BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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| WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,<br><br>Complainant,<br><br>v.<br><br>CASCADE NATURAL GAS CORPORATION,<br><br>Respondent. | DOCKET NO. UG-060256 |

# COMMISSION STAFF'S RESPONSE BRIEF

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ROB MCKENNA
Attorney General

GREGORY J. TRAUTMAN
Assistant Attorney General
Office of the Attorney General
PO Box 40128
1400 S Evergreen Park Drive SW
Olympia, WA 98504-0128
(360) 664-1187

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## I. INTRODUCTION

*1* Public Counsel devotes a substantial portion of its initial brief making various challenges to the Settlement Agreement's provisions adopting a decoupling mechanism. Public Counsel also contends that the Settlement Agreement's provisions on cost of capital are not sufficient. As more fully set forth below, none of these contentions have merit.

## II. ARGUMENT

### A. All of the settling parties agree that decoupling removes the disincentive for utilities to encourage conservation that is inherent in volumetric pricing. Public Counsel fails to address this underlying conflict between company revenues and conservation anywhere in its brief.

*2* Public Counsel incorrectly contends, at paragraph 1 of its brief, that there is not one theory of decoupling, but "many, as evidenced by the competing methods and arguments in this Docket." This is clearly wrong. There is one overriding premise to which *all* of the settling parties agree — namely, that the recovery of fixed costs through volumetric prices results in a disincentive for the utility to encourage conservation.[1] As Ms. Steward points out, under traditional ratemaking with volumetric pricing, a utility is motivated to promote gas sales in order to increase its revenues and profit; otherwise, lower profits will compromise the utility's ability to recover its fixed costs. Decoupling removes the motivation to promote sales and makes the utility indifferent to changes in customer usage. This removes the company's disincentive to promote energy efficiency.[2]

*3* Both Cascade and the Northwest Energy Coalition agree with this premise, which is founded upon economic reality. The settling parties do not disagree upon the fundamental basis for, and need for, decoupling; the debate among the parties was limited to the mechanics of the application. Public Counsel simply fails to address this issue anywhere in

[1] *See* Initial Brief of Cascade, ¶ 45; Initial Brief of Staff, ¶¶ 3-4; Exhibit 311 at 4:23 - 5:15 and 7:3-14 [Weiss].
[2] Ex. 421 at 3:13-20 [Steward].

its brief. While Public Counsel points out that Cascade has experienced customer growth in recent years, this does not address the fact that under volumetric pricing, the utility will suffer economically when usage per customer declines. Decoupling addresses this fundamental contradiction in a meaningful manner.

### B. Contrary to Public Counsel's assertions, decoupling is not a great departure from traditional ratemaking that will produce "windfalls" for regulated utilities or punish customers who conserve energy.

*4* Public Counsel contends that decoupling rests on the "shaky and untested assertion" that "traditional ratemaking is broken."[3] But decoupling is not the great departure from traditional ratemaking that Public Counsel would like the Commission to believe. It relies on the traditional test period review of costs and revenues. It *is* a departure from wholly placing the recovery of costs authorized from that balanced review in volumetric pricing.

*5* Public Counsel objects that this constitutes an unwarranted foray into "single-issue ratemaking," which should not be done except in "extraordinary" circumstances.[4] Yet a tariff rider, which Public Counsel supports,[5] is another example of single-issue ratemaking. In adopting tariff riders and deferrals for conservation program cost recovery, the Commission has ostensibly recognized that certain limited types of single-issue ratemaking can be adopted in support of sound policy goals. The Commission has approved cost recovery mechanisms (deferrals or tariff riders) outside of rate cases for Puget Sound Energy ("PSE"), Avista, PacifiCorp, and Cascade.[6] Decoupling is a similar form of relief that encourages utility support for conservation that should be adopted in this docket.

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[3] Initial Brief of Public Counsel, ¶ 14.
[4] *Id.*, ¶¶ *29-32.*
[5] *Id.*, ¶ 105.
[6] Docket Nos. UG-950288 and UE-970686 (PSE); Docket Nos. UE-941377/941378 (Avista); Docket No. UE-001457 (PacifiCorp); Docket Nos. UG-021117, UG-051135 and UG-051481 (Cascade).

