Date Received: 8-10-93

Docket No.: UG-920840

Company: Washington Natural Gas

<u>Distribution:</u>

Pat Dutton
Mert Lott
Regulatory Affairs
Chairman Nelson
Commissioner Casad
Commissioner Hemstad
Policy Planning
*Ken Elgin
*Kath Thomas
Dixie Linnenbrink
*Jaime Ramirez
*Mike Parvinen
*Jim Russell
*Alan Buckley
*Bob Cedarbaum
*Jeff Goltz
Lisa Anderl

+

Washington Natural Gas
A Washington Energy Company

D. Scott Johnson
Attorney

August 10, 1993

Mr. Paul Curl
Secretary
Washington Utilities and Transportation Commission
1300 S. Evergreen Park Drive SW
P.O. Box 47250
Olympia, WA 98504-7250

Re: Washington Natural Gas Company
Docket No. UG-920840

Dear Mr. Curl:

Enclosed please find an original and nineteen copies of the Company's Brief in the above docket. Please accept the same for filing.

Very truly yours,

DS

D. Scott Johnson

Enclosure

cc w/enc.: Counsel 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

BRIEF OF WASHINGTON NATURAL GAS COMPANY

D. Scott Johnson
Attorney
Washington Natural Gas Company
815 Mercer Street
Seattle, Washington 98111
(206) 622-6767

Marion V. Larson
Harry E. Grant, Jr.
Riddell, Williams, Bullitt & Walkinshaw
1001 Fourth Avenue Plaza
Suite 4400
Seattle, Washington 98154
(206) 624-3600

INDEX

I. INTRODUCTION

In this general rate case, the Washington Utilities and Transportation Commission ("Commission") is required to confront an unprecedented number of issues which have serious financial implications to Washington Natural Gas Company ("the Company"). Issues decided here will affect the Company's ability to provide proper and necessary services to its ratepayers. As further testified by Jim Waldo, Chairman of the Washington Energy Strategy Committee, the Commission's decision will determine the Company's capability to meet energy demands recognized by planners in the state who expect the Company to absorb future growth in the Everett-Seattle-Olympia service territory, and to assist in facing the known challenges confronting the electric industry in Washington. Hearing Transcript ("TR") p. 2918, ln. 24-p. 2919, ln. 11. See also , Hearing Exhibit ("EX") 320. Indeed, advancing the efficiency and availability of natural gas to residents of the State of Washington is by legislative declaration a desired policy of this State. RCW 80.28.074 (2).

The critical questions facing the Commission are:

- Should the Company lose its "A-" rating for its debt securities, thereby having to pay higher interest rates or face being unable to issue debt securities in tight credit periods, both being detrimental to ratepayers;
- Should the Company issue common stock through its parent, Washington Energy Company, in the \$15-\$16 range vs. the \$25-\$26 range prevailing prior to filing of Staffs' case, again to the detriment of ratepayers;
- Should the Company curtail its traditional utility services to its customers;
- Should the Company dismantle its incentive compensation programs for its employees that improve the operations of the Company;
- Should the Company abandon approximately 100,000 customers who are currently leasing appliances from the Company;
- Should the Company be denied ratepayer assistance in making its gas distribution system even safer than it is today;
- Should the Company be denied ratepayer assistance in cleaning up former manufactured gas plants, in compliance with current environmental statutes;
- Should the Company be left unable to inform current and future customers of the benefits of natural gas and efficient gas appliances that enable them to conserve energy;
- Should the Company be denied an attrition allowance, which if granted, would offset the negative effects of regulatory lag caused by inflation, increased costs and increased rate base, thereby giving the Company a reasonable opportunity to earn a fair rate of return;
- Should the Company be able to meet the expectations of the energy planners of the state who have recognized the significant role natural gas must play in the future?

While Staff has raised some pertinent criticisms, Staff's case has been marked by many other misplaced claims often laced with unnecessary vitriolic rhetoric. That approach has distracted the parties and diverted attention from the important energy and regulatory issues before this Commission. One example of this approach is Staff's attack on the Company's conservation-oriented advertising, without any study by a witness possessing expertise in the field of advertising or gas appliance efficiency. TR 1349, ln. 10—1350, ln. 7. Staff compounded this unsupportable approach by announcing that utility marketing was governed by the Commission's advertising regulation and on the basis of that wholly unfounded assertion, recommending exclusion of the Company's marketing expenditures. TR 1355, ln. 16-1356, ln. 4; EX 225, p. 150, ln. 14-21.

Staff took a similar tack in urging this Commission to deny the Company's operating expense adjustment for all of its variable or incentive compensation payments, without adequate legal support or technical analysis for such a recommendation. See Section II.7. Staff's recommendation was offered with no study; with no analysis by a witness with expertise in the field; EX 225, p. 164, ln. 12-p. 165, ln. 3; and, indeed, with no Staff testimony as to at least two of the incentive compensation programs that Staff sought to adjust.

The Company responded in its rebuttal case to the criticisms of Staff and the other parties. The Company also adjusted its rebuttal case to reflect the most current information from the capital markets. As a result of these adjustments, the Company's request for rate relief was reduced from approximately $34 million to approximately $14 million. The Commission should not penalize the Company for being a reasonable, fair-minded participant in the regulatory process. The Company has already reduced its original request for rate relief by $20 million; the Commission has deferred or dismissed $7 million more. What remains in the Company's rebuttal case is a request for $14 million in rate relief that is imperative for the Company's continued operational health. EX T-316, p. 16, ln. 22-p. 17, ln. 11. Further, as a matter of regulatory practice, the Commission should recognize the forthright, reasonable approach taken by the Company in presenting a responsive (rather than defensive) rebuttal case. The Company's need for rate relief, in the amount set forth in the Company's rebuttal case has been subject to scrutiny and review. Granting relief in accordance with the Company's rebuttal case will protect the interests of ratepayers and also ensure compliance with binding legal standards, discussed below.

The Commission's order should include relief as follows:

(1) Fair Rate of Return: In order to allow the Company to finance future growth on reasonable terms, the Commission must grant a fair rate of return which will enable the Company to maintain its "A-" long-term debt rating. This requires adoption of a fair rate of return utilizing a 12.00% to 12.25% return on common equity and allocating a 45% portion of the capital structure to common equity. Foremost, from a practical standpoint, the Company's long-term debt rating of "A-" must be protected to "assure confidence in the financial soundness of the utility," as provided in Bluefield, infra. Of course, ratepayer interests would suffer if the Company's credit rating were to fail. TR 3436—3438.

(2) Attrition Allowance: The Commission should grant an attrition allowance of $5,185,000, as revised in EX 407, 411 and 412. If Staff's attrition calculations are adjusted for three fundamental errors, the Staff-indicated attrition allowance would be $6,334,000 or approximately $1,150,000 greater than what the Company has requested.

(3) Marketing and Customer Service: The Company must be allowed the funds to perform necessary and proper utility marketing, much of which is actually customer service, required to fulfill its utility obligations to existing and prospective customers. Staff's recommended reductions to the Company's marketing program will create a profound disservice to customers who are served and protected by these "marketing" functions which often are safety, educational, service, planning, and information-disseminating activities of the Company. Staff proposes disallowance of $6,900,000 at the net operating level for the Company's marketing expenses. The Commission should reject Staff's recommendation.

(4) Advertising: The Company has engaged in conservation-related advertising, being mindful in developing its advertising of the Commission regulation at WAC 480-90-043. Staff has announced in this rate case two new "tests" to be applied in interpreting WAC 480-90-043. The Company should not have these interpretations applied after it has incurred advertising expenses that effectively informed customers of energy conservation opportunities. Further, Staff's strident criticism of the Company's advertising, by a witness with no genuine advertising experience or expertise, (see TR 1346, ln. 24—1347, ln. 7; EX 225, p. 12, ln. 23-p. 13, ln. 11) should be rejected. The Commission should reject Staff's proposed disallowance of $1,191,000 at the net operating income level for the Company's advertising expenses.

(5) Proforma Adjustments to Allowance for Working Capital: Significant expenditures incurred by the Company for purchases of storage gas as part of its Least Cost Plan and for environmental remediation expenses should be granted as an adjustment to Allowance for Working Capital. The Company's request is based on undisputed cost data in the record (EX 146,148; EX 410, 414-417) and, further, has been significantly reduced in the Company rebuttal case to meet Staff's concern that amounts be "known and measurable." Staff's allegation that these costs are being funded by ratepayers from other sources is unfounded.

(6) Safety Program: Primarily because of the Settlement and Operating Agreement entered into in good faith with Staff and approved by the Commission, and in part because of changes in safety regulations, the Company has proposed proforma adjustments of $743,000 at the net operating income level and an increase to rate base of $4,029,000 for safety expenditures. In its direct case these requests by the Company were $2,783,000 and $8,104,000 respectively. Staff persists in contending that the amount now requested cannot be recovered in rates because it is based on the Company's reasonable estimates; Staff's argument must be rejected by the Commission. See W.U.T.C. v. Washington Natural Gas Co., 23 P.U.R. 4th 184, 194 (1977).

(7) Lease Program: Staff's proposal to remove the Company's leasing program from its regulated activities on a basis which the Company has demonstrated would not make it whole should be rejected. This program has been in place and accepted by the Commission since the 1960's. In addition, the Company has responded in rebuttal to Staff's concerns with respect to the leasing program by offering fair and reasonable alternatives.

(8) Incentive Compensation: Staff's proposal to disallow all incentive compensation actually paid by the Company in the test year should be rejected. Company Witnesses Mark Gordon and James Gustafson clearly establish the appropriateness of incentive compensation in a utility and have demonstrated the benefits such plans have for ratepayers. Staff concedes these programs benefit ratepayers. The paucity of Staff analysis on this subject suggests there is no basis for disallowing these legitimate compensation expenses. Indeed, the Commission has previously approved payments made by the Company to employees for meritorious work. W.U.T.C. v. Washington Natural Gas Co., 32 P.U.R., 4th 530, 544 (1979).

(9) Weather Normalization: The Company has proposed a weather normalization adjustment to mitigate the financial hardships brought about by significant weather swings, and to smooth out ratepayer bills. The Company's proposal is fair and reasonable and should be approved by the Commission.

A. Legal Standards

In determining a fair rate of return for a utility, the Commission is governed by the guidelines set forth in Bluefield Waterworks and Improvement Co. v. Pub. Serv. Comm'n, 262 U.S. 679, P.U.R. 1923D 11 (1923) and Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 51 P.U.R NS 193 (1944). These decisions form the foundation for the principles articulated by the Washington Supreme Court in People's Organization for Washington Energy Resources (P.O.W.E.R.) v. Utilities & Transp. Comm'n, 104 Wn.2d 798, 711 P.2d 319 (1985). P.O.W.E.R. is the controlling authority in this state regarding utility ratemaking.

In P.O.W.E.R., the Washington Supreme Court cited Bluefield as follows:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties. . . . The return should be reasonable, sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties.

P.O.W.E.R., 104 Wn. 2d at 813 (quoting Bluefield, 262 U.S. 679) (emphasis in P.O.W.E.R.). In this case, "confidence in the financial soundness of the utility" is a matter of paramount concern, as evidenced by the general agreement of all witnesses addressing the subject, that WNG should be left in a position to preserve its "A-" long-term debt rating. TR 2560, ln. 7-13; TR 2666, ln. 13-2667, ln. 8.

P.O.W.E.R. adopted language from Hope to the effect that rates should "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed . . ." P.O.W.E.R., 104 Wn. 2d at 81. Hope also held that the regulated company should be placed in a position to provide a return to shareholders that is "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." 320 U.S. 591, 603, 88 L. Ed. at 345.[1]

B. Burden of Proof

The burden of proving that a proposed increase is just and reasonable is upon the Company. Washington Util. & Transp. Comm'n v. Washington Nat. Gas Co., 32 P.U.R. 4th 530, 533 (W.U.T.C. 1979). It is well-settled, however, that the burden of proving the appropriateness of departing from presently effective rates or policies rests upon the party attacking those rates or policies. Id. (citing State ex rel. Model Water & Light Co. v. Department of Public Serv., 199 Wn. 24, 35, 90 P.2d 243 (1939)). Staff has proposed a reduction in rates and, therefore, bears the burden of proving by a preponderance of the evidence that the downward adjustments and changes in existing policy that it has proposed are reasonable. In proposing the reductions, Staff must affirmatively prove that its recommended adjustments are reasonable with respect to future, as well as current, ratepayers. This is because the Commission's mandate in rate-making is to provide the broadest benefit for all ratepayers, balancing immediate benefit with long-term benefit. Washington Util. & Transp. Comm'n v. Pacific Northwest Bell Tel. Co., 138 P.U.R. 4th 580 (W.U.T.C. 1992).

C. Pro forma Adjustments

The Company will face a financial crisis if its rates are reduced, as proposed by Staff. In order to save the Company's "A-" long-term debt rating, it is imperative that the Company be allowed the pro forma adjustments it has requested and to which it is entitled. EX T-345; EX T-349.

"Pro forma adjustments are defined as those adjustments which give effect for the test period to all known and measured changes which are not offset by other factors." WAC 480-09-330 (2) (b) (ii). Pro forma adjustments take into account known and measurable post-test-year changes in revenues and expenses. Washington Util. & Transp. Comm'n v. Pac. Northwest Bell Tel. Co., 39 P.U.R. 4th 126 (W.U.T.C.

[1]The Commission has applied these standards as the fundamental requirements of rate-making. See, e.g., Wash. Util. & Transp. Comm'n v. Pacific Power & Light Co., 68 P.U.R. 4th 396, 407-08 (W.U.T.C. 1985) (citing Federal Power Comm'n v. Hope Nat. Gas, 320 U.S. 591 (1944)).

1980). Pro forma adjustments should give effect to all "known and measurable" factors that will affect the Company's financial operation in the period rates are in force. See Wash. Util. & Transp. Comm'n v. Washington Natural Gas Co., 23 P.U.R. 4th 184, 189 (W.U.T.C. 1979).

In order for a factor to be allowed as a pro forma adjustment, the dollar amount must be subject to reasonable projection, but need not be established with absolute precision. W.U.T.C. v. Washington Nat. Gas Co., 23 P.U.R. 4th 184, 194 (1977). Where the projection is made by persons with special expertise, the credibility of the projection is strengthened. Id. In the case cited above, the Commission held as follows:

> The commission recognizes the concern of the staff that the company's treatment of this adjustment is based upon a projection and not actual experience. However, the commission recognizes that not all things in a rate case hearing are provable with absolute certainty or are precisely measurable. For example, the rate of return necessarily includes a judgment factor. The company's engineering staff has vast and extensive experience in dealing with maintenance and as a professional staff we recognize it has developed a degree of expertise which goes into its judgment. We must and do recognize that a judgment or projection made by people having special expertise has credibility, if the projection is supported by believable testimony and experience.

Id. (emphasis supplied). The Company's proposed pro forma adjustments are based on projections made by Company personnel and witnesses with expertise and credibility. The Company's pro forma adjustments are supported by ample evidence, as discussed below, and should be allowed. Id.

II. NET OPERATING INCOME ADJUSTMENTS

1. Advertising Restating Adjustment-EX 208(bh)

Staff has recommended a disallowance of $1,191,000 for the Company's advertising expense. The Company strongly believes that this expense was proper and should be allowed by the Commission.

The Staff's argument is premised on the Commission's advertising regulation, WAC 480-90-043. The regulation allows gas utilities to recover expenditures for advertising that "informs consumers how they can conserve energy or can reduce peak demand for energy" or "promotes the use of energy efficient appliances, equipment or services." See WAC 480-90-043(1) and (3)(a) and (e).[2] The phrases "conserve energy," "reduce peak demand for energy" and "use of energy efficient appliances" are not defined in the regulation. The Company has sought at all times to comply with WAC 480-90-043 in advertising appliances that conserve energy. Consistent with the need expressed in Washington's Energy Strategy

[2]The Commission has held that costs of nonpolitical, nonpromotional advertising are within a utility's cost of service. See Washington Util. and Trans. Comm'n v. Puget Sound Power & Light Co., 74 P.U.R. 4th 536, 679 (W.U.T.C. 1986).

Report (EX 320) for better consumer information through utility advertising, the Company now urges the Commission to refrain from applying Staff's unnecessarily restrictive interpretation of the advertising regulation in this case. EX T-319, p. 6, ln. 20-24.

Under the terms of WAC 480-90-043, the Company is entitled to recover costs of advertising that informs customers how they can either conserve energy or use energy-efficient appliances. Staff argues that the term "conserves energy" means "conserves natural gas," and therefore only advertising costs that promote using less natural gas should be recoverable. EX T-155, p. 16, ln. 11-15. However, the argument is unsupported by the language of the regulation. Simply put, the regulation does not state that advertising must promote use of less natural gas in order to inform customers how they can use less energy. The language is clear. Staff cannot substitute the words "natural gas" for the word that has been in the regulation for years —"energy." Staff's related argument concerning advertising is equally flawed. Staff argues that since advertising which informs consumers about high efficiency gas burning appliances could have a secondary effect of promoting the use of natural gas, it should not be considered appropriate under the rule. Such an interpretation makes the exception set forth in WAC 480-90-043(3)(e) meaningless. Staff Witness Kenneth Elgin ("Elgin") admitted that Staff is unable to point to any judicial decision or ruling of the Commission or Washington courts in support of Staff's interpretations of the regulation. TR 1352, ln. 7-16. Staff acknowledged in cross-examination that if an advertisement is specifically designed to promote energy efficient appliances, it is an appropriate expense. TR 1350, ln. 14. On that basis <u>alone</u>, a large portion of the Company's advertising should be treated as an appropriate operating expense.

The Maryland State Commission has held that a gas utility's advertising is beneficial to ratepayers and is a necessary and proper response to the competitive situation faced by the utility for all of its services. <u>Re Maryland Natural Gas</u>, 98 P.U.R. 4th 539, 79 Md. P.S.C. 298 (1988). The Commission in that state allowed the utility to recover the entire amount of its advertising expenses, concluding that consumers benefit from advertising because they can make better-informed decisions as to which energy source best fits their needs. <u>Id</u>.

Decisions by other state regulatory commissions support recovery through rates of expenses for advertising such as the Company's. The Wisconsin Public Service Commission has allowed a utility to charge to ratepayers the cost of advertising which demonstrated energy conservation methods or methods for reducing ratepayer costs. <u>See</u> <u>Re: Northern States Power Company</u>, 4220-UR-106, 1993 WL 97449 (Wis. P.S.C. Jan. 14, 1993). Similarly, the District of Columbia Public Service Commission identified the advertising theme of deferral of costly new power plants as conservation-related. Re Potomac Elec. Power Co., 140 P.U.R. 4th 25 (D.C. Pub. Serv. Comm'n 1993) Like the Company's advertising, Potomac Electric's advertising was not a blunt directive to conserve, see EX T-336, p. 9, ln. 5-10, but rather an effort to persuade consumers to conserve by suggesting cost-saving benefits. As Company Witness James Thorpe ("Thorpe") testified, to encourage consumers to conserve energy, it is necessary to persuade them that natural gas will cost them less. TR 2830, ln. 8-11.

Company Witness Webb Green ("Green") conducted a study of the Company's advertising in order to evaluate the message conveyed by the campaign. He reviewed the advertisements produced in connection with the Company's 1989 through 1991 advertising campaign, and concluded that the basic message of the ads was to emphasize the advantages of energy-efficient appliances. As Green testified in EX T-336, p. 13, ln. 5-10, and p. 9, ln. 1-10:

> Although I have over 25 years of marketing research experience, my evaluation of any individual ad is not what should govern. It's the public's perception of what the overall advertising message is what is important. That is why I've focused on the results of the consumer research survey.

EX T-336, p. 13, ln. 5-10. Consumer research surveys reveal:

> The Company's advertising efforts have helped to steadily increase the number of people who believe gas costs less. This is important because the "gas costs less" message grabs the attention of the consumer with a compelling proposition. It is a far more efficient way to educate people on energy cost issues and conservation than a didactic "thou shalt conserve energy" message. In fact, while a direct message such as this would also be allowable under the advertising rule, it would not work with consumers.

EX T-336, p. 9, ln. 1-10.

Staff inaccurately claims that the Company's advertising is unnecessary because it only encourages people to switch from electricity to gas. EX T-206, p. 41, ln. 19-28. Green testified, however, the main point of the Company's message, as reviewed by its customers is "gas is efficient."

> The meaning behind "gas is efficient" applies not only to the fuel but to the equipment that runs the fuel. In this response people said gas is efficient, gas is better, gas is faster, gas is warmer, gas is heating-effective.

EX T-336, p. 10, ln. 20-27. Green concluded:

> The Company's advertising message is educating people that gas is the least expensive fuel which is beginning to change beliefs about the energy efficiency of gas and gas appliances. This conservation message leads to a change in behavior: The use of less gas; and/or the use of more efficient gas equipment.

EX T-336, p. 13, ln. 26-p. 14, ln. 4. The message of the Company's advertising is consistent with showing consumers how they can conserve energy. Accordingly, the cost of that advertising should be allowed in operating expenses. At a minimum, the Company should recover as a proper utility expense the allocation to regulated operations of $1,207,000 (out of total advertising expense in the test year of $2,158,000) which was determined in the recently performed independent allocation study. EX 324, tab 38.

2. Marketing Restating Adjustment EX 208(bi)

The Commission, should recognize Staff's proposed marketing adjustment of $6,900,000 for what it is: a completely mistaken reading of WAC 480-93-043, the Commission advertising regulation.

Utility marketing is vitally important. As Chairman Nelson stated:

> We are entering an area when we will see more competition in the area generally and I think the utility will need to continue marketing to its various segments.

TR 3251, ln. 16-19. What the Company calls "marketing" is often customer service, and is a necessary part of its operation. Company Witness Don Gessel "Gessel") testified that utility marketing is inherently different from merchandising:

> There is a very distinct merchandising activity, and there is a very distinct utility marketing activity . . . . These segments, this group of people that are set aside or set there to deal with various market segments, are absolutely necessary in the performance of our obligation to serve.
>
> Those functions of new construction, of dealer, of industrial, of residential and commercial non-merchandising, are absolutely necessary.

TR 3234, ln. 24 - 3235, ln. 11.

