Case No. 80911

In the Supreme Court of Nevada

SOUTHWEST GAS CORPORATION,

Appellant,

vs.

PUBLIC UTILITIES COMMISSION OF NEVADA; and STATE OF NEVADA BUREAU OF CONSUMER PROTECTION,

Respondents.

APPEAL

from the Eighth Judicial District Court, Clark County
The Honorable WILLIAM KEPHART, District Judge
District Court Case No. A791302

APPELLANT'S REPLY BRIEF

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INTRODUCTION

Southwest Gas appeals the categorical denial by the Public Utilities Commission of Nevada ("Commission") of millions of dollars in costs Southwest Gas reasonably incurred for key software projects and pension expenses. The Commission failed to apply a presumption of prudence, and so disallowed these costs. Had the Commission properly applied the presumption, Southwest Gas would have recovered them. The Commission further imposed an unreasonably low rate of return on equity beneath that of Southwest Gas's peer utilities that are less risky investments. Reversal is required.

Respondents PUCN and the State of Nevada Bureau of Consumer Protection ("BCP") (collectively, "respondents") and amicus curiae Nevada Resort Association ("NRA") insist no presumption of prudence can exist without a "giant irrational leap of logic." But their rhetoric is belied by this Court's decision in *Ely Light & Power*,[1] the Commission's own practices, and the reality that numerous courts outside of Nevada and the Federal Energy Regulatory Commission ("FERC") consistently

[1] *Public Service Commission v. Ely Light & Power Co.*, 80 Nev. 312 (1964).

apply the presumption in utility rate cases—often implicitly, but in many instances explicitly. Had the presumption been applied here, Southwest Gas's software project and pension expenses would have been allowed. Respondents' tortured arguments to the contrary are unpersuasive.

ARGUMENT

I.

A PRESUMPTION OF PRUDENCE APPLIES IN GENERAL RATE CASES

Respondents' and NRA's arguments rest on a distortion. They argue that U.S. Supreme Court jurisprudence cannot support a mandatory presumption of prudence in utility rate cases. They contend that Southwest Gas derives the presumption from cases such as *Southwest Bell*[2] and *West Ohio Gas*[3] through deception and sleight of hand,[4] despite this Court's clear adoption of the presumption of prudence in *Ely*

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[2] *Mo. ex rel. Sw. Bell Tel. Co. v. Pub. Serv. Comm'n of Mo.*, 262 U.S. 276 (1923).

[3] *W. Ohio Gas Co. v. Pub. Utils. Comm'n*, 294 U.S. 63 (1935).

[4] BCP, for instance, contends that Southwest Gas cherry-picked from U.S. Supreme Court precedent to "sell . . . the lie" of a presumption of prudence, (BCP Br. 53) and that "a giant irrational leap in logic" is required to derive a presumption of prudence from the U.S. Supreme Court's decision and Justice Brandeis' concurrence in *Sw. Bell*. (BCP

Light & Power. By reaffirming the presumption of prudence first adopted in *Ely Light & Power*[5] and arising from U.S. Supreme Court jurisprudence, would stand with a substantial number of courts nationwide that have done likewise. (AOB 28 n.2 (citing cases applying the presumption of prudence in utility rate proceedings); *see also* BCP Br. 65 (recognizing that "other courts . . . have taken this footnote [*Sw. Bell*] and turned it into a full-blown burden shift – the presumption of prudence").) For the reasons below, respondents' and NRA's arguments disputing the presumption are unpersuasive.

A. BCP Relies on Hollow Semantic Distinctions to Deny the Presumption of Prudence

Respondent BCP attempts to distract from this Court's precedent by arguing that Southwest Gas derives a presumption of prudence only by conflating three distinct legal doctrines: (1) the Prudent Investment Rule; (2) the Arbitrary Substitution of Judgment Rule; and (3) the Presumption of Prudence. (BCP Br. 54.) Examining these three concepts and the cases that BCP contends are representative of each, however,

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Br. 59.)

[5] *Public Service Commission v. Ely Light & Power Co.*, 80 Nev. 312 (1964).

reveals a conceptual framework grounded in semantic distinctions that are both arbitrary and incoherent.

In reality, it is respondents who seek to nullify this Court's precedent in *Public Service Commission v. Ely Light & Power Co.*, 80 Nev. 312 (1964) by disregarding the context in which that case was decided, the U.S. Supreme Court precedent upon which it relied, and the near-universal recognition that those precedents form the foundation of the presumption of prudence applied by other courts, the FERC and other state utility commissions, and—until recently—even the Commission itself.

1. The Presumption of Prudence Is Ubiquitous, as Confirmed in the Cases Southwest Gas Cited

Southwest Gas in its opening brief cited decisions from across the country applying the presumption of prudence in utility rate cases. (AOB 28 n.2 (citing twenty federal and state court decisions, a treatise, and a law review article recognizing the presumption of prudence).) BCP purports to distinguish just two of them. For instance, BCP disputes *Pacific Telephone & Telegraph Co. v. Whitcomb*, 12 F.2d 279 (W.D. Wash. 1926), *aff'd* 276 U.S. 97 (1928), as an instance of a court applying the presumption of prudence to a utility rate case. BCP argues

that *Whitcomb* applies the "Arbitrary Substitution of Judgment Rule" instead. (BCP Br. 65 n.18.) It is revealing that BCP hand-picks *Whitcomb* for rebuttal, yet its argument hinges on hollow semantic distinctions.

