. SWEEP points out that under decoupling, the Company's net income would be held
23 constant despite changes in usage per customer, including the potential for returning to customers
24 revenues received above the baseline established in the rate case if per customer usage increases.

25 120. SWEEP cites *RUCO*'s discussion of the acceptable parameters of adjustment
26 mechanisms as follows:

27 Automatic adjustment clauses are designed to ensure that utilities maintain
28 a relatively constant profit despite an increase in a specific cost anticipated

1 by the adjustment clause. An automatic increase allows a utility to recoup
 2 cost increases by passing the costs on to the customer, while at the same
 3 time maintaining the utility's net income. The same is true in the converse
 4 situation, that of an automatic decrease. The decrease in cost is passed on
 5 to the customer without disturbing a utility's profit. In essence, an
 6 automatic adjustment clause is designed to offset increases or decreases,
 7 leaving the utility's ultimate net income unchanged.¹⁵

8 121. SWEEP distinguishes the case of *Arizona Community Action Association v. Arizona*
 9 *Corporation Commission*, in which the court determined that a Commission decision that granted
 10 step increases to Arizona Public Service Company ("APS") that were tied solely to declines in returns
 11 on APS' common stock equity was not permissible. The court indicated that because APS could
 12 influence the return on common stock by buying or selling stock, it constituted an impermissible
 13 automatic adjustment because of the potential that automatic rate increases could be triggered by
 14 factors over which APS exercises total control.¹⁶

15 5. NRDC

16 122. NRDC argues that a decoupling mechanism is neither an interim rate, as contemplated
 17 in *RUCO*, nor an automatic adjustment clause as described in *RUCO* and *Scates*. According to
 18 NRDC, the Alternative B decoupling mechanism would not reflect potential changes to the Company
 19 in operating costs, such as wholesale commodity costs, but would instead incorporate SWG's fair
 20 value, after a full hearing in this case, and simply remove the linkage between retail gas sales and the
 21 recovery of costs that do not fluctuate with sales. NRDC claims that the decoupling mechanism
 22 proposed in this case is very different from the automatic adjustment discussed in *Scates*, which was
 23 tied to fluctuations in variable operating costs that were passed on to customers. In contrast, NRDC
 24 contends that full revenue decoupling would simply rely on per-customer revenue requirements
 25 adopted by the Commission in this proceeding, but would not readjust those revenue requirements
 26 over time.

27 6. Staff

28 123. Staff points out that under Article 15, Section 3, of the Arizona Constitution, the
 Commission has "full power to, and shall, prescribe just and reasonable classifications to be used and

¹⁵ 199 Ariz. 588, 591-592; 20 P.3d 1169, 1172-1173 (internal citations omitted).

¹⁶ 123 Ariz. 228, 231; 599 P.2d 184, 187 (1979).

1 just and reasonable rates and charges to be made and collected by public service corporations within
 2 the State for service rendered therein.” Staff notes that the Commission has broad discretion in its
 3 determination of just and reasonable rates, subject to the obligation to ascertain the fair value of the
 4 utility’s property and establish rates that “meet the overall operating costs of the utility and produce a
 5 reasonable rate of return.”¹⁷ As argued by Staff, the courts do not mandate that the Commission
 6 employ a particular method in setting rates or exclude consideration of all relevant factors; and the
 7 Commission’s authority extends to every necessary step of ratemaking.¹⁸

8 124. Staff argues that, in undertaking its ratemaking authority, the Commission is restrained
 9 by the requirements of Article 15, Section 14, of the Arizona Constitution, which states that the
 10 Commission “shall, to aid it in the proper discharge of its duties, ascertain the fair value of the
 11 property within the state of every public service corporation doing business therein....” Although the
 12 courts have determined the Commission must use fair value in calculating just and reasonable rates,
 13 Staff asserts that the Commission has substantial discretion to adopt methodologies and approaches to
 14 address particular issues, such as significant capital investment and additional operating expenses
 15 incurred by a utility. Staff cites *Arizona Corporation Commission v. Arizona Public Service Co.*, in
 16 which the Arizona Supreme Court stated that the Commission “in its discretion can adopt any of the
 17 various approaches used by public utility regulative bodies in considering plant under construction as
 18 long as the method complies with the constitutional mandate [of finding fair value] and is not
 19 arbitrary and unreasonable.”¹⁹ The court went on to explain:

20 [I]t is obvious that the Commission in its discretion can consider matters
 21 subsequent to the historic year, bearing in mind that all parties are entitled
 22 to a reasonable opportunity to rebut evidence presented....We would not
 23 presume to instruct the Commission as to how it should exercise its
 24 legislative functions....However, it appears to be in the public interest to
 have stability in the rate structure within the bounds of fairness and equity
 rather than a constant series of rate hearings.

25 (*Id.*, citations omitted.)

26 _____
 27 ¹⁷ *Scates*, 118 Ariz. 531, 534, 578 P.2d 612, 615.

28 ¹⁸ *Simms v. Round Valley Light & Power Co.*, 80 Ariz. at 151, 294 P.2d at 382; *Arizona Corporation Commission v. State ex rel. Woods*, 171 Ariz. 286, 294, 830 P.2d 807, 815 (1992).

¹⁹ 113 Ariz. at 371, 555 P.2d at 329.

1 125. Staff also cites *Arizona Community Action* in which the court addressed the issue of
 2 step increases that were permitted if the return on APS' common stock fell below 13.75 percent.
 3 Staff claims that the court quoted extensively from the *APS* opinion, and emphasized that the
 4 Commission may consider plant under construction and placed in service at a future date in
 5 determining FVRB, and that the Commission had established fair value through the approved
 6 methodology. The court stated that:

7 In view of [*APS*], *supra*, we find entirely reasonable that portion of the
 8 Commission's decision allowing the inclusion of construction work in
 9 progress to go on line within two years from the effective date of the Step
 10 II increase. Nor do we find fault with the Commission's attempt to
 11 comply with our indication in [*APS*], *supra*, that a constant series of
 12 extended rate hearings are not necessary to protect the public interest. The
 13 hearing culminating in the order of August 1, 1977, resulted in a
 14 determination of fair value. The adjustments ordered by the Commission
 in adding CWIP to that determination of fair value were adequate to
 maintain a reasonable compliance with the constitutional requirements if
 used only for a limited period of time. Adjustments obviously would be
 made after a full hearing [using] a test year ending December 31, 1978, as
 provided in the contested order.²⁰

15 However, as discussed above, the court found fault with tying the step increases to APS' return on
 16 equity because it could be influenced by actions taken by APS.

17 **B. Discussion of Constitutional Arguments**

18 126. We agree with the Settlement proponents that either of the proposed decoupling
 19 mechanisms satisfy constitutional requirements because the mechanisms flow from a general rate
 20 case in which all costs have been determined to be just and reasonable, and SWG's FVRB and
 21 FVROR will not fluctuate for purposes of determining future adjustments. Further, both decoupling
 22 options are based on a determination of the Company's approved fixed cost recovery, either through
 23 the loss of fixed costs due to energy efficiency efforts under Alternative A, or through an annual true-
 24 up, upwards or downwards, based on the authorized revenue per customer established during the rate
 25 case. Indeed, under the uncontroverted facts presented in this proceeding that SWG has been unable
 26 to earn its authorized return for many years due to declining usage, and given the additional energy
 27

28 ²⁰ 123 Ariz. 228, 230-231.

1 efficiency standards that the Company has been ordered to meet, a reasonable argument could be
2 made that some form of revenue decoupling is necessary to establish rates that “meet the overall
3 operating costs of the utility and produce a reasonable rate of return.”²¹

4 127. However, even if the decoupling mechanisms could be considered automatic
5 adjustment mechanisms, as defined by the courts, both options presented in the Settlement would
6 satisfy the concerns expressed in prior cases. As indicated in *Scates*, an adjustor is permissible if it is
7 designed to ensure recovery of fluctuating identifiable costs, as long as the utility’s profit or rate of
8 return do not change. The Settlement maintains the Company’s FVRB and FVROR, and prohibits it
9 from exceeding its authorized return. Further, unlike the adjustment surcharge that was disallowed in
10 *RUCO*, here the Company’s FVRB is determined in a rate case.

11 128. We agree with SWEEP that the proposed decoupling mechanism is “as much rate
12 design as it is rate adjustment.” (SWEEP Initial Brief, at 9.) The just and reasonable rates and
13 charges set in this Decision use a rate design that is intended to collect the revenue requirement we
14 have determined after considering the Company’s FVRB; however, due to the documented declining
15 usage and the mandatory EE standards, traditional rate design may not allow SWG to collect the
16 revenues authorized. Therefore, components of the “rate design” encompassed in the Settlement
17 Agreement will provide the Company a reasonable opportunity to recover its authorized revenue
18 requirement.

