Date Received: 8-10-93

Docket No.: UG-920840

Company: Washington Natural Gas

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Re: WUTC v. Washington Natural Gas Co.
Docket No. UG-920840

Dear Mr. Curl:

Enclosed please find an orignial and 19 copies of the Brief of Public Counsel in the above case.

Sincerely,

CHARLES F. ADAMS
Assistant Attorney General
Public Counsel Section

CFA/ljb
Enclosure
cc: Parties

CERTIFICATE OF SERVICE

I hereby certify that I have this day served one copy of the foregoing document upon all parties of record in this proceeding, as shown on the attached service list, by hand delivery, by electronic telephone transmission, by inter-office mail or by mail properly addressed and prepaid.

Dated this 10th day of August, 1993.

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BEFORE THE

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Cause No. UG-920840

WASHINGTON NATURAL GAS COMPANY

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Brief of Public Counsel
Office of the Attorney General
August, 1993

Brief of Public Counsel
Docket No. UG-920840

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I. PROCEDURAL HISTORY AND OVERVIEW

A. Procedural History

On July 27, 1992, Washington Natural Gas Company (hereinafter "WNG" or "Company") filed for a general rate increase totaling $28.4 million and for an additional increase of $13 million related to environmental cleanup costs, natural gas refueling stations (CNG), and safety improvements. The Commission suspended these tariff filings on August 19, 1992 and subsequently instituted an investigation of the Company's rates and practices.

Hearings were held to receive and cross-examine WNG's case in January and February, 1993. During this phase of the case, the company agreed by stipulation to withdraw its request for an environmental tracker pending the outcome of insurance litigation and to only seek recovery of its carrying costs of these expenditures through a working capital allowance. In addition, at the conclusion of these hearings the Commission granted the motion of the non-WNG parties to dismiss its Schedule 117 CNG tracker (Third Supplemental Order dated March 12, 1993).

Hearings were held in May, 1993 in which the evidence of Staff, Public Counsel and intervenors was presented and cross-examined. In addition, hearings were held on May 24 and 26, 1993 for the public in Tacoma, Seattle and Olympia.

Finally, hearings were held in June to receive and cross-examine the rebuttal testimony of the company. In its rebuttal case, WNG reduced its requested general rate increase to $ 14.8 million, including its tracker.

This brief is filed at the conclusion of the case and presents the views of Public Counsel on the requested increases.

B. Overview

As the Commission is aware, WNG's rate filing has resulted in a particularly complex proceeding. A major cause of this complexity is the long lapse of time since WNG's last rate case. In fact, WNG's last general rate case was concluded by stipulation in 1984 (Cause No. U-84-60). The last fully contested rate case was concluded in 1982 (Cause No. U-82-22/37). Thus WNG has evaded the scrutiny that comes with a general rate case for a long time.

Because of the complexity of this case, Public Counsel will briefly summarize its views of some of the major policy issues presented in this case at the outset. The details of these issues will be discussed at greater length in following portions of this brief.

1. Cost of Capital. WNG's currently authorized 16.25% return on equity is a relic of the highly inflationary early 1980s when it was authorized. Of course, WNG is not supporting that level in this case, but its request for a 13% ROE in its direct case and a 12./25% ROE in its rebuttal case is also hardly reflective of today's ROE requirements. It does not take a rocket scientist nor an economist - and certainly not a Wall Street analyst - to observe that interest rates and equity returns have dropped dramatically in recent years. Public Counsel witness Hill's Exhibit 299, Schedule 1 shows this dramatic drop graphically, (Attachment B to this Brief) but all of us have observed this phenomena first hand in terms of the interest that we can get on our savings accounts or CDs.

Utilities, which uniformly claim regulatory lag during inflationary periods, try to avoid rate cases in order to enjoy "reverse" regulatory lag when inflation and interest rates decline. Thus WNG has not filed a general rate case since 1984, and its current authorized rates are still based upon a 16.25% ROE, a 12.88% overall rate of return and an attrition allowance - all vestiges of the high interest and inflation environment of 10 years ago. Although WNG is not currently earning at this level, its current market to book ration of about 1.5 times clearly demonstrates that its current projected earnings substantially exceed the earnings necessary for investors to earn the required return on their invested capital (book value). WNG's stock price in many ways is similar to a bond, in that the stock rises as interest rates decline, assuming a constant payout. Unlike the bond market, utility regulators owe a responsibility to ratepayers to insure that they only pay prospectively a reasonable return on the capital invested in the company, not the inflated returns and windfalls that have come with declining interest rates.

Now that WNG has filed tariffs seeking to increase rates to customers, it is time to end this reverse regulatory lag. The recommendations of Public Counsel witness Hill and Staff witness Lurito of 10.5% are reasonable estimates of investors' current ROE requirements. In fact, interest rates - and investor required returns - have continued to fall since their testimony was presented. Thus their recommendation probably overstate the current required returns somewhat. In addition, both witnesses recommend capital structures with equity ratios of 41 - 42%, which are considerably above the 36% average ratio the company has actually experienced over the last 5 years and the 34.2% equity ratio it actually had in 1992. They also provide far better coverages then what WNG actually experienced. In spite of the fact that the individual year and five year averages of the capital structure ratios and coverage ratios were considerably below the rating agency "guidelines" for an A rating, WNG was not down - rated. It was actually uprated by one agency during the five year period. It is obvious that those "guidelines" are only that - guidelines -, and that the rating agencies look at many other factors in making their evaluations. The recommendations of Public Counsel will allow WNG to attract capital on reasonable terms while not unnecessarily penalizing ratepayers with excessive

capital costs. WNG's recommendations would penalize ratepayers with both an excessively costly ROE and capital structure.

Finally, it is important to note that the determination of a reasonable cost of capital for WNG, while at times appearing to be an arcane and academic jousting match of the hired experts, has other important ramifications beyond the obviously important immediate rate year revenue requirement. The authorized rate of return also becomes embodied in the various capitalization rates used by the company for AFUDC and AFUCE, as well as the discount rates applied for weatherization programs, line extension determinations and similar uses. Thus excessive rates of return can penalize ratepayers well into the future.

2. Merchandising/Jobbing and Homeguard: A considerable portion of the record of this proceeding has dealt with issues relating to the unregulated activities of WNG and of its affiliated companies in the areas of merchandising and jobbing, as well as its related advertising costs. The majority of members of the public who presented testimony represented business and addressed these issues, complaining of WNG's unfair competition and self dealing. Although it is not within the Commission's authority to regulate the competitive marketplace, this testimony dramatically supplemented and reinforced the expert testimony of Public Counsel and Staff that the costs of these unregulated activities were being shifted to captive regulated customers, but not the profits. What the competitor saw as unfair competition was reflected on the flip side or regulated side as unreasonable costs and excessive rates.

WNG has been aware of the Commission's and the public's concerns over its affiliate and unregulated activities for a long period of time, but has continued to abuse these relationships. As early as 1981, the Commission strongly chastised WNG for impropriety in the handling of inter-affiliate transactions. Again in 1982, the Commission threatened disallowance of advertising expenses because of the lack of an allocation of advertising costs to unregulated merchandising.

This proceeding is the first fully contested proceeding since 1982, and WNG has expanded its M & J related activities considerably since that time. However, even in the

lapse between rate cases, these issues continued to percolate. In 1987, the House Energy and Utilities Committee raised concerns about the improper subsidization of its merchandising operations with utility revenues. This legislative inquiry resulted in a Staff investigation and a Commission report to the Legislature with findings that WNG was improperly accounting for merchandising costs. Subsequently, even the company's "independent" accounting firm, Arthur Anderson, made recommendations on how to account for and allocate these costs. WNG for the most part ignored these various recommendations, as well as the requirements of RCW 80.04.270, and proceeded with business as usual.

In light of WNG's continuing and flagrant abuse in its accounting for these affiliate and unregulated costs, and because of the complexity of making appropriate allocations for these interrelated activities, Public Counsel believes that the best approach for this case for dealing with these problems is to bring the M & J and Homeguard net operating income before income taxes above-the-line. This would have the effect of reducing WNG's originally proposed revenue request by approximately $8.8 million.

Public Counsel, however, does not recommend this approach on a going-forward basis. Under ideal circumstances with a cooperative utility, Public Counsel would recommend joint operations with a proper cost allocations, which would allow appropriate and reasonable joint economies for both regulated and unregulated activities. However experience indicates that such an approach with WNG would only endlessly continue the battle over appropriate cost allocations. In addition, WNG has in its rebuttal case apparently now made the decision to proceed with separate subsidiaries. While we strongly disagree with WNG's attempt to use the hastily prepared and unimplemented Arthur Anderson separate subsidiary cost allocation study for purposes of this case, it may be the most practical way to proceed in the future. However, it is important to realize that the creation of separate subsidiaries alone will not necessarily resolve the cost allocation/cross-subsidization issues. Homeguard is a separate affiliate, but that hasn't stopped WNG from improperly allocating many of its costs to gas ratepayers. Likewise, experience with separate affiliates and subsidiaries in the telephone industry suggests close scrutiny will continue to be necessary.

3. Cost of Service/Rate Design: The Company proposed allocating about 90% of its proposed rate increase to the residential class, and actually reducing rates for interruptible and transportation customers in the context of a proposed major rate increase.

During the pendency of this case, the Company has already received a major tracker increase of about 10%. Combined with the tracker, the Company proposal would increase residential rates by about 18% over those in effect last winter. This may be a bitter way for consumers to learn whether the Company's "Gas Costs Less" slogan really applies to them.

Upon review by the Staff and Public Counsel witnesses, numerous errors in the Company's cost study came to light. Some of these errors the Company's witness, Mr. Johnson, admitted to, such as failing to charge interruptible customers for costs of gas storage facilities. Others were issues of differences in approach from those adopted in the past by the Commission; generally these differences relate to whether the costs of the gas transmission and distribution system should be allocated based on usage throughout the year, or only on the peak day of the year. The Commission has consistently ruled in the past that the gas facilities are used throughout the year and should be apportioned accordingly.

When the Company's errors were corrected in the cost of service study presented by Staff witness Buckley (and even in the alternative study presented by the Company), it is evident that residential customers are fully paying their share of costs and should receive only a proportionate increase or decrease in rates.

The Company did make one progressive rate design proposal, which was to eliminate its declining block residential rate design. This should be approved, but it should not, contrary to the Company request, be linked to its confusing and unpredictable "weather adjustment" mechanism. This would cause rates to be lower in colder months and higher in warmer months, but customers would not know in advance what their rates would be.

Finally, the Company proposed rate reductions for its transportation and interruptible customers. These customers are already paying much less than other classes, and far less than a fair portion of the Company's total revenue requirement. These reductions should not be approved.

4. Other Issues: Numerous other issues came up during this proceeding, in part because it has been nearly a decade since the Commission has reviewed WNG's rates and revenues. It came to light that the Company has been offering an untariffed propane service to a small number of customers, at a considerable economic loss, and charging the costs to its gas expense accounts. It also is offering rental appliances at far less than cost. It even proposed an attrition adjustment to account for supposed inflation, even though its incremental cost of capital is much lower than the average cost of funds. All of these issues need to be resolved in this filing.

II. UNCONTESTED ISSUES RAISED BY PUBLIC COUNSEL

Public Counsel raised a number of revenue requirement and other policy issues relating to cost of capital, merchandising and jobbing, meter reading and billing expense, and an adjustment related to the Company's policy of leasing uneconomic water heaters. The Company contested some of these issues, but others were not rebutted and should be considered uncontested. The uncontested issues raised by Public Counsel are:

> **A. Meter reading and billing expense:** Mr. Lazar proposed an adjustment related to meter reading and billing expense. The adjustment reflects three factors which cause WNG's meter reading and billing expense to be unnecessarily high. First, WNG reads meters and renders bills every month, when Commission rules only require bimonthly meter reading and billing. Second, WNG reads all of its meters independently, rather than jointly with electric and water utilities serving the same customers. Finally, the Company uses the billing envelope for non-utility purposes, such as charitable solicitations, and a portion of the cost should therefore be treated as a charitable contribution. The Company did not rebut any of these issues. **This adjustment increases net operating income by $1,939,393.** [Ex. T-279, P. 9]

> **B. Water heater leasing:** Mr. Lazar testified that the Company has leased some 31,000 relatively inefficient water heaters since 1990, when he himself gave the Company written notice that the units were less than economically optimal.