In *Whitcomb*, a utility claimed that rate orders entered by the Department of Public Works were confiscatory under the U.S. Constitution. *See id.* at 281. The Department denied the utility's applications for increased rates upon finding, among other things, that its investment in a "switching machine apparatus" was "unnecessary, unreasonably, and injudicious." *Id.* at 288. But the district court, reiterating the principle that "[t]he right of a public utility corporation [to] honestly and in good faith carry on its business and direct its affairs must not be wrested from it under the guise of rate making," concluded the "expenditure was judicious and proper." *Id.* The *Whitcomb* court relied on the presumption of prudence, explaining that, "[i]n the absence of evidence to the contrary, investments may reasonably be assumed to have been made in the exercise of reasonable judgment." *Id.*

BCP contends *Whitcomb* stands for (2) the Arbitrary Substitution of Judgment Rule and not (3) the Presumption of Prudence. Yet the

Whitcomb court's reasoning could not be more straightforward: a utility's "investments may reasonably be assumed to" be reasonable "[i]n the absence of evidence to the contrary." *Id.* at 288. The *Whitcomb* court could point to evidence in the record showing the reasonableness of the expenditure—but does not. Instead, the court points to the *absence* of evidence of *unreasonableness*. In this way, the *Whitcomb* court assumes that the utility exercised reasonable judgment (i.e., prudence), and regards the absence of contrary evidence as dispositive. And for that presumption of prudence, the *Whitcomb* court cites to Justice Brandeis' concurrence in *Sw. Bell*. *See id.*

Whitcomb demonstrates that BCP's supposed distinction between (2) ("Arbitrary Substitution of Judgment Rule") and (3) ("Presumption of Prudence") lacks a meaningful difference. The rule prohibiting a public utility commission from substituting its business judgment for that of the utility has been widely interpreted by courts—including *Whitcomb*—as an evidentiary presumption because the plain language of *Sw. Bell*, *W. Ohio Gas*, and *Ely Light* dictates that result.[6]

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[6] As Southwest Gas noted in its Opening Brief, the federal district court in *Denver Union Stock Yard Co. v. United States*, 57 F.2d 735, 748 (D. Colo. 1932), explicitly recognized the connection between *Sw. Bell* and

BCP's arguments that *Sw. Bell*, *W. Ohio Gas*, *Ely Light*—and *Whitcomb*—fail to support a presumption of prudence are fundamentally semantic. BCP assigns *Southwest Bell* and *West Ohio Gas* to category (2) ("Arbitrary Substitution of Judgment Rule") by semantic sleight of hand, insisting that neither belongs to category (3) ("Presumption of Prudence") because neither opinion expressly references an evidentiary presumption. (BCP Br. 59, 61-3.)

2. This Court Relied on the Same Line of Cases to Adopt the Presumption of Prudence in Ely Light

BCP's semantic argument runs aground on *Ely Light*, which BCP conspicuously fails to locate within its three-category framework. (BCP Br. 53-67.) In *Ely Light*, this Court surveyed the case law and recognized the "many references . . . to the *presumption* of the proper exercise of judgment by the utility." 80 Nev. at 324 (emphasis added). BCP argues that neither *Sw. Bell* nor *W. Ohio Gas* recognize a presumption of

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the presumption articulated in *Whitcomb*. (AOB 28.)

prudence because neither opinion references a "presumption of prudence." (BCP Br. 58-63.) But as *Ely Light* indicates, that is precisely what a "presumption of the proper exercise of judgment" means.[7]

B. The Presumption of Prudence Harmonizes with Nevada's Statutory Scheme

Rather than confront the binding precedent from this Court in *Ely Light*, itself rooted in the constitutional principles articulated by the U.S. Supreme Court, respondents and NRA resort to attacking the presumption as inconsistent with the Commission's own regulations. This argument is untenable for three reasons: First, the Commission cannot through regulation overrule a presumption previously recognized in the common law. Second, regardless, the purported conflict is illusory, as confirmed by the Commission's own recognition of the presumption in its prior decisions. Third, the presumption is consistent with the broader statutory scheme governing rate cases.

[7] "Prudence" being defined as "skill and good judgment in the use of resources." (BCP Br. 28 n.7.)

1. The Commission Cannot Negate a Constitutional and Common Law Presumption of Prudence Through Regulation

Respondents and NRA argue that the presumption of prudence is incompatible with NAC 703.2231, because NAC 703.2231 allocates the burden of proving prudence to the utility. (BCP Br. 21-24, 38-39; PUCN Br. 63; NRA Br. 6-8.) But the Commission cannot negate the presumption of prudence through regulation because the presumption is based in the common law and the U.S. Constitution, not a statute. (AOB 39-44.)

But Respondents' argument illuminates a critical issue: whether the Commission has unfettered discretion to decide what evidentiary standard should apply, and when, in rate proceedings. The Commission merely assumes that it does, arguing that Southwest Gas was "specifically put on notice" in the 2012 rate case of the standard of proof the Commission would demand next time around (i.e., this time). (PUCN Br. 36-37.) BCP likewise argues the Commission's statement in the 2012 rate case that Southwest Gas bears the burden of showing prudence estops Southwest Gas from challenging the Commission's denial of the presumption in this appeal. (BCP Br. at 41.)

This kind of ad hoc rulemaking is not just misguided, but *ultra vires*. The Commission has no authority to simply discard the presumption at whim. Further, Respondents' argument that the Commission has discretion over the evidentiary standards in rate cases is made more threatening by the Commission's selective and inconsistent application of evidentiary standards *in this case*. (*See* Part I.D.4.)

2. The Presumption of Prudence Does Not Conflict with NAC 703.2231

Setting aside that the Commission cannot negate the presumption of prudence through regulation, the presumption does not conflict with NAC 703.2231 or with the premise that the utility bears the ultimate burden of proof. The cited conflict between NAC 703.2231 and the presumption of prudence rests on a straw man.

The presumption of prudence is rebutted if a party raises "serious doubt" about the prudence of an expense. (*See* AOB at 28 n.2, 38, 57, 58 (citing cases recognizing the presumption).) Serious doubt is not proof. Rather, "[s]erious doubt must be more than a bare allegation of imprudence, but . . . not so demanding that it effectively reverses the statutory burden of proof." *Pac. Gas & Elec. Co.*, 165 FERC ¶ 63001, ¶ 623, 2018 WL 4917873 at *101 (2018).

By conflating distinct evidentiary standards, Respondents and NRA manufacture a conflict between NAC 703.2231 and the presumption of prudence. (PUCN Br. 53 ("Requiring the other parties to prove imprudence . . . would be a dangerous outcome that this Court should not support."); BCP Br. 51 ("This burden shift is akin to a defendant in a criminal case being presumed guilty until proven innocent."); NRA Br. 11 ("This is entirely different from shifting the direct burden of proof from the utility to customers and other parties in the first instance.").) But non-utility parties need only show serious doubt to rebut the presumption; they need not *disprove* prudence, as Respondents and NRA repeatedly insist.

