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Company: Washington Natural Gas

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August 10, 1993

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STATE OF WASH.
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Paul Curl, Secretary
Washington Utilities and
Transportation Commission
1300 S. Evergreen Park Drive S.W.
Olympia, WA 98504

RE: WUTC v. Washington Natural Gas Company
Docket No. UG-920840

Dear Mr. Curl:

Enclosed for filing are the original and 19 copies of the Brief of Commission Staff in the above-referenced matter.

Very truly yours,

ROBERT D. CEDARBAUM
Assistant Attorney General

RDC:rz
Enclosures
cc/enc: Parties of Record
Lisa Anderl, ALJ

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. WASHINGTON NATURAL GAS COMPANY, Respondent.	DOCKET NO. UG-920840

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August 10, 1993

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I. INTRODUCTION

In this case, the Washington Natural Gas Company (WNG or the Company) seeks a rate increase to fulfill its mission to make natural gas widely available in the region and to strengthen an otherwise weakened financial position of its parent Washington Energy Company (WECO) with continued handsome profit to its shareholders. That is the essence of the WNG case.

The essence of the Staff's case is threefold.

First, WNG should reevaluate its mission and its means for delivery of that message. As a public service Company, it must provide service for the benefit of existing ratepayers. Ratepayers are not well served if they subsidize non-ratepayers, future ratepayers, or shareholders. Likewise, ratepayer interests are not served if they fund a quasi-governmental mission assumed by the Company to encourage the consumption of natural gas. It is not the ratepayers who must finance a regional energy strategy through unfettered growth by the Company.

Second, the Commission must focus on its mission to act as a surrogate for competition. That mission would not be fulfilled if the Commission permitted practices which allow ratepayers to assume costs while the corresponding revenues are enjoyed by a non-regulated operation. No competitive market would tolerate the subsidies inherent in the operations of WNG to its affiliates or unregulated operations.

Third, <u>if</u> Staff's recommendation results in financial distress to WECO and its shareholders, that by itself is not sufficient reason to reject or modify the Staff case. It is not the goal of regulation to save a Company from itself or to preserve a certain profit level to shareholders. Indeed, a surrogate for competition must allow the regulated entity to suffer consequences like a competitive entity. To the extent that acts of WNG may result in financial stress to WECO and its shareholders, the Commission should not force ratepayers to bail it out. It is the shareholders, not ratepayers, who are compensated for risk. If the operations, by fault or otherwise, have resulted in problems for WECO, that is part of the risk shareholders assume.[1]

Staff's case is consistent with the role of the Commission as a surrogate for competition. That role, and the numerous warnings the Commission and its Staff have given the Company regarding the consequences of that role, should have forewarned the Company and investors of the general thrust of Staff's case.[2]

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[1] This is not to say that this Commission should allow the Company go broke. That clearly would not be in the best interest of ratepayers. However, the Company has not shown that adoption of the Staff case would result in such dramatic consequences. The cutbacks proposed by Staff are manageable by WNG. Ex. T-155, at 4. To the extent that a reduced revenue requirement in the future may result in unmanageable cutbacks, WNG is free to later file for increased rates and can include a request for interim relief. The Company has made such a request for interim relief in the past, and upon a proper showing would be entitled to it. Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-80-111, at 6 (2d Supp. Order, March 3, 1981) (interim relief granted); Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., Nos. U-80-25, U-80-27 (3d Supp. Order, October 17, 1980) (interim relief denied).

[2] We use the term "should" advisedly. The Company's expert from Wall Street, Mr. Tulis, testified that he studies this Company and has made buy or sell recommendations which have substantially impacted WECO's financial health and the price of its stock. Tr. 3422, 3433. However, he does not closely follow WNG's relationship with the Commission or WNG's filings. He was not aware of the numerous exceptions the Commission has taken to budget items, and he did not read Staff's case in this proceeding, not even the policy testimony of Mr. Elgin. He only looks at "the bottom line." Tr. 3428.

II. STATEMENT OF THE CASE

A. Procedural History.

On July 27, 1992, WNG filed its direct case and accompanying tariffs. The Company requested an annual revenue increase of $41,421,000 or 12.98 percent, of which $28,402,000, or 8.90 percent, was for general rate relief. The balance was for three "trackers" relating to environmental cleanup, safety programs, and a proposal to encourage (through another ratepayer subsidy) the use of compressed natural gas in vehicles. Ex. T-1, at 4. By motions of Staff, Public Counsel, and Intervenors, the Commission dismissed the environmental and compressed natural gas trackers.[3]

Staff, Public Counsel, and the Intervenors filed their respective cases on April 20, 1993, with Staff's case calling for a rate decrease of $22,215,386.[4] In response to Staff's case, WNG filed its rebuttal case on June 8, 1993, which revised its requested increase downward to $14,773,000. Ex. 407, col. (h).

B. Regulatory History of Washington Natural Gas Company.

WNG and WECO do not come to this Commission with a clean slate. There is a history of Staff and Commission involvement which must serve as a backdrop to this case. For years the Companies have been on notice that Staff and the Commission have concerns about their operations.

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[3] The Commission decision dismissing the environmental tracker to date is memorialized in an oral ruling only. Tr. 509. The dismissal of the CNG tracker is embodied in the Third Supplemental Order in this proceeding, reported at 142 P.U.R. 4th 298 (March 12, 1993).

[4] This was amended on May 19, 1993, to recommend a decrease of $24,182,250. The Notice of Hearing advised all parties that existing rates, not just proposed increases, were at issue.

Many of the issues in this case have been considered in prior proceedings. For example, the Commission has disallowed the cost of space devoted to merchandising display, rejecting an argument that the space would have been used anyway;[5] notified the Company that there was a subsidy from the regulated to the unregulated operations;[6] rejected use of end-of-period rate base and attrition adjustments except in very extraordinary periods of inflation;[7] sustained the Staff's recommended use of the Discounted Cash Flow (DCF) method to determine cost of equity capital;[8] rejected use of promotional advertising;[9] upheld a Staff removal of various

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[5] Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-10003, at 7 (2d Supp. Order, Sept. 20, 1971). Indeed, in a related context, dealing with regulated operations providing dollars to unregulated affiliates, the Commission stated over a decade ago:

> This commission will not tolerate Washington Natural as a regulated Company bearing the expense of providing funds to the other subsidiaries of Washington Energy Company. . . . 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.

Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-80-111, 44 P.U.R. 4th 435, 441, (3d Supp. Order, Sept. 24, 1981).

[6] Ex. 185.

[7] Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-78-38, at 5 (2d Supp. Order, Jan. 16, 1979); see also Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-79-15, at 5, 32 P.U.R. 4th 530 (1979); Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., Nos U-80-25, U-80-27, at 6 (4th Supp. Order, Nov. 19, 1980); Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., Nos. U-82-22, U-82-77, at 6 (3d Supp. Order, Dec. 29, 1982); but see Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-80-111, at 5-7, 44 P.U.R. 4th 435 (3d Supp. Order, Sept. 24, 1981), (stating grounds for occasional allowance of end-of-period rate base).

[8] E.g., Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-80-111, at 14, 44 P.U.R. 4th 435, 445 (3d Supp. Order, Sept. 24, 1981). There, the Commission stated: "The Commission in numerous previous cases has accepted the DCF method as an appropriate means of determining fair rate of return on common equity and does so in this case."

[9] In Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-73-26 at 7-8 (2d Supp. Order, Nov. 15, 1973), the Commission disallowed one-half of test period expenses, directing that the remainder be used in a "conservation-oriented advertising program, with particular emphasis on

marketing and "influence" activities, such as tickets to sporting events;[10] questioned the inclusion in rates of dues to the American Gas Association;[11] taken exception to numerous gas main expansions which could later be deemed uneconomic;[12] placed the Company on notice that its rate of return will be set without regard to the financial well-being of its non-regulated affiliates;[13] and rejected the notion that in tough economic times the Company should be accorded some extraordinary favorable rate treatment.[14]

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insulation."

In Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-74-28, at 7 (2d Supp. Order, March 21, 1975), the Commission reiterated:

> We specifically direct the Respondent in its advertising program to refrain from promotional advertising which tends to encourage increased consumption of natural gas. We shall expect the Respondent to follow this directive literally and remove from its advertising program any inducement, whether directly or indirectly, that encourages increased consumption of natural gas. It is not the desire nor the intention of the Commission that Respondent should cease all advertising, but only that promotional advertising shall be directed to conservation and not consumption.

[10] Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., Nos. U-82-22, U-82-37, at 15 (3d Supp. Order, Dec. 29, 1982) (disallowing, among other expenses, $2,845 for miscellaneous sports tickets).

[11] Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., Nos. U-82-22, U-82-37, at 13 (Dec. 29, 1982).

[12] WNG has been placed on notice on every submission of its annual construction budget and every proposal to extend service since U-85-08 that it was at risk to prove the plant would be economic and not cause harm (i.e., increased rates) to existing ratepayers. See Ex. T-155, at 9; Tr. 1361.

[13] In re Washington Natural Gas Co., No. U-77-63, at 8-9 (Order Granting App., November 4, 1977).

[14] See Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-10003, at 5-6 (2d Supp. Order, Sept. 20, 1971) ("[T]he economic facts of life at this most difficult time dictate, and the public interest requires, that each segment of the economy bear its equitable share of the burden created by our current poor condition of the economy.").

The issues in this case, therefore, are not new. WNG cannot claim "shock" at the Staff's case.[15] What is new is the Company's plea for financial assistance from ratepayers who have been bearing the brunt of subsidies to the Company's leasing and merchandising ventures for years. The Commission should disallow continuation of such subsidies, disallow substantial Company operating expenses during the test year, and adopt a reasonable rate of return consistent with the Commission's statutory obligation.

III. REGULATORY FRAMEWORK

This Commission often has described its statutory mission and the constitutional limitations on that mission in past orders.[16] That mission is complicated here somewhat by the structure that WECO has chosen. Unregulated affiliated operations as well as unregulated operations within the regulated utility pose particular problems. The Commission's role is to treat WNG as if it were a stand alone utility. Indeed, the Company concurred in that approach in 1977 when the Commission approved the creation of WECO as a holding Company. In Washington Natural Gas Company, No. U-77-63 (Order Granting App., November 4, 1977), the Commission accepted a representation from the Company that it would not seek a rate of return higher than it would if the reorganization had not taken place. The Commission stated:

> [T]he statement as submitted effectively removes any possibility of WNG-Wa [now the Company and subsidiary to

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[15] WNG's policy witness James Thorpe stated that his "immediate reaction" to the Staff's case was one of shock. Ex. T-316, at 2.

[16] E.g., Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., Nos. U-82-22, U-82-37, at 2-3 (3d Supp. Order, December 29, 1982); see generally POWER v. Utilities & Transportation Comm'n, 104 Wn.2d 798, 711 P.2d 319 (1985).

> WECO] contending in any rate proceeding involving its revenue requirements, a higher rate of return on common stock than would be applicable to a comparable gas utility distributor operating independently of a holding Company and, further, that WNG-Wa will not contend in any rate proceeding involving its revenue requirements, dividend requirements on common stock at any higher amount per share than would be consistent with past practice of WNG-Del [the preexisting stand alone utility].

Id. at 9.

IV. REVENUE REQUIREMENTS[17]

A. Introduction.

The Commission in the exercise of its statutory duties has adhered to historic test year ratemaking with two types of adjustments. "Restating adjustments" are

> those adjustments which adjust the booked operating results for any defects or infirmities which may exist in actual recorded results which can distort test period earnings. Restating actual adjustments are also used to adjust from an as-recorded basis to a basis which is acceptable for rate making. Examples of restating actual adjustments are adjustments to remove prior period amounts, to eliminate below-the-line items which were recorded as operating expenses in error, to adjust from book estimates to actual amounts, and to eliminate or to normalize extraordinary items which have been recorded during the test period.

WAC 480-09-330(2)(b)(i).

"Pro forma adjustments" are

> those adjustments which give effect for the test period to all known and measured changes which are not offset by other factors. The filing shall identify dollar values and underlying reasons for each of the proposed adjustments.

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[17] Attachment A shows the various adjustments and the relative Company and Staff positions. The adjustments on lines 2-17 (net operating income) and lines 52-55 (rate base) are uncontested. In addition, there is no dispute on the means to calculate the debt interest pro forma adjustment (ai), except for the final rate base and weighted cost of debt components to be used. Also, on rebuttal WNG proposed a revision to Staff's affiliated insurance restating adjustment (aw), which staff accepts. Ex. 408, at 4, col. (aa). Staff also accepts the conversion factor shown on Exhibit 330.

Id. (ii).

These are requirements for the utility in its filing. If the utility does not comply with the mandates of these rules (which are nothing more than adoption of standard ratemaking theory), the utility cannot sustain its burden of proof on any adjustment which would result in an increase in rates from test year results.

With these concepts in mind, we turn to a discussion of the issues.

B. Results of Operations.[18]

1. Merchandising and Jobbing Adjustments (f), (ad), (aj-av), (aw-1).

This Commission has consistently placed WNG on notice that there should be no subsidy from the regulated to the unregulated operations, whether they be under WNG or a separate subsidiary of WECO.[19] Indeed, the Legislature has indicated that such a separation is required. RCW 80.04.270 states in part:

> Any public service Company engaging in the sale of merchandise or appliances or equipment shall keep separate accounts, as prescribed by the commission, of its capital employed in such business and of its revenues therefrom and operating expenses therefor. The capital employed in such business shall not constitute a part of the fair value of said Company's property for rate making purposes, nor shall the revenues from or operating expenses of such business constitute a part of the operating revenues and expenses of said Company as a public service Company.

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[18] At the close of the hearing, the Administrative Law Judge directed the parties to organize their briefs to conform with the summary exhibit associated with Staff's case. Ex. 3783. We have done this with three caveats: (1) we separated expense and rate base adjustments; (2) we separated uncontested adjustments; and (3) we consolidated discussion of adjustments on a given topic (e.g., merchandising and jobbing).

[19] Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-10003, at 7 (2d Supp. Order, Sept. 20, 1971); Ex. 185; see also Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., No. U-80-111, 44 P.U.R. 4th 435, 441 (Sept. 24, 1981) (affiliated operations).

In its direct case, WNG allocated expenses and plant to its unregulated operations based on an incremental approach, generally assigning directly identifiable costs to the unregulated operations, while leaving all other costs (including indirect and common costs) in regulated operations. Exs. T-183, at 5, 8-9; T-316, at 8. Though Mr. Thorpe asserted that the unregulated operations had been subsidizing the regulated operations for years, Tr. 2857, 2903, in reality, the subsidy flowed the other way. See Ex. 185.[20]

Because this issue was not adequately addressed in WNG's original case, and consistent with earlier Commission directions and admonitions, Staff undertook, with limited time and budget (due to the magnitude of the other issues in this case), its own cost and space allocation study, allocating operating expenses and plant using the best data and accounting techniques available.[21] The result was the series of merchandising and jobbing and affiliated

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[20] Though any operation performing both regulated and unregulated operations can result in benefits to both, this Commission should be wary of any result that benefits unduly a Company's unregulated operations. That would result in an unlevel playing field in the competitive marketplace. The competitors with WNG's unregulated operations made this abundantly clear in the public hearings. E.g., Tr. 2320-22, 2326-33, 2335-39, 2458, 2470-74, 2501, 2506-10, 2768, 2785-89, 2801, 2817. While Staff believes that both regulated and unregulated operations should benefit from joint operations, because of this competitive concern, the bulk of the benefits should accrue to the ratepayers. See Ex. T-206, at 51-52.

[21] Of course, Staff could not create data specifically for this purpose, nor could it spend hundreds of thousands of dollars conducting interviews with line level employees. See Ex. 203, at 15-18; Tr. 1670-71. However, it did conduct substantial interviews, take measurements, and review responses to hundreds of data requests on the subject. This was not a casual study. See Tr. 1694 (comments by Chairman Nelson in response to direct testimony of James Russell).

adjustments, resulting in a net operating income increase of $3,695,000 and rate base reduction of $12,393,000.[22]

Realizing that such an endeavor should not have to be repeated. Staff recommended that WNG retain an outside consultant to conduct an objective separations study to devise a workable means to perform such allocations on an ongoing basis without resort to ad hoc massive separation studies. Ex. T-183, at 2-3, 16-17; Tr. 1638-41.