Because the Company's marketing activity directly relates to fulfilling its customer needs and expectations, it is a necessary ratemaking expense. Reductions in those efforts, as proposed by Staff, are totally unwarranted and would harm the utility and its customers. The Company will still need to perform utility marketing functions even after the separation of the Company's merchandising operations. As Gessel testified:

> Staff tends to think that price will dictate all. That is not the case. We'll still need to communicate in the utility. We still need to talk to our customers and tell them about it.
>
> . . . We will still have representatives who will go out and do audits and deal with the customers and take care of their needs. That's in the residential area. Certainly in the area of construction we will continue servicing those builders, and architects and the dealers . . . .

TR 3253, ln. 17 to p. 3254, ln. 16; EX 225 p. 150, ln. 14-21.

Staff argues that marketing activities of the Company should be subject to the limitation urged by Staff on advertising under WAC 480-90-043. EX 225, p. 48, ln. 19-24. However, as Staff concedes, the regulation does not refer to marketing, and there is no decision by any court or any order of the Commission in support of Staff's interpretation to apply the advertising regulation to marketing. TR 1356, ln. 2-8. On EX C-222, Staff has listed various marketing activities of the Company such as architect and builder promotions and dealer functions which Staff argues should not be allowed as deductions from operating income. The marketing activities listed on EX 222 are appropriate utility marketing activities. Most of the marketing that Staff characterized as "inappropriate for ratemaking" will (as Staff acknowledged) not occur in 1993 "due to budgetary reasons." EX 225, p. 49, ln. 18-25. Thus, Staff's proposed adjustment would be inappropriate for the period that rates will be in effect. Company marketing involves responding to the needs of current and potential natural gas ratepayers. Those activities provide ratepayer service and deserve ratepayer support. EX T-316, p. 11, ln. 9-25.

3. Merchandising and Jobbing/Affiliate Restating Adjustments EX 208(f), (ad), (aj)-(am), (ao)-(av), (aw), (aw-1) See also below Section III, 2.

The Company and Staff have made different restating adjustments which relate to merchandising and affiliate operations. The Company's figures are based upon an independent detailed cost allocation study and should be accepted by the Commission.

a.(1) Arthur Andersen Cost Allocation Study; Background.

In its direct case, the Company applied a recognized and accepted cost allocation methodology known as a "marginal" or "incremental cost" approach. EX T-316, p. 8, ln. 11-13. Both the Company and Staff had used this allocation method in rate proceedings from 1970 through 1984 (the year of the Company's last general rate filing). EX T-316, p. 8, ln. 13-16; TR 2845-2846.

After receiving the Company's filing, Staff Witness James Russell ("Russell") attempted to apply a "fully distributed" approach to cost allocation (which Staff had not used previously in the Company's rate filings). TR 3014, ln. 24-25. But his application of this approach was deficient. Russell admitted that he faced time constraints in his work. EX 203, p. 15, ln. 22-23. He did not interview key Company personnel with whom he testified it would have been "good to visit", although interviews are an important audit technique. EX 203, p. 15, ln. 22-25, p. 16; TR 3053, ln. 3-5; TR 3055, ln. 22-24. Nor did he review necessary accounting data. TR 1639, ln. 1. Because of these limitations, Russell made several allocations on the basis of general rather than comprehensive allocation factors. EX T-316, p. 9, ln. 14-19; EX T-329, pp. 3-5.

Russell recommended an independent separation study because of these shortcomings[3]:

> Q. <u>Is it because of the time constraints and the lack of certain documents</u>, for example, that you've suggested that there should be some type of an <u>independent study done by an independent accounting firm</u> or something like that?
>
> A. <u>Yes</u>.

TR 1670, ln. 16-21 (emphasis supplied). He concluded that a firm with cost allocation experience should develop a "much more detailed independent study" than his own. EX 203, p. 51, ln. 15-17; TR 1641, ln. 14, 22; TR 1691, ln. 18-19.

(2) <u>Engagement</u>

The Company engaged the independent accounting firm of Arthur Andersen & Co. ("AA") to prepare the detailed study that Russell advocated. EX T-316, p. 9, ln. 9-19; TR 2956, ln. 3-5. AA's work was at all times independent. The Company neither instructed AA employees how to do their audit nor suggested any approaches to cost allocation. EX 317, p. 1. AA's sponsoring witness, Witness Catherine Thompson ("Thompson"), defined an independent study:

> The meaning of an "independent" study . . . is that we were to perform the allocation of costs as discussed above based on our knowledge of and experience with cost allocation techniques, our professional and business judgment, and our understanding of the Company's operations.

EX T-323, p. 5, ln. 24-26, p. 6, ln. 1-2.

AA also brought considerable experience to the job. Thompson described AA's extensive experience in conducting cost allocation studies. TR 3011, ln. 21; TR 3014, ln. 7-10. As supervisor of the engagement, Thompson noted her own personal experience and familiarity with cost allocation studies. TR 2955, ln. 20-21; TR 2982, ln. 20, 24-25. AA employed 13 people on the Company's project with a wide variety of skills, from a number of AA offices. TR 3010, ln. 7-11.

(3) <u>Objectives and Approach</u>

AA allocated costs of the Company's operations for the test year ended December 31, 1991, under two scenarios provided by the Company. Scenario A assumed that merchandising would continue with the Company. Scenario B assumed that merchandising would be separated from the Company and not use any Company services except certain corporate governance functions. EX 324, p. II-2. AA studied test year

---

[3]Other problems and shortcomings in Russell's cost-allocation approach are discussed in detail in Company Witness Lance Corbin's ("Corbin") rebuttal testimony. EX T-329, pp. 8-25.

costs and cost allocations as if the respective scenarios had been in effect at that time. TR 2960, ln. 13-18, 22-23.

To complete the studies, AA applied an "activity-based costing" or ABC approach to cost allocation. The ABC approach attributes costs to products and services based on cost-causation analysis, and was applied by AA in a comprehensive manner. EX 317, p. 2; TR 3014, ln. 17-18. Discrete cost pools were identified which allowed for efficient cost analysis. AA interviewed Company personnel for each cost pool and analyzed Company records to determine the causation of costs. Approximately 125 Company employees were interviewed by AA, which represented a "substantial part" of the studies according to Thompson. EX 324, p. II-1; TR 2983, ln. 25.

(4) Results

Exhibit 324 represents a rational and systematic approach to cost allocation which is consistent with the standards employed in the accounting industry. EX T-323, pp. 3-5; TR 2957, ln. 15-16. AA developed an objective analysis of the Company's operations which resulted in a lesser allocation, in total, to non-regulated operations compared to Staff's allocation, but greater than the allocation in the Company's original filing. TR 2957, ln. 10-11; TR 3012, ln. 1-2. The AA analysis should be accepted because it represents the detailed separation study which Russell recommended be performed.

AA allocated $64,074,000 of test year costs to merchandising operations, under Scenario A, and $62,388,000 of test year costs to merchandising operations under Scenario B. AA also allocated $2,176,000 of test year costs to affiliate operations, under Scenario A, and $2,139,000 of test year costs to affiliate operations under Scenario B. EX 324, pp. III-2, III-3. The amounts associated with each cost pool studied (and which add up to the total allocations) are shown on pp. IV-3 and IV-4 of the study. The study sections discuss in detail how the amounts and allocations were derived.

Because the Company expects to operate, commencing October 1 of this year, in accordance with Scenario B, the rates which take effect in October should reflect that reality. EX T-329, p. 7, ln. 21-24. To properly reflect that, Corbin subtracted the Company's original merchandising allocation (in its direct case) of $55,507,000 from AA's Scenario B allocation of $62,388,000, and the original affiliate allocation of $1,254,000 from AA's Scenario B allocation of $2,139,000. The respective differences were adjusted for federal income taxes and other factors, and result in additional adjustments of $4,541,000 for merchandising and jobbing and $399,000 for affiliates. (These adjustments include an allocation of advertising expense to merchandising of $951,000, see EX 324, p. IV-4, ln. 38 and discussion supra.)

EX T-329, p. 8, ln. 1-12; EX 332; EX 408, columns (f) and (bb). These additional adjustments compare with Staff's various adjustments for merchandising and jobbing and affiliate transactions (exclusive of the adjustment for marketing, see discussion, supra.), which are separately broken out and shown in Exhibit 208.

The key issue which determines the foregoing adjustments is, of course, the Company's decision to operate under Scenario B. The following section discusses the history of merchandising operations and the Company's decision to now separate those operations. The section also discusses why prospective rates should reflect that decision.

b. Affiliate Formation.

The Company has engaged in the sale of gas-appliance merchandise since before natural gas arrived by pipeline in the Pacific Northwest in 1955. Gessel testified that the Company developed the merchandising business to provide an outlet for appliances, so that new gas customers could be connected to the Company's mains. EX T-337, p. 14, ln. 4-16. Appliance sales caused gas load to increase and unit customer costs to decline. The Company's costs per customer have thus been consistently lower, since 1981, than those of other Northwest gas utilities, as shown in Exhibits 362 and 363 to Company Witness James Gustafson's ("Gustafson") testimony. EX T-359, pp. 32-33. Chairman Nelson commented that the Company's exhibits with respect to costs were "tremendously encouraging." TR 3585, ln. 20.

The Company also promoted the development of an independent dealer network to expand the benefits of gas service. For many years the Company sponsored extensive training, financing, and educational programs for dealers. EX T-337, p. 14, ln. 12-14. The Company has worked very hard to become a good neighbor with ratepayers and other members of the public. Satisfaction ratings in excess of 90% verify the success of the Company's efforts. TR 3589, ln. 6-8.

(1) Current Issues

The merchandising market has changed in recent years. There are now many outlets for gas appliances in addition to the Company. The vast majority of these dealers have supported the Company's efforts to encourage natural gas service. But a few dealers apparently fault the Company as witnessed by their appearance at the public hearings. Although they are in the minority, their attitude still concerns the Company.

Of more concern to the Company, however, are the reactions of Staff and the public. Staff inflamed the issue of merchandising throughout its direct case. Examples abound in Staff Witness Kathryn

Thomas' ("Thomas") testimony. She asserted that the goals of the appliance business and gas operations are "inextricably linked," and that the Company is unable to "separate the two businesses in its own corporate focus." EX T-206, p. 43, ln. 10-12. Thomas and other Staff members raised the specter of cross-subsidization by ratepayers of merchandising but, as the Company showed, merchandizing revenues subsidized ratepayers. TR 2901, ln. 16-18.

Staff's negative attitude has two major impacts. First, if the Company continues to merchandise, it can never get a fair shake from Staff. Staff advised Corbin that if the respective businesses were not separated, Staff would be impeded in its allocation of costs. TR 3081, ln. 20-23.

Second, the public has received a highly negative image of the Company. Staff's inflammatory statements are available to any member of the public who wants to read them. TR 2888, ln. 12. Staff has unfairly characterized the Company as a rogue operation, and that message has been heard by the public to the Company's detriment.

Then-Commissioner Pardini expressed his concern about this case as "trial by press." TR 2015, ln. 5-6, 10-11. Statements by Elgin about alleged ratepayer subsidies have appeared in the press. TR 2833, ln. 8-9; TR 2878, ln. 3. From the Company's perspective, it makes no difference whether Staff communicated directly to the media, or whether a reporter simply reviewed Staff's filings. TR 2880, ln. 10. In either event, the Company has been <u>damaged</u> and tried <u>unfairly</u> as a result of media reports. TR 2860, ln. 2-3; TR 2879, ln. 22-24; TR 2880, ln. 10.

(2) <u>Formation</u>

The above events have engendered controversy and concern. As a result, as Gessel testified, "the Company proposes to remove the source of the concern." EX T-337, p. 12, ln. 3-5. The Company has determined to fully separate its merchandising activities into a separate subsidiary of its parent, Washington Energy Company. EX T-316, p. 10, ln. 13-15; TR 2834, ln. 15-19, 22-23. The Board of Directors of Washington Energy Company approved the separation in mid-June. TR 2830, ln. 21-23; TR 2862, ln. 4-6.

To the extent possible, then, this separation will create the "clean line" between regulated and non-regulated operations which Chairman Nelson was attempting to find, and which "will make our lives all that much easier." TR 3252, ln. 1-2. The new subsidiary will be a stand-alone company with its own management team and departments. TR 2894, ln. 2; TR 3188-3189; TR 3253, ln. 1-3. It will advertise on its own and not use the Company name or logo. TR 2872, ln. 7-14. All subsidiary employees will be housed in separate office space, thus allowing the Company to accommodate the space needs of its regulated operations. EX 318, pp. 1-2; TR 2855, ln. 21-24; TR 2866, ln. 16-21; TR 3765, ln. 23-25. According to Gessel, "the Company will not be selling merchandise, . . . TR 3255, ln. 25.

Although WNG will not sell merchandise, it must continue to provide utility marketing. Chairman Nelson stated to Gessel that "you're absolutely right in the point in your testimony that the utility marketing efforts need to be supported." TR 3251, ln. 12-14. Gessel testified that the Company will still communicate with customers, builders, and architects about the benefits of natural gas. TR 3252-3255. The Company recognizes that utility marketing is essential to the continued use and development of gas service in this region.

(3) Rate Consequence

The Company's decision to separate will make everybody's life easier. No longer will inordinate time and attention be focused on the amount of, and reasons for, the Company's allocations. No longer will Staff need to devote resources to cost allocation efforts. The Company has proposed a clean line between utility and merchandising operations, commencing October 1.

Reference has been made to the respective Scenario B and Scenario A cost allocations for merchandising. TR 2986-2987. However, the decision to separate was not determined by AA's cost allocations. There are solid and practical reasons, as outlined above, why the Company should move forward as planned. The Company has no desire to relive the events of the last year and the attacks on the Company's reputation. The Company will carry out its separation plan no matter which allocation scenario the Commission approves.

However, the Company strongly urges the Commission to accept the Scenario B allocation. Approval is warranted because a prospective rate structure should reflect reality. It would be anomalous for the Company and the new subsidiary to operate completely separate businesses, at entirely different locations, yet have rates in effect which reflect only a single business operation. Wrong signals would be sent to ratings agencies and analysts.

Finally, acceptance of the Scenario B approach will simplify future rate case proceedings before this Commission. The savings of time and expense resulting from avoiding "allocation arguments" in future rate cases will undoubtedly benefit ratepayers.

c. Customer Service

Russell argued that "any activity beyond the meter is a competitive service, the costs of which should not be included in the utility's operating or capital accounts." EX T-183, p. 10, ln. 20-22. This argument greatly concerns the Company with respect to its service function.[4]

The Company does not contend that other contractors cannot provide customer service. TR 3533-3534. The Commission should, however, recognize that the Company occupies a unique role. As the energy provider, the Company is perceived by customers as a major source of service for gas appliances. EX T-359, p. 25, ln. 7-10. The Company must be able to respond to thousands of calls, with 24-hour availability and reliability. EX T-359, p. 24, ln. 14-28; EX 367; TR 3534, ln. 4-6. It is impossible to equate the Company's responsibilities with those of independent contractors.

Staff may argue that the issue instead is how the service should be charged. TR 3550, ln. 18-23. That misses the point. Customers link gas service with appliance work. They look to the energy provider for that service. If customers are charged for Company service, then many of them will not take that service. TR 3541, ln. 2-4; TR 3550, ln. 8-9, 13-16. They may decide to "do without" because they do not perceive other service options as available.

Most importantly, these decisions have safety consequences. Russell recognizes that an exception to his argument should be made for customer and system safety. EX T-183, p. 10, ln. 19-20; EX 203, p. 127, ln. 3-4. Unfortunately, one cannot draw a bright line between safety and non-safety service calls. Obviously odor and no-heat problems pose safety concerns. EX T-359, p. 24, ln. 21-28; TR 3546, ln. 17; TR 3597, ln. 24. If a customer fails to call (because he or she does not want to be charged), a potentially unsafe condition may go undetected. TR 3541, ln. 1-9. Even a simple event such as a light-up or appliance adjustment has safety ramifications. The equipment is technically sophisticated and can create a hazard if left unserviced or if unskilled persons attempt to start the equipment themselves. TR 3550, ln. 16-17; TR 3598, ln. 22-23.

Commissioner Casad expressed the Commission's concern for safety:

> There are safety issues in this case and the Commission previously has requested the Company to take more aggressive action regarding safe situations, and so it's kind of a paramount thing, I think, in our minds, and we would want to insure that every customer of the gas company would

---

[4]The services performed by the Company include combustion service (light-up and adjustment) to customer-owned or leased appliances; warranty work on Company-sold appliances (for which the manufacturer reimburses the Company); and maintenance of leased equipment. EX T-359, p. 24 ln. 1-5.

have access to emergency response on a noncomplicated kind of a basis where you don't have a bunch of dispatching problems and not adequate people to get it and so forth.

TR 2477, ln. 13-22. The Company should not now be penalized for providing safety service to <u>all</u> of its customers, regardless of whether they previously purchased merchandise from the Company. TR 3543, ln. 20-21; TR 3551, ln. 21.

In Gustafson's words, there is a "definite safety advantage to the public from our being on the premises and finding these conditions." TR 3599, ln. 1-3. The service is comparable to the service provided by other gas utilities. TR 3588, ln. 22-23; TR 3589, ln. 1-3. Expenses for this service are considered appropriate utility operating expenses. EX T-183, p. 34, ln. 17-24. As Thorpe emphasized, the Company's service program must be viewed as a <u>fundamental</u> <u>utility</u> <u>obligation</u> which should not be undermined by staff's ill-conceived recommendation. EX T-316, p. 6, ln. 7-8; TR 2892, ln. 18-25; TR 3589, ln. 7-8.

4. <u>Leased Plant Restating Adjustments</u> EX 208 (ae-1) and (ae-2)

For over 30 years, the Company has maintained a utility tariff for the lease of certain gas appliances. EX T-386, p. 48, ln. 12-16. Rate Schedule No. 71 permits leasing of various residential water heater models at a range of $2.00 to $4.45 per month. EX 42, Sheet 23. Residential or commercial customers may lease a conversion burner at a monthly charge of $2.85 to $10.05 (depending upon the burner size). EX 42, sheet 25. Some customers also rent equipment under schedules which are currently "frozen" to new access, including Schedule No. 72 (frozen since October 24, 1975) and Schedule No. 75 (frozen since January 1, 1971).

The Commission and the Company are being challenged by Staff to determine whether the appliance rental program should be continued and, if not, to devise a framework for "phase-out." Staff Witness Jaime Ramirez ("Ramirez"), surprisingly, was not aware of the Puget Power electric water heater rental program. TR 1587, ln. 16. Ramirez was therefore unaware that Staff had <u>unsuccessfully</u> challenged the Puget program before this Commission in Docket No. U-89-2688-T.

Staff claims the public policy justifications for the rental program "are no longer present and valid because the conditions of the market environment have changed." EX T-166, p. 19. But neither customer growth nor price advantage void the economic benefits of high summer load factor gas purchases. The Staff criticism does not make sense. All parties agree that the rental program encourages increased gas load and customer base load. All of the Company's customers benefit because summer season or "valley" demand is filled in with additional base load for water heating, thereby enabling the Company to make more economic gas purchases. EX T-337, p. 17, ln. 23-28. The rationale for the program is as valid today as it was 30 years ago.

Staff raises other, more oblique, criticisms of the rental program suggesting rental appliance customers do not pay their own way. EX T-155, p. 27, ln. 20-21, EX T-166, p.18, ln. 20-23. Staff ignores the beneficial effect of the added gas load. Staff's premise is in direct contravention to the Commission's declaration in the Cole case.

> We find to isolate the revenues and expenses of the rental equipment and treat them as distinct from the gas sales they are designed to promote is not only illogical, it is inconsistent to the established regulatory view of such programs. W. W. Cole, et al. v. WNG, WUTC Cause No. U-9621, Proposed and Final Order of November 1, 1968, p. 37.

Staff suggests that the utility should phase-out the appliance rental program, under penalizing terms; accept no new rental customers and stop replacing of appliances. TR 1569, ln. 10-13. The Company believes strongly, however, that ongoing policy considerations justify continuation of the rental program. The improved load factor from water heating continues to benefit all customers as it did in 1961 and in 1968 when the program was reviewed in the Cole decision. Cole, supra. The gas water heater rental program obviously encourages gas water heating, which is important from a policy standpoint because gas is a more efficient applicant of energy than electricity.

Staff's proposal further fails to recognize the administrative logistics of its recommended phase-out. Ramirez admitted that the administrative demands of the Staff proposal would create "quite a management challenge." TR 1577, ln. 21-23. The Company would incur exceptionally high costs in a program to dispose of the 130,000 rental appliances currently in the program. Customer confusion and dissatisfaction will also result if this long-standing tariffed program were to be suddenly terminated in the manner Staff suggests.

Apart from its administrative lapses, Staff's plan is patently unfair to the Company. Although Staff repeatedly asserts the proposal is a "make-whole proposal," TR 1566, ln. 9-10, it clearly is not a make-whole proposal. In the initial year of the phase-out, the Company would only be entitled to recover 80 percent of the first of five years of amortization of its investment in appliances, as proposed by Staff. Staff's formula denies the Company fair value for its invested capital from day one, and it gets worse. Recovery would fall to 60 percent in year two, 40 percent in year three, and 20 percent in year four. Staff's five-year phase-out is, in effect, only a four-year phase-out with absolutely no recovery during year five. This apparent taking is supposedly justified as an "incentive" for the Company to sell its leased appliances quickly. EX T-166, p. 23, ln. 12-18. But such a harsh provision is neither necessary nor appropriate. See, Lucas v. South Carolina Coastal Commission, 112 S. Ct. 2886 (1992).

The Company proposes as follows:

1. An immediate water heater rental rate increase from $3.05 to $4.00 to deter customer additions and to minimize the cost subsidy.

2. Incremental rate adjustments in future years to reduce the program further on a manageable and orderly basis.

3. Installation or replacement of all leased water heaters hereafter with a .6 heat factor or better, thus encouraging responsible demand side management.

4. Elimination of the current customer allowance for installation costs, so that the customer will pay the entire cost of installation.

5. De-emphasis of the appliance lease program through customer communications and a purchase option program.

6. Closing the conversion burner rate schedule to new rental customers.

EX T-337, p. 17, ln. 4-15; EX T-316, p. 12, ln. 25-p. 13, ln. 9.

The Company proposal significantly increases the rental tariff cost to customers, encourages conservation, reduces rate base and provides a demand side management tool with even greater energy savings potential than the electric appliance lease program currently in effect by Puget Power. The Company's primary proposal is markedly superior to Staff's proposal because it responds to Staff's concerns (through substantial removal of the cost subsidy and reduction in rate base), but does not penalize the Company in an unfair manner. The penal aspect of Staff's proposal is wholly inappropriate and cannot be adopted if the guidance of Lucas, supra is followed.

