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SERVICE DATE

SEP 27 1993

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Washington Utilities and Transportation Commission, Complainant, v. Washington Natural Gas Company, Respondent.	DOCKET NO. UG-920840 FOURTH SUPPLEMENTAL ORDER REJECTING TARIFF FILING; AUTHORIZING REFILING

PROCEEDINGS: This is a general rate increase filing by Washington Natural Gas Company. On July 27, 1992, Washington Natural Gas Company filed tariff sheets to effect a general rate increase of approximately $41.4 million. On rebuttal the company lowered its request to an increase of $14.8 million.

The Commission suspended the tariff revisions pending hearings on the justness and reasonableness of the rates requested in the filings. The company waived the suspension date to October 1, 1993.

HEARINGS: The Commission held hearings on September 17, 1992 and January 25, 26, 27, February 11, 12, 22, May 17, 18, 20, 21, 24, 25, 26, and July 6, 7, 8, and 9, 1993. The hearings were held before Chairman Sharon L. Nelson, Commissioner Richard D. Casad, Commissioner A.J. Pardini,[1] Commissioner Richard Hemstad and Administrative Law Judge Lisa A. Anderl of the Office of Administrative Hearings. The Commission gave proper notice to all parties.

APPEARANCES: Washington Natural Gas Company was represented by Harry E. Grant, Marion V. Larson, and D. Scott Johnson, attorneys, Seattle. The Staff of the Washington Utilities and Transportation Commission (Commission Staff) was represented by Jeffrey D. Goltz and Robert D. Cedarbaum, assistant attorneys general, Olympia. The public was represented by Charles F. Adams, assistant attorney general, public counsel section, Seattle (Public Counsel). Intervenor Northwest Industrial Gas Users (NWIGU) was represented by Paula E. Pyron and Edward A. Finklea, attorneys, Portland, Oregon. Intervenor Partnership for Equitable Rates for Commercial Customers (PERCC) was represented by Carol S. Arnold, attorney, Seattle. Intervenor Seattle Steam Company (Seattle Steam) was represented by Frederick O. Frederickson, attorney, Seattle.

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[1] Commissioner Pardini's term expired while this proceeding was pending. He took no part in the decision announced in this order.

SUMMARY: The Commission rejects the company's filed tariffs and requested rate increase. The Commission orders the company to refile tariffs consistent with a reduction in rates in accordance with the terms of this order.

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I. SCOPE OF PROCEEDINGS

A. History

This is a general rate increase filing by Washington Natural Gas Company (WNG or company). On July 27, 1992, Washington Natural Gas Company filed tariff sheets to effect a general rate increase of approximately $41.4 million. The tariff filing had a stated effective date of August 27, 1992. In addition to general rate relief of $28.4 million, the company requested rates in the form of special trackers, totaling $13 million, to fund programs for safety costs, environmental clean-up costs, and to construct compressed natural gas vehicle refueling stations. The Commission suspended the tariff revisions pending hearings on the justness and reasonableness of the rates requested in the filings.

Commission Staff subsequently filed its direct case recommending a decrease of $22.2 million to existing rates. The decrease was revised to $24.2 million during presentation of Staff's direct testimony. The recommendation included the rejection of all the proposed special trackers, disallowance of many expenses, including advertising and merchandising expenditures, and a lower cost of capital than requested by the company. Staff also recommended that no attrition allowance be granted -- attrition accounted for $5 million of the increase requested by the company in its direct case.

The three intervenors and Public Counsel also filed testimony and presented witnesses on many of the issues raised in this filing, including the company's proposal for transportation service, the cost of service, the cost of capital, and the company's non-utility merchandising and jobbing activity.

On rebuttal the company revised its request to an increase of $14.8 million. This revision recognized the Commission's decisions, during the proceeding, to defer consideration of a tracker designed to recover environmental remediation expenses (but to allow the parties to argue for a working capital allowance)[2] and to deny a tracker designed to fund compressed natural gas vehicle refueling stations.[3] In addition, the company substantially revised its case from that which it had originally filed. This order will discuss the issues presented by the company's filing as modified on rebuttal,

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[2] This ruling was made on the record at the January 27, 1993, hearing session.

[3] This ruling was made by Commission order entered March 12, 1993.

unless the specifics of its original filing are relevant to the discussion.

The parties presented the following witnesses: For the company in its direct case, James Thorpe, Chief Executive Officer, policy witness; Karl Karzmar, revenue requirements; Lance Corbin, revenue requirements; Timothy Hogan, environmental remediation; James Gustafson, engineering and gas safety; Ritchie Campbell, rate design; Jerome Sullivan, rate design; James Torgerson, cost of money; and, Richard Johnson, cost of service. Those witnesses, except Mr. Hogan, also appeared on rebuttal, along with the following additional witnesses: James Waldo, policy; Catherine Thompson, merchandising and jobbing allocation study; Mark Gordon, employee compensation; Daniel Tulis, finance; William Green, advertising; Donald Gessel, marketing; and Heidi Caswell, line extensions.

Commission Staff witnesses were Kenneth Elgin, policy; Jaime Ramirez, gas safety; Michael Parvinen, James Russell, and Kathryn Thomas, revenue requirements; Nancy Hughes, attrition; Alan Buckley, cost of service; Curtis Winterfeld, weather and temperature adjustments; and Richard Lurito, cost of money. Public Counsel's witnesses were James Lazar, rate design and cost of service; Steven Hill, cost of money; and James Dittmer, revenue requirements. NWIGU's witness was Donald Schoenbeck. PERCC's witnesses were Roy Cosper, Don Monroe, James Sutherland, and Doug Betzold. James Young appeared as the witness for Seattle Steam.

The company had not filed for general rate relief since 1984. In Cause U-84-60, the Commission granted a rate increase pursuant to a settlement agreement filed by all parties and accepted by the Commission. The company's most recent adjudicated rate case was in Cause U-83-27, decided September 28, 1983, and even that case involved a stipulation as to revenue requirement. Given the amount of time since Commission Staff has had an opportunity to fully investigate the company's operations and given the broad scope of the rate request filed in this case, discovery and the hearing process were both extensive. The company waived the tariff suspension date to October 1, 1993.

Hearings consumed 18 days. The transcript numbered 3,785 pages. In addition, over 400 exhibits were identified and admitted, ranging in length from a single page to nearly 200 pages. At the close of the hearing the parties briefed the issues, in briefs expanded to 80 pages by leave of the Commission. The Commission recognizes the 80 page limit is fewer pages than the parties previously may have been accustomed and that the issues in this case were numerous and complex. Nonetheless, the parties are to be commended on filing excellent,

thorough briefs which the Commission found to be very helpful in its deliberations.

B. Governing principles

The Commission is charged by statute to regulate in the public interest the rates, services, facilities, and practices of all persons engaging within the state in the business of supplying any utility service or commodity to the public, including gas companies. RCW 80.01.040. Rates and charges of a gas company are to be just, fair, reasonable, and sufficient. RCW 80.28.010. The Commission is to determine, after hearing, whether proposed charges are just, fair, reasonable, and sufficient and if not, the Commission is to determine and set rates which are. RCW 80.28.020. When the proposed rates increase current charges, the burden is on the public service company to show that the increase is just and reasonable. RCW 80.04.130.

Rates should be established for utility service which allow the company an opportunity to recover the reasonable costs of providing that service, and which are at the lowest level which will meet those costs. Costs of providing utility service include labor costs, supplies, materials, taxes, and other expenses, and also the costs of the capital, both debt and equity, needed to acquire the assets used in providing service.

In this rate proceeding, the Commission will determine the appropriate test period for examining the company's operations; the rate base, i.e., the net assets provided by investors' funds which are used and useful in providing utility service to the public; the company's results of operations during the test period; the company's capital costs, including the rate of return on equity and the overall rate of return; any revenue deficiency; and the allocation of any rate increase or decrease fairly and equitably among ratepayers.

C. Elements Previously Decided

The company originally proposed three trackers for 1) recovery of costs associated with a compressed natural gas refueling station project, 2) recovery of environmental remediation expenditures, and 3) recovery of expenditures associated with gas safety issues.

A tracker is a mechanism to recover expenditures on a dollar for dollar basis that is passed through directly to the ratepayers. The Commission, in ruling on motions made by Commission Staff and other parties, has already denied the compressed natural gas refueling station tracker and deferred consideration of the tracker for environmental remediation.

D. Tracker for Gas Safety Expenditures

The company had proposed a tracker mechanism to recover the asserted costs of compliance with Commission rules on gas safety and with the settlement of a complaint filed by the Commission on its own motion in Docket No. UG-920487.[4] The company contended that the expenditures are incremental, i.e., they are above and beyond what it would otherwise have expended, and, because they are the result of Commission-ordered action, should be fully recovered through a tracker.

Commission Staff argued that most of the expenditures are not incremental and would have been incurred in the normal course of business if the company were in compliance with federal and state safety requirements. Staff argued that those expenditures which are incremental should be recovered through inclusion in results of operations in future rate proceedings. Public Counsel concurred with Staff. The intervenors opposed recovery of safety costs through a tracker mechanism and argued that any prudently-incurred incremental costs should be recovered in general rates.

The Commission rejects the use of a tracker mechanism to recover compliance-related expenditures. A tracker is a unique method of recovering costs and a departure from ordinary ratemaking treatment. Earlier in this proceeding, the Commission stated the factors to be considered in determining when a tracker is appropriate. Expenses which are easily measurable, beyond the company's ability to control, and which are both substantial and essential to the company's operations may be recovered through a tracker. The Commission has also generally required that there be a substantial ratepayer benefit.

In this case, the tracker would offer a dollar-for-dollar recovery of certain safety-related expenditures, most of which have not been shown by the company to be incremental to its normal operations. Additionally, the total amount to be expended is unknown at this time, but the expenditures are within the company's ability to control. To the extent these safety-related expenditures, for which recovery is sought via a tracker, are prudently-incurred and required by the company's obligation to serve, they are recoverable as operating expenses or as incremental investment when they are known and measurable. Recovery will be considered in future proceedings.

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[4] Essentially, the company agreed to make certain plant improvements, especially replacement of cast iron pipe that is susceptible to corrosion. See First Supplemental Order, Docket No. UG-920487, June 19, 1992.

II. RATE BASE

The company's rate base is the investor supplied utility plant and equipment used and useful in providing service. The rate base, valued by the Commission and expressed as a dollar amount, is the amount upon which the company may earn a return for investors on its regulated operation. Attachment 1 shows the parties' positions on the calculation of rate base.

A. Test period

In determining the rate base, the Commission must first determine an appropriate test period in which to measure the rate base. The test period should be 12 months for which complete financial statements are available. In this case, all parties agreed that the 12 months ended December 31, 1991, is the appropriate test year. This was the most recent year-end financial data available when the company filed its tariff revisions. The Commission agrees that this is the appropriate test period.

B. Contested Adjustments

1. Working capital

The working capital allowance is a measurement of the additional capital required by the company from investors in addition to those investments directly included in rate base. The allowance for working capital in the rate base calculation is a recognition of the investor supplied capital upon which it is appropriate for the company to earn a return, acknowledging that the funds have value to the company and that the investor should be compensated for the use of the money.

