

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION,

Complainant,

v.

CASCADE NATURAL GAS  
CORPORATION,

Respondent.

DOCKET NO. UG-060256

**INITIAL BRIEF OF COMMISSION STAFF**

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## I. INTRODUCTION

1           The parties to this rate case proceeding have, pursuant to WAC 480-07-740, brought forth a Settlement Agreement for consideration by the Commission. As set forth in the agreement and in the Narrative Statement filed in support, the parties have reached consensus on nearly all of the issues in the case, and urge the Commission to ratify the resolution of these issues as in the public interest. Namely, the parties have reached agreement (with each party either expressing support or not taking a position in opposition) on all of the following items: (1) revenue requirement adjustments; (2) miscellaneous service charges; (3) low income assistance; (4) rate spread issues, and; (5) rate design issues, including rates for transportation customers and basic charges. Staff reiterates its support for the Settlement Agreement's resolution of each of these items.

2           Only two issues remain upon which Public Counsel has expressed opposition: (1) the partial decoupling mechanism agreed to by Commission Staff ("Staff"), Cascade Natural Gas Corporation ("Cascade" or "the Company"), and the Northwest Energy Coalition ("the Coalition"), to be implemented for a three-year pilot period in conjunction with the Company's conservation program; and (2) cost of capital. This brief addresses these two remaining contested issues. For the reasons set forth below, Staff supports the Settlement Agreement's resolution of these issues and urges the Commission to approve them as in the public interest.

## II. ARGUMENT

### A. **The Commission Should Approve the Partial Decoupling Mechanism Set Forth in the Multi-Party Settlement Agreement Because it Appropriately Balances the Interests of Cascade and its Customers, and Removes the Disincentive to Conservation Inherent in Volumetric Pricing.**

#### 1. **Decoupling furthers a significant public purpose that advances the interests of both the Company and its customers.**

3 Paragraph 15 of the Settlement Agreement recommends that the Company be authorized to implement a partial decoupling mechanism for a three-year pilot period. Decoupling is a regulatory mechanism that separates, or “decouples,” a utility’s revenues from its sales of energy—in this case, natural gas—and “recouples” revenues to some other factor, such as the number of customers. The mechanism gives the utility recovery of deviations in actual revenue from its authorized level of revenue,<sup>1</sup> through rate surcharges or credits.<sup>2</sup>

4 Under current rate structures, revenues are largely generated through volumetric charges. Therefore, reducing energy use may result in lower profits for the utility and compromise its ability to recover its fixed costs. Decoupling removes the motivation to promote sales and makes the utility indifferent to customer usage. It thereby removes the utility’s disincentive to promote conservation and energy efficiency. Decoupling restores the margins that are lost due to customer efficiency, which allows the utility to pursue energy efficiency without losing profits, and makes it more likely that the utility will recover

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<sup>1</sup> Decoupling concerns the revenues and costs associated with delivering natural gas to customers, or “margin”—costs that are generally fixed costs. The gas commodity costs are passed through to customers through Cascade’s purchased gas adjustment (PGA). Ex. 421-T at 3 n. 1.

<sup>2</sup> Ex. 421-T at 3:6-10 (Steward).

its fixed costs. Accelerated energy efficiency and increased renewable energy investment, in turn, benefits customers and society through lower customer bills and reduced pollution.<sup>3</sup>

**2. Several compelling reasons exist for the Commission to implement partial decoupling for Cascade now.**

5 Numerous reasons exist for the Commission to implement the partial decoupling for Cascade proposed in the Settlement Agreement. First, there has been substantially increased volatility in the natural gas market in recent years. Cascade's customers, in fact, have seen natural gas costs increase 32 percent in the last three years alone, through PGA increases of 0.8% in November 2003 (Docket No. UG-031583), 4.9% in November 2004 (Docket No. UG-041772), and 26.3% in November 2005 (Docket No. UG-051483).<sup>4</sup> Implementation of decoupling, by removing the Company's disincentive to promote conservation and energy efficiency, will assist customers to cope with these rising gas commodity costs. A recent study suggests that accelerated energy efficiency and renewable energy investment in the Pacific Northwest may help bring down natural gas prices by up to 38%.<sup>5</sup>

6 Second, decoupling will align ratemaking with Commission policy supporting conservation. The Commission has stated that it "favors utility efforts to accomplish cost-effective conservation that reduces both the utility's costs and enables consumers to manage their natural gas bills."<sup>6</sup> Moreover, the National Association of Regulatory Utility Commissioners passed resolutions in 2004 and 2005 that endorse decoupling and rate designs that will encourage conservation and efficiency.<sup>7</sup>

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<sup>3</sup> Ex. 421-T at 3:15-4:5 and 7:1-2 (Steward).