WNG offered units of different efficiency in different parts of its service territory. In order to secure cooperation from Snohomish PUD, WNG offered units with Energy Factors of .58 to .60 in Snohomish County, but only leased units with Energy Factors of .53 to .55 to the vast majority of customers. WNG not only did not rebut this issue, but in fact it confirmed that "efficient" water heaters were not being leased to most customers. Mr. Gessel testified on rebuttal that WNG wanted to retain its water heater rental program "...because it will encourage ratepayers to install an efficient .6 heat factor unit rather than purchase a less efficient model. [T-337, P. 18] [clarified as Energy Factor at Tr. 3240]

Mr. Lazar computed the economic loss to consumers, taking into account the lower first cost, but higher operating cost, of the less efficient water heaters. He determined that each such water heater cost the consumer an extra $9 per year. [T-279, P. 6; Ex. 281 P. 2]. The annualized adjustment at the revenue level is $280,908. Mr. Lazar proposed that this amount be treated as imputed revenues associated with the water heater leasing program.

As the staff testimony details, the leasing program is not covering costs. The monthly gas bills of consumers who lease these particular inefficient water heaters are higher than they should be, and we think that any adjustment should directly benefit the consumers who are paying these higher bills. Raising their water heater rental rates to fully cover costs would result in rate shock. We propose that offsetting that revenue requirement with the amount of this $9 per year efficiency adjustment coupled with WNG's $0.75 per month rental rate increase, is an appropriate way to balance the Company's failure to provide efficient service with the fact that current equipment lease rates do not fully cover costs. The Commission should also rquire that only .6 heat factor waterheaters can be rented in the future.

C. Bill Format: Mr. Lazar proposed major revisions to the Company's bill format, along the same lines as the bill prepared by Puget Power. [T-279, P. 52, and Ex. 284] The Puget bill provides the rate schedule, the usage for the current month, a 14 month consumption history, current period weather, and comparable weather conditions for the period a year earlier. This information allows consumers to determine if their conservation efforts are paying off, or if some other conditions are causing higher usage. **WNG should be directed to improve its bill format within 120 days of the order in this proceeding.**

III. COST OF CAPITAL

As previously discussed in the overview section, capital costs have fallen dramatically in the last 10 + years, and they have continued falling during the pendency of this proceeding (see Attachment B, Ex. 299; Ex. 350, Sec. 1; Tr. 3298). In fact, capital costs have fallen further since Attachment B was prepared in April, 1993. (Tr.

3459) There is little expectation of substantial changes in interest and inflation rates in the near future. (Ex. T-296, p. 5-10)

WNG's currently authorized return on equity is 16.25% and is a product of the highly inflationary early 1980s. In this case, it has sought a new ROE of 13% in its direct case and then 12-12.25% on rebuttal. These inflated ROE requests, although lower than its outdated currently authorized ROE, are simply renewed attempts to continue the regulatory lag that WNG has enjoyed for many years.

The recommendations of Public Counsel witness Hill and Staff witness Lurito although their analysis differs somewhat, are both quite similar and are reasonably representative of current investor return requirements in today's low interest, low inflation environment. These rates are sufficient to attract capital on reasonable terms and to maintain WNG's stock price above book value. It should be reiterated that this Commission has historically based equity returns upon the invested capital or book value of WNG, not on its current market value of 1.5 x book value or even the .8 x book value which has existed in some previous years.

Before discussing these issues in greater detail, it is helpful to display the recommendations of each witness, since the recommendations are very similar on some cost rates and need not be discussed further:

	Torgerson Direct	Torgerson Rebuttal	Hill	Lurito
Cost Rate:				
Common	13.00	12-12.25	10.25-10.5	10.50
Preferred	8.38	7.66	8.05	7.79
ST Debt	4.38	3.75	4.06	3.75
LT Debt	9.06	8.72	8.91	8.76
Capitalization:				
Common	45.0	45.0	42.14	41.0
Preferred	8.24	7.69	8.18	7.5
ST Debt	2.12	2.78	5.49	6.0
LT Debt	44.64	44.53	44.19	45.5

As can be seen from the table above, the principle differences lie in the common equity cost rate, and the common equity and short term debt capitalization ratios. Mr. Torgerson's recommended cost rates for preferred, short term debt and long term debt were somewhat high in his direct case, but his rebuttal cost rates are reflective of current lower cost rates and are reasonable. Mr. Hill used year-end, 1992 figures which reflect a time frame in between the company's direct and rebuttal cases. We will adopt Mr. Torgerson's cost rates for these capital items, since they are the most current figures. In addition, all of the witnesses preferred and long term debt capitalization ratios are very close. Mr. Hills ratios are reasonable as recommended, but we do not oppose the similar ratios of either of the other witnesses.

Thus we are left in reality with four remaining cost of capital issues: common equity cost rate; common equity capitalization ratio; short term debt capitalization ratios; common equity cost rate effect of weather normalization. Public Counsel submits that Mr. Hill has clearly established that 9.11% is both a sufficient and economic rate of return to be applied in this case. If the company's request for weather normalization is granted, the equity cost rate should be reduced to 10.25% making a 9.01% overall rate of return. These figures are calculated as follows:

Capitalization x cost rate = weighted average

	Capitalization	Cost Rate	Wtd. Cost
Common Equity	42.14	10.5	4.42
Preferred	8.18	7.66	0.63
Short term debt	5.49	3.75	0.21
Long term debt	44.19	8.72	3.85
Overall Return	100.00%		9.11

A. Common Equity Cost Rate

In analyzing and recommending the appropriate return on equity of 10.5% for WNG, Mr. Hill used a variety of methods to arrive at his conclusion, relying primarily on the DCF methodology but cross-checking these results with earnings-price ratio

analysis, market-to-book ratio analysis and the CAP M methodology. These various methods produced a range of results of 10.35%, 10.28%, 10.16% and 8.77% respectively. Mr. Hill then concluded that a 10.5% ROE was reasonable (Ex. T-296).

Although Mr. Torgerson lowered his recommended return on equity in his rebuttal testimony, it still greatly exceeds a reasonable return in today's financial environment. It is interesting to note that Mr. Torgerson's DCF analysis produces only an 11.09% return on equity, before he marks it up for FERC order 636, flotation costs and denial of weatherization (Ex. 346 Sch. 29). That figure consists of a 5.59% dividend yield and a 5.5% growth rate. It is this growth rate that is totally out of line with reasonable expectations. For example, Value Line, which Mr. Torgerson cites regularly , shows a 3.5% historical dividend growth rate for the last 10 years, a 3.0% dividend growth rate in dividends for the past 5 years and estimates only a 3.0% dividend growth rate for the '90 - '92 to '96 - '98 period. (Ex. 294, p.1). A.G. Edwards, in a securities report dated September 2, 1992, estimated dividend growth for WNG at 2.8% annually with a current dividend yield of 6.2%, at that time, for an annual return of 8.8% for Washington Energy (Ex. T-296, p.6). That was before the dividend yield and interest rates fell further.

A more recent example of what investment firms are telling investors is contained in Ex. 348, another A.G. Edwards report dated March 31, 1993. Although selected pages of this report were sponsored by Mr. Torgerson in reference to weather normalization (Ex. 346, Sch. 25), he omitted the pages that gave A.G. Edwards' investor expectation of annual returns. Public Counsel entered these omitted pages as Exhibit 348, and they differ markedly from Mr. Torgerson's recommendation.

> **Declining allowed returns on equity.** Declining interest rates have led to lower returns on equity as allowed by state regulators. In response, many LDCs have begun to slow the rate at which they raise their common dividends. We expect this trend to continue in future years, even under the assumption of stable interest rates. Ex. 348, p.3
>
> Are LDC stocks trading too high relative to book value? In our opinion, the answer is yes.
>
> The higher valuation in recent years is primarily due to lower interest rates, not to improvement in company profitability. In fact, utility profitability has declined over the last 10 years as regulators have

systematically lowered utility allowed returns on equity. Market-to-book values are not a function solely of a company's return on common equity but of a utility's profitability returns relative to that required by investors. Higher price-to-book value ratios reflect the fact that regulators have not reduced utility allowed returns on equity as fast as the required rate of return by investors has fallen. This concept is often referred to as "reverse regulatory lag." Reverse regulatory lag will continue only as long as interest rates continue to fall. Once we reach a period where interest rates stop falling and allowed utility returns catch up to interest rates, we would expect to see market-to-book value ratios begin to fall. Ex. 348, p. 6

Through discussions with companies, we believe that dividend payout is of primary concern to many companies and that dividends are likely to grow at a rate below the rate of normalized earnings over the next five years in order to lower dividend payout. We project median dividend growth of 2.0% annually until dividend payout has been reduced to a level of approximately 75%. On a long-term basis, we expect dividends to grow at a rate of 2.5% annually.

Industry Total Return Projection

Our estimated total return potential for the industry has fallen to 7.8% in response to lower dividend yields. Estimated total return potential for the industry is a function of the median dividend yield and our estimates for dividend growth. As of March 31, the median dividend yield for the industry fell to 5.0% from 5.5%. Our estimates for dividend growth remain unchanged. Accordingly, our estimate for the total return potential for the industry has fallen to 7.8% from 8.0% on December 31, 1992. This return offers only a slight premium to the total return offered by long-term government bonds of 6.9% and is in line with the total return potential for most high-quality corporate utility bond yields. In our opinion, estimated potential gas utility total returns do not adequately compensate investors for the additional risks taken to own equity instead of a fixed-income security. As a result, we continue to be cautious regarding LDC stock investments. Ex. 348, p. 7

Even WNG witness Tulis, the Smith Barney witness who was presented to "defend the interests of the retail and institutional purchasers of the Company's common stock ... "(Ex. T-349, p. 2), confirmed that a 2-3% dividend growth rate was expected by investors. In response to a question from Commissioner Hemstad, he indicated as follows:

Witness: Yes, yes. I would say that the area of 2 to 3 percent a year -- our projections for the overall market in terms of dividend growth over the

next three years is somewhere between 2 and 3 -- something like 2.5 percent a year. [Tr. 3466-67.]

Thus the industry has much lower dividend growth expectations for WNG than does Mr. Torgerson. Application of his current dividend yield of 5.59% in conjunction with industry estimates of dividend growth of 2-3% produce return estimates of 7.59 - 8.59%. These results are even lower than those recommended by witnesses Hill and Lurito.

On rebuttal, Mr. Torgerson for the first time attempted to discredit the DCF methodology which produced the most reasonable results and to put greater emphasis on the CAP M methodology which he used to produce a higher rate of return. It is ironic that he places increased reliance on the methodology which has been severely criticized in recent years, in particular by professors Fauma and French from the University of Chicago (Ex. T-296, p. 37-40). Dr. Lurito concurred in this criticism (Ex. T-285, p. 41-43).

Mr. Hill also used the CAPM methodology as part of his analysis but he used it only as a check in support of his DCF analysis because of the shortcomings of the model described in his testimony. His CAPM analysis produced an equity return of 8.77% for the gas distributor sample group, which Mr. Hill felt somewhat understated the low current equity capital costs for LDCs. Thus, both the DCF and CAPM analysis, when reasonably performed, indicate that the 10.5% recommendations of witness Mr. Hill and Lurito are reasonable, and perhaps even somewhat generous. Mr. Torgerson's further attempts to inflate investors' equity returns by additionally marking up the cost of equity for FERC Order 636 risk, for flotation costs, and for the potential denial of a weather normalization clause which WNG does not even have. These issues are discussed in the following subsections.

B. Flotation Costs are Not Appropriate When Stock Is Issued Above Book Value

Both Mr. Torgerson and Dr. Lurito incorporated a flotation or financing adjustment in their recommended equity return level, which Public Counsel submits unnecessarily inflates the required return to ratepayers. Public Counsel strongly disagrees with the propriety of a flotation adjustment when a company is selling new stock at 1.5 times book value. In the case of Dr. Lurito's testimony, his ultimate recommendation of a 10.5% equity return level is reasonable, although the somewhat lower equity return that would be obtained without the financing adjustment would also be reasonable. However, Mr. Torgerson's adjustment further inflates an already inflated equity return recommendation.

Mr. Hill at pages 46-48 of Ex. T-296 provides a detailed technical explanation of why the flotation cost adjustment is improper in the current environment. However, for purposes of this discussion, two of the more obvious concerns will be discussed. First, as we discuss later, we do not agree with the 45% equity capitalization ratio proposed by WNG, and thus WNG does not need to issue additional stock. Second, and perhaps more important, WNG's stock currently sells at 1.5 times book value. WNG will therefore receive, net of any issuance costs that they might arguably incur, proceeds which still substantialy exceed book value, which is the basis for any allowed equity return. While there may be justification for such an adjustment when a stock is issued at or below book value in order to avoid dilution, there is no justification for it in the current market. This is a costly, as well as unnecessary, adjustment for ratepayers. For example, Dr. Lurito's financing adjustment embeds in rates <u>$2.16 million</u> per year for financing costs, which WNG receives whether it issues new stock or not (Tr. 2661).