Respondents and NRA premise other arguments on this conflation. For instance, they argue that a presumption would unreasonably place non-utility parties at the mercy of the utility, as the utility controls the evidence necessary to "prove" imprudence. (PUCN Br. 53; BCP Br. 51, 53; NRA Br. 7-8.) Again, raising serious doubt is not equivalent to proving imprudence. In the FERC's formulation, for instance, serious doubt is "more than a bare allegation." *See Pac. Gas & Elec. Co.*, ¶ 623.

Because the non-utility parties may rebut the presumption of prudence by meeting a lesser evidentiary standard ("serious doubt"), the presumption does not re-allocate a utility's ultimate burden of proof. *See id.* (recognizing "[t]he regulated entity has the burden of proof to establish prudence," notwithstanding the presumption of prudence). For that reason, the presumption does not conflict with NAC 703.2231.

3. The Presumption of Prudence Harmonizes with Nevada's Larger Statutory Scheme Governing Utilities

Respondents also argue the presumption of prudence is incompatible with Nevada's statutory scheme governing utilities more generally. (BCP Br. 24-28; PUCN Br. 62-64) Yet Respondents again conflate a rebuttable presumption with re-allocation of the ultimate burden of proof.

Respondent PUCN's argument focuses on Nevada's statutes and regulations that provide a framework for integration resource planning ("IRP"). It argues that a constitutional presumption of prudence for all utilities usurps the purpose of Nevada's IRP laws and regulations, nullifying them. (*See id.*)

PUCN conflates the application of a rebuttable presumption of prudence with a *final* determination of prudence. Nevada's IRP framework authorizes a final determination. *See, e.g.*, NRS 704.661(6) ("If . . . accepted by the Commission . . . the facility shall be deemed to be a prudent investment . . ."). PUCN argues the framework cannot be squared with prudence being "an automatic giveaway in a general rate proceeding." (PUCN Br. 63.) But the presumption is far from an "automatic giveaway"; any party may hold the utility's feet to the fire by raising "serious doubt" about a claimed expense.

Respondent BCP's argument focuses on NRS 704.110(3) and NAC 703.695(1), which describe evidence a utility must present in a general rate case and direct the utility to present affirmative evidence before other parties present rebuttal evidence. (BCP Br. 25-8.) BCP argues these statutes and regulations preclude a presumption of prudence because a utility cannot at once present its evidence first and also wait to present evidence until another party raises serious doubts. (*See id.*)

Nothing in NRS 704.110(3) or NAC 703.695(1), however, is inconsistent with the presumption of prudence. BCP does not allege that Southwest Gas failed to present evidence of the basic facts set forth in

NRS 704.110(3). This Court has explained that a "rebuttable presumption is a rule of law by which the finding of a basic fact gives rise to a presumed fact's existence," unless rebutted. *See Bass-Davis v. Davis*, 122 Nev. 442, 449 n.11, 134 P.3d 103, 107 n.11 (2006). Southwest Gas presented evidence of the basic facts required by NRS 704.110(3)—including evidence of expenses, investments and capital costs. By operation of the presumption of prudence, evidence of these basic facts (i.e., what was incurred, when, and for what purpose) gives rise to a presumption that the expenditures were prudent.[8] There is no conflict with either NRS 704.110(3) or NAC 703.695(1).

4. A Presumption of Prudence in General Rate Cases Is Supported by Nevada Power Co. *and AB 7*

In 2007, the Legislature enacted Assembly Bill 7 ("AB 7"). AB 7 overruled *Nevada Power Co.* and amended NRS 704.185 to deny a rebuttal presumption of prudence in deferred energy accounting proceedings. (AOB 56.) The Legislature declined to amend the statutory provisions applicable to general rate cases to bar the presumption. And both

[8] For 99.5% of the expenses associated with the CWOs, the presumption was not rebutted. The Commission did not have discretion to categorically deny these expenses totaling $50.7 million. (See Part II.A-B below.)

before and after AB 7, the Commission has applied a rebuttable presumption of prudence in general rate cases—including in this case. (*See* AOB 57; *infra* Part I.D.4.)

Respondents unpersuasively argue this sequence has no bearing on whether a presumption applies in general rate cases. But their arguments fall flat. In *Re Nev. Power Co.*, 2009 WL 1893687 (Nev. Pub. Utils. Comm'n June 24, 2009), a general rate case decided *two years* after AB 7, the Commission applied a "rebuttable presumption" that expenses in a rate application are "prudently incurred." PUCN simply disregards *In Re Nev. Power Co.* (*see* PUCN Br. 55-59), while BCP contends the Commission erred in applying an "unknown" rationale. (BCP Br. 40-41.) But the rationale for the Commission's continued application of the presumption in general rate cases is hardly unknown; it is rooted in common law and the U.S. Constitution, and the Legislature through AB 7 conspicuously passed on the opportunity to disallow its application in general rate cases.

C. FERC Precedent Remains Persuasive Authority for a Constitutional Presumption of Prudence

Respondent PUCN discounts Federal Energy Regulation Commission ("FERC") decisions recognizing a constitutional presumption of

prudence in utility rate cases. (PUCN Br. 32-33; *see also id.* 25 n.9.) PUCN argues that FERC decisions are non-binding and, in any event, reflect administrative "practice[s]," not constitutional mandates. PUCN is correct that FERC decisions are not binding on this Court, but they illustrate that administrative agencies interpret *Southwest Bell* and *West Ohio Gas* to mandate a presumption of prudence in utility rate cases and demonstrate why PUCN's efforts to distinguish these decisions are unpersuasive.[9]

In *Re Midwestern Gas Transmission Co.*, 65 P.U.R.4th 508, 30 FERC P 61260 (F.E.R.C. Mar. 7 1985), the FERC recognized and applied a rebuttable presumption of prudence. *See id.* at 61543 ("It is presumed, where there is no evidence to the contrary, that actual expenses contained in a cost of service study reflect good faith and prudent management decisions."). For the presumption, it relied on *W. Ohio Gas*. *See id.*

[9] PUCN correctly points out that *Office of the Consumers' Counsel, State of Ohio v. F.E.R.C.*, 914 F.2d 290, 292 (C.A.D.C. 1990) does not cite to *Sw. Bell*, as Southwest Gas stated in its Opening Brief. The case cites to *Re Midwestern Gas*, which in turn cites to *W. Ohio Gas*.