19 **V. Analysis and Conclusion Regarding Settlement Agreement**

20 129. By issuance of its Policy Statement, the Commission sought to address issues related
21 to increased energy efficiency standards imposed on both gas and electric utilities operating in
22 Arizona. The Policy Statement recognized that traditional ratemaking would not necessarily be
23 sufficient to allow companies to recover their fixed costs if they were experiencing ongoing declines
24 in usage and revenue per customer due to increasingly stringent efficiency and conservation
25 mandates. The Policy Statement issued by the Commission endorsed revenue decoupling as, in
26 effect, an alternative rate design element that would enable companies like SWG to recover their
27

28 ²¹ *Scates*, 118 Ariz. 531, 534.

1 authorized revenues per customer in light of the new standards.

2 130. This case presents what is effectively a single contested issue: Whether the
3 Commission should approve a revenue decoupling mechanism for Southwest Gas and, if so, should it
4 be full or partial decoupling. With submission of the Settlement Agreement, signed by all active
5 parties except RUCO, the issue of decoupling comprised nearly all of the pre-filed testimony, as well
6 as direct and cross-examination testimony presented at the hearing.²²

7 131. The Settlement Agreement provides that the revenue requirement under Alternative A
8 is the same as presented through Staff's direct, pre-Settlement testimony, which would provide SWG
9 with an overall revenue increase of \$54,927,101, a return on common equity of 9.75 percent, and a
10 FVROR of 7.02 percent on FVRB of \$1,452,933,39. Under Alternative B, the agreed upon revenue
11 requirement is even less than Staff's litigation position, with an overall revenue requirement of
12 \$52,607,414, a return on common equity of 9.50 percent, and a FVROR of 6.92 percent on the same
13 \$1,452,933,391 FVRB. RUCO's final revenue requirement position would provide SWG with an
14 overall increase of \$47,569,309, a return on common equity of 9.50 percent, and a FVROR of 6.85
15 percent on the same FVRB of \$1,452,933,391.

16 132. For the reasons outlined below, we find that the Settlement Agreement represents a
17 reasonable compromise of all issues presented by SWG's application and should be approved. The
18 reasons why the Settlement is in the public interest are numerous and have been discussed at length
19 above through the testimony presented by various witnesses in support of the Agreement.

20 133. Under both decoupling options, the Settlement provides a number of customer
21 benefits, including significant benefits for low-income customers. For example, SWG has committed
22 to improve its education and outreach efforts for the LIEC weatherization program, and to provide \$1
23 million of non-ratepayer funds for the program over the next five years. The Company has also

24
25 ²² RUCO also continued through its post-hearing briefs to advocate for a slightly different FVROR methodology than the
26 one presented by Staff witness Parcell, and which forms the basis for the Settlement Agreement's revenue requirement
27 recommendation (7.02 percent FVROR under Alternative A). However, RUCO witness Dr. Johnson conceded at the
28 hearing that his criticism of Mr. Parcell's methodology was "flat wrong" and was based upon an "incorrect assumption."
(Tr. 775-776.) We also note that under Alternative B, the stipulated FVROR would be even lower, 6.92 percent, which is
only slightly higher than RUCO's FVROR recommendation of 6.85 percent. (Ex. A-14, at 10; Ex. R-10, at 18.) We
believe Staff's FVROR methodology and recommendation in this proceeding, as incorporated in the Settlement
Agreement, is just and reasonable and consistent with prior Commission decisions in which the issue has been addressed.

1 agreed that any increases to the DSM adjustor will not be passed through to the low-income tariffs;
2 nor will the COYL adjustor be applied to low-income tariff customers. Further, customers served
3 under the low-income tariff will be subject to a lower rate increase than other customers, and the
4 current 20 percent discount for the first 150 therms of usage in winter months will be increased to a
5 30 percent discount.

6 134. As described above, other requirements common to both decoupling options are: a
7 \$2.5 million per year expense reduction commitment by SWG; a continuing obligation by the
8 Company to replace early vintage plastic pipe; establishment of the COYL program; a commitment
9 for the Company to submit modified EE and RET plans to achieve annual energy savings of at least
10 1,250,000 therms within 9 months of this Decision; no increase to the basic customer charge under
11 either decoupling option; a commitment for improved customer communications; additional
12 information required in the Company's Annual Gas Procurement Plan; exclusion from rate base of
13 \$225,445 of capital costs associated with the Yuma Manors pipe replacement project; a commitment
14 by SWG to file in its next rate case a comprehensive depreciation study; and a requirement that SWG
15 submit within 30 days of this Decision a revised ICM model.

16 135. Given these commitments and requirements, we believe that the Settlement
17 Agreement, with adoption of either of the decoupling options, is in the public interest and would
18 produce rates that are just, fair and reasonable for both ratepayers and the Company. However, given
19 the totality of the evidence, including the substantial additional customer benefits and protections, we
20 find that Alternative B is the better revenue decoupling option in this case. The reasons for reaching
21 this conclusion are many, and have been described through detailed testimony presented by a number
22 of the Settlement proponents' witnesses. Although we appreciate Staff's efforts in developing and
23 presenting two different decoupling mechanisms, we are concerned with several potential problems
24 that could arise if the Alternative A option were to be adopted. First, Alternative A carries a higher
25 revenue requirement, as well as a higher ROE and FVROR. In addition, we are concerned that a
26 partial decoupling mechanism such as is included in Alternative A could create conflicting incentives
27 for the Company by, on the one hand, imposing significant energy efficiency goals that must be
28 achieved while, on the other hand, leaving in place a structure that would concurrently provide an

1 incentive for SWG to sell higher volumes of gas in order to improve its bottom line, thereby
2 undermining the Policy Statement's goal of encouraging conservation. Another concern raised by
3 Alternative A is the nature of the annual proceedings that would be required to review the
4 performance of the LFCR mechanism, and the likelihood that those proceedings would be extremely
5 adversarial as parties were forced to litigate on a yearly basis whether SWG had achieved the required
6 energy efficiency goals. Further, as Mr. Cavanagh pointed out, adoption of Alternative A may cause
7 SWG to pursue energy efficiency programs that look good on paper but deliver much less in actual
8 savings.

9 136. Compared to the potential problems that could arise with implementation of the LFCR
10 partial decoupling mechanism under Alternative A, Alternative B would impose a number of
11 obligations on SWG and would provide additional customer protections and benefits, including
12 quarterly and annual reporting requirements, an annual review of the decoupling mechanism, an
13 annual earnings test, and a 5 percent cap on recovery of annual non-gas rate adjustments. The expert
14 testimony indicates that these terms and conditions are more stringent than in many other states,
15 where annual reviews typically do not occur for several years and do not include an earnings test.
16 Other customer benefits unique to Alternative B include, as mentioned above: a 5 percent annual non-
17 gas upward rate adjustment; the potential for downward sur-credit adjustments; a minimum five-year
18 rate moratorium on rate cases; and the ability of the Commission, during the annual decoupling
19 review process, to modify or eliminate the decoupling mechanism entirely.

20 137. The evidence is undisputed that SWG has been unable to earn its Commission-
21 authorized rate of return for at least 15 years, due primarily to an ongoing trend of declining usage.
22 This trend is likely to continue, and will be exacerbated by, the recent implementation of the gas
23 energy efficiency standards in Decision No. 72042. Given these factors, SWG's financial profile may
24 deteriorate, ultimately leading to higher rates for ratepayers as the Company's ability to secure debt
25 and equity financing at reasonable rates is compromised.

26 138. We are not persuaded that RUCO's proposed alternative, which even AARP opposes,
27 is a reasonable option. As Mr. Olea explained at the hearing, RUCO's recommendation would shift
28 more cost recovery into the fixed monthly charge, and would have a negative impact on low usage

1 customers who would be unable to reduce their bills no matter how much they conserve. We do not
2 believe that such a proposal would be a wise ratemaking methodology under the facts and
3 circumstances presented in this case; nor would it be consistent with the stated goals of the Policy
4 Statement.

5 139. For these reasons, we approve the Settlement Agreement in its entirety, with the
6 inclusion of Alternative B.²³

7 140. In accordance with the terms of the Settlement Agreement, we find, for purposes of
8 setting rates in this case: SWG's jurisdictional test year revenues are \$410,907,419; SWG's
9 jurisdictional original cost rate base is \$1,070,115,558; its jurisdictional reconstruction cost new
10 depreciated rate base is \$1,835,749,225; and its jurisdictional fair value rate base is \$1,452,932,391.

11 141. We also find that, for purposes of this case, a revenue increase of \$52,607,414, with a
12 return on common equity of 9.50 percent, and a fair value rate of return of 6.92 percent, are just and
13 reasonable and in the public interest.