To provide the Commission with an alternative to program continuation, the Company has also outlined a method to freeze access to the water heater rental tariff. Gessel testified that a freeze program is "easily administered and the task of regulatory oversight and audit is minimal as compared to a five-year transitional program as proposed by Staff." EX T-337, p.18, ln. 19-28. Rental water heaters remaining in rate base would be depreciated over their useful lives of 12 to 15 years. Gas piping would remain in rate base as suggested by Staff to be depreciated over the useful life.[5]

[5] The Company suggested one other alternative as preferable to the Staff's proposal. A special rental water heater tariff rate could be adopted for gas consumed by rental appliances, in order to provide the amount required to remove cross-subsidization entirely. Gessel provided detail on how such a

In summary, the appliance rental program can and should be continued as sound public policy and as part of responsible demand side management.

5. Test Year Normal Weather (EX 208(2)

The revenue and gas costs on the Company's books, reported for the test period, reflect the revenues and gas costs associated with actual weather. Staff and the Company agree that the actual weather in the test period was warmer than what would "normally" be expected. Therefore, the Company's revenues and gas costs must be restated to levels which would have occurred in the event of normal weather. EX T-377, p. 2, ln. 10-22; p. 3, ln. 10-12. The Company and Staff disagree on the exact measurement of normal weather appropriate for the test period.

a. Estimate of Normal Weather for Test Period

The Company determined that normal weather for the test-period could be measured by 4658.3 heating degree days ("HDDs"). EX T-377, p. 14, ln. 5-8. Staff claimed that 4748.6 HDDs should be used. EX T-255, p. 16, ln. 7-8. Staff's estimate projects colder temperatures for the test period than what the Company believes is realistic. Correspondingly, Staff projects greater "normalized" therm sales than what the Company reasonably expects. EX T-377, p. 14, ln. 19-22.

The Company analyzed actual annual HDDs over the past 32 years and found a statistically significant trend. By incorporating the trend in its estimate, the Company concluded that the best statistical predictor of normal weather for the test period (1991) was 4658.3. EX 44, p. 1, Column D (1991); EX T-377, p. 9, ln. 10-14; EX T-386, p. 10, ln. 10-19. To test this conclusion, the Company grouped the individual year HDD data into 15-year moving averages. When the more stable 15-year averages were analyzed, the Company found that the 15-year average appropriate for the test-period[6] predicted normal HDDs of 4658.6, which was very close to the first estimate. TR 660-662; EX 44, p. 2, Column C (1998); EX T-377, p. 9, ln. 16-22.

Staff Witness Curtis Winterfeld ("Winterfeld") chose to ignore the statistically significant trend of HDDs over time, and opted instead to simply use an average of the past HDDs over the last twenty years (eliminating the "high" and the "low"). EX T-255, p. 16, ln. 8. Winterfeld did not conduct any tests to determine whether his methodology produced acceptable statistical predictors. TR 2210, ln. 4-25; TR 2211;

---

program might be implemented. EX T-337, p.19, ln. 5-19.

[6]The Company used the time period 1984-1998 in its fifteen-year average because the mid-point of 1991 represented the test-period in this proceeding. TR 662, l. 6-12; Ex. T-41, p. 12, l. 22-26).

TR 2212, ln. 1-17; EX T-377, p. 10, ln. 25-26; p. 11, ln. 1-3. He testified that he had "no specific reason" why he used the past twenty-year average rather than a 15-year average. TR 2210, ln. 15. The sole rationale for his recommendation was because it was done that way in the past. EX T-255, p. 14, ln. 25-28.

Winterfeld stated that he could have used statistical tests to compare normalizing approaches. TR 2212, ln. 17. Had he done so, he would have found that Company Witness Ritchie Campbell's ("Campbell") findings resulted in a better statistical predictor than his own. This is because the tests that Winterfeld employed are automatically achieved by Campbell's regression analysis. TR 2208, ln. 3-7.

The Company was surprised that Winterfeld opted to use a simple average of HDDs because it showed that a simple average would significantly overstate the best statistical estimate: 4833.3 versus 4650.3. EX 44, p. 1, Column A. The information in EX 44 led the Company to report in its direct case that a simple average of past HDDs should not be used because it represented a biased statistical estimate of test period weather. EX T-377, p. 9, ln. 1-4. Winterfeld ignored this fact and the demonstrated statistical trend. His estimate is statistically biased and must be rejected by the Commission. EX T-377, p. 8, ln. 25-27, p. 9, ln. 1-8, p. 10, ln. 7-17.

Winterfeld apparently felt that the trend should be ignored because it could change in the future. EX T-255, p. 13, ln. 13-16. The Company does not dispute the fact that a trend could change in the future. However, during the time periods that Campbell and Winterfeld evaluated weather conditions (32 and 20 years), annual HDDs had a statistically significant decreasing trend (as Winterfeld admitted). This trend was apparent for both SeaTac as well as the other weather stations suggested by Winterfeld. TR 2215, ln. 14-18; TR 2215, ln. 23-25; TR 2216, ln. 1-3; EX T-377, p. 14, ln. 10-12; EX T-386, p. 14, ln. 1-5. Moreover, even if the trend were to reverse itself and become positive in a future rate case, the Company would still incorporate that trend in its methodology, and thereby use "the best and most current information available at a point in time." EX T-377, p. 14, ln. 12 to 14; EX T-386, p. 14, ln. 22-25, p. 15, ln. 1-2.

Mr. Winterfeld stated that a simple average of HDDs, measured over a 20-year period, responds quickly enough to whatever underlying trends occur. EX T-255, p. 15, ln. 24-26. The Company strongly disagrees. The past 20-year average does not come close to representing the best or most current information available; it is a statistically biased predictor which should not be adopted.

b. Heating Degree Day Measurement

Staff has also raised issues concerning the proper definition of a HDD. The relationship between past test period therm sales and HDDs (measured at a base temperature of 65°F) is extremely accurate. EX T-377, p. 7, ln. 4-12. Although this fact is uncontroverted, Winterfeld speculates that the normalization methodology might be improved even more if the Commission used a different HDD definition (for example, 55° F). EX T-255, p. 12, ln. 5-6. However, he does not know if the accuracy of the process would thereby be improved. Nor has he performed any studies to test his thesis. EX T-268, p. 12, ln. 11-16; p. 15, ln. 7-12.

Campbell testified that lowering the base temperature from 65° F to 55° F would eliminate useful information. EX T-377, p. 5, ln. 22-26; EX 384. Because the Company has properly measured the actual relationship between usage and HDDs (incorporating non-linear relationships at low HDDs), it is unnecessary to use a new HDD definition with a lower base temperature. EX T-377, p. 6, ln. 25-27; EX T-386, p. 13, ln. 4-23. There is no reason why the Commission should abandon the base temperature of 65°F that it has consistently and appropriately used.

c. Multiple Weather Station Data

Winterfeld stated that, even though the weather data had a demonstrated trend, the Commission should not incorporate the trend in the normalizing adjustment, for "administrative" and "equity" reasons. He claimed that it would be inappropriate to change the methodology used to estimate normal HDDs corresponding to a test period. EX T-255, p. 14, ln. 23-25.

Contradicting his own logic, Winterfeld then introduces a new theory "yet to be tested" to redevelop normal weather. EX T-255, p. 9, ln. 17. His theory—using multiple weather stations—would break with Commission precedent and require the Company to change its method of estimating normal HDDs by unnecessarily including and analyzing actual HDD data from "one to ten" weather stations in the Company's service territory. EX T-255, p. 9, ln. 24. Implementing Mr. Winterfeld's suggestion would be, in his own words, "difficult and extremely cumbersome." EX T-255, p. 8, ln. 26. Indeed, Mr. Winterfeld claims that it would be so time consuming that he did not perform any analysis of his hypothesis, but that the Company should nevertheless be required to perform these studies in its next general rate filing. EX T-255, p. 9, ln. 14, 22-26.

The Company has never used multiple weather stations, and for good reason. First, the Company's existing regressions provide nearly perfect estimates. Additional weather data will not improve the statistical process. EX T-377, p. 12, ln. 1-5. Second, unlike other gas utilities whose service territory extends over diverse weather conditions, 86% of the Company's sales occurred within 27 miles of its single weather station (SeaTac), and 98.4% of those sales occurred within 49 miles. EX T-377, p. 12, ln. 7-15; EX 378. Third, as shown in Exhibit 379, the Company's service territory is divided in half by SeaTac. Fourth, the Company's service territory has been classified by NOAA as an "area within the state having similar climatological characteristics." EX T-377, p. 13, ln. 4-9; EX 379. For the above reasons, multiple weather data information would not be appropriate for the Company.

d. Weather Normalization Restating Adjustment for Test Period EX 208(z)

The actual revenue and gas costs on the Company's books, reported for the test period, reflect the revenue and gas costs associated with actual weather. Both Staff and the Company agree that the actual weather in the test period was warmer than would "normally" be expected. Therefore, the Company's revenues and gas costs must be restated to levels which would have occurred, had normal weather been experienced.

The Company testified that corresponding to normal weather (4658.3 HDDs), it would have sold 836,217,408 therms. The Company also testified that the lost and unaccounted-for volume indicated for the test year was negative because of differing weather conditions during the last 15 days of December, 1991, compared to the corresponding period in December 1990. The Company's normal lost and unaccounted-for volume is 0.7 percent of total receipts which required an adjustment of 6,795,800 therms to account for normal weather and 7,658,200 therms to correct the total purchases for the normal lost and unaccounted-for quantities. The total adjustment of 14,454,000 therms resulted in total gas receipts amounting to 842,071,000 therms.

Corresponding to these sales and purchases, the Company's test period revenue and gas costs were properly restated by $5,008,443 and $4,165,769. Staff testified that had its version of normal weather occurred,the Company would have sold 18,732,214 additional therms for a total volume of 848,201,358 therms. To make these additional sales, Staff calculated that the Company would have been required to purchase an additional 17,584,256 therms bringing the total volume to 845,201,256 therms. This information is provided in the following table:

	Normal Weather HDDs	Normalized Sales (therms)	Additional "Restated" Normalized Revenues	Normalized Purchases (therms)	Additional "Restated" Normalized Costs
COMPANY	4658.3	836,217,408	$5,008,443	842,071,000	$4,165,769
Citations		EX 45, p. 1, col. (g), l. 35	EX 45, p. 1, col. (i), ln. 35	EX 47, p. 1, col. (e), ln. 37	EX 47, p. 1, col. (g), ln. 37
STAFF	4748.6	848,201,358	$7,178,682	845,201,256	$4,707,064
Citations		EX 242, p. 2, col. (h), ln. 35	EX 242, p. 2, col. (j), ln. 35	EX 201, p. 2, col. (e), ln. 37	EX 201, p. 2, col. (g), ln. 37

Obviously, the Company cannot have sold more therms than it purchased. Staff simply made a mistake. As the Company testified (EX T-386, p. 25, ln. 24) the purchased therms that Staff used were too low by 9,441,224. Therefore, Staff's Restated Normalized Costs were too low, because of its mistake in the therms purchased, by $1,649,099.

First, the Company's finding of normal weather for the test period was correct. Secondly, corresponding to this normal weather, the Company's normalized therms, both for its sales and its purchases, were also correct. Finally, corresponding to these normalized therms, the Company's restated revenues and gas costs are correct, and should be accepted by the Commission.

Staff's proposition suffers because, not only did it assume that normal weather for the test period was colder, and hence, it forecasted greater therm sales than the Company can realistically make, it also made an arithmetic mistake on the purchase side, by understating the therms that would actually be purchased by the Company if Staff's normal weather were actually experienced. This led to the error in its restated gas costs of $1,649,099. Therefore, the Commission should accept the Company's numbers.

6. Revenue and Gas Cost Pro Forma Adjustment EX 208(aa) and (bj)

There are four separate pro forma revenue adjustments discussed in Ex. T-41, pp. 16-18. Cumulatively, these adjustments total $12,568,112.

Each pro forma revenue adjustment , except the adjustment for Puget Power, has a corresponding gas cost adjustment. The total gas cost impact of these four adjustments in $9,543,000. Staff testified that corresponding to its notion of colder weather, the Company's pro forma revenue adjustments would have equalled $14,633,183,and its gas cost adjustment would have equalled $9,294,667. This information is provided in the following table:

	Pro Forma Sales (therms)	Pro Forma Purchases (therms)	Pro Forma Revenues Adjustment	Pro Forma Gas Costs Adjustment
COMPANY	836,193,832	842,047,400	$12,568,112	$9,543,000
Citations	EX 45, p. 1, col. (g), ln. 35	EX 47, p. 1, col. (e), ln. 37	EX 5, p. 1, col. (c), ln. 1	EX 5, p. 1, col. (c), ln. 1
STAFF	848,177,782	844,715,656	$14,663,183	$9,294,667
Citations	EX 242, p. 2, col. (h), ln. 35	EX 201, p. 2, col. (e), ln. 37	EX 208 (aa) plus (hj); or use EX 242, p. 2, col. (l), ln. 35, and cols. (f), (j) and (l) on p. 4	EX 208, or use EX 201 p. 2, col. (j), ln. 37, plus p. 3, cols. (e), (h) and (k)

Staff's gas costs, however, are inconsistent with its sales levels, because Russell reduced gas costs to reflect the cessation of propane sales, while Staff Witness Alan Buckley ("Buckley") made no corresponding adjustment to sales and revenues. The reduction to gas costs was $262,220, corresponding to 462,000 therms. See EX 201, p. 3 or 3, col. (f), ln. 36. The Commission should accept the Company's proposed adjustment because Staff failed to match its gas-purchases level to its sales level. The net effect of this error is to impute too much operating income to the Company.

The Company's finding of normal weather for the test period is correct. Corresponding to this normal weather, the Company's pro forma revenues and gas cost adjustments are correct.

Staff's proposal suffers because, not only did it assume that the test period was much colder than normal, and, hence, it forecasted greater therm sales than the Company can realistically make, it also made an arithmetic mistake on the purchase side, by mismatching the therms that would actually be purchased by the Company if weather were actually this cold. Because Staff's pro forma revenue adjustment and its pro forma gas cost adjustment are a result of mismatched therms, the Commission must reject Staff's calculations.

7. Incentive Pay and Performance Share Plan Restating Adjustments EX 208(bf) & (bg)

Staff has proposed an adjustment of approximately $895,000 for employee compensation paid by the Company in the test year pursuant to three incentive compensation plans.

> Goals Make Cents incentive plan. Open to all salaried and union employees of the Company, the Goals Make Cents program is based on stated performance goals including safety, containment of costs and customer satisfaction.
>
> Performance share plan. Long-term incentive plan tied to performance over a four-year period.
>
> Annual incentive plan (AIP). Tied to one-year performance; based on goals linked to operating cost.

EX T-334, p. 3, ln. 23-p. 6, ln. 4. Staff's recommended disallowance has absolutely no basis. For example, Staff presented no testimony whatsoever regarding the Company's AIP plan, yet maintains that AIP compensation costs are not an appropriate test year cost. Further, Staff failed to acknowledge that the Goals Make Sense program applies to all employees, including those with union contracts. The fixed salaries and wages paid to Company employees are clearly an operating expense. If a portion of compensation is paid as variable or incentive compensation (such as in the Company's plans), those compensation expenses should continue to be considered a part of operating cost because they remain a form of employee compensation and, clearly, a cost of delivering utility service to ratepayers. For example, a variable pay arrangement tied to overall Company revenues benefits ratepayers because the Company preserves its ability to pay employees less if Company revenues fall.

Staff asserts that although the incentive programs benefit ratepayers, Staff cannot quantify the benefit, so the compensation expense should be disallowed. Staff admits there is no regulation to support this. EX 225, p. 163, ln. 7-17. The Company's incentive compensation plans benefit ratepayers in several ways, as testified by Company Witness Mark Gordon ("Gordon") (a specialist in compensation plans). First, by making a part of compensation variable, base salaries are kept lower. The expensive part of total labor costs--fringe benefits--are kept lower because their costs are tied to base salary. (EX 334.)

Second, incentive goals benefit ratepayers by focusing the attention of Company employees on overall efficiency and cost-management that the Company wants to achieve. TR 3097, ln. 5-18.

Incentive compensation helps the Company's competitive position by helping attract and retain talented people, and enables the Company to identify performance and behavior goals that it wants people to achieve. TR 3097, ln. 23 to 3098, ln. 12.

Incentive compensation benefits ratepayers from a cost standpoint because paying employees on a variable basis keeps costs down from year to year, and enables the Company to avoid building an ever-increasing base salary scale in terms of fixed pay. See TR 3103, ln. 19 to p. 3104, ln. 8. Other benefits that accrue to ratepayers include commitment to the Company (because experienced people stay on the job with the Company). TR 3104, ln. 23 - TR 3105, ln. 10.

Staff acknowledges that it did not perform any study to determine if the Company pays its officers, managers, and contract employees above or below market rates. TR 1791, ln. 24-1792, ln. 3. Nor did Staff compare Company compensation levels to those in similar compensation and job markets. TR 1792, ln. 8-12. Staff performed no study of the Company's contract employee productivity, see TR 1792, ln. 13-

16, and no study of the Company's contract employee turnover.[7] TR 1793, ln. 17-20. Staff did not perform any study regarding the Company's contract employee benefits compared to benefits provided in equivalent job markets. TR 1793, ln. 21-25. Staff acknowledges that it has not studied whether it is more or less expensive to ratepayers to pay all compensation in the form of salaries and wages, rather than including incentive bonuses. TR 1794, ln. 1-11. Nor did Staff study whether the Company must make pension payments and 401(k) matching payments on incentive compensation provided to its employees. TR 1794, ln. 12-17. Staff should have studied these issues or at a minimum, it should have retained or consulted an expert in the field of compensation before recommending complete disallowance of the Company's test year expense for incentive compensation. EX 225, p. 108, ln. 3-21.

Staff suggests that for the cost of incentive programs to be recovered from ratepayers, the Company must prove that such programs provide measurable benefits to ratepayers. EX 225, p. 113, ln. 9-21. However, this illusory test (which has no support in Washington regulatory decisions) is without merit, and has in fact been expressly rejected by at least one public utility commission. The District of Columbia Public Service Commission held that a utility's executive management incentive program is an appropriate test-year cost, and that the program did not have to pass a cost savings test before inclusion in rates. Re Potomac Electric Power Company, Formal Case No. 912 1992 WL 396109 (D.C.P.S.C. 1992). The District of Columbia Commission noted that it would be difficult or impossible to design a cost savings test that could replace management judgment, and concluded that the company's test-year wage and salary costs were reasonable.

In Washington Util. & Transp. Comm'n v. Pacific Power & Light, 78 P.U.R. 4th 84 (W.U.T.C. 1986), Staff recommended reducing the company's expense for productivity and merit pay to utility employees. In responding to that recommendation, this Commission held:

> The Commission has in numerous cases, rejected the staff arguments regarding productivity and merit increases. This case is no exception.

78 P.U.R. 4th at 92 (emphasis supplied). The Commission accepted the Company's general wage increase adjustments as proposed. The Commission further noted that the Company, in evaluating its salaries in

---

[7]Staff may argue incorrectly that employee turnover has not improved with the institution of the "Goals Make Cents" incentive compensation program. EX 335 includes marketing department personnel in the turnover rate. See TR 3106, l. 13. Marketing personnel traditionally have a high turnover rate, and the inclusion of marketing personnel in the response to the data request gives an excessively high indication of turnover rate with respect to participants in incentive compensation programs.

comparison to the marketplace, should fully consider economic factors. Id. Clearly, those factors exist in this case because of the prevalence of incentive compensation plans in the marketplace today. EX T-334 p. 6, ln. 9-12.

Other public utility commissions from throughout the country have approved incentive compensation plans because such plans benefit ratepayers. For example, the Massachusetts Department of Public Utilities held that a properly designed and administered incentive compensation program with quantifiable employee performance benchmarks, defined goals, and reasonable performance rewards benefits ratepayers by avoiding additional salary expense and reducing system gas costs. Re Bay State Gas Company, 139 P.U.R. 4th 3 (Mass. D.P.U. 1992). The Massachusetts Commission upheld the utility's extraordinary performance bonus and key-employee incentive compensation programs, and denied the Attorney General's request to disallow a portion of test-year expense relating to those programs. Id.

The Florida Public Service Commission held that incentive compensation plans linked to achieving corporate goals are appropriate and provide cost-control incentives. Re Florida Power Corp., 138 P.U.R. 4th 472 (Fla. P.S.C. 1992). The utility's witness testified that the company "used incentive compensation to focus the attention and efforts of key employees on achieving goals that have a direct and significant influence on individual, organizational and corporate performance." The Commission concluded that many of the goals related directly to controlling costs, encouraging good customer service, and energy efficiency, and included the plans in rate base.

The Delaware Public Service Commission allowed Delmarva Power & Light to include incentive compensation in operating expenses. Re Delmarva Power & Light Company, PSC Docket No. 91-20, Order No. 3389, 1992 WL 465 021 (Del. P.S.C. 1992). The Delaware commission noted that, among other benefits, ratepayers benefit from incentive plans because increased productivity extends the time between rate case filings. The commission further concluded that shareholders should not be required to share the costs of incentive plans for employees, because doing so would act as a disincentive for the company to engage in such plans.

8. Pension Restating Adjustment EX 208(bd)

Staff recommends disallowing the Company's pension expense because the expense was accrued and not funded during the test year. Staff agrees that it does not matter if the recognition of expense is on a cash or accrual basis. EX 225, p. 172, ln. 4-13. Staff's concern apparently is whether the ratepayer or the shareholder is benefitted by the cost of money during the period the Company is accruing but not paying the expense. EX T-206 p. 25, ln. 15-19.

The Company demonstrated in Exhibit No. 333 that the working capital allowance is reduced by the amount of the pension accrual. Therefore, any benefit which would accrue to the shareholder is offset. In its rebuttal case, the Company proposes a pension restating adjustment to net operating income in the approximate amount of $167,000. EX 333. This adjustment is based on the appropriate portion of the Company's obligations under its defined benefit pension plan, which provides benefits to all regular employees of the Company who have attained 21 years of age and have completed one year of service to the Company. See, EX 86. The Pension Restating Adjustment proposed by the Company properly reflects the Company's accrued obligations for the test year and, therefore, should be granted as proposed by the Company. Staff's $167,000 adjustment to remove pension expense from the test year should be rejected.