<sup>4</sup> Ex. 421-T at 7:15 and n. 2, and Ex. 424-T at :12-18 (Steward).

<sup>5</sup> Ex. 421-T at 8 n. 3 (Steward), citing William Prindle, R. Neal Elliot, Anna Shipley, *Impacts of Energy Efficiency and Renewable Energy on Natural Gas Markets in the Pacific West*, American Council for an Energy-Efficient Economy, Report No. E062, <http://aceee.org>, January 2006.

<sup>6</sup> *Rulemaking to Review Natural Gas Decoupling*, Summary, Analysis of Comments and Decision to Close Docket Without Action at 10, Docket No. UG-050369 (October 17, 2005).

<sup>7</sup> Ex. 55 (Cascade's Response to Public Counsel Data Request No. 46) (Stoltz).

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Third, decoupling will appropriately balance the interests of the Company and customers. As noted above, it provides the Company recovery of margin costs authorized in a general rate case despite declining customer usage. At the same time, decoupling retains volumetric pricing, which allows customers to retain the benefits of conserving from lower bills—as opposed to having sharp increases in basic charges or a straight fixed/variable rate design, which would substantially reduce the potential bill savings for customers.<sup>8</sup> All of these policy considerations strongly argue in favor of approving the partial decoupling mechanism set forth in the Settlement Agreement.

**3. The partial decoupling mechanism set forth in the Settlement Agreement is superior to the mechanism originally proposed by Cascade, and has several features that commend its approval.**

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The partial decoupling mechanism set forth in the Settlement Agreement provides the correct policy direction of effectively removing the disincentive for conservation and allowing for recovery of fixed costs, but does so in a more constrained and, in Staff's view, superior way than the decoupling mechanism originally proposed by Cascade. Namely: (1) it is limited to non-weather related changes in consumption; (2) its duration is limited to three years; (3) it will be evaluated thoroughly by an independent consultant before the mechanism can be reauthorized, and any such reauthorization must be done as part of a general rate filing. Finally, decoupling will be carried out in conjunction with a detailed conservation plan to be undertaken by Cascade over the next three years.

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First, the partial decoupling mechanism in the Settlement Agreement defers margin variances based on weather-normalized volumes. That is, the scope of the decoupling will include only non-weather related effects that cause changes in usage, such as customer conservation, energy efficiency improvements, programmatic changes from Company

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<sup>8</sup> Ex. 421-T at 9:13-18 (Steward).

programs, and price elasticity.<sup>9</sup> By properly excluding weather, the partial decoupling mechanism adheres to the Commission policy favoring conservation efforts. Moreover, the partial decoupling mechanism, as a compromise measure, uses the Company's proposed weather methodology, which has a smaller coefficient for the weather component than does Staff's, and thus lessens the projected deferral under the mechanism.<sup>10</sup> As Ms. Steward indicated in response to Chairman Sidran's question, the settlement proposal takes weather out of the decoupling equation, and that factor therefore is treated as it is now—rates are based on normalized weather, and the risks and benefits of warmer and colder weather remain with the Company.<sup>11</sup>

10           Second, the partial decoupling mechanism in the Settlement Agreement is a three-year pilot program. This limitation will help ensure that unintended consequences do not occur as a result of decoupling. As noted earlier, current ratemaking relies on volumetric pricing, and inherent in this is the implication that costs track sales. Decoupling instead uses the number of customers, rather than sales, to track costs. Two regression analyses on decoupling prepared in the early 1990's found that, on a short-term basis, neither factor was superior to the other in its ability to track costs.<sup>12</sup> However, these findings were based upon short-term studies. Staff believes that the three-year pilot period will allow the parties to determine whether these assumptions hold true, and whether other adjustments to the mechanism need to be made.

11           Third, the partial decoupling mechanism can be reauthorized only as part of a general rate case to be filed by the Company prior to the expiration of the mechanism.

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<sup>9</sup> Ex. 1 at 10, ¶ 15(a) (Settlement Agreement), Tr. at 197-98 (Steward).

<sup>10</sup> Ex. 34 (Stoltz); Tr. at 200 (Stoltz; Steward).

<sup>11</sup> Tr. at 289-90 (Steward).

