SERVICE DATE

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BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. CASCADE NATURAL GAS CORPORATION Respondent.	DOCKET NO. UG-930511 FOURTH SUPPLEMENTAL ORDER APPROVING SPECIAL CONTRACT

PROCEEDINGS: On May 5, 1993, Cascade Natural Gas Corporation ("Cascade", "respondent" or "company") filed a special contract dated March 25, 1993, with BP Exploration & Oil, Inc. ("BP"), for delivery of natural gas to BP's Ferndale, Washington facility.[1]

HEARINGS: Administrative Law Judge Alice L. Haenle held a prehearing conference at Olympia, Washington, on August 24, 1993. Administrative Law Judge Elmer E. Canfield conducted hearings at Olympia on October 11, 1993, and January 5, 1994.

APPEARANCES: The respondent was represented by John West, attorney, Seattle; Commission Staff by Robert Cedarbaum, assistant attorney general, Olympia; the public by Charles F. Adams and Robert F. Manifold, assistant attorneys general, Public Counsel Section, Seattle; Intervenor BP by Douglas S. Little, attorney, Seattle; and Intervenor Tenaska Washington Partners, L.P. ("Tenaska") by James F. Fell, attorney, Portland, Oregon.

SUMMARY: The Commission approves the Cascade special contract with BP. The Commission will consider prudence and ratemaking matters in a later proceeding. No revenue shift is approved in this case.

I. PROCEDURAL HISTORY

On May 5, 1993, Cascade filed with the Commission a special, 20 year contract with BP for delivery of natural gas to BP's Ferndale, Washington facility. The contract provides for an effective date of "the later of February 1, 1993 or the date regulatory approval is granted . . ." By order dated June 2, 1993, the Commission suspended operation of the special contract and ordered hearings on the matter. The Commission entered an order instituting an investigation on July 15, 1993.

[1]BP sold the refinery to Tosco Northwest Company, who succeeds to BP's interest in the contract, in December 1993. For the sake of clarity, the Commission will use the name of BP throughout this order.

Administrative Law Judges from the Office of Administrative Hearings conducted hearings. All parties then waived an initial order and asked the Commission to enter a final order. The Commission allowed the record to be directly submitted for Commission final order. All parties filed opening briefs on January 27, 1994, and answering briefs on February 17, 1994.

II. BACKGROUND

Cascade Natural Gas Co. ("Cascade") provides natural gas service within Whatcom County. BP operates a large petroleum refinery in Whatcom County near Ferndale, Washington. Cascade currently serves BP under tariff rate Schedule 663. BP is the host facility for a cogeneration plant built by Tenaska at the BP refinery site. BP is to receive the steam output from Tenaska's cogeneration facility. Recognizing that there would be times when steam would not be available, Tenaska promised BP to back up the supply of steam with a portion of Tenaska's firm gas supply.

Tenaska had investigated building a bypass pipeline before negotiating a contract with Cascade for gas transportation. On March 18, 1992 the Commission approved Cascade's special contract with Tenaska in docket UG-911247.

A contract dispute developed between Cascade and Tenaska when Tenaska announced in April 1992 that it intended to provide gas transportation service to BP at the Tenaska contract rate. Cascade said this was never its intent. This caused a stalemate in the underlying negotiations between Tenaska and BP over a Steam Agreement and Lease. Tenaska had the option of canceling its contract with Cascade since it had not yet secured financing for the cogeneration project by June 1, 1992, one of the conditions precedent in the Tenaska contract. In July 1992, Tenaska resurrected its threat to construct a bypass pipeline to serve its needs, as well as the needs of BP. Cascade, believing it would lose both Tenaska and BP, agreed to offer BP a special transportation contract at rates similar to those contained in the Tenaska contract. Cascade and BP finalized this contract and Cascade filed it for Commission approval in May 1993.

Intervenors BP and Tenaska support Cascade's filing, while Staff and Public Counsel urge rejection of the BP contract.

III. SPECIAL CONTRACTS RULE

The Commission's rule on special contracts is set forth in WAC 480-80-335[2]. This rule requires that every such contract be filed for Commission approval not less than thirty days prior to the proposed effective date.

IV. ISSUES PRESENTED

Natural gas companies face a rapidly evolving competitive and regulatory environment. Local distribution companies (LDCs) face increasing competition at both ends of their pipe. The dominant electric generation resource of the near future appears to be natural gas-fired projects, often owned by independent power producers such as Tenaska who are capable of both generating electricity from natural gas and building their own pipelines to get it.