9. AGA Dues Adjustment EX 208(bc)

Staff has recommended disallowance of Company expenses for American Gas Association ("AGA") dues in the approximate amount of $391,430, of which $131,170 is embedded in Staff's recommended disallowance of certain advertising costs. The AGA dues adjustment has always been allowed in the past by the Commission.

Staff's recommendation is based on flawed analysis. As Company Witness Karl Karzmar ("Karzmar") testified:

> Staff assumed that 10.24% of AGA expenses are for lobbying, yet only approximately 0.5% of total expenses are actually for lobbying as reported pursuant to the Federal Regulation of Lobbying Act. In addition, Staff assumes that "common costs" are in support of communication and marketing services. This is simply not the case. The "common costs" support member company activities in specific areas.

EX T-406, p. 31, ln. 17-23. Although Staff relies on a NARUC audit of the AGA, Karzmar further testified:

> AGA's advertising and communications relate to public information and education. In fact, the December 1989 NARUC Audit Report indicated that 77.5% of advertising was classified as customer education.

EX T-406, pp. 31-32. Staff's recommendation to disallow $391,430 in expenses for AGA dues is inconsistent with even the NARUC audits. The Commission should not depart from its past decisions on AGA dues. Cause Nos. U-84-60, U-83-27, U-82-22/37, U-80-25 and U-80-111.

10. Debt Interest Pro Forma Adjustment EX 208(ai)

The pro forma debt interest adjustment reflects the income tax effect of the level of interest expense for test period rate base. Pacific Power & Light, supra, 78 P.U.R. 4th at 92. When the actual test year debt level differs from the debt level included in a capital structure adopted for ratemaking purposes, a pro forma debt interest adjustment is required. Id. Such an adjustment is required in this case in the amount of $1,547,000, as proposed by the Company.

The Company and Staff are in agreement as to how this adjustment is calculated. EX 413 and EX 173. The difference of $358,000 is brought about by differences in the respective pro-forma capital structures and cost of capital used by the Company and Staff.

11. Revenue Restating Adjustment EX 208(bj)

Please see the discussion of the Revenue and Gas Cost Proforma Adjustment EX 208(aa), Section 6, above.

12. DCD Low Income Weatherization Pro Forma Adjustment EX 208(k)

Staff recommended exclusion of the proposed five-year amortization of $300,000 paid by the Company to the Washington Department of Community Development ("DCD") for operation of the DCD's "Energy Matchmakers" low income residential weatherization programs within the Company's service territory. The Company was encouraged by the Commission to participate in this program and was the first LDC to do so. The Company proposes to amortize this expense over a 5-year period, or $60,000 per year with a net operating income effect of $40,000.

Staff proposes to disallow this amount on procedural grounds because Staff was not consulted before the funds were expended. In explaining Staff's recommendation, Thomas testified that the "primary problem is that we are not sure that it provided any benefits." EX 225, p. 41, ln. 13-17. Staff also complains that, "Had the Company come to Staff and asked for a preapproval for that program, they would have known that that was essential as part of the conduct of such programs." Id. at ln. 2-5. The Commission should reject Staff's claim of ignorance regarding the DCD Weatherization Program because Staff studied the DCD Weatherization Program and is well acquainted with it. EX 225, p. 68, ln. 12-14; EX 225, p. 81, ln. 6-24; EX 225, pp. 71-72.

Staff's assertion of ignorance of the benefits of the DCD low income weatherization programs is neither credible nor determinative of this issue. Staff chose to ignore relevant information. EX 225, p. 83, ln. 3-6; EX 225, p. 88, ln. 5-21. To the extent Staff "preapproval" should have been obtained, the

Commission should waive strict compliance and accept the Company's pro forma adjustment for its participation in the low income weatherization programs. The Company's 5-year amortization proposal is reasonable and should be allowed.

13. Safety Pro Forma Adjustment EX 208(t)

The Company has requested adjustments of $743,000 in operating expense and $4,029,000 in rate base. EX 408, Sheet 3 of 4, ln. 13, 15. These adjustments result from the Company's compliance with the Settlement and Operating Agreement ("Agreement") which the Commission approved in Docket No. UG-920487, and the revised safety rules which the Commission adopted in Docket No. UG-911261. EX 113, EX 170. The foundation calculations for the adjustments appear in Exhibit 360; they are based upon the Company's actual and committed costs through April 30, 1993, extrapolated through June 17, 1993 (concluding the first year of the Agreement). EX T-359, p. 18, ln. 20-23.

(1) Settlement and Operating Agreement

Staff and the Company entered into the Agreement in June, 1992. The Agreement imposes significant obligations upon the Company. The Company must replace more than 300 miles of cast iron pipe. EX 113, Para. 1G, 3K; EX 114, pp. 1-2. The Company must replace significant quantities of bare steel main and services. EX 113, Para. 3B; EX 114, pp. 3-4. Finally, the Company must incur substantial expense associated with various Agreement requirements. EX 113, Para. 3B, 3E, 3I-3L; EX 114.

The financial consequence of these obligations is dramatic. In its direct case, the Company estimated that it would need to spend $125 million in 1992 dollars, without any adjustment for future inflation, to comply with the Agreement. EX T-38, p. 6, ln. 19-20; EX 39; TR 1125, ln. 19. This figure has since been revised downward to reflect certain understandings with Staff on the Agreement's scope, the Company's experience in complying with the Agreement, and studies performed on the Company's system. EX T-359, pp. 12-13, 18-20. However, Staff has been unwilling to further limit the scope of the single biggest expense item, the cast iron replacement program. TR 3602, ln. 23-24. Faced with total first-year capital expenditures of more than $4,000,000, the Company must request rate support for the Agreement.

(2) Safety Regulations

In October, 1991, Staff convened a meeting to discuss proposed changes to WAC 480-93. EX T-359, p. 5, ln. 21-25. Following comment on the proposed rules, the Commission adopted final rules in September, 1992. EX 170. The rules impose additional (incremental) obligations upon the Company and have caused considerable expense through the first Agreement year.

(3) Staff Position

Ramirez contends that the Company may not, in this proceeding, recover any expenditures under the Agreement or the revised WAC rules. He makes two arguments. First, he claims that the Agreement requirements are not "incremental" to the requirements of WAC 480-93 (pre-amendment) and existing Federal safety rules (49 C.F.R. Part 192). Second, he argues that even if the requirements are incremental, the resulting expenditures are not "known and measurable" under the Commission's accounting rules. EX T-166, pp. 1-3.

(4) Incrementality

Cast Iron Replacement: Ramirez' position on incrementality is belied by his own testimony with respect to the cast iron replacement program. He admits that compliance with the program creates additional cost for the Company (EX T-166, p. 11, ln. 17-18) which, according to Gustafson, amounts to $1,912,870 through the first Agreement year alone. (This amount is in addition to replacement costs incurred during 1991, which are reflected in the Company's cost of service.) Ramirez further concedes that there has never been any state or Federal regulation, or order of this Commission (other than the Agreement), which has ever required replacement of cast iron. EX 168, p. 64, ln. 13-15, 24. The program cost is clearly incremental by Ramirez' own definition.[8]

Although not an accountant (EX 168, p. 9, ln. 16), Ramirez raises certain accounting issues respecting cast iron which he feels are "important to understand." He claims that the Company has received funds to date from the historical depreciation of cast iron pipe. He therefore speculates that these funds could have been earlier applied towards cast iron replacement, thus avoiding any need for replacement today. EX T-166, p. 11, ln. 21-24. Ramirez makes this claim even though he has no idea (because he has "not made that calculation") whether depreciation funds would be sufficient to replace the pipe according to

[8]The cost shown in Exhibit 360 is for replacement only and not for cast iron installation (which Federal law has not permitted since 1971). Despite innuendo to the contrary, (Ex. T-166, p. 10, ln. 16-17), Ramirez acknowledged during cross examination that the Company neither installs nor intends to install cast iron main in its distribution system. Ex. T-359, p. 15, ln. 12-13; Tr. 1554, ln. 12, 15.

the Agreement's timetable. EX 168, p. 71, ln. 7-8, 10. His speculation is also refuted by the rebuttal testimony of the Company's Chief Accounting Officer. The cash flow from depreciation has been used as prescribed in the Company's First Mortgage Bond Indentures to repay capital financing incurred to finance main construction. These funds are certainly not available or sufficient to fund an extremely costly replacement program beginning in 1993. EX T-359, p. 16, ln. 13-18; EX T-406, p. 42, ln. 13-18.

With the advantage of 20-20 hindsight, Ramirez argues that there would be no need for cast iron replacement today if the Company had not "discontinued" a replacement program from the 1970s. EX T-166, p. 12, ln. 5-6. However, he has no knowledge concerning the reasons for the replacement level during those years. EX 168, p. 72, ln. 23. As Thorpe testified in response to Chairman Nelson, the Company never "discontinued" replacement of cast iron main but, instead, decelerated replacement to a more normal basis following certain years of heavy replacement activity. TR 2900, ln. 3-17; EX 361. This activity had occurred because, based on an engineering analysis of repair-replace alternatives at that time, the Company decided to replace more cast iron than usual. EX T-359, p. 10, ln. 25-28, p. 11, ln. 1-4. Later, the Company repaired main rather than replacing it, by using an internal sealing program on cast iron in downtown Seattle. EX T-359, p. 11, ln. 12-15. None of these actions warrant criticism of the Company's subsequent replacement policy. As Gustafson and Karzmar testified, if the Company had spent significant replacement dollars in the 1980s that did not need to be spent, the costs would have been imbedded in rate base and the Company would already be charging ratepayers for this replacement in the form of higher rates. EX T-359, p. 11, ln. 9-19; EX T-406, p. 41, ln. 15-24.

Steel Main Replacement: The steel main replacement program results in capital expenditures of $394,751 during the first Agreement year. (This amount is in addition to replacement costs incurred during 1991, which are reflected in the Company's cost of service). EX 360, ln. 6. The 1992 revisions to WAC 480-93-188(3) (incorporated into the Agreement, see EX 113, ¶ 1C, 3B) added a new sub-section (e) which mandates semi-annual leakage surveys of areas with unprotected steel pipe. EX 170, p. 13. This frequency is incremental to the lesser frequency under the Federal rules (see 49 C.F.R. Parts 192.457(b) and 192.723(b)). The Company has performed economic analyses and determined that the cost of compliance with the new state requirement makes replacement the most economical and practical alternative. TR 592, ln. 21-25.

Ramirez does not question this incrementality. Instead, he claims that the expenditures for steel pipe replacement are overstated because the Company has not yet completed an area study. EX T-166,

p. 13, ln. 3, 13-15. Ramirez is wrong. As shown in Exhibit 360, the capital cost of unprotected steel replacement is based upon a completed study of the Company's system. EX T-359, p. 19, ln. 10-13. These expenditures should be approved by the Commission.

Services Replacement: The requirement for services replacement also stems from Paragraphs 1C and 3B of the Agreement, as well as the new requirements of WAC 480-90-188(3)(e), and results in capital expenditures of $1,721,482 during the first Agreement year. (This amount is in addition to replacement costs incurred during 1991, which are reflected in the Company's cost of service). EX 360, ln. 5. The figure is based on the Company's experience with instrument leakage surveys, as well as the completed system study which is referenced above. EX T-359, p. 19, ln. 3-5. These services must be replaced because, as Gustafson testified, it is impossible in most cases to cathodically protect bare steel services. TR 591, ln. 22-25. These expenses should also be accepted by the Commission.

Operating Expense (Agreement): The following expense items are incremental under the Agreement.

(1) Testing and tie-over work in connection with cast iron replacement, together with joint clamping when cast iron is exposed and not replaced in the course of service replacement. EX T-359, p. 20, ln. 4-9; EX 360, ln. 19-20.

(2) Upgrading of the Company's computer system and the design and utilization of new leakage survey forms, per ¶ 3E of the Agreement (not required by the pre-amendment version of WAC 480-93-186). EX T-166, p. 15, ln.1; EX 360, ln. 23.

(3) Use of a field inspector at Staff-agreed attendance levels to ensure compliance with 49 C.F.R. Part 192.755 (relating to cast iron protection), per ¶ 3I of the Agreement. EX T-166, p. 16, ln. 4-5; EX T-359; EX 360, ln. 24-25.

(4) Clamping of joints during construction. EX 360, ln. 27.

(5) Recording of conditions of all mains and services (including metallic and plastic pipe), per ¶ 3J of the Agreement. EX 360, ln. 28. The expense is incremental because federal record-keeping regulations only apply to metallic pipe (not plastic), as Ramirez agreed. TR 1548, ln. 4; see also 49 CFR Part 192.451(a).

(6) Designation of a qualified quality control person, per ¶ 3L of the Agreement. EX 360, ln. 28; EX T-166, p. 17, ln. 12-13; EX 168, p. 85, ln. 23.

The incremental expenses for these items total $633,002 for the first Agreement year (net of 1991 levels), as shown in Exhibit 360.

Operating Expense (Regulations): The following expense items are incremental under the revised WAC rules:

(1) Notification to gas customers when leak investigations are found to originate from foreign sources or facilities, per WAC 480-93-185. EX T-166, p. 8, 11. 10-11.

(2) Additional requirements for recordkeeping, per WAC 480-93-187. EX 168, p. 44, ln. 8-10.

(3) Increased frequency of leakage surveys which results in incremental expense, per WAC 480-93-188, including the use of a gas detection instrument to conduct surveys (which Ramirez admits has never been required previously). EX T-166, p. 10, ln. 3-7; EX 168, p. 61, ln. 19, p. 62, ln. 8.

The incremental expenses for these items total $242,056 for the first Agreement year (net of 1991 levels), as shown in Exhibit 360.

Known and Measurable

During his deposition, Ramirez claimed that the Company's safety costs are not known and measurable because "they have not been expended." EX 168, p. 98, ln. 18-19. He testified that the Company would have to proceed to another general rate case to address these costs. EX 168, p. 94, ln. 14. Even at that time, however, the costs may not be recoverable according to Ramirez:

> [T]he Company can request recovery at a later time when the expenditures have been made and all the system benefits that result from the expenditures have been realized.

EX T-166, p. 2, ln. 1-3 (emphasis supplied). He then concluded that this "benefit analysis" could delay rate recovery for up to 15 years (the duration of the cast iron replacement program):

> [W]e will look at the benefits as they develop, and again, . . . in order to look at these we may even take the 15 years that the program is -- the replacement program is scheduled for.

TR 1551, ln. 11-16 (emphasis supplied).

Deference should be given to the Company's cost projections with respect to the safety program. In a prior docket, the Commission gave similar deference to the "vast and extensive experience" of the Company's engineering staff in dealing with maintenance matters, and its credibility in projecting expenses. Washington Util. & Transp. Comm'n v. Washington Nat. Gas Co., 23 P.U.R. 4th 184, 194 (1977). In that case, the Company was granted a pro forma adjustment to offset increased maintenance costs attributable to recently adopted rules pertaining to reclassification of leaks. Staff attacked the Company's proposed adjustment on grounds that it was based on a projection, not actual experience. The Commission held:

> The Commission recognizes that not all things in a rate case hearing are provable with absolute certainty or are precisely measurable. For example, the rate of return necessarily includes a judgment factor. The company's engineering staff has vast and extensive experience in dealing with maintenance and as a professional staff, we recognize it has developed a degree of expertise which goes into its judgment. We must and do recognize that a judgment or projection made by the people having special expertise has credibility, if the projection is supported by believable testimony and experience. We believe it is reasonable to assume that the new rules on reclassification of leaks will result in additional maintenance and expenses, and on a whole, the company as a whole will as a result of the new rules, incur additional expenses.

23 P.U.R. 4th at 194 (emphasis supplied). Similarly, the Commission should give deference to the Company's "sound engineering and business judgment and expertise" which, as Gustafson testified, form the basis for the Company's pro forma adjustments. EX T-359, p. 4, ln. 23-26. The Company's actual expenditures and projections (through June 1993) are supported by testimony that is based on experience and expertise in this area.

Staff's rigid adherence to test year regulation and "benefit analysis" creates the worst form of regulatory lag. The Agreement represents an extraordinary circumstance which severely strains the Company's capital budget, and absent which the Company would not make the associated expenditures. TR 1126, ln. 1, 4; EX T-38, p. 6, ln. 25-26, p. 7, ln. 1-2. In Exhibit 360, the Company revised the requested adjustments to include only actual expenditures through the first Agreement year (extrapolated where necessary), less the 1991 expenditure level for these line items. The resulting figures are very conservative and do not reflect any contingency factor. TR 3576, ln. 13-14. But as Gustafson testified in response to Commissioner Hemstad, if recovery of actual expenditures incurred were delayed into the extended future, as Ramirez advocates, the Company would suffer immensely due to the immediacy and the magnitude of these expenditures. TR 3592, ln. 1-14.

The Company proposes to collect the safety expenditures by way of an equal-cents-per-therm tracker mechanism, and to appear annually before the Commission to 1) reconcile estimated and actual expenditures during the prior year, 2) approve additions to rate base during the prior year, and 3) adjust the tracker accordingly. EX T-3, p. 14, ln. 13-23; TR 3556-3558. This should allay any concern that the Company is being given carte blanche to impose a charge with a "life of its own." EX T-252, p. 22, ln. 23-24. The annual review process will also permit the Company, to the extent possible, to measure system benefits as a result of the safety program and to offset these benefits against the program cost. EX T-359, p. 21, ln. 26-27, p. 22, ln. 10-12.

Staff claims that the existence of these benefits requires denial of rate relief. EX T-166, p.2, ln. 1-3; EX T-206, p. 18, ln. 1-9. Staff ignores the fact that the Company will be able to measure during the annual review, to a certain degree of accuracy, the nature and scope of these benefits. TR 3596, ln. 19. Whether the benefits can be quantified to the same degree as during a rate case, see TR 3596, ln. 9-11, is not the point. The benefits can be estimated during the annual review, with deference properly accorded to the Company's engineering department in that process. EX T-359, p. 22; TR 3596, ln. 15. Adjustments to the Company's estimates can, if necessary, be made during the next rate case. The Commission would thereby recognize the enormity of the obligations now imposed upon the Company, and make appropriate allowances for their financial impact.

14. Uncontested Adjustments to Net Operating Income EX 208(g)-(i), (m), (o), (p), (w), (x), (ah), (an), (ax), (ay), (az), (ba), (bb), (bd), and (be)

III. RATE BASE ADJUSTMENTS

1. Leased Plant Restating Adjustment EX 208(ad-l)

Please see above Net Operating Income Adjustments, Section 4, Leased Plant Restating Adjustment.

2. Merchandising and Jobbing Plant Restating Adjustment EX 208(ad)

The Company submits that, with the adoption of Scenario B from the AA Study, (See above, II, Section 3), there is no applicable rate base adjustment. The merchandising operations will move out of Company buildings and utility employees will then occupy the space entirely. TR 2854, ln. 14-15; EX TR 2855, ln. 21-24; TR 2866, ln. 16-21; TR 3765, ln. 23-25.

3. Storage Gas, Environmental, and Safety Restating and Pro Forma Adjustments EX 208(r), (s) and (t)

With respect to the impact of Storage Gas and Environmental costs in the Allowance for Working Capital, please see Working Capital Allowance, below. With respect to the impact of Safety Expenses on Rate Base, see Safety Pro Forma Adjustment.

4. Working Capital Allowance EX 208(af)

The Company proposes a total allowance for working capital of $15,670,000 consisting of $7,472,000 actual per books for the 12 months ended December 31, 1991 and adjustments totalling $8,198,000 relating to storage gas and environmental cleanup costs.

Staff, on the other hand, proposes to reduce the $7,472,000 allowance for working capital per books for the 12 months ended December 31, 1991 to $1,290,000, a difference of $6,182,000. In addition, Staff rejects entirely the Company's proposed pro forma adjustments. EX 410.

a. Test Year Allowance for Working Capital

The $6,182,000 difference in the test year calculation of Allowance of Working Capital before adjustments consists of 4 items:

(1) Gas Cost Deferral The Company agrees with Staff's adjustment to invested capital if the $769,000 federal income tax effect, necessary to make the adjustment correct, is made. EX T-406, p. 25, ln. 15-24.

(2) Deferred Environmental Remediation Costs The $2,293,000 of pre-1991 environmental remediation costs should be included in allowance for working capital. In accordance with Financial Accounting Standards Board (FASB) statement No. 5, "accounting for Contingencies," (GAAP), the Company has recorded its cost related to environmental remediation from 1984 through December 31, 1990 as an accounts receivable.

Staff contends that environmental remediation costs should be removed from working capital allowance in accordance with the Commission's Order in the accounting petition in Docket UG-920781. EX T-171, p. 17, ln. 16-20.

There is no indication in the Commission's adoption of the accounting methods approved in the Accounting Order in Docket UG-920781 that pre-1991 costs related to environmental remediation should be reflected as a deferred charge; EX T-406, p. 27, ln. 12-16. The continued recording of pre-1991 costs should remain in accounts receivable, in conformance with the Commission's ruling in Docket UG-920781, which was silent as to the treatment of such costs; and in conformance with FASB statement No. 5, Accounting for Contingencies (GAAP). The Company has thus reclassified this item from Staff's adjustment to the investment-related deferred debit, back to accounts receivable, where it belongs. The environmental remediation costs are properly in accounts receivable; are not part of the Company's non-operating investment; are not related to any investment the Company is making at all, and clearly not an investment-related deferred debit. The Company's adjustment for this item and reclassification back to the book account of accounts receivable is proper and should be allowed as part of working capital for ratemaking purposes. The Company is no longer allowed to accrue carrying charges on this item, TR 3767, ln. 15-17, and an appropriate working capital allowance instead would now be fair and reasonable.

Further, see discussion of Environmental Remediation Costs below.

(3) Restating Adjustments This difference between Company and Staff has no effect on the total average net investment or net allowance for working capital. It relates only to the utility working capital allowance component, based upon the Commission's determination as to the significant rate base reductions proposed by Staff for leasing and merchandise and jobbing. EX 177, ln. 16, 24; EX 410, ln. 16, 24.

(4) Working Capital Allowance - Merchandise Inventories The Company performed an allocation study regarding the amount of materials and supplies classified in its books as "Other" to be allocated to merchandise, and also the amount to be allotted to jurisdictional portion of inventory. The relevant materials are those usable for both merchandise and underground distribution, construction and repair work.

