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Ms. Carole J. Washburn
Secretary
Washington Utilities and Transportation Commission
1300 South Evergreen park Drive SW
P.O. Box 47250
Olympia, Washington 98504-7250

VIA ELECTRONIC FILING TO
records@wutc.wa.gov

Re: *Rulemaking to Review Natural Gas Decoupling*
Docket No. UG-050369

Dear Ms. Washburn:

In response to the Washington Utilities and Transportation Commission's ("WUTC's" or "Commission's") May 16, 2005 Notice of Opportunity to File Written Comments, the Northwest Industrial Gas Users ("NWIGU") submit these written comments in response to the rulemaking to review natural gas decoupling. NWIGU participated in all phases of these discussions to date with active participation in the workshops conducted by the Commission Staff, and appearances at related public hearings, including the Commission's meeting with the Public Utility Commission of Oregon ("OPUC") to consider Northwest Natural Gas Company's ("NW Natural's") Oregon decoupling and weather adjustment mechanisms.

NWIGU appreciates the opportunity to submit these Comments in this rulemaking docket. NWIGU applauds the Commission for undertaking a thorough review of decoupling policy application for natural gas local distribution companies ("LDCs") before the initiation of any mechanisms for Washington gas utility operations. NWIGU represents the interests of industrial customers of all four LDCs regulated by this Commission: Cascade Natural Gas Corporation ("Cascade"); Puget Sound Energy ("Puget"); Avista Utilities ("Avista"); and NW Natural.

NWIGU brings a unique perspective to the issues raised in this rulemaking. NWIGU has been active in regulatory proceedings impacting LDCs in Washington since 1984. NWIGU is also active in regulatory proceedings affecting LDCs in Oregon and Idaho, thus lending a regional perspective to its views. The decoupling proposal forwarded by Cascade does not apply directly to industrial customers, as it focuses on fluctuations in use per customer by residential and commercial customers. The adoption of any decoupling mechanism, however, will impact

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the rates of all customers of the local distribution company. NWIGU therefore brings its perspective to the issues raised in this docket in an effort to address how decoupling will impact all natural gas ratepayers.

In these comments, NWIGU will address not only the specifics of particular decoupling mechanisms, but how a decoupling mechanism can be implemented in order to achieve the stated objectives and address fairness issues between ratepayers and shareholders. NWIGU will address its comments in the topic areas as set forth in the Commission's Notice of Opportunity To File Written Comments.

Issues 1 and 2: Response and Specific Changes to Cascade Decoupling Model

NWIGU recognizes that under current methods of cost allocation and rate design, significant fixed cost recovery for LDCs is tied to natural gas sales, as the WUTC both allocates fixed costs based on energy usage and designs rates to include fixed-cost recovery in volumetric energy rates. If adopted, Cascade's decoupling proposal would result in less volatility in Cascade's revenues stemming from changes in per customer usage.

NWIGU suggests that the proper standards by which to judge Cascade's decoupling are set forth by this Commission in *WUTC v Puget Sound Power & Light,* in which this Commission articulated the following standards by which to judge any alternative form of rate regulation:

a.) It must be measurable;
b.) It must be reasonably simple to administer;
c.) It must be easily explained to utility customers; and
d.) It must be an improvement, on balance, over the current method of regulation at the WUTC.

WUTC v Puget Sound Power & Light, Docket Nos. UE-901183-T, UE 901184, Third Supplemental Order, (April 1, 1991) *citing* Notice of Inquiry, Docket No. UE-900385 (May 9, 1990).

NWIGU observes that the first three criteria seem to be met by Cascade's proposal. The focus of NWIGU's concern is whether, on balance, the mechanism is an improvement on the current method of regulation.

Cascade's proposal focuses strictly on protecting the Company's shareholders from the risks associated with lower usage per customer by residential and commercial customers. There are at least two countervailing trends that tend to offset the impact from declines in per customer usage. First, Cascade's customer growth could more than offset lower per customer usage between rate cases. If customer growth is left to the benefit of shareholders, while the risk associated with decreases in per customer usage is shifted to ratepayers, the current regulatory balance is tipped in favor of shareholders. Second, a properly structured decoupling mechanism would contain a sharing mechanism to provide the utility with an incentive to operate below general rate case baseline expense levels, while at the same time, sharing a portion of the efficiency gain with customers. Any decoupling mechanism should contain provisions that retain an incentive for the LDC to operate efficiently and continue striving to achieve productivity improvements. If a utility is realizing productivity improvements due to declines in per customer expense ratios, at the same time that per customer usage is declining, under Cascade's proposed decoupling mechanism ratepayers would pay higher rates due to the decline in per customer usage, while productivity improvements would be left for the benefit of shareholders. This is an untenable result.