The calculation of working capital has several components. One is the "per-books" calculation of working capital; others would include any *pro forma* or restating adjustments to that amount. Both the company and Commission Staff used the investor supplied method of calculating per books working capital. The company's calculation on rebuttal is $7.5 million, while Staff's is $1.3 million. The difference consists of disagreements on gas cost deferral amounts (conceded by Commission Staff on brief), other adjustments which affect the working capital calculation (discussed elsewhere in this order and not disputed once the underlying issue is resolved), and pre-test period environmental remediation costs. Public Counsel recommended removal of the test year's environmental remediation expenditures, based on the average of monthly averages balance.

a. Environmental Remediation[5]

The company claimed $2,293,000 in pre-test period environmental remediation expenses as a part of working capital. Also included in the company's per books working capital calculation is the test period expense, deferred per the Commission's order in Docket No. UG-920871. In addition, the company made a pro forma adjustment to working capital of $6.8 million, representing post-test period remediation expenses. Staff argued that only test period amounts should be allowed in working capital, under the terms of the accounting order. Pre-test period amounts should, according to Staff, be classified as deferred debits. Staff thus removed them from accounts receivable. Post-test year expenses are not properly included in working capital, according to Staff, because of the uncertainty that the company will actually be liable for them.

Public Counsel agreed with Staff that no pre- or post-test period remediation expenses should be included in the allowance for working capital. Public Counsel went further, arguing that no remediation expenses are properly included in working capital. He removed the expenses incurred during the test period and included by both the company and Commission Staff in the per books working capital calculation. NWIGU concurred with Public Counsel. Public Counsel noted that the company will go to trial in October 1993 against its insurers to recover all remediation costs, including interest. The company has expressed confidence that it will prevail. If so, there is the potential for double recovery, or the problem of refunding ratepayers' contributions. Public Counsel cautioned that ratepayers should not pay the carrying charges on expenditures whose prudence has not yet been determined. While Commission Staff saw merit to this position, they would nonetheless allow the test year expenses as noted above.

In denying the company's request for a tracker mechanism to recover these expenditures, the Commission did not foreclose the parties from arguing whether there should be an

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[5] There are three groups of environmental remediation costs: (1) The pre-1991 costs of $2.3 million are dollars which have already been spent in remediation at the Tacoma Tide Flats site. (2) The test period amounts, for which the company requested and received an order for deferred accounting treatment in Docket No. UG-920781. (The $521,000 cost is included as per books working capital.) (3) The post-test period remediation expenses. The expenses from January 1, 1991, through April 30, 1993, comprise the $6.8 million pro forma adjustment sought by the company.

allowance for working capital for these expenditures. In deciding this issue, the Commission made note of the fact that trial is about to begin in the company's litigation against its insurance carriers to recover these expenses and the company's confidence of full recovery. This recovery may include interest, which the company has requested. In addition, the Commission has taken into account the fact, recognized by all the parties, that the prudence of these expenses has not yet been determined. The Commission concludes that Public Counsel offers the more reasonable course under the circumstances. The Commission adopts Public Counsel's position on the issue of a working capital adjustment for all environmental remediation costs. None of the expenditures should be included in the working capital allowance. Commission Staff's adjustment should be increased, and the working capital allowance thereby decreased by $521,000.

The Commission does not preclude argument for recovery of the deferred costs at some point in the future. If the insurance litigation does not result in full recovery for the company, and if the Commission can determine that the expenditures were reasonable and the result of prudent operations, the Commission would consider an argument for recovery of those costs, including interest. To this end, the company should keep a record of those expenditures if it wishes to preserve them for Commission review and possible recovery.

b. Storage gas pro forma

The company proposed a pro forma adjustment to working capital to include expenditures for the purchase of increased Clay Basin storage gas inventories. This occurred after the test year. The Staff opposed this adjustment on the basis that the source of funds is not known and that offsetting benefits cannot be determined. The company claimed that the purchases were necessary and prudent and that they benefit the ratepayer through the purchase and storage of lower priced summer gas.

The Commission allows the adjustment to working capital for Clay Basin storage gas. The Commission believes this purchase to have been a benefit to ratepayers. The company would be unfairly disadvantaged during the rate year if this adjustment were disallowed.

2. Storage Gas Restating

There is no difference in methodology between the company and Commission Staff. Their result diverges because of differences in calculating working capital. The Commission has calculated the proper adjustment based on our decision regarding working capital, discussed below.

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3. Other adjustments

Other proposed adjustments to rate base are the 1) merchandising and jobbing (M & J) plant allocation restating, 2) lease M & J restating, 3) performance share plan restating, 4) incentive pay restating, and 5) adjustment for safety expenses. These are discussed more fully in the results of operations section, below, as each of these rate base adjustments has a corresponding operating income adjustment. The Commission adopts the adjustment based on the company's Scenario A (discussed in Section III.A.3., infra) for the M & J plant allocation. The Commission also accepts the company's position with regard to leased plant and incentive plans and therefore no adjustment is made for those items. The Commission does not allow an adjustment to rate base for safety expenses as requested by the company.

C. Uncontested adjustments

The uncontested adjustments to rate base include those for 1) the Jackson Prairie storage facility, 2) the sale of excess land, and 3) new building costs. The Commission has reviewed these adjustments and finds them proper for ratemaking purposes, based on the information of record. They are therefore accepted. TABLE 1 shows the Commission's determination of rate base items.

Table 1
WASHINGTON NATURAL GAS COMPANY RATE BASE
12 MONTHS ENDED DECEMBER 1991
(Thousands of Dollars)

Per books results		$485,157
Uncontested adjustments		($ 878)
Contested adjustments:		
Merchandise & Jobbing allocation	($6,473)	
Lease M & J restating -Plant	0	
Special incentive plans	0	
Working capital	4,740	
Environmental	0	
Storage gas pro forma	1,788	
Storage gas	(411)	
Total Contested Adjustments		($ 356)
Pro Forma Rate Base		$483,923

The Commission finds itself with a limited choice. It can accept the Commission Staff's adjustment, based on Staff's analysis of the expenses, which allows some customer service related expenses. In the alternative, it could accept the company's position, which clearly includes expenses that are inappropriate for ratemaking treatment.

The Commission concludes that the Commission Staff's adjustment for marketing should be accepted. It is quite clear from the record that many of the marketing expenses that the company would include in rates, such as season tickets to sporting events and hosted weekends out of town for builders and dealers, are simply not customer service expenses. The company has the best information on the nature of the expenses and is in the best position to allocate between customer service and "marketing". The burden of proof is on the company to establish that the marketing expenses are legitimate expenses related to its gas utility operation. It could have come forward with further information on rebuttal. The company failed to do so. The Commission therefore accepts Staff's adjustment to exclude a portion of the marketing expense.

The Commission recognizes that customer service is a vitally important part of the company's regulated operation. In general, the Commission believes that the company provides excellent customer service, something that is especially important for a utility whose product has special safety considerations. Nothing in this order should detract from the company's commitment to customer service, or from the company's obligation to continue providing that level of service. The company must be prepared to support actual customer service expenses in future proceedings.

2. Advertising (bh)

Commission Staff proposed disallowance of advertising expenses during the test year in the amount of $1.8 million. Public Counsel concurred. Both argued that the advertising is comparative and promotional in nature and does not promote safety, conservation, or any other permissible subject under the Commission's rule on advertising, WAC 480-90-043.[6] The company

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[6] WAC 480-90-043 provides, in pertinent part, as follows: (1) No gas utility may recover from any person other than the shareholders (or other owners) of such utility, any direct or indirect expenditure by such utility for promotional or political advertising. (2) As used in this rule: . . . (c) The term "promotional advertising" means any advertising for the purpose of encouraging any person to select or use the service or additional service of a utility or the selection or installation of any

III. RESULTS OF OPERATIONS / NET OPERATING INCOME

The parties agreed that calendar year 1991 is the proper test period to examine the company's results of operations. Actual results of operations during the test period are adjusted two ways. First, the restating adjustments are intended to cure defects in booked results which might distort test period earnings and to remove costs not properly allowed in rates. Second, pro forma adjustments are those which give effect in the test period for all known and measurable changes which are not offset by other factors.

The company's unadjusted results of operations for 1991 reflect a net income of $41,334,000. During the proceeding, some 50 adjustments were proposed by the parties. By the time briefs were submitted, a number of these were uncontested.

There remain many adjustments on which there is disagreement between Commission Staff and the company. In addition, Public Counsel proposed some adjustments that reflect positions differing from both the Staff and the company. When the adjustments can be grouped according to general topics, they are consolidated for discussion. The parties' positions on results of operations are shown on Attachment 2.

A. Contested Adjustments

1. Marketing (bi)

Commission Staff proposed an adjustment to disallow a substantial portion of the company's marketing expenses, some $9.7 million, which would increase calculated net operating income by $6.9 million. Staff argued that utility marketing operations, which promote the use of gas and gas appliances by such means as dealer and builder events, are not appropriate expenses to be included in rates. The company argued that what it calls "marketing" is often customer service and is a vital part of utility operations. The company contended that Staff's adjustment would eliminate legitimate expenses related to serving jurisdictional gas customers.

The Commission agrees that there may well be some legitimate customer service expenses included in the account. The question here is how to separate the legitimate customer service expenses from the merely promotional marketing expenses. The Commission Staff proposed its adjustment, after analysis and evaluation of the information available to it. Exhibit C-222 details many of the test year expenses proposed by the company for inclusion in rates that the Staff believed were inappropriate for ratemaking. The company countered with the flat assertion that the expenses are legitimate customer service expenses.

argued that its advertising is designed to promote energy efficient appliances and to encourage conservation. The company noted that the rule allows advertising which tells a customer how to conserve <u>energy</u>, not limited to gas, and argued that any advertising which promotes the use of gas over electricity therefore complies with the rule as it promotes conservation of electricity. The company's expert argued that the Commission should not listen to the words of some advertisements, but rather to the studies of listener feelings and beliefs, to determine the advertisement's true meaning. The company stated that it sought at all times to comply with the Commission rule defining the advertising that would be proper for ratemaking purposes.

WAC 480-90-043 provides that a gas utility may recover the expenses of promotional or political advertising only from the shareholders of the company, not the ratepayers. Promotional advertising is defined as advertising for the purpose of encouraging any customer to select or use the service of the utility, or the selection or installation of any appliance or equipment designed to use such utility's service. The rule makes exception for advertising which tells the customer how to conserve energy or reduce peak demand, and advertising which promotes the use of energy efficient appliances.

The Commission had an opportunity to see and hear the advertising which the company proposed to include in rates. The advertising is clearly promotional, designed to encourage consumers to select the service of the utility. It encourages customers to switch to gas from electricity, and it promotes the use of appliances that use gas. The advertisements do not encourage the use of efficient appliances, and do not provide information on how to conserve energy or reduce peak demand. The company's theory that the advertisements promote energy conservation because they promote the use of gas over electricity is novel, but would allow the very promotional advertising that the rule specifically forbids. Nor is the Commission convinced that the actual message of the advertising is "use less gas"; indeed, the advertising included illustrations of increased consumption. The adjustment proposed by Staff is adopted.

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appliance or equipment designed to use such utility's service. (3) As used in this rule, the terms "political advertising" and "promotional advertising" do not include: (a) Advertising which informs customers how they can conserve energy or can reduce peak demand for energy, . . . (e) Advertising which promotes the use of energy efficient appliances, equipment or services . . . .