6 In addition, Public Counsel makes sweeping contentions that decoupling will result in overearnings and a "windfall" for the Company.[7] These contentions are both exaggerated and alarmist. According to Public Counsel, "Ms. Steward admits that once decoupling is in place, a mismatch will swiftly come into play."[8] This is not what Ms. Steward said. What Ms. Steward discussed was the *potential* for a mismatch between costs and revenues *over a period of time*. This is precisely why the parties' Settlement Agreement limits the decoupling mechanism to three years.[9]

7 Nor does Public Counsel offer any empirical evidence that decoupling will lead to a "windfall" for the company. In fact, Ms. Steward twice stated categorically that the mechanism will not produce a "windfall." The simulations that Staff and the Company have performed indicate, at most, a potential surcharge of less than one percent of revenue for the individual customer classes.[10] Public Counsel relies nearly exclusively on Mr. Weiss' testimony to suggest that the decoupling mechanism produces a windfall. However, the Northwest Energy Coalition supports the proposed mechanism and extensively explains in its initial brief why it does *not* provide "an unwarranted windfall."[11]

8 Moreover, it is incorrect for Public Counsel to imply that Cascade is overearning in Oregon as a result of decoupling.[12] First, Ms. Steward *never* "acknowledge[ed] that Cascade is overearning in Oregon,"[13] contrary to Public Counsel's unsupported allegation. Rather, it was Ms. Krebs who made that assertion in a question during cross-examination. Second, all that has happened to this point is that the Oregon staff has initiated a show-cause

[7] Initial Brief of Public Counsel, ¶¶ 56-67.
[8] *Id.*, ¶ 57.
[9] Tr. at 274:11-21 [Steward].
[10] Tr. at 276:20-24; 277:9-12 and 17-20 [Steward].
[11] Post-Hearing Brief of Northwest Energy Coalition, ¶¶ 8-12.
[12] Initial Brief of Public Counsel, ¶¶ 59, 65.
[13] *Id.*, ¶ 59.

proceeding seeking reductions in Cascade's rates and revenues. That proceeding is still underway and has not yet been decided. Third, and significantly, the Oregon decoupling mechanism went into effect in the spring of 2006 (as Public Counsel mentions in its brief[14]) and, therefore, could not have been a factor in Cascade's earnings in the prior year.

*9* Finally, decoupling does not reward Cascade while somehow "punishing" customers who engage in conservation measures and use less energy. Public Counsel, in both its brief and at the hearing, refers to the supposed "perverse incentives" that will harm those who conserve, because decoupling may result in some rate increases to compensate the Company for the decline in energy usage per customer. But this tells only part of the story. As Ms. Steward has pointed out,[15] and as Mr. Stoltz emphasized during the hearing, the cost of gas supply itself will likely decrease significantly because of conservation, and this will greatly benefit, not harm, consumers:

> Certainly, if [customers] have a successful conservation measure, they're going to be paying less because they get to avoid the cost of gas supplies as well for every therm that they save . . . .As Ms. Steward put it her testimony, the conservation potential in the Northwest could drive the cost of natural gas down by 38 percent. That would be much more significant than the small incremental change that we may implement through the CAP program.[16]

### C. The Settlement Agreement's decoupling mechanism and conservation plan for Cascade are superior to the various approaches suggested by Public Counsel.

*10* Public Counsel states that "Cascade should be both encouraged and required to pursue utility sponsored conservation."[17] Staff agrees. The multi-party settlement does both. It adopts a three-year decoupling mechanism to remove the Company's disincentive to pursue conservation. But it also requires Cascade to file a conservation plan with the

[14] *Id.*, ¶65.
[15] Ex. 421, at 8:2-11 [Steward].
[16] Tr. 257:19-22 and 258:12-17 [Stoltz].
[17] Initial Brief of Public Counsel, ¶ 98.

Commission, containing annual targets and benchmarks. Public Counsel claims that "[p]roponents of decoupling advance the theory that if one simply removes management's financial incentive in growing gas sales . . . conservation programs will arrive and somehow flourish." This claim is entirely baseless. Staff does not simply rely on the Company's good faith to pursue conservation; rather, it has mandated a conservation plan as a condition for decoupling.