<sup>12</sup> Ex. 431 (Steward) and attachment



Moreover, the Settlement Agreement requires that an independent consultant, retained by the Company after consultation with interested parties, conduct a thorough evaluation of the mechanism and address at a minimum the following issues: (1) What customer classes should be included within the scope of the mechanism? (Currently, partial decoupling is limited to residential and commercial customers.); (2) How well does the mechanism remove Cascade's disincentive to promote energy efficiency?; (3) What would the bill impacts have been if weather-related impact on usage was included?; and, (4) Was there any discernible effect on service quality due to the existence of the mechanism?<sup>13</sup> These are all issues that Staff recommended for review prior to reauthorization of decoupling.<sup>14</sup>

12 Finally, and significantly, the Settlement Agreement combines partial decoupling, which removes the utility's disincentives to conservation, with a commitment for Cascade to more strongly pursue energy efficiency efforts in its Washington service area. The Company has contracted with Stellar Processes to prepare an assessment of the conservation potential in its service area.<sup>15</sup> With this study as the basis, the Company will convene an advisory group and develop a conservation plan for the next three years. Since Cascade does not have an in-house staff to manage programs, the Company will contract with a third party to implement programs.<sup>16</sup> The Conservation and Low Income Weatherization Plan, which must be filed with the Commission within 90 days of the initial meeting of the advisory group, shall contain specific programmatic and energy efficiency targets and

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<sup>13</sup> Ex. 1 at 11 (Settlement Agreement).

<sup>14</sup> Ex. 421-T at 15:16-16:2 (Steward).

<sup>15</sup> Ex. 111-T at 12:1-3 (Barnard).

<sup>16</sup> The use of third party contractors to implement the programs will be more efficient than trying to build an in-house staff, which would require a greater ramp-up time. Tr. at 262-217 (Steward) and Tr. at 205 (Stoltz).

related benchmarks. If the benchmarks are not met in subsequent years, penalties may be imposed pursuant to the plan.<sup>17</sup>

13 Staff notes that the Company currently provides incentives for high efficiency furnaces and water heaters to residential customers, high-efficiency equipment and insulation for commercial and industrial customers, and weatherization for low-income customers. Refinements to these programs may be included in the conservation plan.<sup>18</sup>

**4. The partial decoupling mechanism in the Settlement Agreement addresses the factors set forth in the Commission's recent PacifiCorp order regarding decoupling.**

14 The Commission's recent order in the PacifiCorp rate case,<sup>19</sup> set forth factors that should be addressed when proposing a decoupling mechanism for approval by the Commission. The partial decoupling mechanism set forth in the Settlement Agreement addresses each of these factors.

15 Factor 1 concerns the scope of risk to be covered. The proposed mechanism is limited to the non-weather related changes in consumption, *i.e.*, changes due to customer conservation or energy efficiency. Decoupling is intended to remove the disincentive for conservation. Including weather in the mechanism does not serve this purpose and would have unpredictable consequences for ratepayers.

16 Factor 2 concerns the scope of fixed costs included. The proposed mechanism includes only the costs related to the delivery of gas (*i.e.*, margin). This is a much simpler distinction with a gas utility compared to an electric utility, which also has fixed costs related to production.

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<sup>17</sup> Ex. 1 at 12-13 (Settlement Agreement).

<sup>18</sup> Ex. 421-T at 19:19-20:2 (Steward).

<sup>19</sup> *Washington Util. & Transp. Comm'n v. PacifiCorp d/b/a Pacific Power and Light Co.*, Docket UE-050684, Order 04, at 41-42, ¶ 109 (April 17, 2006).

17 Factor 3 concerns the customer classes to be included and whether the baseline would be on an individual or class basis. Customer classes are identified in the Settlement Agreement as those taking service under Rate Schedules 503 and 504 (residential and commercial). The baselines are on a class level basis.<sup>20</sup>

18 Factor 4 addresses the detail of accounting for and calculation of any true-up. These were available in workpapers and in the proposed tariff (which will be modified to reflect changes agreed upon since the original filing).

19 Factor 5 addresses rate of return implications. Staff, in its original testimony, stated that the return on equity should be adjusted by 0.25% if a decoupling mechanism were adopted.<sup>21</sup> The cost of capital agreed upon by Staff and Company in the Settlement Agreement takes into account the inclusion of the partial decoupling mechanism. These two elements were considered together, along with other factors, in crafting the compromise Settlement Agreement.

