Docket No. UG-95____
Exhibit ____ (JEH-Testimony)
Witness: James E. Haug

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

GENERAL RATE APPLICATION
OF
CASCADE NATURAL GAS CORPORATION

DECEMBER 11, 1995

Prepared Direct Testimony of

James E. Haug

Restatement of Wages and Related Costs
Restatement of Postretirement Benefits other than Pension
Proforma Restatement of Wages and Related Costs
Quincy WA. System Refurbishment
Proforma Income Tax Adjustment on Proforma Capitalization
Restatement of Membership Dues Expense

WUTC UG-950326,
DOCKET NO. -951415
EXHIBIT # T-46
ADMIT W/D REJECT

PREPARED TESTIMONY OF JAMES E. HAUG

Q. Please state your name and address for the record.

A. My name is James E. Haug. My business address is 222 Fairview Avenue North, Seattle, WA 98109.

Q. By whom are you employed and in what capacity?

A. I am employed by Cascade Natural Gas Corporation as its Treasurer and Chief Accounting Officer.

Q. Please describe your education and employment background.

A. I graduated from the University of Washington in 1972 with a Bachelor of Arts degree in Business Administration, with emphasis in accounting. From 1972 to 1977, I was employed in various accounting capacities by Wright Investments, Inc., First Healthcare Corporation, and Evans Engine and Equipment Co. In 1977, I was hired by Cascade Natural Gas Corporation as an accountant. I subsequently held the positions of Supervisor of General Accounting, Manager of General Accounting, and Controller. In 1981, I was named Treasurer. In 1988 I became Treasurer and Chief Accounting Officer.

Q. What are your primary responsibilities as Treasurer and Chief Accounting Officer?

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A. I am responsible for the general supervision of all accounting functions for the Company. This includes both internal and external financial reporting, compliance with all applicable accounting standards, taxation, billing, and collections.

Q. Have you previously testified or sponsored testimony before utility commissions?

A. Yes. I have testified before the Washington Utilities and Transportation Commission in Cause Nos. U-80-101, U-81-64, U-82-20, U-82-55, and U-86-100. In addition I have sponsored testimony before the Oregon Public Utility Commission in several rate case filings.

Q. Do you sponsor exhibits in this filing?

A. Yes, I sponsor six exhibits, each of which adjusts test year expenses or rate base. They are Exhibit _____(JEH-1), the restatement of wages and related costs for the general wage increase effective April 1, 1994; Exhibit _____(JEH-2), the pro forma adjustment for the implementation of SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions"; Exhibit _____(JEH-3), the pro forma adjustment for the general wage increase effective April 1, 1995; Exhibit _____(JEH-4), the pro forma

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adjustment of rate base and depreciation expense for the cost of the Quincy distribution refurbishments; Exhibit _____(JEH-5), the adjustment of income tax expense to reflect pro forma capitalization; and Exhibit _____(JEH-6), the restatement of membership dues expenses.

Q. Were all of these exhibits prepared by you or under your supervision?

A. Yes they were.

EXHIBIT _____(JEH-1) - RESTATEMENT OF WAGES AND RELATED COSTS

Q. Please explain Exhibit _____(JEH-1).

A. This exhibit shows the amount necessary to restate test year operating and maintenance expenses and payroll taxes for the annualizing effect of changes in wages and salary levels during the year. The Company's contract with its union employees calls for annual wage increases each April 1. The Company's practice is to also adjust the salaries of its non-union employees each year to coincide with the union wage increase.

This adjustment restates test year expenses to the

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level which would have been incurred had the April 1, 1994 salary levels been in effect as of the beginning of the year.

Q. How did you calculate the amount of the adjustment?

A. I first determined the total amount of salaries and wages paid to each of the following seven categories of employees for the period January through March 1994. This was the portion of the test year prior to the effective date of the April 1 increases. The employee categories are: General Office Non-Exempt; General Office Exempt; Officers; District Managers and Superintendents; Consumer Representatives and Local Managers; Customer Account Service Representatives and Office Managers; and Union Employees. The first three categories listed are General Office employees and the salary amounts are subject to the 1994 Washington allocation factor of 78.90%. The remaining four categories are dedicated totally to Washington operations. To these totals by employee category, I applied the average rate of wage or salary increase granted to employees in each group. The resulting amounts are the increased salary and wage levels which

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would have applied to the first quarter of the test year had the increases granted April 1 been in effect for the entire test year.