The Company apparently conceded the subsidy issue and hired Arthur Anderson to conduct an allocation study.[23] However, that study did not provide an ongoing mechanism to assist in the allocation process and has limited use for this proceeding.[24]

Scenario A of the study allocated test year costs assuming the merchandising operations stayed with WNG. Scenario B allocated test year costs assuming that the merchandising operations were placed in a then fictional subsidiary of WECO.[25] The Company

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[22] The contested expense adjustments are listed in Table A and Ex. 208 as items (ad), (aj), (ak), (al), (am), (ao), (ap), (aq), (ar), (as), (at), (au), (av), and (aw-1).

[23] The study itself cost $350,000 or more and required extensive additional tapping of Company resources. Tr. 2958. The study involved considerable interviews which would have to be repeated if the results are to be reliable and useful in subsequent rate cases.

[24] The Arthur Anderson study was never intended as a working model that could be adjusted. Tr. 2993. Indeed, the study could not be used to ascertain the allocation of specific costs, unlike Staff's study and related adjustments. Tr. 2963-93.

[25] The Board of Directors has made the policy decision (though not all the operational decisions) to spin off the merchandising operations to a new subsidiary. The stated basis for this decision was to reduce, as Commissioner Hemstad put it, Tr. 3028, the "static" which arose out of the controversy over this case. Stating that the public had been "misled," Mr. Thorpe alleged trial in the press. Tr. 2829-31, 2834. We would hope that major management decisions which can impact both ratepayers and shareholders are not based solely on perceived public dissatisfaction with Company past practices. However, we acknowledge that corporate structure generally is a management prerogative, and just like this Commission should not "force" a pure utility to enter unregulated

suggests an adjustment based on Scenario B. Both Scenarios should be rejected; Staff's adjustments should be adopted.

WNG used Scenario B directly to make its adjustments. But neither Scenario A nor Scenario B attempted to recognize the impact of the study results on other issues including the wage and benefit adjustments made elsewhere. Tr. 3059. This failure means that the adjustments made by the Company based on the study results understate the amount of costs which should be allocated to merchandising and affiliates. In contrast, each of Staff's adjustments includes the effect of other adjustments. Exs. 187-199.[26]

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business ventures, it should not prohibit a diversified utility to cleanse itself to a certain degree.

[26] If Scenario A is adopted (other than marketing and advertising) it should be revised to account for the following:

First, because Account 416.34, Parts Work Cost, in the amount of $847,332 was double counted by WNG once in Mr. Corbin's adoption of Mr. Russell's Customer Service adjustment and again in Arthur Anderson's cost allocation study, an adjustment is necessary. This was concurred in by the Company on rebuttal. Tr. 3050.

Second, though Service Contract Costs (Account 416.31) was treated as jobbing (which WNG argues is a utility service) in the Arthur Anderson cost studies, $278,600 in offsetting Service Contract revenue (Account 415.28) was not brought above the line (Arthur Anderson did not look at revenues. Tr. 3001.)

Third, because the pro forma payroll and associated payroll tax adjustment is made at the per book level, any subsequent allocation of wages and associated payroll taxes to M&J or affiliated operations should also reduce the pro forma payroll and payroll tax adjustment. Staff's M&J and affiliated adjustments took this into account by grossing up any allocation of wages below the line for such pro forma wages and payroll taxes. WNG's M&J and affiliated adjustments do not and, therefore, are understated.

After adjusting Scenario A for Parts Work Costs and Service Contract Revenues, Scenario A results in allocation of only $56,000 [-542,000 (Ex. 328, at 1, line 25) + 847,000 (Parts Work Costs) + 279,000 (Service Contract Revenues) - 528,000 (M&J Payroll Tax Adj. Ex. 208 col. aw-1)] more to M&J and Affiliates than Staff's adjustment for the same departments. However, Staff's adjustments are adjusted for pro forma payroll tax, and if Scenario A were adjusted for pro forma payroll taxes, as it should be, Scenario A would result in an even greater amount being allocated to M&J and affiliates.

Further, both Scenarios assume that the jobbing function (diagnostic and repair of appliances) will remain with the regulated utility.[27] Recalling the role of the Commission to act as a surrogate for competition, how could one presume that in the real competitive world a merchandising operation would not also provide diagnostic, repair, and customer service functions? No merchandising operation could survive selling only appliances without service, including checks for appliance safety. Granted, as argued by WNG, safety is an important function for the regulated Company, but that is not the issue. If the expenses of the regulated jobbing operation include over $10.7 million of customer service costs while jobbing related revenues are only $1.6 million, Ex. 324; Ex. C-184 (parts work billed and service contract revenues), the net cost of the customer service function, or $9.1 million, is proposed to be recovered from ratepayers. A substantial part of customer service costs are related to non-safety (jobbing) matters. Ex. T-183, at 31-35; Ex. 191; Ex. 367. If WNG had no merchandising functions and was in competition with other gas utilities, it would not have such dramatic customer service expenses. The non-safety portion of the customer service function should not be borne by the regulated ratepayers. The Arthur Anderson study does not attempt to make a reasonable distinction between customer service costs incurred for safety or

[27] Scenario B assumes the spinning off of only the more profitable merchandising (sales) operation.

non-safety reasons.[28] Nor is there any other evidence describing a reasonable level of safety related repair expenses, based on a utility which does not sell appliances nor make related repairs.

In addition, Scenario B has a number of further defects which warrant its rejection. First, Scenario B is riddled with assumptions about how the M&J operation will be spun off. No witness seemed to know exactly how it was going to be done. Tr. 2858-2863, 2961, 3183-3191, 3239. Adoption of Scenario B would result in ratepayers paying for assumed inefficiencies that were not actually experienced in the test period.

Second, Scenario B allocated no plant to merchandising. WNG argued that in 1993 all plant would be used to house Staff remaining with the regulated operation. Tr. 2854. This is a mixing of test year data with post-test year expectations. If Scenario B really attempts to allocate costs (and plant) based on test year results, then plant assigned to merchandising must be assigned to non-regulated operations. See RCW 80.04.270. If, however, Scenario B is intended to be the basis for a pro forma adjustment reflecting the future, then it must be based on known factors for the future.

Though Staff adheres to its proposed adjustment, we recognize that its cost allocation methodology may not be appropriate for ongoing use by WNG. That is the point of the recommendation for an independent study. However, we note that the total of a Scenario

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[28] The Staff's adjustment would leave jobbing costs above the line also. However, we also recommend that the Commission order WNG to file tariffs stating its level of monopoly, customer service defining precisely the safety related functions it will perform as a utility, and then assign costs appropriately. Ex. T-183, at 35.

A adjustment, except for the marketing and advertising expenses and rate base portion and the revisions to it pointed out above, would be very similar to the adjustment proposed by Staff. See Ex. 328, lines 1-24, 32-41. Therefore, the Arthur Anderson Scenario A confirms the result, though perhaps not the methodology, of the Staff adjustment.[29]

2. Weatherization Pro forma (k).

Staff adheres to its proposed weatherization pro forma adjustment. Ex. T-206, at 12-14. WNG seeks to recover an amortized portion of the $300,000 contribution it made to the Department of Community Development. The contribution was made outside the test year with no order authorizing WNG to set up a deferred account for possible later inclusion in rates. Further, there is no demonstrated benefit to ratepayers. Ex. T-206, at 13. The result is an increase of $40,000 to net operating income.

3. Safety Pro forma (t).

The Company increased test year expense levels for its safety program. Staff rejects the adjustment for the reasons expressed in Section IV.,E.,2 concerning the proposal safety tracker. The expenses are not known and measurable, and are offset by other factors which cannot yet be measured. Ex. T-206, at 16-18.

4. Weatherization Adjustment (z), (aa), (bj).

Both Staff and the Company propose to adjust therm sales for the warmer than normal temperature conditions that occurred during

[29] Should recovery of the cost of the Arthur Anderson study ($350,000) be sought in a future filing, Staff would oppose any allowance for them. They were not required for rate case purposes nor were they part of a Commission ordered study, or even consistent with a Staff recommendation.

the test year. Departing from past Commission practice, the Company computes normal temperatures by forecasting a 15-year moving average through 1998 of annual heating degree days (HDD) based on a purported "trend" in annual HDD. This method results in increasing test year therm sales by 6,748,264 therms.[30] Ex. 45.

Staff recommends that the Commission continue its past practice of using an 18-year moving average based on a 20-year historical period, adjusted to remove the two years with the highest and lowest number of HDD. Ex. T-255, at 15-16. This method results in normal HDD of 4,748.6 and an increase in actual test year therm sales of 11,273,900 therms.[31]

Staff also recommends that the Company take reasonable steps to validate its methodology and data for weather normalization as part of its next filing, rather than leaving other parties an implicit burden to prove otherwise. Ex. T-255, at 2-3. Until then, the Commission should reject the Company's weather normalization procedure. First, that methodology and the underlying data used to relate HDD to therm sales contain technical

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[30] The Company's estimate of the trend in annual HDD used 32 years of data from 1960 through 1991. The average annual HDD for that period was 4,833 and the 15-year moving average through 1991 was 4,721. Ex. 44, at 1. Nonetheless, the Company used its estimated trend to forecast a 15-year moving average through 1998 of 4,658.6 to compute normalized sales in the test year. Ex. 44, at 4.

[31] Staff's normalized sales volumes were then used to determine base rate revenues using the same methodology as the Company in Exhibit 45. Staff's restated summary of present revenues by rate schedule is shown in Exhibit 241. Staff's corresponding gas cost adjustments (Ex. 200) are also calculated using the same methodology as the Company. The Company may argue, however, that Staff's final gas costs include a negative loss and unaccounted factor. However, it is irrelevant what gas cost loss factor is embedded in rates in a general rate proceeding because the actual costs associated with loss and unaccounted for gas will subsequently be trued up through the PGA deferral mechanism. Tr. 1678. Therefore, for purposes of determining the Company's revenue requirement in this case, the Commission should adopt Staff's "Weather Normalization" and "Revenue and Gas Cost Pro Forma" adjustments in total with the understanding that, when the company files tariffs to comply with a Commission order in this case, gas costs will reflect currently approved PGA levels.

deficiencies. Ex. T-255, at 5-10. The Company uses HDD data from a single weather station in its service territory (the Seattle-Tacoma Airport) to estimate a statistical relationship with therm sales throughout its service area. However, the Company has not demonstrated that using a single location is superior to using two or more locations or, if data from a single location is used, that Sea-Tac provides the best physical or statistical relationship. In fact, HDD data from other locations in WNG's service area is not well correlated with Sea-Tac data. Tr. 652-653.

The Company also uses HDD data based on a 65°F reference point even though reliable studies clearly establish that, on average, residential and commercial heating begins at a lower reference temperature. Ex. T-255, at 10-12; Ex. 267. This deficiency causes the Company to reduce substantially the number of data points used to estimate the relationship between HDD and therm sales.[32]

Second, the time period used by the Company to support its estimated trend in annual HDD is unreliable from a statistical viewpoint, and it also is unstable from a regulatory viewpoint. It would require the Commission to frequently revise or change its methodology when the predictive power of historical data becomes less clear. Ex. T-255, at 12-15. Rather than providing a complete

[32] WNG's response to these criticisms, essentially, is that its data and methodology are statistically "good enough." Concerning the location of weather data, WNG argues only that a large portion of sales are within 27 miles of Sea-Tac and that major cities in its service area lie within a single weather division. Ex. T-377, at 12-13. As to reference temperatures, the Company only cites statistics estimated for a single season for a single customer class. Id., at 7-8.

The Company should strive for better. With minimal effort, the Company could gather data from other weather stations and HDD bases and perform limited analysis to validate whether or not its current methodology is superior, as claimed, or subject to modest but nonetheless significant improvement.

battery of statistical analysis for methodology and time periods, WNG rests its case on a single analytic technique for a single time period.[33] Ex. 384, Request 823.

In sum, the Company's evidence does not support such a substantial change in Commission practice and policy regarding weather normalized data. The Company's proposal, therefore, should be emphatically rejected, and the Commission should continue to use normalized HDD based on a moving average of historical data.

5. Leased Plant (ae-1), (ae-2).

In 1961, the Commission authorized tariffs under which WNG leases gas appliances, particularly water heaters and conversion burners. The original purpose of the rental program was to encourage additional use of natural gas. Ex. T-155, at 27. A subsidy to the rental tariffs was established to advance that purpose.

Over the years WNG's investment in rental equipment has soared to over 15 percent, or $60 million, of total plant for the test period. Ex. T-166, at 21. WNG has capitalized not only the appliance plant in rate base but also the costs of installing the appliances in customer premises beyond the meter ("inside pipe").

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[33] The Company's analysis was limited to an ordinary least squares regression methodology for a single, 32-year historical period. The Company did not employ other common statistical techniques to verify the existence or extent of a trend in the annual HDD data. Neither did the Company review the results of its methodology but applied to different time periods. In fact, other historical periods show a statistically significant trend of increasing annual HDD at Sea-Tac using the Company's statistical technique. Ex. 267, Request 181. More startling, by shifting two or three years at either the beginning or end of the 32-year period selected by the Company, the estimated trend reverses from negative to positive or visa versa. Even the results of the Company's analysis for its 32-year trend shows a poor correlation of data. Ex. 384, Request 24.

The subsidy contributed to the rental program is tremendous.[34] Most importantly, the market for gas service, particularly in the residential sector, has experienced spectacular growth with expectations that this pattern will continue for the foreseeable future.[35] Ex. T-166, at 19. The policy reasons for implementing and subsidizing the leasing program, therefore, no longer exist. WNG simply does not need the rental program to encourage the additional use of natural gas. Ex. T-155, at 28.

Staff, therefore, recommends that the rental schedules should be frozen immediately and that rental services, including repair and maintenance, should be transferred to unregulated operations. Staff also recommends that the Company file, within three months of a Commission order, a plan for Commission approval to phase out the rental schedules in five years.[36] At a minimum, the rental rates proposed by WNG would apply during the phase-out period.

Finally, Staff recommends the following accounting methodology to remove the rental program from regulated operations. First, all facilities and installation costs necessary to bring gas from the meter to the appliance remain in rate base, along with the accumulated depreciation and deferred taxes associated with that plant. Second, the net investment of the appliances are removed

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[34] WNG does not deny the existence of this subsidy which is about $10.8 million annually. Tr. 3196, 3263. The Company's own cost of service study indicates a total return for rentals of 0.84 percent, which does not even cover debt service. Ex. T-240, at 51.

[35] WNG added 116,000 customers between 1984 and 1991, with 60 percent of these being added in the last three years. Ex. T-1, at 3. WNG currently meets 99 percent of major energy requirements of new single family homes where gas is available. Ex. T-1, at 21.

[36] The plan should describe available alternatives to current customers (including purchase, removal or continued rental) and to customers requiring financial assistance in purchasing equipment.

from rate base, transferred to a below-the-line account, and amortized over a five-year period while the Company attempts to sell the appliances or otherwise requires customers to make compensatory lease payments.[37] All proceeds from the sale of appliances to existing customers are included in this below-the-line account which ensures that the accumulated depreciation and sales proceeds equal the beginning balance in that account. Third, revenues generated by the rental schedules during the five-year phase out are used to offset ratepayers' responsibility for the return and depreciation expense allowed WNG for the investment remaining in rate base.

The Company's direct case was blind to the problems associated with the rental program. On rebuttal, the Company acknowledges these problems first raised by Staff; however, the Company's proposal maintains the rental program in regulated operations and the subsidy to that program from other schedules.[38]

Staff's recommendation is superior to WNG's. First, Staff's recommendation fairly shares the responsibilities for uneconomic rental equipment between the Company and ratepayers and, indeed, provides WNG the opportunity to be made whole for its investment in rental appliances. The Company is allowed to earn a return on all

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[37] A declining amount of amortization is recommended to induce the Company to remove the plant from its books quickly and to sell the appliances to current customers. Ex. T-166, at 23.

[38] WNG proposes to increase water heater rental rates from $3.05 to $4.00 per month, with additional rate increments in later years. Ex. 343, Request 799(b). All new water heaters will have .6 heat factor or better. Installation cost allowances will be eliminated. Finally, the Company will attempt to deemphasize the rental program, but offered no specific proposal to do so. Ex. T-337, at 17. Given the importance of this issue, a more forceful response is necessary.

facilities and installation costs necessary to bring gas to the appliance and to amortize the investment in the appliances themselves, although without a return on that investment.