3. Merchandising & Jobbing allocation issues for NOI -- adjustments (ad), (aj)-(av) & (aw1)

The company had originally proposed a small allocation of additional expenses to the merchandising and jobbing functions (M & J). Thereafter, Commission Staff presented its proposed adjustments to rate base and operating income, supported by a cost allocation study. Staff proposed an increase to net operating income of $3.7 million and a reduction to rate base of $12.4 million. These adjustments are intended to remove the costs associated with the sale (merchandising) and repair (jobbing) of appliances, an unregulated part of the company's operations. The Staff further recommended that the company hire an independent consultant to devise a way to perform such allocations on an ongoing basis, rather than constructing them after the fact in a general rate case.

The company then hired Arthur Andersen to do an allocation study, and it presented the results of that study on rebuttal. The study uses two scenarios: Scenario A is based on allocating M & J as it was operated during the test year, and Scenario B proposed a calculation of the fiscal consequences of moving the merchandising functions to a separate subsidiary. The company on rebuttal proposed that Scenario B be adopted for this case, and has taken steps to create the separate subsidiary assumed in that scenario. The company proposed to implement the change in October 1993, and argued that the rates which take effect in October should reflect that reality. The company has not yet developed a plan to implement the scenario, and was unable to explain with any specificity which or how many employees will go to the subsidiary and what will happen to the space they vacate.

Public Counsel also proposed an adjustment for M & J, recommending through its witness Mr. Dittmer that the revenues from these operations be brought above the line, for this case only. Public Counsel recognized that going forward an allocation methodology may be the best way to separate these dollars, but contended that the company has the obligation to allocate expenses properly on an ongoing basis. Public Counsel argued that the company's failure to keep track of expenses in a way to permit allocations supports Mr. Dittmer's approach, the attribution of M & J revenues to regulated activities. The result would be that no one would have to "unscramble" the intermingled expenses and assets, and ratepayers, who were allocated the costs of the operations by the company, also get the revenues and benefits.

The Commission believes that a cost allocation based on test year operations is the most appropriate. The record contains two embedded cost studies which make this allocation and

which are preferable to and likely more accurate than the solution offered by Mr. Dittmer, although they lack the appealing simplicity of his method.

The Commission Staff's cost study and Arthur Andersen's Scenario A are comparable. However, Staff pointed out flaws in the operating income adjustments under Scenario A wherein the company allocated only test year expenses and failed to allocate pro formed expenses for items such as wages. The Commission concludes that the allocations to operating income as presented by Commission Staff witness Mr. Russell are more accurate and are appropriate for ratemaking purposes. On the other hand, the Commission concludes that the Scenario A rate base adjustments, including depreciation expense, suffer no such flaws. They were calculated more recently and are also somewhat more complete. Those adjustments are therefore adopted for purposes of this proceeding.

The Commission rejects Scenario B for ratemaking purposes as too speculative, and as having no relationship to test year operations. A separate subsidiary may in fact allow for more consistent and comprehensive accounting for M & J activities. The company may wish to pursue that separation, as it has indicated it will, and it is free to do so. However, the record in this proceeding contains only information about actual and adjusted experience during the test year when M & J was integrated with regulated gas activities. The adjusted test year results provide a fair method to treat this issue for ratemaking purposes, regardless of the company's future structural organization. The structure of a separate subsidiary may be appropriate for future ratemaking proceedings, but that issue will be decided if and when it is proposed in a future rate case.

The Commission does have one concern with Scenario B, highlighted by Commission Staff. The separate subsidiary as described by the company would encompass only the more profitable merchandising (sales) function. The company would leave jobbing (diagnostic and repair) in the regulated utility. Some of the jobbing costs are safety related and an important facet of the regulated operation. The company failed to include any of these costs in the subsidiary and would apparently seek to recover all the jobbing expenses from the ratepayer. Staff argued that the company should recover only safety-related jobbing costs as a part of the regulated operation. We expect that appliance repair and service will also follow the M & J functions to a separate subsidiary, if the company takes that approach.

The Commission recognizes that Commission Staff presented a comprehensive cost allocation study in support of its adjustments, undertaken at no small investment of time and with

limited resources. The issues raised by the M & J adjustments have been of concern to the Commission for years. The members of the Commission's Staff involved in the development of the cost allocation study are to be commended for their resourcefulness, endurance, and effort in presenting the Commission with this comprehensive study.

4. Leased M & J restating (ae1&2)

The company leases water heaters and conversion burners to its gas customers. Commission Staff proposed that the program be frozen now, i.e., no new additional customers, and phased out over the next five years. Staff argued that the leasing program has grown to a large percentage of the company's rate base (15%), the program does not cover its own costs at current rates, and the subsidy is not necessary as a means of encouraging gas consumption.

The company wanted to maintain its water heater leasing program but has agreed to freeze conversion burner rentals. The company argued that water heater load increases its year-round load factor and therefore benefits all customers. In addition, the company encouraged the Commission to endorse, from a policy standpoint, the use of gas over electricity to heat water. The company proposed a solution to the water heater leasing issue as follows: It would raise the rental rate now from $3.05 to $4.00 per month; increase rates in future years to reduce the level of program subsidy; install water heaters only with a heat factor of .6 or greater; eliminate the customer allowance for installation costs; and de-emphasize the program through customer communications and a purchase option program.

Public Counsel proposed that the program should either be discontinued or its rates raised to cover costs. Public Counsel also proposed a penalty of $9.00 per year for every inefficient water heater (less than .6 heat factor) that the company has leased since 1990 when it was cautioned that more efficient and cost-effective water heaters were available. This adjustment would impute $280,000 in additional revenues to the company.

The Commission agrees that the leasing program has flaws, including the rental of less than efficient water heaters, and the failure of the program to earn an adequate return. However, the Commission is not persuaded that the company should be directed to get out of the business entirely. The Commission is aware that Puget Sound Power & Light Company has a tariffed water heater program and it believes that these programs can provide customer benefit if they maximize efficient use of resources. WNG has proposed a solution in this case that addresses our concerns with the leasing program.

The Commission will therefore adopt the company's proposal to continue the existing program for water heater rentals, under the conditions outlined above. In addition, the company should offer the leased water heaters for customer purchase, in place, at depreciated book value. It should design an inexpensive and effective way of communicating this offer to the customers. Finally, the company is directed to file a revised tariff which contains a cost-recovering rate for the new, efficient water heaters it proposes to lease, along with a new $4.00 per month rate for the existing heaters.

5. Affiliated insurance (aw)

The Staff proposed an adjustment for payments made to Mercer Insurance, an affiliated company. The adjustment reduces the expense to the average level of Mercer's expenditures, essentially making the expense equivalent to self-insurance. The company generally accepted Staff's approach but recalculated the adjustment based on expenditures Staff missed. On brief, Staff accepted the company's recalculation.

Public Counsel recommended a further adjustment to disallow 50% of Mercer's administrative expenses, contending that many of the expenses of operating a foreign corporation (Mercer is located in Bermuda) are not appropriate for ratemaking.

The Commission adopts the company's figure as the appropriate expense for the affiliated transaction with Mercer Insurance. The company should be advised, as it is certainly already well aware, that affiliated transactions require prior Commission approval, RCW 80.16.020, and that the entire transaction may be disallowed if Commission approval is not obtained. RCW 80.16.060.

6. Temperature Normalization -- (z) purchase gas restating for normal weather and (aa) purchase gas pro forma - gas cost; (bj) revenues restated.

These calculations give effect to the adjustments for normal temperature. The parties agreed that an adjustment should be made to normalize therm sales as if the weather had been normal. This adjustment affects revenues, to reflect the increased gas which would have been sold in a normal year, and expenses, to account for the extra gas the company would have had to purchase in a normal year.

The company and Commission Staff agreed that the weather was "warmer than normal" during the test year. The question then becomes the appropriate method to use to calculate normal temperatures. The company, in a departure from past Commission practice, has calculated normal temperature on a

series of 15-year rolling averages. The company used the period 1984-1998 in this case because the 1991 test period represents the mid-point of that period. The company used this method because it believed that there is a statistically significant trend toward warmer weather which is not otherwise represented. This calculation resulted in annual average heating degree days (HDD) of 4658.3.

The Commission Staff recommended that the Commission continue its past practice of using an 18-year moving average from a 20-year historical period with the highest and lowest years excluded. This method resulted in a calculation of 4748.6 HDD as normal temperature. Staff further recommended that the company be directed to explore the use of data from multiple weather stations, and to look into the calculation of HDD data with a reference point other than 65°F.

The Commission is not persuaded that it should abandon its past practice of using an 18-year moving average to calculate normal weather. While it is not difficult to agree that weather is cyclical, i.e., warmer or cooler from one year to the next, in repeating patterns, the overall conclusion that temperature is in a trend toward being warmer has not yet been established by the company. The Staff's calculation is therefore adopted.

The Commission has considered the other issues raised by Commission Staff but will not at this time direct the company to use data from multiple weather stations, or to recalculate HDD based on a reference point other than 65°F. The record does not show whether the use of multiple stations would cause a statistically significant difference in result, or that it would be more accurate. Nor is it clear that a base of 55°F, or some other reference point, would yield more useful information than that provided under the methods currently used. However, the Commission encourages the intention behind these suggestions, which is to acquire the most accurate data available. The parties are of course free to present alternate methods in the future, if they can demonstrate more reliable or accurate results.

The calculation of normal temperature leads to the computation of normalized therm sales and gas purchases. In this regard, the Commission adopts the Staff's calculations, recognizing that the question of the "negative loss" raised by the company will be resolved in the purchased gas adjustment proceedings.[7] A question about propane service is separately

[7] The "negative loss" is an anomaly in the gas sales and purchases calculation which indicates that during the test period the company booked more gas sales than it purchased.

discussed below in the section on propane service. Consistent with the result of our decision on that issue, $86,500 in booked propane revenues should be reversed.

7. Incentive Plans -- performance share plan restating (bf) and incentive pay restating (bg)

The Commission Staff proposed disallowance of expenses associated with two incentive plans. Staff claimed that the incentives promote goals which benefit shareholders, not ratepayers, and that the ratepayers should not be required to fund the programs. Examples of the goals that Staff found objectionable are those tied to earnings per share, appliance sales, and those promoting customer growth without being linked to cost controls for customer hook-ups.

The company argued that its incentive plans are appropriate and create benefits for ratepayers by reducing employee turnover and keeping fixed salary costs lower. The company contended that Commission Staff should have done some sort of salary study to compare WNG's salaries with those of the industry as a whole, and to evaluate employees' productivity before recommending a disallowance of these plans.

The Commission believes that the expenses associated with these incentive pay plans should not be disallowed in this proceeding. The Commission does agree with Staff that some of the incentives fall short in terms of sending employees the message that the purpose of the program is to encourage improved service. The Commission believes however that the company can do a far better job in the future of creating incentives and setting goals that advantage ratepayers as well as shareholders. Such goals might include controlling costs, promoting energy efficiency, providing good customer service, and promoting safety. Plans which do not tie payments directly to goals that clearly and directly benefit ratepayers will face disallowance in future proceedings.