I then analyzed the labor distribution of the wage and salary amounts paid to each of these categories of employees during the first quarter to determine the percent of the total charged to operating and maintenance expense as opposed to capitalized.

Next I multiplied the total amount of wage or salary increase for each category by the respective percentages applicable to Washington and by the percentages assigned to operating and maintenance expenses. The sum of the resulting amounts for each category is $115,575. These wage and salary increases also subject the Company to an obligation for additional Social Security and Medicare taxes. The estimated amount of this tax increase is $8,144. The sum of these amounts is $123,719, which is the amount necessary to adjust test year expenses to reflect the effect of these wage and salary increases. This amount is carried forward to Exhibit ____ (JTS-1), page 2, column (e), line 12.

EXHIBIT _____(JEH-2) - POSTRETIREMENT BENEFITS OTHER THAN

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PENSIONS

Q. Please explain Exhibit _____(JEH-2).

A. This exhibit shows the amount necessary to adjust test year operating expenses for the effect of implementing Statement of Financial Accounting Standards (SFAS) No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions" (PBOP).

Q. Please briefly describe the requirements of SFAS No. 106.

A. SFAS No. 106 is an accounting standard issued by the Financial Accounting Standards Board (FASB) in December 1990, and effective for fiscal years beginning after December 15, 1992. It required a change in accounting by employers who provide PBOP. Previously, employers accounted for the costs of these benefits on a pay as you go, or cash basis. This new standard now requires employers to record these expenses on an accrual basis. Employers are also required to recognize the liability for the transition obligation, or the measured liability for the previously unrecorded accruals as of the date of adopting the Standard. Upon implementation, employers had the option of immediately recognizing this liability, and recording the expense,

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or spreading the recognition of this obligation over twenty years. The latter option provided employers the opportunity to mitigate the immediate financial impact of adopting this new Standard.

Q. What PBOP are provided by the Company?

A. The Company provides medical and prescription drug benefits to its eligible retirees. A summary description of the plan is included in the 1994 actuarial report on financial statement disclosures, which I have included as part of my exhibit.

Q. What was the immediate impact on the Company of adopting SFAS No. 106?

A. As of January 1, 1993, the Company's transition obligation was measured at $13,140,000. The Company elected to spread the recognition of this obligation over a twenty year period at $657,000 per year. The Company's full accrual for 1993, as required under the provisions of SFAS No. 106, was $2,272,000, including the aforementioned $657,000 amortization of the transition obligation.

Q. How does this amount of $2,272,000 compare to the expense the Company would have recognized under the previous accounting method, had SFAS No. 106 not been

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required?

A. The Company paid cash benefits to retirees in 1993 of $333,604. The incremental accrual in the first year of implementation of SFAS No. 106 was then an additional $1,938,396. I will discuss accrual amounts for 1994 and subsequent years later in my testimony.

Q. Is recognition of PBOP expense, at the levels determined under SFAS No. 106, appropriate for ratemaking purposes?

A. Yes. In Docket No. A-921197, the WUTC issued a policy statement on October 23, 1992, regarding the accounting treatment of PBOP by regulated utility companies. In this policy statement, the WUTC embraced the concept that ratemaking recognition of PBOP, as measured by SFAS No. 106, is appropriate, providing the utility company can demonstrate that it has met certain conditions. First of all, the company must demonstrate in a general rate case that the higher level of PBOP, measured under SFAS No. 106, is reasonable, prudently incurred, and determined under conservative assumptions. The company must further demonstrate that the level of PBOP expense requested reflects prudent and safe funding of the PBOP obligation. The company

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will have to demonstrate that there is a benefit to ratepayers from reflecting the higher SFAS No. 106 level of expense in rates.

