BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Commission's Notice of Inquiry: Examining Regulation of the Local Distribution Companies in the Face of Change in the Natural Gas Industry	))))))	Docket No. UG-940778
In the Matter of Purchased Gas Adjustment Mechanisms	))))	Docket No. UG-970001 POLICY STATEMENT

BACKGROUND

The Commission's *Notice of Inquiry: Examining Regulation of the Local Distribution Companies in the Face of Change in the Natural Gas Industry,* Docket No. UG-940778, posed questions about purchased gas adjustment (PGA) procedures and incentives. Eleven persons responded to the initial set of questions; a second comment round allowed interested persons an opportunity to respond to others' initial comments. Commission Staff hosted a technical workshop on PGA procedures in Spring 1996. On August 15, 1996, Staff noticed its recommendations to all interested persons and invited comments by September 20, 1996. Comments were received from nine persons, including all four local distribution companies (LDCs) regulated by the Commission, two natural gas marketing firms, and three other persons. The Commission reviewed these comments and Staff's recommendations in drafting a set of policy principles. At its May 16, 1997 open public meeting, the Commission adopted the instant policy statement to guide incentive PGA filings by LDCs.

STATEMENT OF POLICY

The Commission issues this policy statement pursuant to WAC 480-09-200. The statement consists of fifteen principles to guide the Commission as it exercises its regulatory authority to incorporate well-structured incentive mechanisms in the purchased gas adjustment filings of the state's LDCs. The statement does not constitute a formal order binding upon either the Commission or the parties that may come before it in formal proceedings, nor is this policy statement a rule. It is neither feasible nor practicable to adopt a rule at this time, as these principles are not perfected so as to be binding on either the Commission or the LDCs. Rather, the statement serves to demonstrate the current opinions held by the Commission concerning the optimal structuring of purchased gas rate adjustment mechanisms. The Commission intends to use these principles in exercising its general regulatory duties and responsibilities, and in developing its opinions and judgements concerning specific regulatory issues which it may be required to address.

Guiding Principles for the Development and Implementation of Purchased Gas Adjustment Incentive Mechanisms

1. The Commission shall consider gas cost incentive mechanisms that reward companies based on performance relative to an external benchmark of market gas cost. The benchmark should be used in conjunction with the current PGA/deferral process. PGA rates, as price signals, should provide the most accurate estimate of expected gas costs and should be based on the Company's most accurate estimate of prospective gas costs, with deferral accounting and true-up of revenues collected to actual costs. The sharing mechanism should be based on a comparison of actual gas costs to a benchmark.

2. Total gas costs should be included in the benchmark, including fixed and variable transportation costs, fixed and variable commodity costs, and fixed and variable storage costs. Transportation and storage components of the benchmark should be updated, as FERC and NEB regulated rates change. The inclusion of total gas costs in the benchmark avoids problems such as how to handle bundled supply resources, avoids gaming of transportation/commodity costs or fixed/variable costs, and provides a potential opportunity to reward or penalize a utility for long term transportation capacity decisions.

3. Incentive mechanisms should be simple to understand and apply, avoiding complex calculations which could lead to disputes or gaming.

4. The gas commodity portion of incentive mechanisms should judge performance against a benchmark for gas costs based on market prices, not an LDCs' historic gas costs. Using an external benchmark for the commodity portion will provide LDCs with the incentive to perform better than the market.

5. Revenue and risk sharing should be symmetrized between the company and ratepayers, *i.e.*, incentive proposals should incorporate a risk of loss from poor performance as well as opportunities for rewards from good performance.

6. Dead bands around the total cost benchmark may be useful to dampen random market effects. If a company's incentive proposal incorporates a dead band, then it must apply to both losses and gains.

7. Incentive mechanisms should be structured as an experiment, so should have limited duration (*e.g.*, three years) and should be explicitly evaluated at the end of the period to determine success or failure. Thus, incentive proposals must provide an evaluation mechanism. The Commission and parties should minimize "tinkering" with experimental mechanisms during the experimental period, to avoid making subsequent comparisons and decisions more complicated or difficult.

8. Proposals for incentive PGAs should include documentation to demonstrate how the LDC would have performed under the proposed incentive mechanism during each of the previous three years. Historic performance under the specific proposals will assist the Commission and Staff in fine tuning specific aspects of benchmarks, setting dead bands, and assessing the performance of experimental incentive proposals.

9. Benchmarks that include a combination of market based indices should demonstrate the liquidity of each index. If it appears an LDC can exert market power and so influence the level of any such index, the LDC should include a proposal for how the company will temper that market power in calculating its incentive benchmark.

10. The Commission should avoid establishing a one-size-fits-all incentive mechanism. Each LDC should be allowed to file an incentive mechanism that conforms with these policies, and meets the company's specific needs. Such an approach will not only allow each company to tailor the mechanism to meet its individual needs, but also will allow for innovation. This policy statement should not be interpreted as implying pre-approval of incentive proposals. Staff should work with interested parties to ensure the incentive mechanisms meet these policies and otherwise are in the public interest.

11. In special circumstances, the Commission may consider gas cost incentive mechanisms other than those based on externally generated benchmarks. However, other gas cost incentive mechanisms should conform generally with these policies. Requests for other incentive mechanisms should include an explanation why a company believes an alternative method is more appropriate to their circumstance than an external benchmark.

12. The Commission should not consider narrowly focused incentive mechanisms, such as simply sharing capacity release revenue or off-system sales revenue. A narrowly focused approach provides too many opportunities for the incentive system to be gamed, thus failing to provide incentives to minimize gas costs.

13. Procedures associated with proposed incentive mechanisms should be tariffed to clearly establish both how fixed and variable components of the benchmark are calculated and how deviations from the benchmark will flow into rates. Providing clearly identified procedures in approved tariffs will help to minimize potential future controversies.

14. Each LDC--even if incentives are not proposed--should clearly tariff the procedures for setting its PGA and deferral rates in that company's next PGA/deferral rate filing. Again, providing clearly identified procedures in approved tariffs will help to minimize potential future controversies.

15. Gas cost incentive mechanisms should not replace the Commission's ability to review the prudence of utility management actions in general rate proceeding or deferred gas cost filing. Prudence reviews will be important to ensure that LDCs do not sacrifice service reliability and that the Commission is meeting its mandate to determine that rates are fair, just, and reasonable.

CHANGES IN POLICY

In light of the rapid pace of change in the natural gas industry, and the state, regional, and federal regulatory and policy issues which may affect the natural gas industry in Washington, the Commission anticipates that it may become necessary to modify or revise the principles established in this policy statement. In such a circumstance, the Commission intends to distribute any modifications or revisions for comment by all interested persons before amending the statement.

Dated at Olympia, Washington, and effective this 16th day of May 1997.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

SHARON L. NELSON, Chairman

RICHARD HEMSTAD, Commissioner

WILLIAM R. GILLIS, Commissioner