Second, the proposed five-year phase out allows sufficient time for WNG to sell existing appliances and to establish an unregulated subsidiary to provide rental equipment and services.[39] WNG suggests that the five-year phase out raises "logistical concerns," Ex. T-337, at 16, but does not produce any evidence to demonstrate that Staff's proposal is onerous and cannot be achieved.[40]

Third, WNG's justification for retaining a regulated leasing program is that the program helps fill in summer season "valley" demand enabling WNG to make more economic gas purchases for its overall requirements. Ex. T-337, at 17-18. In fact, the rental program increases the Company's peak load, which is its most expensive resource acquisition, and WNG's need for additional capacity on the Pipeline and its own distribution system.

WNG also proposes to maintain the tariffed leasing program as a means to provide customers with an alternative to purchasing appliances. Ex. T-337, at 18; Tr. 3214. However, while Staff recommends that the rental <u>tariffs</u> be phased out, rental <u>services</u> will continue to be offered by an unregulated subsidiary.

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[39] Any difficulty the Company may have in selling existing appliances because they are inefficient and, thereby, unmarketable indicates a lack of prudence by WNG when those appliances were originally installed. Such imprudence should not, therefore, be the responsibility of ratepayers.

[40] The Company also claims that a rate over $4.00 would cause "rate shock." Ex. T-337, at 16, although no study was performed to substantiate that belief. Tr. 3212. Further, past experience does not support the argument since the last change in rental rates occurred several years ago and was a <u>decrease</u>. Tr. 3209. Puget Power's rental rate is $6.00. Ex. 340.

Customers will still have the alternative to lease rather than purchase gas appliances. Tr. 3267. In either case, the use of natural gas will continue, along with any of the benefits of consistent load patterns now experienced under the rental schedules. Ex. 343, Request No. 800.

Finally, the Company claims that the leasing program is a significant component of its Demand Side Management Plan because ratepayers are encouraged to install efficient .6 heat factor units rather than to purchase less efficient models. Ex. T-337, at 18. However, there is no reason to suggest that ratepayers would not lease or purchase high efficiency appliances from the unregulated operations. The only difference is that WNG would lose its current ability to support the continued growth of its natural gas business with its rental and appliance marketing activities.[41]

6. AGA Dues (bc).

Staff proposes to disallow 77.83 percent of the dues paid during the test period to the American Gas Association (AGA), as well as an allocated portion of associated administrative costs, because such dues support lobbying and advertising and promotional activities. See Ex. T-206, at 21-24; Ex. 215. In the past this Commission has disallowed dues paid by electric utilities to

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[41] The Company suggested two other proposals concerning its leasing program. Ex. T-337, at 18-19. First, the schedules would be frozen but all associated facilities would remain in rate base and depreciated. This alternative, however, is flawed because it does not eliminate the subsidy to the rental schedules until these facilities are fully depreciated which could take many years. The second alternative is to increase the monthly charge to $4 per month for water heaters and to charge a commodity rate up to an additional $3 per month for the first 25 therms. This alternative, however, raises the same concerns of rate shock that WNG so strongly expressed if rental rates were made fully compensatory.

similar organizations,[42] and has questioned the allowance of dues paid by the Company to the AGA,[43] as has the National Association of Regulatory Utility Commissioners (NARUC). Ex. T-206, at 22.

The Staff adjustment is consistent with its other adjustments to disallow advertising and promotional expenses directly incurred by the Company. The AGA expenses provide even less value (and more remote benefits) to ratepayers than do analogous costs incurred directly by WNG for advertising and promotion.

7. Pension Restating (bd).

WNG made no contribution to its overfunded pension plan in 1991. Nevertheless, it recorded an expense of $630,036. Ex. T-206, at 24. For the reasons stated in testimony, Staff adheres to its proposed pension restating adjustment, Ex. T-206, at 24-28, which would result in an increase of net operating income of $167,498.[44]

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[42] See Washington Utilities & Transportation Comm'n v. Puget Sound Power & Light Co., No. U-81-41, 45 P.U.R. 4th 605, 623 (March 12, 1982) (disallowing membership expense in Edison Electric Institute (EEI)).

[43] See Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co., Nos. U-82-22, U-82-37, at 13 (December 29, 1982) ("not disallowing" dues in case, but directing Company to "provide information in its next case sufficient to permit such allocation [to lobbying activities]" and stating that "[i]f the information is not provided at that time, the total expense may be disallowed").

[44] WNG asserts that shareholders have not benefitted during the last rate case. Ex. T-329, at 26. However, WNG has had access to the funds through rates that were not contributed to the plan. Staff's adjustment simply balances that relationship and does not put ratepayer dollars into the Company which are not needed for the pension plan in the foreseeable future. The ratepayers' cost of capital is different from the Company's, and ratepayers may be harmed if they have to contribute unnecessary funds which will not be income earning assets in the pension plan and thereby reduce pension expense for ratemaking in the future.

8. <u>Incentive Pay Adjustments (bf-bg).</u>

Staff proposes an adjustment for various incentive pay expenses. Ex. T-206, at 29, 37.[45] Essentially, we argue that the program creates incentives based on Company performance and ultimately will benefit the shareholder, not the ratepayer. <u>Id.</u> at 29-31, 33-39. As stated in the Goals Make Sense brochure: "The program is designed to relate your job performance directly to the bottom line." Ex. 88, at 4.[46]

Use of incentive programs can create a ratemaking anomaly in which only shareholders benefit, whether or not the program is successful. If the program is unsuccessful, then the budgeted dollars remain with the Company, benefiting shareholders. Ex. T-206, at 39. On the other hand, if the program is successful, and profits soar, the shareholders, at least between rate cases, benefit. Tr. 3110-12.

A recent decision by the Utah Commission disallowing such expenses under a similar program is relevant:

> Regulators commonly allow recovery of bonus program expenses where they are tied to individual performance, productivity, and customer service criteria. We find, however, that such is not the case here. The program is tied only to shareholder total return. . . . We find that the Division's proposed adjustment should be allowed because the program is solely for the purpose of increasing shareholder wealth. The indirect ratepayer benefit claimed by the Company is little more than words.

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45 Exhibit 111 contains a number of the awards in the stock option program.

46 There is one goal in the Goals Make Cents Program which relates to customer satisfaction (Goal 4). However, that goal need not be achieved in order for awards to be given. Only four of the six goals need be met for incentive costs to be incurred. Ex. T-206, at 32-33. Further, the measurement of customer satisfaction is done by surveys costing $120,000. Ex. C-222, at lines 9-16.

Re US WEST Communications, Inc., 142 P.U.R. 4th 1, 24 (Utah P.S.C., April 15, 1993).[47]

There is no attempted quantification of benefits of the program to ratepayers. Tr. 3100-02, 3109. The identified ratepayer benefits were unquantified cost savings, Tr. 3104-05, and lower turnover rate. Tr. 3104-05. However, WNG's employee turnover rate has not improved under the Goals Make Sense Program. Ex. 335; Tr. 3108.

We commend the conclusion by the Utah Commission: the program is intended to benefit the shareholders; any claimed ratepayer benefit "is little more than words."

9. Advertising (bh).

During the test year, the Company spent $2,075,497 on advertising. Ex. T-206, at 44.[48] Only 11.5 percent of this was charged to unregulated operations. The remainder ($1,836,860) was charged to regulated operations. Id. Staff recommends that this latter amount be disallowed, which, after adjustment for federal income tax, results in a disallowance of $1,191,000. Ex. T-206, at 44-47; Ex. 208, at 6 (bh); Ex. 221. WNG opposes the adjustment arguing that its advertising program plays a key role in the regional effort to educate energy consumers to make "informed

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[47] In that case, the utility had argued much like WNG argues here: the overall compensation package is reasonable, the incentive plan is below average when compared with other companies, and there are ratepayer benefits from enhanced Company performance. The Utah Commission was not persuaded. 142 P.U.R. 4th at 23-24. Other recent decisions disallowing incentive pay expenses include: Re GASCO, Inc., 132 P.U.R. 4th 352, 368 (Hawaii P.U.C., April 3, 1992); Re Illinois Power Co., 131 P.U.R. 4th 1, 63 (Ill. Commerce Comm'n, Feb. 11, 1992); but see Re Wisconsin Gas Co., 138 P.U.R. 4th 294, 298 (Wisc. P.S.C., Oct. 29, 1992) (partial disallowance).

[48] This is the total spent on advertisements. The Arthur Anderson study, Ex. 328, pt. 38, shows $2,158,000 for the test year, based on inclusion of salaries and other costs which were not part of Staff's adjustment.

choices consistent with the public interest when purchasing energy." Ex. T-316, at 4.[49]

The proposed Staff adjustment should be adopted for four reasons. First, the plain language of the current rule on advertising for gas utilities, WAC 480-90-043,[50] prohibits recovery from ratepayers of the contemplated advertising expenses. The thrust of WNG's advertising during the test year was to promote the sale of gas appliances or to encourage the additional services of

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[49] Staff's position is not that WNG may not advertise as it sees fit. The position, consistent with the Commission's advertising rule, is only that ratepayers should not be burdened with such costs. Should WNG decide that it wishes to influence consumer choice by the media, it may do so at shareholder expense. Of course, between rate cases, if that results in additional revenues to the Company (or its affiliated merchandising operation), then the WECO shareholders would benefit.

[50] That rule states:

> (1) No gas utility may recover from any person other than the shareholders (or other owners) of such utility, any direct or indirect expenditure by such utility for promotional or political advertising.
>
> . . . .
>
> (c) The term "promotional advertising" means any advertising for the purpose of encouraging any person to select or use the service or additional service of a utility, or the selection or installation of any appliance or equipment designed to use such utility's service.
>
> (3) As used in this rule the terms "political advertising" and "promotional advertising" do not include:
>
> (a) Advertising which informs customers how they can conserve energy or can reduce peak demand for energy,
>
> . . . .
>
> (e) Advertising which promotes the use of energy efficient appliances, equipment or services, ...

(Emphasis added.) WAC 480-90-043 relates to gas companies. There is a similar rule relating to advertising expenses of electric utilities. WAC 480-100-043.

WNG. Ex. T-206, at 41-42.[51] As such, the Company's advertising clearly is "promotional" within the meaning of the rule.

The Company contends that its advertising falls within the exception of the rule that permits recovery of advertising expenses from ratepayers which promote the use of "energy efficient" appliances. Ex. T-206, at 41.[52] It argues: (1) gas is more efficient than electricity; (2) use of gas appliances will displace the need for electricity; therefore (3) all gas appliances are "efficient" within the meaning of the rule.

WNG's attempted justification falls short because its construction, in effect, reads the words "energy efficient" right out of the rule, allowing any advertising for any gas appliance. In order to give the words "energy efficient" meaning in the context of the rule, they must be construed to mean something more than the minimum efficiency allowed under the state code. Here, the Company's advertising is not for appliances of above average efficiency. They are for appliances which just meet the minimum efficiency standards required by law. E.g., Ex. 279, at 4-6. As such, the advertising is not consistent with the requirements of the rule.

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[51] Exhibit C-220 contains a listing of the test year advertising programs by objective and includes the texts or actual copies of test year advertisements. Exhibits 228-232 are the electronic versions of radio and television advertisements which the Company placed during the test year or were in development during the test year.

[52] While many of the advertisements are limited to encouraging gas appliances, some are even more blatantly inappropriate. The message of "enjoy leisurely showers and spend less money on hot water," Ex. C-220, at 11, carries the message of "use more energy," not just that gas is more efficient. Likewise, the video advertisement showing adults in a hot tub hardly connotes a conservation ethic, which the Company's advertising "expert" suggests the Company is promoting. Ex. 232. Indeed, Mr. Waldo indicated that these visual images are not the ones he would choose. Tr. 2937. They do not "inform customers how they can conserve energy," which is another exception to the rule's prohibition.

Staff's plain language interpretation of WAC 480-90-043 makes sense to Mr. Waldo, an attorney working on energy issues. Ex. T-319, at 8. His disagreement is one of policy. Tr. 2922, 2944. Staff's interpretation is consistent with the administrative history of the rule. The very arguments WNG makes here were made in the adoption process as arguments for modification of the proposed rule.[53] They were rejected then; they should be rejected now.

Staff's interpretation of the Commission's rule also is consistent with interpretations in other states. In Re Northern States Power Co., 73 P.U.R. 4th 395 (Minn. P.U.C., Dec. 30, 1985), the Minnesota Commission disallowed advertising expenses encouraging gas use.[54] Northern States' Power argued that the purpose of its advertising was "to assist and educate customers on the cost-effective energy source that will be in good supply into the next century." 73 P.U.R. 4th at 421. The Minnesota Commission adopted the recommendation of the Administrative Law Judge that the Commission disallow the test year expenses and stated further:

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[53] For example, a witness from Washington Natural Gas Company stated:

> The proposed rule seems to prohibit us from advertising the real reason for conservation, which is the cost benefits and being more comfortable and all those other incentives the customers use.

Ex. 162, at 2.

The letter from Washington Water Power commenting on the proposed rule stated: "Promotional advertising, as defined within the proposed rule (WAC-480-90-043(2)(c)), would encompass the advertising now undertaken by the Company, through the various media, to encourage the selection of natural gas as the primary heating source." Id. Water Power also argued that promotional advertising serves the best interests of ratepayers by lowering the average cost of gas through additional sales. The rule was passed by the Commission despite that claim.

[54] The statute at issue, Minn. Stat. sec. 216B.16(8), while somewhat different than WAC 480-90-043, is similar enough to be on point. Should the Commission desire a copy, we can provide one.

> [T]he commission finds that the obvious effect of the advertising is to promote consumption of the utilities services; i.e., the sale of natural gas. The commission further finds that the intent of the statute is quite clear on its face and prohibits recovering the cost of promotional advertising from ratepayers.

Id.[55]

In sum, the rule controls. As Commissioner Hemstad noted, if there is to be a change, it should be done in a rulemaking proceeding in which all the broad public policy ramifications are considered. Tr. 2944. Mr. Waldo apparently agrees that a generic proceeding may be more appropriate. Ex. T-319, at 8; Tr. 2944.

Second, the Company's stated public policy goals to justify the expenditures are better met through governmental communications programs, not by private utilities outside the normal oversight purview of public agencies. In effect, WNG suggests that it should conduct a public education process. Ex. T-316, at 4; Ex. 319. But is that an appropriate role for a private utility? Public agencies already are spending many dollars sending out the conservation message of the usefulness of natural gas in the overall regional energy effort. Ex. 85, at 12 (BPA budget of $3 million). Mr. Waldo acknowledges that this could be a government role. Tr. 2924.

The result of WNG undertaking this function is to use ratepayers not taxpayers as a revenue source for such public functions. See Tr. 2923-27. While this may seem a clever way of avoiding the legislature (which may find little room in a tight budget for such educational programs), it could set a mischievous

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[55] See also Re Wisconsin Gas Co., 138 P.U.R. 4th 294, 299 (Wisc. Pub. Service Comm'n, October 29, 1992); see generally Re Promotional Practices of Electric Utilities, 8 P.U.R. 4th 268 (Fla Pub. Service Comm'n, January 17, 1975).

precedent under which all sorts of broad public programs could be funded by ratepayers.[56] At the very least, before the Commission accedes to such a precedent, it should await some more formal state policy, not simply Company iterations of a perceived policy. Mr. Waldo admitted that the Washington State Energy Strategy, Ex. 320, is a proposed policy, not a policy itself. Tr. 2918. The Legislature, or possibly the Commission by rule, should adopt a fuel switching policy before delegating implementation of one to the management of WNG.[57]

Third, the type of advertising the Company has chosen is inappropriate. The record is full of text, audio tapes, and video tapes which are inconsistent with the policy espoused by the Company and Mr. Waldo. See Exs. C-220, 228-32.

Finally, the Company has not demonstrated that the advertising would do any good. The price difference between gas and electricity (or gas and home heating oil) is sufficient that the market itself informs consumers. Consumers do not need to see the Company's visual images or read their advertisements to get the message that under appropriate conditions gas costs less. Indeed, where gas is available, WNG already serves 99 percent of new single family home construction. Ex. T-1, at 21. To meet its burden of demonstrating that the expenses are necessary, the Company retained

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[56] Cf. Jewell v. Washington Utilities & Transportation Comm'n, 90 Wn.2d 775, 777, 585 P.2d 1167 (1978) (Commission not authorized to assign costs of charitable contributions to ratepayers).