C. Any FERC Order 636 Risk Is Already Reflected In Existing Stock Prices

Mr. Torgerson further inflates his equity return recommendation improperly by adding a .25% mark up to reflect FERC Order 636 risk. Such an adjustment is inappropriate for a number of reasons.

First, Mr. Torgerson in his direct testimony stated that neither the transition costs associated with Order 636 nor the switch to straight-fixed-variable rate structure "should

have a significant impact up on the Company ..." (Ex. T-48, p. 12). If this is so, then there is no need for such an adjustment.

Then Mr. Torgerson alleges that investors will transfer its perceptions of industry risk to WNG, even though it is not appropriate. First, it is not clear what the industry perceptions of risk are, since Order 636 and the earlier Orders 436 and 500 have been in effect and much discussed for a number of years. Northwest Pipeline has had an open access policy for several years. The discussion has thus gone on already for a number of years, with suggestions of both concern and optimism. The same May 4, 1992 Duff & Phelps report which Mr. Torgerson cited as noting the increase in regulatory risk stated unequivocally on page 1 of the report that " We view Order 636 as very positive for the industry." (Ex. T-296, P. 53). The bottom line is that, whatever the perceptions of risk in investor minds, these perceptions are already reflected in the marketplace and they are already embodied in the DCF, CAPM, and other analytical models. Mr. Torgerson apparently wants the best of both worlds. On the one hand, he is in effect stating that the market is inefficient because it will unfairly attribute Order 636 risk to WNG where such risk does not exist. On the other hand, he uses analytical methodology to estimate return requirements which is premised upon the efficient market by theory (Tr. 3384). As Dr. Lurito indicated, "you would have chaos" without this premise (Tr. 2635).

Finally, as noted by Mr. Hill, a review of the risk or beta coefficients for the group of LDCs analyzed by Mr. Torgerson as published in Value Line actually decreased between April, 1992 and April, 1993 (Ex. T-296, p. 53-54)

D. A Weather Normalization Adjustment Will Reduce Risk and WNG's Cost of Capital

WNG has requested a monthly weather normalization adjustment in order to offset increased revenue volatility, which translates to increased risk (Ex. T-41, p. 5). Obviously, the corollary is also true - reduced revenue volatility translates to reduced risk. However, WNG proposed no reduction to its requested equity return or even to its

capital structure in exchange for this shift of risk to customers. In fact, WNG has gone even a step further on rebuttal to first deny that there is any reduced return that would flow from such an adjustment, and then, to request an additional .25 increase in its cost of equity capital if the requested weather normalization adjustment is denied. Apparently WNG's investors are to be compensated for the Commission's denial of a weather normalization adjustment which it does not currently have! So much for the rational investor and efficient market theories!

Public Counsel is opposed to the weather normalization adjustments on grounds other than just its effect on capital costs. In fact, even assuming the recommended reduction on equity costs of .25% recommended by Mr. Hill, it is not a good deal for customers and should be rejected. [It should be remembered that Mr. Hill's previous research on the subject, including his analysis of the capital implications of decoupling which is similar to weather normalization (Ex. 298), indicated that an equity cost reduction of from 50 to 100 basis points would not be unreasonable, but his recommendation in this case is the more conservative lower end of his equity range or .25 % (Ex. T-296, p. 48-51)]

Public Counsel submits that the explanations given by WNG witness Campbell as to the practical operation of the weather adjustment clearly demonstrate that it will be unintelligible to customers, which will create both confusion and hostility. Charging customers for more than their actual consumption, or even less than actual consumption will only engender distrust. They will see different charges from month to month for the same service. Just look at how customers get upset when utilities use estimated bills. Customers are not stupid, regardless of what WNG may think. They in a general sense know that when it is cold or warm, their bills will similarly increase or decrease and they budget accordingly. They can also take advantage of WNG's budget payment plan if they need more levelized rates throughout the year. This is a very different approach from the weather normalization adjustment where customers will not even know their rate until after the fact, which may be retroactive ratemaking.

The following excerpts from customers letters contained in Ex. 428 emphasize these concerns, which we believe are representative:

2. I object to the so-called "weather normalization" billing method:
a. it is not precise, accurate, &/or informative.
b. I am entitled to an exact, precise, accurate bill, based upon an accurate monthly meter reading, which I can verify.
c. this "weather normalization" scheme could, & should, be offered as an option, similar to WNG Co.'s budget plan.
d. this "weather normalization" billing method should not be forced upon all rate payers.

M.S. Balenti, dated 5/19/93

This is to register my opposition to the Washington Natural Gas Company's rate increase request. I am unequivocally opposed to the so-called "weather-normalization adjustment which will undoubtedly be beneficial to the requesting company but is meaningless to the customer who deprived of still another measure of handling his own affairs instead of some beneficent business handling personal affairs. Whatever that euphemism means, it is subject to the interpretation of the company and opens the door to arbitrary manipulation of the rates.

Jan Friend, dated 11/24/92

WNG's weather normalization adjustment will only benefit the company, not customers. We would not oppose WNG's offering the program on an optional basis, as suggested in the Balenti letter. However, it might be more effective for WNG to do a better job in promoting the budget payment plan. However, if the Commission should decide to implement this mechanism, ratepayers must be compensated through a reduced rate of return.

E. WNG's Proposed Capital Structure Is Neither Necessary Nor Economic

As was discussed earlier, the number of differences on capital stsructure are basically limited to the equity and short term debt capital ratios, but these are very important and costly differences.

The purpose of the capital structure review is to establish a capital structure which is both safe and economical. The trade-off is that the incremental cost of equity is considerably more than that of long term debt and a great deal more than that of short debt [Torgerson: 12.25% equity; 7.38% long term debt; and 3.75%] Thus an

increase in the equity ration increases safety, but at a very high cost. In fact, the cost rate differentials are much greater than shown, when one considers the tax effects of each form of capital. The cost of debt is the same on both a pre-and post-tax basis, since it is fully deductible. Equity, however, is taxable and thus its pre-tax cost is much higher. Thus, for example, Mr. Torgerson's pre-tax cost is much higher. Thus, for example, Mr. Torgerson's pre-tax cost of equity is 12.25% divided by 66 (34% tax rate) or 18.6%, and this is the cost that ratepayers would pay in revenues. (See Tr. 3382-83). Thus equity will cost ratepayers about 2.5 times long term debt costs and almost 5 times short term debt costs.

WNG's proposed capital structure is both uneconomic and unnecessary. The Commission is presented with the benchmark ratings of the various rating agencies an dtold that WNG must be within those parameters or be downrated. First, it is obvious that far more than benchmarks are involved, since WNG and many other A rated utilities do not meet many of the benchmarks. As noted by Dr. Lurito, "What this indicates to me is that these Standard & Poor's published guidelines are suggestive but not definitive in application." (Ex. T-285, p. 39). Thus, for example, Value Line of Boeing lay-offs, expanding high technology businesses, and reduced capital spending with emphasis on hookups on existing mains (Ex. 294, p.1). These clearly are some of the other factors considered by the rating agencies.

WNG was upgraded by S & P in January, 1987 from Bbb & to A- and by Moody's in 1988 from BAA to A1 (Tr. 3334), yet WNG has not met many of the required benchmarks for an A rating. A comparison of the current S & P Benchmarks (Ex. 346, Sch. 4, p. 5 of 6) with WNG's actual financial statistics for 1988-1992 (Ex. 346, Sch. 7, p. 2 of 3) shows that WNG's actual capital structure and its coverages have not been within the A benchmarks throughout that period. Yet WNG was not downrated.

Both witnesses Hill and Lurito propose equity capitalizations of 42.% and 41% respectively, which are considerably safer (and more expensive) than the company's five year average of 36%, without the unnecessary expense of WNG's proposed 45% equity ratio. They also propose the use of 5.49% and 6% of short term debt respectively which is considerably below the Company's actual short-term debt levels for the last 5 quarters

[Ex. 299, Sch. 3, p. 1 of 4; Ex. 287, P. 11]. More importantly, it is a much more economical short term debt ratio than the 2.78% ratio proposed by WNG, particularly where short term debt has about half the cost of long term debt and 1/5 the cost of equity.

The capital structures proposed by both witnesses Hill and Lurito both reasonably balance safety and economy, and should assure access to capital on reasonable terms. They also should allow WNG to ratain its curren A-/A1 bond rating, as both witnesses haves stated. However, if for some reason WNG was to be downrated because of this proposed capital structure, ratepayers would still be better off with the Bbb&/BAA rating that it formerly had up until 1987/1988. This lower rating still allows WNG reasonable access to capital, but at a slightly increased cost rate. WNG witness Tulis provided the cost differentials between A and BBB rated issues in his Ex. 350, Sch. 6, p. 2 of 2. It shows that the current differential is 20 basis points and that the average differential for the last three years has been 25.7 basis points. The differential between an A-and a BBB + would be even smaller. Thus, even in a worst case scenario that resulted in a downrating, the cost of such a downrating to customers would be much lower than the costs of moving to WNG's proposed equity return and capital structure.

IV. MERCHANDISING AND JOBBING

As discussed in the overview, a considerable portion of the record in this proceeding and certainly a large amount of review and preparation time has been spent on issues relating to the unregulated activities of WNG and its affiliates. The record clearly demonstrates that WNG has over a prolonged time period has continued to shift the costs of its unregulated activities to the regulated ratepayer, which has both improperly inflated rates to custpmer and also harmed competitors. Public Counsel urges the Commission to take dramatic action to end these abuses in this case, so that both customers and possible competitors are not harmed by these activities in the future.

A. WNG Has Demonstrated a Continued Disregard of Commission and Legislative Mandates

Unfortunately, the problems of self dealing between WNG and its affiliates and the cost shifting to regulated operations is not a new one. There appear to have been problems ever since the reorganization of the company, which was authorized in Cause No. U-77-64. WNG appears to have been the "milk cow" since that time. Thus, for example, Cause No. U-80-111, the Commission discovered that WNG was providing funds to affiliates without appropriate compensation.

> The record made in this proceeding and in the interim proceeding evidences impropriety in the handling of interaffiliate transactions and an appropriate compensating adjustment has been made to results of operation and ratebase. This Commission will not tolerate Washington Natural as the regulated company bearing the expense of providing funds to the other subsidiaries of Washington Energy Company. The respondent indicates on brief that it has corrected the problems outlined by staff witness Degerness during the pendency of these proceedings. The Commission views with concern the necessity of having to bring this matter to the attention of the company in order to have an improper activity corrected. This does not speak well for management awareness, surveillance and control of intercompany activities. The Commission will closely monitor the activities of respondent with respect to interaffiliate transactions to insure compliance with all provisions of the Commission's order in Cause No. U-77-64 which authorized the reorganization of the respondent corporation. [Third Supp. Order, p. 9 Cause No. U-80-111, issued 9/24/81]

Again, in Cause U-82-22/37, the Commission criticized the lack of allocation of advertising costs:

> The Commission is concerned that there has apparently been no allocation of costs of advertising items which are sold on an unregulated merchandising basis. Data included in the record are not sufficiently comprehensive to permit the Commission to determine the portion of advertising costs which should properly be removed from expenses for ratemaking purposes, under WAC-90-043. The amount of advertising will not be disallowed in this case, but the company is directed to provide information in its next rate case to permit such allocation. The total expense may be disallowed at that time if sufficient information is not provided. [Third Supp. Order, issued 12/29/82 p. 15]

In the 1987-88 time period, the identical M & J issues relating to cross-subsidization, improper allocation of costs and anti-competitive behavior were brought to the Legislature's attention. In fact, some of the same business organization which

presented testimony in the public hearings in this case presented similar testimony at that time to the legislature. The Legislature's inquiry resulted in a Commission report to the Legislature, with findings of improper accounting for M and J costs. The correspondence and Report relating to the Legislative inquiry are contained in Ex. 185. As a consequence of this investigation, WNG received allocation and accounting recommendations form its "independent" auditor Arthur Anderson. In general, WNG did not implement the Arthur Anderson, let alone adequately address the Commission/Legislative concerns (Ex. T-183, p. 9-10).

Again, just last year, the Commission disallowed millions of dollars in purchased gas expenses where WNG paid excessive gas costs to its affiliate, Washington Energy Exploration, Inc. Docket Nos. UG-911236/270, Third Supp. Order, issued 9/29/92.

In addition to ignoring the concerns of the Commission and Legislature, WNG clearly has conducted its M & J operation engaged in "the sale of merchandise or appliances or equipment" keep its accounts for these operations separate from the revenues, expenses and ivestment used to provide regulated services.

With this history of abuse over a long period of time, Public Counsel urges that the Commission take decisive action so that the abuses do not continue on into the future.

