ITEM NO. 1

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: August 8, 2006

REGULAR X **CONSENT** ____ **EFFECTIVE DATE** N/A

DATE: July 26, 2006

TO: Public Utility Commission

FROM: Judy Johnson JJ

THROUGH: Lee Sparling and Ed Busch

SUBJECT: OREGON PUBLIC UTILITY COMMISSION STAFF: Request to open an investigation into the earnings of Cascade Natural Gas.

STAFF RECOMMENDATION:

Staff requests the Commission to: (1) summarily investigate the rates of Cascade Natural Gas (Cascade or CNG) under ORS 756.515; (2) conclude the information contained in staff's public meeting memo provides sufficient grounds to warrant a hearing be held on the reasonableness of the rates; and (3) order that a statement be issued to Cascade notifying it of the hearing and that a notice setting a pre-hearing conference be issued as well.

DISCUSSION:

On April 19, 2006, in Order No. 06-191, the Commission approved a Stipulation between Cascade, Commission staff, Citizens' Utility Board, NW Energy Coalition, Natural Resources Defense Council, Community Action Directors of Oregon, Oregon Energy Coordinators Association, and Northwest Industrial Gas Users. This Stipulation included a decoupling mechanism consisting of two deferral accounts, one to track changes in margin due to variations in weather-normalized usage and another to track changes in margin due to weather that varies from normal. As part of the Stipulation, CNG agreed that if requested by the Commission no later than December 31, 2007, Cascade would agree to submit a general rate filing to Oregon no later than April 1, 2008. The Stipulation did not contain any provision whereby staff was precluded from reviewing and challenging the reasonableness of CNG's rates during the term of the agreement.

After reviewing Cascade's Rate of Return (ROR) and Return on Equity (ROE) for previous years, staff concludes that Cascade should be brought in for a general rate case. Staff finds that Cascade has had excessive earnings for the past several years and that with the company's latest regulatory–adjusted ROR and ROE, these over earnings will continue on a forward-looking basis absent a rate reduction. Below are listed the RORs and ROEs for the last 10 years based on Cascade's Results of Operations, which are filed annually by the company. These figures reflect typical regulatory adjustments to actual operating income and rate base (such as normalizing for weather). The 2005 results also include several additional adjustments, identified by staff's recent audit of CNG's books, which are necessary to provide an accurate assessment of Cascade's current earnings situation.

Year	ROR	ROE
2005	10.46%	13.64%
2004	10.11%	12.12%
2003	9.98%	11.88%
2002	10.19%	12.27%
2001	7.10%	5.56%
2000	13.20%	17.77%
1999	12.17%	15.96%
1998	9.92%	12.04%
1997	9.88%	11.40%
1996	11.15%	14.24%

Staff believes that the historically high RORs and ROEs, coupled with Cascade's 2005 results of operations, are sufficient to warrant the Commission holding a hearing regarding the reasonableness of Cascade's rates. Based on our preliminary review, staff further believes that customers' rates could be lowered by as much as $2.309 million, which is 3.3% overall. This assumes an authorized return on equity of 9.25%. To illustrate the sensitivity of staff's recommended rate decrease to the recommended return on equity, staff also ran the revenue requirement model assuming a 9.75% return on equity. This resulted in a decrease in revenue requirement of $2.048 million, which is 2.9% overall. The results of the sensitivity analysis demonstrates that when assuming a 50 basis point premium to staff's recommended cost of equity, the recommended rate reduction is reduced 0.4%.

PROPOSED COMMISSION MOTION:

The Commission: (1) summarily investigate the rates of Cascade under ORS 756.515; (2) conclude that the information contained in staff's public meeting memo provides sufficient grounds to warrant a hearing be held on the reasonableness of the rates; and

(3) order that a statement be issued to Cascade notifying it of the hearing and that a notice setting a pre-hearing conference be issued as well.

Cascade Show Cause

CASCADE NATURAL GAS CORPORATION®
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August 4, 2006

Oregon Public Utility Commission
550 Capitol Street NE
Salem, OR 97310-1380

Re: August 8, 2006 Public Meeting, Utility Agenda Item 1

SUBJECT: OREGON PUBLIC UTILITY COMMISSION STAFF: Request to open an investigation into the earnings of Cascade Natural Gas.

CASCADE'S RECOMMENDATION:

Cascade Natural Gas Corporation ("Cascade" or "the Company") disagrees with Staff's portrayal of Cascade's earnings situation and, for this and other reasons discussed below, requests that the Commission reject Staff's recommendations.

