

**BEFORE THE WASHINGTON STATE UTILITIES AND TRANSPORTATION
COMMISSION**

Rulemaking to Review Natural Gas
Decoupling

DOCKET NO. UG-050369

WRITTEN COMMENTS OF
CASCADE NATURAL GAS
CORPORATION

**CASCADE NATURAL GAS CORPORATION'S COMMENTS REGARDING
THE RULEMAKING TO REVIEW NATURAL GAS DECOUPLING**

June 10, 2005

Cascade Natural Gas Corporation is providing comments on certain topics contained in the May 16, 2005 **Notice Of Opportunity To File Written Comments**, as follows:

Topic 3. Any general or specific comments on the combined decoupling and weather adjustment mechanism that Northwest Natural Gas briefly summarized at the May 12, 2005, workshop and is currently using in Oregon. In particular, staff is interested in any comments comparing the Northwest Natural mechanism with the Cascade proposal.

Comment: Both Northwest Natural's combined mechanisms and Cascade's mechanism provide relief from the disincentives toward the promotion of conservation by severing the relationship between fixed cost recovery and volumetric sales. Both Northwest Natural's and Cascade's mechanism provides more affordable gas bills during colder than normal weather. Both mechanisms provide improved predictability of revenues. Cascade's mechanism, however, may be simpler and more understandable from the customer's perspective. Cascade's mechanism was designed to increase the customer's engagement in the pursuit of conservation.

Northwest Natural has two mechanisms; a decoupling mechanism to recognize changes in use per customer and a Weather Adjusted Rate Mechanism (WARM) to recognize changes in use that occur due to warmer or colder than normal weather.

Under Northwest Natural's decoupling mechanism, the utility forecasts expected consumption based on weather normalized historical use per customer including the effects of a price elasticity adjustment. New rates to recover its distribution costs are calculated based on this forecasted throughput. During the year, the utility applies a weather normalization calculation to the actual therms consumed and compares the weather normalized consumption to the forecasted consumption and defers any over or

under collection of distribution costs for amortization during the next year. Even though the price elasticity adjustment should minimize the deferral amount, the potential exists for a large balance to amortize the next year.

Cascade's mechanism is designed to recover its distribution costs from a pre-determined set of billing units. Very little estimating and true-ups are necessary under Cascade's proposal. Only those customers with no adequate consumption history to determine their historical low use pattern will need an estimate. Truing up the new customer consumption estimates and recognizing lost recovery opportunities from those customers that cease being customers during the year should create small balances in the deferral account. Cascade's methodology should be simpler to understand.

Northwest Natural's WARM mechanism provides real time rate relief from colder than normal weather events by adjusting the rate per therm prior to issuing invoices to customers. The WARM rate adjustment is based upon variances from normal temperatures. For example, if the latest billing cycle month was colder than normal, the customer's rate per therm is decreased to recognize the increased consumption that would result from such weather. As a result, Northwest Natural does not over recover its fixed cost as a result of the increased sales. Similarly, if the latest billing cycle month was warmer than normal, the customer's rate per therm is increased to recognize the decreased consumption that would result from warmer weather. The increased rate helps Northwest Natural avoid under-recovering its fixed costs. With the WARM mechanism, it becomes necessary to constantly monitor actual weather and compare actual to normal, analyze changes in consumption due to weather, and calculate new rates for each billing cycle for each month throughout the heating season. If this rate adjustment mechanism were applied to 20 billing cycles per month for the 5-month period between November through May, 100 different rates per therm would have to be calculated and applied to customer bills. The customer does not know how much he/she is paying per therm until they receive the invoice.

Cascade's service area is dispersed throughout the state. We have at least four different weather areas. If Cascade were to adopt the WARM model, we would have to monitor all four weather areas and calculate 400 different rates per therm each heating season. Although much of the required calculations would be programmable, the complexities of the rate calculations would likely cause customer and employee confusion.