B. Different Cost Allocation Approaches.

As noted earlier, the record is replete with discussion of the various M & J and other affiliate costs such as Homeguard and the appropriate accounting treatment for allocating these costs. Public Counsel will leave it to others to recite the details. Instead, we will briefly summarize the different approaches, so that we can discuss how the Commission should resolve these issues.

WNG's approach to cost allocation can best be described as superficially incremental. In other words, virtually all costs are charged to utility operations unless a specific task is performed for a specific affiliate or unregulated operation. (Ex. T-269, p.

37-38) Thus, utility customers are the "bank" for all joint and common costs. In this way, non-regulated operations get a free ride for such services as billing and postage, which provides no cost benefits to ratepayers and is harmful to competitors.

Staff undertook a detailed cost/space allocation study of WNG operations, which attempted to rationally allocate costs and plant between regulated and unregulated operations. With limited time and resources, Staff performed a mammoth and difficult undertaking and we applaud their efforts. The results produced by this study are reasonable considering these constraints and the intermixed corporate accounting data.

Public Counsel took a somewhat different approach, but Public Counsel witness Dittmer's analysis identified the same misallocation and incremental allocation problems described by Mr. Russell. Rather than applying the very arduous and judgmental allocation approach performed by staff, he instead brought the net operating results above-the-line, thus for purposes of this case giving ratepayers the benefits, as well as the costs, of these operations. This would decrease WNG's original proposed revenue requirement by $8.8 million.

On rebuttal, WNG produced a brand new cost allocation study which was performed by its "independent" auditor Arthur Anderson during the course of this proceeding. This study produced two scenarios: Scenario A assumes the current joint operation of regulated and non-regulated activities; Scenario B assumes a separate affiliate structure for the performance on non-regulated activities. WNG stated that it would proceed on a Scenario B approach. Neither scenario received sufficient review in the short time lines of the rebuttal case to be deemed reliable, and, in fact, a number of problems were revealed. For example, the study is not integrated with the various otherwise and adjustments in the case. Scenario B, which WNG favors, assumes a separate subsidiary in existence during the test year which is obviously not the case. It has not even been created yet, so we have no actual operating data that can be verified. Additionally, although employees are theoretically relocated to the subsidiary, wages and office costs are not correspondingly reduced to the utility. These studies are simply unreliable for ratemaking purposes and should be rejected.

C. Recommendations

Public Counsel submits that, for purposes of revenue requirements in this case, the Commission should follow the approach suggested by Mr. Dittmer and bring the M & J and Homeguard net operating income before income taxes above-the-line. WNG has flagrantly violated the provisions of RCW 80.04.270, leaving the Commission and parties in the untenable position of attempting to unscramble WNG's intermingled costs and assets in the short time frame of this case. Mr. Dittmer's approach, although admittedly a stop gap solution, allows ratepayers who have borne the costs to at least enjoy some of the profits of WNG's intermingled operations, without getting into the morals of allocation issues. We believe that this approach is both reasonable and legally supportable under the circumstances.

In the longer term, we submit that the separate subsidiary approach, or even removing these operations from WECO entirely, are probably the only practical ways to proceed. This is unfortunate, since there would appear to be many economies of scale and focus which, if costs were properly allocated, would legitimately reduce costs for both regulated and non-regulated operations. However, this approach does not appear realistic in light of the Company's previous conduct.

Finally, it must be recognized that the creation of separate subsidiaries does not fully resolve the cost allocation issues. Homeguard is a separate subsidiary but it still shifted substantial costs to the regulated utility. Continual regulatory oversight will be required to assure that WNG, the regulated monopoly, receives the higher of incremental costs or market value for any services or assets that it provides. We remind the Commission that Mr. Dittmer's recommendation that a 5% royalty be imposed on any affiliate which uses the Company's name, logo, or similar customer familiarity assets was not rebutted by the Company, and should be required in future proceedings if the Company and/or its affiliates continues to engage in merchandising and jobbing.

V. STAFF AND OTHER REVENUE ISSUES

The staff raised a large number of revenue requirement issues. We will address only a few of these in detail. Where we have not taken a specific position which is different from a staff proposal or where we are silent, the Commission should assume we support the staff position on revenue requirements.

A. Propane program is untariffed and should be disallowed.

The Company has been providing an untariffed promotional service for many years, offering propane service in areas where it allegedly expects to install gas lines in the future. In our review of general rate proceedings going back to 1980, we were unable to locate any evidence that this program was ever considered by the Commission in the past. There is no tariff, no Commission order approving the service, and no agreement by the Commission that any operating shortfall from the program should be included in rates to regulated natural gas customers.

Mr. Lazar and the staff both testified that the Company provides this service at a considerable loss and that losses from this program should not be allowed as part of the regulated natural gas revenue requirement. With gas the fuel of choice where it is available, there is no rationale for continueing this promotional and discriminatory service.

On rebuttal, the Company proposed to terminate offering the program to new customers, but it would continue serving existing customers for up to six months. However, it appears that the costs it has incurred in the past would be continued in future rates. [T-337, P. 21], since the costs of the propane service are buried in the Company's purchased gas expense. **The Commission should reject inclusion of the Company's losses on this non-tariffed service which was never considered or approved by the Commission, and adjust NOI by $121,105.**

B. Four current CNG program positions should be disallowed.

The Commission rejected the Company's proposed Compressed Natural Gas vehicles program in it's Third Supplemental Order in this cause, as it would cause other classes to subsidize natural gas vehicles. During the cross-examination of Mr. Johnson, we determined that there are four company employees already operating a CNG vehicle program, and their costs are included in the cost of service studies he prepared. [Tr. 3730]

There are two problems here. First, there are the expenses of four company employees. Second there is the problem of cost-allocation. The cost of the four employees was not separately identified by the Company, but since the CNG program has been rejected, the expenses of the employees already operating this program should be disallowed. We recommend that $200,000 in expense be disallowed, representing the fully loaded costs of four employees. The costs of the CNG vehicle program were originally proposed to be allocated as a tracker, on a cents/therm basis, to all gas delivered by the Company. Mr. Johnson testified that the costs of the existing program were reflected in the cost of service study, and allocated on a per-customer basis. He agreed that this would result in a much larger allocation to residential customers than the tracker method originally proposed by the Company for the CNG vehicle program. However, if our recommendation that the Company's preferred cost of service study be rejected is adopted, this cost allocation issue becomes less important.

The Commission should disallow $200,000 in expenses associated with the CNG vehicle program which are already being expended. This is an additional adjustment to the staff adjustments.

C. Insurance through a Bermuda subsidiary should be terminated.

Staff proposed treating the Company's purchase of liability insurance from Mercer Insurance (another subsidiary of Washington Energy Company) as self-insurance. This resulted in an increase to NOI of $283,100. [T-183, P. 47] In reaching this

conclusion, however, Mr. Russell proposed that the administrative expenses of Mercer Insurance be included as expenses which would be incurred under self-insurance.

During cross-examination, we determined that "Mercer Insurance", despite it's name, is headquartered in Bermuda. The staff was not able to perform an on-site audit of this company or its operations. [Tr. 1719] Frankly, we believe that it is intuitive that a significant portion of the administrative costs of Mercer Insurance is obviously associated with operating the Company at a foreign location, and would not be incurred under self-insurance. We therefore recommend that 50% of the administrative costs be disallowed. As shown in Exhibit 201, the administrative costs which Mr. Russell identified were $67,825 per year; adjusting this amount for taxes at 34% produces an increase to NOI of $44,765.

We recommend that the Commission increase NOI by $327,865 to reflect an assumption of self-insurance, plus discounting the Bermuda subsidiary's administrative expenses by 50%.

D. Advertising expense is promotional, and not allowable under Commission rules.

A major dispute arose between staff and the Company over the Company's general advertising expenses. Staff takes the position that the majority of the advertisements are not conservation, safety, or employment-related, and thus are not eligible for inclusion in rates under WAC 480-90-043 (2)(c).

Many of these advertisements were included in the record. Exhibit C-220 shows the Company's written advertisements, and the text of its broadcast advertisements. Exhibits 228, 229, 230, and 231 are actual video tapes and audio tapes of the Company's advertising. It is evident from viewing these that they are promotional and comparative in nature. Mr. Lazar, one of the region's leading experts on utility conservation and a recognized advocate of cost-effective fuel conversion programs, was asked if the Company's video advertisement showing someone turning up the heat in response to lower costs of gas compared with electricity was conservation-oriented, and he agreed with Staff that it was not.

There can be little question that the advertisements at issue are promotional and comparative, and the costs are not allowable under the Commission's rule. The staff proposed disallowance of approximately $1.8 million [Ex. 220] out of total advertising of $2.1 million [T-206, P. 44] is a reasonable analysis of these advertisements.

The Commission should adopt the staff advertising adjustment, which increases NOI by $1,191,100.

E. AGA Dues are mostly political.

Staff proposed disallowance of 77.83% of the Company's dues to the American Gas Association as political and promotional in nature. This was based upon an extensive audit of AGA prepared by the National Association of Regulatory Utility Commissioners in 1990. [Ex. T-206, P. 23] The Company objected to the use of the NARUC audit, and the characterization of the AGA activities as political and promotional. However, the Company did not provide any substantial evidence to support its position [Exhibit 420 was not admitted].

The Commission has dealt with the issue of trade association dues on many occasions, and has excluded substantial portions of these dues from rates where they are determined to be promotional and/or political. Perhaps most poignant in this regard is the Commission's finding in a Puget Power proceeding involving Puget's payments to the Edison Electric Institute:

> Once again, the Commission rejects the company's attempt to avoid its burden of proof. Self-serving statements that its EEI contributions are directed toward improving "conservation advertising and employee communication techniques" is not sufficient to establish that this is in fact the case. Having failed to justify these expenses, the company must suffer their disallowance. [Cause U-83-54, 4th Supp. Order, P. 39]

The situation in this proceeding is even more compelling than for Puget. The Staff has presented the results of a NARUC audit on which it based its allocation of

AGA expenses. While we believe that WNG has failed to meet its burden of proof that any of the AGA expenses are appropriate for inclusion in rates, we support the allocation performed by the Staff, in which expenses directly assignable to promotional and political activities, along with a pro-rata share of administrative costs, are disallowed.

The Commission should adopt the Staff adjustment to AGA dues, increasing NOI by $162,812.

F. Incentive pay plan is designed to benefit shareholders.

Staff proposed disallowing the Company's incentive compensation program, primarily because the goals and thresholds for this program were related to profitability of the parent corporation, not to any discernible benefits to ratepayers. [T-206, P. 38] The Company, on rebuttal, presented a witness, Mr. Gordon, to defend its incentive compensation program. However, Mr. Gordon's testimony simply confirmed the staff position -- that corporate earnings per share, not customer bill savings, were the primary focus of the program. [T-334, P. 4]

The staff position on incentive pay should be adopted. The incentives are an expense which is incurred only if the Company earns in excess of a fair rate of return; ratepayers should not bear any burden associated with earnings in excess of a fair rate of return.

G. The Company has overstated its working capital requirements.

The Company originally proposed that a tracking adjustment be implemented to flow through the expenses of its program to ameliorate environmental problems caused decades ago by its predecessor manufactured gas companies. The Company agreed by stipulation to withdraw its tracker rquest, but continued to request that its working capital allowance be increased to cover the carrying costs of the expenditures that it is making for these programs, which it claims will amount to about $13.9 million. Staff

recommended that the working capital allowance not be adjusted except for expenses incurred during the test year. [Ex. T-171, P. 7] Public Counsel opposes working capital treatment of an yof these costs.

Public Counsel witness testified that it is equally appropriate to oppose the working capital treatment of these costs as it was the tracker in the first place. (Ex. T-269, p. 20-30). First, WNG is seeking full recovery of its costs with interest from its insurance carriers in litigation which will go to trial this fall. Second, there has been no determination yet of the prudence of these costs, yet ratepayers would be required to pay the carrying charges. This is effectively a ratebasing (return on, but not of at this point) of possibly imprudent and certainly non-used and useful investment that does not provide service for customers, which the courts have held is illegal. POWER v. WUTC. We therefore oppose their inclusion in working capital at this time. However, as Mr. Dittmer also stated, the Commission could authorize deferral of these carrying charges at this time pending later ratemaking determination, but this was not his favored recommendation.

Environmental cleanup costs should be excluded from working capital.

H. The Company does not require an attrition allowance.

WNG's rate request included an $8 million attrition adjustment, which it asserts is necessary to prevent reduced earnings in the future as a result of inflation pressures on its costs. Such a request is astounding and unwarranted in light of the current economic environment and the <u>negative</u> capital cost attrition that WNG currently enjoys. The proposed attrition adjustment should be rejected.