[57] One of the reasons for this came out on cross-examination of Mr. Waldo. He acknowledged that if such a public education campaign is run by a governmental entity, then it is subject to some oversight. Tr. 2927-28. By simply including the costs of a public education program in rates, there is no oversight except in a rate case, which of course is what we are engaged in here.

an advertising expert, Mr. Green. He testified that among non-gas users only 64 percent believed that gas was the cheapest fuel source. Ex. T-336, at 8. However, that includes a sample of home owners within the service area of the Company, which includes Seattle and Tacoma where electricity historically has been cheap compared with other sources of fuel, as well as rural areas where gas may not be available. Tr. 3148-49. Indeed, even Mr. Waldo recognizes that for him gas may not make economic sense with his wood stove even though the main is within a few blocks of his house. Tr. 2919-20. Mr. Green did not consider that, for some customers, the cost to extend the main to serve them may be prohibitive and would lead a person to believe, appropriately, that gas may not be the most efficient fuel. See Tr. 3149.

In sum, the test year advertising expenses should be disallowed as Staff proposes. They are contrary to the advertising rule, inappropriate policy, and unnecessary. Costs of such promotional advertising should be borne by shareholders. If such advertising does result in added economic load then WNG will benefit with increased revenues and earnings which will accrue to shareholders between rate cases.

10. Marketing (bi).

The Staff also proposes to disallow a substantial portion of WNG's marketing expenses for the test year. Ex. T-206 at 47-52; Ex. 208, at 6; Ex. 223. Total marketing expenses for the test year were $10,542,195. Staff's adjustment would disallow 92.1 percent, or $9,710,217 before related payroll incentive pay adjustments.

The net operating income effect of the Staff's proposal is $6,899,681. Ex. 223.

Many of the same policy reasons that justify the advertising adjustment support this one. There is no reason in the 1990s to market gas when the economics of gas versus electricity virtually compel gas installation in new construction where gas is available or when it is inexpensive to customers and economic for the Company to extend the main to serve them. There has been no showing, nor can there be even an implication, that should home builders be deprived of an opportunity for a hosted weekend in Vancouver, British Columbia, or should dealers be deprived of a hosted vacation in Mazatlan, Ex. 206, at 48, there will be a shift away from gas where gas is available. A contrary result would defy laws of economics.

The types of expenses incurred are simply inappropriate: "breakaways" to sunny vacation spots,[58] suites and season tickets to Seattle Seahawks and Seattle Mariners games,[59] and others. Some of the expenses simply seem bizarre, such as payments to the Seattle Republican Leadership Council and the Ballot Issues Analysis Committee.[60] Ex. C-222, at 3.

The Company claims that Staff has gone too far and would eliminate many legitimate expenses relating to gas service. Ex. T-337, at 5-6. However, we cannot ascertain the legitimate or proper

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[58] Exhibit C-222, at 1, lines 59-61, shows the dramatic costs of just one such trip.

[59] Ex. C-222, at 2, lines 26-28.

[60] Indeed, it may be illegal for ratepayers to bear the burden of some of these. See Jewell v. Washington Utilities & Transportation Comm'n, 90 Wn.2d 775, 585 P.2d 1167 (1978).

portions of the marketing expenditures. Staff's adjustment relied the Company's marketing employees identification of costs for "legitimate utility functions" during the test year, including plant in service additions, maintenance, credit and collection, and customer inquiries and meter reading. Such costs were excluded from Staff's adjustment. Tr. 2999. Mr. Gessel does not present any further quantification or separation, and Ms. Thompson cannot explain which specific marketing expenses remain in regulated gas operations after the adjustment based on her study. Ex. 324. Though the study purports to identify marketing costs relating to merchandising, she was unable to determine whether certain expenses are excluded or not. Tr. 2967-73, 2983-93, 2995. So are the Mariners tickets in or out? Are the builder breakaway events in or out? We do not know; the Company cannot and did not tell us.[61]

Given this failure, the Commission has two choices. First, it can simply adopt the Staff's disallowance. This is consistent with the fundamental proposition that the Company, not the Staff, has the burden of proof to demonstrate that its expenses are legitimate for ratemaking purposes. RCW 80.04.130. Alternately, the Commission could attempt to discern from this record the information which WNG did not provide: those portions of the total marketing budget which arguably relate to legitimate utility functions. However, we cannot suggest an appropriate dollar amount for this alternative, and it is not present in either WNG's direct or rebuttal cases.

[61] Arthur Anderson admitted that it did not attempt to determine whether any marketing or advertising costs were appropriate for ratemaking purposes. Its study simply attempted to allocate costs between businesses. Tr. 2993.

Therefore, Staff continues to adhere to its proposed adjustment. The Company has the option of raising the issue once again in any make whole case and to provide appropriate data.

C. Rate Base.

1. Storage Gas Pro forma (r).

The Company proposes a pro forma working capital adjustment for increased storage gas inventory levels beyond the test year, contending that without an allowance for such additional dollars it would be operating with rates inadequate to cover the Company's needs. Ex. T-406, at 34. Staff opposes the adjustment because the Company did not look at the revenues, expenses, and rate base of the future period. Ex. 424. It, therefore, cannot be determined whether these funds were actually provided by the shareholder, ratepayer, or some other entity. Nor can it be determined whether there are any offsetting benefits.[62] No pro forma adjustment to working capital should, therefore, be made.

2. Environmental (s).

The Company proposes a pro forma working capital adjustment of $6,828,000 for post-test year environmental cleanup costs. Ex. 408, at 3, col. (s); Tr. 2888.[63] Only test year expenditures should be included in the calculation.[64]

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[62] The Company filed a working capital calculation with a post test year period in an attempt to refute Staff's position. Ex. 414. The calculation, however, does not compare revenues, expenses, and rate base for that period. Therefore, it is still not possible to determine the source of the provided funds.

[63] The related issue of inclusion of pre-test year costs in the working capital allowance is discussed in Section IV.,C.,7.,c., infra.

[64] The issue of recovery of such costs originally was focussed on a so-called "environmental tracker" by which the Company sought to obtain total compensation for its ongoing cleanup costs. This aspect of the Company's case was dismissed by Commission decision which allowed the Company to revise its

Though the Company has set forth its actual expenditures,[65] it has not demonstrated that the post-test year expenses are actually the burden the Company will incur. First, this fall, WNG's claims against its insurance carriers go to trial. Tr. 27. The Company has stated that it believes it will recover all such costs, including interest. Tr. 3767; see Ex. 86, at 23. Second, though Exhibit 148 indicates that WNG has spent $9,607,359 through February 1993, it also indicates that WNG can obtain contributions from other parties of up to $4,440,000, though no time period for such reimbursement is set forth. See also Ex. 147, at 10. Finally, it is inappropriate that any of this be recovered, as the risks of such cleanup expenses were built into the Company's rate of return in its 1984 rate case (as well as all previous rate cases). The federal Superfund law was enacted in 1980 and the investigation on the coal gasification site was commenced in 1982. Ex. 147 (Record of Decision, at 7 of 36).[66] Public Counsel argues that shareholders were compensated for the risks of such liability in the past. Ex. T-269, at 24. There is merit to this argument,

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testimony to include an "appropriate" working capital allowance. Tr. 509. Just what is an "appropriate" allowance is the issue presently before the Commission. Public Counsel argues that no such allowance is "appropriate." Ex. T-269, at 5. While there is merit to such an approach in that the Company seeks a return of all those expenses, including interest, from its insurance companies, Tr. 3767, and is optimistic about its prospects of such a return, Ex. 86, at 23; Tr. 3767, Staff has acquiesced in an allowance for test year expenses consistent with normal ratemaking principles regarding working capital. In effect, while theoretically providing for possible double recovery by the Company, it provides some compensation for the carrying costs and associated risks.

[65] Staff has not contested these amounts. This is not to say that in some future proceeding (e.g., a revived environmental tracker) we may attempt to disallow some of these as being unnecessary or imprudent.

[66] Also, if the Company had acted quicker, it could have done the work more cheaply. Tr. 1320-25.

and we would explore it further in any future proceedings. However, we do not believe that this Commission should on this record make a ruling which could be precedential in other cases.

3. Safety (t).

Consistent with Staff's exclusion for the expense portion of the Company's safety adjustment, see Section IV.,B.,3., this adjustment removes the amount proposed by WNG related to rate base.

4. Storage Gas Restating (ab).

This adjustment reduces working capital for the amount of interest deferred on storage gas inventory in the 191 account during the test year in order to eliminate a double recovery of that interest. Ex. T-171, at 4, lines 3-11.[67]

5. Merchandising and Jobbing (ad).[68]

Staff proposes to allocate the office buildings and certain associated costs, as well as general plant based on the usage of such plant and facilities during the test year. Ex. T-171, at 10; Ex. 182, at 49, 51.

The Company under Scenario B made no adjustment for office space or general plant utilized by affiliates or WNG's M&J function. Ex. 408, cols. (f), (bb). The Company claims that during the rate year merchandising will be a separate and distinct subsidiary. Scenario B shows the results of that separation.

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[67] The Company and Staff agree that the total of $444,385, Exhibit T-171, at 4 line 15, is the proper test year amount for working capital purposes. Exhibit T-406, page 33, lines 1-10. The only discrepancy is the amount of average net investment and total operating investment which come from the working capital calculation to calculate the investor supplied portion of the $444,385.

[68] This adjustment also was referenced in Section IV.,B.,1., relating to the M&J adjustment to operating expenses. That is because this adjustment also contains a depreciation expense item.

However, it is not known or measurable how many employees will be moved, what functions they will perform, or even where the future sites will be for this newly formed subsidiary. E.g., Tr. 2855, 2858. Scenario B is totally unrelated to test year operations.[69]

Staff's adjustment (as well as Scenario A) allocates buildings and general plant based on actual usage during the test year. In regard to assigning the building costs to functions or departments, Scenario A is very close to Staff as Ms. Thompson agreed. Tr. 2962-63. The major difference, therefore, is in the allocation percentages applied to each function or department.[70]

Regarding the general plant portion of the adjustment, Staff allocated all general plant using the overall allocated percentage of buildings and land because office furniture and fixtures and other miscellaneous general plant are tied directly to the functions being performed at those locations. Ex. 182, at 51. Though WNG's cost study did review each general plant account to determine an appropriate allocation method, Ex. 324, tab 42, at 2-3, it does not allow the Commission to review and address the individual components of the adjustment as does Staff's Ex. 175. The major account is office furniture and fixtures. Both the Staff and WNG allocated this account based on the overall allocated

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[69] During the test year, even under Scenario A, 14 percent of the buildings were allocated to the merchandising function. Ex. 324, tab 42 (Ex. 2); Tr. 6063.

[70] The major flaw with the Company's cost allocation study is the inflexibility or inability to manipulate the results. The Commission has to either accept the study and its results or not accept the study in its entirety. Tr. 2971-72. The Commission can use Staff's Ex. 174 and adjust column A to percentages from the Company's cost allocation study Scenario A and come up with basically the same results. The Commission has the flexibility needed to apply certain percentages as it deems appropriate for specific contested areas and flow them through Ex. 174. This cannot be done with the Company's cost allocation study.

percentage of buildings. Ex. 175; Ex. 324, tab 42, at 2. Staff's rate base adjustment is greater than WNG's for the remaining general plant accounts excluding office furniture and fixtures by $1,040,000.

6. Leased Plant (ae-1).

This adjustment restates rate base and related expenses for the exclusion of the equipment costs related to the Company's lease program. Ex. 171, at 12-13; see Table A, line 62.[71]

7. Working Capital Allowance (af).

Both the Company and the Staff utilized an investor supplied working capital approach to determine the appropriate working capital allowance. There are three areas of contention.[72]

a. Restating Adjustments.

This adjustment simply reclassifies all rate base adjustments made as non-operating investment. Ex. T-171, at 14, lines 14-21; Ex. T-406, at 26. The difference between the Company and Staff relates to the different rate base adjustments made.

b. Deferred Environmental Clean-up Costs.

The Company seeks to include pre-test year environmental cleanup costs in the working capital allowance.[73] It asserts that since all prior costs are recorded as a receivable they should be

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[71] The corresponding net operating income effect of the adjustment for depreciation expense and current deferred federal income tax is shown in Table A, line 26.

[72] A fourth component is uncontested. As a result of the Commission's order in dockets UG-911236 and UG-911270, the 191 account must be adjusted. Ex. T-406, at 253; Ex. T-171, at 15-16. The Company and Staff agree with this portion of the adjustment as presented by the Company. Ex. T-406, lines 15-24; Exhibit 410, col. (b), line 6).

[73] The Company also proposes inclusion of post-test year costs. This is discussed in Section IV.,C.,2., supra.

left in the working capital allowance as a receivable. Ex. T-406, at 27. Staff removes such costs, leaving in the working capital allowance only those costs incurred in the test year. Ex. T-171, at 14-15. Staff's position is appropriate because (1) it can be presumed that the carrying costs associated with the expenditures were recovered by WNG through current rates; (2) the accounting petition allowing such deferrals stated "only that the receivables since January 1, 1991, could be separately deferred and available for a working capital allowance" (emphasis added), Ex. T-406, at 27; (3) this "receivable" is more like a loan in that the Company fully expects to recover the balance plus interest, Tr. 3767-68; and (4) the Company did in fact record interest within the receivable account itself during the test year. Tr. 3767.

c. Merchandise Inventories

Staff accepts the WNG calculation of appliance inventory of $10,035,454 as identified in Exhibit 417, column (c), line 7.[74]

8. Incentive Pay (bf), (bg).

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[74] This adjustment records as a non-operating investment inventories related to the merchandising and jobbing function of the Company. Ex. 171 at 18, lines 11-14.

The Company in its original filing identified a level of inventory associated with the merchandising and jobbing function. Ex. 7, line 23. Staff included the Company's original amount plus identified additional inventory amounts related to the merchandising and jobbing function. Ex.180, col. (d), line 30). The Company on rebuttal accepted a portion of Staff's adjustment but identified some specific corrections. Ex. T-406, at 28.

Staff relied on the Company's response to Staff Data Request No. 593 (Exhibit 422) in determining the amount of parts type inventory associated with appliances and pipe. The Company on rebuttal was able to identify more specifically the amount of parts type inventory associated with appliances and pipe. Ex. T-406, at 28-29.

If the Commission is to accept Staff's Lease Plant adjustment and freeze the rental tariffs, then the $10,035,454 is the number to insert as merchandising inventory in the working capital calculation. If the Commission rejects Staff's proposal and allows the Company to continue its lease program as operated during the test year then a portion of the inventory should be allocated to the lease program as shown in Ex. 417, col. (c), line 9.

Consistent with Staff's adjustment for the expense portion of incentive pay, see Section IV.,B.,8., supra, this adjustment removes the amount of incentive pay capitalized during the test year. Ex. T-206, at 32, 40. Staff further recommends that WNG be ordered to provide in its next case the amount of incentive pay capitalized in plant in service to date so that it may be eliminated from rate base. It is inappropriate to capitalize incentive pay where the Company has been unable to meet its construction cost control goal. Staff therefore recommends that the Company be ordered not to capitalize incentive pay unless and until that goal is met and then be allowed to capitalize only the portion of the incentive pay associated with meeting that goal.

D. Rate of Return.

The fair rate of return is no more than 9.11 percent. In setting the cost of capital to WNG, the Commission must strive to balance consumers' and investors' interests. The rate of return must provide an adequate return on investors' capital while not unduly burdening ratepayers.[75]

1. The Cost of Equity Is No More Than 10.5 Percent.

Staff, through its expert Dr. Lurito, recommended a 10.5 percent return on equity (ROE) based on applying the discounted cash flow (DCF) method to Washington Energy (WECO) and a comparable

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[75] An adequate return to investors has been described by the Supreme Court as one which approximates the return an investor would receive on investments in ventures of similar risk. FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944); Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923). As far as ratepayer interests are concerned, the Commission should consider the prevailing economic conditions in the Company's service area and the customers' ability to pay increased rates. The Supreme Court has stated that it is a commission's duty to provide for ratepayers "a complete, permanent, and effective bond of protection from excessive rates and charges." Permian Basin Area Rate Cases, 390 U.S. 747, 796 (1968).

risk group of six A rated gas distributors. For each of these seven utilities, Dr. Lurito computed a dividend yield for the 12-months ended 2/28/93; this produced a 6.42 percent dividend yield for WECO and a 5.81 percent yield for the group. Ex. 287, at 9. He also analyzed in detail the investors' dividend growth expectations for each of the seven utilities. Ex. 285, at 17-22. This was 3.50 percent for WECO and 4.29 percent for the group. Hence, the bare cost of equity (COE) for WECO is 9.92 percent, while it is 10.10 percent for the comparable group. Ex. 287, at 9. He concluded that WNG's COE is no more than 10.0 percent. Dr. Lurito then marked-up this 10.0 percent COE by 5 percent to arrive at his recommended 10.5 percent ROE to account for historical financing costs. Ex. T-285, at 29-31.