The Company's study indicates that 49.7% and 15.6% of such Company and installers balances are related to merchandise appliances, and the remainder are redistributed in accordance with Staff's adjustment. EX 417, ln. 2-3. Staff performed no study to attempt to determine what the actual relationship should be. Therefore, the Company's position should prevail.

Furthermore, Staff allocated all parts relating to the Company's leased appliance program to merchandise. That program is jurisdictional, and the Company expects it to remain so. Leasing parts should remain part of the regulated business inventory in calculating working capital allowance.

b. Pro Forma Adjustment to Allowance for Working Capital - Environmental Remediation Costs

The Company is entitled to an Allowance for Working Capital for funds it has expended and is continuing to expend in compliance with environmental laws for remediation of a former manufactured gas plant. Although the Commission dismissed the Company's proposed "environmental tracker," designed to recover the amounts being expended, it ruled that the Company would be allowed to argue for an allowance for working capital for such funds. TR 509, ln. 10-12. In responding to questions from the Commissioners, counsel for Staff recognized that it might be appropriate to go beyond test-year expenses when calculating a working capital allowance. TR 501, ln. 5; TR 507, ln. 21.

In its rebuttal case, the Company sought a pro forma adjustment to allowance for working capital for only the amount of remediation expense actually expended from January 1, 1991 through April 30, 1993 of $7,256,000. EX 146; 148. When adjusted consistently with other pro forma or restating working capital adjustments, this amount yields a $6,828,000 pro forma allowance for working capital adjustment. (This contrasts with the Company's request in its original filing, for amortization of operation and maintenance expense of $3,706,000 plus an allowance for working capital adjustment of $11,221,000). Staff's proposed allowance of $521,000 for working capital relating to environmental remediation costs is unreasonable in view of the fact that the Company had expended $7,776,841 from January 1, 1991 through April 30, 1993, and in view of Company Witness Timothy Hogan's ("Hogan") uncontroverted testimony and exhibits which project that the Company will have expended approximately $18,560,000 through June 30, 1994 (only nine months into the first rate year following these proceedings) EX 146, 148. More importantly, Staff's proposed allowance does not respond to the concerns expressed by Commissioners Casad and Pardini, prior to granting of Staff's motion. The Company's proposal, on the other hand, is both reasonable and fully responsive to any "known or measurable" concerns.

c. Pro Forma Adjustment to Allowance for Working Capital - Clay Basin Storage Gas

The Company has proposed a pro forma adjustment to allowance for working capital in the amount of $1,788,000 for increased purchases of storage gas subsequent to the test year. Staff has not recommended any adjustment. Although the Company's expenditures were subsequent to the test year, storage gas will be purchased during the period that rates are in effect. Even more importantly, the Company expenditures for storage gas are contemplated in and consistent with the Company's Least Cost

Plan. If under the Least Cost Plan, the Company is expected to expend funds for storage gas, it must at a minimum recover carrying costs for such funds through a working capital allowance.

The Company's proposed $1,788,000 allowance is reasonable in light of projected commitments. The requested allowance has been significantly reduced from the original $5,891,000 amount. The revised request as been computed using average-of-monthly averages for calendar 1992. As Karzmar testified, the Company has committed to purchase $22.1 million of storage gas. EX T-406, p. 34, ln. 2. These additional storage gas purchases, which result from FERC Order No. 636 and which are an integral part of the Company's Least Cost Plan, clearly benefit ratepayers through purchase of gas at low summer rates. As the Commission stated in its Third Supplemental Order relating to the Company's storage purchases, in Docket No. UG-911236:

> Using its new arrangement, the company has been able to make low-cost gas purchases in the spring and summer months for storage and winter withdrawal. The Commission applauds this efficiency and accepts the company's representation that the practice has saved money for the ratepayers.

The Company's proposed adjustment should be allowed.

d. No Offsetting Amounts From Ratepayers to Fund Increased Environmental Remediation and Storage Gas Costs

Staff alleged that the proposed pro forma adjustments to allowance for working capital are inappropriate because there could be offsetting items which counter the increased working capital requirement. This allegation is unsupported and is refuted by Karzmar's Exhibit 414, which calculates the investor-supplied working capital requirement for the calendar year 1992 following the test year (calculated on a consistent basis), and which yields an allowance for working capital of $24,641,000.

In summary, the Company's allowance for working capital is reasonable and fully responsive to "known and measurable" concerns. Staff's allegations that the increased requirement might have been funded by ratepayers through unspecified offsetting factors have been clearly demonstrated to be unfounded by Exhibit 414.

5. Incentive Pay and Performance Share Plan Restating Adjustments EX 208(bg); (bf).

Please see above, II, 7.

6. Uncontested Rate Base Adjustments EX 208(g), (x), (ac), and (ag)

Staff and the Company agree that the adjustments listed in columns (g), (x), (ac) and (ag) of Exhibit EX 208 are uncontested.

IV. LINE EXTENSIONS

Staff did not propose a monetary adjustment with respect to service extensions, TR 3500, ln. 5-7, and the evidence established that no such adjustment is warranted. Therefore, the Commission should not be swayed by Staff's repeated attempts to evoke a "feeling" that the Company has made financially unreasonable extensions.

As the testimony of Company Witness Heidi Caswell ("Caswell") demonstrates, Staff's assertions that service extensions were economically imprudent is flawed. EX T-351, p. 7, ln. 8-16. Staff's analysis of line extensions between 1984 and 1991 is based on an unrepresentative sample, and it overstates construction costs, and understates expected future revenue. EX-T 351, p. 9, ln. 24 p. 10, ln. 8. Had Staff considered all relevant cost and revenue factors, it would know that the Company's capital expenditures on line extensions between 1984 and 1990 were "economically justified." Caswell testified that:

> Staff's study failed to incorporate several relevant factors which should be considered to determine the "reasonableness" of the plant investments. First, for the projects studied by Staff, costs were overstated and revenues were understated by Staff due to inappropriate assumptions and inadequate consideration of relevant economic factors. Second, the sample of projects studied by Staff included only 17% of the total line extensions and was not representative of all line extensions between 1984 and 1991.

EX-T 351, p. 7, ln. 8-16. Staff's study did not account for the fact that adding service to new residential developments costs less than extending service to existing neighborhoods. EX-T 351, p. 13, ln. 4-27.

Furthermore, Staff's study is unrepresentative of actual costs in that it excluded an enormous number of projects costing less than $25,000 and related downstream projects. EX T-351, p. 12. Such projects typically result in addition of new customers more quickly than extensions into new developments. Line-extension projects in existing areas often result in immediate use of natural gas. EX T-351, p. 13. Staff's study overlooked this fact. EX T-351, p. 13-14.

Staff's study failed to consider project costs net of customer contributions which reduce the Company's net cost of construction. EX T-351, p. 16-17.

Clearly, the Company's service extensions have been economically justified. The Commission should disregard Staff's repeated allusions to such extensions.

V. FAIR RATE OF RETURN

As outlined at the beginning of this brief, the Commission must grant the Company a fair rate of return which will enable the Company to preserve its "A-" long-term debt rating. P.O.W.E.R., supra.

Introduction: Risk Considerations

Investment risk is comprised of two components: business risk and financial risk. Business risk is defined as variability in earnings before interest and taxes (EBIT) or in return on assets (ROA). Even if the business has no debt or, has 100% of common equity in its capital structure, it still faces business risk. Eugene F. Brigham, Fundamentals of Financial Management, 6th edition, The Dryden Press, Fort Worth, Texas, Chapter 11, pages 447-455; see also EX 289. Factors, such as competition, weather, growth, and regulation, contribute to business risk faced by local gas distribution companies. Financial risk is defined as the percentage of debt in a business firm's capital structure and the associated level of interest obligations. Id. The combination of business risk and financial risk equals total investment risk. Id.

Company Witness James Torgerson ("Torgerson") testified concerning total investment risk which the Company faces:

> We have to look at I think the fact that the business risk for LDCs has been increasing with FERC 636. The gas on gas competition we have today, the growth we're experiencing. I mean, these are all affecting the business risk of the company.
>
> And as business risk goes up, the traditional management response is to decrease the financial risk. Investment risk is made up of two components, business risk and financial risk. So, by decreasing the financial risk means lowering the debt ratio or conversely increasing the equity in the company.

Tr. 3392-93, ln. 15 - p. 3393, ln. 1.

Witness Daniel Tulis ("Tulis") of Smith Barney, testified that regulation is a major component of business risk for a regulated utility such as WNG:

> The substantial uncertainty as to the outcome of the rate case engendered by the Staff's recommendation evoked a visceral reaction from some institutional holders.
>
> On April 19, 1993, the day before the Staff report, WEG common stock closed at $25 7/8, $1/2 below the 52-week high of $26 3/8. On Wednesday, April 21, the first day the market had to react to the Staff report, WEG common stock declined to $22 3/4 at the close on 156,300 shares, a 12% price decline on approximately three times normal volume. The 12% price decline was the largest percentage decline in WEG's history. On Thursday, April 22, WEG common stock declined an additional $3/8 on 203,200 shares. From April 22 to June 1, WEG common stock closing prices ranged from $22 to $22 7/8.

EX T-349, p. 7., ln. 3-18.

In accordance with its rules authorizing administrative (judicial) notice, the Commission may notice that at August 9, 1993 the WEG common stock closing price had declined further to 21 1/4.

Torgerson states the following concerning the impact of sales growth on risk and the financial health of WNG:

> Currently, for example, the Company has faced rapid growth in the number of customers we serve. This growth has placed a severe strain on the financial resources of the Company. Cash flow from current operations is not sufficient to fund this expansion. In order for Washington Natural to continue to extend the availability of natural gas for space and water heating in lieu of electricity, the Company must be able to access the capital markets on a continuing basis to fund this growth.

EX T-345, p.8, ln. 3-11.

Bond rating agencies consider business risk and financial risk when evaluating an energy utility's financial position and assigning a specific bond rating. Exhibit 289, pp. 1-6, provides a detailed discussion concerning the factors associated with business and financial risk that Standard and Poor's (S&P) considers when developing and assigning a specific bond rating to a specific energy utility.

In their direct testimony, Torgerson (T-48, p. 28), Staff Witness Richard Lurito ("Lurito") (T-285, p. 10), and Public Counsel Witness Stephen Hill ("Hill") (T-296, p. 44) acknowledged the importance of maintaining WNG's "A-" long-term debt rating. The important differences among these three witnesses are the <u>means</u>, the appropriate capital structure and the appropriate return on capital, to achieve the goal of preserving an "A-" long-term debt rating for WNG.

This Commission's decision should be crafted to maintain WNG's "A-" long-term debt rating and by doing so, to comport with the guidelines established by the Untied States Supreme Court in cases, such as <u>Bluefield</u> (1923), and <u>Hope</u> (1944).

<u>Appropriate Capital Structure Ratios</u>

Comparison of Proposed Capitalization Structure Ratios

Witnesses	Common Equity	Preferred Equity	Short-Term Debt	Long-Term Debt
J. Torgerson	45%	7.69%	2.78%	44.53%
R. Lurito	41%	7.5%	6.0%	45.5%
S. Hill	42.14%	8.18%	5.49%	44.19%

The primary difference between Torgerson and Lurito concerning proposed capital structure is that Torgerson proposes a higher common equity ratio and lower long-term and short-term debt ratios relative to Lurito's proposal. The primary difference between Torgerson and Hill concerning proposed capital structure is that Torgerson proposes a higher common equity ratio and a lower short-term debt ratio relative to Hill. Stated simply, because both Lurito and Hill are exposing WNG to a significantly higher level of financial risk as compared to Torgerson, the Commission should adopt Torgerson's capital structure. Doing so will also provide WNG with the best opportunity to preserve its "A-" debt rating.

Torgerson described in his testimony why Lurito's proposed capital structure is inappropriate and unreasonable for WNG.

> 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. In the final analysis, Witness Lurito is asking the Commission to substitute his judgment for the judgment of management with respect to the Company's proposed 45% common equity ratio even though the Company's ratio falls within both the S&P bond rating criteria and within the common equity ratios maintained and projected for Witness Lurito's selected group of "comparable" gas distributors, as well as for the natural gas industry at large.

EX T-345, p. 3, ln. 8025.

Torgerson also testified as to why Hill's proposed capital structure is inappropriate and unreasonable for WNG.

> While Witness Hill's proposed common equity ratio of 42.14% is slightly higher than Witness Lurito's proposed common equity ratio of 41%, it is still inadequate and unreasonable and does not comport with the common equity ratios maintained by Witness Hill's sample group of gas distribution companies, the projected common equity ratios for these comparable companies, the natural gas distribution industry average common equity ratio, WNG's projected common equity ratio, nor S&P's total debt to total capital benchmark criteria.

EX T-345, p. 13, ln. 9-18.

Role of Preferred Stock in Capital Structure

Preferred stock is a hybrid financing device because it has some features that are similar to bonds and other features that are similar to common stock. Preferred stock dividends are similar to interest payments from bonds because they are fixed in amount and are paid before common stock dividends. However, preferred stock dividends, if not earned, can be omitted without throwing the corporation into bankruptcy. From the perspective of the common equity owner, the preferred dividend is a fixed charge which reduces the earnings on common equity in a similar manner as interest on debt and contributes to financial risk. Brigham, Fundamentals of Financial Management, 6th Edition, p. 454; p. 620.

Torgerson testified to the following important points concerning preferred stock and WNG:

> A. Yes. There are three components there. You have debt, preferred and common equity.

Q. And Standard and Poor's is aware of that possibility, too, I assume?

A. Certainly. And they also when they look at these capital structures, they look at the preferred stock and determine what kind of preferred stock it is and whether they determine if it's more like debt or more like equity.

So, just to say that preferred stock can wash out whatever the debt is not necessarily true. If you have debt and then you have a lot of preferred stock that has maturities that are, let's say, ten years or so, they will consider that to be debt.

TR 3322, ln. 12-25.

Torgerson then explained the following important limitations concerning WNG's preferred stock:

Q. Then let's look at Washington Natural. And what in your preferred stock could be considered debt?

A. I think the -- let's see -- it would be the series one, Roman numeral I, which has a very short maturity, and the Series C. Those all have to be retired within the next I think four years.

Which is the bulk of our preferred stock. That's 25 million out of the 32 million we have outstanding.

Q. When Standard & Poor's computed your total debt to total capital ratio, did they consider that to be debt?

A. I didn't say they oonsidered it to be debt. They considered it to be similar to debt. A debt-like instrument. And they factor it in. They don't put it into the total debt calculation. But they keep it in mind as to what the makeup of the preferred stock is.

TR 3324, ln. 8 to p. 3325, ln. 1.

The Commission should give greatest weight to Torgerson's recommendations regarding the proper capital structure for WNG. Torgerson is WNG's Chief Financial Officer. EX T-345, p. 1, ln. 23. Torgerson is responsible for knowing the securities market as well as the oil and gas markets. TR 1227, ln. 6-18. Lurito has little, if any, practical or "real world" experience in dealing with debt rating agencies or directing utilities financing programs. His testimony illustrates that:

Q. Did you have any practical experience whatsoever in raising capital for utility companies?

A. No.

Q. Have you ever participated with a utility as an advisor in a credit review process before one of the rating agencies?

A. No, sir.

TR 2540, ln. 10, to p. 2541, ln. 1.

Hill also has little, if any, practical or "real world" experience in dealing with debt rating agencies or in dealing with utilities concerning financing programs.

> Q. Have you ever been engaged for a fee to design a financing program for any kind of utility?
>
> A. We went over all of this in the deposition and the answer is no, I have not.

TR 2685, ln. 20, to p. 2686, ln. 13.

In his deposition, Hill testified that he was not a certified financial planner and that he had never been employed as a financial adviser. EX 300, p. 33.

This Commission should not substitute the recommendations of Lurito and Hill for the judgment of Torgerson which is based on his applied financial expertise. Indeed, Torgerson confers regularly with representatives of Standard & Poor's and Moody's regarding WNG's credit rating. Torgerson knows the financial requirements needed for WNG to maintain its "A-" long-term debt rating. Torgerson's recommended capital structure provides WNG with a reasonable opportunity to preserve its "A-" long-term debt rating. That is confirmed by Tulis's testimony. TR 3435, ln. 22, to p. 3437, ln. 16.

Ratepayers benefit from a healthy capital structure such as that proposed by Torgerson. Foremost among the benefits of Torgerson's capital structure will be maintenance of the Company's A- long-term debt rating. Clearly, losing that debt rating results in a higher cost of capital for the Company. Just as clearly, increasing the Company's cost of capital increases the cost of natural gas service for ratepayers.

In summary, the capital structure, specifically the common equity ratio, proposed by Hill and Lurito is inadequate and inappropriate to maintain the Company's "A-" long-term debt rating; increases WNG's financial risk, and does not address the increasing business risk faced by WNG. See, EX 291. In contrast, the capital structure, specifically the common equity ratio, proposed by Torgerson both reduces financial risk and addresses the increasing business risk faced by WNG and is both appropriate and reasonable to maintain the "A-" long-term debt rating. As Torgerson testified:

> In conclusion, therefore, while Witness Hill's suggestion that the Company's de-leveraging would force the Company to forego opportunities to take advantage of low cost capital, it would be more costly in the long run for the Company to take advantage of temporarily low cost short-term capital. It would be more cost-effective for the Company, in the current economic environment, to issue the common stock it proposes to do. EX T-345, p. 18, ln. 25 to p. 19, ln. 5.

Cost of Capital Components.

Witness	Common Equity	Preferred Equity	Short-Term Debt	Long-Term Debt
J. Torgerson	12% to 12.25%	7.66%	3.75%	8.72%
R. Lurito	10.5%	7.98%	3.75%	8.76%
S. Hill	10.25 to 10.50%	8.05%	4.06%	8.91%

Lurito's proposed cost of common equity, as well as Hill's, is significantly lower than the cost of common equity proposed by Torgerson. Both Hill and Lurito inadequately consider the business risks and financial risks facing WNG in developing their estimated costs of common equity.

Lurito exclusively relied on (and Hill primarily relied on) an application of the discounted cash flow (DCF) model in estimating and determining the expected cost of common equity for WNG. Torgerson testified to the following fundamental criticisms of Lurito's and Hill's application of the DCF model.

> These are: (1) Witnesses Lurito and Hill have relied exclusively or primarily upon DCF, a model which is based upon major assumptions that can fluctuate dramatically causing instability in the results; and (2) they have made no adjustment to the DCF indicated common equity cost rate results for their barometer group companies to recognize the financial risk difference between Washington Natural and their selected "comparable" companies as discussed.

EX T-345, p. 20, ln. 8-16.

Lurito has inconsistently applied the DCF model. Torgerson showed in his testimony that Lurito has inconsistently estimated the dividend yields in this rate case relative to Lurito's prior testimony such as in a Potomac Edison Company Case (Case No. 7338) before the Maryland Public Service Commission.

> Clearly, Witness Lurito in the past used a 36-month average dividend which produced a lower yield for DCF purposes compared to a higher 12-month yield and today uses a 12-month average dividend yield to produce a lower yield compared with a higher 36-month average. This result-oriented selection highlights the volatility and subjectivity in Witness Lurito's application of DCF. Again, there is clearly a need to use DCF in conjunction with another method, such as CAPM or pure risk premium. EX T-345, p. 35, ln. 20 to p. 36, ln. 2.

Lurito also developed inconsistent results based on his DCF analysis and considerations of risk factors in this rate case relative to the current Puget Sound Power & Light Company ("Puget") rate case. Torgerson explained this:

> Therefore, notwithstanding Witness Lurito's calculations which show a four times as great potential for deviation from the achieved return for Washington Natural compared with Puget Power, he recommends a higher common equity cost rate for Puget Power than he does for Washington Natural, in both instances using DCF. EX T-345, p. 37, ln. 19-25.

Torgerson additionally demonstrates:

> If Witness Lurito had consistently applied the interest charge coverage criteria to WNG that he applied to Puget Power then Witness Lurito would have recommended a return on equity of approximately 13% for WNG as opposed to his 10.5% return. EX T-345, p. 41, ln. 6-9.

Not only does Lurito reach inconsistent conclusions applying his DCF methodology to WNG and Puget Power, his testimony shows confusion and inconsistency regarding his DCF results, as applied to these two Washington state utilities:

> Q. In short, is it fair to say that you believe the risk faced by the common equity investors in Washington Natural Gas Company is about 25 basis points lower than the risk faced by Puget Power investors?
>
> A. Well, that's what my study seems to have shown, yes.

TR 2610, ln. 24 to p. 2611, ln. 5. However, Lurito goes on to testify:

> Q. So Washington Natural Gas Company's earnings are more volatile than Puget's, according to your analysis?
>
> A. I think that's fair, yes, sir.
>
> Q. When a stock has greater volatility, Dr. Lurito, one would expect investors to require a higher return for the use of their capital, right?
>
> A. All other things the same, yes.

<u>See</u> TR 2612, ln. 21 to p. 2613, ln. 3.

Hill's testimony also illustrates serious confusion concerning his inconsistent positions in the WNG case relative to the Puget Power case:

> Q. Is it fair to say in contrasting your positions in this docket and in the Puget rate case that's now in process before this Commission that the risk of investing in Washington Natural Gas Company is about three quarters to one percent greater than the risk of investing in an electric company?
>
> A. No.

Based on similar common equity ratios for the two Washington utilities, Hill concluded that a 9.5% cost of equity capital was appropriate for Puget Power and a 10.25 to 10.5% range was appropriate for WNG. Plainly, the Previous answer from Hill and his proposed costs of equity capital for Puget and WNG are not reconcilable and suggest a lack of consistency in his testimony.

Hill's analysis concerning the cost of common equity for WNG in this rate case also produces inconsistent results relative to WNG's last rate case. Torgerson shows the following:

If Witness Hill had applied the same spreads from the Company's last rate case to today's rates it would have provided a range of 11.35% to 11.80 based on an A rated utility yield of 7.84% and a 30 year treasury yield of 7.00%.

These rates are much closer to my recommended equity return and since they are historical spreads, they do not reflect the additional 25 basis points for FERC Order 636 or the weather normalization premium. EX T-345, p. 43, ln. 5-14.