The testimony of Public Counsel witness Dittmer, as well as the testimony of Staff witnesses Thomas and Parvinen, provide numerous reasons why an attrition adjustment is totally inappropriate. Focussing on Mr. Dittmer's testimony (Ex. T-269, p. 6-19), he clearly demonstrates that the company's calculations do not recognize the negative capital cost attrition that WNG is currently enjoying. WNG's incremental cost of capital is <u>below</u> current embedded costs (Ex. T-269, p. 12-14). This is a totally

different environment from the early 1980's when WNG last had an attrition allowance. That was a time of high inflation, high interest rates, and high equity costs which were substantially above embedded capital cost rates. The incredibly high 16.25% ROE, which is still this company's authorized ROE, was established in that environment.

To the extent that WNG believes its costs are growing faster than its revenues, it has only itself to blame. As noted by Mr. Dittmer, this "expense growth has been disproportionately caused by WNG's aggressive growth in retail M&J sales", and these costs have been improperly allocated to regulated operations. (Ex. T-269, p. 15-17). In additon, the record reflects major problems in the areas of uneconomic gas line extensions, below-cost equipment rentals, and excessive and improper advertising costs. All of these costs can be effectively managed. It is up to WNG to determine if it wants to effectively manage them.

VI. COST OF SERVICE

WNG presented two cost of service studies in its direct case, through its witness Richard Johnson of Stone and Webster Management Consulting. The first utilized a methodology previously considered and rejected by the Commission, in which the fixed costs of gas supply, transmission, and distribution are treated as "demand-related" and allocated among the classes based on the theoretical demand which would occur if the hypothetical "design peak" day were to occur on the Company's system. The second generally followed the methodology approved by the Commission in Cause U-86-100 (Cascade), affirmed in Cause U-88-2380 (WWP), and refined subsequently in Cause UG-901459 (WWP). The Company did not prepare a revised cost of service study in the rebuttal case, reflecting its much lower requested revenue requirement. The Peak Responsibility methodology was relied on by the Company in proposing larger than average increases for the residential class, and rate decreases for interruptible sales and transportation customers.

Staff presented a cost of service study by Alan Buckley, calculated at the level of revenue advocated by the Staff in its direct case. That study used the methodology

previously approved by the Commission in Cause UG-901459. Public Counsel presented an adjustment to the Company cost of service study which used the Commission-approved methodology, reflecting the effect of specific adjustments (i.e., meter reading and billing expenses and M&J), which would affect the residential class. Both the Staff and Public Counsel analyses show that the residential class is paying at or above the overall rate of return required by the Company. [Ex. 283, P. 1; Ex. 243, P. 1]

All of the studies except the one prepared by the Company on a "design day peak responsibility" basis shows that the residential class is paying at least a fair rate of return. Public Counsel submits that the Commission should again reject the "design day peak responsibility" method, and reaffirm the methodology it has previously accepted for computing class cost responsibility for natural gas distribution companies.

A. The Company study is unreliable.

The Company Peak Responsibility study should be rejected as unreliable and erroneous, inconsistent with the incurrence of expense on the gas utility system, and inappropriate for use on the Washington Natural Gas system. There are several problems with this study. First, the Company proposal to allocate fixed gas supply, transmission, and distribution costs solely on the basis of peak demand are inappropriate; these costs are incurred both to meet peak demand and to meet annual energy needs, and should be allocated accordingly. Second, as the Commission has held in numerous cases in the past, a hypothetical "design day" is an inappropriate basis upon which to allocate those costs which are "demand" related. Third, the Company study treats major administrative and general costs as "customer" related, when in fact these costs are associated with the general overhead of the system and they should be allocated to all classes on the basis of their usage of that system. Finally, and perhaps most important, Mr. Johnson admitted to some very significant errors in his study with respect to the allocation of certain costs to interruptible customers, which further undercuts the flawed conclusion that the Company relied upon in recommending a decrease to interruptible service rates.

1. Fixed costs should be allocated on both peak demand and commodity usage.

The first problem with Mr. Johnson's preferred Peak Responsibility study is that he allocates 100% of the fixed costs of gas supply, transmission, and distribution on the basis of peak demand, and none on the basis of therm usage on other than the peak day of the year. This is flawed for several reasons, as Mr. Lazar testified to in detail and as was brought out in cross-examination.

First, there are economies of scale in construction of transmission and distribution facilities. [Ex. T-279, P. 22] The cost of "overbuilding" a system to meet peak demand is a small portion of the total cost. Expenses such as trenching and pipe laying are largely independent of the size of the pipe; only the materials cost differs significantly as a pipe is sized larger to handle a higher on-peak demand.

Second, the fixed cost of peaking resources is much lower than the fixed cost of baseload resources. The Commission has long recognized this in electric utility cost allocation decisions, in approval of the "peak credit" methodology. In the gas area, the same principles prevail. Exhibit 404 clearly shows that peaking resources have fixed costs which are as low as $.21/year for a therm of peaking capacity. As Mr. Johnson testified, baseload resources, such as TF-1 transportation, can cost twenty times as much or more. [Tr. 3741] In addition, there is the fixed cost of reserving a baseload gas supply, which drives the cost of baseload resources even higher. The 90% commodity, 10% demand allocation methodology for allocating fixed gas supply costs which was approved by the Commission in Cause UG-901459, and was used by staff witness Buckley in this proceeding is a reasonable way to fully recognize that only a small portion of the cost of securing baseload gas supplies is related to peak day capacity; the balance is needed in order to secure low-cost resources throughout the year.

Finally, as Mr. Lazar testified, the justification for building many transmission and distribution lines may be to serve customers whose total (or primary) usage may be off-peak. He gave a specific example of a food processor which used no gas during the coldest period of the winter, but still derived a great deal of benefit from a gas line. [T-279, P. 24-25] If the costs of these lines are allocated solely on the basis of peak

demand, an off-peak customer would be completely exempt from paying for the lines; if they are allocated on a combination of demand and therm usage, all customers share in the costs, just as all customers share in the benefit.

This issue has been before the Commission many times before, in both gas and electric cost allocation proceedings. The Commission has consistently ruled that fixed production and transmission costs should be allocated on the basis of both peak usage and annual usage [Cause U-81-41, Cause U-82-10, Cause U-82-12, Cause U-85-53, Cause U-86-02, Cause U-86-100, Cause U-88-2380, Cause U-89-2688, Docket UG-901459]. The last case, a WWP gas proceeding, is most clearly and directly similar to the situation now before the Commission. The Commission stated there (as it has stated many times):

> Cost of service analysis thus should reflect the fact that fixed costs are incurred for the company to deliver gas year-round, not just on a peak day. The Staff's allocation proposal recognizes this. [Docket UG-901459, 3rd Supp. Order, p. 8]

2. Design day is the wrong definition of "peak."

A second problem with Mr. Johnson's preferred cost of service study is that he determined each class's share of demand-related costs based upon the amount of gas he predicted each class would use if a hypothetical "design-day" were to be observed on the WNG system. The "design-day" load is based upon temperature conditions which occurred once in the history of the Northwest -- in 1950 -- which is prior to the availability of natural gas in the region. [T-279, P. 19] A one day in 43 years criteria is simply irrational as a basis for allocating costs on a utility system.

The use of a design day for determining class peak demands is flawed for several reasons. First, the total system revenue requirement is computed on the basis of temperature-normalized usage. To then allocate those temperature-normalized costs on the basis of a hypothetical design day peak results in a mismatch of costs and revenue responsibility. [T-279, P. 20; Tr. 2090] Second, the Company should assume that under extreme weather conditions, some customers will curtail operations, some will respond to requests for limited usage, and others will simply reach the limits of their installed capacity and be unable to increase usage as temperatures drop.

In Docket UG-901459, the Commission considered a similar request by WNG to use a single peak day to allocate demand-related costs. The Commission adopted a more reasonable method, stating:

> The Commission rejects the company's proposal to allocate demand-related costs on the basis of a single peak day. A figure averaging several days for several years is more likely to avoid wide swings from year to year due to unusual weather conditions that are unlikely to occur frequently. [Docket UG-901459, 3rd Supp. Order, P. 8]

WNG has gone a step beyond what WWP proposed in that docket. WWP proposed relying solely on an actual peak condition, and the Commission expressed concern that this method **might** result in reliance on a situation not likely to recur. WNG proposes to rely **solely** on a design-day condition which **it knows is extremely unlikely to recur.** WNG's proposal is flawed on its face. It does not represent anything known or measurable. It is simply a hypothetical load which might occur if cold conditions unprecedented in the Company's history as a natural gas provider recur, and if customer usage increases in a linear fashion under such cold conditions. Neither is a reasonable assumption, and neither is based on relevant experience.

The staff cost of service study was prepared using the more conventional measurement of peak demand, an average of the highest peak days in recent years. [Ex. T-240, P. 17] It is representative of conditions which actually occur on the WNG system, and the reaction of customers to actual weather conditions.

The Commission should reaffirm its position that a multi-day, multi-year average of actual conditions should be used for determining class peak demand in cost allocation studies.

3. Administrative costs are not customer-related.

A third problem with the Company cost studies are the treatment afforded to administrative and general costs. The Company has allocated many of these joint costs

between classes based on the number of customers in each class. [Ex. 56A, Schedule 5, P. 4] On the basis of this study, Mr. Johnson testified that the customer-related costs on the system amounted to over $22 per month per customer. [Ex. 57, P. 23]. On the other hand, when the Commission's definition of customer-related plant is applied to WNG's costs, as Mr. Lazar has done in Exhibit 282, the correct amount is only $3.90 per month per customer. By allocating costs as it has, the Company has shifted massive amounts of administrative costs to the residential class. In the Staff cost of service study (and even in the Company's alternative "Commission basis" study), where a substantial part of these joint costs are allocated on the basis of total gas usage, these shifts do not occur.

4. Mr. Johnson admitted to major errors in his study.

The clearest basis for rejecting Mr. Johnson's cost of service studies are the major errors which were identified in the cross-examination of Mr. Johnson. Mr. Johnson testified that "interruptible customers should not have a 'free ride' on the system." (T-386, P. 52) He agreed that interruptible customers were often on the system at the time of withdrawal of storage gas (Tr. 3733). In fact, as shown in Exhibit 403, gas was taken from storage every day from November 1, 1992 through March 31, 1992, and interruptible customers used gas every single day of that time. Mr. Johnson agreed that interruptible customers benefit from storage and would need to be curtailed more frequently if the storage were not available. [Tr. 3733]

He also asserted that many costs of gas storage were allocated to interruptible customers (Tr. 3739), and that he had assigned storage costs to the interruptible customers. In fact, Mr. Johnson allocated no costs of any of the following categories of storage expense to interruptible customers:

Storage facilities O&M
Underground storage expense
Underground storage rate base
Underground storage wells and lines
Reservoir and cushion gas
Compressor station equipment
SGS-1/SGS-2/LS-1/CB Capacity

So, in fact, Mr. Johnson did not assign the storage costs to interruptible customers which he asserted he had. His only response, on cross-examination, when faced with the fact that his choice of allocation factors had not actually assigned any of these costs to the interruptible customers was "That's correct. And, really, the intention was to have assigned some of those costs." [Tr. 3736]

The multitude of flaws and errors in Mr. Johnson's cost of service studies make them unusable for the purposes of this proceeding. In addition, since the Company prepared them only at the original revenue request level, and did not revise them as the requested revenue and expense levels were reduced, they do not even begin to reflect the cost allocation problem which is now before the Commission.

B. The Commission's long-standing principles of cost allocation should be reaffirmed.

The Commission first adopted principles of cost allocation for gas utilities in Cause U-86-100, involving Cascade Natural Gas Company. That was an appropriate forum for establishing a precedent for cost allocation, since all of the revenue requirement issues in that case were resolved by stipulation, and the only contested issues related to cost allocation and rate design. The general principles resolved in that proceeding were:

a) Gas pipeline baseload demand charges should be allocated primarily on the basis of therm usage;
b) A design-day is inappropriate for allocating weather-normalized revenues and expenses;
c) Transmission and distribution line investment and expenses are partially demand-related, and partially commodity-related;
d) Services and meter investment and expenses are partially demand-related, partially customer-related, and partially commodity-related;
e) Administrative costs should be spread partly on the basis of non-gas costs, and partly on the basis of therm usage;
f) Not all classes should necessarily provide the same rate of return, as rates must on occasion be set in a competitive manner (so-called "benchmark" rates).

The Commission has reaffirmed these principles on several occasions since that time, most recently in the WWP proceeding, Cause UG-901459. These principles remain valid and should be reaffirmed in this proceeding.