In making this recommendation, Dr. Lurito noted that: (1) the rate-effective period is assumed to mirror 1992-93 economic conditions; (2) the risks of FERC Order Nos. 636, 636-A,and 636-B are fully reflected in his 10.5 percent ROE; and (3) investors are not expecting approval of a weather normalization adjustment.[76]

WNG, through Mr. Torgerson originally recommended a 13 percent ROE applying both the DCF method and the capital asset pricing model (CAPM), giving equal weight to each. Ex. T-285, at 41. On rebuttal he lowered his ROE recommendation to 12.0 percent-12.25 percent because capital costs had declined. Ex. T-345, at 46. Mr. Torgerson's 11.62 percent CAPM COE result was based on adding a 7.25 percent riskless rate forecast to the product of a .6 beta and

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[76] Dr. Lurito's 10.5 percent ROE recommendation is at the upper-end of Public Counsel's recommendation set forth by Mr. Hill.

a 7.28 percent risk premium. Ex. 346, Sch. 26. The 11.09 percent DCF COE was produced by adding a 5.59 percent dividend yield for a group of nine comparables to a 5.5 percent dividend growth expectation. The average of the two COE estimates is 11.36 percent, which Mr. Torgerson then marked-up by 25 basis points for FERC Order 636 risk,[77] by 0 to 25 basis points depending on if weather normalization is allowed by the Commission and by about 35 basis points for flotation costs. This produced his 12.0%-12.25% ROE recommendation.

Mr. Torgerson's ROE recommendation is overstated.

Regarding his CAPM result, the current yield on 30-year T-bonds is 6.68 percent, not the 7.25 percent Mr. Torgerson used. Tr. 3316. His 7.28 percent risk premium is highly suspect; had he used a 61-year period instead of a 65-year period to compute it, the risk premium would be 6.64 percent. Finally, WECO's beta is only .55, not .6. Ex. 294. These alternative inputs produce a 10.33 percent COE, not 11.62 percent, a 129 basis point reduction.

Regarding his DCF result, Mr. Torgerson improperly assessed future dividend growth to mark up the current yield. Ex. T-285, at 44 and App. The DCF calls for dividend growth, not earnings growth. However, Mr. Torgerson's 5.5 percent dividend growth rate reflects a <u>Value Line</u> <u>earnings</u> per share growth expectation of 7.39 percent when, in fact, <u>Value Line</u> only forecasts a 3.72 percent <u>dividend</u> growth. Ex. 346, Sch. 28. Mr. Torgerson also admitted

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[77] Such a mark up is not based on any studies. Ex. 85, at 26; Tr. 1248. Mr. Tulis made a similar recommendation, quoting a decision of the Hawaii Commission which allowed a COE increase on the basis of risk. However, as he admitted, his quote omitted key language which lessened any impact that decision should have. <u>See</u> Tr. 3404-05.

that his 5.5 percent growth expectation reflects Value Line's projection that gas distributors will earn 13.5 percent on equity in the 1996-1998 period. Such a projection is simply outlandish given the current market situation. Had Mr. Torgerson excluded the Value Line earnings per share growth projection, his average growth rate would only have been 4.80 percent, not 5.5 percent. Id. Hence, by combining a 5.59 percent dividend yield with a 4.80 percent dividend growth rate, a 10.40 percent COE results. In other words, by adjusting Mr. Torgerson's CAPM and DCF results to reflect current financial reality, the resulting COE is not inconsistent with Dr. Lurito's recommendation.

Other facts support rejection of Mr. Torgerson's 12.0 percent to 12.25 percent recommendation. First, in the first quarter of 1985 (the time of WNG's last rate order), the yield on A rated utility bonds was 13.31 percent. Ex. T-285, at 5. Currently, that yield is 7.48 percent, a 583 basis point drop. The Commission allowed WNG to earn 16.25 percent on equity in 1985; to allow it to earn 10.5 percent today as Staff recommends, would imply a 575 basis point fall in the cost of equity, a fall that is in line with the interest rate decline. Second, Dr. Lurito's comparable group earned 11.21 percent on equity in 1992 and had a 1.62 market-to-book ratio. Ex. 287, at 7. This shows that were WNG allowed a 10.5 percent ROE, WECO's market-to-book ratio would remain above 1.0, as Dr. Lurito recommends.[78] Third, Dr. Lurito proved in

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[78] Mr. Torgerson appeared to dismiss the relevance of market-to-book ratio in any COE analysis. Tr. 3374-76. However, this Commission has in the past looked to market-to-book ratio as a relevant benchmark in such analysis. E.g., Washington Utilities and Transportation Comm'n v. Washington Natural Gas Co., No. U-79-15, 32 P.U.R. 4th 530, 538-39 (Sept. 25, 1979); Washington Utilities & Transportation Comm'n v. Pacific Northwest Bell Telephone Co., No. U-77-87, 26

unchallenged testimony that WNG's COE would have to be around 10 percent given its 11 percent earned ROE in order for WECO's market-to-book ratio to be around 1.4, where it has been over the 1989-1992 period. Ex. T-285, at 26. Fourth, the historical record on the ROE allowed by other commissions around the country shows that 10.5 percent is a fair and reasonable ROE.[79]

On rebuttal, Mr. Torgerson indicated that he had two fundamental problems with Dr. Lurito's application of the DCF method: (1) he relied exclusively on it; and (2) he made no adjustment to WNG's COE to reflect its higher risk relative to that of his comparable group. Ex. T-345, at 20.

It is appropriate to adhere to the DCF method.[80] Methods such as CAPM and risk premium have "excluded themselves" because they produce volatile results. Tr. 2602-03.[81] The CAPM and risk premium approaches are suspect because they rely on beta as a measure of risk, a measure under attack in the scholarly literature. Ex. T-285, at 43.[82] If there is no theoretical problem with the DCF, but there is with CAPM or risk premium, how

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P.U.R. 4th 495, 525-26 (Oct. 18, 1978).

[79] Also, it appears that WNG's previously retained expert, Mr. Robert Jackson (who is a "very acute intellect on financial matters, Tr. 158), would recommend a lower COE than Mr. Torgerson. <u>See</u> Ex. 90.

[80] This Commission has long adhered to the DCF method. <u>See, e.g.</u>, <u>Washington Utilities & Transportation Comm'n v. Washington Natural Gas Co.</u>, No. U-80-111, at 14, 44 P.U.R. 4th 35, 445 (3d Supp. Order, Sept. 24, 1981).

[81] Mr. Torgerson agreed that he knew of no scholarly work that claimed that the DCF method is theoretically flawed. Tr. 3320. The Company sought to show that Professor Fama had suggested that markets are not efficient and, therefore, that a premise of the DCF is suspect. This contention is false. Tr. 2594-96.

[82] Even Mr. Torgerson testified that "beta has limitations as a comprehensive measure of risk." Ex. T-345, at 51.

can a better estimate of the COE be obtained by diluting the result from a reliable method with a dubious one?

Also, it is inappropriate to adjust WNG's COE to reflect higher risk. The comparable utilities selected by Dr. Lurito were among those selected by Mr. Torgerson. They were selected because they were of comparable risk to WNG and WECO. Ex. T-285, at 14.

Mr. Torgerson claimed that since WECO's year-end 1992 common equity ratio was 37.6 percent while Dr. Lurito's group's was 46.5 percent, Dr. Lurito should have adjusted upward his 10.0 percent COE finding to reflect that fact. Ex. T-345, at 26-27. Mr. Torgerson admitted that he chose to focus solely on common equity ratio differences rather than focus on the Standard & Poor's guideline in this regard. Tr. 3329. The fact is that Dr. Lurito's group's total equity to total capital ratio at year-end 1992 was 50.3 percent, while he recommended that WNG be regulated based on a 48.5 percent total equity to total capital ratio. Tr. 3327. There was no need for Dr. Lurito to make a COE adjustment for an alleged differential risk.

Mr. Torgerson's other attacks on Dr. Lurito's analysis are also without merit.[83]

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[83] Mr. Torgerson claimed that Dr. Lurito inconsistently applied the DCF because he used a 12-month period to compute the dividend yield in this case, whereas, in the distant past, Dr. Lurito used a 36-month dividend yield. Ex. T-345, at 34-35. There is nothing inconsistent in Dr. Lurito's approach. He testified that "the key here is to find a period that the analyst believes is representative of the future.... If a longer period of time or a shorter period ... would capture what I believe that reality is, then that's what I would use." Tr. 2659.

Mr. Torgerson claimed that Dr. Lurito should have recommended a 13.02 percent ROE for WNG to be consistent with the pre-tax coverage he recommended in the Puget case. Ex. T-345, at 36-41. However, it is inappropriate to tie what ROE a utility should be allowed to earn to some targeted pre-tax interest coverage. Dr. Lurito testified: "[w]hat really is happening is that regulation is abdicating responsibility for what is an appropriate return on equity to some

Mr. Tulis testified that in his opinion were Staff's case accepted by the Commission, WECO would be forced to cut its dividend. Ex. T-349, at 9. However, he admitted that he is not an expert on the cost of equity or on revenue requirement matters. Tr. 3431. Mr. Torgerson, WNG's Chief Financial Officer, never testified that WECO would cut its dividend if Staff's case were accepted.[84] In this regard, the Commission must consider the fact that WNG's non-regulated subsidiaries must pull their own weight as far as dividends are concerned; they are not.[85] The fact is that there is no evidence in the record that Staff's case, if accepted, would cause WNG not to be able to carry its fair share of WECO's dividend burden. Mr. Tulis' opinion about the dividend cut must be taken in context: his employer, Smith Barney, "owns a lot of

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formula which says this is a particular coverage we're trying to target. It would ignore the market because it's in the market that the cost of equity is determined." Tr. 2651.

Recall that Mr. Torgerson believes that investors expect this Commission to grant WNG's request for a weather normalization adjustment and Dr. Lurito does not. Mr. Torgerson admitted that he made no study to support his recommendation that if the Commission rejects the Company's proposed adjustment it should increase the ROE by 25 basis points. Tr. 3300-01. This Commission has not granted such an adjustment to any gas distributor under its regulatory purview and rational investors do not pay in price for an expectation; they pay for reality. Tr. 2579-82.

Mr. Tulis testified that his studies showed that the "market does not seem to be assigning any <u>significant</u> differences in value to companies with and without weather normalization clauses." Ex. T-349, at 21.

[84] He testified that "if Staff's case is accepted, the Board of Directors will look at the dividend policy and then determine what's an appropriate action." Tr. 3366.

[85] Mr. Tulis indicated that oil and gas businesses "rarely pay a dividend or a very low dividend and that WECO's other non-regulated businesses really weren't earning much money up until recently." Tr. 3409. Mr. Torgerson indicated that in 1992 WECO's non-regulated subsidiaries only contributed about 25 to 30 cents to its earnings per share; he admitted that WECO lost over $4 million last year in its coal and bio-waste business. Tr. 3371. He agreed that WECO's non-regulated operations should not be subsidized by WNG's ratepayers. Tr. 3370.

[WECO] stock," Tr. 3426, and that he is here to defend the interests of investors. Tr. 3435.

Finally, the Company contended that if Staff's case were accepted, WECO's common stock price would fall. Ex. T-349, at 9-10. That could well be the case. However, that is exactly what should happen as utility allowed rates of return begin to catch up with the falling cost of equity. This is exactly what A.G. Edwards' analyst reported. Ex. 348, at 6. When market-to-book ratios were well below 1.0 in the late 70's and early 80's, Company witnesses deluged this Commission with testimony about how investors' ownership would be diluted unless this situation were corrected. The Commission did correct the situation and investors in WECO common stock received a 200 percent return on investment between 1984 and today and ratepayers paid the rates that produced this windfall profit. Tr. 3433.[86] Now the situation has reversed itself. Ratepayers are entitled to pay in rates only what investors require, which is a 10.5 percent return on equity; they are not responsible for maintaining WECO's market-to-book ratio at levels that are inconsistent with a 10.5 percent ROE requirement.

2. The Cost of Long-Term Debt, Short-Term Debt and Preferred Stock.

Staff and WNG virtually agree on cost of long-term debt (Staff: 8.76 percent; WNG: 8.72 percent). Both Staff and WNG recommend the use of a 3.75 percent cost of short-term debt.

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[86] The Legislature has suggested that where a Company so earns the Commission may take that into account in setting rates prospectively. RCW 80.04.360; see, e.g., Washington Pub. Serv. Comm'n v. Washington Water Power Co., No. U-9143, 33 P.U.R. 3d 468, 492-94 (April 21, 1960). WNG's claim that it needs capital to finance expansion after years of such earnings justifies a lower, not a higher rate of return, contrary to what the Company suggests.

Regarding preferred stock, Staff recommends 7.98 percent. Originally, WNG proposed a 8.38 percent cost; on rebuttal, this was lowered to 7.66 percent. Ex. T-345, at 45.[87]

3. <u>Staff's Capital Structure Should Be Used to Set Rates.</u>

The difference between Staff's proposed capital structure and WNG's lies in the different short-term debt/common equity ratio recommendations. Dr. Lurito recommends the use of a short-term debt ratio about 325 basis points higher than the Company's and a common equity ratio 400 basis points lower. In support of his 6.0 percent recommended short-term debt ratio, Dr. Lurito testified that WNG had a 9.7 percent average short-term debt ratio at fiscal year-end over the last 5 years. Ex. T-285, at 9. Moreover, the Commission in WNG's last base rate case (Cause No. U-84-60) used a 6.09 percent short-term debt ratio to set rates.

Dr. Lurito's recommended 41.0 percent common equity ratio is well above the 37.8 percent ratio the Commission used in Cause No. U-84-60; it is very close to the 41.6 percent equity ratio WNG had at year-end 1992. Tr. 2634. Finally, Dr. Lurito tested the safety of his recommended capital structure and found it eminently safe. Ex. T-285, at 34-37. His test went unchallenged.

In contrast, Mr. Torgerson recommended that WNG's rates be based on a 2.78 percent short-term debt ratio and a 45.00 percent common equity ratio. Ex. T-345, at 45. Mr. Torgerson justified

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[87] This change was occasioned by the issuance of $50 million of new preferred and the retirement of Series C, F, and I. Dr. Lurito was not aware that WNG planned to retire Series C, F, and I. Had he been so aware, his cost rate would have been comparable to Mr. Torgerson's updated cost rate. While Staff does not propose to reduce its 9.11 percent overall rate of return recommendation, although it is based on a 7.98 percent preferred cost, we note that by using Mr. Torgerson's updated figure, the return on equity allowance would rise from 10.5%-10.56%.

his capital structure solely on the ground that it is within the Standard & Poor's guideline for an A rating.

The issue of capital structure is one of the most important issues in this case. The entire thrust of Mr. Torgerson's rebuttal testimony on this issue has to do with the inadequacy of Dr. Lurito's recommended <u>common</u> equity ratio. Mr. Torgerson testified that:

> Witness Lurito's proposed WNG capital structure ratio is inconsistent with the capital structure ratios maintained and projected to be maintained by Witness Lurito's selected gas distributors. Witness Lurito's proposed capital structure is also inconsistent with the capital structure maintained by companies within the natural gas industry at large, as well as inconsistent with Standard & Poor's (S&P) financial benchmark total debt to total capital criteria for local gas distribution companies (LDC's) whose long-term debt is rated A, and the capital structure WNG is projected to maintain.

Ex. T-345, at 3.

By "capital structure ratios" Mr. Torgerson was focusing on the <u>common</u> equity ratio. Tr. 3329. However, he admitted that the only guideline Standard & Poor's (S&P) sets out related to capital structure is the total debt to total capital ratio. Tr. 3322. With this admission, <u>all</u> of Mr. Torgerson's allegations about the inadequacy of Dr. Lurito's recommendation became moot. First, Mr. Torgerson alleged that Dr. Lurito's capital structure is inconsistent with that maintained by his selected LDC group. However, Mr. Torgerson had to admit that the data on his Exhibit 346, Sch. 1, show that Dr. Lurito's group had a 49.7 percent total debt to total capital ratio at year-end 1992; Dr. Lurito recommended that rates be based on a 51.5 percent total debt to total capital ratio, a ratio just 1.8 percent higher. Mr.