Cascade's proposed mechanism provides the customer with rate certainty for the distribution portion of the customer's gas bill regardless of weather. Cascade will not over or under collect its fixed cost. Like the WARM mechanism, under Cascade's proposed mechanism, customers receive protection from over-paying for the delivery of their gas supply during colder than normal weather and customers pay slightly more for the delivery component during warmer than normal periods. The difference is, under Cascade's mechanism, the delivery rate is determined before gas is consumed, rather than after the fact.

Topic 4. Any decoupling model that you or your organization believes should be considered as an alternative to the Cascade and Northwest Natural models.

Please explain why you believe such an alternative model would be preferable in general, or with specific reference to the objectives of your organization.

Comment: The simplest alternative model is a deferred accounting decoupling mechanism that recognizes all changes in customer use regardless whether the change is the result of conservation or weather. This model would forecast use per customer, including price elasticity, based on an agreed upon weather scenario. The utility's distribution costs plus the amortization of any past deferred balances are divided by the forecasted throughput to determine the rate per therm for the next year. During the year, actual consumption is compared to forecasted consumption and the margin differences are deferred. The mechanism is fairly simple to implement and understand.

The most significant criticism of this type of mechanism is that it is possible to create large deferral balances during a warmer than normal winter that would have to be recovered from customers during the next year. If the next year happens to be colder than normal, the customers would not only be paying for more actual gas use, but also paying a higher rate due to the amortization of the previous year's large deferral balance.

The potential for building up a large surcharge amortization can be mitigated by adopting a warmer than normal weather scenario in the forecasting model. In this way, the deferral balance is almost always in the customer's favor. It is usually more palatable to the customer to amortize large credits than it is to have a large surcharge.

Regardless of the weather scenario selected for forecasting purposes, customers are going to be paying too much for the delivery of their gas during colder than normal weather under a deferred accounting type decoupling mechanism. Cascade's proposed mechanism does not over-charge the customers during colder than normal weather.

ADDITIONAL COMMENTS

There has been some suggestion that decoupling results in benefits that should be reflected as a reduction in capital costs and must be passed on to ratepayers at the same time a decoupling mechanism is approved. Cascade believes that it is difficult to hypothesize what change in capital cost will occur as a result of implementing our proposal. There are many risk factors considered in determining a company's cost of capital. The mitigation of one risk may or may not have a material affect on a company's cost of capital. RCW 80.28.025 expressly directs the Commission to adopt policies to encourage gas companies to conserve energy through improvement of "...efficiency of energy end use." Any reduction in rates based upon a hypothetical reduction in cost of capital negates the encouragement the Commission's Rulemaking Docket had fostered. However, we believe it is appropriate to discuss cost of capital as a result our proposed mechanism.

COST OF CAPITAL

Cascade's decoupling mechanism proposes to provide customers and investors more predictability. Decoupling is designed to mitigate monthly and quarterly revenue

volatility. During cold winters Cascade would not realize as much revenue as it would without decoupling and conversely, during periods of warm weather Cascade would realize more revenue than it would without decoupling. Customers would not be charged as much during cold winters and would be charged more during warm winters. Additionally, Cascade will continue to recover its fixed cost as customers practice energy efficiencies and install conservation measures. The customer charges would be more consistent year-to-year and more predictable.

One suggestion is that decoupling transfers risk from the Company to the customer. If we look at a comparison of our proposed decoupling and existing regulation, there is evidence that the Company and customers both benefit from reduced risk. Currently, rates are established based on NOAA 30-year average degree-days, (“normal”). Under current rate design, when actual degree-days are above “normal” the utility delivers more natural gas and generates more revenue—the customer pays more. When degree-days are below “normal” the utility delivers less natural gas and generates less revenue and the customer pays less. Over time, in theory, natural gas delivered, converges to the “normal”. Decoupling will mitigate the year-to-year volatility due to weather. The utility and the customer appreciate less volatility. The customer’s risk of over paying for the delivery of their gas during colder than normal weather or for other increases in use is eliminated and the Company’s risk of under recovery of fixed cost during warmer than normal weather or as a result of conservation is also eliminated.