1. Fixed costs of baseload gas supply should be allocated to all customer classes.

WNG proposed treating all of its fixed gas supply costs as demand-related. In previous decisions, the Commission has ruled that the costs of reserving a baseload supply of gas, or a baseload gas transmission service should be allocated on the basis of how the resource will be used -- every day throughout the year. In this case, it was clearly established that WNG uses its baseload and seasonal gas supplies on days other than the peak day, and these costs should be so allocated. We take no exception to the allocation of the cost of true peaking resources on the basis of actual peak day usage, but as shown in Exhibit 404, this is a relatively small portion of the cost of gas supply.

The Commission should reaffirm that baseload and seasonal gas supply costs should be allocated over annual or seasonal usage, not just peak day usage.

2. Multiple days of actual peak demand should be used for peak allocation.

WNG proposed using a single, "design-day" for allocating costs which it classified as demand-related. The Commission has previously rejected use of a design day for allocation (Cause U-86-100), and has even rejected use of a single experienced day (Docket UG-901459). The reasons for using multiple days of multiple years, as discussed above, are quite clear. This leads to more representative results, and more stable rates for all classes.

The Commission should reaffirm that multiple days of multiple years should be used for determining class peak demand responsibility.

3. Transmission and distribution facilities are 50% commodity-related.

In all past gas proceedings, the Commission has rejected proposals by utilities and/or intervenors that transmission and distribution facilities be allocated without regard to actual usage through the year. The reasons for allocating these costs partly on the basis of throughput are very straightforward: the costs are incurred more to provide service throughout the year than on a single day or a few days of the year. Only a small portion of the costs are associated with adding peaking capacity to the system. On electric systems, the Commission has ruled that 70% - 80% of transmission costs should be allocated on the basis of annual energy usage, rather than peak demand. In this case, even the staff cost of service study only allocates 50% of transmission costs on the basis of annual usage, an approach much more favorable to the large users than is applied in electric cost of service. The Commission has been unambiguous on this issue in the past in electric proceedings:

> We agree with the recommendation of POWER that transmission costs should not be fully allocated to demand but should be allocated to both energy and to demand. [U-81-41, Second Supp. Order at 23]
>
> Classification of transmission system cost should be applied using the same principles as for production plant. [U-82-10, Second Supp. Order at 37]
>
> The Commission requires that the company present in the next proceeding an allocation of these [transmission] costs between energy and demand using the same principles as for production plant. [U-82-12/35, Fourth Supp. Order at 35]
>
> No party other than Counsel for POWER addressed the company's allocation of transmission costs. Counsel for POWER correctly argues that the Commission in the company's previous rate case, Cause U-81-41, ordered the company to allocate all transmission costs to demand and energy using the same principle as for production costs. The Commission also affirmed this principle in the most recent rate cases involving The Washington Water Power Company (U-82-10) and Pacific Power and Light Company (U-82-12). The Company is ordered in its next rate case to present a cost of service study that complies literally with the Commission's directive related to the allocation of transmission costs. The Commission does not intend that remote transmission costs should be allocated differently than total transmission costs. [U-82-38, P. 31]

The Commission should reaffirm that transmission and distribution costs should be allocated 50% on the basis of peak demand, and 50% on the basis of annual usage.

4. Administrative costs are properly borne on a commodity basis.

The Company's proposed treatment of administrative costs -- to assign 77% of the cost of the company officers, attorneys, and other administrative costs to residential customers [Ex. 56A, Schedule 5, Page 4) who collectively use only 40% of the Company's gas deliveries [Ex. 56A, Schedule 10, P. 4] -- is illogical.

In fact, most of the time spent in this proceeding by the Company officers has been in the service of shareholders (revenue requirement issues) or in the service of interruptible and transportation customers (for whom they are seeking rate reductions). It is absurd, in light of this fact, that the Company seeks to assign these costs to the residential class.

Even the methodology previously approved by the Commission, and utilized by Mr. Johnson in his alternative "Commission-basis" study allocates 60% of A&G costs to residential customers, one and one-half times their share of total gas usage. [Ex. 67A, Schedule 5, Page 4].

The Commission should reaffirm that A&G costs should be allocated at least 50% on the basis of gas throughput, and 50% on the basis of non-gas expenses.

We note that this is one area where the Staff witness, Mr. Buckley, failed to follow previous Commission directives, and actually allocated some 73% of A&G expense to the residential class. [Ex. 243, P. 11] Thus, even the staff cost of service study overstates the cost responsibility of the residential class.

C. The Staff study is the closest of all to being reflective of system costs.

In this proceeding, the Commission has three complete cost of service studies. The first is Mr. Johnson's Design Day Peak Responsibility study (Ex. 56A); the second is Mr. Johnson's so-called "Commission-Basis" study (Ex. 67A). The third is Mr. Buckley's cost of service study at the Staff revenue requirement (Ex. 243). Finally, there is Mr. Lazar's adjustment to Mr. Johnson's "Commission-basis" study contained in Exhibit 283.

Of these, only Mr. Buckley's study is prepared at anything resembling the revenue requirement we anticipate will result from this proceeding. The Company studies (upon which Mr. Lazar based his adjustment) are fundamentally flawed, and were never updated when the Company made significant reductions to its proposed revenue requirement.

We recommend three adjustments to Mr. Buckley's proposed cost of service results in order to put class revenues and cost responsibility into proper perspective:

1) The uncontested adjustment proposed by Mr. Lazar for meter reading and billing costs should be included;

2) The uncontested adjustment proposed by Mr. Lazar for the inefficient rental water heaters should be included;

3) The administrative and general costs should be allocated using Factor 358 (50% O&M minus gas cost; 50% commodity), instead of Factor 148 (O&M minus gas cost).

The first two adjustments will increase the residential and small commercial rates of return, without any effect on other classes; the last would slightly increase the residential rate of return, and slightly decrease that for the large use classes. Mr. Buckley's conclusions, without these adjustments, are as follows:

	Per Buckley
Residential Rate 23	10.04%
Residential Rate 24	10.60%
Residential Other	.34%
Residential Total	10.27%
C&I Rate 31	23.39%
C&I Rate 36	25.47%
C&I Rate 41	51.25%
C&I Other	24.26%
Total C&I	25.70%
LV Rate 85 Firm	22.00%
LV Rate 85 Int	23.00%
LV Rate 85 Total	22.62%
LV Rate 86 Firm	10.20%
LV Rate 86 Int	16.06%
LV Rate 86 Total	14.66%
LV Rate 87 Firm	.05%
LV Rate 87 Int	-2.70%
LV Rate 87 Total	-2.23%
Rate 57 LV Trans	5.64%
Rate 58 Lim Vol Trans	1.04%
System Average:	12.56%
Required Rate of Return:	9.11%

As is evident, all classes except for Schedule 87 and the transportation rates are already paying rates which exceed the fair rate of return required by WNG. With the Public Counsel adjustments, the residential class would be even further above the required rate of return and in fact well above the system average rate of return, as shown by Mr. Lazar's Exhibit 283.

D. Not all classes impose the same risks, and not all classes should provide the same rate of return.

In this proceeding, even the Company agrees that the industrial customers pose special risks and should not necessarily be entitled to service at the same rate of return as lower risk classes. Mr. Johnson testified:

Q. Do you believe that all rates should provide the same rate of return to the Company?

A. No. Clearly the larger volume customers, who can switch to an alternate fuel on very short notice, pose a greater risk to the Company than a residential customer who has installed a new furnace with an expected life of twenty or more years. [Ex. T-386, P. 57]

Mr. Lazar proposed a specific plan to incorporate this risk differential into the spread of rates between classes. He recommended that Schedules 41, 85, 86, and 87, plus the transportation rates, provide a target rate of return which is at least 3% or 4% above the system average. [T-279, P. 38]

The Commission should formally recognize that large users are riskier than small residential and commercial customers and should provide a higher rate of return to the utility than the system average.

VII. RATE SPREAD

Within the context of its request for an overall increase in rates, WNG proposed that residential customers receive a much larger than average increase, and that interruptible and transportation customers receive rate decreases. [Ex. 77]

Staff witness Buckley proposed a rate spread implementing the staff-proposed rate decrease which provided a larger-than-average decrease to the Schedule 41 customers, an average reduction to the remaining firm commercial and industrial customers, plus residential and Schedules 85 and 86, a zero decrease to transportation and Schedule 87 rates (plus Schedules 11, 16, and 61), and a smaller than average decrease for Schedules 43 and 51 [Ex. T-240, P. 37]

Mr. Lazar proposed certain specific items to guide the Commission in allocating any allowed rate increase or decrease in this proceeding. First, he recommended that if a decrease in rates is proposed, it should apply as a uniform percentage of margin to all schedules except Schedule 87. If an increase is ordered, he proposed that the first $2 million be assigned to Schedule 87, and that any additional increase be applied on a

uniform percentage of margin basis. [Ex. T-279, P. 37]

As several witnesses testified, it is difficult to make concrete recommendations with respect to rate spread when it is uncertain if rates will be increased, as requested by the Company, or decreased, as recommended by the staff. Public Counsel makes the following general recommendations:

1) **Residential rates should receive an average increase or decrease.**

2) **Schedule 87 and transportation rates should receive a much larger than average increase if rates are increased, and should receive no decrease if rates are decreased.**

3) **Firm commercial and industrial customers should receive average or smaller increases if rates are increased, and larger than average decreases if rates are decreased.**

A. The Company approach to increase residential rates while decreasing Large Volume and Transportation rates is unreasonable.

The Company proposal to increase residential rates by about 8.2%, while decreasing rates to Large Volume and Transportation customers by 5.7% and 17.5% [Ex. 401] is inappropriate for several reasons.

First and foremost, the Company has relied upon a cost of service study which employs an unsupportable Design Day Peak Responsibility method, and contains numerous errors which understate the cost responsibility of interruptible and transportation customers. Even if the Commission were to grant WNG a rate increase (rather than the decrease recommended by Staff), the Company cost of service methodology and the associated rate spread proposal are unreasonable.

In addition, we question whether such a distribution of a rate adjustment would satisfy regulatory goals often enunciated by this Commission, including perceptions of fairness and equity, avoidance of rate shock, and gradual change over time. Residential customers recently were subjected to a tracker increase of approximately 10%. [Docket

No. UG-930615]. To allow a general rate increase of the magnitude proposed by the Company -- an additional 8% -- would cause rates this winter to be 18% higher than last year, a clear case of rate shock. To raise residential rates by this magnitude while at the same time reducing rates to other customers classes would not be perceived by the public to be fair. Fortunately, a more accurate cost allocation study, such as that presented by Staff, shows that a more equal increase across the classes is appropriate.

B. The Company proposal to actually reduces rates for interruptible customers during an overall rate increase should be rejected.

The Company proposal would actually decrease rates for interruptible and transportation customers in the context of an overall increase in rates. We believe that a general regulatory principle should be that no class should get a decrease in the context of an increase (and that no class should get an increase in the context of a decrease). The regulatory principle of perception of fairness should control to some extent here.

C. The residential class should get an average increase or decrease in rates.

WNG proposes an overall increase of $14.8 million in its rebuttal case, of which it proposes that the residential class be assigned an increase of $13.8 million, over 90% of the total increase [Ex. 401], when this class uses only 40% of the total gas delivered by WNG. That recommendation is based primarily on the Company's flawed cost of service study. The Company's alternate cost study [Ex. 67A] shows that residential customers are very close to paying their way; both the Public Counsel adjustment of that study at the Company's proposed expense level [Ex. 283] and the Staff study [Ex. 243] show that the residential class is already paying above a fair rate of return, and therefore no rate increase is appropriate for the residential class.

The Commission should direct that the residential class receive an average increase or decrease.

D. The firm commercial and industrial classes should get a larger decrease, or a smaller increase, than the average.

All of the various cost of service studies agree on one result: the smaller firm commercial and industrial customers are paying far above a fair rate of return. These smaller customers, served on Schedule 31, Schedule 36, 41, and other minor schedules, should receive an average or lower rate increase, or an average or higher rate decrease.

E. Schedule 87 is heavily subsidized, and should get a larger than average increase.

Both the Company's "Commission-Basis" cost study [Ex. 67A] and the Staff study show that Schedule 87 is heavily subsidized. In fact, the tailblock of this sales service rate, at $.16/therm [Ex. 78], is actually below the Company's Weighted Average Cost of Gas (WACOG) of $.178/therm [Ex. 47, P. 1, Line 37, Column (i) divided by Column (h)]. The Company's "Commission-Basis" cost study shows this class to be providing a negative rate of return of -5.82%; the staff study (with much lower expense levels) shows a rate of return of -2.23%.

Schedule 87 should get a much larger than average rate increase; if rates are decreased, the schedule should get no rate decrease. It may also be desirable to raise the tailblock at least to the WACOG.

