

CASCADE NATURAL GAS CORP  
Form 10-Q  
May 09, 2006

## FORM 10-Q

# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

### QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2006

Commission file number: 1-7196

## CASCADE NATURAL GAS CORPORATION

(Exact name of Registrant as specified in its charter)

**Washington**

(State or other jurisdiction of  
incorporation or organization)

**91-0599090**

(I.R.S. Employer  
Identification No.)

**222 Fairview Avenue North, Seattle, WA**

(Address of principal executive offices)

**98109**

(Zip code)

(Registrant's telephone number including area code) **(206) 624-3900**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

| <b>Title</b>                          | <b>Outstanding</b>              |
|---------------------------------------|---------------------------------|
| Common Stock, Par Value \$1 per Share | 11,481,486 as of April 28, 2006 |

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CASCADE NATURAL GAS CORPORATION

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**PART I. Financial Information****Item 1. Financial Statements**

**CASCADE NATURAL GAS CORPORATION**  
**CONSOLIDATED CONDENSED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**  
(unaudited)

|   | THREE MONTHS ENDED |              | SIX MONTHS ENDED |              |
|---|--------------------|--------------|------------------|--------------|
|   | Mar 31, 2006       | Mar 31, 2005 | Mar 31, 2006     | Mar 31, 2005 |
| (thousands except per-share data)                     |                    |              |                  |              |
| Operating revenues                                    | \$ 162,796         | \$ 117,711   | \$ 321,428       | \$ 222,324   |
| Less: Gas purchases                                   | 118,010            | 78,331       | 236,075          | 147,452      |
| Revenue taxes   | 11,555             | 8,538        | 21,331           | 15,108       |
| Operating margin                                      | 33,231             | 30,842       | 64,022           | 59,764       |
| Cost of operations:                                   |                    |              |                  |              |
| Operating expenses                                    | 10,755             | 11,021       | 20,398           | 21,441       |
| Depreciation and amortization                         | 4,435              | 4,280        | 8,849            | 8,485        |
| Property and miscellaneous taxes                      | 870                | 944          | 1,856            | 1,903        |
|   | 16,060             | 16,245       | 31,103           | 31,829       |
| Income from operations                                | 17,171             | 14,597       | 32,919           | 27,935       |
| Less interest and other deductions - net              | 2,884              | 2,976        | 5,855            | 5,870        |
| Income before income taxes                            | 14,287             | 11,621       | 27,064           | 22,065       |
| Income taxes  | 5,301              | 4,269        | 10,038           | 8,081        |
| Net Income  | 8,986              | 7,352        | 17,026           | 13,984       |
| Other Comprehensive Income (Loss)                     |                    |              |                  |              |
| Unrealized losses on derivative commodity instruments | (890)              |              | (985)            |              |
| Income tax benefit                                    | 319                |              | 353              |              |
| Other Comprehensive Income (Loss)                     | (571)              |              | (632)            |              |
| Comprehensive Income                                  | \$ 8,415           | \$ 7,352     | \$ 16,394        | \$ 13,984    |
| Weighted average common shares outstanding            | 11,455             | 11,312       | 11,441           | 11,296       |
| Earnings per common share, basic and diluted          | \$ 0.78            | \$ 0.65      | \$ 1.49          | \$ 1.24      |
| Cash dividends per share                              | \$ 0.24            | \$ 0.24      | \$ 0.48          | \$ 0.48      |

The accompanying notes are an integral part of these financial statements.



**CASCADE NATURAL GAS CORPORATION**  
**CONSOLIDATED CONDENSED BALANCE SHEETS**  
(Unaudited)

|   | Mar 31, 2006           | Sep 30, 2005 |
|---|------------------------|--------------|
|   | (dollars in thousands) |              |
| <b>ASSETS</b>   |                        |              |
| Utility Plant, net of accumulated depreciation of \$265,393 and \$257,008   | \$ 340,712             | \$ 340,461   |
| Construction work in progress   | 1,078                  | 2,021        |
|   | 341,790                | 342,482      |
| Other Assets:   |                        |              |
| Investments in non-utility property   | 202                    | 202          |
| Notes receivable, less current maturities   | 3                      | 46           |
|   | 205                    | 248          |
| Current Assets:   |                        |              |
| Cash and cash equivalents   | 6,678                  | 1,128        |
| Accounts receivable and current maturities of notes receivable, less allowance of \$1,347 and \$1,319 for doubtful accounts | 75,714                 | 23,163       |
| Prepaid expenses and other assets   | 7,152                  | 9,463        |
| Derivative instrument assets - energy commodity   | 16,663                 | 91,957       |
| Materials, supplies and inventories   | 6,289                  | 14,142       |
| Deferred income taxes   | 2,233                  | 2,292        |
|   | 114,729                | 142,145      |
| Deferred Charges and Other  |                        |              |
| Gas cost changes  | 6,461                  | 16,630       |
| Derivative instrument assets - energy commodity   | 13,841                 | 43,440       |
| Other   | 8,335                  | 7,960        |
|   | 28,637                 | 68,030       |
|   | \$ 485,361             | \$ 552,905   |