14 **VI. Bill Impact**

15 142. As set forth in "Exhibit C" attached hereto, a single-family residential customer with a
16 monthly average summer usage of 11 therms would experience an increase of \$1.46, from the current
17 \$24.07 to \$25.53, or 6.07 percent. A single-family residential customer with a monthly average
18 winter usage of 39 therms would experience an increase of \$5.17, from the current \$58.10 to \$63.27,
19 or 8.90 percent.

20 143. An average multi-family residential customer with a monthly average summer usage
21 of 10 therms would experience an increase of \$1.50, from the current \$21.68 to \$23.18, or 6.92
22 percent. A multi-family residential customer with a monthly average winter usage of 21 therms
23 would experience an increase of \$3.15, from the current \$34.86 to \$38.01, or 9.04 percent.

24 144. A low-income single-family residential customer with a monthly average summer
25 usage of 11 therms would experience an increase of \$1.64, from the current \$20.55 to \$22.19, or 7.98
26 percent. A low-income single-family residential customer with a monthly average winter usage of 39
27

28 ²³ The full rate schedules and typical bill comparisons for residential customers are attached as "Exhibit C."

1 therms would experience a decrease of \$0.54, from the current \$44.50 to \$43.96, a decrease of 1.21
2 percent.

3 145. A low-income multi-family residential customer with a monthly average summer
4 usage of 11 therms would experience an increase of \$1.64, from the current \$20.55 to \$22.19, or 7.98
5 percent. A low-income multi-family residential customer with a monthly average winter usage of 26
6 therms would experience a decrease of \$0.36, from the current \$32.17 to \$31.81, a decrease of 1.12
7 percent.

8 CONCLUSIONS OF LAW

9 1. SWG is a public service corporation within the meaning of Article XV of the Arizona
10 Constitution and A.R.S. §§ 40-250, 40-251, and 40-367.

11 2. The Commission has jurisdiction over SWG and the subject matter of the application.

12 3. Notice of the application was provided in accordance with the law.

13 4. The Commission adopted the Gas Utility Energy Efficiency Standards (A.A.C. R14-2-
14 2501 et seq.) in Decision No. 72042 (December 10, 2012), which require gas utilities to achieve, by
15 December 31, 2020, cumulative annual energy savings, expressed as therms or therm equivalents,
16 equal to at least 6 percent of the affected utility's retail gas energy sales for calendar year 2019.

17 5. Adoption of the Settlement Agreement, as discussed herein, is in the public interest.

18 6. The rates, charges, and conditions of service established herein are just and
19 reasonable.

20 ORDER

21 IT IS THEREFORE ORDERED that the Settlement Agreement dated July 15, 2011, and
22 attached to this Decision as Exhibit A, is hereby approved as discussed herein.

23 IT IS FURTHER ORDERED that Southwest Gas Corporation is hereby directed to file with
24 the Commission, on or before December 31, 2011, revised schedules of rates and charges consistent
25 with Exhibit A and the findings herein.

26 IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective
27 for all service rendered on and after January 1, 2012.

28 IT IS FURTHER ORDERED that Southwest Gas Corporation shall notify its affected

1 customers of the revised schedules of rates and charges authorized herein by means of an insert in its
2 next regularly scheduled billing and by posting on its website, in a form acceptable to the
3 Commission's Utilities Division Staff.

4 IT IS FURTHER ORDERED that Southwest Gas Corporation shall implement and comply
5 with the terms of the Settlement Agreement as discussed herein, including filing all reports, studies,
6 and plans as set forth in the Settlement Agreement and herein.

7 IT IS FURTHER ORDERED that Southwest Gas Corporation shall file with Docket Control,
8 as a compliance item in this docket, quarterly reports, starting April 30, 2012, regarding the
9 performance of the decoupling mechanism that would address monthly bill impacts for the residential
10 and non-residential sectors, comparing pre- and post-decoupling bills, and monthly bill impacts by
11 individual tariff, based on average therm usage, with comparisons of pre- and post-decoupling bills.

12 IT IS FURTHER ORDERED that Southwest Gas Corporation shall file with Docket Control,
13 as a compliance item in this docket, annual reports, beginning April 2013, to permit the Commission
14 and all parties an opportunity to review the performance of the decoupling mechanism. The annual
15 reports shall include a listing of customer complaints related to decoupling, a showing that energy
16 efficiency disincentives have been removed by the end of 2012, compliance with the Commission's
17 required annual energy savings, analysis of differences between new and existing customers,
18 comparison of new and existing usage per customer, analysis of overall customer usage, UPC, and
19 customer growth pre- and post-decoupling, analysis of customer migration to tariffs not subject to
20 decoupling, analysis of Company activities supporting new customer growth, and encouragement of
21 new and economic uses of natural gas.

22 IT IS FURTHER ORDERED that Southwest Gas Corporation shall file with Docket Control,
23 as a compliance item in this docket, a report every 6 months, beginning March 31, 2012, detailing
24 developments in its efforts to improve communications with customers, including a section on
25 whether the Company can use texting to communicate with customers, or an explanation as to why it
26 is unable to do so.

27 IT IS FURTHER ORDERED that Southwest Gas Corporation shall create a new section in its
28 Annual Gas Procurement Plan to document the use of financial instruments; and to provide an

1 explanation in any future purchased gas adjustor reports when it begins to recover compressed natural
2 gas costs the PGA, including an indication of the reasons for such service, the expected length of time
3 such service will be necessary, and the estimated cost and volume of such service.

4 IT IS FURTHER ORDERED that Southwest Gas Corporation shall file with Docket Control,
5 as a compliance item in this docket, within 60 days of the effective date of this Decision,
6 documentation defining all current line items in its monthly PGA report; and for the Company to
7 include in the cover letters for future monthly PGA reports an explanation of any additions, deletions,
8 or changes in the terms used in the report.

9 IT IS FURTHER ORDERED that Southwest Gas Corporation shall prepare an accounting of
10 the gas heat pump technology development costs funded by Arizona ratepayers through base rates
11 and the R&D surcharge, prepare a plan to reimburse ratepayers for their proportionate level of
12 funding of gas heat pump technology development costs, and file the plan with Docket Control, as a
13 compliance item in this docket, within 90 days of the Decision in this case. Staff shall file a
14 recommendation to the Commission within 120 days thereafter.

15 IT IS FURTHER ORDERED that Southwest Gas Corporation shall file with Docket Control,
16 as a compliance item in this docket, within 30 days of the effective date of this Decision, a revised
17 ICM model that prevents the Company from collecting contributions in aid of construction that result
18 in an expected ROE, as generated through the ICM model, that is more than 50 basis points above the
19 return on common equity authorized by this Decision. Staff shall submit a recommendation to the
20 Commission within 90 days of SWG's filing of the revised ICM model.

21 IT IS FURTHER ORDERED that Southwest Gas Corporation shall file a comprehensive
22 depreciation study in its next general rate case that addresses depreciation and amortization rates for
23 all of the Company's jurisdictional Direct and System Allocable depreciable and amortizable plant
24 accounts.

25 IT IS FURTHER ORDERED that Southwest Gas Corporation shall meet with the parties to
26 this Docket, within 45 days of the effective date of this Decision, to develop a plan to enhance
27 customer education and outreach for its LIEC weatherization programs.

28 IT IS FURTHER ORDERED that Southwest Gas Corporation shall, starting February 2013,

1 and each February thereafter, file with Docket Control, as a compliance item in this docket, a report
2 of leak surveying associated with the customer owned yard line replacement program informing the
3 Commission and the parties of the Company's findings and any recommendations regarding the
4 program. The report shall include the information set forth in the Settlement Agreement. Staff shall,
5 within 45 days thereof, submit a recommendation to the Commission regarding the report and request
6 to reset the COYL surcharge amount.

7 IT IS FURTHER ORDERED that Southwest Gas Corporation shall not file a general rate
8 application prior to April 30, 2016, with a test year ending no earlier than November 30, 2015.
9 However, the Company is not prohibited from filing other interim rate applications as necessary,
10 including demand side management surcharge resets or requests for accounting deferral orders to
11 comply with new or revised pipeline safety requirements or other unfunded state or federal mandates.

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1 IT IS FURTHER ORDERED that Southwest Gas Corporation shall, as part of its next general
2 rate application, include as one of its rate design proposals an inclining block rate design.

3 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

4 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

5
6
7 CHAIRMAN _____ COMMISSIONER _____

8
9 COMMISSIONER _____ COMMISSIONER _____ COMMISSIONER _____

10
11 IN WITNESS WHEREOF, I, ERNEST G. JOHNSON,
12 Executive Director of the Arizona Corporation Commission,
13 have hereunto set my hand and caused the official seal of the
14 Commission to be affixed at the Capitol, in the City of Phoenix,
15 this _____ day of _____ 2011.