8. Pension Plan Restating (bd)

The Commission Staff proposed a restating adjustment to remove the test year pension expense. The company was not required to fund, and did not in fact fund, its pension plan during the test year. The plan is currently overfunded and the company has no current obligation to make contributions, although it will in the future. The Staff also proposed that the company be required to account for capitalized pension expense since 1987, and the amount should be removed from rate base in the next general rate proceeding.

The company countered that its pension plan restating adjustment to net operating income properly reflected its pension obligation during the test year and should therefore be granted.

The Commission believes that Commission Staff's adjustment to remove the pension fund expense which was accrued but not paid is proper, but as a <u>pro forma</u> adjustment to operating income, not as a restating adjustment. The Commission will not order a rate base adjustment to remove pension funds capitalized to date, nor will it allow reversal of pension accruals made prior to the date of this Order.

9. <u>AGA Dues</u> (bc)

This adjustment was proposed by Commission Staff; Public Counsel concurred. Staff characterized the dues paid to the American Gas Association (AGA) primarily as an expense for lobbying and governmental relations. Staff would disallow approximately 75% of that expense. The company contended that a far smaller fraction of AGA expenses are for lobbying than represented by Staff. The company also pointed out that the Commission has allowed these expenses in prior rate cases.

The company is correct that AGA dues have not been disallowed in past cases. However, in a comparable situation, the Commission has disallowed an electric company's dues to the Edison Electric Institute when the company failed to document the level of lobbying expense.[8] The Commission also explicitly questioned the purpose of AGA dues in a previous order involving this company's rates. The Commission directed the company, at page 13, Third Supplemental Order, Cause U-82-22/37, to provide specific information sufficient to allocate a portion of the dues to lobbying activities or face disallowance of those expenses in a future case. The company has not provided the requisite information in this case. The Staff's proposed disallowance for AGA dues is therefore adopted.

10. <u>Weatherization</u> (k)

The company proposed an adjustment to amortize its investment in the Washington State Department of Community Development's "Energy Matchmakers" low-income weatherization program. Commission Staff proposed disallowing this expense as outside the test period and having no proven benefit to ratepayers.

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[8] Second Supplemental Order, Cause No. U-81-41, March 12, 1982.

The Commission will allow the company to amortize its $300,000 investment over five years at $60,000 per year, for a net operating income effect of $40,000. The funds were expended in good faith on a legitimate, government-sponsored, conservation-related program. The Commission will not pretend that this is the usual treatment for an adjustment of this type, because the company failed to follow the proper procedure for deferral. However, the Commission believes it is an appropriate item for recovery through rates in the manner we here provide.

In the future, the company must petition for an accounting order authorizing deferral of an expense for later inclusion in a rate proceeding. For an expense such as this, inclusion in the company's least cost plan will also give the Commission an opportunity to evaluate the program to ensure that benefits will accrue to ratepayers from the expense.

11. Safety pro forma (t)

The Commission has described above its reasons for rejecting the tracker mechanism for recovery of costs claimed to be associated with safety requirements set by Commission rule and order. There remains the issue of whether the company should be permitted recovery through general rates by way of pro forma adjustments to operating expense and rate base.

The Commission Staff opposed any inclusion in rates, arguing, as it did on the tracker issue, that the safety expense is not yet known and measurable, and that much of the expense is not incremental. Staff recommended recovery in future general rate cases when incremental costs are actually incurred and are known and measurable, including any offsetting benefits and efficiencies.

The Commission rejects the company's proposed pro forma adjustment for safety expenses incurred for compliance with the settlement agreement in Docket No. UG-920487 and the new rules in chapter 480-93 WAC. The Commission agrees with the company that prudently-incurred expenses of this sort are properly considered in setting rates. We also agree with Commission Staff, however, that many of these expenses do not appear to be incremental; those that are, are not known and measurable to the extent required for a pro forma adjustment. Particularly, the offsetting benefits and efficiencies cannot yet be factored into any calculation. Prudently-incurred expenditures for compliance

with Commission rules and the settlement agreement may be recovered in future rate proceedings.[9]

12. Debt interest pro forma calculation (ai)

The parties agreed on the methodology of calculation, but reached different results because of the varied proposals for capital structure and cost of capital. Those differences are resolved below in the discussion of capital structure and rate of return. Table 2 shows the calculation of pro forma interest.

Table 2

WASHINGTON NATURAL GAS COMPANY -- PRO FORMA INTEREST
12 MONTHS ENDED DECEMBER 1991
(Thousands of Dollars)

Description	Amount
Pro forma rate base	$483,923
Construction work in progress	3,275
Total investment	$487,198
Weighted cost of debt	3.94%
Pro forma interest expense	$19,196
Per books interest expense	24,302
Pro forma interest adjustment	($5,106)
Federal income tax effect 34%[10]	1,736
Net operating income	($1,736)

B. Uncontested adjustments

The remaining adjustments to operating income are uncontested between the company and Commission Staff, either because the Staff did not challenge the company's direct case, or because the company has accepted the Staff position. These adjustments are for the following items: least cost planning; showerheads; payroll increase pro forma; Jackson Prairie; general taxes; bad debts; federal income tax per return as filed restating; WUTC fee; workers compensation; purchased gas; salary investment plan; miscellaneous revenue; and, insurance restating adjustments.

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[9] The company appeared to argue that some of the items it agreed to are unnecessary and imprudent. The company also agreed to pursue renegotiation of the settlement, and to seek a Commission determination to eliminate any proven unneeded work.

[10] This will be recalculated at the new 35% federal income tax rate.

These adjustments have been reviewed by the Commission and found to be proper for ratemaking purposes. They are therefore accepted for this proceeding.

TABLE 3 shows the Commission's determination of the appropriate adjustments to the company's results of operations for the test period.

Table 3

WASHINGTON NATURAL GAS COMPANY NET OPERATING INCOME
12 MONTHS ENDED DECEMBER 1991
(Thousands of Dollars)

Per books results		$41,334
Uncontested adjustments		($1,613)
Contested adjustments:		
Safety	$0	
Marketing	6,900	
Advertising	1,191	
Merchandise & Jobbing allocation	3,490	
Lease M & J restating - Income	0	
Lease M & J restating -Plant	0	
Affiliated insurance	155	
Rev. Purch. gas proforma	2,173	
Rev. Purch. gas restate	1,441	
Revenues restated	925	
Special incentive plans	0	
Pension	167	
AGA dues	179	
Pro forma debt	(1,736)	
Weatherization program	(40)	
Total Contested Adjustments		$14,845
Total Adjustments		$13,232
Pro Forma Net Operating Income		$54,566

IV. RATE OF RETURN/COST OF CAPITAL

A. Capital structure

The capital structure of the utility is the percentage of debt and equity in the total of investor supplied capital. WNG does not have an actual capital structure to consider, as it is wholly owned by its parent, Washington Energy Company (WECO). Although WECO is a publicly traded company, its capital structure

is not necessarily appropriate for WNG. For these reasons, and because the Commission must determine an appropriate capital structure rather than an actual one, a hypothetical capital structure deemed appropriate for ratemaking is used.

The company, Commission Staff and Public Counsel each proposed a capital structure for WNG. Their positions are summarized in Table 4, below, which also includes information about each party's proposed cost rate for each element of capital.

Table 4

WASHINGTON NATURAL GAS COMPANY
RATE OF RETURN COMPARISON

	Capital Structure	Cost Rate	Weighted Return
Company- Mr. Torgerson			
Long term debt	44.53%	8.72%	3.88%
Short term debt	2.78%	3.75%	0.10%
Preferred equity	7.69%	7.66%	0.59%
Common Equity	45.00%	12.25%	5.51%
Company Rate of return	**100.00%**		**10.09%**
Staff- Dr. Lurito			
Long term debt	45.50%	8.76%	3.99%
Short term debt	6.00%	3.75%	0.22%
Preferred equity	7.50%	7.98%	0.60%
Common Equity	41.00%	10.50%	4.31%
Staff Rate of return	**100.00%**		**9.11%**
Public Counsel- Mr. Hill			
Long term debt	44.19%	8.72%	3.85%
Short term debt	5.49%	3.75%	0.21%
Preferred equity	8.18%	7.66%	0.63%
Common Equity	42.14%	10.50%	4.42%
Pub. Counsel Rate of ret.	**100.00%**		**9.11%**

One factor which the company considered in determining its recommended structure is its possible effect on the company's bond rating. The company wished to maintain its Standard &

Poor's "A-" rating[11] in order to minimize its cost of debt and facilitate the sale of its bonds. Bonds with a higher rating are less expensive and allow a company to raise debt capital at a lower cost. The disadvantage to that benefit is that a company with a high bond rating will likely have less debt, requiring more capital on the more expensive equity side of the equation. No party contended that it is inappropriate for the company to maintain an "A-" bond rating.

The Commission adopts a capital structure in this case which should allow the company to maintain its current bond rating and which reflects a safe, economic, and fair apportionment of capital between debt and equity. In general, the appropriate structure increases the equity over the Commission Staff and Public Counsel recommendations and increases the short term debt above the company proposal. The structure represents a more realistic use of short term debt in today's markets -- and is more in line with WECO's actual experience -- while allowing the company to increase its actual equity.

The Commission chooses the company's calculation of preferred equity. The figure is extremely close to that presented by the other parties; it is the most recent calculation of WECO's preferred stock, and it is also the most appropriate calculation.

The Commission determines that a capital structure containing 44% common equity is appropriate. This ratio is one hundred basis points below the company's request, but higher than that proposed by Commission Staff or Public Counsel. The Commission believes that this equity ratio better balances elements of cost and safety for WNG. This ratio also represents the parent company's highest actual equity ratio of record (March 1993).

The appropriate short term debt ratio is 5.5%. In this regard, the analysis presented by Commission Staff and Public Counsel is persuasive. The parent company's lowest short term debt ratio during the past five quarters was roughly 8%, and it was over 9% consistently during the past five years. With the cost of short term debt at historic lows, it is not economic to use the 2.78% ratio proposed by the company.

Long term debt, at 42.81%, is the remainder of the capital structure. Combined with short term debt, it produces a

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[11] Standard & Poor's considers the company's debt ratio and its interest coverage when rating the company, in addition to various other factors specific to a particular company's operations.

total debt ratio of 48.31%. To the extent that this ratio is of concern for the company's bond rating, it is firmly within the most recent guidelines set by Standard & Poor's for an "A" rated local distribution company: 42-50% total debt.

The Commission adopts an appropriate capital structure for WNG of 7.69% preferred equity, 44% common equity, 5.5% short term debt, and the balance, 42.81%, long term debt.

B. Cost of debt and preferred equity

All parties agreed to a short term debt cost of 3.75%. The Commission finds this cost rate appropriate and adopts it. The cost of long term debt is also not greatly disputed. The parties' were within 4 basis points of each other in the 8.72-8.76% range. The Commission adopts the company's proposed cost rate of 8.72%. Finally, the Commission adopts the company's proposed 7.66% cost rate for its preferred stock.

C. Cost of common equity

The remaining capital structure issue for the Commission to determine is the company's cost of common equity. The parties proposed various methods for determining this cost, but it is important to note some general principles before discussing the specific proposals.