Straining to distinguish *Midwestern Gas*, PUCN misquotes its key passage. PUCN argues that the FERC applies the presumption of prudence merely "[a]s a matter of practice," not as a constitutional mandate. (PUCN Br. 32.) PUCN seizes on language the FERC in *Midwestern Gas* quotes to describe the procedural operation of the presumption. *See id.* at 61543 (quoting *Re Minnesota Power & Light Co*, 11 FERC ¶ 61312, 61645 (1980)). But *Midwestern Gas* does not rely on this language for *the existence* of the presumption. *See id.* For *that*, *Midwestern Gas* relies on U.S. Supreme Court's decision in *West Ohio Gas*. *See id.*

D. No Parade of Horribles Results from the Presumption of Prudence

1. Because the Presumption of Prudence Is Rebuttable, Utilities Cannot Run Out the Clock

Respondents and NRA argue a presumption of prudence would enable utilities to exploit ratepayers through delay and by withholding evidence. Because the Commission has only 210 days to evaluate "evidence concerning the prudency of each expense," they argue that, if utility expenses are presumed prudent, a utility may run out the clock by withholding the evidence other parties need to show imprudence. (BCP

Br. 53; NRS Br. 6-8.) Apart from the fact that the Commission's regulations concerning discovery preclude this type of behavior, this case aptly demonstrates that a utility cannot recover imprudent expenses this way because the presumption is *rebuttable* upon a lesser evidentiary showing of serious doubt.

Southwest Gas agrees that certain discrete expenses identified by Staff should not have been part of its rate application. Southwest Gas voluntarily withdrew these expenses during the discovery phase of the proceeding.[10] But a presumption of prudence would not have enabled Southwest Gas to recover these expenses. Staff raised serious doubt as to these expenses by noting they were unrelated to the projects to which they were charged. Had Southwest Gas not voluntarily withdrawn the expenses during discovery, the Staff's objections at the hearing would have rebutted the presumption, and Southwest Gas would have needed to produce evidence showing that the expenses were prudent. Respondents and NRA's arguments regarding the dangers of "[r]equiring the other parties to *prove* imprudence" (*see, e.g.*, PUCN Br. 53 (emphasis

[10] The withdrawn expenses amounted to less than one-half of 1 percent of the total cost of the CWOs. (AOB 13.)

added)) misrepresents the evidentiary standard by which the presumption may be rebutted and greatly overstates the risk that a utility may benefit by sandbagging discovery.

2. Respondents and NRA Misapprehend the Commission's Duty to Balance the Interests of the Utility's Customers and Shareholders

Respondents and NRA argue that a presumption of prudence deprives the Commission of beneficial leverage to ensure utilities do not recover imprudent expenses from captive ratepayers. (NRA Br. 15-6, BCP Br. 50-3, PUCN Br. 41.) But Respondents and NRA, in this way, conflate the Commission's statutory duty with BCP's mandate to protect the consumer against industry. In actuality, the Commission must "balance the interests of customers *and shareholders* of public utilities." NRS 704.001(5) (emphasis added). A rebuttable presumption of prudence harmonizes with this statutory duty by ensuring utilities may generally recover costs they incur in the course of normal business operations, yet requiring closer scrutiny whenever serious doubt is raised as to any expense. Far from being incompatible with the Commission's duty, the presumption complements the duty.

3. The Presumption of Prudence Does Not Increase Costs Borne By Ratepayers

Nor would a presumption of prudence shift increased costs to ratepayers. Conceptually, a presumption promotes efficiency by focusing the general rate case on material issues that are in genuine dispute. *See In re Pac. Gas & Elec. Co.*, 165 FERC ¶ 63,001 (Oct. 1, 2018) ("[T]o ensure that rate cases are manageable, a presumption of prudence applies . . ."). Pragmatically, eliminating the presumption would significantly increase the costs utilities reasonably incur to prepare for rate cases, and those increased costs are borne by ratepayers. *W. Ohio Gas Co. v. Pub. Utilities Comm'n of Ohio*, 294 U.S. 63, 72-73, 55 S. Ct. 316, 321 (1935).

If the Commission's categorical disallowance of Southwest Gas's incurred expenses (whether for the CWOs or for pensions) is allowed to stand even though no party raised serious doubt as to their prudence, then a utility moving forward must prepare an evidentiary defense for every expense—even those not reasonably disputable. This would increase Southwest Gas's—and any other utility's—reasonable rate costs to prepare for rate cases by an order of magnitude. Because utilities may recover their reasonable case costs from ratepayers, this will be to

the detriment of all involved. *W. Ohio Gas Co.*, 294 U.S. 63, 72-73 (1935).

Respondents unpersuasively argue that any heightened costs for rate proceedings are insignificant "compared to the dollars at stake in large capital investment projects." (PUCN Br. 60.) Respondents compare apples to oranges. Increased case costs must be compared to imprudent expenses—not all expenses claimed. For instance, Southwest Gas incurred $51 million in expenses associated with the CWOs. Less than one-half of 1 percent of that total were challenged as imprudent. The heightened costs Southwest Gas would reasonably incur to defend the unchallenged $50.7 million would dwarf the allegedly imprudent expenses identified in this case.

4. The Commission Applied The Presumption of Prudence in This Case to Ratepayers' Benefit

In fact, it would be worse than that. Taking the Commission seriously would mean that the presumption of prudence would be eliminated even as to *unchallenged* expenses—144 work orders, here—exponentially increasing the cost of rate proceedings.

This is apparent because the Commission did not even take its "no presumption of prudence" seriously, or consistently, in this case. Without saying so, the Commission in this case reasonably applied the presumption of prudence to the benefit of Southwest Gas and ratepayers both. The approved rate captures myriad costs Southwest Gas incurred—but for which it made a more streamlined evidentiary showing (just the company's incurrence and nature of the costs) than it made for the CWOs. For example, Southwest Gas presented direct evidence for 144 work orders costing a total of $84.8 million that mirrored the evidence it presented for the CWOs—it showed Southwest Gas incurred the costs, when, and why.[11] Yet the Commission included these costs in the approved rate. What was different about them? Unlike the CWOs, no party challenged the prudence of any costs associated with these work orders. This is the presumption of prudence in action.[12]

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[11] *See* 13 JA 3038-39, 3057; *see also, e.g.*, 23 Reply App. 5355–65, 21 ROA 15,966–74 (detailing expenses for, among other things, "office supplies and expenses," which would include such costs as professional dues of attorneys, accountants, and other licensed professionals).

