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BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	DOCKET NO. UG-941408
Complainant,	)	THIRD SUPPLEMENTAL ORDER
v.	)	
CASCADE NATURAL GAS CORPORATION,	)	COMMISSION DECISION AND ORDER
Respondent.	)	

Nature of Proceeding: This is a PGA (Purchase Gas Adjustment) proceeding for Cascade Natural Gas Corporation ("Cascade" or "Company").

Procedural setting: Commission Staff and Public Counsel challenge the Company's treatment of costs for its purchase of winter peaking service from two of its customers, Tenaska Gas Company ("Tenaska") and Longview Fibre Company ("Longview"), contending that a portion of the claimed costs were imprudently incurred and should be disallowed. The Commission suspended the filing and undertook this review.

Commission decision: The Commission rules that the Company failed to present sufficient information that the Tenaska contract was prudently entered, but finds that no harm to ratepayers resulted and no rate adjustment is required. As to the Longview Fibre contract, the Company must be prepared to document that its decisions to enter or not to enter negotiations with Longview for price renegotiation periods after the date of this order are prudent and that its negotiated prices are prudent. The Commission does not disallow costs under the contract for prior periods, but requires determinations as to reasonableness of decisions regarding such gas supply contracts to be made prior to approval of deferrals for collection through rates.

Appearances: John L. West, attorney, Seattle, represents Cascade Natural Gas Corporation. Robert Cedarbaum, assistant attorney general, represents the Staff of the Washington Utilities and Transportation Commission (Commission Staff). Donald T. Trotter, assistant attorney general, Seattle, is Public Counsel.

MEMORANDUM

This is a Purchase Gas Adjustment proceeding involving Cascade Natural Gas Corporation.

Contracts between Cascade and two customers are the source of disagreement in this proceeding. Both are industrial customers who use natural gas to produce process heat and electrical energy. Both do now, or did in the past, appear capable of bypass.

Cascade has purchased peaking gas supply from the two customers. Under the agreements, Cascade enjoys the right to divert gas from the two industrial customers to the benefit of its other customers on a limited number of days per year, up to a maximum number of therms per day. The quantities and the costs vary between the two contracts.

We have previously noted that this sort of a relationship, which Cascade appears to have pioneered, can be an innovative, "win-win" sort of arrangement that can assist Cascade in meeting its peak gas supply requirements at reasonable cost; that can assist Cascade in retaining a customer who otherwise might bypass its system; and that can reduce the customer's costs of doing business in a competitive marketplace[1].

1. Prudence. The fact that such an arrangement offers the *potential* for prudent results does not guarantee that it will *achieve* prudent results. This sort of relationship can present temptations for a utility company to overpay for its purchase of capacity in order to induce the industrial customer to remain on the system and to shift costs from the industrial customer and the utility to the utility's core customers.[2]

The Commission has noted that natural gas companies' contracts may be subject to prudence review.[3] All parties concede that these transactions should be measured by the standard of "prudence". They disagree as to whether the Company's actions regarding the contracts met that standard.

The fundamental difference between these contracts and the Company's other gas supply contracts is that these are not acquired on the open market, where buyer and seller have equivalent bargaining power and the market strongly influences conditions and price. Instead, these transactions were with industrial natural gas customers whose volume of service and perceived bypass ability may give them leverage and tilt toward them the balance of bargaining

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[1]See, e.g., the Commission September 4, 1991, letter accepting Cascade's 1991 Least Cost Plan (UG-910148).

[2]We use the term core customer to refer to customers who have no transportation or bypass options.

[3]WUTC v. Cascade Natural Gas, Docket No. UG-930511, Fourth Supp. Order (April 29, 1994).

power. That is why the review for "prudence" is appropriate.

The test for prudence is:

> [W]hat would a reasonable board of directors and Company management have decided given what they knew or reasonably should have known to be true at the time they made a decision.[4]

Regulated companies bear the burden of proving that their decisions are prudent,[5] as they bear the burden generally to demonstrate that proposed rate increases are just and reasonable.[6]

In this proceeding, the Commission Staff and Public Counsel voice concerns about the two contracts. The concerns differ from one contract to the other.

a. Longview Fibre. Cascade and Longview have at least three arrangements for natural gas. Longview's mill buys gas from Cascade under tariff schedule 663. Last year Cascade began supplying gas to a cogeneration facility located at the mill under a special contract approved by the Commission. Finally, the two companies have a Peaking Gas Supply (PGS) contract that is the subject of dispute in this filing.