20 Factors 6 and 8 address the method of cost recovery, and the timing and calculation of rate adjustments. These items are described in Cascade's proposed tariff.

21 Factor 7 concerns the design of the pilot test period and evaluation of the mechanism before determining whether to make it permanent. This is set forth in the Settlement Agreement at page 11, paragraph 15(c).

22 Factor 9 concerns the impact of new customers on revenue recovery. New customers are accounted for in the proposed partial decoupling mechanism.

23 Factor 10 concerns the impact of the mechanism on low-income customers. There is no specific provision tied to low-income customers. However, the Settlement Agreement

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<sup>20</sup> Ex. 1 at 10, ¶15(a) (Settlement Agreement).

<sup>21</sup> Ex. 361-T at 3:9-13 (Parvinen); Ex. 391-T at 17:5-6 (Parcell).

does provide \$800,000 annually in low-income bill assistance.<sup>22</sup> Furthermore, as Mr. Weiss indicated in response to questions from Chairman Sidran, decoupling likely will not have a differential impact on low income customers. Many of them are quite low users, and may have already conserved because of price pressures perhaps as much as they can conserve. Low income weatherization programs will also aid these customers.<sup>23</sup>

24           Finally, Factors 11 and 12 concern identification of incremental conservation measures expected to be undertaken, and development of a target for energy conservation. These are addressed in the Settlement Agreement at page 12, paragraph 15(e).

25           In conclusion, Staff asks that the Commission approve the partial decoupling mechanism set forth in the multi-party Settlement Agreement because it appropriately balances the interests of the Company and its customers. It furthers the significant public policy goal of removing the Company's disincentive to conservation. Moreover, its duration is initially limited to three years, and the Company is required to file with the Commission and implement a detailed conservation program in conjunction with the partial decoupling mechanism.

**B.     The Commission Should Approve the Cost of Capital Set Forth in the Multi-Party Settlement Agreement Because It Represents a Balanced Compromise of the Positions of Staff and the Company and Results in Rates that Are Fair, Just, Reasonable, and Sufficient.**

26           Only Staff and the Company sponsored witnesses, provided testimony, and set forth litigation positions on cost of capital in this proceeding. Staff provided the testimony and exhibits of David C. Parcell,<sup>24</sup> while the Company provided the testimony and exhibits of

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<sup>22</sup> Ex. 1 at 9, ¶ 14 (Settlement Agreement).

<sup>23</sup> Tr. at 312-314 (Weiss).

<sup>24</sup> Exs. 391-T through 406 (Parcell).

Dr. Roger A. Morin.<sup>25</sup> Public Counsel sponsored no witnesses, provided no testimony or exhibits, and conducted no cross-examination on this issue.

27 As the Settlement Agreement indicates, a number of issues were in dispute between Staff and the Company with respect to cost of capital, including return on equity, common equity ratio, and whether short-term debt should be included in the capital structure.<sup>26</sup> The Narrative Statement Regarding the Settlement Agreement further points out that Staff recommended an overall rate of return of 8.33%, which included a 9.50% return on equity, an equity ratio of 41.13%, and the inclusion of short-term debt. The Company had requested an overall rate of return of 9.37%, which included an 11.15% return on equity, and an equity ratio of 50%. The revenue requirement associated with Staff's return recommendation was \$5.6 million; the revenue requirement associated with the Company's return recommendation was \$9.4 million.<sup>27</sup>

28 The Settlement Agreement provides for a revenue requirement of \$7.5 million with respect to the return. This is a compromise figure that was agreed upon as part of a larger agreement between the Staff and the Company on overall revenue requirement, and resulted from compromises on a number of issues by both parties in the interests of reaching a fair, just, and reasonable settlement. As the Narrative Statement further points out, the Settlement Agreement on cost of capital is in the middle of the range between the two parties' litigation positions on this issue.<sup>28</sup>

29 The rates that result from this settlement, including the parties' agreement on cost of capital, are fair, just, reasonable, and sufficient. Public Counsel has provided no evidence to

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<sup>25</sup> Exs. 161-T through 173-T (Morin).

<sup>26</sup> Ex. 1 at 4, ¶ 12(a) (Settlement Agreement).

<sup>27</sup> Ex. 2 at 3, ¶ 5(a) (Narrative Statement).


<sup>28</sup> *Id.*

support any argument to the contrary. The Commission should, therefore, approve the cost of capital set forth in the Settlement Agreement as in the public interest.

DATED this 16<sup>th</sup> day of November, 2006.

Respectfully submitted,

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