*11* The conservation program and performance plan outlined in the Settlement Agreement achieves the same goals intended for PSE in its 2002 settlement agreement. It creates an advisory group, it establishes that a target will be set based on a comprehensive assessment of the potential in Cascade's service area, and it includes possible penalties and incentives.

*12* Certain other utilities (namely, Avista and PSE) have aggressively pursued conservation without decoupling. It is not coincidental, however, that the only gas utilities with strong gas efficiency programs are also electric utilities. These utilities were able to leverage their electric efficiency programs to build their gas programs.[18] Yet, both of these utilities are also seeking decoupling for the gas utility. The margins are much slimmer on the gas side since the gas utilities do not own the means of production as they do on the electric side. This is why decoupling makes more intuitive sense for gas utilities.

*13* In contrast to the decoupling mechanism and conservation plan adopted by the parties to the Settlement Agreement, Public Counsel suggests that other approaches be taken. Staff believes that these suggested "solutions" are short-sighted at best. First, Public Counsel suggests that the Commission enforce a minimum level of conservation, yet it does

[18] Tr. at 216:24 – 217:2 [Steward].

not recommend what that level should be.[19] The Commission should not be an arbitrary actor. A minimum level needs to properly reflect the potential opportunities in the utility's service area. We need the cooperation of the utility to do this, as Staff and the stakeholders do not have the resources to do this on our own. The procedure for adopting and implementing a conservation plan set forth in the Settlement Agreement will best achieve the necessary conservation goals.

*14* Public Counsel also suggests that an incentive/penalty mechanism be adopted.[20] However, this approach cannot be effective if the company is losing more margin as a result of customer conservation than it will receive as an incentive. Rather, the underlying problem needs to be addressed. Decoupling, together with a conservation plan, addresses this problem.

*15* Finally, Public Counsel recommends that a tariff rider be adopted and further suggests that PSE's aggressive conservation is the result of its tariff rider.[21] But this conclusion is drawn from several erroneous premises. First, a tariff rider is a cost recovery mechanism only. The process for developing programs and establishing targets takes place through separate filings. Second, PSE's tariff rider recovers its electric conservation program costs. PSE's gas program costs are recovered through a tracker mechanism, which is a deferral of expenditures for recovery in the subsequent year. PSE's electric tariff rider has been in effect since 1997[22] (not 2002, as Public Counsel suggests[23]), and PSE's gas tracker has been in effect since 1995.[24] Both of these mechanisms were in effect well before

[19] Initial Brief of Public Counsel, ¶ 99-101.
[20] *Id.*, ¶¶ 106-108.
[21] *Id.*, ¶¶ 102-105.
[22] Docket No. UE-970686.
[23] Initial Brief of Public Counsel, ¶ 9.
[24] Docket No. UG-950288.

PSE began ramping up its conservation programs and, therefore, cannot be construed as having been the impetus for PSE's current aggressive conservation. Similar to PSE's gas tracker, the Commission has already authorized Cascade to defer its conservation program expenditures for recovery in the subsequent year.[25]

*16* In summary, only by first addressing the underlying conflict between revenues and encouraging conservation can any tool truly be effective. The Settlement Agreement, with both a limited, three-year decoupling mechanism and the requirement that Cascade adopt and implement a conservation plan, should be approved.

### D. Public Counsel's challenge to the Settlement Agreement's provisions on cost of capital is without merit.

*17* Public Counsel contends that the Settlement Agreement "does not contain any information about the adopted cost of capital, capital structure, or overall rate of return," and therefore, should be rejected because it cannot be determined whether the rates under the settlement are fair, just and reasonable, "now and in the future." This claim is without merit.

*18* First, the Commission has held that when examining a proposed settlement, the agreement is reviewed as a whole, with a view to whether the "overall result in terms of revenue requirement is reasonable and well supported by the evidence."[26] Furthermore, "ratemaking is not an exact science," so that if the overall result is reasonable, "close scrutiny of individual adjustments is not required."[27] Finally, because they are the product of compromise, "all settlements have a so-called black box quality to one degree or another

[25] Docket Nos. UG-021117, UG-051135, and UG-051481.
[26] WUTC *v. PacifiCorp d/b/a Pacific Power & Light Co. (PacifiCorp),* Docket No. UE-032065, Order No. 06, ¶ 62 (October 7, 2004).
[27] *Id.*, ¶¶ 61-62.