Q. Are these expenses reasonable and prudently incurred?

A. Yes. These benefits represent essentially the same level of benefits as have been provided to retirees for many years. In prior rate cases, the costs associated with these benefits have been allowed for ratemaking purposes. Thus they have been considered to be reasonable and prudent. SFAS No. 106 merely provides a new mandatory method of measuring these benefits for financial reporting purposes.

Q. What steps has the Company taken to mitigate the effects of SFAS No. 106?

A. The Company has curtailed its retiree medical plan with respect to retirees who were hired by the Company after May 31, 1992. As it stands now, any employee hired after that date will not be eligible for postretirement medical benefits when he or she retires. The Company is contemplating alternative plans to provide benefits to those employees no longer eligible for retiree medical benefits, but currently no such plan is in place.

To mitigate expense accruals for the more

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immediate time frame, the Company has adopted a policy of generally funding the plan, on a tax preferred basis, to the extent allowable under the Internal Revenue Code. This funding provides plan assets which are invested in corporate securities. The earnings on these assets directly reduce the amount of accruals required under SFAS No. 106. The 1995 accrual includes a component for expected return on plan assets of $245,692. The comparable amount in the projected accrual for 1996 is $345,000. In subsequent years, this amount is expected to increase each year, as a result of growth in plan assets.

Q. Are the Company's accruals of PBOP determined under conservative assumptions?

A. Yes. In the WUTC's policy statement, the term "conservative" is qualified as to the Commission's intent of its meaning. The policy statement says ". . . *the Commission intends that it be understood that the lowest reasonable assumptions be used for inflation related matters and the lowest reasonable costs be used. To the extent that this definition of conservative differs from that which is meant for financial reporting purposes, the Commission will* *accept its own definition for ratemaking purposes in preference to that of the accounting community."*

Compliance with this definition is identified as an objective in our discussions with the Company's actuaries, who prepare our SFAS No. 106 analyses and accrual amounts. In other words, the intent is to develop a PBOP analysis which produces the lowest level of SFAS No. 106 accrual which still meets the criteria established by the FASB in SFAS No. 106. The assumptions which were used are included in the actuarial reports which I have included with my exhibit.

Q. To the extent that the Company is funding its PBOP obligation, does the SFAS No. 106 accrual recorded by the Company reflect prudent and safe funding of the PBOP obligation?

A. Yes. The plan assets are invested in high quality common stocks and corporate bonds which are expected to produce reasonable returns over time.

Q. Is there a benefit to ratepayers from reflecting the higher SFAS No. 106 level of PBOP expense in rates?

A. Yes. I believe that sound ratemaking policies, involving cost based rates, require that ratepayers

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pay, on a current basis, the current cost of providing service. SFAS No. 106 provides a reasonable measure of the amount of such benefits attributable to the working years of employees. The working years of employees are when employees provide service to ratepayers. The benefits being earned by these employees during their working years are the amounts which should be included in rates during those same years. This is basically the same principle as including in rates the amount of pension accruals calculated under SFAS No. 87.

Another benefit to ratepayers of including SFAS No. 106 expenses in rates is the avoidance of the consequences of excluding these expenses. The Company is required to recognize expenses calculated under SFAS No. 106 regardless of whether it is allowed to include these expenses in rates. But if such rate recognition is denied, the Company will suffer severe financial harm. It would be denied the opportunity to achieve a reasonable level of earnings. As a result, the Company's credit rating would likely suffer, thus hindering its ability to raise capital at reasonable cost. The higher capital costs would ultimately be

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borne by ratepayers.

Q. How has the Company accounted for the Washington allocated portion of SFAS No. 106 accruals from implementation in 1993 through the current period?

A. The incremental amount of these costs have been deferred, as permitted by the WUTC's policy statement. The incremental amount is the difference between PBOP measured under SFAS No. 106 and the amount of expense measured under the pay as you go method, or the amount of actual cash benefits paid to retirees.