The Commission does not set the cost of equity, but rather determines what the market requires as a return on this type of investment. The Commission seeks to find the rate of return on equity which fairly compensates the stockholders for their investment. To this end, the rate of return must be competitive with what investors could earn by placing their money in other enterprises with corresponding risks. The authorized rate of return should assure investors' confidence in the financial integrity of the utility, enable the company to maintain and support its credit position, and permit it to attract additional capital on reasonable terms.

Concerns about investors and the company's financial health are necessarily balanced by the Commission's duty to provide for ratepayers' interests and to protect them from excessive rates and charges.

1. Discounted cash flow

The company, Commission Staff, and Public Counsel presented calculations of the cost of equity using the discounted cash flow (DCF) approach. Only the company argued that the DCF

method should be used in conjunction with other methods to reach a conclusion. Public Counsel used other calculations only as a check.

The company proposed a return on equity of 12.00-12.25%. Mr. Torgerson calculated the return by averaging the results of the company's DCF analysis, 11.09%, with the results of his capital asset pricing model (CAPM) analysis, 11.53%, to reach a bare cost of equity of 11.36%. To this cost, he added 25 basis points to account for additional risk related to Federal Energy Regulatory Commission (FERC) Order 636, and added another 25 basis points should the Commission deny the proposed weather normalization adjustment. Finally, he added 3.1% to cover flotation costs.[12]

Commission Staff witness Dr. Lurito recommended a 10.50% return on equity, which included a cost of equity of 10.00% and flotation costs of 5%. This recommendation assumed no premium for FERC Order 636 risks, and no effect on return if the weather normalization adjustment was denied. These additional factors are discussed below. Public Counsel witness Mr. Hill calculated a range of 10.25-10.50%, with the lower end recommended if the weather normalization adjustment was approved. Mr. Hill stated that risks associated with Order 636 are already reflected in stock prices, and flotation costs should not be added when stock is sold at more than book value.

The Commission continues to believe, based on experience and consideration of alternate approaches, that the discounted cash flow analysis represents the most satisfactory method of measuring investor expectation. We also remain convinced that the CAPM methodology is flawed and of extremely limited usefulness in that analysis. As such, the Commission finds little to recommend the approach of averaging the results of the two methods.

The Commission concludes that the company's cost of equity is 10.50%. Dr. Lurito and Mr. Hill reach almost the same result in the application of the discounted cash flow method. The Commission concludes that these witnesses used reasonable calculations of dividend yield and dividend growth expectations. The calculations are based on a reasoned, well founded analysis

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[12] To avoid dilution, stock should sell sufficiently above book value that proceeds of a new issue, minus the costs of flotation (selling the new issue), equal not less than book value in order to avoid diluting book value. The flotation allowance discussed by the witnesses accommodates that need. The flotation allowance is expressed as a percentage of the recommended return; the referenced 3.1% is thus 3.1% of 11.36%.

of the company's circumstances and of similarly-situated companies in a comparable risk group. The similarity of the results serves as a check on their reasonableness. Indeed, when Mr. Torgerson's DCF calculation is corrected, to account for dividend growth versus earnings growth as explained by Commission Staff on brief, his result is also similar to the 10.50% result.

This authorized return will allow the company to continue to attract capital. It provides the company with an opportunity to earn on its overall capital at a rate of 9.15%, a level which fairly compensates investors and is consistent with expected returns in current economic markets.

3. <u>Other factors</u>

The company added a factor to its authorized rate of return on equity for risks associated with FERC Order 636. Public Counsel and Staff believed the market already recognizes any additional risk, if any exists, and opposed the increase. The Commission believes that a risk premium for the effects of Order 636 is not appropriate. The company did not establish that any such premium is warranted, and if it is, that it is not already reflected in the return currently required by investors.

The weather normalization adjustment proposed by the company is discussed more fully below in the rate design section. Here, the Commission simply notes that it is not clear from this record whether the returns of comparable companies incorporate the effects of a weather normalization adjustment. The company contended it is reflected, and that a premium is warranted if the adjustment is denied. Public Counsel contended that the weather normalization adjustment, if granted, would reduce risk, and therefore the required return. Public Counsel argued that no adjustment is anticipated by investors so that no premium is warranted if it is denied. The Commission concludes that it is not clear from this record that a weather normalization adjustment has an impact on risk beyond that which is already reflected in the analyses.

The company and Commission Staff proposed an allowance for flotation costs while Public Counsel contended that no flotation costs should be added when stock is sold at a price higher than book value. The Commission does not add a specific adjustment for flotation costs, but concludes that the authorized rate of return on equity of 10.50% covers the cost of equity and any flotation which might be appropriate. TABLE 5 shows the Commission's determinations on capital structure and cost of capital for WNG.

Table 5

WASHINGTON NATURAL GAS COMPANY
RATE OF RETURN SUMMARY

	Capital Structure	Cost Rate	Weighted Return
Long term debt	42.81%	8.72%	3.73%
Short term debt	5.50%	3.75%	0.21%
Preferred equity	7.69%	7.66%	0.59%
Common Equity	44.00%	10.50%	4.62%
Rate of return	100.00%		9.15%

V. ATTRITION

The company proposed an attrition adjustment which would increase its revenue requirement by $5.2 million. Attrition is the change in relationship among revenues, expenses, and rate base over time, in which growth in expenses exceeds growth in revenues from factors beyond the company's control. During periods when attrition threatened a company's fiscal health and its ability to provide service, the Commission has allowed an attrition adjustment to rate case revenue requirements.

WNG requested an attrition adjustment in this case. The Commission approved an attrition adjustment in the company's two previous rate cases. The company claimed that the economic conditions which warranted attrition adjustments in the past continue to be present today, particularly with regard to the company's rapid growth to serve new customers and new service territories.

Commission Staff opposed the attrition adjustment. The Staff argued that the economic factors which may have justified an attrition allowance in the past -- declining gas sales, increasing gas prices, and high inflation -- are no longer present. As to the actual attrition adjustment, the Staff took issue with the growth factors used by the company, and disagreed with the company's statement that it used the identical methodology in this case to develop an attrition allowance as was used by Commission Staff in the company's previous rate case.

The Commission concludes that no attrition adjustment should be granted in this case. An adjustment for attrition is an extraordinary measure, not generally included in general rate relief. A request for such an adjustment should be based on

extraordinary circumstances, not shown by the company to be present in this case.

Past attrition adjustments have been allowed when the Commission found that, without such an adjustment, the company would have no reasonable opportunity to earn its authorized rate of return. The Commission does not believe that the company will be impeded from earning its authorized return in today's climate of low inflation, declining interest rates, and increasing gas sales. The company already has an approved tracker mechanism to pass through changes in its cost of gas. This purchased gas adjustment further reduces the risk that attrition will have a negative impact on the company's ability to earn its rate of return.

VI. GROSS REVENUE DEFICIENCY

The adjustments to operating income and rate base, when calculated with the Commission-approved capital structure and cost of capital, demonstrate that the company earns more than its authorized rate of return under current rates. The surplus amounts to $16,909,000[13]. The company will be ordered to reduce rates to produce the required reduction in revenues. Details are discussed below in Section VIII.

The calculation of actual revenue requirement from net operating income requires the application of a conversion factor. On brief, Commission Staff accepted the company's calculation of the conversion factor from exhibit 330 as 0.6083769542. In its brief, the company requested that the Commission take official notice of the increased corporate income tax rate (from 34% to 35%) and apply a recalculated conversion factor of 0.5991591216.

The Commission believes it is appropriate to recognize the increase in the corporate income tax rate to 35%. The company shall also consider increased revenues from its agreed equipment lease increases in calculating the revenue requirement reduction. The parties are directed to consult and recalculate the revenue requirement in this case including the appropriate conversion factor for the tax rate. The agreed revenue requirement should be noted and filed with the revised tariffs, along with a detailed portrayal of the calculation of both the conversion factor and the revised revenue requirement.

TABLE 6 Summarizes our calculation of the company's revenue requirement.

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[13] Subject to recalculation to recount for the new 35% federal income tax rate.

Table 6

WASHINGTON NATURAL GAS COMPANY
CALCULATION OF REVENUE REQUIREMENT
12 MONTHS ENDED DECEMBER 1991
(Thousands of Dollars)

Pro Forma Rate Base	$483,923
Authorized Rate of Return	9.15%
Net Operating Income Requirement	$44,279
Pro Forma Net Operating Income	54,566
Operating Income Deficiency/(Excess)	($10,287)
Conversion Factor	0.60837695
Gross Revenue Deficiency/(Excess)	($16,909)

VII. PUBLIC TESTIMONY

Hearings were held in Tacoma, Seattle, and Olympia for the purpose of taking testimony from members of the public. The hearings were well attended and the participants provided thoughtful and knowledgeable comments on the rate proposals.

In general, the witnesses were either individual ratepayers or persons involved in the home heating industry. The ratepayers all felt that the rate increase requested by the company was too high and that the company should first cut costs in order to cover some of the claimed revenue deficiency. Many customers did not object to a small increase in rates. The witnesses involved in the home heating industry, some of whom are members of ACCA (Air Conditioning Contractors Association) testified generally that they feel that the company should not be permitted to subsidize its merchandising operations with its regulated operations.

These contractors do not object to competing with the company for furnace and window sales, but want to do so on a "level playing field." In this regard, the witnesses expressed concerns about access to the company's billing inserts for advertising, and about allegations that the company offers preferential prices for initial service connections if the customer purchases appliances from the company rather than from an independent dealer.

The letters submitted by the public were marked and admitted, for illustrative purposes, as exhibit 428. In general, these letters were opposed to the rate increase originally requested by the company, although many customers accepted that the company might need a more modest increase. The ratepayers asked whether the company had taken steps to reduce and control expenses before requesting the increase. Several letters expressed disagreement with a seasonal surcharge for gas in winter. Finally, customers stated they wanted to see the company separate its non-utility functions such as window sales and home security systems from the regulated operations.

Many ratepayers, both at the public hearings and by letter, addressed the issue of the weather normalization adjustment. They are strongly opposed to it being imposed on a mandatory basis, although many find it acceptable if offered on an optional basis. The sentiment most often expressed was that the consumer felt more than capable of budgeting for cold weather and did not need the company to do so for them. In addition, the consumers expressed a strong desire to have precise, accurate bills which reflect actual usage, not some weather adjusted bill which they felt would be difficult to verify. The consumers also noted that the budget billing program which is already in place appears to meet the needs of any ratepayer who might want the effect of the weather normalization adjustment.

Finally, the Commission must address an issue raised by one of the public witnesses. She testified at Olympia that following her appearance at the Seattle hearing, a person called her who identified himself as an official of the company. She heard him make comments about her testimony and her heating industry business that she interpreted as potential threats.

Commission Staff and Public Counsel investigated the complaint and secured information from the company. The official testified in the company's rebuttal case, denying the accusation and presenting telephone records indicating that no call to the witness' number was placed using either his office telephone or his cellular telephone.

The Commission considers such matters to be extremely serious. Any such incident on the part of any party that is corroborated or otherwise sufficiently demonstrated will be referred to appropriate authorities for criminal or civil action. Witness intimidation or reprisals for testifying in our public proceedings are reprehensible and intolerable.

From the evidence of record, the Commission cannot determine with certainty what actually transpired. Both witnesses were credible in their assertions. No issue in this case requires us to make a determination, and the Commission has

no jurisdiction over personal responsibility for the incident. No party on brief asked the Commission to take any action or premise any determination on the incident. The Commission will take no action on the basis of this record, but expresses its continuing concern about any such incident.