Risk Mitigation

A question arises as to what effect decoupling might have on Cascade’s, or any company’s, cost of capital? Is there risk mitigation and if so how does a shift in risk affect cost of capital?

To examine this question we have looked at how the weighted cost of capital (WCC) is calculated. There are a few different approaches to WCC all with varying levels of support by various groups. Cascade is not presenting this information as a basis for discussion of an acceptable WCC but rather to establish a basis for determining risks in different situations.

Let’s first look at a WCC based on the Capital Asset Pricing Model (CapM) with an assumed 35% debt to total market capital and a Cascade beta of .85, as reported by A.G. Edwards in its April 2005 Quarterly Review. Cascade’s .85 beta compares to a .76 average beta for the A.G. Edwards distribution group, see Figure 1 attached. Beta measures the volatility of stock prices compared to the broad market with a measure of 1 equal to the market. Cascade’s .85 indicates greater volatility than other gas utilities but less than the general equity market. Investors may perceive Cascade stock as one with somewhat less risk as a utility but more risk than other natural gas utilities. A WCC for a hypothetical company with a .76 beta and a 35% debt to market capital would be lower than Cascade’s as follows:

Method	Debt/Cap	Beta	WCC
CapM	35%	0.85	9.6%
CapM	36%	0.76	9.1%

The comparison produces a Cascade WCC 9.6% compared to 9.1% for the hypothetical company—see Exhibits A and B.

Company Risks in General

We have examined a measure of risk in the form of beta and there is an apparent higher risk perception for Cascade compared to other natural gas companies. To further evaluate risk we considered information provided by Moody's. An ROE study performed by Moody's in 2004, published in July 2004, highlights certain factors they identified that classify 32 local distribution companies as those that realized (R) their allowed return on equity (ROE) and those that did not realize (NR) their allowed return. While we are not considering an appropriate allowed ROE, it is informative to consider the factors examined by Moody's. Their study draws the following conclusions:

- A higher proportion of R companies were “A” rated
- They tend to focus in one-state jurisdictions
- They operate more often in urban areas compared with the NR companies
- R companies tend to be larger and deliver greater volumes of natural gas
- The R companies experience slower or steady growth
- R companies concentrate on maintaining their operating systems rather than on expanding them into new service territories
- R companies are better positioned to control the rising operating costs of employee pension and medical benefits through workforce reduction programs
- R companies with their larger size and scope of operations tend to avail themselves with greater critical mass especially when combined with urban concentration resulting in better economies of scale
- R companies tend to have weather normalization clauses and the absence of goodwill from acquisitions. They also have widespread use of automation and central shared services
- Moody's also states “a progressive and supportive regulatory environment would certainly help companies achieve their earnings goals... Given the pervasive ‘regulatory lag’ that permeates the industry, jurisdictions that permit the use of future test periods for cost recovery, especially capital cost recovery, would go a long way toward helping these companies attain their allowed rates of return and help stabilize their credit metrics.”

This list of factors is indicative of factors necessary for successful operation of a natural gas distribution company. None of the factors by themselves necessarily

determines the risk profile of a gas distribution company. It is all of the factors combined with judgment that determines a company's credit rating. It also should be clear with many different regulatory jurisdictions, over the long-term, maximizing returns to shareholders is not incompatible with providing customers good service and a fair price.

Implementation Risk

Cascade is pursuing an approach to charge customers a rate that mitigates the effect of conservation and weather in the charges to residential and commercial customers--decoupling. At this point the mechanism is being finalized and only after approval by the WUTC will the mechanism go into affect. There may be differences from Cascade's proposal to the final, approved mechanism. Once the mechanism is approved Cascade must implement it effectively and properly monitor the mechanism for 175,000 customers. It may take some time before the Company has a perfectly working system for billing under the new approach. Cascade bears all the risk of successfully implementing and administering the new rate mechanism.