16 _____
17 ERNEST G. JOHNSON
18 EXECUTIVE DIRECTOR

19 DISSENT _____

20 DISSENT _____

1 SERVICE LIST FOR: SOUTHWEST GAS CORPORATION

2 DOCKET NO.: G-01551A-10-0458

3

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27
28

EXHIBIT A

SOUTHWEST GAS CORPORATION

PROPOSED SETTLEMENT AGREEMENT

DOCKET NO. G-01551A-10-0458

JULY 15, 2011

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**PROPOSED SETTLEMENT OF DOCKET NO. G-01551A-10-0458
SOUTHWEST GAS CORPORATION REQUEST FOR RATE ADJUSTMENT**

The purpose of this Settlement Agreement (“Agreement”) is to settle disputed issues related to Docket No. G-01551A-10-0458, Southwest Gas Corporation (“Southwest Gas” or “Company”) application to increase rates. This Agreement is entered into by the following entities:

Arizona Corporation Commission Utilities Division (“Staff”)
Arizona Investment Council (“AIC”)
Cynthia Zwick
Southwest Energy Efficiency Project (“SWEEP”)
Southwest Gas Corporation (“Southwest Gas” or “Company”)
Natural Resources Defense Council (“NRDC”)

These entities shall be referred to collectively as “Signatories,” a single entity shall be referred to individually as a “Signatory.”

The following numbered paragraphs comprise the Signatories’ Agreement.

I. RECITALS

- 1.1 This Agreement (with the Commission’s selection of either Alternatives A or B, in each alternative’s entirety) resolves all issues presented in Docket No. G-01551A-10-0458 in a manner that will promote the public interest.
- 1.2 On November 12, 2010, Southwest Gas filed an application requesting approval of: (i) a general rate increase for its Arizona rate jurisdiction; (ii) its proposed Energy Efficiency Enabling Provision; (iii) its proposed Energy Efficiency and Renewable Energy Resource Technology Portfolio Implementation Plan (“EE and RET Plan”) and corresponding budget; (iv) its proposed pilot program for customer owned yard lines (“COYL”) and a deferred accounting order; (v) a deferred accounting order for the costs associated with replacement of Aldyl HD pipe as part of the Company’s 20 year plan to replace all early vintage plastic pipe (“EVPP”); and (vi) various proposed amendments to its Arizona gas tariff (“Application”).
- 1.3 The Commission approved the applications to intervene filed by the Residential Utility Consumer Office (“RUCO”), Tucson Electric Power (“TEP”), Cynthia Zwick, AIC, SWEEP and NDRC (collectively referred to as “Parties to this Docket”).

- 1.4 Staff, RUCO, and Cynthia Zwick filed direct testimony June 10, 2011. Staff, RUCO, NRDC, and SWEEP filed direct rate design testimony June 24, 2011.
- 1.5 Southwest Gas filed a Notice of Settlement Discussions June 21, 2011. The Parties to this Docket subsequently held settlement discussions beginning June 28, 2011 and continuing through July 14, 2011.
- 1.6 The settlement discussions were open, transparent, and inclusive of all parties to this docket who desired to participate. All Parties to this Docket were notified of the settlement discussions, were encouraged to participate in the negotiations, and were provided an opportunity to participate either in person or via teleconference.
- 1.7 The Signatories agree that they have reached a compromise and agreement that resolves all outstanding and contested issues that were raised during the course of this proceeding. The Signatories believe that the terms and conditions of this Agreement (inclusive of Alternatives A and B as presented) are just, reasonable, and fair, and that the Agreement promotes the public interest.
- 1.8 This Agreement results in a settlement package that addresses Southwest Gas' need for a rate increase and balances this need with terms and conditions that provide several specific customer benefits. The Signatories submit that many benefits of this negotiated settlement package would not otherwise have been accomplished through a litigated proceeding. Some of these customer benefits include but are not limited to:
- Commitments Benefiting Low Income Customers on the low income rate schedule(s).
 - An increased Low Income Rate Assistance discount from 20 percent to 30 percent for the low income rate schedule(s).
 - A Southwest Gas commitment to increase funding for Low Income Energy Conservation Weatherization program with non-ratepayer funds of at least \$1 million over 5 years.
 - A commitment to develop enhanced communication programs to increase awareness of low-income programs.

- Rate Stability.
 - Approval of a decoupling mechanism to improve Southwest Gas' revenue stability, which, in turn has a positive impact on its financial profile and credit ratings - benefiting customers through reductions in future debt costs.
 - Approval of decoupling mechanisms to mitigate rate increases in future rate proceedings and reduce the frequency of time consuming and expensive rate cases.
 - A moratorium on general rate case applications for over five years – reflected in Alternative B only.
 - An operating Expense Reduction Commitment of \$2.5 million per year.
 - Continuation of a 20-Year Plan to Replace Early Vintage Plastic Pipe.
 - The Establishment of a Customer Owned Yard Line Replacement Program.
 - Energy Efficiency Enhancements.
 - Energy Efficiency initiatives resulting in customer annual energy savings of at least 1,250,000 therms.
 - Implementation of a decoupling mechanism.
 - To align utility, customer and societal interests to pursue annual customer bill savings through the recently enacted gas energy efficiency goals – reflected in Alternatives A and B.
 - Reducing utility disincentives to support customer energy efficiency.
 - Prompt protection of customers from high winter monthly bills following extreme weather events as reflected in Alternatives A and B.
 - Rate Design.
 - No increase to the monthly basic service charge to enhance customer bill savings through energy efficiency and conservation efforts.
- 1.9 The Signatories request an order from the Commission: (i) finding that the terms and conditions of this Agreement are just and reasonable; (ii) concluding that the Agreement is in the public interest; (iii) approving the Agreement in its entirety (including the selection of only either Alternative A or B in each alternative's entirety) and ordering that the terms and conditions therein become effective upon Commission approval; and (iv) making any and all other findings and orders in support of this Agreement that the Commission deems necessary.

- 1.10 Consistent with Arizona Administrative Code ("A.A.C.") R14-2-103, the Signatories request the issuance of a Commission order approving this Agreement with an effective date of new rates no later than January 1, 2012.

II. SUMMARY OF FILED REVENUE POSITIONS

- 2.1 The Company's application and supporting testimony requested approval, *inter alia*, of a revenue increase of \$73.2 million. The requested capital structure consisted of 52.3 percent common equity and 47.7 percent long-term debt, relative to an 8.34 percent embedded cost of long-term debt and a cost of common equity capital of 11.00 percent. Southwest Gas also requested a fair value rate of return ("FVROR") of 7.50 percent using a 1.24 percent inflation-adjusted risk-free return on the fair value increment (the differential between the fair value rate base ("FVRB") and the original cost rate base ("OCRB")).
- 2.2 Staff made several recommendations pertaining to the Company's proposed rate base, expenses, revenues, and net operating income resulting in a recommended revenue increase of \$54.9 million. Staff agreed with the Company's capital structure and embedded cost of long-term debt, but recommended a cost of common equity capital of 9.75 percent and a FVROR of 7.02 percent using a 1.25 percent inflation-adjusted risk-free return on the fair value increment (differential between FVRB and OCRB).
- 2.3 In its direct testimony, RUCO recommended a revenue requirement increase of approximately \$29.2 million. For its cost of equity, RUCO recommended a 9.00 percent cost of equity. The recommended RUCO capital structure consists of 50.15 percent common equity and 49.85 long-term debt with a cost of long-term debt of 7.35 percent.

III. AGREEMENT ON TWO ALTERNATIVES FOR REVENUE DECOUPLING

- 3.1 Because of the unique circumstances presented by the revenue decoupling proposals offered in this proceeding, the Signatories have agreed to present to the Commission two alternatives (Alternative A and Alternative B), as set forth in more detail below. It is the

intent of the Signatories that the Commission select one Alternative in its entirety as part of this Settlement Agreement.

- 3.2 Staff supports both Alternatives A and B equally, and Staff agrees to support both Alternatives equally during any subsequent hearing or other Commission proceeding involving this Agreement. Southwest Gas supports the inclusion of the two Alternatives in this Agreement, but Southwest Gas shall be permitted to express its preference for either Alternative A or B during any subsequent hearing or other Commission proceeding involving this Agreement. The remaining Signatories will support at least one Alternative (either Alternative A or B), and they shall not be precluded from expressing their respective positions on the Alternatives set forth in this Agreement during any subsequent hearing or other Commission proceeding involving this Agreement.
- A. Alternative A.**
- 3.3 Alternative A consists of a partial revenue decoupling mechanism, a monthly weather adjustor consistent with the Southwest Gas proposal, an overall revenue increase of \$54,927,101, a return on common equity capital of 9.75 percent, and a FVROR of 7.02 percent on FVRB (using Staff's fair value methodology and valuation).
- 3.4 Should the Commission select Alternative A, the Company will implement a partial revenue decoupling mechanism comprised of two components, a Lost Fixed Cost Recovery ("LFCR") component and a weather component. The partial revenue decoupling mechanism permits Southwest Gas to recover lost base revenues attributable to achievement of the Commission's required annual energy savings and to adjust customer bills each month when actual weather during the billing cycle differs from the average weather used in the calculation of rates.
- 3.5 The LFCR component permits the Company to recover, through a per unit surcharge, the total amount of the anticipated lost-base revenues, assuming it achieves 100 percent of the Commission's required annual energy savings. This amount will be trued-up to

actual lost base revenue due to energy efficiency during an annual reconciliation process each April.