F. The transportation rates should be approximately equal to the margin portion of interruptible rates.

WNG proposed significant rate decreases for its transportation customers. These customers presently pay rates which are based on the margin of their equivalent sales schedules; in the case of the large volume transportation customers, the margins on Schedule 87 are close to zero or even negative, and the corresponding transportation rates are very low. Transportation service does not provide operating benefits of any kind to the system, and should be priced so that it does provide economic benefits.

Among the major issues is how these customers should pay for the balancing services which the Company provides.

1. Company must have pipeline contract to provide balancing for transportation customers;

In order for WNG to provide balancing services to the transportation customers, it must have a gas transportation contract of its own with the pipeline and must be using gas under that contract. Balancing occurs when a transportation customer uses more gas or less gas on a particular day than it has contracted for. As Mr. Johnson stated, "Well, if a transportation customer nominates 1,000 units and if the thousand units comes to the city gate and the customer only takes 900 units, that 100 units has to go somewhere." [Tr. 3725] In fact, as Mr. Johnson indicated, most likely what happens is that gas which WNG has purchased goes into the Jackson Prairie storage project, or extra gas comes out of storage. [Tr. 3724]

Since the transportation customers benefit from the existence of the pipeline contract and the storage facilities, they should bear a portion of these upstream costs of providing gas service. The Company cost of service studies assigns none of these costs to transportation service. The rates for transportation customers must recover a portion of these costs.

Transportation rates must contribute to pipeline contract and storage facility costs.

2. Interruptible sales customers help maintain system load factor; shifting them to transportation imposes costs on other classes.

The Company indicated that one goal of its rate design was to maintain a high level of interruptible sales load on the system. [Tr. 3726] This is desirable because of FERC pricing policies which place a very heavy emphasis on peaking capacity utilization and load factor, and very little emphasis on commodity throughput. Interruptible sales help to maintain the system load factor; the system was designed around an expectation

of significant interruptible sales load; in the absence of the interruptible customers (or in the absence of firm residential load, for that matter) there would be increasing pressure on rates for all other classes of customers.

The Company strategy to keep transportation rates at or above the level of interruptible sales rates is a sound proposal and should be accepted.

VIII. RATE DESIGN

The Company proposed many different types of changes to its various rates. We will address only a small number of the proposals affecting residential and transportation customers.

A. The residential customer charge should be set no higher than $4.00/month.

The Company currently has a residential customer charge of $4.51/month, and is proposing that it be rounded to $4.50/month. Mr. Lazar prepared a detailed analysis of the costs of meters, services, meter reading, and billing costs which are customer related, plus the administrative and general costs supporting those customer-related costs. [Ex. 282] He included meter and service costs, plus meter reading and billing costs. These are precisely the costs which Mr. Campbell, for the Company, asserted were customer-related. [T-377, P. 31]

In accordance with the Commission policies adopted in Cascade, WWP, and other rate proceedings, Mr. Lazar included only one-half of the meter and service investment as customer-related. In accordance with his testimony and revenue requirement recommendation, he counted only one-half of WNG's monthly meter reading and billing costs, since he testified that Commission rules and prudent utility practice requires only bimonthly meter reading. His analysis found that a customer charge of $3.90/month would fully recover WNG's customer-related costs. [Ex. 282]

Staff witness Buckley recommended that the entire residential rate decrease be applied to the customer charge until a $2.00/month customer charge floor is reached. [Ex. T-240, P. 45] This approach would provide the maximum incentive for conservation, since the variable rate for therms of gas would be higher than under the Company's proposal. Oddly, the Company opposed this recommendation, while at the same time Mr. Campbell went on at length about how the Company's rate per therm was too low to produce good conservation results. [Ex. T-377, P. 40-42] One would expect that the Company would support Mr. Buckley's proposal to minimize the customer charge as a way to maintain good price signals.

Mr. Lazar discussed the customer charge issue philosophically, pointing out that the entire notion of a customer charge is anti-competitive, discourages customers from selecting gas service, and makes gas service uneconomical for apartments or small housing units. He pointed out that many utilities apply a very small or zero customer charge.

Mr. Campbell attempted to confuse this issue by presenting in his rebuttal testimony the customer charges of a few select utilities. He erred or neglected to include several with zero customer charges, such as Northwest Natural Gas, Snohomish PUD, and Seattle City Light. [Tr. 3681-3684] Mr. Campbell acknowledged that he had not done a "systematic study" in evaluating customer charges. [Tr. 3685] (As requested by Judge Anderl at Tr. 3683, we have provided the tariff to Mr. Campbell and he now accepts that the Snohomish PUD has a disappearing minimum residential rate schedule.)

The Commission should affirm Mr. Lazar's methodology of counting 50% of meter and service costs as customer-related plus bimonthly meter reading and billing costs, in computing the appropriate level of customer-related costs. The customer charge should not exceed the customer-related costs. It should adopt a customer charge of not more than the cost-based $4.00/month; if stronger conservation or market pricing signals are desired, a lower or zero customer charge is appropriate.

B. Company flat seasonal residential rate design should be accepted, but should not be linked to the approval of the Weather Adjustment mechanism.

WNG proposed changing its declining block rate design to a flat rate, with a higher rate in the winter than in the summer. Staff proposed a flat rate year round. Public Counsel disagrees with staff on this issue and supports the Company proposal. WNG's gas supply costs are 5-10 cents/therm higher in winter than in summer. It's peak demand is in winter. The staff proposal results in a simpler rate design, but the Company proposal is a more accurate rate design. We believe that eliminating the declining block rate and instituting seasonal rates, as proposed by the Company, is a sound concept.

The Commission should adopt the flat, seasonalized rate design as proposed by WNG.

C. Weather adjustment mechanism should be rejected or made optional.

As previously discussed, WNG proposed a complex and confusing weather adjustment mechanism which would result in higher rates in warmer months, and lower rates in colder months.

In addition to cost of capital considerations, we are concerned about several aspects of this proposal. First, there is a concern about retroactive ratemaking. Customers would not know what their rates were at the time they use gas during a month, since it is unknown what the weather will be until after the fact. Second, there is unnecessary confusion, with customers seeing very different charges month to month for the same service -- an October with 100 therms of usage might be normal weather and standard rates, but the same level of usage in January might reflect warmer weather and be billed at higher rates.

In addition, staff raised several technical concerns with the proposal. Mr. Winterfeld pointed out that the weather at Sea-Tac airport, upon which the adjustment

would be based, was not the same as in other parts of the service territory. [Ex. 258] He also identified technical errors in the Company's formula. [T-255, P. 21] Finally, he pointed out that the Company had done no studies of the impact of its proposals on actual customers, and done no analysis of the economic benefits of such a mechanism.

Mr. Lazar indicated that one possible resolution to this dispute was to make the weather adjustment mechanism optional for consumers. [T-279, P. 47]. However Public Counsel does not believe that such a mechanism is in the best interests of customers, even assuming some cost of capital benefits.

The proposed weather adjustment mechanism should be rejected, or made optional.

D. Transportation service should be provided under a single rate.

The Company proposed two different transportation rate schedules. Schedule 57 would have a minimum annual usage of 750,000 therms, while Schedule 58 would have a minimum annual usage of 240,000 therms. The proposed rate for Schedule 58 is much lower than for Schedule 57. [Ex. 43]

Intervenors pointed out that the much higher rate for Schedule 58 meant that a customer using less than the minimum for Schedule 57 might well be better off buying and flaring gas in order to get the much lower rate that schedule offers. [T-302, P. 6; Ex. 307] Clearly it does not make sense to adopt a rate which encourages customers to waste gas.

This problem can be corrected by implementing a single rate schedule applicable to all transportation customers. The initial blocks of usage should be priced at a level slightly above the level proposed for Schedule 58, since that proposed schedule does not cover its cost of service. The end block should be priced at a level slightly higher than that proposed by the Company for Schedule 57, since that schedule <u>also</u> does not cover its cost of service. [See, e.g., Docket UG-901459, 3rd Supp. Order, P. 28]

The Commission should adopt a single transportation rate with an annual minimum usage of 240,000 therms.

E. Aggregation of transportation for multiple locations served through a single city gate should be permitted to meet the threshold for transportation service.

PERCC witness Betzold proposed that aggregation of usage be permitted for transportation customers operating jointly. He defined two categories; the first was ratepayers with multiple commonly-owned meters, like the Tacoma School District. The second was for customers who "pool" their nominations through a broker. [T-302, P. 8]

Public Counsel supports a limited form of aggregation. Mr. Lazar testified that one problem with transportation service is that customers must take much greater responsibility for their gas supply than with sales service, and must therefore derive sufficient benefits from transportation to justify the staff and training needed to fully understand the service. He indicated that savings of $12,000 per year, as he estimated likely under Schedule 58, would satisfy that threshold. [T-279, P. 50]

In cross-examination of Mr. Betzold, we clarified that he expected that multiple customers might be permitted to aggregate for the purpose of meeting the threshold for transportation service, but they should still expect to pay the minimum charge and block rate structure on a site by site basis. [Tr. 2724] With that clarification, we can support aggregation of commonly owned meters served by a single city gate, as proposed by Mr. Lazar.

The other form of aggregation involved a single broker aggregating nominations for multiple unrelated customers to satisfy the minimum threshold. We are opposed to this form of aggregation, because the broker is not the customer, and it is the customer who must ultimately understand transportation service, secure gas supplies, and (hopefully) get sufficient benefit to justify the staff training needed to fully comprehend transportation service. A broker acting on behalf of customers is not the Company's

customer, and does not have the same responsibility to provide reliable service that a regulated public service company such as WNG has.

The Commission should permit aggregation by customers with multiple meters on a common city gate for purposes of qualifying for transportation service and determining balancing. The rates paid, however, should be calculated on a site by site basis in accordance with the tariff. Aggregation through brokers should not be allowed.

F. Notice requirements for transportation service should be longer.

Mr. Lazar proposed a minimum two-year contract for transportation service, with a minimum one-year notice to modify or renew that contract, so that the Company can plan for the growth in service (or the need to shed gas supplies) or the return of customers to sales service. [T-279, P. 49] He proposed that the total contract length be 10-20 years, but that customers be permitted to change their level of service (up or down) on one year's notice. [T-279, P. 50]

On rebuttal, Mr. Sullivan attempted to confuse this testimony as calling for 10-20 year contract terms without changes during the term of the contract. [T-374, P. 26] Mr. Lazar's recommendation for a minimum one-year notice period for changes in the amount of service requested was not addressed by the Company in its rebuttal testimony, and should be accepted by the Commission.

The Commission should require a minimum one-year notice for increases or decreases in transportation service.

G. Balancing rates proposed by Company should be approved.

One controversial issue relating to transportation service is the terms and level of charges for balancing service. As discussed above, balancing occurs when a transportation customer uses less or more gas than they had nominated on a particular day. It is possible only because the utility has a pipeline contract, storage facilities, and

a diverse customer base. While it may not be possible to identify the "cost" of providing balancing, it is a competitive service which should be priced based upon value, not necessarily upon cost.

WNG proposed balancing charges with a "zero tolerance" band; any over or under amounts would be subject to charges, but the amount of the charge would be quite modest until the imbalance exceeded 3% of the nominated volume. Staff witness Buckley proposed a tolerance band of 3%, but much higher penalties for larger imbalances, up to $2.00 per therm for imbalances over 10%.

In rebuttal, the Company accepted Mr. Buckley's formula and tolerance band, but not his proposed reference to "highest cost" and "lowest cost" gas. The Company also recommended that if any tolerance band is approved, that a portion of the Company's storage costs should be allocated to transportation. [T-374, P. 13] We agree.

Since the Company's cost of service study does not do this, its proposed transportation revenues do not reflect any balancing revenues. We should expect that there will be balancing revenues, and these should not be a windfall to the Company. We propose that all balancing revenues be tracked through to sales service customers through the Company's Purchased Gas Adjustment (PGA) filings. As greater experience is gained with transportation service, it may be possible to use known and measurable balancing service volumes and revenues to set rates in future general rate proceedings.

The Commission should adopt the Company's rebuttal position on balancing, and direct that all balancing revenues be tracked through to sales service customers in PGA filings.

IX. APPLIANCE LEASING PROGRAM

Washington Natural Gas has leased gas appliances for many years. The origination of the program was due to the fact that there was not an established infrastructure for installing and maintaining gas appliances in the region. [T-337, P. 18] That is no longer the case; there are now many contractors who can install and maintain

gas appliances. The question then, is whether any benefit to the public exists which justifies continuing this program.

The first problem is that the current lease rates do not come close to covering costs. The Company's cost of service studies [Ex. 46A and 57A] show rentals providing rates of return of 2% or less. The staff study [Ex. 243] does not show a rate of return for rentals, since the staff proposes that the program be detariffed. If the program is to be continued, it must begin to cover costs.