These are serious shortcomings and flaws in both Lurito's and Hill's estimations of the expected cost of common equity. In contrast, rather than placing exclusive or primary reliance upon only DCF, Torgerson used the two methods of DCF and the Capital Asset Pricing Model (CAPM) in developing an estimate of the expected cost of common equity. Torgerson recognizes the relative strengths and shortcomings of both DCF and CAPM for estimating the cost of equity for an energy utility. As Torgerson testified, approximately 80% of the regulatory commissions in the United States rely on a combination of methods. See, EX 346, Schedule 13.[9]

Torgerson concludes that the appropriate expected cost of common equity for WNG is between 12% and 12.25% for this rate case. Torgerson testified:

By taking the midpoint of the CAPM and DCF methods, I determined a bare cost of equity capital of 11.36%. To that I add the additional risk premium related to FERC Order 636 of .25% for a total of 11.61%. Should the WUTC deny the Company's request for a weather normalization adjustment, up to an additional .25% should be added to the cost of equity capital. This provides a range from 11.61% to 11.85% as shown on Exhibit 346, Schedule 30. After adjustments for flotation costs of 3.10% from Exhibit 346, Schedule 31, my recommended equity cost of capital ranges from 12.0% to 12.25% EX T-345, p. 49.

In summary, Torgerson's recommended range of 12% to 12.25% for the expected cost of common equity reasonably and appropriately considers business risks and financial risks facing WNG.

Overall Rates of Return

Torgerson recommends an overall return on capital of 9.98% to 10.09% for WNG. EX T-345, p. 45, ln. 26. Lurito recommends an overall return of 9.11%. EX T. 285, p. 40, ln. 11-13. Hill recommends an overall return of 9.14% to 9.24% which is similar to Lurito. EX T-296, p. 44, ln. 16-18.

---

[9]The Hawaii Public Utilities Commission has held that in determining the cost of common equity, the DCF, CAPM and RP methods should all be considered and given equal weight. See Re Hawaiian Electric Co., Inc., 128 P.U.R. 4th 471, 536 (Haw. P.U.C. 1991). The West Virginia Public Service Commission has held that the critical factor in setting return on equity is not which method is applied, CAPM or DCR, but rather that the Hope, Bluefield, and Permian Basin tests of financial integrity, capital attraction, comparable earnings, credit maintenance, and confidence in the soundness of the utility be met. See Monongahela Power Co., 125 P.U.R. 4th 126, 146-47 (W.V.P.S.C. 1991). In that case, the Commission rejected Hill's recommended return on equity of 11.5%, and instead allowed the utility a 12% return.

The overall rate of return on capital recommended by Torgerson is appropriate and provides a reasonable foundation for WNG to maintain its current "A-" long-term debt rating. By contrast, the overall rates of return on capital recommended by Hill and Lurito are inadequate and unreasonable because of the following previously discussed considerations: (1) inadequate common equity ratio which does not reasonably balance the business risks and financial risks facing WNG; and (2) flaws and shortcomings in their application of the DCF method used to estimate an unreasonably low cost of equity capital.[10]

Coverage Ratios and Impact on Bond Ratings

Based on his overall rate of return, Lurito proposes a 2.82 times before tax coverage of WNG's total interest obligation. EX T0285, p. 37, ln. 20. Lurito also acknowledges that, based on his analysis, the Company's overall rate of return could be 27.31% lower which would result in a before income tax coverage of 1.90 times based on historical experience. See, EX T-345, p. 6, ln. 18 - p. 7, ln. 8. Hill proposes a 2.81 to 2.85 times before tax coverage of WNG's interest obligations.

Standard & Poor's Corporation has established guidelines or benchmarks for pre-tax interest coverage ranges from 3.0 times to 4.25 times for an "A" rating and 2.0 to 3.25 times for a "BBB" rating. EX 289. Clearly, Lurito's and Hill's recommendations to this Commission fall solidly within the "BBB" category and are below the "A" category. Thus, Lurito and Hill propose to jeopardize WNG's debt rating of "A-" by their recommendations to this Commission.

By contrast, Torgerson proposes a 3.35 to 3.39 times before tax coverage of WNG's interest obligation, and this proposed coverage ratio should maintain the "A-" long-term debt rating considering business and financial risk factors. See, EX 346, Schedule 23.

In considering the differences between the recommendations of Lurito and Hill (which would apparently result in a downgrading of WNG's long-term debt rating) and Torgerson's proposal, which would protect the Company's rating, the Commission should remember Tulis's testimony:

> For debt and preferred stock, credit ratings are a slippery slope. It is much more difficult to improve a notch than to drop a notch. Rating agencies typically demand consistently improved results over extended periods, coupled with realistic positive forecasts, before granting upgrades. Downgrades create unfavorable perceptions in the market which linger long after interest coverage and cash flow begin to improve. EX T-349, p. 12, ln. 4-10.

---

[10]The Commission in past cases has favored selection of comparable companies that match actual cost of equity of the utility. See Washington Util. & Transp. Comm'n v. Pacific Power & Light Co., 68 P.U.R. 4th 396, 409 (W.U.T.C. 1985). The Commission has rejected use of companies with higher bond ratings and equity ratios as "comparable companies". 68 P.U.R. 4th at 408.

Market-to-book Ratios

Lurito uses 1.05 as a target or reasonable market-to-book ratio for WNG in his analysis for estimating the cost of equity based on DCF analysis to be 10.5%. T-285, p. 30, ln. 6 to p. 31, ln. 15. Hill uses a market-to-book ratio analysis, which is based on DCF theory, to support his recommended cost of common equity for WNG to be between 10.25% to 10.5% that is primarily based on DCF. T-296, p. 35, ln. 3 to p. 36, ln. 25 and p. 44, ln. 3 to ln. 15.

Torgerson presents the following important cautions concerning market-to-book ratios and DCF analysis:

> In conclusion, any time a stock sells either greatly above or below book value, DCF is an unreliable technique, particularly if relied upon exclusively, given that the cost rate is derived from: (1) a measure of value different than the measure of value to which it is applied; (2) given that there is no proof that investors behave the way the DCF model assumes, including the efficient market hypothesis and the other various assumptions regarding investor behavior, including, but not limited to the notion that stock prices grow in proportion to changes in earnings, dividends, book value, and retention growth; and (3) the further notion that, over time, dividend payout ratios and price-earnings multiples remain constant. EX T-345, p. 33, ln. 19 to p. 34, ln. 4.

Tulis also recognizes limitations concerning market-to-book ratios in estimating the cost of a regulated energy utility:

> Q. Let's enter into a little bit of theory here. Do you think it would be appropriate for regulation to set a utility rate sufficient to produce a market-to-book ratio of, say, only .8?
>
> A. I believe that the rate should be set at such a level that would allow the company to cover its fixed obligations and to earn a reasonable profit for its investors, and the market-to-book ratio will take care of itself.
>
> People like myself will influence the market-to-book ratio. A lot of it is psychology. A lot of it is anticipation. A lot of it is the feeling about the fairness of the regulatory treatment to the utility.
>
> If I felt that there was going to be a major change in a particular state and so made that aware to clients, the market-to-book ratio would be affected. A lot of it is prospective rather than trying to set a return to get a certain market-to-book ratio.
>
> I think it's more, as Mr. Torgerson testified, that it should be a fair return that allows the shareholder just to see a benefit.
>
> Q. You aren't rejecting market-to-book ratio as an indicator?
>
> A. No. But I wouldn't determine the rates on the market-to-book ratio. If that would be the case, then I would recommend to you today that the market-to-book ratio should be between 1.7 and 2. And I don't know if that's -- you know, that's not the -- we're not saying that, although there might be a rationale for that.

> The average market-to-book ratio, as shown here, is about 1.5 or -- no. I think it should be based on a level of return that's compensatory with interest rates and other -- covering costs so that we can see an earnings growth and dividend growth pattern.

TR p. 3422, ln. 5 to p. 3423, ln. 18.

Weather Normalization Adjustment—Impact on Cost of Common Equity.

Lurito does not explicitly consider in his DCF analysis that the majority of the six LDCs in his DCF group of comparables already have weather normalization adjustment clauses which reduce business risk. Hill opines that a 10.25% return on common equity, which is at the low end of his recommended range, would be appropriate if the Washington Commission approves a weather normalization clause. EX T-296, p. 51, ln. 8-12. However, Hill fails to consider that approximately half of his group of comparable LDCs already have weather normalization clauses which reduce business risk.

Torgerson makes the following reasonable and appropriate conclusions concerning a weather normalization clause and the cost of common equity in this rate case:

> Because a majority of the LDC's in Witnesses Lurito and Hill's barometer groups already have weather normalization clauses, if Washington Natural's request for a weather normalization clause is approved, then a reduction in the expected cost of common equity capital based on both Witnesses Lurito and Hill's analysis using their barometer groups should <u>not</u> be made. On the other hand, if Washington Natural's request for a weather normalization clause is not approved, then an increase in the expected cost of common equity capital based on both Witnesses Lurito and Hill's analysis using their barometer groups would logically result. EX T-345, p. 44, ln. 14-25.

Torgerson recommends that a .25% increase in the cost of common equity capital, to 12.25%, for WNG should be allowed if the Commission does not permit a weather normalization clause to be implemented in order to reduce business risk.

SUMMARY

In responding to a question from Commissioner Casad, Tulis provided a fitting explanation of the financial importance of this rate case and the Commission's final order for the Company:

> COMMISSIONER CASAD: Your view of that, I gather from your testimony, in your view substantial damage has already been sustained by the company as a product of the staff's recommendation in this rate case.
>
> * * *
>
> If that's the case, what do you believe or how badly do you believe the damage that the company has sustained is? And even if this Commission issued; what many would consider a fair order has the company not still been hurt? And would this not still potentially affect their ratings?
>
> THE WITNESS: If I could just maybe elaborate on that.

* * *

> I would say that the damage is not perpetual. It's not irrecoverable. I think right now based on the writings that I have done and others that there are enough people out there that understand that the process is going on and that we'll know in September.
>
> That's the key. And if it's reasonable, I believe that the company will recover and do reasonable . . . .

TR 3462, ln. 9 to TR 3464, ln. 8.

VI. ATTRITION ALLOWANCE

An attrition adjustment is warranted to mitigate the adverse effects of the thirty-three month lapse between mid-test year 1991 and mid-first rate year (after rates go into effect). The negative impacts of regulatory lag on the Company are documented in the Company's attrition study. The Commission should adopt the Company's proposed attrition allowance in order to offset regulatory lag.

Staff argues that historical, stated results of operation should enable the Company to earn a fair return without an attrition adjustment because the Company has growing sales and increasing numbers of customers. TR 1382 ln. 24-p. 1383, ln. 4. Staff Witness Nancy Heller Hughes ("Hughes") testified that: (1) the Company is not suffering from decreased sales, high gas costs or high inflation as in 1984; and (2) based on her analysis, a negative attrition allowance is justified. EX T-233, p. 7, ln. 12-24. Hughes acknowledges that the heart of her recommendation is that the inflation rate is lower now than in the 1980s, when the Commission adopted the attrition rate in the last case. TR 1895, ln. 3-7.

Staff's attrition analysis is flawed for the following reasons:

- Staff asserts inaccurately that the Company is unaffected by current inflation rates;
- Staff made fundamental computational errors which resulted in drastically understating the effects of attrition on the Company; and
- Staff concluded erroneously that the Company is likely to slow spending on capital facilities.

Each of Staff's errors is discussed below.

Staff based its recommendation on the inaccurate assumption that the inflation rate is lower now than in 1985. On the contrary, current inflation rates are comparable to 1985 rates, as Lurito illustrated. Inflation in the first quarter of 1985, when the new rates were in effect in the last case, was 4.25 percent, while the rate in the first quarter of 1993 is 4.0 percent. EX T-285, p. 5, ln. 19; EX T-3, p. 2211, ln. 16. Clearly, current inflation rates are comparable to 1985 rates. A combination of high inflation and rapid growth of the utility are resulting in increased investment per customer by the Company. EX T-406, p. 20, ln. 12-16. Id.

As Karzmar testified, whether the adjustment is warranted is controlled by changes in test-year relationships, not merely by whether levels of sales and costs are high or low. EX T-3, p. 24, ll. 24-26, p. 25, ln. 1-20; EX T-406, p. 20, ln. 20-24. Indeed, when Staff recommended an attrition adjustment in 1984, gas sales were increasing. EX T-406, p. 15, ln. 18-p. 16, ln. 2. In 1984, Hughes projected an increase in operating revenue growth of 3.58 percent. Id. Her recommendation in this case is therefore inconsistent with her earlier position.

Hughes made three computational errors which resulted in understated effects of attrition:

- Hughes mistakenly included transportation volumes of customer-owned gas in computing average cost of purchased gas;
- Hughes used a 30-month attrition period instead of a 33-month period and
- Hughes applied attrition rates inconsistently by using the Company's adjusted test-year rates, rather than Staff's recommended test-year results.

EX T-406 p. 17, ln. 7 to p. 18, ln. 27. When Hughes's computations are corrected for these errors, it is apparent that a positive attrition adjustment should be allowed. EX T-406, p. 19, ln. 13-18.

Hughes made a significant error in computing load factors related to purchased gas costs. Hughes did not know what customer-owned gas was, and did not understand that the Company does not purchase customer-owned gas. TR 1872, ln. 3-7, TR 1873, ln. 8-10. Hughes should not have included customer-owned gas when she computed the average cost of purchased gas.

Hughes failed to understand the importance of load factors in determining purchased gas costs. She acknowledged that load factors are outside her area of expertise and that she did not consider load factors in her analysis. TR 1880, ln. 21--p. 1881, ln. 4. TR p. 1885, ln. 18-21. Staff did not take into account growth and load factors, which have a crucial effect on the Company's return. TR 1401, ln. 11-14.

Purchased gas load factors, load factors, and growth factors are extremely important in determining attrition rates for purchased gas costs, as testified by Company Witness Richard Johnson ("Johnson"). EX T-386, p. 2, ln. 8 to p. 9, ln. 21. Johnson stated that a growth rate developed for gas costs which simply projects the average cost per therm purchased in the test year to the rate year (as proposed by Hughes), understates the true cost by not recognizing that a greater proportion of peaking supplies must be contracted to provide the growth volumes for low-load factor customers. EX T-386, p. 9, ln. 16-21. The peaking supplies, which are the most expensive supplies, still must be purchased by the Company. Id.

Hughes' second fundamental computational error occurred when she applied a 30 month attrition period instead of the 33 months determined to be appropriate for this calculation. EX T-406, p. 18, ln. 4-11.

Hughes' third error was that she never considered Staff's revenue requirements or recommendations. TR 1879, ln. 15-18. Those factors were considered by the Commission in prior rate cases. Hughes' study is therefore inconsistent with her attrition adjustment analysis and treatment accepted in earlier dockets before the Commission.

The Company corrected Hughes' proposed attrition rates with respect to purchased gas costs by excluding the value of customer-owned gas from the cost of purchased gas of the Company, and then applying Hughes' attrition rates to other factors. This analysis is consistent with both Staff's and the Company's revenue requirements, and reveals that attrition is impacting the Company. The Company considered all of Hughes' concerns with attrition rates and used rates which she developed. EX T-406, p. 15, ln. 4--p. 24, ln. 19; EX 408; EX 409.

The Company's attrition analysis and recommendation is consistent with Commission precedent. The Commission has acknowledged in prior WNG rate proceedings that the impact of regulatory lag and attrition should be considered in setting rates. In Cause No. U-80-111, the Commission concluded that:

> (1) average rate base is the most favored; and
>
> (2) year-end rate base is an appropriate regulatory tool under one or more of the following conditions:
>
> (a) Abnormal growth in plant.
>
> (b) Inflation and/or attrition.
>
> (c) As a means to mitigate regulatory lag.
>
> (d) Failure of a utility to earn its authorized rate of return over an historical period.

See Commission Final Order in No. U-80-111, p. 6. The Commission acknowledged in that Order that inflation and attrition are different concepts, and may be analyzed independently. Id. at ¶ 2(b). In Cause No. U-80-111, the Company was affected by both inflation and attrition. However, only one (not both) of those conditions was necessary to warrant consideration of year-end treatment as a means to mitigate regulatory lag.[11] In this proceeding, the Company has established that abnormal growth in plant is occurring, and that it is one of the fastest-growing utilities in the country. Staff acknowledges this fact. EX T-233, p. 5, ln. 15-16.

Both the Company's own computation and its corrected computation of Hughes' proposed adjustment reveal that attrition is affecting the Company. Therefore, three of the conditions set forth in the Commission's Order in Cause U-80-111 apply. Any one of those conditions would justify an attrition or year-end rate base adjustment to offset the effects of regulatory lag. Clearly, where three of the conditions are present, as in this case, an attrition adjustment is warranted.

In Docket U-80-111, the Commission authorized year-end rate base treatment. Subsequently, in combined causes U-82-22 and U-82-37, the Commission concluded that selection of the average of monthly averages with some recognition of potential attrition will prevent distortions in calculations of customers and expenses. Further, in Cause U-84-60, an attrition adjustment was allowed to mitigate the impact of regulatory lag.

An attrition allowance or other mechanism such as adjustment for year-end rate base would provide a mechanism to offset regulatory lag in this case. EX T-206, p. 46, ln. 20--p. 49. The year-end rate base treatment could actually be more than an attrition adjustment. Id. Approximately half the utility commissions in the country recognize year-end or future test year to compensate for the effect of regulatory lag.[12]

---

[11]This Commission awarded an attrition adjustment in a case where an "unusual" level of inflation was not anticipated. Washington Util. & Transp. Comm'n v. Pacific Pow. & Light Co., 68 P.U.R. 4th 396, 427 (1985). The crucial factor was that it appeared that growth in revenues would not balance growth in costs of plant and expenses. See id. at 426. The Commission noted that an attrition allowance would not be denied merely because the award of such an adjustment requires exercise of judgment:

> The Commission believes that attrition is no more nor less subject to the Hope and Bluefield tests than another expense of the company. That attrition may be the subject of a higher level of judgment does not render it different in kind, but only in degree, from the recognition of the past purchase of a pencil or an hour of labor at a stated cost. Other elements of the rate-making process are similarly the subject of higher levels of judgment, including the calculation of investors' required rate of return, and assignment of an appropriate hypothetical structure.

Id. Similarly, in this case, growth in WNG's revenues will not balance growth in costs of plant and expenses, and accordingly an attrition adjustment is warranted.

[12]Regulatory Commissions continue to award attrition adjustments, notwithstanding lower inflation rates in recent years. The California Public Utility Commission awarded attrition adjustments in a 1989 rate proceeding. Re Pacific Gas and Electric Company, 111 P.U.R. 4th 509, 513 (Cal. P.U.C. 1989).

The Company has proposed an attrition adjustment in this docket rather than year-end rate-base adjustment because its attrition methodology is more thorough, quantifiable and measurable in determining the amount of relief required. The Company's calculation of $8.9 million year-end rate base lends support to the need for an attrition adjustment.

The Company has shown that Staff's recommendation with respect to attrition was flawed in that growth and load factors were not considered. Furthermore, as Staff's own evidence reveals, the current inflation rate is comparable to that in 1985, when an attrition adjustment was allowed. Allowing the

---

In a 1988 rate case, the District of Columbia Public Service Commission granted an allowance to reflect anticipated completion of a natural gas transmission line extension one month before the date of the decision in the rate case. Re District of Columbia Natural Gas, 102 P.U.R. 4th 582, 585 (D.C.P.S.C. 1988). The cost of the project was known and measurable, and rate payers would benefit from the increased price competition produced by interconnection with a third pipeline wholesale supplier. Id.

In Re Southern California Edison Company, Application 90-12-018, 1992 WL 477, 665 (Cal. P.U.C. 1992), the California Public Utility Commission accepted the Company's proposed deferred tax attrition adjustment because it was a change to the "base 1992 deferred tax figure." The Commission granted the company's requested attrition adjustment for book depreciation expense used to determine the 1993 revenue requirement. The Commission authorized an attrition adjustment for federal income tax deductions, and also granted an adjustment for escalation of certain "other" expenses, which included health care expenses, pensions and benefits expenses, property insurance expenses, injuries and damages expenses, miscellaneous administrative and general expenses, rent expenses, and Nuclear Regulatory Commission fees.

The Oklahoma Corporations Commission has held that post test year events are appropriate to recognize as a pro forma adjustment if the affects of the events occur shortly after the test year, are known and measurable, and recognition will more accurately represent going-forward events when new rates are expected to be in effect. Re Southwestern Bell Telephone Company, 137 P.U.R. 4th 63 (Okl. C.C. 1992). The Commission allowed adjustments to offset insufficient historical depreciation rates and for the separation process used to divide the Company's expenses and investment jurisdictionally between interstate operations and intrastate operations. Id.

In 1992, the Delaware Public Service Commission rejected a recommendation of a negative allowance for working capital. Re Delmarva Power and Light Company, P.S.C. Docket No. 91-20, 1992 WL 465021 (Del. P.S.C. 1992). Normalization adjustments were used to increase tree trimming expenses, injuries and damages reserves, and uncollectibles. The Commission concluded that the records supported a decision to allow the company to include CWIP in rate base, with a corresponding AFUDC offset to income.

In 1992, the Rhode Island Public Utilities Commission allowed an attrition adjustment to operations and maintenance expenses to reflect the impact of inflation on expenses not otherwise adjusted for known and measurable changes from test-year amounts to the pro forma rate year. Re Blackstone Valley Electric Co., Docket No. 2016, 1992 WL 501, 574 (R.I.P.U.C. 1992). The Commission utilized the attrition factor recommended by the Company and the Attorney General.

attrition adjustment in this case will not distort the concept of the historical test year. The Company's request for an attrition adjustment is reasonable, and should be allowed.[13]

VII. TRANSPORTATION

A. Nature of Service.

Company Witness Jerome Sullivan ("Sullivan") testified that transportation service allows a customer to purchase gas and transport it through the Company's distribution system to the customer's business. The customer is responsible for securing gas supply and arranging pipeline transportation to the Company's city gate. EX T-46, pp. 13-14.

B. Company Proposal.

In this proceeding,[14] the Company proposes Schedules 57 and 58 as separate schedules for transportation service. EX 43, Sheets 17-28. The schedules include the following terms:

(1) Volume levels of 750,000 and 240,000 therms, respectively.

(2) A one-year minimum contract term of October 1 through September 30, with advance notice by July 1 to secure service.

(3) Telemetering, at customer expense, of daily metered volumes at each delivery point.