Torgerson alleged that Dr. Lurito's capital structure is inconsistent with what was projected by Value Line to be maintained by his group of gas distributors. However, Mr. Torgerson's Ex. 346, Sch. 2, shows that Value Line projected a 52.1 percent common equity ratio for Dr. Lurito's group for the 1996-1998 period. Value Line projected a 51.0 percent common equity ratio for WECO. These projections are not only far above Dr. Lurito's recommendation but are also far above Mr. Torgerson's. Because Value Line's projections relate to the 1996-98 period, they are meaningless for this case.

As mentioned, Mr. Torgerson alleged that Dr. Lurito's capital structure is inconsistent with that maintained by companies within the natural gas industry. However, Mr. Torgerson's Exhibit 346, Sch. 3, at 5, shows that the average gas distributor with total capital over $200 million had a 53.57 percent total debt to total capital ratio, which is 207 basis points higher than Dr. Lurito's 51.5 percent recommended ratio in this case. Tr. 3347-48.

Finally, Mr. Torgerson alleged that Dr. Lurito's capital structure is inconsistent with the S&P guidelines for an "A" rating.[88] On this basis, Dr. Lurito's recommended 51.5 percent total debt to total capital ratio is within the prior S&P guideline and slightly outside the most recent guideline. This fact however has no significance for causing a potential downgrading of WNG's debt for two reasons: (1) over the 1988-1992 period Dr. Lurito's group of comparable LDC's had a 51.6 percent total debt to total

[88] The April 16, 1990, S&P guideline called for a total debt to total capital ratio of 42%-52% ratio. Tr. 3332-33. The most recent guideline calls for a 42%-50% ratio. Tr. 3330.

capital ratio, which was outside the S&P guideline and yet each Company maintained its A rating by S&P, Tr. 3323-33; and (2) WNG had an average total debt to total capital ratio over the 1988-1992 period of 56.6 percent, which is also outside the S&P guideline did not suffer a downgrade. Tr. 3333. "In light of this, there is no reason to believe that WNG's "A" rating is in any jeopardy." Ex. T-285, at 39. In sum, all of Mr. Torgerson's allegations concerning the inconsistency of Dr. Lurito's recommended capital structure with S&P guidelines are without merit.

Mr. Torgerson alleged that Dr. Lurito's pre-tax interest coverage of 2.82 times falls below the S&P guideline minimum of 3.0. Ex. T-345, at 8. The fact that Dr. Lurito's coverage is slightly below 3.0 has no significance. This is because: (1) the average gas distributor had a 2.95 times coverage in 1992, Ex. 346, Sch. 3, at 5; (2) WECO had only a 2.1 times pre-tax coverage over the 1988-1992 period and maintained its "A" rating Id., Sch. 7, at 1;[89] and (3) Dr. Lurito's group's pre-tax interest coverage during 1988-1992 was only 2.6 times and yet each LDC in his group maintained an A rating from S&P. Id., Sch. 8, at 1.

Regarding the use of short-term debt in the capital structure, Mr. Torgerson sought to justify the use of a 2.12 percent short-term debt ratio, which he changed to 2.78 percent in his rebuttal testimony, by contending that WNG's short-term debt ratio fluctuates over its fiscal year. He indicated that after the summer months WNG has extensive cash needs and that short-term debt

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[89] Indeed, S&P reaffirmed WNG's A rating as recently as October, 1992, Tr. 3358, despite the fact that WECO's coverage has only exceeded 3.0 times once since 1969. Tr. 3359.

is used during the fall and winter to finance capital requirements. He also indicated that during the June time frame, WNG's short-term debt is "at a low." Tr. 1164-5. Exhibit 407, prepared by WNG, shows that this contention is false. WNG's short-term debt ratio for June of 1988, 1989, 1990, 1991, and 1992 averaged 9.64 percent; its short-term debt ratio for September of 1988, 1989, 1990, 1991, and 1992 averaged 9.72 percent, virtually the same. Tr. 1167. The fact is that WNG's use of short-term debt is not cyclical; furthermore, its proposed use of a 2.78 percent short-term debt ratio in this case is well below what this ratio has been over the last five years as was shown earlier. The 6 percent short-term debt ratio Dr. Lurito recommends is far more in line with WNG's historical use of short-term debt to finance rate base and is consistent with the 6.09 percent ratio used by the Commission in WNG's last case. Given the fact that short-term debt costs are currently near historical lows, it is uneconomical to use a 2.78 percent short-term debt ratio to set rates.[90]

The evidence clearly shows that WNG's recommended 12 to 12.25 percent ROE is far above the current and prospective cost of equity; Staff's and the Public Counsel's 10.5 percent ROE reflects the reality that interest rates have reached historically low levels. Ratepayers for many years have been burdened by 16.25

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[90] As Dr. Lurito testified:

> Mr. Torgerson has made no studies to show that his proposed capital structure is safe and economical. Surely if a 9% plus short-term debt ratio was economical enough for WNG to target, as it did, over the last five years when short-term debt costs were far higher than they currently are, then the 2.12% [2.78%] short-term debt ratio now being proposed by WNG is clearly inappropriate.

Ex. T-285, at 47.

percent ROE that is embedded in WNG's current rates, a return that has been and is well beyond what is reasonable. The Commission must not require ratepayers to continue to pay for this excess. Staff's recommended capital structure is safe and economical and will permit WNG to maintain its A bond rating.

E. Other Issues.

1. Attrition Allowance.

The Company proposes a $5.185 million attrition allowance in this proceeding. This single adjustment represents over one-third of the Company's revised revenue increase proposal of $14.8 million.

The Commission's policy has always been to review requests for attrition allowances with extreme care, to approve them sparingly and only under extraordinary circumstances over which the Company has no control such as high inflation.[91] The Commission should continue this policy and reject the proposed attrition allowance because present circumstances are very different than they were seven to eight years ago when attrition adjustments were approved for WNG. (Cause Nos. U-83-27 and U-84-60.)

At the time of the Company's 1983 rate filing, normalized gas sales had been declining since their peak in 1973. In 1984, normalized gas sales were just beginning to increase, although at growth rates much lower than the Company currently experiences. Ex. T-233, at 5. Today, gas sales and customers continue to increase dramatically. The Company is one of the fastest growing

[91] Third Supplemental Order, Cause No. U-84-65, p. 33; Second Supplemental Order, Cause No. U-84-28, p. 20.

gas distribution companies in the nation. Ex. T-3, at 22. Furthermore, the cost of gas has declined substantially, and the Company is expected to slow down its spending in capital facilities. Ex. T-233, at 6.

Inflation was also very high during the early to mid-1980s compared to current levels. With the exception of a single year, the change in the Consumer Price Index (CPI) for 1992 of 3 percent is at its lowest level since 1967. Ex. T-233, at 5. During the four years preceding WNG's last rate order (1980-1983), the change in CPI averaged 8.28 percent. By contrast, during the most recent four years, the change in CPI has averaged only 4.35 percent. Ex. T-269, at 10. The Company's cost of financing new plant facilities has also decreased significantly since its last rate case. Ex. T-269, at 12.

The Company argues that an attrition adjustment is warranted even in times of low inflation because the cost of adding new customers greatly exceeds the embedded facilities cost of existing customers. Ex. T-3, at 22. The Commission must be extremely cautious in recognizing this argument as justification for an attrition allowance in this case. Staff has presented compelling evidence that the Company has aggressively extended service since its last rate case. However, the Company has failed to demonstrate that its extensions to new customers were economic. Ex. T-155, at 3. In fact, absent the dramatic decline in cost of capital, Staff would propose significant adjustments to rate base to recognize the Company's aggressive service expansion.

For purposes of attrition analysis, the significant issue is the <u>relationship</u> of revenues, expenses, and rate base. The Company has significant control over its facilities planning and can administer its current tariffs to ensure that service extensions do not unduly burden existing ratepayers. It is the combination of uncontrollable factors, such as high inflation and declining sales, coupled with reasonable facilities expansion that may cause attrition to occur. None of these conditions, however, exist in this case.

Present economic conditions alone, therefore, justify rejecting the Company's proposed attrition allowance. However, Staff also reviewed the Company's attrition study and recommended certain adjustments to the growth rates WNG used to project revenues, expenses, and rate base for the rate year ending June 30, 1994. Staff's analysis demonstrates that the Company will not suffer a deterioration in rate of return between the adjusted test year and the rate year. In fact, Staff's analysis shows that a <u>negative</u> attrition allowance of about $1 million may be justified. Ex. 399. Nevertheless, Staff still recommends that no attrition allowance, either positive or negative, be adopted in this case.

The Company identified three fundamental differences with Staff's analysis. First, the Company accepted all of Staff's growth rates with the exception of purchased gas expense. Ex. T-406, at 17. However, the Company's 7.943 percent growth rate for purchased gas cost reflects an incorrect Company Used and Unaccounted For Gas percentage of 2.51 because it includes customer owned gas. The normal percentage is .7 percent, Tr. 3699, which is comparable to the figure used by Staff and excludes customer owned gas. Ex. 399. Therefore, Staff's annual growth rate of 6.99 percent for purchased gas expense is correct.[92]

Second, the Company claims that three months should be added to the 30-month attrition period used by Staff. Ex. T-406, at 17-18. This argument, however, does not impact Staff's recommendation to disallow any attrition allowance given the low inflation and increasing sales now experienced by WNG.

Finally, the Company argues that Staff's growth rates should have been applied to its adjusted test year results. Ex. T-406, at 18. The Company is incorrect. Staff's test year results reflect adjustments made to allocate costs to nonutility merchandizing and jobbing activities. Tr. 1896-98. Therefore, to be consistent with the rest of Staff's case, it would have been necessary to restate the historic annual data used to establish Staff's trended growth rates in order to eliminate nonutility expenses which have been improperly allocated to utility functions. This data was either not available or extremely difficult to develop for the past ten years. Therefore, Staff applied its growth rates to the Company's test year results.

For these reasons, the Company's proposed attrition allowance should be rejected. Allowing an attrition allowance in today's economic climate means that attrition must be evaluated in <u>all</u>

[92] Furthermore, increases or decreases in purchased gas costs from the test year are automatically reflected in rates through the Company's Purchased Gas Adjustment (PGA) mechanism. Tr. 3751. Therefore, projected increases in purchased gas costs do not constitute a basis for an attrition allowance.

circumstances. Such a policy is not only bad ratemaking, but it would also unwisely complicate and lengthen regulatory proceedings.

2. Gas Safety Tracker (Schedule 115).

Through Schedule 115, the Company proposes a .717 cents per therm surcharge to recover estimated expenses the Company alleges are required by the Settlement Agreement, Ex. 113, in Docket No. UG-920847[93] and by amendments to the gas safety rules in chapter 480-93 WAC made effective September 9, 1992. These expenses are reflected on Exhibit 360.

The gas safety tracker should be rejected. Instead, Staff recommends recovery in future general rate cases when incremental safety expenses are actually incurred and, along with any offsetting system benefits and efficiencies, can be fully and accurately analyzed in test year results. Ex. T-206, at 18.

First, the proposed safety tracker guarantees recovery of expenses before they are actually incurred. No sunset date is proposed for Schedule 115. Tr. 3577. The safety tracker, therefore, creates and institutionalizes a disincentive for the Company to comply with the Settlement Agreement and safety rules in the most cost effective and prudent manner.[94] Tr. 1403, 1583.

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[93] The Agreement was the result of a complaint against WNG alleging violations of various state and federal laws and regulations concerning gas safety. Tr. 1062-1063. The Company agreed to various undertakings to enhance the safety of its distribution system, including the replacement of all cast iron pipe within 15 years. Ex. 113, ¶ 3.k The Company does not now propose to amend any of the requirements of the Agreement. Tr. 3601. Rate recovery for the vast majority of such expenses was neither assumed nor guaranteed in this proceeding. Ex. 113, ¶ 4; Tr. 3560.

[94] For example, the single most expensive item included in the Company's proposal is about $43 million to replace all cast iron pipe over 15 years. Ex. 360, line 4. However, the Company did not engage in competitive bidding to arrive at any of the estimates upon which Schedule 115 is based. Tr. 3576. Nor is the Company's cast iron replacement design, including the selection of pipe size and material for downtown Seattle, backed up by a load survey. Tr. 580-581.

Second, the amounts included in Exhibit 360 are nothing more than estimates. Tr. 3552, 3554. They do not represent the expenses the Company will actually incur. By definition, therefore, these expenses are neither known nor measurable.

Third, the Company admits that there will be offsetting system benefits associated with the Settlement Agreement and rule amendments.[95] Ex. T-359, at 21; Tr. 3554. However, those benefits are not reflected in Exhibit 360. Tr. 3555. The proposed tracker, therefore, charges ratepayers for expenses the Company will not actually incur, but fails to offset those expenses with other reduced costs the Company acknowledges will occur but cannot yet quantify.

Fourth, none of these flaws are resolved through the Company's proposed annual review. Indeed, the Company could not describe the annual review with specificity, except to state that the purpose is to "true up" the Company's estimates to actual expenses incurred. No examination of the Company's overall cost of service is contemplated. Tr. 3556. Once again, recovery of actual safety expenses is guaranteed, but with no reflection of any offsetting benefits. Indeed, the Company admits that those benefits would be "best measured in subsequent rate cases because the cost of service would incorporate whatever levels of efficiency or reduced

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Approval of the safety tracker only serves to encourage such behavior.

[95] These benefits include, for example, reduced leak repair and survey costs, and reduced expenses associated with bell clamping and monitoring cast iron pipe. Ex. T-206, at 17-18.

maintenance would be experienced."[96] Tr. 3556. The annual review, therefore, requires Commission, Staff, and interested party involvement in a yearly process that fails to capture all ratemaking impacts of the Settlement Agreement and rule amendments.

Fifth, the Company and Staff agree that only "incremental" safety expenses should be recovered through rates.[97] Staff and WNG, however, clearly disagree as to whether a particular expense is incremental. It can only be through an analysis of test year results in a general rate proceeding that the Commission can resolve that controversy. That issue should not, and need not, be decided at this time on the basis solely of estimates of expenses not yet incurred.

Sixth, elsewhere Staff has been critical of the Company's penchant for unfettered and uneconomic expansion. The gas safety tracker triggers this same concern by eliminating the Company's risk for cost recovery and, thereby, allowing WNG to further direct its attention toward growth at any cost.

For these reasons, Staff's recommendation allows WNG to recover all reasonable and prudent incremental safety expenses. Staff's recommendation is consistent with established ratemaking principles and rule concerning pro forma adjustments, and should be adopted.

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[96] The Company's annual review also allows WNG the opportunity to overearn since actual costs associated with the Settlement Agreement and rule amendments are fully recovered, but any offsetting reductions in other costs are not reflected in rates until the next general rate proceeding.

[97] An incremental expense is one which is not already required by preexisting federal or state laws and regulations dealing with gas safety and, thereby, is not already included in the Company's cost of service. Ex. T-166, at 3.

V. COST OF SERVICE/RATE DESIGN

A. Introduction

In Cause No. U-86-100, Ex. 135, and Docket No. UG-901459, Ex. 122, the Commission carefully evaluated cost of service (COS) principles as they apply to the natural gas industry. Several guidelines were established. First, embedded COS studies are important tools for comparing the relative contributions of different customer classes to a Company's overall costs. Second, embedded cost studies should allocate some fixed costs on the basis of throughput. Third, embedded cost studies are only one consideration in determining rate spread and rate design. Finally, any discounting for competitive purposes should be done explicitly.

The COS study presented by Staff conforms to these principles and the accepted Commission methodology, but with certain modifications where appropriate to reflect the Company's distribution system and customer class characteristics.[98] Ex. T-240, at 23-30.

In contrast, the Company's COS study is a radical departure from these accepted principles. Staff recognizes that any Company may present alternative COS methodologies if such proposals are well supported and fully argued. However, the Company's rationale for its alternative does not meet that standard.