- 3.6 If the Company does not meet 100 percent of the Commission's required annual energy savings, the difference between the 100 percent it was allowed to collect and the actual lost revenue would be refunded to customers during the next annual reconciliation process.
- 3.7 If the Company exceeds its energy efficiency goals in any reconciliation period, the Company will only be allowed to recover 100 percent of the upcoming year lost base revenues. However, the Company will be permitted to recover, through the surcharge, in the following year the difference between the 100 percent collected from customers and the actual amount of the lost-base revenues associated with attaining energy savings greater than 100 percent of the year's goal, as limited by the Commission's required annual energy savings.
- 3.8 The initial LFCR surcharge will be set at \$0.00213 per therm, beginning when rates under this Agreement become effective. This surcharge amount is based on the Commission's 2011 energy efficiency savings goal.
- 3.9 Southwest Gas shall make a filing annually, starting April 2013, to permit the Commission and all Parties to this Docket an opportunity to review the performance of the LFCR mechanism and to allow the Company an opportunity to reset the surcharge to recover the lost-base revenues attributable to its achievement of the Commission's required annual energy savings. Under or over collections should be trued up as part of the surcharge reset.
- 3.10 The weather-related component will be incorporated through a monthly true-up to winter (November through April) bills. When actual weather during the billing cycle differs from the average weather used in the calculation of rates there will be either an upward or downward adjustment to the customers' bill. In the event of an extreme cold weather event, customers will receive an immediate real-time benefit as there will be a downward

adjustment to their bill.

Special Terms and Conditions for Alternative A

- 3.11 Staff will perform an annual review to determine compliance with the Commission's required annual energy savings and the Company agrees to pay up to \$50,000 for an independent consultant selected by Staff for this review.
- 3.12 No Signatory will petition, nor join in a petition, to suspend, terminate, or modify the LFCR mechanism prior to the Company's next general rate case, unless for two consecutive years the results of the annual review process conclude the Company did not comply with the Commission's required annual energy savings. Paragraph 3.12 applies to the LFCR mechanism only.
- 3.13 Prior to the granting of any request to suspend, terminate, or modify the LFCR mechanism, a hearing will be conducted to permit the Signatories due process and an opportunity to be heard prior to any suspension, termination, or modification of the decoupling mechanism.
- 3.14 Southwest Gas will not be subject to a rate case application moratorium under Alternative A.
- 3.15 Southwest Gas will submit a proposed customer outreach/education plan to Staff for review and approval, with service to the Parties to this Docket. The plan shall outline how the Company intends to explain decoupling to customers.
- 3.16 Alternative A in its entirety, as described herein, consisting of a partial revenue decoupling mechanism, a revenue increase of \$54,927,101, a return on common equity of 9.75 percent, a FVROR of 7.02 percent, as well as the special terms and conditions stated herein, is a carefully negotiated, integrated package representing compromises in the positions of the Signatories that results in a package that is just, reasonable, and in the public interest.
- B. Alternative B.**
- 3.17 Alternative B consists of a full revenue decoupling mechanism, a monthly weather

adjustor consistent with the Southwest Gas proposal, an overall revenue increase of \$52,607,414, a return on common equity capital of 9.50 percent, and a fair value rate of return of 6.92 percent on FVRB (using Staff's fair value methodology and valuation).

- 3.18 Should the Commission select Alternative B, the Company will implement a full revenue decoupling mechanism whereby rates will adjust to reflect any differences between authorized revenues per customer and actual revenues per customer – as proposed by the Company in its Application. This full revenue decoupling mechanism shall also include a monthly weather component and an annual non-weather component.
- 3.19 The weather-related component will be incorporated through a monthly true-up to winter (November through April) bills. When actual weather during the billing cycle differs from the average weather used in the calculation of rates there will be either an upward or downward adjustment to the customers' bill. In the event of an extreme cold weather event, customers will receive an immediate real-time benefit as there will be a downward adjustment to their bill.
- 3.20 There will also be an annual true-up reflecting the difference between the non-gas revenues authorized by the Commission and the actual non-gas revenues experienced by Southwest Gas. The phrase "revenues authorized by the Commission" is defined as the Commission authorized monthly revenue per customer multiplied by the total number of customers billed for service during the month. "Experienced revenue" is defined as the billed revenue for the month. At the end of each year, a per-therm rate adjustment will be computed by dividing the balance in the deferred account by the previous 12 months sales volume. The resulting rate will remain in effect for a 12-month period to refund or collect the deferred account balance.

Special Terms and Conditions for Alternative B

- 3.21 Southwest Gas shall file quarterly reports each April, July, October and January with the Commission on the performance of the decoupling mechanism. The first quarterly report will be filed no later than April 30, 2012.

- 3.22 The quarterly reports will address at a minimum: (i) monthly bill impacts for the Residential and Non-residential customer sectors, based on average sector therm usage, with comparisons of pre- and post-decoupling bills over two years, with a year-to-year comparison going forward; and (ii) monthly bill impacts by individual tariff, based on average tariff therm usage, with comparisons of pre- and post-decoupling bills over two years, with a year-to-year comparison going forward.
- 3.23 Commencing April 2013, Southwest Gas will file annual reports, each April, to permit the Commission and all Parties to this Docket an opportunity to review the performance of the decoupling mechanism. The annual filing shall include, but not be limited to: (1) listing of customer complaints resulting from or associated with revenue decoupling; (2) a showing that disincentives to energy efficiency have been removed by December 31, 2012; (3) compliance with the Commission's required annual energy savings and as contemplated in Section V.C. of this Agreement; (4) an analysis of usage differences between new and existing customers; (5) a comparison of the differences between new and existing customer usage per customer ("UPC"); (6) an analysis of overall customer usage, UPC, and customer growth per class on a pre- and post-decoupling basis; (7) an analysis of customer migration to tariffs not subject to decoupling or converting to non-gas energy usage; and (8) an analysis of Company activities in supporting new customer growth including the encouragement of new and economic uses of natural gas. These items are types of information that should provide meaningful information regarding the full revenue decoupling mechanism. The presence or absence of information responsive to any one of these items shall not, in and of itself, be indicative of whether to continue, suspend, terminate or modify the full revenue decoupling mechanism.
- 3.24 The Company's annual filing shall be the subject of an Open Meeting for the Commissioners to deliberate the performance of the full revenue decoupling mechanism. If the Commission determines that good cause exists to suspend, terminate, or modify the full revenue decoupling mechanism, then the matter shall be set for hearing to permit the

Parties to this Docket due process and an opportunity to be heard prior to any suspension, termination, or modification of the decoupling mechanism. In the event the Commission decides to suspend or terminate the full revenue decoupling mechanism prior to the Company's next general rate case, the moratorium for filing general rate case applications shall terminate. If the Commission decides to modify the full revenue decoupling mechanism, the Commission shall also determine if the modification is material enough that the moratorium for the filing a general rate application should be eliminated.

- 3.25 With the implementation of the full revenue decoupling mechanism, Southwest Gas will be subject to an annual earnings test whereby the Company will be prohibited from recovering any decoupling deferral amounts, to the extent that recovery would increase earnings such that the Company would be earning more than its authorized return on common equity.
- 3.26 Commencing April 2013, Southwest Gas shall include in its annual report, the results of its annual earnings test in a format consistent with the report attached hereto as Exhibit A.
- 3.27 The data points and assumptions to be utilized in the earnings test report will include the following:
- Reporting period shall consist of the 12 months ending December 31;
 - FVRB held constant at \$1,452,933,391;
 - FVROR held constant at 6.92 percent, and all related cost of capital components held constant, including capital structure (52.30 percent equity and 47.70 percent debt), cost of debt (8.34 percent), cost of equity (9.50 percent), and return on fair value increment (1.25 percent);
 - Experienced non-gas revenue for the reporting period;
 - Recorded operating expenses for the reporting period, adjusted for certain ratemaking adjustments. The ratemaking adjustments will consist of recorded dollars less the Staff-specified disallowance percentage for the following Staff adjustments:

- C-3, Management Incentive Program (“MIP”) expense will be limited to fifty percent of the recorded and allocated cost, however Staff may make a further adjustment if Staff believes the MIP expense has increased unreasonably;
 - C-4, the cost of all stock-based compensation (other than MIP) shall be excluded;
 - C-5, all Supplemental Executive Retirement Expense charged or allocated to Arizona operation shall be excluded. (Arizona);
 - C-6, forty percent of American Gas Association dues shall be excluded;
 - C-7, all losses related to the sale of employee homes for relocation shall be excluded;
 - C-9, all Gas Heat Pump Development Expenses shall be excluded;
 - C-11, fifty percent (50%) of all Directors' and Officers' Liability Insurance expense shall be excluded;
 - C-13, leased aircraft expense shall be limited to the lesser of (1) the actual recorded amount or (2) Staff's proposed allowance of \$472,000;
 - Staff's Schedule B adjustments and Staff's Schedule C adjustments C-1 (Completed Construction Not Classified Correction), C-2 (Yuma Manors Pipe Replacement), and C-10 (Interest Synchronization) will remain constant because rate base and FVROR remain constant for the purposes of the earnings test;
 - Staff's Schedule C adjustment C-8 (Rent Charged to Affiliate IntelliChoice Energy LLC) and C-14 (COYL Leak Detection Survey) will be recorded in Southwest Gas' operating expenses going forward, so no further adjustment will be necessary for the earnings test;
 - Staff's Schedule C adjustments C-12 Reserve for Self Insurance, is a normalizing adjustment and Southwest Gas will use its recorded amounts for purposes of the earnings test;
 - For purposes of calculating income taxes, interest expense will be held constant since the FVROR will be held constant;
 - Any surcharge revenues and expenses will not be included in the earnings test.
- 3.28 Staff will perform an annual review to analyze the information submitted by Southwest Gas and the Company agrees to pay up to \$75,000 for an independent consultant selected by Staff for this review.
- 3.29 Any surcharge through the decoupling mechanism that will result in an annual increase

in non-gas revenue of greater than 5 percent from the test-year non-gas base revenue per customer will be capped at 5 percent. Southwest Gas will carry the deferral account balance forward for recovery in the next year and subsequent years with no carrying charges. There will be no cap on annual surcharge decreases.

- 3.30 Southwest Gas will not file a general rate case application prior to April 30, 2016 with a test year no earlier than November 30, 2015 and none of the Signatories will request any change, nor join in a request for any change, to the Company's base rates that would take effect prior to May 1, 2017. This moratorium is not intended to preclude the Company from filing other interim applications as may be necessary or required, including without limitation, proposals to reset its demand side management surcharge mechanism, or requests to establish deferred accounts for costs incurred by the Company to comply with new or revised pipeline safety requirements, or other unfunded state or federal mandates.
- 3.31 Southwest Gas will submit a proposed customer outreach/education plan to Staff for review and approval, with service to the parties of record. The plan shall outline how the Company intends to explain decoupling to customers.
- 3.32 Alternative B in its entirety - consisting of a full revenue decoupling mechanism, a revenue increase of \$52,607,414, a return on common equity capital of 9.50 percent, a fair value rate of return of 6.92 percent, as well as the special terms and conditions stated herein - is a carefully negotiated package representing compromises in the positions of the Signatories that results in a package that is just, reasonable, and in the public interest.

C. Rates and Charges are Just, Reasonable, and in the Public Interest.

- 3.33 The Signatories agree that the overall rate increases associated with Alternatives A and B are just, reasonable, and in the public interest based upon the unique circumstances of each alternative, but only if either Alternative A or B is implemented in its entirety, as intended by the Signatories herein. The Signatories further agree that if any of the components of Alternative A or B are changed, including any other remaining components of this Agreement, then the rates and charges associated with the changed

alternative may not be considered just and reasonable by the Signatories.

- 3.34 A comparison of the various revenue requirement increases and returns on equity ("ROE") proposed by certain Signatories, as compared to those contained in each of the settlement alternatives, is set forth in the following table:

	Company Direct	Staff Direct	Settlement Alternative A	Settlement Alternative B
Proposed Revenue Increases	\$73.2M	\$54.9M	\$54.9M	\$52.6M
Requested ROE	11.00%	9.75%	9.75%	9.50%
Overall Average Rate Increase %	9.26%	6.95%	6.95%	6.66%

IV. LOW INCOME PROGRAMS

- 4.1 Southwest Gas will enhance and increase the funding level of the Low Income Energy Conservation ("LIEC") weatherization program by committing to make non-ratepayer funded contributions to the LIEC weatherization program each year for the next 5 years. This commitment shall result in a total contribution of at least \$1 million.
- 4.2 The demand-side management adjustor rate for the low-income residential rate schedule(s) will not be increased above the rate currently collected, which is \$0.00200 per therm.
- 4.3 The Customer Owned Yard Line cost recovery mechanism ("CCRM") will consist of a per therm charge, and the CCRM will not apply to the low-income rate schedule(s).
- 4.4 The proposed increase to the low-income residential rate schedule(s) shall be mitigated by increasing the Low-Income Rate Assistance discount to 30 percent, from the current 20 percent for the first 150 therms in the winter months (November through April). This will result in an average monthly bill increase of either \$0.70 (Alternative A) or \$0.59 (Alternative B) depending upon the alternative selected by the Commission.
- 4.5 Southwest Gas will meet with the Parties to this Docket within 45 days of the effective date of any order approving this Agreement to develop a plan to enhance customer

education and outreach for its LIEC weatherization programs.

V. AGREEMENTS REGARDING OTHER SPECIFIC ISSUES

5.1 Upon the Commission's selection of either Alternative A or B in each alternative's entirety, the Signatories agree to the following remaining issues regarding the Company's general rate application. The Commission's selection of either Alternative A or B in their entirety does not materially impact the compromises reached by the Signatories on these remaining issues.

A. Cost of Capital.

5.2 The Signatories agree that a capital structure comprised of 47.70 percent long-term debt and 52.30 percent common equity is appropriate and shall be adopted for ratemaking purposes, and for the purposes of this Agreement.

5.3 The Signatories agree that an embedded cost of debt of 8.34 percent is appropriate and shall be adopted for ratemaking purposes, and for the purposes of this Agreement.

B. Rate Base.

5.4 For ratemaking purposes and for the purposes of this Agreement, the Signatories agree that the Company's jurisdictional OCRB for the test year ending June 30, 2010 is \$1,070,115,558.

5.5 For ratemaking purposes and for purposes of this Agreement, the Signatories agree that the Company's jurisdictional Reconstruction Cost New Depreciated ("RCND") rate base for the test year ending June 30, 2010 is \$1,835,749,225.

5.6 For ratemaking purposes and for purposes of this Agreement, the Signatories agree that the fair value of Southwest Gas' jurisdictional rate base for the test year ending June 30, 2010 is \$1,452,932,391.

C. Energy Efficiency and Renewable Energy Resource Technology.

5.7 Southwest Gas included in its Application a request for approval of its EE and RET Plan pursuant to A.A.C. R14-2-2501 *et seq.*

5.8 Southwest Gas agrees to provide supplemental EE information to support a modified EE

and RET Plan for EE measures that are cost-effective at the measure level as part of this Agreement. This modified EE and RET Plan shall result in an incremental improvement of EE that exceeds the current Southwest Gas approved portfolio budget of \$4.4 million, and that results in customer annual energy savings of at least 1,250,000 therms within nine months of Commission approval of the modified Plan.

- 5.9 Staff will provide recommendations on as many measures of the modified EE and RET Plan as possible in a report filed prior to the Open Meeting where the Commission intends to vote on the Recommended Opinion and Order approving this Agreement. In an effort to achieve timely approval of the modified EE and RET Plan, the Signatories urge the Commission to vote on the measures in Staff's report on the date the Commission votes on this Agreement.
- 5.10 The Signatories acknowledge that the energy savings proposed in the modified EE and RET Plan may not be sufficient to meet the 2011 energy savings goals set forth in A.A.C. R14-2-2501 *et seq.* In order to increase the customer annual energy savings that are being agreed to as part of this Agreement, Southwest Gas shall file in a new docket within 60 days of filing this Agreement a new and revised EE and RET Implementation Plan pursuant to A.A.C. R14-2-2501 *et seq.* setting forth a plan for how it proposes to comply with the energy savings goals set forth therein. The new and revised EE and RET Implementation Plan will be incremental to the modified EE and RET Plan measures that are being committed to by Southwest Gas as part of this Agreement.
- 5.11 Southwest Gas shall achieve customer annual energy savings equivalent to the 2011 requirement of the gas energy savings goals within 12 months of Commission approval of the new and revised EE and RET Implementation Plan. Staff agrees to make its best efforts to review the Company's new and revised EE and RET Implementation Plan and file recommendations for Commission approval on a schedule that contributes to timely implementation of the energy savings programs that are necessary to achieve the 2011 energy savings target. In 2012 and beyond, Southwest Gas will comply with the

cumulative annual energy savings requirements set forth in A.A.C. R14-2-2501 *et seq.* At least 75 percent of the cumulative annual energy savings shall be achieved through EE programs. In this regard, Southwest Gas agrees to file its implementation plans consistent with the requirements of A.A.C. R14-2-2501 *et seq.*, on schedule, at the energy savings targets identified therein, and commits to work with SWEEP and Staff to avoid the need to file a request for waiver during any plan year from 2011-2015 in lieu of submitting an implementation plan designed to achieve the energy savings targets set forth in A.A.C. R14-2-2504. Staff agrees to make their best efforts to review the Company's implementation plans and file recommendations for Commission votes on a schedule that contributes to timely implementation of the energy savings programs that are necessary to achieve the energy savings targets set forth in A.A.C. R14-2-2501 *et seq.*