Q. Were there conditions imposed by the WUTC as to the Company's permission to defer these costs?

A. Yes. The policy statement specifically states that in order to be allowed to defer these costs for future rate recovery:

(a) the company must be before the Commission in a general rate case, for which the effective date of rates under the statutory suspension rules, if applicable, will occur within five years from the effective date of SFAS 106;

(b) the general rate case must include a proposal for recovery of the prior accrued but unrecovered amount of the deferral; and,

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(c) the company may not defer the increment in costs for future recovery, if it experienced excessive returns during the interim period sufficient to exceed the amount of the annual accrual.

Q. Has the Company met each of these conditions?

A. Yes. Condition (a) effectively states that the Company must file a general rate case for which rates will be effective no later than January 1, 1998, which is five years from January 1, 1993, the effective date of SFAS No. 106. Under the applicable statutory suspension rules, rates granted in this case will be effective in 1996.

Condition (b) is met by the inclusion of this testimony and the accompanying exhibit.

Condition (c) is met because in neither of the two full years during which the Company has deferred these costs, has it experienced excessive returns. The policy statement specifies that compliance with this condition is measured by comparing the last allowed rate of return authorized by the Commission with the reported rate of return in the Company's semi-annual Commission basis report of earned rate of return. The Company's

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report for 1993 showed an adjusted, Commission basis rate of return of 8.02%. The comparable report for 1994 showed a return of 8.65%. Both of these are below the rate of 11.95%, upon which rates were established in the Company's last general rate case.

Q. Are there other requirements of a company electing to defer PBOP accrual amounts prior to inclusion of these costs in rates?

A. Yes. Appendix A of the policy statement establishes certain reporting requirements. Companies electing to record such deferrals are required to report annually to the WUTC detailed information on accruals under SFAS No. 106.

Q. Has the Company complied with these reporting requirements?

A. Yes.

Q. How did you calculate the adjustment amount of $1,413,128 as shown in your exhibit?

A. The calculation was done in several steps. The first was to determine an annual level of amortization of deferred PBOP expenses. The second was to determine the amount to include for the ongoing SFAS No. 106 accruals. The third was to compare the sum of these two

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amounts to the amount of cash benefits paid to retirees and charged to Washington operating expense during the test year. The resulting difference is the adjustment amount of $1,413,128.

Q. Please describe each of these steps in detail.

A. The amortization amount is developed in Schedule 3. To determine the amortization amount, I first had to determine the total amount to be deferred and subject to amortization. The amounts deferred for 1993 and 1994 are as recorded on the Company's books. They were determined by subtracting the Company's total cash payments of PBOP in each of those years from the SFAS No. 106 PBOP accrual amount. This result was then multiplied by the Washington allocation factor to determine the Washington amount of incremental PBOP expense, all of which was deferred. The estimated amount of 1995 deferrals is calculated in much the same way. Our actuaries have provided the SFAS No. 106 accrual amount for 1995. They have provided an estimate of 1995 net benefit payments to retirees. For 1996, the actuaries have provided estimates of both SFAS No. 106 accruals and cash benefit payments. Based upon a revised SFAS No. 106 accrual expense received from the

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actuaries, I have judgmentally reduced the 1996 estimates previously provided by them.

For purposes of this calculation, I have assumed that rates established in this case will be effective April 1, 1996. Therefore, one-fourth of the estimated 1996 SFAS No. 106 PBOP increment would be subject to deferral. The resulting total deferral amount, subject to amortization is estimated at $4,410,125. This amount is shown in column (f), on line 5.

The WUTC's policy statement specifies that *"the balance of the deferred SFAS 106 incremental expense to be amortized and recovered through rates over a period not to exceed ten years from the effective date of SFAS 106"*. This means that amortization must be completed by December 31, 2002. Consistent with the assumed effective date of rates granted in this case, this establishes an amortization period of six years and nine months. Line 9 shows the resulting annual amortization to be $509,876. This amount is brought forward to Schedule 1.

As this rate case progresses, it is expected that the estimates used herein for 1995 and 1996 amounts, as well as the estimate of the effective date, will be

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refined. At that time, the estimated amounts can be revised accordingly. Further, the Company would not object to an amortization period extending beyond the year 2002, as such an extension would mitigate the rate impact without harming the Company's earnings.