Cogeneration projects may produce steam as a by-product that can be offered to large, established industrial natural gas customers as an energy substitute for gas or other fuels. The dual benefits from such projects make them particularly attractive. Several large industrial customers have bypassed LDCs in this state in those circumstances.

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[2]Subsection (5) of WAC 480-80-335 reads as follows:
(5) Each contract filed for commission approval shall be accompanied by such documentation as may be necessary to show that the contract does not result in discrimination between customers receiving like and contemporaneous service under substantially similar circumstances and provides for the recovery of all costs associated with the provision of the service. In addition, the utility shall file the following information in conjunction with each contract submitted for commission approval:

(a) A statement summarizing the basis of the rate or charge proposed in the contract and an explanation of the derivation of the proposed rate or charge;

(b) An explanation of all cost computations involved in arriving at the derivation of the level of the rate or charge in the contract; and

(c) A statement indicating the basis for the use of a contract rather than a filed tariff for the specific service involved.

Both the banded rates statute (RCW 81.28.075) and the special contracts rule (WAC 480-80-335) were intended to be tools for gas companies to use in responding to these competitive pressures. They are designed to encourage flexible pricing, a necessary step for them to meet competition and retain high volume customers. In the larger sense, a high degree of regulation, such as reflected in strict guidelines, formalized feasibility studies, contested cases, and disclosure of pricing information, may be incompatible with a competitive industry which can require quick decisions and confidentiality of price and cost information.

A consequence of bypass is that core customers may be in very real danger of bearing the burden of large sunk costs for bypassed facilities, or of paying more than an appropriate share of overhead and general costs. A contract which does not pass muster should not be approved. The Commission is presented with facts in this particular case that raise all of these issues.

A. <u>WAS THE JULY 1992 BYPASS THREAT REAL?</u>

The Commission must first consider whether the bypass threat was real. If there was no real bypass threat, the company cannot justify its offer of a special contract to BP.

Commission Staff and Public Counsel argue that Cascade was not faced with a real or credible threat of bypass because cascade understated its estimate of bypass costs for the summer of 1992 by not updating a 1991 feasibility study; and Tenaska would have faced delays and significant reimbursement costs to Cascade if Tenaska cancelled its contract with Cascade and pursued a joint bypass with BP.

Cascade and intervenors maintain that the bypass threat was not only real but imminent in July 1992 as announced by Tenaska at a July 10, 1992 meeting. Cascade believed Tenaska would cancel its contract and construct the bypass pipeline. The parties note that Cascade has already experienced lost business via a joint bypass pipeline constructed to serve a refinery and a smelter at Cherry Point, Washington.

BP did not have an economically feasible independent bypass alternative, but rather had what at the time appeared to be a credible joint bypass alternative with Tenaska. To pursue it, BP would have had to withhold agreement on the Lease and Steam Agreement, which would have further stalled Tenaska's cogeneration financing. That would have forced Tenaska to cancel its contract with Cascade and build joint bypass facilities with BP. BP states that it was not willing to enter into the Steam Agreement until Tenaska made good on its promise to secure reduced natural gas transportation costs for BP.

Cascade argues that, absent the BP contract, the joint ownership bypass line was the only way Tenaska could save the cogeneration project at the BP site.

Tenaska argues that it was still feasible to go ahead with the bypass pipeline in July 1992. Tenaska points out Tenaska's right to cancel its contract with Cascade during this period, notwithstanding a Reimbursement Agreement under which Tenaska agreed to reimburse Cascade for costs incurred in developing the pipeline expansion. Tenaska points out that it could purchase materials from Cascade at cost and could, in turn, use these materials to construct a bypass line. Tenaska reviewed the contracts associated with the cogeneration project and determined that the contracts could accommodate delays brought about by construction of a bypass pipeline.

The Commission accepts Cascade's position that, based on the information available to it at the time, it rationally believed that the threat of bypass was real. The fact that BP could not independently bypass is not controlling--a joint bypass threat can serve the same purpose. The ARCO-INTALCO bypass experience is noteworthy in this regard. The Commission declines the invitation of Staff and Public Counsel to substitute its judgment for the company's. The contract will, like any other special contract, be subject to prudence review in the company's next general rate case.

The company has made a showing that it was faced with a credible bypass threat. Thus, its decision to enter into a special contract is supportable. This threshold having been met, the next question is whether the contract complies with requirements for special contracts.