VIII. TARIFF STRUCTURE

A. Cost of service studies

As a part of any general rate case, the Commission has found that it is aided in its rate setting function by a cost of service study that analyzes the division of the company's total costs among customer classes.

While these studies do not dictate rates, they can provide a useful reference point for analysis. To the extent that one goal of ratemaking is to adopt rates for each customer class that reflect the cost of serving that class, cost of service studies are a useful tool. To the extent that such studies must allocate historical and common costs, the studies can only approximate cost relationships. Market conditions and public policy considerations may dictate that returns vary between customer classes. The Commission therefore may vary from the indications of an acceptable study in allocating revenue requirements.

In previous cases, the Commission has discussed methods for proper cost allocation in a cost of service study. General principles that are accepted for cost of service studies for the natural gas industry have been stated[14] as follows:

(1) They are important tools for comparing the relative contributions of different customer classes to the company's overall costs.
(2) Embedded cost studies should allocate some fixed costs on the basis of throughput.
(3) Embedded cost studies are only one consideration in determining rate spread and rate design.
(4) Discounting for competitive purposes should be done explicitly.

Both the company and Commission Staff prepared cost of service studies. The company prepared one study under its preferred methodology and one at Commission Staff request under

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[14] See, Third Supplemental Order, WUTC v. The Washington Water Power Co., Docket No. UG-911459 (March 9, 1992), citing Fourth Supplemental Order, WUTC v. Cascade Natural Gas Corporation, Cause No. U-86-100 (May 9, 1987).

the so-called Cascade methodology[15] or Commission Staff preferred methodology. The main difference between the two approaches is that the Cascade methodology allocates costs in part on the basis of throughput, or annual volumes, and in part on the basis of peak period use. The company's method allocates some costs by direct assignment and most costs on the basis of peak use. Public Counsel supported the Staff method while PERCC and NWIGU supported the company's preferred study.

Commission Staff argued that it is appropriate to allocate plant 50% on annual throughput per the Cascade methodology because the system is "built to deliver gas" and all users should share in the costs of use. The company countered that it is appropriate to allocate plant on a peak responsibility method because the system is "sized to meet peak day requirements".

Commission Staff and Public Counsel pointed to errors in the company study, including the company's failure to allocate storage costs to interruptible customers. Staff also pointed out that the company did not submit a revised cost of service study consistent with its rebuttal case and that the company's original study is in any event only marginally useful, considering the changes in the company's case.

The company in turn argued that the Cascade methodology is outdated and does not recognize that circumstances have changed significantly since it was adopted. In addition, the company argued that Staff is inconsistent -- it advocated direct allocation elsewhere (in the merchandising and jobbing allocations, for example) but opposed it here.

The Commission will not accept any of the cost studies presented in this proceeding. The company's study focuses almost wholly on the design of the system for peak demand, but ignores how the system is used throughout the year. We continue to believe that the Cascade approach can properly reflect the actual usage of the system in a way that demand-driven methodologies do not.

Nevertheless, the cost study presented in the Cascade proceeding did not address the existence of transportation as a separate function of the utility. Thus, in Docket No. UG-901459 (Third Supplemental Order, p. 9), the Commission relied on

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[15] The "Cascade methodology" is the approach that the Commission adopted in the Commission's Fourth Supplemental Order in Cause No. U-86-100, above, as appropriate for use in that proceeding. Commission Staff prepared the study it offered in this proceeding using the Cascade study as its model.

Commission Staff's cost of service study which followed the Cascade model in classifying costs based on both the design and usage of the system, but also pointed out that the method had not been applied in a manner that identified the true system cost of transporting gas. The Commission there offered the following advice for future cost of service studies:

> [T]he Commission instructs the parties to study the cost of providing transportation functions to all customers (bundled sales and transportation customers alike). Then, additional costs of providing bundled service should be analyzed as well as any costs unique to transportation customers (e.g., daily nominations). (Order, p. 10)

The Commission is disappointed that the studies submitted in this proceeding ignored this instruction. These studies offered little guidance in terms of setting prices, especially in the area of new tariffs such as transportation service. The fact that transportation was not identified as a distinct function of local distribution at the time the Cascade method was first applied suggests at a minimum that the same classification factors and allocation ratios that fit Cascade might not be directly applicable to another system today. The Commission will therefore issue a Notice of Inquiry in which parties will be asked to participate in an effort to determine how to analyze a gas distribution company's costs with transportation included as a distinct function.

B. Transportation

Transportation of gas has been an issue in the company's rates over the past several years[16], and was to be fully addressed in this proceeding. As noted above, the company did not provide an analysis of the cost of transporting gas on its system. The Commission is especially distressed by this failing, because our order in Docket No. UG-900210 unequivocally directed the company to provide a complete cost of service study for transportation. Among other explicit instructions, the Commission stated that "supporting data will be necessary to determine what, if any, monthly minimum bill is suitable for [transportation customers]." (Second Supplemental Order, Docket No. UG-900210, p. 5) The Commission enumerated a number of different cost reduction suggestions and service distinctions that such a study should have evaluated for cost. The Commission

[16] See, for example, Second Supplemental Commission Order, Docket No. UG-900210, January 4, 1991, and, Fifth Supplemental Order, Docket No. UG-910871, April 7, 1992.

could hardly have been more explicit in requiring the company to develop and provide cost support for its transportation proposals.

Without such a study, many of the highly contested issues related to transportation service in this case, such as balancing, minimum bills, interruptibility, and pricing, cannot be finally resolved. Parties who advocated both higher or lower transportation rates than proposed by the company expressed frustration over the lack of a cost analysis against which to evaluate the company proposals. Such information is a prerequisite for developing a stand-alone transportation tariff structure that properly separates sales and transportation service.

In the absence of a thorough study, the Commission will approve the company's proposed "separately stated" transportation tariffs as detailed below, but will require that the new tariffs expire March 31, 1994.

1. The nature of the service in general/proposals by parties

Each party has a specific proposal for how transportation should be offered and priced. The proposals vary depending upon how each party answers the following questions: 1) whether transportation is a basic service; 2) whether all or some customers should be able to transport; and 3) how transportation should be priced relative to sales service.

The company answered these questions in a way that would restrict the availability of transportation to large volume customers and would favor system sales over transportation. Commission Staff's position was generally the same. The commercial and industrial customers, and to some extent Public Counsel, would allow greater access to the service, although their pricing proposals differ significantly from one another.

The company proposed two new schedules for transportation service. Schedule 57 would serve large volume transporters with an annual minimum volume of 750,000 therms. Schedule 58 would serve limited volume transporters with an annual minimum volume of 240,000 therms. Both schedules have declining block rates, both are designated interruptible (with a firm option for some customers), and both have minimum monthly bills of $4,500 and $3,200 respectively, a monthly customer charge ($500 and $200 respectively), a one-year contract requirement, and a mandatory charge to the customer for installation of telemetering equipment. The company also proposed to require transporters to pay for balancing service,

with penalties for failure to meet month-end balancing requirements.

The company originally proposed a zero tolerance balancing provision, but has since adopted Commission Staff's recommendation that there be a 3% tolerance band with balancing required at the end of the month. Customers are allowed 15 days to "go through zero" and come back into balance. Penalties are on a sliding scale and range from 25% of the cost of gas to $2.00 per therm for overtakes, or the company taking title to excess gas for undertakes in excess of 10%.

Commission Staff generally supported the company's proposal, but took issue with the rates and revenue requirement proposed by the company for these schedules as being too low. Staff also argued for elimination of the distinction between firm and interruptible service, and a service designation only as "distribution system transportation service", neither firm nor interruptible. Staff proposed that customers would essentially be paying for and receiving firm service, as interruptions on the system are rare. Staff would design a credit mechanism to compensate the customer when interruptions did occur.

Public Counsel witness Lazar in direct testimony supported the general structure of the company's transportation tariff proposal, except for a concern that Schedule 57 rates as proposed might not be fully compensatory. On brief, Public Counsel recommended that the Commission instead adopt a single transportation rate with an annual minimum usage of 240,000 therms. Public Counsel would allow aggregation of volumes to qualify for the annual minimum and for determining balancing. Public Counsel also proposed a two-year minimum contract with one-year notice of changes.

The intervenors all had different views on what elements and requirements are appropriate for this service. They hold in common the view that the company has failed to provide adequate cost support for any elements of its proposed tariff. The commercial and industrial interests represented by PERCC, NWIGU, and Seattle Steam contended that the balancing requirements are onerous. They would have the company's balancing provisions parallel those of Northwest Pipeline Company, with a 5% band, a 45 day make-up period, and no requirement to "pass through zero" in order to avoid penalties. The smaller customers also argued that the minimum bill and annual minimum therm requirements would unfairly preclude them from taking the service.

NWIGU would retain two separate schedules with lower rates than currently proposed, while PERCC would combine the two schedules to lower the price of the initial blocks relative to

the tail blocks. Seattle Steam is most concerned with the large volume rate and with the concept of interruptibility. Seattle Steam contended that Commission Staff mischaracterized interruptions as "rare" -- its experience is that interruptions occur quite frequently.

2. Rate design and rate spread for transportation

The Commission continues to be convinced that transporting gas has significant direct costs, as well as a responsibility to recover a portion of the system's common costs and to provide a return to the company. To the extent that small customers are unable to perform certain direct functions without the assistance of the company, and to the extent that smaller volumes of gas provide less opportunity to recover costs on a per therm basis, the Commission agrees that it is proper to make a rate distinction between transportation users of different sizes. However, the Commission is not persuaded that the way the company has actually proposed to distinguish between transportation customers on the basis of two usage levels is adequately reflective of how costs are incurred on the system.

The company has provided no cost data that support its very significant proposed differentiation in per therm rates between small- and large-volume transporters. As PERCC notes in its brief, the company did not demonstrate that there are unique economies of scale associated with transportation customers who meet the 750,000 therms/year threshold, compared to customers who meet the 240,000 therms/year threshold. The Commission also finds plausible the concern of Public Counsel and PERCC who raise the prospect that under the proposal for two distinct transportation schedules, some customers could save money by ordering service under the higher schedule and paying the penalty for unused volumes.

To the extent that the company's proposal to rely on usage volumes does represent an appropriate way to distinguish between transportation customers, the Commission is inclined toward the recommendations of PERCC and Public Counsel that the company consolidate its proposed transportation rate into a single declining block tariff. However, it does not appear that the company has developed a cost analysis that would enable it to propose a reasonable customer charge, or to determine the levels for each block of a consolidated schedule at this time. The Commission will order the company to file a single, declining block transportation tariff, supporting it with accounting and cost information, not later than January 1, 1994.

In the interim, the Commission authorizes transportation rates designed in accordance with the following conditions. The company may file two separate schedules as

envisioned in its testimony, based on an annual minimum volume of 240,000 therms for Schedule 58 and 750,000 for Schedule 57. Minimum bills should be calculated based upon the monthly minimum at rates filed pursuant to this Order. Customer charges should be set at the levels agreed to by company, Commission Staff, and Public Counsel.