If a decoupling mechanism simply makes it possible for a utility to adjust its rates upward for one factor, lost revenues due to decreased customer usage, without customers benefiting from productivity improvements, increased efficiencies, increased revenue from customer growth, cost controls, and lower cost of capital, then ratepayers are disadvantaged by the mechanism. NWIGU urges the Commission to clarify through this rulemaking that decoupling mechanisms must balance the interests of ratepayers and shareholders by finding ways to ensure that productivity improvements and customer growth, two factors that work in a countervailing direction from decreases in usage per customer, be taken into account through a balanced policy. Care should be taken to design a mechanism that keeps incentives in place for the utility to innovate, and deliver services efficiently. Decoupling mechanisms, if improperly designed, can reward inefficiencies because the utility can recover increased revenue from declining sales without the rigors of a rate case.

A second critical element of any decoupling policy is to address how and under what circumstances this Commission would allow an LDC to implement a decoupling mechanism. For a variety of reasons, a decoupling mechanism should only be implemented in the context of a general rate case or equivalent cost review. Cascade suggests in its materials that a decoupling mechanism could be adopted in isolation, without the scrutiny inherent in a general rate case. NWIGU strenuously disagrees. For a decoupling mechanism to be fair to all ratepayers and to the company's shareholders, it should be adopted in the context of a general rate case.

As this Commission is aware, Cascade has not filed a general rate case in the State of Washington since 1995. Thus, it has been a decade since the Commission closely examined Cascade's overall revenue requirement, including its level of expenses, its cost of capital and capital structure, the way costs are allocated to the various customer classes and how its rates are designed. The analysis necessary to develop a properly structured decoupling mechanism would include complete scrutiny of the Company's operations, the development of a sharing and quality control mechanism, the determination of the appropriate revenue requirement benchmark, including the cost of capital, and the measure or measures by which the Company's performance would be judged. The LDC's capital structure and overall cost of capital are particularly important components of an LDC's rates that must be analyzed in a time frame contemporary to the implementation of a decoupling mechanism. Currently, LDCs take the risk between rate cases that per customer usage will decline. Cascade's authorized rate of return on equity and its debt-to-equity ratio both reflect the capital market and the level of risks facing the Company in 1995. It is beyond dispute that a decoupling mechanism will lower the financial risks facing an LDC because the utility is permitted to adjust its rates if per customer usage declines in response to conservation and other factors. If a decoupling mechanism is implemented in the context of a general rate case, then all of these factors can be considered at the same time that the decoupling mechanism is being designed. The LDC's debt-to-equity ratio and its authorized return on equity can then be reset to reflect the change in the LDC's risk profile as a result of the decoupling mechanism.

The LDC's allocation of its costs and its rate design are equally important and can be best addressed in the context of a general rate case. As Cascade stresses in its proposal, the primary reason for an LDC to adopt a decoupling mechanism is to insulate the utility's shareholders from the risk of lower fixed cost recovery if per customer usage declines. The percentage of fixed costs allocated to each customer class, however, depends on the results of a cost-of-service study. Moreover, the percentage of fixed costs recovered through volumetric charges depends on the rate design adopted by this Commission, again using the results of a cost-of-service study to guide those determinations.

A general rate case affords this Commission and all interested parties an opportunity to examine how costs are allocated to the various customer classes and how rates are designed to reflect the cost causation drivers identified in the cost-of-service study. If a decoupling mechanism is adopted in isolation, as simply an add-on to the existing rates of an LDC that have not been examined in the context of a general rate case for many years, there is no way to determine if the mechanism will indeed balance the interests of ratepayers and shareholders.

Issue 3. Comments Regarding NW Natural Decoupling And Weather Adjustment Mechanisms

NWIGU did not oppose NW Natural's Oregon decoupling mechanism as it appropriately only applies to residential and commercial customers and was followed by a timely general rate proceeding that included an in-depth review of the Company's cost of capital, cost allocations and rate design. Indeed, having a general rate case to address cost inequities embedded in NW Natural's underlying rates was an express condition of the settlement stipulation adopted by the OPUC. *In re NW Natural Gas Company*, OPUC Docket No. UG 143, Order No. 02-634, p. 6

(Sept. 12, 2002). As a result of NW Natural's Oregon general rate case, docketed as UG 152, the Company's costs were realigned with substantial movement toward rates reflecting more closely the actual cost of providing service to the various customer classes, including the cost of providing sales and transportation services to firm and interruptible industrial customers.

Because decoupling focuses on fixed cost recovery, it is extremely important that fixed costs be properly allocated before designing a mechanism to enhance the recovery of those fixed costs caused by declines in gas usage by residential and commercial customers. As described above, NW Natural's decoupling mechanism was first implemented in Oregon in the context of a broader shift in regulatory policy that included lowering firm and interruptible industrial sales and transportation rates to reflect what had been a mis-allocation of costs among NW Natural's customer classes. NWIGU's position on NW Natural's decoupling mechanism was heavily influenced by the fact that inequities in that LDC's rate structures were addressed in a timely fashion following implementation of the decoupling mechanism on an experimental basis.