In early 1991, Cascade analyzed Longview's bypass options and found that the customer could build a new line economically, compared with its payment to Cascade. Faced with the possibility of discounting rates substantially to keep Longview Fibre as a customer, Cascade widened negotiations to include having Longview Fibre provide gas to Cascade during periods of peak demand.

Cascade and Longview Fibre signed the PGS contract in November 1991. Longview will provide Cascade with a maximum number of therms per year, up to a stated limit of therms per day. To obtain this service, Cascade pays Longview an annual fee (the "PGS Fee"). The contract, with a 20-year term, also contains a provision that says:

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[4]WUTC v. Puget Sound Power & Light Co., Cause No. U-83-54, Fourth Supp. Order (September 1984). Here the decision relates in one instance to entering a contract and in the other instance to enforcing a contract provision. The concept of "prudence" requires a reasonable decision process and a reasonable decision -- though not necessarily a "correct" decision. See, also, WUTC v. Puget Sound Power & Light Co., Docket No. UE-921262, 19th Supp. Order (September 27, 1994).

[5]W.U.T.C. v. Puget Sound Power & Light Co., Docket Nos. UE-921262, et al., 11th Supp. Order (September 21, 1993).

[6]RCW 80.04.130(2).

> The PGS Fee shall be adjusted by mutual agreement of the Parties to ensure the PGS Fee is comparable to least cost alternative sources of peaking service reasonably available to Cascade.

The Company asks to include the full PGS Fee in its PGA, which would result in a rate increase of $.0078/therm for all customers. The Commission Staff did not object to the deferral in 1992 or 1993 PGA proceedings. Falling prices for natural gas caused them to raise the issue in this, the 1994 PGA proceeding.

Commission Staff concedes that the initial decision to enter the contract appears prudent. It challenges the Company's failure to renegotiate the PGS Fee under the contract, however, contending that the reasonable availability of lower cost alternatives (i.e. a two-year offer of storage release by Washington Water Power Company (WWP)) required Cascade to seek renegotiation under the contract.

Commission Staff recommends reducing the allowance of cost of the Longview Fibre contract by $395,168, which would trim the required PGA increase to $.00561/therm.

The Company contends that the "adjustment" language in the contract is a safety valve allowing renegotiation rather than a mandate requiring renegotiation. The Company argues that the parties' intent was that the PGS Fee could not cost more than comparable alternative resources. Cascade maintains that there are no lower cost comparable alternatives; the Longview contract is available for a long term, which makes it substantially different from a short term (two year) offer of storage capacity.

A resource available for a five-year term would be a comparable resource, according to Cascade, but the PGS contract costs less than such a peaking service. The Company also argues that because the PGS contract helped Cascade avoid bypass, it helped Cascade preserve margin and add greater value. Under the Commission Staff's interpretation, argues the Company, the PGS fee would fluctuate every year and would no longer offer the advantage of a stable price.

The Commission Staff points out that the Company has characterized both PGS service and storage as broad-based peaking resources, and notes that WWP's storage release would deliver the same amount as the Longview Fibre contract, 150,000 therms/day, so is a comparable resource. Even though the WWP storage release is lower cost than the Longview contract, Commission Staff says that it has not been shown to be the least cost alternative, and other resources may be lower, so adjusting the contract to be the level of storage release costs is a conservative approach.[7]

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[7]The Commission Staff notes that Cascade received an unsolicited offer of peaking service well below the PGS price, although after the PGS renegotiation date.

Commission Staff argues that the PGS contract is not a fixed rate contract because it does not lock in prices for any period of time longer than one year, and can be renegotiated at the request of either party. Thus, argues Staff, the time horizon for which a peaking alternative is available is irrelevant because the price horizon is one year.