[12] Nevertheless, it was unlawful for the Commission to categorically disallow all costs associated with the CWOs. Staff raised substantial doubt regarding only a small subset of these expenses, and those expenses were withdrawn. (*See* Part II.B.)

Application of the presumption benefits ratepayers and utilities, as this case illustrates. These benefits evaporate if this Court affirms the Commission's refusal to recognize the presumption. If so, the Commission may continue to arbitrarily apply the presumption when it makes the Commission's job easier or when doing so will result in lower rates.[13] But utilities may no longer rely on it. Rather, to account for the risk that the Commission may disallow *all* costs associated with a multi-million dollar project because the utility failed to screen a handful of non-recoverable expenses—as the Commission did here—the prudent business decision for utilities will be to prepare an evidentiary defense for *all* claimed expenses. Doing so will be costly, but reasonable in the absence of a presumption of prudence. Ratepayers will bear that increased cost.

[13] See Part PART One:II.C for a discussion of the Commission's arbitrary acceptance of Southwest Gas's discount rate for pension expenses only in years when that rate would not significantly increase expenses.

II.

SOUTHWEST GAS'S CHALLENGED WORK ORDERS FOR SOFTWARE PROJECTS AND PENSION EXPENSES SHOULD HAVE BEEN APPROVED

A. The Commission May Not Categorically Disallow Expenses

This Court should reverse the Commission's disallowance of 100% of Southwest Gas's costs for the Challenged Work Orders ("CWOs") because 99.5% of these expenses were categorically disallowed without regard to their prudence. (*See* 20 App. 4869, Respondent PUCN's District Court Brief ("Southwest Gas perhaps exercised prudent judgment with regard to the disallowed costs associated with the [CWOs] . . . . The [Commission] did not find that the costs were improperly incurred.").) This contravenes the well-established rule that the Commission must analyze "each practice or transaction separately to determine whether the utility prudently incurred the costs associated with each practice or transaction."[14] *Nev. Power Co.*, 122 Nev. at 837, 138 P.3d at 497. *Nevada Power Co.* was not overruled in this regard.

[14] BCP repeatedly confirms that the PUCN must decide expenses on an individual basis: BCP Br. 59 ("[T]he PUCN must recognize **each expense** made by the utility and cannot disallow or deny **a request or expense** without substantial evidence of inefficiency or improvidence to

Respondent PUCN argues that *Nevada Power Co.*'s direction that the Commission must analyze "each practice or transaction separately" does not apply here because *Nevada Power Co.* interpreted a statutory provision applicable only to deferred energy accounting proceedings—not general rate cases. (PUCN Br. 76.) But there is no reason why the Commission should be free to disregard this rule in general rate cases. PUCN's arguments purporting to distinguish *Nevada Power Co.* are unpersuasive for three reasons.

First, cases interpreting the common-law presumption of prudence regularly make clear that the presumption operates at the level of each expenditure: "[W]here some other participant in the proceeding creates a serious doubt as to the prudence of *an expenditure*, then the applicant has the burden of dispelling these doubts and proving *the questioned expenditure* to have been prudent." *State ex rel. Associated Nat. Gas Co. v. Pub. Serv. Comm'n*, 954 S.W.2d 520, 528–29 (Mo. Ct. App. 1997) (quotation marks and citation omitted); *accord Anaheim, Riverside, Banning,*

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support such a decision."; *id.* at 53 (PUCN must "make decisions . . . concerning the prudency of **each expense** . . ."). (Emphasis added.).

Colton & Azusa, Cal. v. FERC, 669 F.2d 799, 809 (D.C. Cir. 1981) (quoting Opinion No. 86, *Minnesota Power & Light Co. Opinion and Order on Rate Increase Filing*, Docket No. ER76-827, at 14, 20 Fed. Power Serv. 5-874, 5-887 (June 24, 1980) and citing *Sw. Bell*). This is not a quirk of Nevada's statutes on deferred energy accounting proceedings. It is inherent in the common-law presumption that the Commission used to apply, drawing from FERC opinions and the U.S. Supreme Court's opinion in *Southwest Bell*.

Second, PUCN's and NRA's policy argument is nonsensical. They insist that general rate cases require more diligent examination of utility costs. (PUCN Br. 58; NRA Br. 12.) But even if that is true, nothing about the presumption of prudence precludes a review of individual costs; every improvident expenditure may be challenged. It is paradoxical for PUCN to now insist, absent any supporting authority, that the rule announced for deferred energy accounting and other proceedings that the Commission characterizes as "full-blown rate proceeding[s]"—where the Commission must analyze "each practice or transaction separately"—should not apply to a general rate case. (PUCN Br. 57-58, 76.)

Third, in characterizing the annual rate adjustment in NRS 704.110(9) as a "full-blown rate proceeding," PUCN implicitly concedes that there is no practical obstacle to analyzing individual expenses in a general rate case. (PUCN Br. 57-58.) The Legislature's choice to eliminate the presumption of prudence in *other* proceedings is irrelevant to the Commission's duty in a general rate case (as in other "full-blown" rate proceedings) to analyze each expense separately.[15] Respondent BCP concedes this point. (BCP Br. 59 (recognizing the Commission has a duty to analyze "each expense made by a utility" and "cannot disallow or deny a request or expense without substantial evidence.").)

The Commission disallowed approximately $50.7 million in expenses associated with the CWOs without finding they were imprudent. (*See* 20 App. 4869, Respondent PUCN's District Court Brief.) It could have easily disallowed expenses deemed imprudent on a line-item basis. Southwest Gas produced all invoices, vouchers, and costs associated

[15] NRS 704.110(9)(e), which does not apply to general rate cases, provides "[t]here is no presumption of reasonableness or prudence . . . and the public utility has the burden of proving reasonableness and prudence in the proceeding." Nothing in that statute or the statutes governing general rate cases constitutes a license to disallow entire categories of expenses when a small number of expenditures within the category have been shown to be imprudently incurred.

with the disallowed CWOs. (8 App. 1965-66, 1986; 11 App. 2675, 2678; 10 App. 2493, 5 ROA at 3165-66, 3186, 3878, 3881, 3693.) Staff witness Adam Danise testified that he reviewed each of these invoices, but found no other improper costs. (8 App. 1983:18-22.) Southwest Gas even voluntarily withdrew discrete expenses from its application on a line item basis. The Commission's categorical disallowance of the remaining expenses was improper.