D. Customer Owned Yard Line Replacement Program.

- 5.13 Southwest Gas shall be permitted to establish a program for replacing customer owned yard lines ("COYL") consistent with the terms of this Agreement.
- 5.14 Southwest Gas will purchase four (4) Remote Methane Leak Detection ("RMLD") units, field test and validate the effectiveness of the RMLD equipment, and work with Staff to obtain approval for the use of the RMLD equipment. Following approval of the RMLD equipment, Southwest Gas will begin to leak survey COYLs utilizing the RMLD equipment and other conventional equipment as necessary. Prior to leak surveying the COYLs, Southwest Gas will notify customers with COYLs and obtain permission, where necessary, to perform leak surveying of the COYL. The Company estimates that it has approximately 102,000 COYLs in its service territory. Southwest Gas commits to leak survey approximately one-third of the COYLs every year.
- 5.15 So as to not unduly financially burden its customers, Southwest Gas will replace all COYLs that are found to be leaking, either as a result of the COYL leak survey process or from a leak survey following an odor call complaint. Southwest Gas will be allowed

to recover the capital investment associated with the COYL replacement program through a COYL cost recovery mechanism ("CCRM") that will be reset annually. The CCRM shall not result in a surcharge amount greater than \$0.01 per therm in any single year.

- 5.16 The CCRM is based solely on actual costs and costs eligible for recovery, which are depreciation and pre-tax return. The original cost pre-tax rate of return authorized by the Commission is applied to gross plant, less accumulated depreciation and less all credit-balance Accumulated Deferred Income Taxes related to the plant cost incurred under this program. Depreciation expense includes actual recorded depreciation expense at the currently-authorized depreciation rate of 5.30 percent per year for services, applied on a monthly basis to COYL replacement plant as of the previous month-end, plus amortization of deferred depreciation expenses.
- 5.17 Recovery of costs through a CCRM surcharge terminates upon inclusion of the COYL replacement cost in rate base. A surcharge schedule, showing a detailed calculation of the COYL revenue requirement and the surcharge will be included in the Company's annual application for cost recovery. A sample calculation illustrating the mechanics of the CCRM is attached hereto as Exhibit B.
- 5.18 Upon completion of the first six months of leak surveying, Southwest Gas will file a report with the Commission, with service to the Parties to this Docket, informing them of its findings and any recommendations regarding the program. Southwest Gas will then report on its findings and recommendations on an annual basis thereafter. The annual report shall include the following: (1) location by address of each leak detected; (2) indication of how the leak was discovered, i.e. leak detection or odor complaint; (3) itemization of the cost and the plant installed at each location; (4) the surcharge calculation; and (5) a schedule describing the survey rotation provided to Staff. Southwest Gas will file its annual report and CCRM application in February of each year with data from the previous calendar year, with the initial filing to be made in February

2013. Staff will review the filing and within 45 days make a recommendation to the Commission regarding the report and the request to reset the surcharge amount.

- 5.19 The Company shall make modifications to its operations and maintenance manuals as may be required by the Commission's Office of Pipeline Safety for the Company's COYL replacement program.

E. Expense Reduction Plan.

- 5.20 The Company will identify cost reduction initiatives to reduce its expenses on an annual basis by an average of \$2.5 million per year beginning in 2012. Southwest Gas agrees the \$2.5 million average annual expense reduction commitment will continue through the end of the test year in the Company's next general rate case. The \$2.5 million annual expense reduction by Southwest Gas represents an average annual reduction - in some years, it may exceed \$2.5 million.

F. Customer Communication Improvements.

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

G. Gas Procurement.

- 5.22 The Company agrees that it will create a new section in its Annual Gas Procurement Plan to document the use of financial instruments - including providing an explanation.
- 5.23 The Company agrees that it will provide an explanation in any future purchased gas adjustor ("PGA") reports when it begins to recover compressed natural gas costs through the PGA mechanism, including an indication of the reasons for such service, the expected length of time such service will be necessary, and the estimated cost and volume of such service.

H. Purchased Gas Adjustor.

5.24 Southwest Gas will file, within 60 days of the effective date of an order approving this Agreement, a document defining all current line items in the monthly PGA report. The Company will include in its cover letters for future monthly PGA reports an explanation of any additions, deletions, or changes in the line item terms used in the report.

I. Yuma Manors.

5.25 Southwest Gas will not be permitted to recover in base rates the remaining \$225,445 associated with the Yuma Manors pipe replacement project that occurred in 2006 and that was the subject of Decision No.70665.

J. 20 Year Plan To Replace Early Vintage Plastic Pipe.

5.26 Southwest Gas shall continue with its 20-year plan for replacing EVPP, and provide documentation of progress and money spent in future rate case proceedings.

5.27 Southwest Gas shall not establish a deferral account in conjunction with the replacement of EVPP.

5.28 Southwest Gas shall not modify or discontinue the write-off requirements associated with Aldyl HD pipe.

K. Development of Gas Heat Pump Technology.

5.29 The Signatories agree that for ratemaking purposes all gas heat pump technology development costs shall be removed from operating expenses.

5.30 Southwest Gas agrees that no new gas heat pump projects shall be funded through the Commission-approved research and development surcharge.

5.31 Southwest Gas will prepare an accounting for all gas heat pump technology development costs that have been funded by Arizona ratepayers through base rates and the research and development surcharge through the date of the Commission's final order in this case. Southwest Gas will track the Arizona ratepayer funding for gas heat pump technology development as a potential regulatory liability, to be returned to ratepayers, only to the extent commercial development occurs and revenues and royalties are received by

Southwest Gas and profits and royalties are received by any other entities that are affiliated with Southwest Gas including but not limited to IntelliChoice Energy LLC.

- 5.32 Southwest Gas will prepare a plan to reimburse Arizona ratepayers for their proportionate level of funding of gas heat pump technology development costs. This plan will include a methodology for how the benefits of any commercialization revenues and royalties associated with the gas engine driven air conditioning units are to be shared with Southwest Gas' Arizona ratepayers to ensure that customers receive credit for any investment that contributed to the development of this technology. Southwest Gas will file its above-referenced plan and related information with the Commission, with service to the Parties to this Docket within 90 days of the effective date of an order approving this Agreement. Within 120 days of Southwest Gas' submittal of this plan and related information, Staff will submit its recommendation to the Commission for its consideration.

L. Incremental Contribution Method.

- 5.33 In compliance with Decision No. 70665, Southwest Gas provided, in its application, an explanation, including sample calculations and documentation, of how it has been implementing the Incremental Contribution Method ("ICM") and Rule 6 of its Arizona Gas Tariff. The Signatories agree to the Company's continued use of its ICM and ICM model.
- 5.34 Within 30 days of the effective date of an order approving this Agreement, Southwest Gas will submit to the Commission a revised ICM model that prevents the Company from collecting contributions in aid of construction ("CIAC") that result in an expected ROE, as generated through the ICM model, that is more than 50 basis points above the authorized return on common equity. Within 90 days of the Company's filing of the revised ICM model, Staff will submit a recommendation to the Commission for the Commission's consideration.

M. Depreciation Study.

5.35 Southwest Gas will file a comprehensive depreciation study as part of its next general rate case application that addresses depreciation and amortization rates for all of Southwest's Arizona Direct and System Allocable depreciable and amortizable plant accounts. Southwest Gas shall not omit any such accounts from such studies.

N. Rate Design and Revenue Allocation.

5.36 The Signatories agree to a base rate revenue allocation resulting in an equal percentage increase among all customer classes, with the exception of the low income rate schedules.

5.37 A comparison of the overall average rate increase, the average residential and low-income rate increase, and the average monthly bill impact for residential and low-income customers associated with certain Signatories' filed positions and the results of Alternatives A and B of this Agreement is contained in the following table (which includes gas costs but not surcharges):

	Company Direct	Staff Direct	Settlement Alternative A	Settlement Alternative B
Overall Average Rate Increase (%)	9.26%	6.95%	6.95%	6.66%
Average Rate Increase (%) - RESIDENTIAL	13.55%	10.31%	8.11%	7.77%
Average Monthly Bill Impact - RESIDENTIAL	\$5.81	\$4.42	\$3.48	\$3.33
Average Rate Increase LOW INCOME	16.08%	11.61%	2.16%	1.81%
Average Monthly Bill Impact - LOW INCOME	\$5.20	\$4.04	\$0.70	\$0.59

5.38 A comparison of the proposed increases associated with Alternative A for each rate schedule is contained in Exhibit C and a comparison of the proposed increases associated with Alternative B for each rate schedule is contained in Exhibit D.