Cascade is operating its business in a cost effective manner, in response to the incentives established by the Commission in several previous orders. These Orders encouraged the Company to operate efficiently and control costs, and thereby produce improved earnings that would be shared with customers. This is precisely what the Company has done, and customers have benefited – and will continue to benefit – from the incentives provided by the Commission and the Company's response to them. The Staff recommendation would strip away the incentives provided by the Earnings Sharing Mechanism, and would unfairly penalize the Company for the outstanding results it has been able to achieve in response to those incentives.

Staff's recommendation should be rejected for the following additional reasons:

- Adopting the Staff recommendation would undermine a recent settlement reached in Docket UG 167, and thereby discourage settlements in Commission proceedings.

- Adopting the Staff recommendation would be administratively inefficient, inasmuch as the Company already agreed in the UG 167 Stipulation that it would be willing, at the request of the Commission, to file a case within the next 18 months and accept the burden of proof in that filing.

- Staff's recommendation is based upon an audit report that includes several disputed adjustments made by Staff in reaching its findings regarding 2005 earnings levels. If the Company's results are calculated fairly, there are no excessive earnings that would justify the extraordinary action of commencing a rate proceeding.

For these reasons, discussed in further detail below, the Company urges the Commission to reject Staff's recommendations.

DISCUSSION

The Incentive Provided by the Earnings Sharing Mechanism and the Company's Response

Cascade is operating under an Earnings Sharing Mechanism as authorized by the Commission in Docket UM 903 under Order Nos. 98-543 and 99-272. Order No. 98-543 approved a settlement document among Staff, Avista and Cascade to establish the Earnings Sharing Mechanism within the PGA mechanism. Order No. 99-272 established the Earnings Sharing Mechanism within the PGA mechanism for NW Natural, based upon the record rather than upon a settlement; the Earnings Sharing threshold for NW Natural was within 5 basis points of the Earnings Sharing thresholds for Cascade and Avista as reflected in the earlier stipulated settlement.

The intent of the Earnings Sharing Mechanisms was to encourage the utilities to pursue operational efficiencies and new business opportunities that might increase earnings. If the utilities were successful in achieving such earnings, the utilities were required to share earnings beyond the threshold with their customers. The Earnings Sharing Mechanism was designed to further encourage the utilities to pursue earnings growth opportunities by creating a generous "dead band" or "no-action band" before any sharing would begin. As articulated in Order No. 99-272 in Docket UM 903, this no-action band was 300 basis points. Order No. 99-272 encouraged the utilities to achieve earnings within the dead band and beyond with the following assurance:

> An earnings threshold set at 300 basis points above the benchmark ROE will protect the interest of ratepayers and allow the company the opportunity to pursue increased earnings through cost management and operating efficiencies. (Order No. 99-272 at page 8.)

Thus, under the approach established by the Commission, the interest of ratepayers are deemed protected even when the utility's earnings are within the dead band. If the utility's earnings exceed the 300 basis points above the benchmark ROE, ratepayers have the increased benefit of sharing 1/3 of earnings beyond the threshold.

In Cascade's view, a sharing mechanism that allows the utility to retain 2/3 of the earnings in excess of the threshold represents Commission encouragement to pursue unbounded earnings growth opportunities. Cascade responded to this clear regulatory incentive by doing so. Cascade had the distinction of being the only utility to actually share earnings with our customers, for which we were justifiably proud. It is disappointing that Staff now takes the position that the Company's performance in response to the incentives provided by the Earnings Sharing Mechanism should be used as the basis for requesting a show cause investigation.

This response by Staff is particularly peculiar given that Staff previously had adequate opportunity to abort Cascade's cost-savings initiatives but elected instead to further encourage the Company's fiscal strategy. The Earnings Sharing Mechanism was initially granted only for a four-year trial. Cascade succeeded in having earnings to share in two of those four years. Rather than using these earnings achievements as the basis for terminating the Earnings Sharing Mechanism, Staff instead supported a three-year extension of the Earnings Sharing Mechanism. On February 19, 2004, Staff filed a motion, with the support of the Citizens' Utility Board ("CUB"), the Northwest Industrial Gas Users ("NWIGU"), other consumer groups and the utilities, to modify the sharing threshold calculation and extend the effectiveness of Earning Sharing Mechanisms contained Order Nos. 98-543 and 99-272 through 2006. The Commission approved that motion and entered Order No. 04-203 on April 6, 2004. If Staff was concerned about the Cascade's earnings successes – or if the Commission determined that the Mechanism was not operating in the manner intended – these concerns could have been expressed in 2004, when the Earnings Sharing Mechanism could have been terminated. But no concerns were voiced and Cascade acted upon the assumption that the Commission and its Staff were encouraging Cascade and the other utilities to continue to pursue earnings growth opportunities.

As recently as July 25, 2006, Staff indicated a willingness to further extend the Earnings Sharing Mechanism. In an email sent to Cascade and the other participants in Docket UM 903, Staff suggested another two-year extension.