B. Application of the Presumption of Prudence Would Result in Allowance of the Challenged Work Orders

Respondents argue that, even if the presumption of prudence applies, its application would not have resulted in allowance of Southwest Gas's CWOs. (PUCN Br. 42-3; BCP Br. 90.) Even if the presumption applied, respondents argue, Southwest Gas failed to present sufficient evidence after Staff rebutted the presumption. (PUCN Br. 43; BCP Br. 90.) The Commission also relies on this reasoning in the modified order. (*See* 2 App. 282-3, ¶ 622.) But this reasoning is belied by the record.

Nowhere does the record show that Staff or any party raised serious doubt about the lion's share of expenses associated with the CWOs. Southwest Gas incurred $51 million in expenses relating to the CWOs.

(*See* 2 App. 264-81, ¶¶ 563-620 (description of total CWO project expenditures).) Serious doubts were raised by Staff concerning one-half of 1 percent of this total amount. (AOB 8-10; PUCN Br. 13-15 (cataloguing "problematic expenditures").) The Commission must analyze each "practice or transaction" separately (*see* Part II.A), yet the presumption of prudence as to the expenses comprising the remaining $50.7 million was never rebutted—notwithstanding Staff's review of every invoice relating to the CWOs.[16] These unrebutted costs should have been recovered in rates.

PUCN argues that the presumption of prudence for the CWOs was "rebutted by evidence of SWG's management exercising poor judgment *with regard to specific costs* included in the CWOs and evidence *raising questions* as to whether SWG prudently explored alternatives." (PUCN Br. 43 (emphasis added).) But evidence relating to "specific costs" cannot rebut the presumption as to an *entire project* when this Court has held, and respondents admit, that the Commission's analysis must consider "each practice or transaction separately." *Nev. Power Co.*, 122 Nev. at 837.

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[16] 8 JA 1938:18–22.

Nor could the presumption have been rebutted as to *the entirety of the CWOs* merely because Staff raised "questions" as to whether Southwest Gas prudently explored alternatives. (PUCN Br. 43.) This argument assumes the presumption does not apply. There was no suggestion that the CWO expenses were unreasonable (apart from the few expenses that Southwest Gas voluntarily withdrew). Staff's *wondering* about alternative solutions is no rebuttal. Serious doubt is less than proof—but more than speculation. *See Gramanz v. T-Shirts & Souvenirs, Inc.*, 111 Nev. 478, 485, 894 P.2d 342, 347 (1995) (speculation is not evidence).[17] If the presumption were rebuttable in this way, without *any* evidence that an alternative solution would *in fact* deliver greater value, it would be rebutted instantly in every case.

Even if the Commission were not required to analyze each expense separately, no rational basis supports the Commission's finding of "a systemic lack of accountability, oversight, and prudent management" as to the CWOs. For that finding, the Commission relied on a handful of expenses Southwest Gas voluntarily withdrew after Staff disputed them

[17] Respondent BCP also argues the presumption was rebutted, but does not purport to explain how. BCP's argument fails for the same reasons.

during the discovery phase. (*See* 2 App. 256-86, Modified Order, ¶¶ 540-627).) No other costs associated with the CWOs were challenged. Respondents spotlight the expenses Southwest Gas withdrew—for massages, meals, golf course membership, consumer electronics, polo shirts—and invite the inference that they reflect corruption or waste that casts serious doubt on the projects in their entirety. (PUCN Br. 13-5; BCP Br. 11, 88-9.) Not so.

First, respondents' argument against a presumption of prudence hinges on cherry-picked, inflammatory examples that were included in error—examples that, all parties stipulated, Southwest Gas was not seeking to recover as prudently incurred expenses.

Second, though Southwest Gas had not intended to include these expenses in its application, respondents ignore their true context. They disregard pre-filed testimony from two Southwest Gas witnesses explaining that these costs were reasonable business expenses incurred in connection with the CWOs as prizes to incentivize and reward employees. (*See* 13 App. 3070-92 (N. Murandu Rebuttal Testimony, Q/A 13-44), 13 App. 3134-45 (R. Cunningham Rebuttal Testimony, Q/A 18-53).) Alt-

hough such employee-incentive programs are common[18]—hardly indicative of profligate mismanagement—Southwest Gas was mindful that such expenses should be borne by shareholders, not incorporated into rates. (*See id.*)

So, it was Southwest Gas's practice to exclude such costs from its rate applications. Here, however, a limited number of expenses were erroneously billed to the CWOs, even though, as Mr. Murandu testified, most were reasonably incurred and correctly billed to these projects. (*See id.*) What is important is that these costs were not personal expenses surreptitiously inserted by Southwest Gas in the rate application, as respondents insinuate. They were reasonable business expenses that Southwest Gas should have, and intended to, remove from its rate application, but inadvertently overlooked. That the Staff audit caught them early—and that Southwest Gas immediately withdrew them—demonstrates that the process works, not that the presumption of prudence must be dismantled altogether.

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[18] *See, e.g.*, BOB NELSON, 1501 WAYS TO REWARD EMPLOYEES 315 (2012) (suggesting as examples of employee rewards services like "a housecleaning for a year, babysitting coupons, spa visits, and facials").

Third, the notion that these costs signal a systemic or project-wide failure is contrary to all evidence. Far from it, Staff witness Adam Danise testified that he reviewed *all invoices* associated with each of the five CWOs, and yet identified as improper costs totaling just one-half of 1 percent of the total project costs—and an even smaller fraction of Southwest Gas's total work orders.[19] For respondents to pretend these costs are representative of Southwest Gas's imprudence as a whole is to grossly distort the record.

Thus, because the presumption of prudence was never rebutted as to the majority of CWO expenses the Commission disallowed, Southwest Gas would have recovered these expenses if the presumption had been applied.

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[19] 8 JA 1938:18–22. *See* 13 JA 3038-39 (enumerating 149 work orders over $100,000); 2 JA 359-65, Modified Order, ¶¶ 1-47 (granting Southwest Gas application in part, but ordering removal of all expenses associated with five CWOs). Southwest Gas's costs for all work orders exceeded $135 million.