– they are by nature compromises of more extreme positions that are supported by evidence and advocacy."[28]

*19* When considering the individual components of a settlement, the Commission undertakes a three-part inquiry. It asks:

1) Whether any aspect of the proposal is contrary to law;

2) Whether any aspect of the proposal offends public policy;

3) Whether the evidence supports the proposed elements of the Settlement Agreement as a reasonable resolution of the issue(s) at hand.[29]

*20* None of the aspects of the Settlement Agreement's provisions on cost of capital is contrary to law or offensive of public policy. Furthermore, the Settlement Agreement and the Narrative Statement in support contain substantial evidence supporting the cost of capital agreed to by the parties. The parties' positions on return on equity, equity ratio, and overall rate of return are all set forth in these documents. The overall rate of return requested by the Company was 9.37 percent, while Staff requested an overall rate of return of 8.33 percent. The revenue requirement associated with the Company's return recommendation was $9.4 million, while that associated with Staff's return recommendation was $5.6 million. The revenue requirement associated with the overall return in the Settlement Agreement is $7.5 million — "in the middle of the range between the two Parties' positions on this issue," as the Narrative Statement clearly states. To state that the overall return cannot be fairly estimated based upon the evidence set forth in the Settlement Agreement is simply incorrect.

*21* In fact, the Commission has approved settlement agreements with less specific information regarding overall return and the various components than those contained in the present one. Most notably, in Northwest Natural Gas Company's settled 2003-2004 rate

[28] *Id.*, ¶ 61.
[29] *Id.*, ¶ 59.

case, the Commission approved a settlement agreement that stated only (with two exceptions not relevant here) the agreed-upon overall revenue requirement of $3.5 million. The agreement stated that the parties did not negotiate the revenue requirement "without regard to any specified adjustments to . . . cost of capital components, or the Company's capital structure." The Commission found that, overall, the settlement resulted in fair, just, and reasonable rates.[30] The present settlement clearly contains sufficient information regarding the parties' agreed-to compromise on cost of capital.

*22* Public Counsel also contends that, unless the settlement contains "an authorized rate of return," one cannot determine whether rates are fair, just and reasonable "in the future." This is a fallacious argument. Whether or not the settlement agreement contains an express overall rate of return or return on equity will not address whether rates in the future are reasonable. The appropriate rate of return would have to be reexamined at that time. Public Counsel admits that "as time passes and circumstances change, a test year revenue requirement becomes less and less reflective of actual financial conditions[.]"[31] So too does the rate of return and the return on equity. One could not reasonably contend, for example, that Cascade's rate of return in this docket should be determined by that authorized in 1995, the time of its last general rate case. Public Counsel's arguments here are without merit.

*23* Finally, Public Counsel contends that the Settlement Agreement's resolution of cost of capital issues does not account for a decoupling mechanism.[32] This is simply wrong. Both Staff's and Cascade's cost of capital witnesses presented evidence on the effect of adopting a decoupling mechanism on Cascade's rate of return. Given that the Settlement

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[30] Docket No. UG-031885, *WUTC v. Northwest Natural Gas Co*, Order No. 04, Order Approving and Adopting Settlement Stipulation as Amended, ¶¶ 8, 10, 11 (June 23, 2004); Docket No. UG-031885, Stipulation, ¶ 1 "Revenue Requirement".
[31] Initial Brief of Public Counsel, ¶ 113.
[32] *Id.*, ¶¶ 114-115.

Agreement includes a decoupling mechanism, the recommended rate of return necessarily reflects the impact of rate of return associated with adoption of the decoupling mechanism.

## III. CONCLUSION

*24* For the reasons stated above, Public Counsel's arguments concerning the decoupling mechanism and the cost of capital provisions set forth in the Settlement Agreement are without merit and should be rejected. The Settlement Agreement results in rates that are fair, just, and reasonable, and in the public interest, and should be approved.

DATED this 5th day of December, 2006.

ROB McKENNA
Attorney General

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GREGORY J. TRAUTMAN
Assistant Attorney General
Counsel for Washington Utilities and
Transportation Commission Staff