5.39 As part of Southwest Gas' next general rate application, Southwest Gas will include as one of its rate design proposals an inclining block rate design.

O. Miscellaneous Tariff Changes.

5.40 The miscellaneous housekeeping and other proposed changes to its Arizona Gas Tariff that were proposed in the Company's Application shall be accepted, except as otherwise specifically addressed in this Agreement.

5.41 Southwest Gas agrees that it shall modify its Arizona Gas Tariff consistent with Staff witness Bryan Frye's testimony supporting metering configurations where a sub-meter is installed by Southwest Gas downstream of the primary meter.

VI. FORCE MAJEURE PROVISION

6.1 Notwithstanding anything contained herein to the contrary, Southwest Gas shall not be prevented from requesting a change to its base rates in the event of conditions or circumstances that constitute an emergency. For the purposes of this Agreement, the term "emergency" is limited to an extraordinary event that is beyond Southwest Gas' control and that, in the Commission's judgment, requires base rate relief in order to protect the public interest. This provision is not intended to preclude any Settlement Party from opposing an application for rate relief filed by Southwest Gas pursuant to this paragraph.

VII. COMMISSION EVALUATION OF PROPOSED SETTLEMENT

7.1 The Signatories agree that all currently filed testimony and exhibits shall be offered into the Commission's record as evidence. The Signatories waive the filing and submission of rebuttal testimony and exhibits from Southwest Gas, the filing and submission of surrebuttal testimony and exhibits from Staff and Intervenors, and the filing and submission of rejoinder testimony and exhibits by Southwest Gas.

7.2 The Signatories recognize that Staff does not have the power to bind the Commission. For purposes of proposing a settlement agreement, Staff acts in the same manner as any party to a Commission proceeding.

7.3 This Agreement shall serve as a procedural device by which the Signatories will submit their proposed settlement of Southwest Gas' pending rate case, Docket No. G-01551A-

10-0458 to the Commission.

- 7.4 The Signatories recognize that the Commission will independently consider and evaluate the terms of this Agreement. If the Commission issues an order adopting all material terms of this Agreement, such action shall constitute Commission approval of the Agreement. Thereafter, the Signatories shall abide by the terms as approved by the Commission.
- 7.5 The Signatories agree that each Signatory, with the exception of Staff, retains the right to express its respective positions on Alternatives A and/or B during any hearings held by the Commission on this Agreement and at any subsequent Commission proceeding where the Commission votes on this Agreement. However, the selection of either Alternative A or B in each alternative's entirety by the Commission at Open Meeting does not relieve any of the Signatories from their respective obligations to support and defend this Agreement from that point forward.
- 7.6 The Signatories agree that if the Commission, in selecting between Alternative A and Alternative B, selects the alternative in its entirety that was not supported by a Signatory, such Signatory will nonetheless continue to be bound by the terms of this Agreement and the Commission order. With respect to this paragraph only, each of the Signatories waives its right to request a rehearing under Arizona Revised Statutes ("A.R.S.") § 40-253 or an amendment or modification under A.R.S. § 40-252 solely on the basis that the Commission selected an Alternative (either Alternative A or B) that was not supported by such Signatory.
- 7.7 If the Commission fails to issue an order adopting all material terms of this Agreement, or makes material modifications to either Alternative A or B as part of the acceptance, or imposes any additional material conditions on approval of this Agreement any or all of the Signatories may withdraw from this Agreement, and such Signatory or Signatories may pursue without prejudice their respective remedies at law, subject to Paragraph 7.6. For the purposes of this Agreement, whether a term is material (except for Alternative A

or B) shall be left to the discretion of the Signatory choosing to withdraw from the Agreement. If a Signatory withdraws from the Agreement pursuant to this paragraph and files an application for rehearing (except as set forth in Paragraph 7.6), the other Signatories, except for Staff, shall support the application for rehearing by filing a document to that effect with the Commission that supports approval of the Agreement in its entirety. Staff shall not be obligated to file any document or take any position regarding the withdrawing Signatory's application for rehearing.

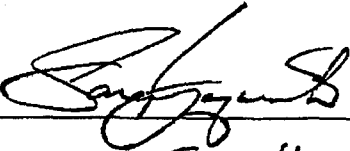
- 7.8 Within ten days after the Commission issues an order pertaining to this Agreement, if not sooner, Southwest Gas shall file compliance schedules for Staff's review.

VIII. MISCELLANEOUS PROVISIONS

- 8.1 This Agreement represents the Signatories' mutual desire to compromise and settle disputed issues in a manner consistent with the public interest. The terms and provisions of this Agreement apply solely to and are binding only in the context of the purposes and results of this Agreement.
- 8.2 This case has attracted a number of participants with widely diverse interests. To achieve consensus for settlement, many participants are accepting positions that, in any other circumstances, they would be unwilling to accept. They are doing so because this Agreement, as a whole, with its various provisions for settling the issues presented by this case, is consistent with their long-term interests and with the broad public interest. The acceptance by any Signatory of a specific element of this Agreement shall not be considered as precedent for acceptance of that element in any other context.
- 8.3 Nothing in this Agreement shall be construed as an admission by any Signatory as to the reasonableness or unreasonableness or lawfulness or unlawfulness of any position previously taken by any other Signatory in this proceeding.
- 8.4 No Signatory is bound by any position asserted in negotiations, except as expressly stated in this Agreement. No Signatory shall offer evidence of conduct or statements made in the course of negotiating this Agreement before this Commission, any other regulatory agency, or any court.

- 8.5 Neither this Agreement nor any of the positions taken in this Agreement by any of the Signatories may be referred to, cited, or relied upon as precedent in any proceeding before the Commission, any other regulatory agency, or any court for any purpose except in furtherance of securing the approval and enforcement of this Agreement.
- 8.6 To the extent any provision of this Agreement is inconsistent with any existing Commission order, rule, or regulation, this Agreement shall control.
- 8.7 Each of the terms of this Agreement is in consideration of all other terms of this Agreement. Accordingly, the terms are not severable.
- 8.8 The Signatories shall make reasonable and good faith efforts necessary to obtain a Commission order approving this Agreement. The Signatories shall support and defend this Agreement before the Commission. Subject to paragraph 7.5, if the Commission adopts an order approving all material terms of the Agreement, the Signatories will support and defend the Commission's order before any court or regulatory agency in which it may be at issue.
- 8.9 This Agreement may be executed in one or more counterparts and each counterpart shall have the same force and effect as an original document and as if all the Signatories had signed the same document. Any signature page of this Agreement may be detached from any counterpart of this Agreement without impairing the legal effect of any signatures thereon, and may be attached to another counterpart of the Agreement identical in form hereto but having attached to it one or more signature page(s).
- 8.10 Nothing contained in this Agreement is intended to interfere with the Commission's authority to exercise any regulatory authority by the issuance of orders, rules or regulations.

DATED this 15th day of July 2011.

By: 

Printed Name: Gary Yaguinto

Company: Arizona Investment Council

Title: President

DATED this 15th day of July 2011.

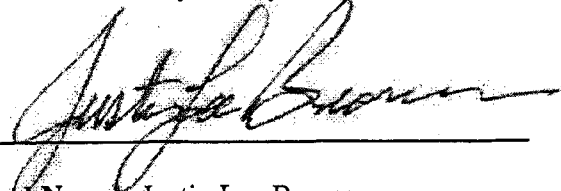
By: 

Printed Name: CYNTHIA WICK

Company: _____

Title: _____

DATED this 15th day of July 2011.

By: 

Printed Name: Justin Lee Brown

Company: Southwest Gas Corporation

Title: Assistant General Counsel

DATED this 15th day of July 2011.

By:  _____

Printed Name: STEVEN OLEA

Company: Utilities Division - Arizona Corp. Comm.

Title: DIRECTOR

DATED this 15th day of July 2011.

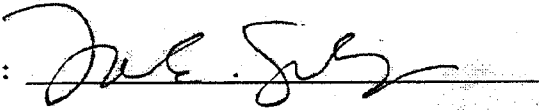
By: Jeffrey A. Schlegel

Printed Name: Jeffrey A. Schlegel

Company: Southwest Energy Efficiency Project (SWEEP)

Title: Arizona Representative of SWEEP

DATED this 15th day of July 2011.

By: 

Printed Name: LAURA E. SANCHEZ

Company: NRDC

Title: STAFF ATTORNEY