Conclusions

Cascade Natural Gas Corporation is of the opinion that risk change is very broad and complex. Cascade is presenting to the WUTC an approach to mitigate the effects of weather and conservation on the Company and its customers. We view this mitigation as being in the best interest of our utility customers and provided the best opportunity to promote the conservation of a valuable resource for the good of society. We consider it important to not be penalized for pursuing a new approach that provides such wide spread benefits.

As stated above, there are many factors that determine the overall risk of a company. There are several factors that should provide Cascade a higher allowed ROE but these factors have never explicitly been included by the WUTC in considering Cascade's WCC. It is not appropriate that the WUTC single out an approach to reduce volatility due to weather and conservation and suggest an adjustment to ROE or WCC because of this single factor when there are at least seven other risk factors identified by Moody's that put Cascade in a higher risk status. Additionally, the implementation of a new rate design may create significant regulatory, implementation, and administrative risk for Cascade.

Cascade rejects the argument that there should be any adjustment to WCC resulting from implementation of a decoupling mechanism for the following reasons:

- It is contrary to the idea of encouraging and developing mechanisms that promote conservation
- It is one risk among many a natural gas distribution company faces in its efforts to properly serve its customer base
- There is no sound method of determining the effect of a change in a single risk

- Cascade has significant system implementation and administration risks connected to decoupling

The marketplace may eventually overlook the other risk factors and reward Cascade with lower capital costs due to the implementation of our proposed decoupling mechanism. But such lower capital costs are not a certainty and we do not believe it would be appropriate to adjust ROE or WCC until such lower costs are realized, if they are.

FIGURE 1 Master List Gas Utilities

Sym	Exch/ FY	Investor Suitability	Price 3/31/05	Price Obj.	52 Week Price Range		Market Capital	Average	Institu-	Beta
					High	Low		Daily Volume	tional Holdings	
			\$	\$	\$	\$	\$ (million)	1000	%	
BUYS										
ENERGEN	EGN	N/12	Aggressive	66.60	74.00	68 - 40	2,393	216	68	0.74
MDU RESOURCES	MDU	N/12	Aggressive	27.62	29.00	29 - 22	3,265	308	38	0.69
NATIONAL FUEL GAS	NFG	N/09	Conservative	28.59	31.00	30 - 24	2,379	320	46	0.62
NW NATURAL	NWN	N/12	Conservative	36.17	37.00	37 - 27	996	88	47	0.66
ONEOK INC	OKE	N/12	Aggressive	30.82	31.00	31 - 20	3,209	596	81	0.77
SEMPRA ENERGY	SRE	N/12	Aggressive	39.84	44.00	43 - 31	9,330	1,201	60	0.70
HOLDS										
AGL RESOURCES, INC.	ATG	N/12	Conservative	34.93		36 - 27	2,679	275	64	0.76
ATMOS ENERGY	ATO	N/09	Conservative	27.00		29 - 23	2,140	376	54	0.71
CASCADE NATURAL GAS	CGC	N/09	Conservative	19.96		23 - 19	225	29	41	0.85
EQUITABLE RESOURCES	EQT	N/12	Conservative	57.44		61 - 44	3,506	337	75	0.59
KEYSPAN ENERGY	KSE	N/12	Aggressive	38.97		42 - 34	6,267	573	52	0.65
LACLEDE GROUP	LG	N/09	Conservative	29.20		33 - 26	614	59	31	0.75
NEW JERSEY RES.	NJR	N/09	Conservative	43.53		46 - 37	1,206	120	50	0.69
NICOR INC	GAS	N/12	Speculative	37.09		40 - 32	1,636	290	65	0.76
NISOURCE INC	NI	N/12	Aggressive	22.79		23 - 20	6,168	1,092	75	0.65
PEOPLES ENERGY	PGL	N/09	Aggressive	41.92		45 - 39	1,587	210	57	0.67
PIEDMONT NAT. GAS	PNY	N/10	Conservative	23.04		24 - 19	1,768	249	40	0.68
QUESTAR	STR	N/12	Aggressive	59.25		63 - 34	5,003	565	68	0.67
SEMCO ENERGY INC.	SEN	N/12	Speculative	5.75		6 - 5	163	117	39	0.89
SOUTH JERSEY IND.	SJI	N/12	Conservative	56.40		58 - 40	783	30	48	0.56
SOUTHERN UNION	SUG	N/12	Aggressive	25.11		27 - 18	2,652	574	56	0.89
SOUTHWEST GAS	SWX	N/12	Aggressive	24.16		26 - 22	868	103	64	0.76
VECTREN CORP.	VVC	N/12	Conservative	26.64		28 - 23	2,022	177	40	0.75
WGL HOLDINGS	WGL	N/09	Conservative	30.96		32 - 27	1,507	202	52	0.72
WILLIAMS COMPANIES	WMB	N/12	Speculative	18.81		19 - 10	10,496	3,726	68	1.42
SELLS										
EL PASO CORP.	EP	N/12	Speculative	10.58		13 - 7	6,806	5,438	80	1.12
Industry Average							3,064	664	56	0.76