It is also important for the WUTC to recognize that Oregon has an annual earnings review sharing mechanism in its regulatory scheme. Under this mechanism, if an LDC is found to be earning more than 300 basis points over its authorized return based on the annual financial records the utility submits to the OPUC, the OPUC can order a rate reduction without a rate case. This mechanism existed in Oregon separate and apart from the decoupling mechanism, as the review is conducted in the context of the LDC's annual Purchased Gas Adjustment filing. The earnings review provides some protection for ratepayers in the context of a decoupling mechanism because offsetting gains, whether arising from productivity improvements, customer growth or lower cost of debt, are accounted for as part of an earnings review. NWIGU urges the WUTC to overlay some method of similar ratepayer protection if any decoupling concept is considered for Washington LDCs.

NWIGU also notes that with reference to NW Natural's decoupling mechanism, the OPUC just initiated a new docket, UG-163, to address whether the mechanism will continue in the future. The implementation of NW Natural's decoupling mechanism in UG 143 was on a temporary, experimental basis. Rather than proposing permanent adoption at the end of the experiment, the Company is proposing a three-year extension (which would link up with the termination of its weather adjustment mechanism). Among the issues to be addressed in that proceeding are whether NW Natural's cost of equity capital and its capital structure should be changed in light of the existence of the combination of the decoupling mechanism and the weather adjustment. The OPUC Staff and intervenors will file testimony later this year on the topic. There is a strong case to be made that both the decoupling mechanism and the weather adjustment have lowered NW Natural's overall cost of capital by shifting risk away from shareholders and onto ratepayers. Similar issues are posed for this Commission if a decoupling mechanism or a weather adjustment mechanism is to be authorized for Washington LDCs.

Finally, in UG 163, NW Natural is seeking to increase its current 90% distribution margin deferral rate to 100% recovery, but such change is a further risk shift that the OPUC will have to address following the development of a full record. Any proposal considered by this Commission will have the same issues (i.e., the degree of deferral that should be allowed balancing the interests of the utility and ratepayers).

Issue 4: Alternatives to Cascade and NW Natural Decoupling Models

As Cascade properly pointed out in its May 12, 2005 presentation, a very large percentage of the costs of providing gas delivery service are fixed, yet under Cascade's current rate structure a large percentage of fixed costs are collected through volumetric charges. NWIGU urges the WUTC to consider adopting rate designs that collect a greater percentage of fixed costs through a combination of customer charges, and for appropriate rate schedules and demand charges. NWIGU has noted for many years in its written testimony before this Commission that both allocating fixed costs based on volumetric usage, and collecting fixed costs through volumetric charges can cause an LDC's rates to be out of sync with how its costs are incurred. For example, LDCs size their distribution systems to meet peak demand for firm customers. If cost allocation and rate design ignore that reality, there will be a mismatch between how the LDC incurs the costs of providing service and how the LDC collects its revenues. If cost allocation and rate designs more appropriately reflect cost incurrence, the problems of fixed cost recovery identified by Cascade will be minimized. This is another strong reason for implementing any decoupling mechanism in the context of a general rate case.

It also may be appropriate for the Commission to impose a cap on the size of any rate increase that could result solely from a decoupling mechanism. A cap could be in place when the decoupling mechanism is first instituted, and then the Commission could review in subsequent years whether the cap should remain, or be adjusted in later years.

Issue 5: Identify and rank the interests and/or objectives that need to be addressed and satisfied before NWIGU can support a natural gas decoupling methodology

As described above, any decoupling methodology should balance the interests between utility shareholders and customers. NWIGU ranks the following list in order of importance.

1. A decoupling mechanism should only be implemented in the context of a general rate case or equivalent cost review. While a general rate case does not necessarily need to occur at the same time the mechanism is approved, a utility should be required to file a general rate within six (6) months of implementing a decoupling mechanism. *Must Have.*

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2. Once a decoupling mechanism is in place, on an annual basis, the WUTC should review the Company's financial health. To the extent a utility is earning more than 300 basis points over its authorized return, the WUTC should order a rate reduction without a rate proceeding. *Must Have*.

3. A properly structured decoupling mechanism must contain a sharing mechanism to provide the utility with an incentive to operate below general rate case baseline expense levels, while at the same time sharing a portion of the efficiency gain with the customers. *Must Have*.

4. A properly structured decoupling mechanism must also contain a true-up that accounts for customer growth as it could more than offset lower per customer gas usage the decoupling mechanism is intended to capture. *Must Have*.

NWIGU appreciates the opportunity to submit these comments and will be happy to participate in all aspects of this important rulemaking docket.

Very truly yours,

Edward A Finklea

Edward A. Finklea
On behalf of the Northwest Industrial Gas Users

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