The company should set initial declining block rates for each schedule using the "equal margin" approach and based on the margins resulting for Schedule 85 and 87 customers, adjusted as ordered in this proceeding. While the Commission is willing to believe that providing transportation service imposes additional costs on the company beyond those attributable to sales customers (once gas acquisition costs are subtracted), the testimony in this case does not support a determination that such costs are not fully recovered through the direct customer, minimum bill, balancing, and telemetry charges, nor to observe the return gained from providing the service. In designing a consolidated tariff, the company should be prepared to demonstrate a cost basis if the per-therm transportation charge exceeds the margin paid by similarly situated sales customers.

Aggregation is approved as proposed by Public Counsel. This will permit customers with multiple sites served through a single city gate to aggregate volumes to meet the annual minimum threshold and for calculation of any balancing charges.[17] If the company believes that it costs more to transport a given volume of gas to multiple sites in this fashion, it should provide cost support and set a reasonable charge, rather than proposing a prohibition.

The Commission adopts a one-year contract requirement, with the contract to be signed by July 1 for a term beginning October 1. The notice period and contract length are appropriate to minimize disruptions from switching among services, and to permit the company a period to arrange its gas supply for the following heating season.

The Commission also will adopt the balancing provisions agreed upon by Commission Staff, the company, and Public Counsel, except that a 5% tolerance band is more reasonable and should be allowed. Although the company's balancing provisions are more stringent than Northwest Pipeline's, the Commission believes that with the 5% tolerance band they are reasonable. The customers

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[17] Balancing is the principal benefit offered by this aggregation, as a customer would not be barred from transportation service by the failure to transport minimum volumes. That failure, however, would have economic consequences under the tariff that could render transportation uneconomic.

who opposed the provisions did not demonstrate that the penalties would be unduly burdensome or that compliance with the provisions would be difficult to achieve.

The Commission will not at this time change the nature of the service from interruptible, as proposed by Commission Staff. The proposal is a change from the status quo and the Commission is not convinced that it would be an improvement over the current practice. Staff seems correct when it notes that much more service is sold as interruptible than ever will actually be interrupted. The operational distinction between firm and interruptible transportation is not well established.

The concept of a credit for interruptions, essentially a purchase by the company of the right to interrupt service, is a good one, is being explored in electric company service, and deserves additional study for this company. To the extent that interruptible service does provide operational benefits to the company, the company may decide to use it as a resource. Cost information, not presented in this proceeding, would be especially helpful in determining the costs and benefits of interruptibility in order to price the service.

Other issues, not greatly disputed, are the charges for telemetering equipment and the charge for deficiency throughput volumes. While customers are reluctant to pay for telemetering equipment, they generally do not oppose a one time charge for installation of non-duplicative equipment. The Commission approves the charge for telemetering equipment, with the noted limitations. The Commission will also approve the charge for deficiency throughput volumes, which was not challenged.

C. Weather normalization adjustment

The company has proposed a weather normalization adjustment (WNA) under Supplemental Schedule 120 for consumers whose usage is weather sensitive -- Schedules 23, 24, 31, and 36. This proposal has already been referenced in this order in conjunction with the cost of equity capital, and in terms of ratepayer reaction to the proposal.

The company described the proposal as an adjustment to customers' bills for usage differences that result solely from weather differences. The company stated that it now "over-earns" during colder than normal weather and "under-earns" during warmer than normal weather. The WNA would offset these revenue effects by making credits and surcharges to ratepayers. A January bill in a "colder than normal" January would be lower than it would be without the adjustment, while a warmer January would see a higher bill than it would without the adjustment. The company claimed that ratepayers would benefit from a lower cost of capital, from

the resulting more predictable bills, and from the lower bills during colder weather.

Staff opposed this adjustment, arguing that the company had not demonstrated that it is technically accurate and unbiased, or that it fairly and efficiently allocated the adjustment among customers within a class, or that it provided financial benefit to ratepayers.

Ratepayers clearly did not favor this adjustment, preferring to predict their bills based on their actual knowledge and experience with both the weather and their own consumption. Public Counsel recommended that the adjustment be rejected or made optional.

The Commission concludes that the weather normalization adjustment has not been shown to have a benefit to ratepayers and should not be adopted. Ratepayers believe that this adjustment will make their bills unpredictable and difficult to understand and verify. Both points seem well taken. In addition, Commission Staff has noted technical difficulties, such as the use of the same adjustment to bills which are for almost entirely different billing periods, and questions about the allocation of the adjustment to individual customers within a class, that are of sufficient concern to warrant rejection of the adjustment.

Finally, from a least cost planning standpoint, the adjustment has several problems. It does nothing to remove the company's incentive to sell more gas. It provides no incentive for the customer to conserve -- lower bills during colder months might actually dull the incentive to conserve. Because the company's revenues are temperature sensitive, it has an incentive to improve load factor to smooth out volatility. To the extent that this adjustment would levelize revenues and remove temperature sensitivity, the incentive to improve load factor may also be reduced.

D. Rate Spread and Rate Design

In this section, the Commission will discuss the appropriate way to allocate the revenue reduction among the various customer classes (rate spread), and other changes to the rate schedules (rate design). These issues have already been discussed and decided above as they pertain to the separate transportation service; the remaining rate issues are discussed in this section.

The Commission concludes that the revenue requirement decrease ordered should be calculated as a percentage of marginal revenues -- i.e., total company revenues less gas costs. This system average shall be applied equally (unless ordered otherwise

in the individual sections, below) to the marginal revenue for each rate class to determine the actual decrease for each class.

1. Residential

The following changes should be made to residential rates in the context of an overall rate reduction. The reduction to residential rates should be equal to the system average, with the reduction first applied to reduce the customer charge from $4.51 to $4.00 per month, on the basis of Public Counsel's cost analysis. Any further reduction should be applied to the commodity rate.

The Commission accepts the company's proposal to eliminate declining block rates; it should implement a flat rate in schedules 23 and 24. These schedules may remain separate as requested by the company to facilitate record keeping, so long as the rates charged are the same. The Commission rejects the company's proposal to add a seasonal surcharge to winter gas prices. The Commission will consider moving toward such a surcharge in the future -- the elimination of the declining block is a first step.

Public Counsel proposed a revised bill format to all customers' bills.[18] Public Counsel witness Mr. Lazar proposed numerous revisions to the company's bill format along the lines of the format used by Puget Power. The changes would provide the customer with information about current and past usage, and current period weather compared with weather during the same period a year earlier. In general, the revised format would provide the customer with a basis for analyzing usage and conservation measures.

The Commission believes that Public Counsel's recommendations regarding the bill format are well taken. Rate revisions and pricing signals are generally communicated to the customer through the customer's bill. To the extent that the bill can provide more information in a clear and understandable format, the company should explore and implement feasible revisions to its bill format.

Public Counsel also suggested an adjustment in this proceeding relating to meter reading and billing expense. The company reads meters and bills monthly; Public Counsel suggested that substantial savings may be realized by bimonthly billing and a joint meter reading effort with electric utilities. Commission

[18] This issue is discussed in conjunction with residential rate issues for convenience.

Staff agreed that there is the potential for savings but suggested that no adjustment be made in this proceeding.

The Commission concurs with Staff -- the company should be on notice, in future proceedings, to either have implemented those suggestions or be able to provide a justification for not having done so. Failure to do one or the other may result in the disallowance suggested by Mr. Lazar on meter reading and billing expenses.

2. Commercial and Industrial

There appears to be a consensus among the parties that the rates for schedules 31, 36, and 41 are earning well above the system average rate of return and should receive a larger than average decrease in rates. The Commission concurs and orders a rate decrease for these schedules of 150% of the system average.

The company would retain declining blocks for all three schedules. Commission Staff would establish a single rate for 31 and 36, but retain a declining block rate for Schedule 41 to recognize customer size and the availability of alternate fuels. The Commission adopts Staff's rate design proposal and orders a single rate for schedules 31 and 36. Schedule 41 should remain on a declining block structure.

3. Large volume sales

The customers served under schedules 85, 86, and 87 are the large volume sales customers. The schedules are currently denominated as interruptible service, with a "firm-up" option which customers apparently use for relatively small amounts of gas to operate minimum system requirements during periods of interruption. PERCC supported the company's proposal to retain the firm up option. Rates are structured as declining block rates. The company proposed no significant changes to these schedules. Transportation sales which are currently made under these schedules would be moved to the new transportation schedule.

Commission Staff recognized the benefits the company receives from retaining its large volume interruptible sales customers and therefore recommended that the present declining block rate structure be retained. Staff would designate these schedules as interruptible only, eliminate the option to firm up small amounts of gas, and require those firm sales to be moved to Schedule 41. Rates under schedules 85 and 86 would be reduced by the system average rate reduction, while Schedule 87 would receive no rate reduction, as it does not cover costs at current

levels. Public Counsel concurred in the rate spread recommendations and added that it may be desirable to increase the tail block of Schedule 87 (currently $0.16 per therm plus demand charges) to at least the company's weighted average cost of gas (WACOG), $0.178 per therm.

The Commission believes that each party has made worthwhile rate spread and rate design suggestions for these schedules. The Commission retains the declining block structure, but concludes that the tailblock of Schedule 87 must at least cover the company's WACOG. These schedules may retain the firm-up option, which appears to be covering costs, although further information in a subsequent case may produce a different result. Finally, the rate reduction ordered in this case should be applied to schedules 85 and 86 at the system average reduction while Schedule 87 should receive no decrease.

4. Other rate schedules

a. Compressed Natural Gas and Schedule 50

The company proposed a new Schedule 50 for the sale of natural gas as a vehicle fuel. The schedule contained rates for both compressed and non-compressed gas. In addition, the company currently provides compressed natural gas (CNG) to a limited number of customers under schedules 31, 85, and 86.

The Commission Staff recommended that Schedule 50 be rejected as it does not cover the costs of providing service. Staff did support the development of a cost-based tariff for the sale of non-compressed gas for vehicle use and urged the company to address this issue. Such a tariff could be filed at any time and would be a benefit to the company in that it could provide incremental, non-seasonal load to the benefit of ratepayers and shareholders.

Commission Staff also recommended that the company be ordered to stop selling CNG under schedules 31, 85, and 86, as the tariffs do not authorize the sale of compressed natural gas and do not cover the cost of that service. Staff would allow the company to continue the sale of CNG under Schedule 31 only, and only for a 90 day period, so that existing customers are not stranded. Thereafter, Staff would allow CNG sales only through a subsidiary.

The Commission adopts Staff's recommendations on this issue, with modification. The company may continue to sell CNG so long as it does so at compensatory rates that are properly tariffed. Staff's recommendations protect existing customers, bring rates in line with cost, and leave the company free to develop a rate schedule for non-compressed gas as a vehicle fuel.

The Commission does not mean to discourage the company from developing a CNG market. In fact, the company's forays in this area are quite interesting. However, CNG must be sold at cost and not at the expense of utility ratepayers. The rates proposed in Schedule 50 are therefore rejected as they do not cover the cost of service.

b. Propane service

The company currently provides propane service to approximately 130 households. The propane service was apparently designed and offered as a "bridge"-type service to areas where it was anticipated that natural gas distribution service would arrive in the near future. The company provides customers with the meter and service line, while the propane is provided by independent dealers who bill the company for the propane. The company then bills the customer at the pertinent natural gas tariff rates. The service has been in place for many years, but has never been proposed to or approved by the Commission. Many customers have received service for a period of time well in excess of what is contemplated in a "bridge"-type service.