C. Application of the Presumption of Prudence Would Result in Allowance of Southwest Gas's Pension Expenses

Had the Commission applied the presumption of prudence, it would have also accepted the 3.75% discount rate Southwest Gas proposed for pension expenses in 2018. (AOB 11-12.) No party challenged that rate before the hearing. Southwest Gas presented evidence of its discounts rates that were used to develop its pension expense for 2014-2018. (13 App. 3186-89.) Yet, while accepting the rates for 2014-2017 based on the evidence submitted, the Commission recognized that applying the 3.75% discount rate in 2018 would increase pension expenses. So the Commission arbitrarily adjusted the 2018 discount rate, stating "the corrected rate for 2018 represents a more appropriate period reflective of historical figures." (AOB 12.) As a result, a lower pension expense was included in rates than what Southwest Gas actually incurred for 2018.

The Commission did this under the guise of applying a three-year "normalizing" average, but the problem is that the Commission did so arbitrarily: it applied the so-called three-year average to just *one* year—2018—when pension costs were highest, while not applying the average

to the prior two years to much such a sudden change in methodology fair. Indeed, the three-year normalized rate would have *elevated* pension costs in the prior years. The Commission's unilateral and selective revision of historical evidence was an arbitrary step to limit Southwest Gas's recovery of its prudently incurred pension expense.

This, too, manifests the disregard of the presumption of prudence. Southwest Gas would have been entitled to a level of pension expense resulting from the use of the 3.75% discount rate if the Commission applied the presumption, because serious doubt was not raised as to the discount rate that was used nor the prudence of the proposed level of pension expense to be included in rates. In fact, the record reflects that no party challenged Southwest Gas's discount rate or evidence of 2018 pension expenses. The Commission's unilateral inquiry at the hearing and selective revision of evidence to support lower rates violated Southwest Gas's due process rights. Had the Commission applied the presumption of prudence, Southwest Gas would have recovered its proposed pension expenses—which were the expenses it actually incurred—because serious doubt was never raised as to their prudence.

D. Alternatively, Substantial Evidence Does Not Support the Commission's Categorical Disallowance of the Challenged Work Orders

Alternatively, even if the substantial evidence standard applies, the Commission's order must be reversed. Respondents argue the Commission's categorical disallowance of expenses associated with the CWOs is supported by substantial evidence because the record shows Southwest Gas failed to satisfy its burden. (PUCN Br. 73-9; BCP Br. 87-90.) However, this argument assumes the presumption of prudence does not apply. There is no dispute that Southwest Gas proved that its expenses were actually incurred. Here, the presumption was never rebutted as to $50.7 million in disallowed expenses associated with the CWOs. (*See* Part II.B.)

Further, the Commission disallowed the $50.7 million in expenses based not on substantial evidence that they were imprudent, but based on purported evidence of "a systemic lack of accountability, oversight, and prudent management by SWG." (*See* 2 App. 282, ¶ 622.) The evidence of "systemic" dysfunction, however, is nothing more than evidence that a small percentage (approximately 0.5%) of the expenses associated with the CWOs were improper for rate making purposes. This mode of

analysis—extrapolation of imprudence as to all project expenses from limited, discrete expenses deemed improper—was foreclosed by *Nevada Power Co.* Nor is there any rational basis to infer from these costs a *systemic* lack of prudent management or oversight. (*See* Part II.B.) Simply put, a handful of expenses that Southwest Gas voluntarily withdrew *during discovery* cannot be substantial evidence supporting a categorical disallowance of all expenses associated with the CWOs.

Respondent PUCN argues that substantial evidence supports the Commission's disallowance of even prudent expenses associated with the CWOs because the modified order "walks through each phase of the case and explains why SWG never met its burden of proof." (PUCN Br. 74 (citing Modified Order, ¶¶ 623-626).) Respondents, like the Commission, frequently fall back on this expedient—that Southwest Gas failed to meet its burden of proof. But this argument fails under scrutiny.

For instance, the Commission found that Southwest Gas "was unable to provide the Commission with any evidence regarding the prudence of the expenditures associated with the [CWOs]." (2 App. 285-86.) Respondents contend, in a similar vein, that Southwest Gas was given

every opportunity, including on rebuttal, to satisfy its burden of showing the prudence of its disallowed expenditures—but failed to do so. (*See, e.g.*, PUCN Br. 1; BCP Br. 79.) However, the record demonstrates the opposite.

Southwest Gas pre-filed rebuttal testimony from its Chief Information Officer, Ngoni Murandu,[20] explaining the business rationale for management's decisions relating to the CWOs. (*See* 19 App. 4635-68; 13 App. 3066-145.) Responding to testimony from Staff and BCP regarding the CWOs, Southwest Gas also submitted rebuttal testimony from Mr. Murandu. Mr. Murandu further testified from the stand on cross-examination and redirect. (*See* 9 App. 2125:11-2127:3.) The Commission found that Southwest Gas failed to meet its burden, but Mr. Murandu's testimony shows this finding is not only unsupported but contrary to the record.

For instance, with respect to the Financial System Modernization ("FSM") project,[21] Mr. Murandu testified to Southwest Gas's business

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[20] Mr. Murandu joined Southwest Gas in 2017, but was educated to testify about events in which he was not personally involved—not unlike a 30(b)(6) corporate representative. (*See* 9 JA 2125:11-2127:3.)

[21] Mr. Murandu's written testimony, which was admitted into evidence, explains Southwest Gas's rationale and decision-making for all five

rationale for selecting Oracle as the vendor.[22] (*See* 9 App. 2127:12-2132:13.) He testified that Southwest Gas selected Oracle because it was already invested in supply chain management, database inventory, and human resources payroll systems on Oracle's platform. (*See id.* at 2128-29.) He testified Southwest Gas compared Oracle's solution for the FSM project to what other utilities implemented. (*See id.* at 2130-31.) He testified that PricewaterhouseCoopers prepared a study for Southwest Gas assessing alternative solutions for the FSM project from vendors PeopleSoft, JDE, SAP, and Lawson. (*See id.* at 2133.)