B. The Company's Cost of Service Study Should Be Rejected.

1. Summary of Company Methodology.

The Company's COS study is contained in Exhibit 153. It differs from the methodology previously accepted by the Commission

[98] The principal modifications are summarized in Exhibit 248, Request 21.

in three ways. First, it relies heavily upon "special studies" with which the Company claims to have directly assigned about 75 percent of its distribution plant.[99]

Second, the Company allocates a majority of plant and expense accounts, including storage, transmission, and distribution, solely on the basis of demand. Only non-demand related Pipeline and purchased gas costs are allocated on the basis of commodity.[100]

Third, the Company uses a coincident demand methodology to allocate demand related plant and expense costs on the basis of a single peak day. This methodology allocates costs to customer classes in proportion to their contribution to system peak day demand.[101]

2. Competition and FERC Order 636 Do Not Justify Changes to Cost of Service Methodology.

WNG states that its COS methodology is justified due to the unbundling of Pipeline services under FERC Order 636 and the resulting necessity of the Company to respond to competition. Ex. T-55, at 30-36. The Company criticized the Commission cost of service methodology as follows:

> The utilization of annual volume to allocate 50 percent of the plant investment and 90 percent of the supply and pipeline demand charges, and the use of the non-coincident peak to allocate 25 percent

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[99] The Commission has rejected the use of direct assignments as being inconsistent with embedded cost allocations. Ex. 122, at 7. Furthermore, the direct assignments used by WNG are nothing more than another form of allocation based on preconceived assumptions rather than a specific assignment based on identifiable factors. Ex. T-240, at 19-23.

[100] In contrast, combination demand and commodity allocation factors are used in both the Commission accepted methodology and Staff's cost study in this case.

[101] The Commission has rejected proposals to allocate demand costs on the basis of a single peak day because an amount averaging several days for several years avoids wide swings due to unusual weather conditions. Ex. 122, at 8.

> of the plant investment is a completely inappropriate allocation methodology and would cause the Company to experience the loss of sales volumes to transportation service.
>
> The allocation of 90 percent of the supply and pipeline demand charges on the basis of commodity would encourage, if not drive, these customers to make direct purchases of gas rather than utilize the Company's capacity on the pipeline and its right under gas purchase contracts.

Ex. T-240, at 18 (emphasis added).

These factors, however, do not justify abandoning the Commission's COS principles. First, the rate design and cost allocation proposed by the Pipeline to implement Order 636 have not yet been finally approved or implemented. More importantly, any changes resulting from Order 636 affect only costs "upstream" from the Company's city gate. FERC initiatives through Order 636 provide no basis for altering the methodology by which the Company's "downstream" costs are allocated.[102]

Second, in Docket No. UG-901459 the Commission stated that competition, while important, should not determine the methodology employed in a COS study:

> However, just as a cost study should not be the sole determinate of rates, rate goals should not be used to determine what cost methodology is used. Discounting for customers with bypass or other competitive alternatives should be done explicitly rather than by reliance on insupportable theories of cost causation.
>
> Skewing cost study parameters to obtain preconceived results means that the resulting cost of service study no longer provides useful information.

[102] The Company itself recognized that FERC actions do not control how this Commission should decide rate design and cost allocations for the Company's local distribution services. While WNG recommended rolled in pricing before FERC in the Pipeline's recent certificate expansion proceeding, the Company's proposals in this proceeding are based substantially on incremental pricing. Tr. 3613.

Ex. 122, at 4-5. Instead, the Commission stated that special contracts or banded rates are accepted mechanisms to respond to competitive pressures.

3. The Company Did Not Submit a Cost of Service Study Consistent With Its Rebuttal Case.

The Company's rebuttal case reduced the request for rate relief from $41.4 million to $14.8 million. The Company did not, however, revise its COS study to reflect the adjustments the Company made to its initial filing. The Company, therefore, failed to provide the Commission with a cost of service study consistent with the Company's revised revenue requirement.

C. Staff's Cost of Service Study Should Be Adopted.

The rates of return by customer class under Staff's COS study are contained in Exhibit 243, pages 1 and 2. Staff's study generally uses the Commission's methodology for "downstream costs" by allocating some fixed costs on the basis of throughput. Ex. T-240, at 24-26. The Company failed to demonstrate that its fixed costs are strictly related to peak demand.

Staff's study also incorporates the Commission's methodology for "upstream costs" and attempts to recognize the package of gas services that are used by each customer class. Ex. T-240, at 26-28. The Company failed to demonstrate that its upstream capacity is exclusively related to peak day demand. The record is also clear that the Company generally provides firm service to all customers, and curtails customers only in rare and under extreme circumstances. See Section VI.,G., infra.

Staff's study is, therefore, consistent with Commission policy and the operational characteristics of the Company's system. It should be adopted.

VI. RATE SPREAD/RATE DESIGN

A. Introduction

Several basic factors and principles guided Staff's recommendations on rate spread and rate design. First, Staff needed to spread a $24 million revenue reduction, while also providing appropriate price signals to ratepayers within customer classes. Second, Staff was guided by a COS study that incorporates Commission approved principles and methodology. Third, Staff sought to achieve equity and fairness among and between rate schedules. Finally, simplicity and the elimination of redundancy within the tariffs were kept in mind.

In contrast, the Company's proposals violate these guidelines. First, the Company does not achieve equity and fairness. Residential customers receive a percentage increase almost two times the system average, while firm commercial and industrial rates do not change, and large volume sales and transportation classes receive significant decreases. Second, the Company did not submit a COS study incorporating its revised revenue requirement of $14.8 million. The Company's proposed rate spread, therefore, does not reflect the results of any COS study. Third, the Company does not adequately simplify its tariffs. Proposals such as the Weather Normalization Adjustment will only serve to further confound ratepayers.

The details of the Staff and Company rate design and rate spread proposals are addressed below.

B. Residential (Schedules 11, 23, 24 and 55)

The principal residential rate schedules are Schedules 23 and 24. Schedule 23 is open to any residential customer, while Schedule 24 is open only to customers with both gas heat and gas hot water.[103]

There are three issues between Staff and the Company associated with Schedules 23 and 24. First, the Company proposes to retain the separation between these schedules but with the same rates and charges. In contrast, Staff proposes to combine Schedules 23 and 24. Staff's proposal should be adopted because service to these customers is similar, as are the customer facilities and costs necessary to provide the service. Tr. 3670. Staff's proposal also simplifies existing tariffs. Any customer identification concerns, Ex. T-386, at 23, can be addressed in some fashion other than maintaining two schedules for essentially indistinct services.

Second, the Company proposes to implement a winter/summer differential commodity rate in place of the existing declining block rate. In contrast, Staff proposes to incorporate a single block rate that has no winter/summer differential. Staff's proposal should be adopted because it sends appropriate price signals to customers. Furthermore, while the Company alleges that

[103] Staff agrees that Schedule 55 should be eliminated with customers incorporated into a residential schedule in order to more properly reflect the cost of providing that service. Staff also supports the Company's recommendation to freeze rate Schedule 11 because that schedule does not demonstrate an acceptable rate of return.

gas obtained in the winter is more costly, it has not supported this contention with any studies that consider all factors, including storage. No seasonal differential should, therefore, be allowed.

Finally, the Company proposes to increase the commodity rates in Schedules 23 and 24 by 8.7 percent but with no increase in the present customer charge of $4.51 per month. Staff proposes to reduce the customer charge to $2.00 per month to account for most of the system average residential revenue requirement decrease of seven percent. The single block commodity rate would be reduced to obtain any remaining revenue decrease. Staff's proposed $2.00 per month customer charge is consistent with Cascade's and Northwest Natural's Washington gas operations. Tr. 3671.

The Company submitted surveys comparing current customer charge with other utilities. Ex. 380. The Company also attempted to demonstrate that residential customer based costs exceed the Company's current charge of $4.51 per month. Ex. T-377, at 32. However, these customer costs were obtained from the Company's COS study which does not reflect its revised revenue requirement. Had the Company submitted a COS study consistent with its revised revenue requirement, the costs allocated to residential customers may decrease significantly.

More importantly, Staff does not claim that its proposed $2.00 customer charge is purely cost based. The fact is that Staff's COS study indicates that residential customers generate a rate of return above the recommended overall return. The fact also is that the Company's overall revenue requirement should be reduced drastically. It was, therefore, necessary to decrease the residential revenue requirement in some manner. Reducing the customer charge does just that while also maintaining appropriate price signals concerning commodity costs.

Finally, the Company claims that reducing residential rates is contrary to the Commission's least cost planning principles. Staff's recommendations are based on its recommended revenue requirement and incorporate a rate spread proposal that is consistent with approved COS principles. Staff's rate spread proposal, therefore, properly reflects the costs assignable to the residential class. To suggest that residential rates should be maintained at levels unsupported by an appropriate COS study purely to promote the acquisition of more efficient appliances, the weatherization of homes or other DSM programs, is patently absurd.

C. <u>Commercial and Industrial Sales (Schedules 31, 36, 41, 43 and 51)</u>

Staff recommends the following rate adjustments for the commercial and industrial customer classes. First, the present declining rate blocks in Schedules 31 and 36 are replaced with a single rate block that would receive the system average revenue reduction of seven percent. The existing customer charge is unchanged. Second, the current rate design for Schedule 41 should be maintained, but the per therm rates reduced by 10.5 percent, or 150 percent of the system average. Third, the present declining rate blocks in Schedule 43 are replaced with a single rate block which is reduced by one-half the system average, or 3.5 percent. The Company's proposed minimum charge language for Schedule 43 is accepted. Finally, the present declining rate blocks for Schedule

51 are replaced with a single block rate. Schedule 51 revenues are reduced by one-half the system average, or 3.5 percent, which is applied first to the customer charge until a proposed floor of $2.00 per month per unit is reached. Any remaining revenue decrease is then applied to the commodity rate.

The Company proposes to extend the winter/summer differential to Schedules 43 and 51. For the reasons discussed in Section VI.,B. concerning residential schedules, a winter/summer differential for Schedules 43 and 51 should also be rejected.

Staff's recommendations for small commercial and industrial rates simplify existing schedules, while maintaining proper price signals and incorporating Staff's overall revenue requirement decrease. Staff's recommendation to maintain the declining block structure for Schedule 41 recognizes this schedule's customer size distribution and the availability of alternate fuels.

D. Large Volume Sales (Schedules 85, 86 and 87)

Large volume interruptible and firm sales service is currently offered under Schedules 85, 86 and 87. The Company proposes no significant changes to these schedules although the firm use charge is increased to a uniform $1.50 per therm per month, and the commodity charge under Schedules 85 and 87 is decreased. The Company also proposes to move transportation service under Schedules 85 and 87 to the new Schedules 57 and 58. Finally, the Company proposes to replace the minimum bill with minimum purchase amounts.

Staff recognizes the operational benefits the Company receives from its large volume interruptible sales customers. Staff, therefore, recommends that the present declining commodity blocks be retained for interruptible sales service, with the block rates adjusted on an equal percentage basis to obtain Staff's revenue requirement.[104]

Staff recommends, however, that Schedules 85, 86 and 87 should be designated as interruptible only. Firm service under these schedules should be moved to Schedule 41 (High Volume High Load Factor Gas Service) or a separate cost based firm sales schedule to be filed by the Company. Ex. T-240, at 52; Tr. 2015-2016.

Staff's recommendation should be adopted. First, the Commission has consistently expressed a goal of establishing separate cost based rates for a particular level of service. Staff's proposal accomplishes that goal by clearly distinguishing between firm and interruptible volumes, as the Company admitted. Ex. T-386, at 62.

Second, present Schedules 85, 86 and 87 do not include minimum volume requirements for firm service which is more representative of Schedule 41 service. For example, a Schedule 87 customer may, therefore, firm up varying amounts of its sales service throughout the year but with no corresponding benefit to the Company being demonstrated.

Finally, Staff's recommendation will not result in increases to Schedule 85 and 87 customers who must firm up sales under Schedule 41 rates. In fact, Staff recommends an immediate 10.5 percent decrease to Schedule 41 rates, with further decreases

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[104] Schedules 85 and 86 interruptible rates are reduced by the system average of seven percent, while Schedule 87 rates are unchanged.

likely as additional firm volumes and demand are moved to that schedule and incorporated into a cost of service study as a high load factor service.

E. Compressed Natural Gas

The Company currently provides compressed natural gas (CNG) under Schedules 31, 85 and 86 to a limited number of customers. Although these tariffs allow the sale of uncompressed gas for use in vehicles, they do not authorize CNG service. Furthermore, the rates under these schedules do not cover the cost of CNG. Ex. T-240, at 46.

Staff, therefore, recommends that the sale of CNG by WNG should be discontinued 90 days after a Commission Order and that the associated costs should be removed from the cost of service. During that 90-day period, CNG sales should be frozen with existing customers obtaining interim service but only under Schedule 31 which reflects rates closer to cost. After that period, CNG sales can continue but only through an unregulated subsidiary, if the Company so chooses. Staff's recommendation should be adopted. It protects existing customers while ensuring that CNG service is not subsidized by other customer classes.

The Company also filed a proposed Schedule 50, "Fuel for Natural Gas Vehicular Use," with both uncompressed and compressed components. Schedule 50 should be rejected because it does not cover cost. However, Staff does support the development of a separately stated tariff with cost based rates for uncompressed natural gas to be used in vehicles. Tr. 2009-2010, 2021. Staff is perplexed at the Company's total failure to address this issue on rebuttal. The Company has failed to support the development of a highly desirable, high load factor, incremental load. Staff continues to support a cost based tariff for uncompressed service, recognizing that such a tariff can be filed at any time and would provide the Company with incremental revenues to the benefit of both ratepayers and shareholders.

In sum, Staff's recommendations concerning CNG should be adopted. They adequately protect existing customers, bring rates in line with cost, and provide WNG with a new market to sell uncompressed gas for vehicular purposes.

F. Propane Service

The Company provides propane service to a number of customers in areas where natural gas service is unavailable.[105] Propane service is not authorized under the Company's existing tariff. Tr. 3276. Instead, the Company bills these customers as if they were natural gas customers. These billing rates for propane fall far short of even covering the cost of the propane itself and, thereby, result in a significant subsidy from other ratepayers.[106]

For these reasons, Staff recommends that the Company immediately cease propane service and that the associated costs (including service line and meter costs) and revenues be removed from the Company's COS study. Ex. T-240, at 49. Existing propane

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[105] The service line and meter connection are provided by WNG. The propane is supplied by independent dealers who bill the Company directly. At the end of 1991, 132 customers were receiving propane service. A significant number of those customers have received propane from WNG since the early 1970s. Ex. T-240, at 47-48. This is clearly contrary to the stated intent of providing propane only as a precursor to natural gas within one or two years.

[106] Test year revenues to propane customers were about $86,500 while test year propane costs were $254,600. Ex. T-240, at 48.

customers can be adequately served by independent propane companies at compensatory rates. The Company may file a tariff for propane service that covers cost and contains predefined limitations on time period (e.g., one-two years) and service areas (e.g., subdivisions) so that propane is available only where natural gas service is reasonably foreseeable.

The Company does not deny the problems first raised by Staff concerning propane. It proposes to freeze propane service and to conduct a study within 60 days to determine which customers could be economically served with natural gas within six months. All other customers would be moved off the current utility rate. Ex. T-337, at 20-21. However, the Company expects to be made whole for its provision of propane service. Tr. 3226, 3232, 3278. It seeks to recover not only the costs of the service lines and meters, but also all costs associated with terminating propane service. Ex. T-337, at 21.

The Company's proposal should be rejected. Ratepayers should not be held accountable for any costs associated with terminating a service that has not been properly authorized. In contrast, Staff's proposal immediately ends the current subsidy to propane customers for an unauthorized service, but allows WNG to design a tariff that is compensatory and truly aimed at providing propane in advance of natural gas. Staff's proposal should, therefore, be accepted.

G. Transportation Service (Schedules 57 and 58)

The Company proposes separately stated distribution system transportation service under Schedules 57 and 58, which are differentiated by annual minimum volume requirements of 750,000 therms and 240,000 therms, respectively. Staff supports the development of separately stated transportation rates.[107] In fact, the following components of Schedules 57 and 58 are uncontested between Staff and WNG:

1. Basic customer charges of $500 per month (Schedule 57) and $200 per month (Schedule 58);
2. One year minimum contract term of October 1 through September 30;
3. Notice by July 1 to secure distribution system transportation service;
4. Telemetering;
5. Single site aggregation as defined in Rule No. 2 of WNG's tariff;
6. Minimum bill provisions;
7. General deficiency throughput requirements; and
8. Limited balancing provision with penalties based upon either a published spot market index or the Company's commodity WACOG.