The ongoing level of expense is developed on Schedule 2. For this calculation, the 1996 estimate of the SFAS No. 106 accrual is $1,811,000. This is multiplied by the Washington allocation factor of 78.93% to produce a Washington amount of $1,429,422. Once SFAS No. 106 expenses are included in rates, then a portion of the accruals will be capitalized, in a similar manner to other benefit costs. An appropriate method to capitalize benefits is to apply the ratio of capitalized payroll to total payroll. This percentage is 21.96% for the test year. Reducing the above-mentioned $1,429,422 by 21.96% leaves $1,115,521 chargeable to Washington operating expense, as shown on line 5. This amount is brought forward to Schedule 1.

Schedule 1 summarizes the pro forma level of PBOP expense and the resulting adjustment. The sum of the amortization amount and the ongoing expense amount, to be charged to Washington operating expense is

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$1,625,397. The recorded amount of cash expense for PBOP in the test year was $344,609. The Washington allocated amount is $272,000. Reducing this by the 21.96% capitalization ratio leaves $212,269 charged to Washington operating expense. The difference between $1,625,397 and $212,269 is $1,413,128, which represents the amount by which test year expense should be adjusted to reflect PBOP expense measured under SFAS No. 106. This amount is carried forward to Exhibit ___ (JTS-1), page 2, column (f), line 11.

EXHIBIT _____(JEH-3) - PRO FORMA ADJUSTMENT OF WAGES AND RELATED COSTS

Q. Please describe Exhibit _____(JEH-3).

A. As I explained earlier in my testimony, the Company generally grants wage and salary increases to its employees on April 1 each year. This adjustment of $423,649 is necessary to adjust test year expense to reflect the effect of the increases granted on April 1, 1995.

Q. How did you develop this amount?

A. I analyzed the payroll records to determine the total amount of wages and salaries paid during the test year

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to each of the seven employee categories described earlier in my testimony on Exhibit _____(JEH-1). To these amounts, I added the amounts previously calculated for the effect of the April 1, 1994 increases in wages and salaries. The result is the amount of restated wages and salaries for the test year.

For the General Office Exempt and Officer categories, additional adjustments were made to the restated test year wage and salary amounts. Subsequent to the end of the test year, two officers have retired, before the effective date of rates to be granted in this rate case. To fill the vacancies created by these retirements, two employees have been promoted from the General Office Exempt category. Additionally, one officer position has been eliminated.

After adjusting for the result of these classification changes, the resulting restated test year amounts, for all categories except officers, were multiplied by 4%, the average wage and salary increase for all employees. The result is the annual total wage and salary increase for each category of employee.

I used a different methodology to develop the

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corresponding amount for the Officer category. The aggregate amount of officer salaries at the April 1, 1995 rates, excluding the salary of the officers, is less than the restated test year officer salaries. This results in a negative pro forma adjustment in salary expense with respect to the officer category.

For each of the pro forma changes, by category, I performed the same calculations described in my testimony on Exhibit _____(JEH-1) to determine the amounts of these adjustments appropriately charged to Washington operating expense. The resulting adjustment of salaries and wages charged to Washington operating expenses is $391,091. The resulting adjustment of Social Security and Medicare payroll taxes is $32,558 for a total adjustment of $423,649. This amount is carried forward to Exhibit ___(JTS-1), page 3, column (c), line 12.

EXHIBIT _____(JEH-4) - QUINCY SYSTEM REFURBISHMENTS

Q. Please describe Exhibit _____(JEH-4).

A. This exhibit shows the pro forma adjustments to rate base, depreciation expense, and property tax expense to reflect the cost of the refurbishments of the main line serving the Company's distribution system in Quincy.

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Q. Please explain how you developed the adjustment amounts.