The Commission improperly disregards Mr. Murandu's testimony in its Modified Order because he was not directly involved in the execution of the projects. (2 App. 285-86, ¶ 626.) In categorically disallowing Southwest Gas's expenses associated with the CWOs, including the FSM project, the Commission recites Staff's contention that Southwest Gas failed to justify "why it chose the contractor it chose," (2 App. 267, ¶ 572) and focuses on disputed expenses associated with the FSM project—for rental cars, consultant overtime, flights—that Southwest Gas

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CWOs. (*See* 13 JA 3063-95.)

[22] The FSM Project is one of the five disallowed CWOs. (AOB 6-7.)

withdrew during the discovery phase. The Commission ignores Mr. Murandu's testimony explaining that Southwest Gas considered how other utilities implemented similar solutions, considered multiple vendors, and selected Oracle for the FSM project because it was already heavily invested in Oracle's platform.

III.

SOUTHWEST GAS'S RATE OF RETURN ON EQUITY SHOULD HAVE BEEN APPROVED

A. The Commission's Rate Was Arbitrary, Dismissing the Consensus Evidence of Southwest Gas's Risk

The Commission approved a 9.25% rate of return on equity (ROE) that was arbitrary, capricious, and confiscatory because it defied the evidence that Southwest Gas was riskier than comparable utilities that averaged a 10.23% rate of return. (AOB 75-78.) The Commission's arbitrary selection of a ROE near the low end of its own reasonable range (9.10-9.70%), in conjunction with its categorical disallowance of $50.7 million in costs Southwest Gas already incurred for the CWOs, is confiscatory also because it imposes on Southwest Gas an *effective* ROE lower than the lowest ROE in the Commission's range of reasonableness.

Respondent BCP relies on *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281 (1944) to argue that the Commission's ROE is confiscatory only if Southwest Gas shows the rate impairs confidence in its financial integrity or ability to attract capital (the "end result" test). BCP contends the 9.25% rate cannot be deemed confiscatory because Southwest Gas has not presented any evidence showing the rate "caused" these ill effects. (BCP Br. 93-98.) Not so.

Southwest Gas has shown the 9.25% rate of return is confiscatory. *Hope* tied the end-result test to whether the ROE is "commensurate with returns on investments in other enterprises having corresponding risks." 320 U.S. at 603; *see Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314, 109 S. Ct. 609, 619 (1989) ("Admittedly, the impact of certain rates can only be evaluated in the context of the system under which they are imposed."). The record reflects the Commission arbitrarily imposed on Southwest Gas a lower ROE than investors expect from comparable natural gas utilities. (AOB 13.) Southwest Gas cannot realistically show that the 9.25% rate has already "caused" the ill effects contemplated by *Hope*, but it established that the rate is arbitrarily lower

than the 10.23% rate investors expect from comparable utilities that are *less risky*.[23] (*See id.*)

Southwest Gas presented evidence that credit agencies consider it to be *higher risk* than comparable utilities in the proxy group, and that it had more debt. (AOB 13-4.) Respondent PUCN argues the Commission reasonably set a ROE *lower* than the proxy group average because it found Southwest Gas "was not riskier than its peers"—based in part on a "credit-supportive environment" that would not favor Southwest Gas specifically. (PUCN Br. 66.) But even assuming there were *some* evidence to support this conclusion, the Commission should have set *the same* rate of return as peer utilities with equal risk.

A "credit-supportive environment" aside, PUCN dismisses the consensus evidence that Southwest Gas is *risker* than its peers, arguing that evidence of Southwest Gas's higher relative debt "has nothing to do with the proxy group." (*See id.*) But Southwest Gas cited testimony from

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[23] Respondents argue the 10.23% rate cannot be considered because Southwest Gas presented that number for the first time in its petition for reconsideration. (PUCN Br. 7; BCP Br. 96.) Not so. The 10.23% rate, which is the average authorized ROE for the proxy group, is easily derived from the data in the exhibit Southwest Gas cites. (*See* 19 App. 4572-88.)

Respondent BCP's expert witness, Daniel Lawton, that "SWG . . . has slightly higher financial risks (in terms of higher debt levels in capital structure) than the comparable group." (17 App. 4198-9.)

The Commission's below-industry-average 9.25% ROE was confiscatory because the undisputed evidence shows Southwest Gas is *risker* than the proxy group, which averages a 10.23% rate of return. *See Duquesne*, 488 U.S. at 314 ("[A]lways relevant to setting the rate under *Hope* is the return investors expect given the risk of the enterprise.").

B. Southwest Gas's Effective ROE Is Far Less Because of the Commission's Exclusion of Expenses

The Commission's 9.25% ROE is confiscatory in a vacuum, but worse in context. Based on recommendations from Respondents PUCN and BCP, the Commission set the range of reasonableness for ROE between 9.10 and 9.70 percent. (5 App. 1004-9.) BCP recommended the lowest range of any party, with a lower bound of reasonableness at 9.00 percent. (*See id.* at 1005.)

ROE cannot be assessed in a vacuum. When a utility incurs costs that the Commission excludes from the approved rate, these costs subtract from the utility's ROE. *See Duquesne*, 488 U.S. at 312 (describing

relationship between ROE and disallowed expenses in analyzing end result of rate order). Because the Commission disallowed $50.7 million in costs that Southwest Gas incurred, the 9.25% ROE cannot be achieved unless Southwest Gas diverts revenue from operating income to replace the $50.7 million that it will not recover via the approved rate. The end result is an *effective* ROE that is *less than* 9.10%—the lowest bound of the Commission's range of reasonableness. Moreover, because the $50.7 million in disallowed costs were deemed imprudent, the sub-9.10% *effective* ROE represents the actual end result of the Commission's order. That is, by the Commission's own definition, an unreasonable rate.

CONCLUSION

For these reasons, this Court should reverse.

Dated this 31st day of March, 2021.

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CERTIFICATE OF COMPLIANCE

1. I certify that this brief complies with the formatting, typeface, and type-style requirements of NRAP 32(a)(4)–(6) because it was prepared in Microsoft Word 2010 with a proportionally spaced typeface in 14-point, double-spaced Century Schoolbook font.

2. I certify that this brief exceeds the type-volume limitations of NRAP 32(a)(7) because, except as exempted by NRAP 32(a)(7)(C), it contains 8,188 words. A motion for leave accompanies this brief.

3. I certify that I have read this brief, that it is not frivolous or interposed for any improper purpose, and that it complies with all applicable rules of appellate procedure, including NRAP 28(e). I understand that if it does not, I may be subject to sanctions.

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