---

[13]Public Counsel Witness James Dittmer's ("Dittmer") testimony should be disregarded because he failed to support his conclusions with an attrition analysis. Several other public utility commissions have rejected Dittmer's testimony for similar reasons. For example, the Ohio Public Utilities Commission rejected Dittmer's cash working capital recommendation because it was based on adjustments to someone else's study. Re Dayton Power & Light Co., 45 P.U.R. 4th 549 (Ohio Pub. Serv.Comm'n 1982). In 1990, the Indiana Utility Regulatory Commission rejected a downward adjustment in O&M expenses recommended by Dittmer because he failed to support his contention that a plant opening would result in operational savings with quantified data, and the downward adjustment would in fact have resulted in double counting of the savings. Re Indiana Michigan Power Co., 116 P.U.R. 4th 1, 60 (Ind. Util. Reg. Comm'n 1990).

In 1989, the Indiana Utility Regulatory Commission rejected Dittmer's proposed methodology for deferred tax accounting because it was "not supported by factual evidence." Re Northern Ind. Pub. Serv. Co., 100 P.U.R. 4th 328, 341 (Ind. Pub. Reg. Comm'n 1989). The Commission stated:

> Mr. Dittmer proposed flow-through methodology is piecemeal in nature, is arbitrarily applied to certain assets and would clearly cause an expense/revenue mismatch. . . Therefore, Mr. Dittmer's proposal is rejected and petitioner's transition methodology adopted.

Id. Similarly, Dittmer's recommendations that the attrition adjustment be denied in this case is based on no analysis. TR 2251, l. 5-p. 2252, l. 5.

[14]The history of the Company's transportation proposals is extensive. TR 779, 781. Most recently, the Company withdrew its filing in Docket No. UG-910871 with the intent of submitting the schedules proposed in this proceeding.

(4) Balancing provisions which reconcile deliveries to the Company with the customer's actual consumption.

(5) Interruptible transportation service, with the option of firm service on a contracted basis, where available.

(6) Appropriate rates and charges (including minimum bills).

C. Discussion of Issues.

1. Volume Levels.

The volume level in Schedule 58 is based in part on the Commission's Third Supplemental Order in Docket No. UG-901459 (involving the Washington Water Power Company) ("WWP Order"), wherein the Commission approved a tariff which limited transportation service to commercial and industrial customers "whose annual requirements exceed 250,000 therms." EX 122, p. 18. The volume level for Schedule 57 is based upon a continuation of the Company's existing volume level in Schedule 87 (for transportation volumes). EX 119, p. 12, ln. 6-15.

The intervenors claim that the Schedule 58 level is unduly restrictive. But a customer who desires to take less than 240,000 therms is not prevented from taking transportation service. The customer may, for example, choose to take 100,000 therms, pay the minimum bill each month, and realize an effective service rate that is higher than shown in Schedule 58. EX T-374, p. 21, ln. 17-22. That is an economic choice which is up to the customer. TR 695, ln. 19-24. Buckley noted this fact when he recommended approval of the proposed volume levels. EX T-240, p. 34, ln. 6-9, p. 61, ln. 18-19.

Although he fails to distinguish the WWP Order (Exhibit 112), PERCC Witness Doug Betzold ("Betzold") claims that a more "natural threshold" than the level in that docket is "approximately 100,000 therms." EX T-302, p. 2, ln. 19. Public Counsel Witness Jim Lazar ("Lazar") disagrees:

> At 240,000 therms/year, customers will be using about $100,000/year in gas; that is a level sufficient to ensure that at least one employee is trained in gas procurement . . . At lower levels of usage, I am concerned that customers may not realize sufficient savings to economically justify the employee time and training needed to fully comprehend the responsibilities of a gas transportation customer.

EX T-279, p. 51, ln. 15-22. But even assuming that the volume level in Schedule 58 were to be lowered, the rate under the schedule would need to increase significantly. The Company's allocation of transportation costs and the resulting rate design were premised upon the 240,000 level. As Sullivan testified, the rate level would be much higher with a lower volume level. EX 119, p. 33, ln. 2-6; TR 3656, ln. 24-25. The Company is not obligated to offer unlimited transportation at a low rate to all customers, at whatever volumes they choose to transport, just so they can realize savings compared to sales service.[15] The Commission has already concluded that a gas utility does not have an obligation to provide unlimited transportation service to all who request it. EX 122, p. 14.

Staff recommended aggregation of transportation volumes at a "single site" for purposes of meeting volume levels (as well as for balancing). EX T-240, p. 55, ln. 21-24. In Exhibit 248 (at p. 13), Buckley clarified this term to mean single or contiguous property. This is acceptable to the Company. EX T-374, p. 14, ln. 12-18.

2. Contract Term.

The proposed contract term is based on the Company's need to acquire supply and capacity for firm requirements customers. Sullivan testified that the Company typically negotiates new contracts in the fall for supply for the ensuing year. TR 809, ln. 11-15. To plan the Company's system capabilities, it is necessary to obtain advance commitments from transportation customers. This enables the Company to better meet system supply requirements at the least cost. EX 119, p. 43, ln. 14-19, p. 45, ln. 19-22.

Lazar's suggestion for a longer contract term should be reserved pending experience with the new tariff. EX T-374, p. 26, ln. 4-10, 17-20. Betzold's claim that a July 1 designation date might disadvantage transporters is not well founded, as Sullivan testified that this date will not interfere with the customer's gas supply negotiations. EX T-302, p. 12, ln. 16-18; EX T-374, p. 23, ln. 6-8. Staff supports the Company's proposal. EX 244, p. 105, ln. 2-3, 11.

3. Telemetering.

Telemetering equipment permits the Company to compare a customer's confirmed nominations to the actual gas which the customer uses. This allows the Company to maintain system control, as Buckley noted, which minimizes system costs and avoids entitlements on Northwest Pipeline ("NWPL") that can occur at any time. EX 119, p. 35, ln. 4-7, 20-22; EX 244, p. 183, ln. 3-4. It is essential for this purpose that the Company receive immediate data by way of telemetry, rather than rely on meter readings by the customer which have frequently been estimates rather than actual data. EX 244, p. 185, ln. 10; EX T-374, p. 23, ln. 1-4. Staff recommends approval of the telemetry requirement. EX 244, p. 106, ln. 2.

---

[15]Betzold's criticism of the volume requirement in Schedule 58 is ironic considering that, in Docket No. UG-900210, the PERCC members asked the Company to calculate minimum volumes necessary to achieve the minimum bill. Tr. 777, ln. 17-21. This proceeding is the Company's second attempt to compute a minimum bill as a function of a volume level and as a generous guide to Betzold's clients. Tr. 784, ln. 1-3.

Implementation of this requirement will not present a problem. All of the Company's current transportation customers should have telemetry equipment installed by October 1 of this year. TR 3638, ln. 6-9. The costs of billing quality equipment will not be duplicative of any equipment already in place to service that customer. EX T-374, p. 25, ln. 9-11. Staff agrees that, for cost causation reasons, transportation customers should pay for the telemetry equipment. EX 244, p. 183, ln. 20.

4. Balancing

Staff proposes that the Company bill at "imbalance rates," based on the excess of delivered volumes over confirmed nominations, for the current billing period:

Percentage	Imbalance Rates
0-3%	No charge
3-6%	150% of "highest cost of gas"
6-10%	200% of "highest cost of gas"
Greater than 10%	$2.00 per therm

The customer would be allowed a "make-up period" of the next billing cycle (30 days) to balance the excess volumes between 0 and 3 percent. (This has been characterized as "going through zero.") If the customer remains out of balance at the end of the next billing cycle, the customer would pay an amount equal to the remaining excess volumes times $2.00 per therm. EX T-240, p. 58, ln. 11-25, p. 59, ln. 1-8.

Additionally, Staff proposes that the Company credit the customer's account, at "imbalance rates," based on the excess of confirmed nominations over delivered volumes for the current billing period:

Percentage	Imbalance Rates
0-3%	No charge
3-6%	67% of "lowest cost of gas"
6-10%	50% of "lowest cost of gas"
Greater than 10%	Zero Cost (Company takes title to gas)

The customer would be allowed the same make-up period to balance the excess nominations between 0 and 3 percent. If the imbalance were not corrected by "going through zero" during the next billing cycle, the Company would take title to the gas (at zero cost). EX T-240, p. 59, ln. 10-20.

Exhibits have been introduced which explain how Staff's balancing proposal, as described above, would work in practice. EX 245; EX 246; EX 247. The proposal is acceptable to the Company if certain modifications are made. The "highest cost of gas" and "lowest cost of gas" standards (used to calculate the imbalance charges) should be changed to either the Company's stated tariff cost of gas or some published spot market index. Sullivan discussed the rationale for the changes, and Buckley acknowledged they would be proper. EX T-374, pp. 11-13; TR 2105, ln. 18-20.

The intervenors claim that the Company's balancing provisions should mirror NWPL's balancing provisions (which include a 5% balancing range and a 45-day make-up period). However, there is no reason why the respective provisions should match. The two distribution systems are completely different from an operational and cost-allocation standpoint, as Sullivan explained. EX T-374, p. 18, ln. 6-8, p. 25, ln. 13-17; TR 802, ln. 9-18. Lazar also testified:

> Q. In your opinion, Mr. Lazar, is it necessary for the balancing provisions and services that the company offers to its customers to exactly parallel the tolerance percentages and balancing provisions that Northwest Pipeline has in effect?
>
> A. <u>No, absolutely not</u>. . . . The purpose of a balancing service for a local distribution company should be to provide a service to transportation customers who desire it and to secure for the captive customers who otherwise will have to bear the cost of pipeline capacity some benefit, and I think that <u>having stricter terms on the distribution company system makes sense since the distribution company or at least its customers that it serves and are represented by this state and by this Commission have an interest in getting some of the value of that balancing from the customers who receive the service</u>.

TR 2383, ln. 10-25, TR 2384, ln. 1-8 (emphasis supplied).

The intervenors criticize the balancing proposal as not "cost-based." EX 244, p. 156, ln. 14; TR 3635, ln. 17. This criticism is misguided. The purpose of a balancing provision is to strongly encourage customers to match nominations with actual gas usage. EX 119, p. 38, ln. 11-12; EX T-374, p. 221, ln. 15-19; TR 3634, ln. 13-15. As Buckley testified, Staff's proposal is designed to "motivate people taking transportation service to remain within the tariffs." EX 244, p. 156, ln. 14-16. This motivating tool provides intuitive and undenied value from an operational and planning standpoint, by encouraging the Company's customers to remain in balance. EX 244, p. 158, ln. 3-8.

The intervenors' argument is further undermined when one analyzes their preferred alternative. There is no evidence in the record to suggest that NWPL's balancing provisions are in any way cost-based. In fact, one of the prime sponsors of intervenors' argument, Seattle Steam Witness James Young ("Young"), admitted that he had no idea whether NWPL's provisions are cost-based. TR 2139, ln. 11-12, 21. It is inconsistent for intervenors to offer NWPL as a talisman, yet fail to present evidence concerning the cost basis (if any) of NWPL's balancing charges.

5. Firm/Interruptible Service

There is an old saying: "If it ain't broke, don't fix it." That saying could easily apply to Staff's recommendation that the Company offer only firm transportation service.

The Company has provided interruptible transportation service to customers for many years (under Schedules 85, 86 and 87) with firm transportation service as an option if the distribution system can accommodate that service. TR 2046, ln. 2; TR 3652, ln. 12-13. Customers such as Seattle Steam have been satisfied with this approach because it has allowed them to assume gas purchasing and pipeline capacity responsibilities, yet still transport their gas requirements on the Company's system at an interruptible rate. EX T-374, p. 10, ln. 16; TR 2162, ln. 6-8. Buckley agrees that customers have benefitted from interruptible service. TR 2118, ln. 19-21. In turn, and because the Company's distribution system is designed to provide service only to firm customers during peak weather conditions, the Company is able to lower system costs by curtailing interruptible service to large accounts at the design peak temperature. EX T-359, p. 27, ln. 1-6; TR 1956, ln. 18-19. Both sides of the service equation have therefore benefitted.

Gustafson testified about the Company's system constraints and its inability to accommodate system-wide, firm transportation service. EX T-359, pp. 27-29. Buckley did not contact Gustafson to discuss these constraints. EX 244, p. 87, ln. 25. Had he done so, he would have realized that the Company cannot rely on "system reinforcement" to provide unlimited transportation service by tariff. EX 244, p. 97, ln. 4-10. Many low-pressure areas simply cannot be reinforced; as Buckley admitted, in some situations it is "just plain uneconomical" to provide 100 percent firm transportation service. EX 244, p. 97, ln. 2-4; TR 1959, ln. 20-22. Further, it will be very difficult for the Company to avoid outages of existing firm sales customers next winter in the event of design weather, much less provide additional firm service to transportation customers. EX T-359, p. 18, ln. 19-26.

Although he lacks any system design experience (EX 244, p. 7, ln. 1), Buckley downplayed the significance of the above problems by speculating that curtailment will be "rare" on the Company's distribution system. EX T-240, p. 56, ln. 16. The curtailments since 1980 are shown in Exhibit 250 and are definitely not "rare" in Young's opinion as a Company customer. TR 2147, ln. 14, 16-24. System curtailments are likely to occur in the future, and perhaps even increase in number, if the recent experience of frequent curtailments is any indicator. EX 250; TR 2150, ln. 9-10. The problem is real, and incompatible with Staff's proposal.

Lastly, Buckley suggested that "credits" be given to transportation customers if distribution system interruptions occur. EX T-240, pp. 56-57. Buckley proposes adjustments to Schedules 57 and 58 as follows:

> (1) In a day that the firm distribution system is curtailed, the Company will take title to the customer's nominated gas and <u>reimburse or credit the customer at the highest price of gas obtained by the Company during that month</u>.
>
> (2) The Company will credit the customer account an amount equal to the volumetric transportation rate times the maximum daily volume to be transported as set forth in the service agreement with the customer. This amount may exceed the confirmed nominated volume for the curtailed day.
>
> (3) Balancing volumes will be adjusted by an amount equal to the customer's confirmed nomination for that day.

EX T-240, p. 57, ln. 2-16 (emphasis supplied).

Perhaps a mechanism could be designed at some theoretical level which resolves the Company's concerns. But Buckley's credit suggestion is not that mechanism. Throughout his testimony Buckley hedged, speculated, and qualified regarding the manner in which credits would be given:

- Buckley admitted that the suggestion is nothing more than "conceptual" on his part. EX 244, p. 100,ln. 2; TR 2072,ln. 17.

- Staff is equivocal as to the manner in which credits to customers would be calculated. EX 244, p. 101, ln. 18-21.

- Buckley did not know how the "highest price of gas obtained by the Company" would be calculated (although Mr. Sullivan expressed numerous concerns regarding this feature). EX T-240, p. 57, ln. 5-7; EX 244, p. 102,ln. 2, 4; EX T-374, pp. 7-8.

- Buckley did not attempt to analyze or reconcile the credit mechanism under the Commission's least cost principles, although Sullivan testified that these principles are critically important in evaluating service options to transportation customers. EX 244, p. 103, ln. 7-8; EX 248, p. 15; EX T-374, pp. 8-9.

Ultimately, Staff's proposal to eliminate the distinction between firm and interruptible service is based only on Buckley's "gut feeling" that it will work. EX 244, p. 103, ln. 9-11. Should the Commission rely on that "feeling" as the sole basis for tinkering with a method of service that has proven successful for many years? As Sullivan concluded:

> I am very concerned about a proposed mechanism which has obviously not been thought out and for which numerous ambiguities exist in the language which Mr. Buckley suggests in his direct testimony as a starting point.

EX T-374, p. 6, ln. 16-21. It is also important to remember, as Johnson testified, that adoption of Staff's proposal would deprive customers such as the Boeing Company of a service which they obviously desire, as well as increase the Company's exposure to bypass. EX 244, p. 95, ln. 17-22; EX T-386, p. 66, ln. 12-24, p. 67, ln. 5-12. The interruptible feature of the Company's proposal "ain't broke"; it most certainly shouldn't be "fixed".

6. Rates/Charges

The Company proposes "separately stated" transportation rates per therm for Schedules 57 and 58. EX T-46, p. 7, ln. 22-23. Staff favors the use of a "separately stated" rate structure. EX T-240, p. 54, ln. 16-18.

Several rate issues have arisen during this case. The first issue concerns Betzold's argument that Schedules 57 and 58 should be combined into a single rate schedule. EX T-302, p. 2, ln. 1-2. But Sullivan testified:

> [The proposal] is a bold-faced attempt to capture the benefits of economies of scale for Rate Schedule No. 58 customers at the expense of Rate Schedule No. 57 customers.

EX T-374, p. 22, ln. 1-5. The Company's cost-of-service study and Staff's cost-of-service study justify a rate differential between the two schedules. EX 153; EX 243.

The second issue concerns the minimum bill for Schedule 58. The minimum bill of $3,200.00 and the volume level of 240,000 therms were developed based on the Company's cost to provide transportation service, and the guidance of the WWP Order. EX 122. It is "apples and oranges" to compare another utility's costs and tariff language to those of the Company. EX 375; TR 3650.

The intervenors also claim that the Company is no more than a filling station, and that the margin on sales (allegedly "full service") should be greater than the margin on transportation (allegedly "self service"). EX T-312, p. 26, ln. 20-22. However, the Company is not indifferent with respect to the net margin of sales and transportation. EX T-374, p. 16, ln. 19-22. With the implementation of straight fixed variable ("SFV") rate design, per-unit gas supply costs will be greatly affected by load factors as well as annual usage, meaning that (as Sullivan testified) "increased utilization of contracted firm pipeline capacity and firm gas supply contracts is an imperative." EX T-374, p. 16, ln. 24-27, p. 17, ln. 1-4.

The Company therefore designed its rate structure with a preference toward system supply sales. EX T-374, p. 17, ln. 6-8. In the WWP Order the Commission stated:

> The Commission agrees with the position of the company that it should, to the extent possible, make transportation service available to end-use customers <u>without otherwise prejudicing its obligation to provide service to its core group of sales customers. The extent of its obligation does not rise to the level of "common carrier" status whereby the company would be required, under any circumstances, to provide transportation service to all who request it.</u>

EX 122, p. 14 (emphasis supplied). Transportation service is distinguishable from sales and should be subordinated to the interests of sales service and the customers on system supply. The latter interests are paramount, and justify a margin differential as a means of encouraging sales over transportation. Buckley agreed that a utility must be able to retain business in the post-Order 636 competitive environment, "preferably as sales." EX 244, p. 27, ln. 15, 23-24, p. 36, ln. 23-24.

This is not to say that the Company does not value its transportation customers. The Company's position simply reflects the realities of the currently-competitive markets for gas supplies and capacity. The threat of bypass from sales is a proper consideration in rate design, as Buckley testified. EX 244, p. 55, ln. 13-15. The Company must address that threat with the tools at its disposal.

VIII. COST OF SERVICE

The Company presented a comprehensive cost-of-service study with its direct case which was prepared by Johnson. EX 153. Buckley submitted a cost-of-service study on Staff's behalf. EX 243.

1. Recent Decisions

The Commission applied cost-of-service principles to the natural gas industry for the first time in its Fourth Supplemental Order in Docket No. U-86-100, involving Cascade Natural Gas Corporation ("Cascade Order"). EX 135. In the Cascade Order, the Commission adopted the Johnson/Herbig study presented by Staff, which placed greater weight than Cascade's study on therms sold as a means of allocating costs. Staff's study was characterized as "similar to the Seaboard method used in the past by the Federal Energy Regulatory Commission." EX 135, p. 8.[16] The Commission then suggested -- but did not require -- that the Johnson/Herbig model be followed in future gas cases. The Commission stated: "This recommendation would not prohibit the parties from presenting other types of proposals to the Commission in the future, so long as such proposals are <u>fully argued</u> and <u>well supported</u>." EX 135, p. 11 (emphasis supplied).

---

[16]The Seaboard methodology has been superseded within FERC. A Modified Fixed Variable ("MFV") methodology was adopted in 1983 which left only the equity return and related income taxes in the commodity portion of the rate. FERC is now implementing the Straight Fixed Variable ("SFV") approach which allocates <u>all</u> fixed costs to demand. EX T-386, p. 37, ln. 14-21. Buckley testified that the implementation of SFV will be completed very shortly on the Company's pipeline supplier, NWPL. EX 244, pp. 114-115.

Five years later, the Commission returned to this issue in the WWP Order. EX 122. The Commission stated that some costs of WWP's distribution system should be allocated on the basis of annual throughput. EX 122, p. 5. In that docket, the Commission approved a Staff allocation of distribution plant on the basis of 25 percent to non-coincident peak, 25 percent to coincident peak, and 50 percent to commodity. EX 122, p. 8. The Commission also made certain findings about the direct assignment of WWP costs to certain customers, as discussed more fully below. EX 122, pp. 6-7.

In this proceeding, Buckley relies heavily on the Commission's decisions in the WWP case. He made little attempt to independently assess appropriate cost methodologies for this case. EX T-386, p. 39, ln. 1-9. He did agree that the cost studies in this case need not adhere to the cost studies in the earlier decisions. EX 244, p. 24, ln. 7.

2. Direct Assignments

Buckley mistakenly believes that direct assignments as a cost allocation method were rejected outright by the Commission in the WWP Order. It is true that, in that Order, the Commission disallowed WWP's direct assignment of certain costs to transportation Schedule 148. But, this disallowance was because of WWP's direct assignment to specific customers to lower their costs. EX 122, p. 7.

This is a significantly different from the approach which Johnson applied for the Company. His study traced and directly assigned approximately 60 percent of the total plant to Schedule Nos. 85 and 58. Smaller proportions of the plant were traced and directly assigned to Schedule Nos. 87 and 57. EX T-386, p. 28, ln. 16-19. These customer classes were identified to ensure that mains of two-inch diameter or less were fully assigned not to artificially lower their costs. At no time did the Company intend that these customers not be responsible for any of the common plant. EX T-386, p. 28, ln. 25-27, p. 29, ln. 1-2.

Johnson accomplished the assignment in a logical and straightforward manner which was consistent with the rest of his study. He segregated distribution main between two-inch and smaller, and three inch and larger diameter mains because the Company's recent growth has been primarily residential and small commercial. EX T-386, p. 29, ln. 8-11, p. 54, ln. 7-13. Some Rate 85 customers were supplied with new two-inch mains, and were assigned the entire costs of such mains where traceable. Each Rate 85 and 87 customer was examined to make this determination. In most cases, however, the smaller pipe was traceable to the residential and commercial customers who caused the growth, rather than to the very large Rate 57, 58, 85 and 87 customers. EX T-386, p. 29, ln. 15-20, 25-27, p. 30, ln. 1-9.