The total recorded construction cost, including overhead, for this project is $1,011,453. To this amount I applied the Company's annual depreciation rate for mains of 2.67%. The resulting amount is a pro forma adjustment of depreciation expense in the amount of $27,006. This amount is shown on line 6 of my exhibit, and is carried forward to Exhibit ___ (JTS-1), page 3, column (i), line 13.

The property tax adjustment of $12,071 is calculated by multiplying the construction cost by 1.22%, which is the average property tax rate experienced by the Company in 1994.

For the rate base adjustment, I include three components of rate base: utility plant, accumulated depreciation, and accumulated deferred income taxes. The utility plant component is merely the recorded construction cost. For accumulated depreciation and accumulated deferred income taxes, I assumed a half-year depreciation for the first year for both book and tax depreciation. The accumulated depreciation component is then one half of $27,006, or $13,503.

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First year tax depreciation is calculated by using the 150% declining balance method and a tax life of 20 years. This produces accumulated tax depreciation of $37,929. The difference between accumulated book depreciation and accumulated tax depreciation is $24,426. Multiplying this difference by the 35% tax rate produces a deferred tax amount of $8,549. The sum of these rate base components is $989,401, which is shown on line 10. This amount is carried forward to Exhibit ___(JTS-1), page 3, column (i), line 21.

Q. Why is a pro forma rate base adjustment appropriate?

A. Typically in a rate case, rates are established by use of test year average recorded account balances for rate base components. This is generally appropriate because increases in rate base are generally associated with concurrent growth in customer base. In other words, when money is spent to build additions to the Company's distribution system, there are new customers which connect to these new lines. In such situations, the Company has an opportunity to earn a return on its investment in new facilities.

However, the Quincy project is different from the above described "typical" rate base additions. This

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project represents a major expenditure which is required in order to be able to continue to serve existing customers.

In order to acquire these customers, the Company has already made the typical expenditures in main extensions, service lines, meters, and regulators. Revenues derived from these customers are currently providing a return on these investments.

But this new project will not be accompanied by the corresponding near-term increase in sales to incremental customers that typically occurs with investment in new main extensions. This amount must be included in rate base in order for the Company to have an opportunity to earn a return on its investment prior to its next general rate case. Otherwise, the resulting earnings deficiency will harm the Company's ability to raise capital at reasonable cost. The resulting higher capital costs would ultimately be borne by ratepayers. This issue is discussed at length by Mr. Wessling in his testimony.

EXHIBIT _____(JEH-5) INCOME TAX ADJUSTMENT FOR PRO FORMA CAPITAL STRUCTURE

Q. Please explain Exhibit _____(JEH-5).

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A. This exhibit develops the amount by which federal income tax expense must be adjusted to reflect the pro forma capital structure being proposed in this case. In Mr. Wessling's exhibit, he proposes a pro forma capital structure. In this pro forma capital structure, the debt ratio and cost rates are different from those experienced in the test year. In addition, this rate application includes pro forma adjustments to rate base. I used these pro forma amounts of rate base, debt ratio and cost rate for long-term debt, and debt ratio and cost rate for short-term debt to develop an amount of pro forma interest expense. These calculations are shown in detail in my exhibit.

The resulting pro forma interest expense is $6,710,067, as shown on line 9. For the test year, an interest deduction of $6,411,688 was used to develop the amount of federal income tax expense charged to utility operations. The difference between these two amounts represents a pro forma increase in interest expense of $298,379, as shown on line 11. Multiplying this increased interest expense by the federal income tax rate of 35% produces the resulting decrease in federal income tax of $104,433 shown on line 13. This

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amount is carried forward to Exhibit ___(JTS-1), page 3, column (g), line 17.

EXHIBIT _____(JEH-6) ADJUSTMENT OF MEMBERSHIP DUES EXPENSE

Q. Please explain Exhibit _____(JEH-6).

A. Test year operating expenses include the cost of dues payments by the Company for memberships in certain organizations. During discussions between Company management and WUTC Staff members, it was agreed that $100,000 would be an appropriate reduction of operating expenses. This amount represents an estimate of the portion of dues paid by the Company used by the organizations to fund lobbying activities.

Q. Does this conclude your prepared testimony?

A. Yes.

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