Cascade's fiscal strategy has paid ample dividends to its Oregon customers. Cascade has the lowest natural gas rates in Oregon. An average winter bill for residential customers using 100 therms, for example, is $20.34 below Northwest Natural and $24.87 below Avista. Cascade has not filed for a general rate increase for sixteen years. In 1998, Cascade voluntarily reduced its rates by over $800,000 per year. In the Company's recently approved Conservation Alliance Plan decoupling mechanism in Docket UG 167, Cascade further reduced earnings by providing over $500,000 of current revenues as Public Purpose Funds for the pursuit of conservation and low-income bill payment and weatherization assistance. In the stipulation adopted in Docket UG 167, the Company agreed to continue the Earnings Sharing Mechanism during the life of the Conservation Alliance Plan. More important, the Company also agreed to reduce the earnings sharing threshold by 125 basis points so that the Company will begin sharing earnings growth successes with its customers much sooner.

Moreover, the Company has been able to achieve these cost savings while still providing excellent customer service. It is our understanding that we have the best Company-at-fault complaint ratio in Oregon. The Company's customer satisfaction ratio remains high. To reinforce our commitment to excellent customer service, Cascade agreed to adopt Service Quality Measures (SQM) in the Docket UG 167 Stipulation.

The Commission's actions in establishing – and continuing – the Earnings Sharing Mechanism demonstrate encouragement for the Company to continue to pursue earnings growth. A threat of a show cause investigation is contrary to the underlying premise of the Earnings Sharing Mechanism, and would strip the Mechanism of the incentives that have proven to be so effective.

Undermining the Docket UG 167 Stipulation

In Docket UG 167, the Commission in April 2006 approved a Stipulation among Cascade, Staff, NWIGU, CUB, NW Energy Coalition and CADO/OECA pursuant to which Cascade implemented its Conservation Alliance Plan in Oregon. In that Stipulation, the Company reluctantly agreed that it would file a general rate case following one full fiscal year of experience under the Conservation Alliance Plan. Paragraph 9 of the Stipulation states:

> If requested by the Commission no later than December 31, 2007, Cascade agrees to submit a general rate filing in Oregon ("2008 Rate Case") not later than April 1, 2008. Cascade shall bear the burden of proof in such filing, in accordance with ORS 757.210. The historic test period for purposes of such filing shall be fiscal year 2007 (the twelve months ended September 30, 2007), or such other period as may be agreed upon by the Parties.

Although the actual language of the Stipulation did not foreclose Staff's right to review and challenge the reasonableness of Cascade's rates prior to 2008, it is fairly obvious that the intent of the provision was to have a full fiscal year of experience with decoupling before a general rate case would be required. That was the purpose of defining the historic test period as the twelve months ended September 30, 2007.

The issue of the timing of an Oregon rate case was discussed extensively in the Docket UG 167 proceeding. One of Cascade's operational efficiencies has been to maintain a minimal regulatory staff. Cascade's Regulatory Department is headed by Senior Vice President Jon Stoltz, who also is responsible for Gas Supply. Mr. Stoltz has Kathie Barnard as department head and one rate analyst and one shared department coordinator. The workload of two rate cases at the same time (the Company is currently processing a Washington rate case, to be completed in January 2007) would be overwhelming, as the Company has consistently maintained. In the Company's view, the parties recognized the impracticality of such a workload in settlement discussions and in establishing the rate case language in the UG 167 Stipulation. There is little doubt that if the Commission grants Staff's request to launch an investigation of the Company's rates, the workload on Cascade's limited regulatory staff will significantly increase (even though Staff would have the burden of proof in such an investigation). It is likely the Company will either be required to use significant outside consultants or hire additional staff, both of which would have a negative impact on our customers.

In addition to being contrary to the spirit of the UG 167 Stipulation, adopting Staff's recommendation would seem to be an unwise use of the Commission's and the parties' limited resources. The UG 167 Stipulation already provides for the Company filing a rate case within the next eighteen months, and to bear the burden in such a proceeding. Moreover, the UG 167 Stipulation provides for a 125-basis point reduction in the ROE threshold under the Earnings Sharing Mechanism. As a result, customers will begin to share in the Company's earnings at a lower level. This recalibrated Earnings Sharing Mechanism will remain in place, and provides an effective response going forward to the "excessive" earnings issue raised by Staff.