Public Counsel sees review of the PGS Fee as a sort of "rolling prudence determination," an exception to normal prudence analysis, since it is (and will be) necessary to evaluate the contract's implementation over time, not just at the point when the contract was signed. The Company's criteria for determining alternative resources are too restrictive, says Public Counsel, and Cascade bears the burden and responsibility for finding least cost alternatives. Ratepayers deserve an annual, detailed review of resource options under the contract and enforcement of that option by Cascade, contends Public Counsel; he urges that the Commission order Cascade to conduct that evaluation, assert its rights, and document its analysis. The Commission must protect core customers from a "one way street" disadvantage, says Public Counsel, because Longview Fibre can assert its rights annually if the price of alternatives increases. Public Counsel supports Commission Staff's adjustment as an appropriate way to address this problem.

The Commission rules that under the existing terms of the contract, the Company must consider annually whether to renegotiate. It must also document thoroughly the information that it acquires and considers, and its reasons for making its decisions, to demonstrate that its actions are prudent.

Because there is not a longer time horizon specified in the contract, both parties have the right to seek renegotiation annually and the pricing horizon is annual rather than five years. The Company's voluntary refusal to assert a right, made without any legal assurance that the other contracting party will similarly forbear when circumstances are reversed, is not reasonable. The contract is not comparable to a contract offering five-year availability at a constant price. The "advantage" of price "stability" becomes a disadvantage when that stability merely maintains an unnecessarily high price.

Commission Staff recommends deferring Longview Fibre PGS costs consistent with the cost of WWP storage release. The Company contends that this would amount to retroactive ratemaking, since the PGS contract was approved by the Commission in 1992 and 1993 PGAs. It argues that, since the contract has already been approved, the previous deferral level should remain in place and, if the Commission changes the level in this filing, the new level should be the basis for deferral from that date forward. The Commission Staff responds that its recommendation applies only to the deferral that the Company will make in the next PGA filing.

The Commission will require thorough documentation of alternatives and of the Company's reasoning for renegotiation decisions on a prospective basis, for deferral periods beginning after the date of this order. The Company may continue its present deferrals until the PGA proceeding following the next renegotiation period. In so deciding, the Commission

considers the magnitude of the adjustment, the Company's good faith interpretation of the contract, the timing of this decision, the purpose of the PGA adjustments, and the extent of information available on the record regarding potential least cost alternatives that will meet the Company's needs.

The proposed measure of reasonableness should not be limited to the Washington Water Power contract. The resources upon which the Company argues reasonableness do not appear to address comparable service. An annual, detailed review of resource options appears to be necessary to support the decision regarding the entry of negotiations and to support the negotiation process. The Company is encouraged to work with Commission Staff and Public Counsel to develop an efficient, inexpensive procedure for approaching this question.

The Commission applauds the contract concept as a potential win-win approach to realities of the market, and it especially applauds the "least cost" requirement in the contract.[8] The Company, however, has the obligation to abide by the contract to protect its own interests and those of its core customers.

b. Tenaska. In 1990, Cascade was negotiating a transportation agreement with Tenaska Gas Company, a customer who Cascade believed could bypass relatively easily. At the same time, Cascade load growth forecasts indicated that it would require additional gas supply resources. The Company determined that the least cost option for serving such load was additional peaking resources.

The Company was conducting a generalized search for additional resources when the possibility arose that Cascade could buy Tenaska's rights to firm gas supply of up to 500,000 therms per day of short-term peaking service. The Company examined the cost of several resources, and determined that the Tenaska peaking service was least cost. As a result of this analysis, the Company and Tenaska initiated a second set of negotiations that resulted in the peaking service contract. Among the terms and conditions of the contract, Cascade must supply Tenaska with an alternate fuel (oil).

The Peak Gas Supply Service, or "PGSS", contract was signed on January 15, 1991, and amended on October 3, 1991. The Company's 1994 integrated resource plan (IRP), filed with the Commission in June 1994, assumed that the Tenaska contract could deliver 20,000 therms per day. The Company conducted a deliverability study in October and November 1994 indicating that up to 200,000 therms could be delivered to the Company's customers in Bellingham. Service under the contract did not become effective until the Tenaska cogeneration plant went on line in 1994.

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[8]The provision is an excellent step in the direction of protecting core customers' interests.