Staff recommended that the company be required to cease providing propane service immediately, as the program is not tariffed and does not cover costs. Staff contended that the existing customers can be served directly by independent dealers and will not be harmed if the company stops providing the service.

The company agreed that the propane service should not continue unchanged. It proposed to freeze existing service and conduct a study within 60 days to see which customers might reasonably be served within six months. Those customers could continue to receive propane service until they are connected to the natural gas distribution system within the six-month period. The remaining customers would be removed from the program. The company proposed to help those customers arrange the purchase of propane for an additional year.

The Commission agrees that the existing propane service cannot be continued. The Commission accepts the company's proposal to freeze the program, study the service over the next 60 days, and terminate service within six months. The Commission believes that propane service may be worthwhile as a true bridging service to natural gas. Thus, the company should not be precluded from offering it at a compensatory rate. If the company wants to offer this service in the future, it must do so under a tariff which clearly spells out the terms and conditions of the service.

For purposes of this proceeding, the Commission accepts Staff's recommendation that the appropriate ratemaking treatment is to exclude the costs of the program and thereby eliminate any ratepayer subsidy. The test year costs were $254,600. The revenues from the program, $86,500, will also be excluded from the test year revenue calculation.

c. Schedules 43 and 51

These schedules serve armed forces high volume customers and multiple unit housing heating customers. The company would retain a declining block rate schedule but add a winter differential. Staff proposed a flat rate with no seasonal differential. Staff recommended a smaller than system average decrease for these schedules.

The Commission adopts Staff's recommendations. Consistent with the treatment of the residential schedules, declining block rates should be changed to a flat rate, but no seasonal surcharge should be applied. These schedules should receive a reduction equal to 50% of the system average decrease.

IX. CONCLUSION

The Commission's Order requires that WNG decrease its rates by approximately 5% of total revenues, or about $17 million per year.[19] In light of company and market reactions to the Commission Staff direct case, it is appropriate to state in general terms why the Commission believes that the general result of this Order is both predictable and reasonable.

The company's most recent contested rate proceeding was decided nearly a decade ago. Its current rates are predicated on a cost of capital, both debt and equity, that is substantially higher than the present market demands. The company has been able to finance its recent operations at a substantially lower cost than its current rates contemplate. With each debt financing, its embedded cost of debt has fallen. Investors are also demanding lower returns of similar companies than they demanded when the company's rates were last set.

The company's initial proposal was predicated upon a number of positions that the Commission had strongly and repeatedly rejected. Examples include the Commission's past disallowance of merchandising costs, promotional advertising, and marketing activities. In addition, the company was aware of the

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[19] The exact amount must be determined after the company recalculates the conversion factor, subject to Commission review prior to rates becoming effective.

Commission's questions about AGA dues, the Commission's past reliance on the discounted cash flow method to determine cost of equity, and various other contested issues in this case, as they were previously raised in proceedings involving the company. It is regrettable that so many of these items had to be relitigated in this proceeding.

The Commission believes that the result of this case will be rates and a company return that are more in line with the company's present operating environment. The Commission has disallowed certain of the company's expenses. The company has already committed to ending some of the relevant expenditures, such as many of those connected with its merchandising operations. It has the opportunity to stop others, such as advertising that is not permissible under Commission rule. By reducing such expenditures in the future, the company can conserve dollars that are disallowed in this decision. The result of this Order is appropriate under current conditions. The regulated company will remain healthy and strong under the rate and other decisions made in this Order.

The tariff revisions filed by the company in July 1992 are rejected. The company is directed to refile tariffs effecting a reduction in rates of approximately $16,909,000, as calculated pursuant to the terms of this Order.

FINDINGS OF FACT

Having discussed above in detail both the oral and documentary evidence concerning all material matters, and having stated findings and conclusions, the Commission now makes the following summary of the facts as found. Those portions of the preceding detailed findings pertaining to the ultimate findings are incorporated herein by this reference.

1. The Washington Utilities and Transportation Commission is an agency of the state of Washington vested by statute with authority to regulate rates, services, facilities, practices, rules, accounts, securities, and transfers of public service companies, including gas distribution companies.

2. Respondent Washington Natural Gas Company is engaged in the business of furnishing natural gas to customers in the state of Washington as a public service company.

3. On July 27, 1992, respondent filed revisions to its tariff WN U-2 which were designed to effect an increase in the rates and charges made by the respondent for natural gas service. The stated effective date of the revisions was to be August 27, 1992. On August 19, 1992, the Commission suspended the operation of the tariff revisions pending an investigation

into and hearings on the justness and reasonableness of the proposed rates. The company waived the suspension date to October 1, 1993.

4. The 12-month period ending December 31, 1991, is the appropriate test period to examine the operations of respondent for rate making purposes in this proceeding.

5. Respondent's average rate base for the test year, adjusted pro forma, is $483,923,000.

6. The appropriate capital structure of Washington Natural Gas for ratemaking purposes is 48.31% debt, 44% common equity and 7.69% preferred equity. The appropriate debt component consists of 42.81% long term debt and 5.5% short term debt.

7. Authorization of gross revenue sufficient to achieve a rate of return of 9.15% on respondent's rate base will maintain the respondent's credit and financial integrity and will enable respondent to raise sufficient new capital at reasonable rates to meet its service requirements. A 9.15% return on rate base constitutes a fair rate of return.

8. The respondent's test year net operating income under present rates is $54,566,000.

9. An annual gross revenue surplus of $16,909,000 exists in test year revenues from respondent's operations at the respondent's test year federal income tax level. Respondent should be authorized to recalculate this figure to recognize the change in federal income tax rates since the test year. Respondent should be required to provide information detailing its calculations, when it files rates in compliance with this order.

10. The tariff revisions that the company filed contain rates that are not fair, just or reasonable. Tariffs consistent with the terms of this order will contain rates that are fair, just, reasonable and sufficient.

From the foregoing findings of fact, the Commission enters the following conclusions of law.

CONCLUSIONS OF LAW

1. The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of and the parties to this proceeding.

2. The tariff revisions now under suspension should be rejected. The company should be directed to refile tariff revisions effecting a decrease in revenues of $16.909 million, prepared in accordance with the terms of this order. The company should be authorized to recalculate its revenue requirement consistent with changes in federal income tax law, as specified in this order. Tariff revisions prepared in accordance with this order will result in rates that are fair, just, reasonable and sufficient.

On the basis of the foregoing findings of fact and conclusions of law, the Commission hereby makes and enters the following order.

ORDER

THE COMMISSION ORDERS:

1. The tariff revisions filed by respondent on July 27, 1992, now under suspension in Docket No. UG-920840, are rejected entirely.

2. Respondent is authorized to recalculate the revenue requirement stated in this order, to recognize the effect of the change in federal income tax rates, provided that it submit with its rate filing detailed information explaining its calculation.

3. Respondent is directed to file revisions in the form found to be appropriate in the body of this order, no later than 10:00 a.m., Monday, October 4, 1993. Respondent shall submit, with its filing, detailed information regarding the calculation of the rate levels contained in the filing so that Commission Staff may verify that the tariffs comply with the terms of this order.

4. The filing authorized in this order shall bear an effective date of October 9, 1993.

5. The tariff revisions shall bear the notation on each sheet thereof, "By Authority of the Washington Utilities and Transportation Commission in Docket No. UG-920840".

6. Notice of the filing authorized in this order shall be posted at each business office of respondent in the territory affected by the filing, on or before the date of filing with the Commission. The notice shall state that the filing is to become effective on the date inserted in the tariff as the

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effective date pursuant to the authorization stated above. The notice shall state that a copy of the filing is available for public inspection at each such office. This notice shall remain posted until the Commission has acted on the filing.

7. The Commission retains jurisdiction to effectuate the provisions of this order.

DATED at Olympia, Washington, and effective this 2Hh day of September 1993.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

SHARON L. NELSON, Chairman

RICHARD D. CASAD, Commissioner

RICHARD HEMSTAD, Commissioner

NOTICE TO PARTIES:

This is a final order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-09-810, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-09-820(1).

DOCKET NO. UG–920840

Attachment 1

WASHINGTON NATURAL GAS COMPANY

COMPARISON OF COMMISSION STAFF AND COMPANY POSITONS
RATE BASE
12 MONTHS ENDED DECEMBER 1991

	Company	Staff	Difference
Per books results	$485,157	$485,157	$0
Contested Adjustments			
Safety	$4,029	$0	($4,029)
Merchandising & Jobbing Allocation	0	(12,393)	(12,393)
Lease M & J restating – Plant	0	(30,488)	(30,488)
Special incentive plans	0	(304)	(304)
Working capital	7,472	1,291	(6,181)
Environmental	6,828	0	(6,828)
Storage gas pro forma	1,788	0	(1,788)
Storage gas	(418)	(378)	40
Total Contested Adjustments	$19,699	($42,272)	($61,971)
Uncontested Adjustments:			
Jackson Praire	($53)	($54)	$1
Sale excess land	(638)	(638)	0
New building	(187)	(187)	0
Total Uncontested Adjustments	($878)	($879)	$1
Total Pro Forma Rate Base	$503,978	$442,006	($61,970)

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DOCKET NO. UG–920840

Attachment 2

WASHINGTON NATURAL GAS COMPANY

COMPARISON OF COMMISSION STAFF AND COMPANY POSITONS
NET OPERATING INCOME
12 MONTHS ENDED DECEMBER 1991

		Company	Staff	Difference
Per books results		$41,334	$41,334	$0
Contested Adjustments				
Safety		($743)	$0	($743)
Marketing	*2	3,400	6,900	(3,500)
Advertising	*2	472	1,191	(719)
Merchandising & Jobbing Allocation	*1–*2	1,401	3,694	(2,293)
Lease M & J restating – Income	*1	0	(2,043)	2,043
Lease M & J restating –Plant	*1	0	1,661	(1,661)
Affiliated Insurance Restating	*1	155	283	(128)
Purchase gas pro forma		1,348	2,226	(878)
Revenue/ Purchase gas restating		297	1,441	(1,144)
Revenues Restated		0	925	(925)
Special incentive plans		0	1,096	(1,096)
Pension		0	167	(167)
AGA dues		0	179	(179)
Pro forma debt		(1,547)	(1,905)	358
Weatherization program		(40)	0	(40)
Total Contested Adjustments		$4,743	$15,815	($11,072)
Uncontested Adjustments				
Payroll pro forma		($1,113)	($1,112)	($1)
Jackson Praire		19	19	0
FIT		115	115	0
Payroll restate		151	151	0
Miscellaneous revenue		42	42	0
Least cost planning		(124)	(124)	0
WUTC regulatory fee adjustment		(157)	(157)	0
Bad Debts		(42)	(42)	0
Showerhead program		(17)	(17)	0
Insurance		295	295	0
Workers Compensation		110	110	0
General Taxes		(774)	(774)	0
FIT as Filed Restating		5	5	0
Purchase Gas Adjustment Restating		(123)	(124)	1
Total Uncontested Adjustments		($1,613)	($1,613)	$0
Results		$44,464	$55,536	($11,072)

*1–Public counsel presented an independent position on this issue.

*2–Company's position on these adjustments is based on an allocation of its M & J adjustment as depicted in Exhibit 328, page 2.