The Flawed Analysis in the Staff Audit Report

The Staff memorandum indicates that Cascade's earned ROE for 2005 was 13.64%. This finding is apparently based upon the audit completed by Staff on May 22, 2006;[1] according to Staff's July 26, 2006 Open Meeting Memorandum, this audit included "several additional adjustments . . . which are necessary to provide an accurate assessment of Cascade's current earnings situation." *Staff Public Meeting Memorandum at 2.* The Company does not agree that these adjustments produce an "accurate assessment" of the Company's current earnings situation. Moreover, the ROE levels that Staff uses in its Memorandum as the point of reference for gauging the reasonableness of Cascade's rates are not representative of current capital costs. The 9.25% and 9.75% ROE figures used by Staff, while representative of some of the extreme positions taken by parties in litigated cases before the Commission, do not reflect the ROEs actually *adopted* by the Commission in recent cases, which are 10.0% or greater, and likely to go higher as interest rates continue to increase.

As an example of the inappropriateness of a "necessary" adjustment adopted by Staff in its 2006 Audit Report, the Company has been able to achieve its exemplary record of cost savings by pursuing initiatives such as the Call Center consolidation and the September 2005 reorganization. Yet Staff's proposed ratemaking adjustments would disallow the costs incurred by the Company to achieve the savings associated with these initiatives, which will continue well into the future. Similarly, Staff proposes to disallow certain Director stock awards *(2006 Audit Report at 46)* without examining the reasonableness of the Company's overall Director compensation, which is extremely low by industry standards. Moreover, Staff's ratemaking adjustments are one-sided, and do not include the other normalization/ pro forma adjustments that would be included in a ratemaking setting and that would more than offset the identified adjustments. For example, Staff's proposed adjustments to remove the Call Center

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[1] Audit Number 2006-001. Page 5 of the Staff Audit Report states that "[a]fter proposed adjustments to Cascade' fiscal year 2005 expenses, Cascade exceeded its authorized return on equity (ROE) and authorized rate of return (ROR)." According to the Report, Staff's adjusted ROE and ROR were 13.63% and 10.46% respectively.

Consolidation costs and September 2005 Reorganization expense are more than offset by the $500,000 in public purpose funding.

Additionally, while the 2006 Audit Reports states that the Company has been experiencing increases in both insurance and property taxes in the double digits over the past several years, this expense increase was not taken into account when discussing the Company's earnings situation even though both of these adjustments would be included with a general rate application along with several other known and measurable adjustments (*e.g.*, postage rate changes and pro forma wage adjustments). The earnings picture would look quite different if prepared on a basis that truly reflected likely rate case scenarios, and that took into account the impact of the public purpose funding to be provided by the Company. For the above reasons, the 2006 Audit Report's analysis of the Company's earnings performed by Staff should be accorded little, if any, weight, as its does not result in an "accurate assessment" of the Company's current earnings situation. More attention should be focused on the Company's exemplary performance in cutting costs and the benefits provided to the Company's Oregon customers from those efforts.

In this regard, it is clear from other comments in the May 2006 Audit Report that the Company has acted on the incentives provided by the Earnings Sharing Mechanism to aggressively pursue cost reductions. The 2006 Audit Report states that:

- Cascade's rates are significantly lower than those for the other two natural gas companies operating in Oregon (15 percent lower than for NW Natural and 18 percent lower than Avista). *2006 Audit Report at 34.*
- "For non-gas expenses, Cascade continues to throttle down on operating expenses, which are aligned to recent Cascade initiatives to reduce costs." *2006 Audit Report at 18.*
- "Cascade's aggressive cost-cutting has benefited both the Company and customers." *2006 Audit Report at 35.*
- "[A]lthough Cascade has used certain initiatives to reduce costs, these reductions have not affected customer service." *2006 Audit Report at 48.* In fact, the Audit Report states that Cascade has *increased* labor for maintenance and pipeline safety management.

These findings are similar to the findings made by Staff in its previous operational audit of Cascade, which occurred just one year earlier.[2] Given these acknowledged accomplishments,

[2] In the Staff Audit Report issued April 4, 2005 in Audit Number 2005-001, Staff noted that "Cascade's recordkeeping was excellent, and as a result, Staff did not discover any major concerns with Cascade's financial and operational performance." *2005 Staff Audit Report at 49.* Although that report noted one planning issue and six suggestions for further investigation during a future rate case, "[t]hese findings were fairly minor in scope and did not include any significant monetary impact on Cascade's operations." *Id. at 5.*

Cascade should not be punished for achieving reasonable earnings results. Yet this would be the effect of adopting Staff's recommendation to commence an investigation.

Conclusion

For the above reasons, the Commission should reject Staff's recommendation to commence an investigation.

The Company appreciates the opportunity to comment on this Agenda item. We will be present at the August 8 public meeting, and we look forward to addressing these issues with the Commissioners directly.

Sincerely,

Jon T. Stoltz
Sr. Vice President
Regulatory & Gas Supply