The Company says that purchase of the Tenaska PGSS resource was prudent because it filled a system need and was the least cost alternative available.

Commission Staff maintains that Cascade has not sustained its burden of demonstrating that the decision was prudent, but does not recommend any cost disallowance because it now believes the cost has been shown in retrospect to be reasonable. The Company's contemporaneous analysis did not consider information about several important variables, including whether the gas was deliverable, the expense for oil to dispatch the contract, nor whether it should have waited a few years to acquire such peaking resources.

Public Counsel supports Staff's reasoning that Cascade has not sustained its burden of proof, and asks the Commission to reaffirm the prudence standard. Public Counsel asks the Commission to reject Staff's ex ante analysis of harm for determining the amount of any "prudence" adjustment, since it is based on information from several years after the contract was entered. The Commission Staff says, however, that an analysis based on later data is supportable because the PGSS contract did not become effective until 1994.

The Commission agrees with Commission Staff and Public Counsel that the Company has failed to document that its decision was prudent under the circumstances it faced when the contract was entered.[9] As noted above, it is essential that the Company perform the sort of study or studies that a reasonable board and management would perform prior to making a major decision such as those involving the two contracts in issue. Faced with a decision of substantial financial consequence, a reasonable management board would look closely, requiring such studies as might be necessary, to determine whether the arrangement is the best possible for the interests the Company must protect. It is also essential that there be a sufficient contemporaneous record of the Company's actions to support the reasonableness of those actions.[10]

We agree with Commission Staff that because no adverse consequences resulted to ratepayers, it would be improper to adjust the agreed price under the contract. Public Counsel suggests that we should establish the foreseeable harm at the time the decision was made as the measure of an adjustment. Here, not only is that impossible because the record is insufficient, but our decision does recognize responsibility.

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[9]In the sole document Cascade offered as a record of its analysis, the only recorded consideration involved retaining the customer, rather than whether the supply contract was economic.

[10]We also expect Cascade to be prepared to support the prudence of decisions it makes under the contract in future years, e.g., whether or not to dispatch the peaking resource.

The issue is not one of "damages" in the traditional legal sense of the term, but of a Company's responsibility to act prudently for its ratepayers and to accept financial consequences when that is needed to protect ratepayers from harm. Here, no harm is shown to have resulted. To require an adjustment for an action that did not cause financial harm would be equivalent to imposing a civil penalty. We have not explored whether an imprudent action violates law or rules and thus would support a penalty, or whether such a penalty might be measured by means other than set out in the statutes authorizing penalties. In any event, we decline to impose a penalty on this record.

2. Other issues. Other issues presented in this proceeding include a request for an accounting order; the appropriateness of PGA proceedings to make determinations regarding contracts such as these; the determination of "design day" needs, and the need for documentation of pertinent decisions.

a. Cascade's request for an accounting order. On rebuttal, Cascade offered to treat PGSS oil inventory as a component of rate base in future general rate cases, and asked the Commission to issue an accounting order authorizing the Company to do so.

Commission Staff recommends rejecting this request for three reasons. It contends that oil inventory should be treated similar to other storage-supply resources, (i.e., as a component of working capital). These are generally not treated on an item by item basis, and Staff sees no need for a departure from that general principle in this case. Second, there is no accurate or reliable price in the record upon which the Commission could authorize inclusion in rate base. Oil prices vary significantly, and Cascade has not yet purchased any oil inventory. Finally, Commission Staff notes that the Company has not proposed any specific accounts to which the costs would be booked.

Public Counsel questions whether this issue is properly before the Commission, since Cascade has not filed an accounting petition or a determination of used and useful investment. Public Counsel argues that the record on this question is incomplete and that a general rate case is a preferable forum.

The Commission denies the Company's request because this proceeding is inappropriate and the information is insufficient.

3. Recovery of contract expenses in PGA Proceedings. Public Counsel notes that PGA proceedings were intended to pass along gas supply costs, set by FERC, outside the Company's control. The two contracts at issue here were not outside Company control, were with private industrial companies not subject to FERC review, and were part of Cascade's response to bypass threats. Public Counsel urges the Commission to consider whether the prudence of such contracts should be an issue which is resolved in PGA proceedings, or in some other proceeding.