The second problem is that there may be no justification for continuing a lease program at all. Staff took the position that the competitive market can provide these services, and that WNG should not provide them as a part of its regulated operations. The Company responded, stating that one reason for keeping the program is to have a means to encourage customers to install more efficient water heaters [T-337, P. 17]. This position is hardly credible given the Company's history of leasing over 30,000 inefficient water heaters after the point when WNG had repeatedly been informed by parties' comments to its least cost plans that more efficient units were available and cost-effective to both WNG and its customers.

The staff proposed discontinuing the program, transferring installations expense to the services account, and allowing the Company to amortize its investment over five years. We oppose the staff proposal to transfer installations to the services account, simply because that account is one of the few which the Commission has determined to be appropriate to include the calculation of the monthly customer charge. If the staff proposal is accepted in its substantive aspects, the installation costs should be segregated into a separate account.

The Company responded on rebuttal that it should be allowed to continue the program as it is now established, or at least be allowed full recovery of its investment if the program is discontinued. [T-337, P. 17] The program should not be continued on the current terms and conditions, because it is losing a lot of money. Either it should be terminated, or rates should be increased to fully cover costs.

Finally, this issue is entwined with one of the uncontested issues raised by Public Counsel. Every customer who has obtained a lower-efficiency water heater has been adversely affected by this program. They may be paying subsidized lease rates, but they are paying excessive bills due to higher usage. Our proposed $9/year penalty per water heater should be applied for the life of these units, regardless of whether the program is continued or terminated.

WNG proposed 25% increases in lease rates in its filing. These would be considered rate shock under normal circumstances, but the rates have been unchanged for a decade. They should be approved if the program is allowed to continue. However, as part of this increase, the Company should offer to each customer with a leased appliance the opportunity to buy it at depreciated book value. When coupled with the $9/year penalty to WNG for leasing inefficient water heaters, the 25% increase in lease rates may in fact provide reasonable cost recovery for the leased water heaters.

The Commission should either end the lease program as recommended by staff and require that installations be transferred to a separate account, or else disallow any revenue shortfall resulting from continuation assuming a 25% increase in lease rates.

X. FUTURE DIRECTIVES

A. Cost of service studies should be consistent with Commission policies.

A great deal of time was expended in this proceeding by all parties in addressing the Company's cost of service study. WNG presented two cost studies, one which followed past Commission direction and one which did not. The Company then based all of its rate spread and rate design recommendations on the study which did not conform to past Commission decisions.

We are confident that the Commission will reaffirm its past position that fixed production, transmission, and distribution costs should be assigned to all classes primarily based on annual gas usage. We urge the Commission to provide specific direction to the Company that, in the future, its primary cost of service study shall be

based on the Commission recommended methods, and its primary rate spread and rate design recommendations shall use the Commission-recommended methods as their foundation.

We do not mean to suggest that alternative methods should not be permitted, nor that rate spread and rate design should be based mechanically on the result of any cost study, only that the primary presentation by the Company, to the extent it relies on cost of service data, rely to the results of studies which are consistent with past Commission decisions.

B. Merchandising should be spun off outside of WECO; space now used by merchandising should be leased to others at market prices.

In this brief, Public Counsel has taken the position that for this rate proceeding, the Commission should accept Mr. Dittmer's methodology to assign the profits of WNG's merchandising operation to the regulated operations. We have been forced to this recommendation by the Company's near-hopeless intermingling of regulated operations and merchandizing, in direct violation of both law and previous Commission directives. Over the long run, however, we do not think that this approach is desirable.

Ideally, we recommend that WNG be directed to spin off its merchandising operation to an unaffiliated company. Any operations under the Washington Energy will continue to be subject to the same problems of joint cost allocation, misappropriation of the Company reputation, and unfair market advantage.

In the event that the Commission does allow M&J to continue in any manner still connected to WECO, we strongly recommend that Mr. Dittmer's recommendation for a 5% royalty be imposed in addition to accounting and other safeguards. The reputation of WNG, developed at the expense of the consumer, is a valuable franchise, and should not be given away to an affiliate of the Company to enhance non-regulated profits.

XI. CONCLUSION

For the above stated reasons, the Company's request for increased rates should be denied. In fact, as the evidence of Public Counsel and Staff clearly shows, rates should be reduced for the majority of the Company's customers.

Dated this 10th day of August, 1993.

Charles F. Adams

Assistant Attorney General
Public Counsel Section

Summary of Adjustments Docket UG-920840 Brief of Public Counsel

NET OPERATING INCOME	Staff	Company	PC
Per Books	$41,334	$41,334	$41,334
Uncontested Adjustments			
Jackson Prairie	$19	$19	$19
General Taxes	($774)	($774)	($774)
Bad Debts	($42)	($42)	($42)
Purchased Gas	($124)	($124)	($124)
Workers Comp	$110	$110	$110
WUTC	($157)	($157)	($157)
FIT	$5	$5	$5
Nat Gas Vehicles	$0	$0	$0
Misc Revenue	$42	$42	$42
M&J Cust Service	$333	$333	$0
Payroll Increase	($1,112)	($1,112)	($1,112)
Least Cost Planning	($124)	($124)	($124)
Showerhead	($17)	($17)	($17)
Insurance	$295	$295	$295
Additional FIT	$115	$115	$115
Salary Investment Plan	$151	$151	$151
Subtotal:	($1,280)	($1,280)	($1,613)
CONTESTED ADJUSTMENTS			
Staff Adjustments			
M&J Restating	$0	$4,541	$0
Affiliated Allocation Restating	$0	$399	$0
Weatherization	$0	($40)	$0
Safety	$0	($743)	$0
Weather Normalization	$1,441	$297	$1,441
Revenue & Gas Cost	$2,226	$1,348	$2,226
M&J Plant	$378		$0
Leased Plant	$1,661		$0
Leased Plant Income	($2,043)		$0
Debt Interest	($1,905)	($1,547)	($1,489)
M&J Customer Contact	$99		$0
M&J Credit Dept	$26		$0
M&J Customer Office	$99		$0
M&J Installation	$131		$0
M&J Purchasing	$61		$0
M&J Division Admin	$707		$0
M&J Office Services	$214		$0
M&J Accounting	$166		$0
M&J Information systems	$464		$0
M&J Personnel Training	$301		$0
M&J Public Affairs	$187		$0
M&J Executive	$179		$0
Affiliated Insurance	$283	$155	$328
M&J Benefits	$349		$0
AGA Dues	$179		$179
Pension Restating	$167		$167
Performance Share Plan	$201		$201
Incentive Pay	$895		$895
Advertising	$1,191		$1,191
Marketing	$6,900		$6,900
Revenues	$925		$925
Public Counsel Adjustments			
Water Heaters	$0		$185
Propane Program	$0		$121
Meter Reading / Billing	$0		$1,939
Natural Gas Vehicles	$0		$132
M&J Per Dittmer	$0		$6,203
Homeguard per Dittmer	$0		$596
Total Contested	$15,482	$4,410	$22,140
Total Adjusted NOI	$55,536	$44,464	$61,861

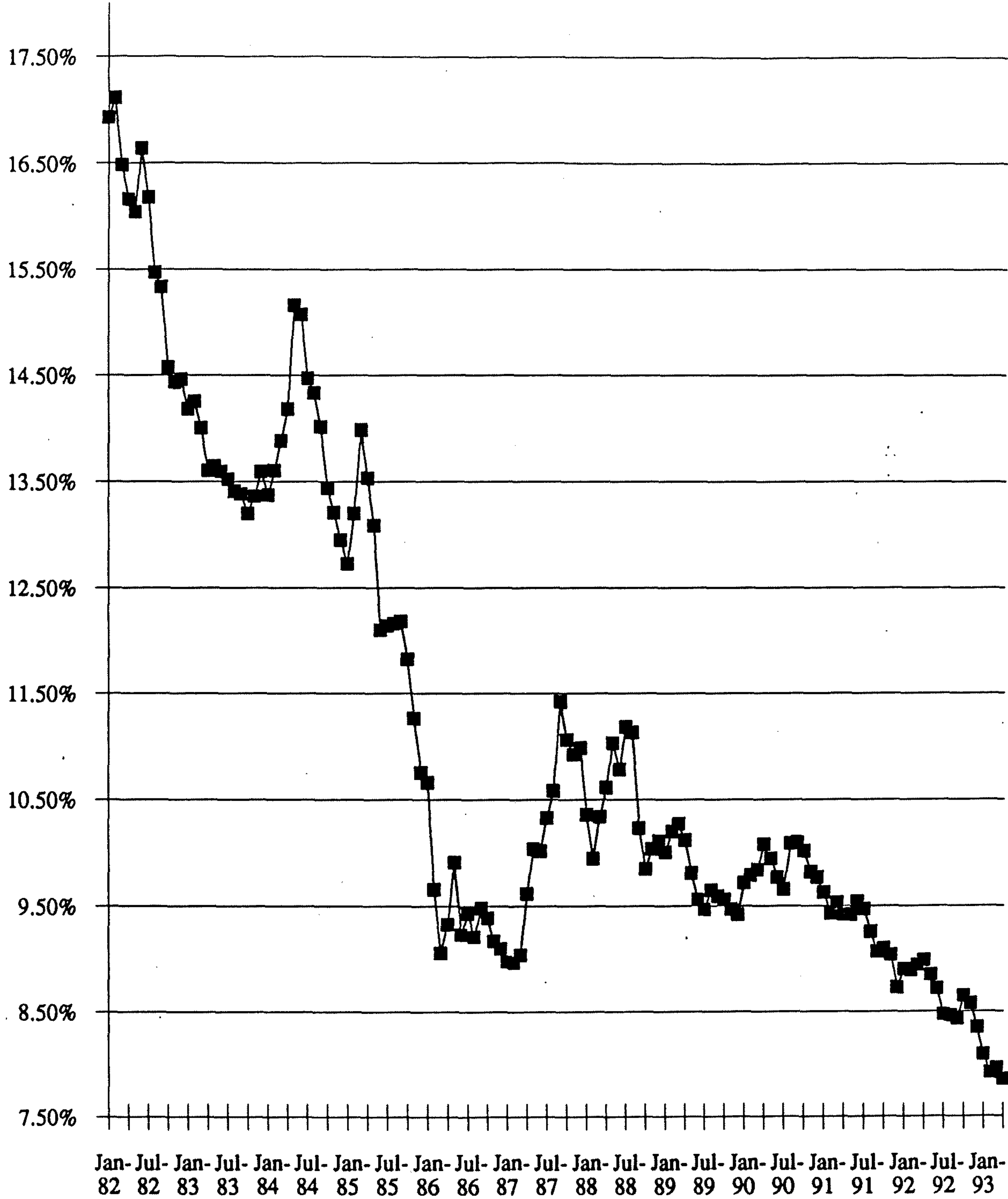
RATE BASE	Staff	Company	PC
Per Books	$485,157	$485,157	$485,157
Uncontested Adjustments			
Jackson Prairie	($53)	($53)	($53)
Nat Gas Vehicles	$0	$0	$0
New Building	($187)	($187)	($187)
Excess Land	($638)	($638)	($638)
Total Uncontested	($878)	($878)	($878)
Contested Adjustments			
Staff Adjustments			
Storage Gas Proforma	$0	$1,788	$0
Environmental	$0	$6,828	$0
Safety	$0	$4,029	$0
Storage Gas Restating	($377)	($418)	($377)
M&J Plant Restating	($12,393)		$0
Leased Plant Restating	($30,488)		$0
Working Capital	$1,290	$7,472	($1,003)
Performance Share	($41)		($41)
Incentive Pay	($263)		($263)
Public Counsel Adjustments			
M&J Per Dittmer			$4,422
Homeguard Per Dittmer			$247
Total Contested	($42,272)	$19,699	$2,985
Total Adjusted Rate Base	$442,007	$503,978	$487,264

REVENUE REQUIREMENT SUMMARY

Adjusted Rate Base			
Return at Current Rates	12.56%	8.82%	12.70%
Required Rate of Return:	9.11%	9.98%	9.11%
Required NOI:	$40,267	$50,297	$44,390
NOI Deficiency:	($15,269)	$5,833	($17,471)
Conversion Factor:	0.631325	0.608377	0.631325
Revenue Deficiency:	($24,186)	$9,588	($27,674)
Attrition Adjustment:	$0	$5,186	$0
Revenue Adjustment:	($24,186)	$14,774	($27,674)

Exhibit_(SGH-3)
Schedule 1
Page 1 of 2

WASHINGTON NATURAL GAS COMPANY
Moody's A-Rated Utility Bond Yields
1982-1993



WASHINGTON NATURAL GAS COMPANY

Moody's A-Rated Utility Bond Yields