B. DOES THE BP CONTRACT COMPLY WITH THE SPECIAL CONTRACT RULE AND COMMISSION GUIDELINES?

WAC 480-80-335 requires a showing that a special contract does not result in discrimination between customers receiving like and contemporaneous service under substantially similar circumstances, and that the special contract provides for the recovery of all costs associated with the provision of the service.

The Commission provided guidance for the evaluation of contracts in WUTC v. The Washington Water Power Company, Docket No. UG-901459, Third Supplemental Order (March 1992). Even though the WWP order involved the banded rates statute (RCW 80.28.075), the rationale is applicable to special contracts as well. Both the banded rates statute and the special contracts rule can be regarded as tools available to gas companies to respond to competitive pressures. In the WWP order, the Commission acknowledged that some customers have the ability to bypass the local distribution company and connect directly with an interstate pipeline. Though bypass is to be examined on an individual, case-by-case basis, the issues can arise in a joint bypass situation such as the one presented here. In the WWP order, the Commission recognized that there are circumstances in which retaining a customer with bypass potential is beneficial to the remaining customers of the system if the contract rate provides contribution to the system. The Commission went on to endorse the Bonbright rate design standards for determining whether competitive pricing is justifiable: 1) do embedded costs exceed marginal costs? 2) do other customers get lower rates as a result? 3) is there good evidence that the rate charged will cover long run marginal costs? and 4) does it seriously prejudice the competitive business relationships between the customers with favorable pricing and those without?[3]

In the WWP order, the Commission established a rate floor at the long-term marginal cost of the lowest-cost customer in the class and a ceiling at fully-embedded costs. The Commission ordered WWP to file a long-term marginal cost study in its next rate case and to demonstrate that other customers will get lower rates as a result of retaining the potential bypass customer. The Commission also held that the contract would be subject to a prudence review in the company's next rate case.

1. <u>Type of Costs Included in Cost Recovery Analysis</u>

Commission Staff and Public Counsel advocate the use of an embedded cost analysis for special contracts. Each refers to the language of the rule that the contract provide for the recovery of "all costs associated with the provision of the service." Commission Staff argues that the company should have conducted a customer-specific feasibility study with proper allocation of shared plant and other common costs. Staff argues that Cascade's feasibility analysis on the Tenaska contract/cogeneration plant fails to evaluate the economic viability of service to BP and that it does not include some of the costs associated with service to BP. Public Counsel adds that the contract must not only be sufficient to recover the utility's capital investment and operating expenses, but it also must provide enough margin to give the utility a fair and reasonable return on its investment.

The Company and intervenors, on the other hand, apply a long run marginal cost analysis in evaluating the BP contract. Citing UG-901459, BP argues that costs should be measured by "a long-term marginal cost study based on the stand-alone costs of the facility to serve the customer", with a focus on costs that would not be required but for the contracted service--that costs

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[3]J. Bonbright, <u>Principles of Public Utility Rates</u>, (1st ed. 1961) pp. 383-384.

should be those avoided by Cascade if BP had entered into a joint bypass pipeline in lieu of executing a contract with Cascade. Referencing the shared plant, other common costs, and shared northern and southern loops advocated by Staff, BP argues that these are embedded costs that Cascade could not have avoided had Tenaska and BP proceeded with the joint bypass pipeline: "These costs are simply irrelevant to the incremental cost analysis that is required by the Commission."

The Commission generally agrees with the company that long run incremental costs (LRIC), plus a contribution to the system, must be considered in determining whether a special contract provides for the recovery of "all costs" under the rule.[4] Sometimes, as with the Tenaska and BP contracts, the term of the contract is shorter than the life of the incremental plant. The LRIC for such contracts should include the full incremental cost of plant. This does not imply that for accounting purposes, the plant should be depreciated over a period inconsistent with the anticipated useful life of the plant. But for purposes of evaluating whether or not to enter a contract, the full cost needs to be measured over the contract life.

The allowable contract floor should also include a contribution to margin that is commensurate with the risks associated with the specific special contract. This floor is not to be considered the basis for setting rates, but rather the "bright line" test which a negotiated contract must pass in order to win Commission permission to vary from the tariff.

2. <u>DOES CASCADE'S FEASIBILITY ANALYSIS SUPPORT THE BP CONTRACT?</u>

Cascade did not develop an independent BP feasibility analysis study, but instead relies on an earlier one conducted for the Tenaska project in January 1991. It updated the study in January 1992. The company used a 20-year depreciation schedule in these studies.