Sources: A.G. Edwards estimates, Baseline and ILX.

EXHIBIT A

CASCADE NATURAL GAS CORPORATION
WACC

Description	Rate	
Cascade Equity Beta	0.85	Based on A.G. Edwards Gas Utilities Quarterly Review April 2005
x Market Risk Premium	7.0%	Average 30 yr US treasury bond 1993-2003
Equity Risk Premium	6.0%	
+ Risk Free Rate	6.1%	
Cost of Equity	12.1%	Target Book Equity to Capital Ratio: 50%. Adjusted with 1.9 Market to Book Ratio. See below for M/B ratio calculation.
x Target Equity/Capital	65%	
Weighted Cost of Equity	7.9%	
Baa Borrowing Rate	7.8%	Average CGC outstanding debt 7.3% plus 0.5% administrative cost.
x (1-Tax Rate)	63.5%	
After Tax Cost of Borrowing	4.95%	
x Target Debt/Capital	35%	
Weighted Cost of Debt	1.7%	
Weighted Average Cost of Capital	9.6%	

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Book Value per Share	11.01	10.34	10.11	10.52	11.44
Market Value per Share	21.6	19.7	19.6	21.23	19.5
Market to Book Ratio	2.0	1.9	1.9	2.0	1.7
Average M/B Ratio	1.9				

Debt to Capital Book Ratio	Debt to Capital Mkt. Ratio	WACC
45%	30%	9.9%
50%	34%	9.6%
55%	39%	9.3%
60%	44%	8.9%

EXHIBIT B

HYPOTHETICAL COMPANY

WACC

Description	Rate	
Group Equity Beta	0.76	Based on A.G. Edwards Gas Utilities Quarterly Review April 2005
x Market Risk Premium	7.0%	
Equity Risk Premium	5.3%	Average 30 yr US treasury bond 1993-2003
+ Risk Free Rate	6.1%	
Cost of Equity	11.4%	Industry average book equity is 43% and market to book ratio is 1.94. The market debt ratio is deducted from 1 to arrive at the equity ratio.
x Target Equity/Capital	64%	
Weighted Cost of Equity	7.3%	
Baa Borrowing Rate	7.8%	Lacking an industry debt cost, the CGC cost was used.
x (1-Tax Rate)	63.5%	
After Tax Cost of Borrowing	4.95%	Based on a 52% book to total capital for the A.G. Edwards group.
x Target Debt/Capital	36%	
Weighted Cost of Debt	1.8%	
Weighted Average Cost of Capital	9.1%	