The Commission agrees that the PGA proceeding is an inappropriate forum for review of non-FERC, non-open-market costs such as those of the two contracts in question. They are not the sort of pass-through elements to which the PGA is suited, unless the costs for deferral are approved in advance of the PGA filing. They are better decided in a general rate case or in a special proceeding -- perhaps in a brief adjudication or other proceeding that can offer expedited review if parties fail to agree or if the Commission declines to accept their agreement.[11]

Pending any changes to the Commission's PGA process, the Company may apply or petition for approval of its agreed rate and other costs incurred under these gas supply contracts. When approved, deferrals may be recovered in the PGA deferral filings. The Company bears the burden of proving that its decisions under such contracts are prudent. It can decide the most administratively efficient means of bringing such decisions before the Commission.

The Commission has solicited views and comments in its recent Notice of Inquiry into the Natural Gas industry, Docket No. UG-940778. It is possible that the NOI may ultimately lead to changes in the PGA process or the prudence review. The Commission encourages broad participation in the NOI. The experience with these contracts is an example of why the existing PGA proceedings appear to fail to function adequately in today's changing environment.

a. Design day peak and cost of meeting it. Public Counsel urges that the Commission decline to approve Cascade's contended design day peak as a necessary cause for purchased supplies, and that it decline to rule that the proposed contracts are necessarily a reasonable way at reasonable cost to meet that requirement.

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[11]The Commission recently noted that similar procedures applicable to Puget Power are becoming problematic in light of analogous changes to the structure of the electric power industry:

> Power costs . . . can be expected to continue to vary. This variability presents risks which must be managed by Puget and balanced between shareholders and ratepayers. . . . [T]he electric industry has changed significantly since PRAM was adopted, and it is time to look at new approaches in dealing with these underlying issues. Rate adjustment mechanisms like the PRAM do not appear to be well suited to an electric industry evolving to accommodate greater competition in power markets and in the electricity services provided by utilities.

WUTC v. Puget Power, Docket No. UE-950618 (Third Supp. Order, September 21, 1995).

We begin by noting that in this proceeding we are confined by the record and the arguments of the parties. Neither Public Counsel nor Commission Staff presented evidence to challenge the Company's use or its calculation of design-day needs. We acknowledge, as Public Counsel points out, that other issues may be present and that they may require our attention in some forum, if not this proceeding. We offer the following comments in the context of this proceeding to highlight areas that we expect to be discussed in the pending NOI.

First, we expect companies to take least cost measures to meet reasonable need. The concept of design day peak has about it several conceptual questions, not the least of which is whether the Company will ever need to meet the need. Beyond that, there is the question of how a company organizes itself and incurs expenses to meet a need that may never materialize. Does it grant interruptible rates to customers whose service may be interrupted and diverted to meet such peak needs? How do the costs of these "supply" contracts to the Company compare with the costs of interruptible gas? Would industrial gas sales be interruptible in any event, offering the Company the flexibility that it needs? Does it agree to purchase gas supplies from customers to meet such needs? If it does, how is a fair and reasonable payment measured?

Here, the measurement was against comparable supply contracts. But the service is not a supply in the traditional sense -- the "supplier" has none of the costs of acquisition and none of the costs of delivery that a true "supplier" would have -- it merely forgoes delivery that it has previously arranged, uses an alternative source that it has previously arranged, and in some senses may be seen to achieve a windfall for an alleged "service" that it may never need to perform.

b. Documentation. Commission Staff notes that the only documentation of the Company decision process is in Exhibit C-24, and that no minutes were kept of Company discussions on the Tenaska contract. The Company is put on notice that documentation of its analyses and its actions regarding relevant major decisions will be required in future prudence reviews.

The documentation will serve two laudable purposes that benefit the Company. First, it will remind the Company of its obligation to undertake a reasonable review of the costs, benefits, and risks of major decisions. Second, it will provide a sound basis for the Company to demonstrate that its decisions were reasonable and will help to avoid long and expensive litigation.