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[4]The Commission can foresee that, in some instances, although the LRIC for existing load customers may exceed the potential bypass costs, the "short run" or "term of contract" incremental cost may be less than the bypass cost. In such cases, depending on other terms of the contract such as the obligation to serve, "all costs associated with providing the service," as specified in the rule, may be the incremental costs for the term of the contract (TCIC), rather than LRIC. Using the TCIC in those circumstances can permit recovery of sunk costs, and a contribution, to benefit ratepayers compared with bypass.

In September 1993 at Staff's request, Cascade performed an after-the-fact feasibility analysis which includes the costs associated with providing service to BP and adjusts for the loss of revenues for BP's firm service under Rate schedule 663.

Cascade argues that the information it provided demonstrates that the BP contract rates provide more than enough revenue to recover all costs associated with service to BP, as well as make a contribution to system-wide costs. Cascade points out that a joint bypass would have caused a loss for Cascade of all of the $580,000 margin from BP, as well as the loss of revenue from the Tenaska cogeneration project estimated to earn in excess of Cascade's allowed rate of return for the life of the Tenaska contract. Cascade argues that by entering into the BP contract, it saved its other ratepayers $4.8 million in lost BP revenues over the life of the contract.

Commission Staff and Public Counsel argue that Cascade's feasibility analysis fails to support the BP contract. Staff points out that the company did not perform a customer specific study; that Cascade did not do a study during July 1992, the critical time, but instead relied on the Tenaska project analysis, which was performed earlier when pipeline construction costs were lower. Staff argues that the company's feasibility study contains cost estimates that are understated.

The Commission accepts the company's feasibility analysis as support for the BP special contract, although we share concerns raised by Staff and Public Counsel. A more contemporaneous study could have provided more up to date information in a period of rapid cost increases. The Commission recognizes that the ideal is not always possible under high-pressure negotiations where time may not be available. Though the company's updated January 1992 feasibility analysis may have had some shortcomings, its use was permissible given how recently it had been updated and the timing of the negotiations.

The Commission finds that the company's special contract with BP meets Commission requirements, including cost recovery and rate discrimination considerations of WAC 480-80-335(5). Despite disagreement in the record, the Commission concludes that the BP contract does not result in discrimination between customers. No other company is in the same position as BP. The practicalities of the service are that it is a joint bypass and by reason of its joint nature, BP's and Tenaska's positions are similar and may be treated similarly. No other customer was shown to receive like and contemporaneous service under substantially similar circumstances to those of BP. The contract therefore does not result in discrimination within the meaning of the rule.

C. <u>RATEMAKING CONSIDERATIONS ARE SEPARATE FROM CONTRACT APPROVAL</u>

Approving a special contract does not automatically decide that a revenue gap will be shifted to other customers. WAC 480-80-335(6). As noted in the WWP order, customers without competitive alternatives should not bear sole responsibility for enabling the company to compete. Recovery in rates will be determined in a future rate proceeding.

The special contracts rule specifically provides for separate handling of ratemaking and contract approval matters. Unless otherwise provided, contract approval will not determine expenses and revenues of the utility for ratemaking purposes. WAC 480-80-335(6).

This approach is consistent with the WWP order, which evaluated contracts under the banded rates statute. The Commission there ruled that a contract will be subject to review for the prudence of the company's decisions. At page 25 of the WWP order, the Commission stated:

> The Commission expects companies it regulates to act responsibly in the best interests of all their customers as well as shareholders. It is only after such a showing that the Commission will be able to determine how much of a revenue shift, if any, is appropriate.

Above and beyond its obligations to its shareholders, the Company carries a burden to consider the interests of its ratepayers. In its role as regulator, the Commission strives to ensure that ratepayer interests are protected. This issue may be reviewed in the company's next general rate case. The prudence of the BP contract can then be examined. The Commission expects the company in its next rate case to demonstrate the benefits, if any, of the BP contract for its other customers. The company is expected to drive hard bargains and will not be allowed to force inappropriate costs onto its captive ratepayers. The company will be expected to show an appropriate cost basis for its decision and to show that the contract results in no improper cross subsidization by ratepayers. Only on a complete record will the Commission be able to determine how much of a revenue shift, if any, is appropriate due to the contract.