Although Buckley disputes this allocation method. But Johnson's approach agrees with the approach recommended by other Staff witnesses. For example, Russell testified that, whenever possible, costs should be directly assigned to those customers for whose benefit they are incurred. EX T-183, pp. 8, 12, 14. In her testimony concerning main extensions, Thomas took the position that whichever customers are served by a main extension are responsible for its costs. EX T-206, p. 53, ln. 2-6. Buckley's position is, therefore, inconsistent not only with Johnson's approach, but the approach of other Staff witnesses. EX T-386, p. 30, ln. 15-24.

The National Association of Regulatory Commissioners ("NARUC") also supports Johnson's methodology. EX T-386, p. 31, ln. 4-6. NARUC has recognized that, because of their size, certain customers may require only higher capacity facilities and, therefore, obtain no benefit from facilities constructed to serve smaller customers (as is the case with the Company's smaller two-inch mains). EX T-386, p. 32, ln. 7-14, p. 33, ln. 1-7, p. 34, ln. 4-9. It was appropriate for Johnson to separate distribution mains by size, in order to ensure that the Company's customers retained cost responsibility for the facilities which they caused to be installed.

Johnson also studied the investment per customer for meters and services. Exhibit 394 shows the investment for various customer classes and compares the results of Buckley's allocation to the Company's results. The differences are dramatic for large volume customers under Schedules 57, 58, 85 and 87. As an example, Buckley inappropriately allocates over <u>58 times</u> the services investment to large Rate 87 volume customers as does the Company. EX T-386, p. 36, ln. 11-15. Staff's approach clearly shifts a significant cost burden to large volume customers. This is patently inconsistent with the purpose of a cost-of-service study which traces actual cost causation and links it to revenue recovery.

Direct assignments and segregation of plant should never be precluded in a cost of service study and, the Cascade Order does not so hold. Even Buckley acknowledged that he conducted direct assignments of plant in the gas studies which he performed prior to this case. EX 244, pp. 10-11, p. 44, ln. 14. Johnson's methodology was logical and correct: Direct assignment should be made to properly measure costs.

3. <u>Annual Consumption</u>

Buckley did not investigate how the Company's costs should be allocated between demand and commodity. Instead, he simply used the split from the WWP Order. EX T-386, p. 37, ln. 4-8. This is unfortunate, particularly because of the new environment (Order 636) that the Company must operate within. The Company urges the Commission to hold otherwise. Recent developments in the industry (including FERC Order No. 636) instruct that past practice should not dictate future events. As Johnson testified:

> The switch to SFV is part of the movement by pipelines away from the marketing function. This recognizes that a pipeline would be more at risk for the recovery of fixed costs in the environment now faced by the natural gas industry, if it were to rely on total throughput for this recovery.
>
> <u>I feel it is very important for the Commission to recognize that cost allocation methodologies should not be considered static</u>. The fact that federal regulators have changed the cost allocation methodology in the face of dynamic developments in the industry shows that <u>the Commission need not, indeed must not, be bound today by past practice in allocating costs</u>.

EX T-386, p. 38, ln. 12-24 (emphasis supplied). These regulatory developments cannot be ignored.

Buckley made other allocations which were overly weighted to the commodity function. Demand costs for flowing gas were classified on the basis of 10 percent coincident peak and 90 percent annual volume to all classes except transportation. In this context, Buckley mistakenly assumed that the demand charges amounted to a base load resource. EX T-240, p. 24, ln. 12. As Johnson testified, however, no more than 20-23 percent of these costs represented a base load resource, or significantly less than Buckley's arbitrary classification of 90 percent. EX T-386, p. 41, ln. 20-27, p. 42, ln. 1-9. There is no basis for the 10-90 split. Moreover, Buckley's proposal would force interruptible sales customers to pay a discriminatory rate for their service which would be substantially greater than actual cost and greater than the comparable price of NWPL sales service. EX T-386, p. 42, ln. 14-27; EX 396.

There are other reasons why Buckley's study fails to treat interruptible customers in an appropriate manner from the standpoint of upstream demand cost responsibility. Buckley's arbitrary classification ratios convert the responsibility of large volume customers to the system load factor of 40 percent. EX T-386, p. 51, ln. 19-21. However, these customers can be curtailed when their gas supply is required by firm customers. Johnson took this into account when he assigned demand units based on differing "imputed load factors," for the 85, 86, and 87 schedules (determined according to the curtailment order). As Johnson stated:

> Our approach clearly recognizes that the interruptible customers should not have a "free ride" on the system. By assigning demand units based on an imputed load factor, appropriate cost responsibility is given to those customers.

EX T-386, p. 50, ln. 19-22 p. 52, ln. 18-21, p. 53 ln. 7-12.

An entirely different classification of 22.73 percent (as coincident peak) and 77.27 percent (as commodity) was recommended by Buckley for Jackson Prairie storage service. As Johnson testified, however, there is no basis for this ratio. EX T-386, p. 44, ln. 16-17. Buckley did not compute these percentages based on any storage study. EX 244, p. 49, ln. 10-20. Although he claimed that the Commission's past orders supported this classification, he never analyzed whether Cascade and WWP used their rights to SGS service in the same manner as the Company did. Johnson testified that the respective utilities possessed different contractual rights to SGS service during the test year, and that neither Cascade nor WWP relied to the same extent on storage compared to the Company. EX T-386, pp. 44-45.

4. Summary

Johnson's comprehensive approach (which accounted for differences in storage deliverability, capacity, and equipment, EX T-386, p. 46, ln. 4-15) is far superior to Buckley's ad hoc classification. It offers guidance to the Commission when allocating both the Company's storage costs and the storage costs of other utilities (EX T-386, p. 46, ln. 20-25), and it responds to, and is consistent with, the guidelines set by this Commission. As Johnson explained:

> I recognize that there can be differences of opinion as to minor matters regarding allocation procedures; however, the reason for the wide disparity between the Company's cost of service study and that submitted by Mr. Buckley cannot be accounted for by any differences of opinion as to why certain facilities were installed or constructs executed. The wide disparity arises from the manner in which the costs are classified for cost allocation purposes.
>
> The Company's study attempted to determine why major elements of cost were incurred and to assign these costs in accordance with the reasons for their having been incurred.

EX T-386, p. 55, ln. 8-12 (emphasis supplied).

Based on his study of cost causation, Johnson made a significant finding with respect to the Company's current rate structure:

> The current rates do not generate sufficient revenues from the residential class to provide the Company with its system average rate of return, and the Company's other rates provide a higher than average rate of return.

EX T-386, p. 56, ln. 1-4, 13-14 (emphasis supplied).

IX. RATE SPREAD AND RATE DESIGN

Once a utility's total revenue requirements have been calculated, it is necessary to: (1) determine the amount of revenue which should be apportioned to each customer group and (2) specify the rates for each group so that its revenue responsibility is recovered. The first step is called "rate spread;" the second step is called "rate design."

A. Company Position

The Company has a total revenue requirement of $334,476,000: $319,703,000 shown in column (d), line 1 of Exhibit 407, plus the required increase of $14,773,000 shown in column (b), line 1 of Exhibit 407.

The Company first apportioned the revenue requirements to its customer groups as follows (EX 401, sheet 2 of 8):

	Revenue Requirement Apportionment
Residential	$181,645,377
General Service	42,477
Commercial and Industrial	87,602,068
CNG	133,751
Large Volume	46,535,096
Transportation	8,959,522
Rental	8,322,707
Other	856,107
Total	$334,477.074

The Company then designed rates for each customer group, and carefully described each component on the record. For example, Sheet 3 of 8 of Exhibit 401 contains the rate design for Rate Schedule Nos. 23, 24 (without a water heater surcharge), and 55. Sheet 5 of 8 contains an option of using a water heater surcharge with Rate Schedule No. 24. Sheet 6 of 8 contains the rate design for Rate Schedule Nos. 11 and 16. Sheet 7 of 8 contains the rate design for Rate Schedule Nos. 31, 36 and 41. Sheet 8 of 8 contains the rate design for Rate Schedule Nos. 43 and 51.

The Company's rate design for Rate Schedule No. 50 is shown on Exhibit 43, Sheet No. 15 of 49. Its rate design for Rate Schedule Nos. 85, 86 and 87 are contained in Exhibit 78, sheet 5 of 6. The rate design for Rate Schedule Nos. 57 and 58 is contained in Exhibit EX 78, sheet 6.

Each of these rate design components was subject to cross-examination. By contrast, upon cross-examination of Staff, it never became clear exactly what its proposal was. Staff simply promised to develop those rates later; TR 2043, ln. 7-25; TR 2103, ln. 4-9; TR 2104, ln. 19-25; TR 2017, ln. 1-5, 9-15; TR 2111, ln. 14 to TR 2114, ln. ln; TR 2120, ln. 19 to TR 2121, ln. 2; TR 2122, ln. 18 to TR 2123, ln. 1.

B. Staff Position.

Staff claims that the Company's revenue requirements equals $299,786,074. In terms of the rate spread and rate design steps corresponding to this Revenue Requirement, Staff stumbled a bit in the first step and fell completely in the second step, never getting to its destination: Where is Staff's rate design?

With respect to rate spread, Staff's dollar apportionment is unclear because Staff never prepared an exhibit or a workpaper describing its recommendation. Using a "conceptual" argument (TR 2103, ln. 22; T-240, p. 36, ln. 9-25), Staff suggested a decrease of 10.5% here, a decrease of 3.5% there, or a decrease of 7% elsewhere. Staff never showed the rate spread corresponding to its conceptualizations, but did state that a check had been made. EX T-240, p. 37, ln. 10.

With respect to rate design, Buckley claimed that Staff would "work it out later." TR 2114, ln. 6-8. Buckley testified that once the Commission approved his cost-of-service study, Staff would then "develop those rates." TR 2113, ln. 2-4; TR 2042, ln. 2-7. Staff's promise to unveil its rate design, after the Commission approved it, led Commissioner Casad to wonder if Staff was asking the Commission to "buy a pig in a poke." TR 2106, ln. 3-5.

The Company does not see how Staff's non-existent rate design can be approved by the Commission. The only comprehensive rate design recommendation in the record that was subject to cross-examination is the Company's.

C. Residential Rate Design.

1. The Company's Customer Charge is Well Founded and Should Not be Changed.

In its residential rate design, the Company did not propose any change in its base residential customer charge (which recovers customer costs) of $4.50 per month. EX T-377, p. 30, ln. 22-25, p. 31, ln. 4-7.

The Commission last reviewed the issue of customer charges in the WWP Order. In its order, the Commission directed utilities in future filings to calculate the proper level for these charges, and explain the basis for the calculations. EX 122, p. 17. The Company followed the Commission's directive; it calculated and explained customer costs (EX 66, p. 19, col. "Total Residential," bottom line):

> Customer costs are those operating capital costs found to vary directly with the number of customers served . . . (and) include the expenses of metering, billing, collection, and accounting, as well as those costs associated with the capital investment in metering equipment and in customers' service connections.

EX T-377, p. 21, ln. 4-10. The Company further demonstrated that customer costs have risen significantly since 1980 (when the current charge was adopted). EX T-377, p. 32, ln. 25-27, p. 33, ln. 1-2.

Staff, on the other hand, ignored the directive in the WWP Order. Buckley stated that he agreed with the Company's cost categories and could have made the cost calculations, but chose not to do so. EX T-386, p. 57, ln. 21-24; TR 2004, ln. 4-20; TR 2005, ln. 14-24. Instead, he settled on an arbitrary figure of $2.00 per month, which represents less than 50 percent of the Company's current charge. EX T-240, p. 43, ln. 7; EX T-377, pp. 32-35.

This position is extremely troubling from the standpoint of cost-of-service. The Company has shown that a conservative, cost-based charge would be close to $20.00 (not even allowing for distribution system costs), or more than <u>four times</u> the existing charge. EX 153, Schedule 11, p. 19; EX T-377, p. 31, ln. 16-18. Amazingly, however, Staff wants to <u>halve</u> the existing charge. The Commission would set an unfortunate precedent and send an inappropriate economic signal to the Company's ratepayers if it agreed with Buckley.

The magnitude of Staff's arbitrary adjustment amounts to $10 Million. There were 335,046 residential customers on the Company's system during the test period. EX 45, Sheet 1, Column D. A reduction in the service charge to $2.00 per month would cause revenues to decline by $10 million ($2.51 x 12 x 335,046). Thus, even though the Company's actual costs to serve its residential customers have increased dramatically since 1980, Staff recommends a $10 Million decrease in rates.

Staff's recommendations to the Commission are incongruous. With respect to the base customer charge, Staff apparently believes that this charge does <u>not</u> have to cover its costs. But in the area of rental rates, Staff believes that it is imperative that those rates <u>should</u> recover its costs. EX T-155, p. 28, ln. 15-16; T-166, p. 18, ln. 21-23. If Staff's recommendation were accepted by the Commission, one wonders why a cost-of-service study would even be prepared.

D. <u>The "Firm-Up" Option Under Rate Schedule Nos. 85, 86 and 87 Should Be Continued</u>

Staff recommends elimination of the firm service option under Schedules 85, 86, and 87. Buckley claims that Staff's recommendation would clarify the schedules so they would be understandable to him and not "confusing." EX 244, p. 78, ln. 10-11; TR 2011, ln. 17-18. He made no attempt, however, to determine whether the Company's customers are "confused" by the tariff option. EX 244, p. 79, ln. 20-25, p. 80, ln. 1-2.

E. Other Rate Design Issues

The Company recommends that, in order to preserve future economic studies on Rate Schedule Nos. 23 and 24, they should be kept separate. Staff's recommendation, to combine these schedules, would cause the Commission and the Company to lose important statistical information from these separate groups.

The Company and Public Counsel recommend that seasonal rates be implemented, so ratepayers will be given a better conservation signal. For some unknown reason, Staff disagrees. EX T-240.

In fact, the option to "firm-up" a portion of customer load has been available for over thirty years. EX T-377, p. 36, ln. 19-21. No evidence suggests that this option has ever proved unworkable or is somehow disfavored by customers. Moreover, Staff's proposal would involve the creation of yet another schedule for firm sales service. EX 244, p. 80, ln. 16-25, p. 81, ln. 1-7; TR 2016, ln. 6.

The option to "firm-up" a portion of sales gas under Rate Schedule Nos. 85, 86 and 87 has worked well for many years and should continue to be allowed by the Commission. "If it ain't broke, don't fix it."

X. WEATHER NORMALIZATION ADJUSTMENT

The Company has proposed a weather normalization adjustment (WNA) for customers whose usage is weather sensitive, i.e., customers under Rate Schedule Nos. 23, 24, 31, and 36. The WNA is presented in Supplemental Schedule 120 to the Company's proposed tariff. EX 43, Sheet 49 of 49.

The WNA would adjust customers' bills for usage differences that result solely from weather differences. EX T-377, p. 15, ln. 20-21. The Company now "over-earns" when weather is colder than normal and "under-earns" when weather is warmer than normal. The WNA would offset these revenue effects by making credits and surcharges to ratepayers. This would allow the Company's earnings to more closely reflect Commission-approved rate levels. Therefore, a WNA benefits the ratemaking objectives of the Commission.

Ratepayers will benefit from the WNA because the Company's capital costs should decrease. Cash flows will be smoothed out, see Exhibit T-377, pp. 16-17; TR 326-327, which should translate into cost savings to the Company and to ratepayers. As Torgerson testified, a WNA would reduce capital costs between 0-25 points.

Ratepayers will also benefit because their monthly bills will be far more predictable (since the volatile portion due to atypical weather will be removed). Another benefit for ratepayers is that the WNA adjustments occur at the best possible times. In months that are colder than normal, when the customer is in the most need of rate relief, the customer's bill is lowered. In months that are warmer than normal, a small additional payment will be charged. EX T-377, ln. 10-27. Lazar agrees that ratepayers will benefit from the WNA because of the reduction in residential bill volatility and because of downward trending bills during colder than normal months. EX T-279, p. 46, ln. 19, 23-24; TR 2378, ln. 16-18; TR 2379, ln. 14.

The benefits to the ratemaking process, to ratepayers and to the Company explain why, as Campbell testified, twenty-six gas companies had commission-approved WNAs through September 1992, and another eight companies have proposed WNAs before their respective commissions. TR 761. WNA billing clauses have worked extremely well for ratepayers and for utilities for over a decade. EX T-377, p. 21, ln. 7-9.

At a minimum, the Commission should put the Company-proposed WNA in place for a trial period of three years. This will help the Company cope with the immediate economic challenges it faces, lower its cost of common equity, preserve its "A-" long-term debt rating, and allow the Commission to further evaluate the WNA.

A. Staff Position.

Staff Witness Curtis Winterfeld ("Winterfield") claimed that the Company did not demonstrate that the WNA: (1) is accurate and unbiased, (2) fairly and efficiently allocates the adjustment among customers in a class, or (3) provides financial and economic benefits to ratepayers. EX T-255, p. 17, ln. 18-26. But the Company has already shown that ratepayer benefits exist. The Staff witnesses also contradict themselves regarding ratepayer savings from a WNA. Although Winterfeld claims that no such benefits exist, Lurito forecasts substantial savings to ratepayers if the WNA is approved. EX T-255, p. 25, ln. 21; TR 2221, ln. 13-17; TR 2574, ln. 15-25; TR 2575, ln. 1-3.

Regarding the issues of accuracy and bias, Winterfeld rhetorically questions several features of the Company's proposal. Campbell responded to each of these questions. Winterfeld's worries are groundless. EX T-377, p. 22, ln. 14-27, pp. 23-24.

Although Winterfeld questioned the technical development of the WNA, he was mistaken about how a WNA actually adjusts a customer's bill. EX T-377, p. 24, ln. 17-27; pp. 25-26. The mistake may have occurred because of Winterfeld's inexperience with WNAs. EX 268, p. 10, ln. 3-5. Winterfeld did not know if the WNA would adjust between usage differences caused by weather, or usage differences which occurred regardless of weather. EX T-377, pp. 25-27; TR 2217, ln. 20-25. Because of his confusion, Winterfeld proposed a modification to the WNA which was not needed. TR 2217, ln. 20-25; EX T-377, pp. 27-28; EX 382.

Nor is there any basis for Winterfeld's concern that the WNA does not fairly or efficiently allocate the adjustment among customers. Campbell explained that the WNA efficiently allocates margin to different customers. This is a decided improvement over a case without a WNA, where ratepayer margin contributions are either excessive or insufficient simply due to weather. EX T-377, pp. 28-29.

Lastly, Winterfeld speculates about the "administrative cost" required to implement the WNA. EX T-255, p. 3, ln. 25. This concern is unfounded. The necessary data already exists in the Company's billing files, and only minor programming changes will be necessary to fully implement the WNA. EX T-377, p. 21, ln. 1-3; T-386, p. 21, ln. 15-24.

B. <u>Public Counsel Issues</u>.

Lazar compares the WNA to the Company's budget payment plan. EX T-279, p. 47, ln. 10-16. But the budget plan does not provide the same regulatory or ratepayer benefits as a WNA: ratepayer rates would be higher in colder than normal years with just a budget payment plan in place, and overcarving would occur. EX T-377, p. 18, ln. 12-21. Also, even though the budget payment plan is optional, the WNA should not be as the benefits would be deeply diluted and ratepayers would lose. EX T-377, p. 19, ln. 1-16.

Lazar speculates that a WNA might prompt ratepayers to increase usage during colder months. EX 279, p. 47, ln. 5-6. But customer usage depends upon temperature, not if that temperature happens to be warmer or colder than normal for the day. Moreover, as the Company pointed out, the overall rate design, not the WNA, should provide the proper economic signal to ratepayers. EX T-386, p. 23, ln. 8-21.

C. <u>Interrelationship With Normal HDDs</u>.

The Company believes that, under its normal HDDs (4658.3), ratepayers will have a fifty-fifty chance of receiving a bill reduction or increase from its WNA. EX T-377, p. 9, ln. 5-8. If the Company's definition is adopted, but Staff proves to be correct and normal HDDs are greater than 4658.3, then the Company would reduce its customers' bills more often than it would increase them. EX 43, p. 49 of 49. This would obviously benefit ratepayers. The opposite logic holds if the Commission adopts Staff's position, but the Company is correct. The Company would increase its customers' bill more often than reduce them. EX 43, p. 49 of 49.

From the ratepayers' point-of-view, the Company's definition should clearly be used. This represents another reason why the Commission should choose the Company's definition of recommended HDDs (4658.3).

XI. CONVERSION FACTOR

The calculation of the conversion factor of .6083769542 the Company proposes for use in determining the revenue requirement in this proceeding is found in Exhibit 330. This calculation method is consistent with the method accepted in prior cases filed by the Company before this Commission. The calculation presented by the Commission Staff differs only in the exclusion of a factor for municipal taxes. If this element is excluded from the conversion factor, the Company will not be compensated for municipal taxes remitted by the Company. Since the filing of Staff's case, the Company believes that Staff concurs with the inclusion of the municipal tax element in the calculation of the conversion factor. Further, the Commission should take administrative (judicial) notice that on August 7, 1993, the Congress passed the Omnibus Budget Reconciliation Act of 1993 (HR 2264) which changes the corporate federal income tax rate from 34% to 35%. This new rate would change the conversion factor shown on Exhibit 330 to .5991591216. The Company's increase in federal income tax expense for the test year, based on this new 35% rate, would be $321,000, increasing the Company's operating revenue requirement by $548,000, following application of a proper attrition allowance.

XII. CONCLUSION

The Company's rebuttal case presents fair and reasonable adjustments. The Company carefully considered all objections and suggestions of Staff, Public Counsel, and Intervenors. The Company modified its requested adjustments accordingly. The Company's requests in this proceeding have been made with an eye toward providing the broadest benefit to ratepayers, and balancing immediate benefit with long-term benefit. The Company respectfully requests that the Commission grant the rate adjustments it has proposed in this proceeding.

DATED this 10th day of August, 1993.

WASHINGTON NATURAL GAS COMPANY

By ______________________
D. Scott Johnson

RIDDELL, WILLIAMS, BULLITT & WALKINSHAW

____
Marion V. Larson
Harry E. Grant
Attorneys for Washington Natural Gas Company