Staff also accepts the Company's proposal for alternative fuel requirements provided that the tariff clearly states that balancing is not a standby service.

Three issues remain contested among all parties. First, Staff recommends eliminating the distinction between firm and interruptible service under Schedules 57 and 58 since the Company's distribution system can clearly meet all customer requirements whether or not, as the Company alleges, Ex. T-359, at 7, the system

[107] Many of the costs of providing specific transportation services (e.g., nominating, balancing and standby) were not separately identified by WNG because certain data were unavailable. Instead, Schedules 57 and 58 were developed through the allocation of functionalized costs using traditional COS techniques, and the numbers of current Schedules 85 and 87 customers and volumes expected to take distribution transportation service. Although this methodology does not fully satisfy the Commission's goal of identifying separate costs of each transportation service for each customer class, it is a step in the right direction. Therefore, to fully achieve the Commission's objectives for transportation service, the Company should maintain detailed accounts and subaccounts of cost once Schedules 57 and 58 are operative.

is designed to provide firm service only during peak weather conditions.[108] In fact, distribution system curtailments are extremely rare. Since 1980, only 15 days of curtailment have been experienced due to distribution constraints. Ex. 250. During the "Arctic Express" in February 1989, the Company ordered full curtailment of Schedules 85, 86 and 87 interruptible customers, but 80 percent of those customers continued to receive service and no firm customers were otherwise curtailed. Ex. 370; Tr. 3572. In fact, a large number of Schedule 85, 86 and 87 customers subsequently revised their existing firm contracts to include additional firm amounts or signed initial contracts for firm service. In other words, the vast majority of customers who paid for interruptible service essentially received the equivalent of firm service.[109] The distinction between firm and interruptible service, therefore, is purely discretionary with the customer and is not a function of any limitation in distribution system capacity.

Finally, it is irrelevant if existing customers have an affinity with the present distinction between interruptible and firm service. It is also not surprising that the distinction

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[108] If the Company can identify specific operational benefits by providing interruptible transportation service to a customer, that customer can be accommodated through special contracts.

[109] The Company claims that curtailment is expected to occur regularly during extreme weather conditions. Ex. T-359, at 29-31. However, WNG does not distinguish between sales and transportation service. Nor does the Company distinguish between curtailments caused by supply and pipeline capacity constraints versus distribution capacity constraints. Tr. 3603.

appeals to these customers since they essentially receive higher quality firm service at low interruptible rates.[110]

The second transportation issue concerns Staff's limited balancing provisions which are described in detail in Exhibit T-240, at 57-59. The Company does not contest Staff's proposal but many of the intervenors favor a balancing service that parallels the balancing provisions of Northwest Pipeline. However, any balancing provision need not mirror the cost, penalties, or benefits associated with the Pipeline's balancing provisions. Balancing should be offered because it is a necessary component of transportation service on WNG's system. Balancing allows the Company to maintain operational control over its own system by motivating customers to remain in balance and, thus, minimizing the Company's own cost exposure from the Pipeline. The limited balancing provisions agreed upon by Staff and the Company accomplish all of these purposes. The intervenors' proposal, on the other hand, does not.

The final transportation issue concerns class revenue requirement and ratespread recommendations. The Company proposes to reduce significantly the effective transportation rate from present levels.[111] Staff recommends that the transportation class revenue requirement remain at the present levels indicated by the

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[110] Staff recommends a credit mechanism to indemnify transportation customers during the rare occurrence of a distribution level curtailment. Ex. T-240, at 56-57. Staff is amenable to working with the Company and other parties to refine the details of the credit adjustment.

[111] The Company proposes to reduce the overall transportation service revenue requirement by 17.5 percent, excluding the safety tracker, and 13.8 percent including the safety tracker.

Company for proposed Schedules 57 and 58.[112] Staff's recommendation to maintain present revenue levels is supported by its COS study. Staff's recommendation also recognizes the uncertainties in volumes attributable to the new separately stated transportation service, as well as the higher level of service that these customers will receive under Staff's proposal. In order to collect the same revenue levels, Staff recommends that the present rate blocks and charges be maintained, with the exception of the demand rate which should be adjusted in order to recognize the increase in demand units under Staff's proposal.

H. <u>Weather Normalization Adjustment Clause (Schedule 120)</u>

The Company proposes a weather normalization adjustment (WNA) through Supplemental Schedule 120 that would provide a cents per therm surcharge or credit to reflect deviations from normal monthly heating degree days (HDD). The WNA would apply to customers on Schedules 23, 24, 31, and 36.[113]

Staff recommends against implementation of the WNA for three reasons. First, the Company has not adequately demonstrated that the adjustment is reasonably accurate and technically unbiased. Ex. T-255, at 17-22. The WNA suffers from the same concerns expressed by Staff in Section IV.,B.,4. regarding the HDD data used

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[112] The Company's revenues are based on the margin rate in effect at the time of the Company's filing and have not been adjusted for subsequent PGA filings.

[113] The WNA would be calculated, apparently for each billing cycle, by multiplying three factors: 1) the ratio of the deviation of normal from actual HDD to actual HDD; 2) the ratio of heat sensitive therms to total actual therm sales; and 3) the total price of gas for a rate schedule less the cost of gas. The second ratio would be determined for the class billed during a particular cycle, rather than individual customer, using a "heating response coefficient" estimated for the class as a whole based on monthly HDD and therm sales.

by the Company. There is also a fundamental inconsistency in the Company's methodology for estimating class heating response coefficients.[114] Finally, the WNA fails to account for changes in a class' measured heat sensitivity with time. If the adjustments for warmer and colder temperatures are to balance out, the Company must update, as needed, the heating response coefficient through general or special rate filings. These technical flaws render the results of WNA suspect in terms of both short-term and long-term accuracy.

Second, the Company has not adequately demonstrated that the WNA fairly and efficiently allocates the resulting credit or surcharge among customers in a class, since the heating sensitivity of an individual customer may be substantially higher or lower than the average for the class. Ex. T-255, at 22-25. Nor has the Company evaluated the effect on individual customers' price signals.[115]

Finally, and most importantly, the Company has not adequately demonstrated that the WNA provides financial or economic benefits to ratepayers that offset the administrative costs and ratepayer

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[114] In normalizing therm sales, the Company made separate estimates for the winter and the summer seasons. The Company then used only five to seven months of data to estimate the heating response coefficient applied during the winter season for customer classes to be subject to the WNA. In contrast, for the WNA (to be applied only during the winter season), the Company used all 12 months of test year data. This inconsistency substantially underestimates the heating response coefficient. Ex. 264.

[115] The Company provided a very limited comparison of the WNA based on individual customer estimates of heating sensitivity versus class-wide estimates. Ex. 392. However, this evaluation, based on a sample of only five customers per class, is far too limited to base any conclusions as to the effects and fairness of the WNA on individual customers.

confusion occasioned by the disruption of monthly rate adjustments.[116] While we all realize that there will be, without any doubt, some level of costs incurred by the Company, the Commission and its Staff, and other affected parties in implementing the WNA, the alleged benefits amount to nothing more than Company platitudes. The Company argues that there will be some lowering of capital costs, but it offers no evidence of this result through its own cost of capital witness or the experience of other utilities with a similar clause in place. While the Company also argues that the WNA will reduce the volatility of customer bills, the customer already has the <u>choice</u> to stabilize monthly bills through the monthly budget plan.

Staff, therefore, believes that until the Company can cure the technical deficiencies of the WNA and can demonstrate that there are net benefits to ratepayers, there is no, absolutely no, reason to proceed with the WNA.

VII. <u>OTHER RECOMMENDATIONS</u>

In addition to revenue requirements, cost of service, and rate design issues, Staff has made a number of other recommendations for inclusion in any final order. These include recommendations on performance and incentive pay, see Section IV.,B.,8., <u>supra</u>, the filing of appropriate tariffs relating to customer service aspects of the Company's jobbing function, see Section IV.,B.,1., <u>supra</u>, and revisions regarding WNG's main extension evaluation process.

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[116] In fact, many ratepayers wrote to the Commission expressing their opposition to the WNA for precisely these reasons. Ex. 428.

Ex. T-206, at 64-65.[117] These along with other appropriate directives[118] to the Company should be included in the final order.

VIII. CONCLUSION

The Staff case is consistent with this Commission's statutory and historic mission: to regulate utility operations in a manner that protects the interests of both ratepayers and shareholders. Though the Company on rebuttal pared down its requested dramatic rate increase, it did not go far enough. Consistent with this Commission's past admonitions to the Company, the Staff case should be adopted. The Company must cut its costs, eliminate unwarranted subsidies to unregulated operations, and focus on its primary mission: to operate a utility at the lowest cost to ratepayers while returning reasonable earnings from regulated operations to its investors.

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[117] Staff disagrees. For example, WNG witness Caswell could not address how WNG developed or would implement or with what regularity it would update its threshold rate of return criteria for investment decisions. She also asserted that it is incorrect to include costs of reinforcement or capacity additions in specific project evaluations, stating that the test of the efficiency of such investments is the overall earned rate of return. This is precisely the point, WNG did not include such costs in evaluating projects for contributions from customers and ended up requesting a revenue increase. Staff's recommendations would reduce this potential.

The study undertaken by Staff was onerous and, of necessity, not all encompassing. Staff recommends that WNG be ordered to produce the evidence in any subsequent request for rate relief which demonstrates that its costs of extending service to new customers were and are economically justified. Staff stated its concerns with WNG's 1993 plans to invest in headquarters construction and other office renovation projects in light of its asserted cash flow constraints. Ex. T-206, at 66-70.

[118] Public Counsel has proposed an adjustment for meter reading and billing expense, Ex. T-279, at 9, as well as recommendations for revisions to the bill format. Ex. T-289, at 52; Ex. 295. While we concur that there can be substantial savings which can be achieved from bimonthly meter reading as well as joint meter reading efforts with electric utilities, it may be inappropriate to disallow rates at this time. Instead, we suggest that the Company be put on notice that the Commission will expect in any future rate filing a justification on why the Company has not undertaken such efforts, holding out the possibility for a disallowance in such proceeding. We also concur in Public Counsel's suggestion on billing format.

DATED this 10th day of August, 1993.

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C E R T I F I C A T E

I hereby certify that I have this day served a true copy of the foregoing document upon the parties of record listed below by mailing a copy thereof properly addressed to each such party via first class mail, postage prepaid.

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August 10, 1993.

TABLE A

		Staff	Company	Difference	Ex 208	Ex 408	Footnotes
	NET OPERATING INCOME (000's)						
1	Per Books	41,334	41,334	0	(a)	(b) (Ex 407)	
	Uncontested Adjustments						
2	Jackson Prairie Restating	19	19	0	(g)	(g)	
3	General Taxes Restating	(774)	(774)	0	(h)	(h)	
4	Bad Debts Restating	(42)	(42)	0	(i)	(i)	
5	Purchased Gas Adj. Restating	(124)	(124)	0	(m)	(m)	
6	Workers Comp. Restating	110	110	0	(o)	(o)	
7	WUTC Adj. Restating	(157)	(157)	0	(p)	(p)	
8	FIT Exp per Return as Filed Restating	5	5	0	(w)	(w)	
9	Natural Gas Veh Program Proforma	0	0	0	(x)		
10	Misc Rev	42	42	0	(ah)	(z)	
11	M&J Customer Service Restating	333	333	0	(an)	(dd)	
12	Payroll Increase Proforma	(1,112)	(1,112)	0	(ax)	(e)	
13	Least Cost Planning Dept. Exp Proforma	(124)	(124)	0	(ay)	(j)	
14	Showerhead Program Proforma	(17)	(17)	0	(az)	(l)	
15	Insurance Restating	295	295	0	(ba)	(n)	
16	Additional FIT Exp. per Return as Filed	115	115	0	(bb)	(x)	
17	Salary Investment Plan Restating	151	151	0	(be)	(d)	
18	Total Uncontested	(1,280)	(1,280)	0			
	Contested Adjustments						
19	Merch & Jobbing Restating	0	4,541	(4,541)	(f)	(f)	
20	Affiliated Allocation Restating		399	(399)		(bb)	
21	Weatherization Proforma	0	(40)	40	(k)	(k)	
22	Safety Proforma	0	(743)	743	(t)	(t)	
23	Weather Normalization Restating	1,441	297	1,144	(z)	(b)	
24	Revenue & Gas Cost Proforma	2,226	1,348	878	(aa)	(c)	
25	M&J Plant Restating	378		378	(ad)		
26	Leased Plant Restating Plant Portion	1,661		1,661	(ae-1)		
27	Leased Plant Restating Income Portion	(2,043)		(2,043)	(ae-2)		
28	Debt Interest Proforma	(1,905)	(1,547)	(358)	(ai)	(u)&(v)	
29	M&J Customer Contact Restating	99		99	(aj)		
30	M&J Credit Department Restating	26		26	(ak)		
31	M&J Customer Office Restating	99		99	(al)		
32	M&J Installation Department Restating	131		131	(am)		
33	M&J Purchasing & Stores Restating	61		61	(ao)		
34	M&J Division Administration Restating	707		707	(ap)		
35	M&J & Affil. Office Services Restating	214		214	(aq)		
36	M&J & Affil. Accounting & Financial Restating	166		166	(ar)		
37	M&J & Affil. Information Systems Restating	464		464	(as)		
38	M&J & Affil. Personnel & Training Restating	301		301	(at)		
39	M&J & Affil. Public Affairs Restating	187		187	(au)		
40	M&J & Affil. Executive Department Restating	179		179	(av)		
41	Affiliated Insurance Restating	283	155	128	(aw)	(aa)	
42	M&J Benefits and Payroll Tax Restating	349		349	(aw1)		
43	AGA Dues	179		179	(bc)		
44	Pension Restating	167		167	(bd)		
45	Performance Share Plan Restating	201		201	(bf)		
46	Incentive Pay Restating	895		895	(bg)		
47	Advertising Restated	1,191		1,191	(bh)		
48	Marketing Restated	6,900		6,900	(bi)		
49	Revenues Restated	925		925	(bj)		
50	Total Contested	15,482	4,410	11,072			
	Total Adjusted NOI	55,536	44,464	11,072	(bk)	(d) (Ex 407)	
	RATE BASE (000's)						(1)
51	Per Books	485,157	485,157	0	(a)	(b) (Ex 407)	
	Uncontested Adjustments						
52	Jackson Prairie Restating	(53)	(53)	0	(g)	(g)	
53	Natural Gas Veh Program Proforma	0	0	0	(x)		
54	Remove New Bdg Costs	(187)	(187)	0	(ac)	(y)	
55	Sale of Excess Land	(638)	(638)	0	(ag)	(cc)	
56	Total Uncontested	(878)	(878)	0			
	Contested Adjustments						
57	Storage Gas Proforma	0	1,788	(1,788)	(r)	(r)	
58	Environmental Proforma	0	6,828	(6,828)	(s)	(s)	
59	Safety Proforma	0	4,029	(4,029)	(t)	(t)	
60	Storage Gas Restating	(377)	(418)	41	(ab)	(q)	
61	M&J Plant Restating	(12,393)		(12,393)	(ad)		
62	Leased Plant Restating Plant Portion	(30,488)		(30,488)	(ae-1)		
63	Working Capital Allowance	1,290	7,472	(6,182)	(af)	(b) (Ex 407)	
64	Performance Share Plan Restating	(41)		(41)	(bf)		
65	Incentive Pay Restating	(263)		(263)	(bg)		
66	Total Contested	(42,272)	19,699	(61,971)			
67	Total Adjusted Rate Base	442,007	503,978	(61,971)	(bk)	(d) (Ex 407)	
68	**RATE OF RETURN**	9.11%	9.98%				

Footnotes:

(1) For information purposes, a $1 million adjustment to rate base has a revenue requirement impact of $126,270 calculated as follows:

	$1,000,000	Rate Base Adjustment (Decrease)
X	9.11%	Staff recommended Rate of Return
	91,100	
	(14,280)	Debt Interest Effect ($1M X 4.20% X 34%) (Increase in Taxes reduces Net Income)
	76,820	Amount to Apply Conversion Factor
	0.60837695	Conversion Factor (Exhibit 330)
	$126,270	Revenue Requirement Impact