D. MISCELLANEOUS MATTERS

1. EFFECTIVE DATE OF APPROVED CONTRACT

The parties suggest various effective dates for the BP contract in the event of Commission approval. These dates range from June 30, 1993 to January 1, 1995.

The Commission will not rewrite or amend the contract. The contract provides for an effective date of the later of February 1, 1993 or the date regulatory approval is granted. Accordingly, pursuant to its own terms, the contract will be effective as of the date of this Commission order of approval.

2. STAFF'S PROPOSED RATEMAKING TREATMENT

Commission Staff proposes that if the contract is approved, in subsequent general rate cases, revenues attributable to service to BP's Ferndale facility be based on the rates in the currently applicable tariff for service to BP and on actual volumes transported to BP.

The Commission defers consideration of ratemaking treatment. Prudence and ratemaking considerations will be reviewed during the company's next general rate case. As noted above, the company should be required to demonstrate that the contract does not draw improper contributions from ratepayers. The company should file its case showing revenues at tariff rates; the Commission will consider an adjustment to contract rates if justified by cost information and evidence that the contract rate was the best obtainable.

3. STAFF'S PROPOSAL TO REOPEN THE TENASKA DOCKET

The Commission rejects Commission Staff's proposal to reopen UG-911247, the Tenaska docket. The Commission has already decided UG-911247. Proper grounds for reopening have not been shown.

4. POST-BRIEF LETTERS

After the filing of opening and answering briefs in this matter, several of the parties submitted letters to the Commission in attempts to correct and clarify certain matters in the briefs. A motion to strike the letters was made. The Commission will here allow the parties to amend their briefs. WAC 480-09-425(5). The letters contain some explanation and argument beyond a mere correction, but nothing new or novel. The Commission believes correction is consistent with the public interest. All parties have had ample opportunity to argue their positions. The Commission denies the motion to strike the letters.

5. FUTURE SPECIAL CONTRACT FILINGS

One particularly troublesome aspect of this case was the posturing by Tenaska. The Commission has the responsibility to approve regulated utilities' contracts with independent power producers.[5] Part of driving a hard bargain is to do as much discovery as possible on parties to a contract and the relationship between cogenerators and their steam hosts. Good faith in negotiations of a cogenerator or steam host includes their disclosure of relevant information. Here, Tenaska did not inform Cascade of its total assurances that it would share the benefits of low rates with its steam host. Tenaska characterizes this as a misunderstanding between the parties, but it clearly results from intentional withholding of information. Neither was Tenaska forthcoming with information that it had signed an indemnity agreement with BP.

The Commission views withholding of relevant information with the gravest concern. In future special contract filings, the Commission will consider failure to disclose relevant information during contract negotiations to be grounds for disapproval.

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 May 5, 1993, the respondent filed a special contract with BP Exploration & Oil dated March 25, 1993, for delivery of natural gas to BP's Ferndale, Washington facility.

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

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[5]The Commission does not reach the question of whether it has direct jurisdiction over independent power producers.

5. The respondent entered into a special contract with BP because it faced a BP/Tenaska joint bypass threat.

6. BP and Tenaska are sufficiently similar under the circumstances of this case to warrant similar treatment. BP's circumstances are not substantially similar to those of any other Cascade customer. Therefore, the BP special contract does not result in discrimination between substantially similar customers as required by WAC 480-80-335(5).

7. The BP special contract provides for the recovery of all costs associated with the provision of the service.

8. Approval of a special contract is separate and distinct from prudence and ratemaking considerations. Such matters will be addressed in the respondent's next general rate case. No revenue shift is approved in this case.

CONCLUSIONS OF LAW

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

2. Respondent's special contract filed in Docket No. UG-930511 should be approved with an effective date coinciding with the date of this order.

3. All motions made in the course of these proceedings which are consistent with the above findings and conclusions should be granted, and those inconsistent should be denied.

O R D E R

IT IS ORDERED That:

1. The special contract filed by Cascade Natural Gas Corporation on May 5, 1993, now under suspension in Docket No. UG-930511, is approved.

2. Respondent shall demonstrate in its next general rate case that ratepayers make no improper contributions. Respondent shall file its revenue request based on service at tariff rates, and may ask an adjustment to contract rates.

3. Commission Staff's request to reopen Docket No. UG-911247 is denied.

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

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

DATED at Olympia, Washington, and effective this 29th day of April 1994.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Sharon L. Nelson

SHARON L. NELSON, Chairman

Richard Hemstad

RICHARD HEMSTAD, 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).