4. Conclusion. The Company has not demonstrated that its decisions to enter the Tenaska contract and to forego renegotiation of its Longview Fibre contract were prudent. For the reasons stated in this order, however, neither of the contracts should be recalculated for ratemaking purposes. Future decisions of the sort evaluated here must be documented sufficiently to demonstrate the information that the Company considers in reaching a decision and its reasoning in using that information, to allow a sufficient evaluation of prudence. Costs resulting from future decisions, including the decision not to take action, may be deferred only subject to the Commission's approval for reasonableness in an appropriate manner as discussed in this Order.

FINDINGS OF FACT

Having discussed in detail the evidence concerning all material matters inquired into, and having stated findings and conclusions, the Commission makes the following summary findings and conclusions. Portions of the preceding discussion are incorporated by this reference.

1. The Washington Utilities and Transportation Commission is an agency of the State of Washington, vested by statute with authority to regulate rates, rules, regulations, practices, accounts, securities and transfers of public service companies, including natural gas companies.

2. Cascade Natural Gas Corporation, respondent, is engaged in the business of providing gas service within the state of Washington as a public service company.

3. On October 31, 1994, the respondent filed for a PGA rate adjustment, seeking approval of costs of gas including contracts for the purchase of peaking capacity from two of its own industrial customers, Longview Fibre and Tenaska.

4. The Commission by Complaint and Order suspended the operation of the PGA tariff and ordered hearings on the matter.

5. The respondent entered into a contract with Longview Fibre to purchase peaking gas supply. The contract provides in part,

> The PGS Fee shall be adjusted by mutual agreement of the Parties to ensure the PGS Fee is comparable to least cost alternative sources of peaking service reasonably available to Cascade.

6. Cascade did not seek to renegotiate the price established in its contract with Longview Fibre for its 1994 PGA period. For future negotiation periods, Cascade must demonstrate that its decision to forego or enter negotiations is prudent.

7. The respondent entered into a contract with Tenaska to purchase peaking gas supply. Cascade has not demonstrated that its decision to enter the contract was prudent. Cascade's ratepayers have suffered no adverse consequences from entry of the contract.

8. Cascade has requested an accounting order authorizing it to treat oil supplies that it purchases under the Tenaska contract as an element of rate base.

9. The tariff revisions filed in this matter will result in rates that are fair, just, reasonable, and sufficient.

CONCLUSIONS OF LAW

1. The Washington Utilities and Transportation Commission has jurisdiction over the subject matter and the parties to this proceeding.

2. Cascade's existing contract with Longview Fibre requires it to consider annually whether it should pursue renegotiation of the price stated in the contract to assure that it is priced at the level of the lowest cost comparable alternative.

3. Cascade should be ordered (a) to perform the required analysis and (b) to renegotiate the price, if needed to lower the PGS fee to the level of the lowest cost comparable alternative, prior to the next PGA period following the opportunity for renegotiation.

4. Cascade failed to demonstrate that it acted prudently in entering a contract with Tenaska for peaking gas supply. No recalculation is required because no adverse consequences resulted.

5. Respondent's PGA rate adjustment in Docket No. UG-941408 should be approved and the tariff revisions allowed to become effective.

6. Respondent should be ordered to document the reasonableness of decisions involving supply contracts with customers.

7. The level of cost attributed to supply contracts with customers should be determined and resolved, before any deferrals of costs relating to the decisions will be authorized for recovery in rates.

8. All motions made in the course of this proceeding which are consistent with the above findings and conclusions should be granted, and those inconsistent should be denied.

ORDER

IT IS ORDERED That:

1. The tariff under suspension herein is allowed to take effect immediately.

2. The Respondent shall document information and deliberations relating to the reasonableness of decisions involving supply contracts with customers.

3. The costs attributable to supply contracts shall be determined and resolved, and approved by the Commission, prior to approval of any deferrals for recovery in rates as to decisions made after the date of this Order.

4. All motions consistent with this order are granted and those inconsistent with it are denied.

5. The Commission retains jurisdiction to effectuate the provisions of this order.

DATED at Olympia, Washington, and effective this 30th day of October, 1995.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

SHARON L. NELSON, Chairman

RICHARD HEMSTAD, Commissioner

WILLIAM GILLIS, Commissioner

NOTICE TO PARTIES:

This is a final order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-09-810, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-09-820(1).