**CASCADE NATURAL GAS CORPORATION**  
**CONSOLIDATED CONDENSED BALANCE SHEETS (Continued)**  
(Unaudited)

|  | Mar 31, 2006           | Sep 30, 2005 |
|--|------------------------|--------------|
|  | (dollars in thousands) |              |
| <b>COMMON SHAREHOLDERS EQUITY AND LIABILITIES</b>  |                        |              |
| Common Shareholders Equity:  |                        |              |
| Common stock, par value \$1 per share, authorized 15,000,000 shares, issued and outstanding 11,471,273 and 11,413,019 shares | \$ 11,471              | \$ 11,413    |
| Additional paid-in capital   | 104,978                | 103,781      |
| Accumulated other comprehensive income (loss)  | (13,120)               | (12,487)     |
| Retained earnings  | 27,434                 | 15,908       |
|  | 130,763                | 118,615      |
| Long-term Debt   | 165,601                | 173,840      |
| Current Liabilities:   |                        |              |
| Short-term debt  |                        | 12,500       |
| Current maturities of long-term debt   | 8,000                  |              |
| Accounts payable   | 35,894                 | 17,841       |
| Property, payroll and excise taxes   | 10,321                 | 5,520        |
| Dividends and interest payable   | 6,947                  | 6,920        |
| Regulatory liabilities   | 16,663                 | 91,217       |
| Other current liabilities  | 24,551                 | 8,209        |
|  | 102,376                | 142,207      |
| Deferred Credits and Other Non-current Liabilities:  |                        |              |
| Deferred income taxes and investment tax credits   | 41,065                 | 43,429       |
| Retirement plan obligations  | 17,869                 | 19,042       |
| Regulatory liabilities   | 20,934                 | 50,584       |
| Other  | 6,753                  | 5,188        |
|  | 86,621                 | 118,243      |
| Commitments and Contingencies  | \$ 485,361             | \$ 552,905   |

The accompanying notes are an integral part of these financial statements.

CASCADE NATURAL GAS CORPORATION  
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS  
(Unaudited)

|   | SIX MONTHS ENDED<br>(dollars in thousands) |              |
|---|--|--------------|
|   | Mar 31, 2006                               | Mar 31, 2005 |
| <b>Operating Activities:</b>  |  |              |
| Net income  | \$ 17,026                                  | \$ 13,984    |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |              |
| Depreciation and amortization   | 8,849                                      | 8,485        |
| Deferrals of gas cost changes   | 2,232                                      | (2,266)      |
| Amortization of gas cost changes  | 7,937                                      | 3,750        |
| Other deferrals and amortizations   | (951)                                      | (491)        |
| Deferred income taxes and tax credits - net                                       | (2,305)                                    | 835          |
| Change in current assets and liabilities  | (2,180)                                    | 1,860        |
| Net cash provided by operating activities   | 30,608                                     | 26,157       |
| <b>Investing Activities:</b>  |  |              |
| Capital expenditures  | (9,492)                                    | (16,130)     |
| Customer contributions in aid of construction                                     | 1,430                                      | 601          |
| Net cash used by investing activities   | (8,062)                                    | (15,529)     |
| <b>Financing Activities:</b>  |  |              |
| Proceeds from issuance of long-term debt, net                                     |  | 28,119       |
| Proceeds from issuance of common stock  | 1,255                                      | 1,290        |
| Repayment of long-term debt   | (239)                                      | (9,000)      |
| Changes in short-term debt, net   | (12,500)                                   | (20,000)     |
| Dividends paid  | (5,501)                                    | (5,431)      |
| Other   | (11)                                       |              |
| Net cash provided by financing activities   | (16,996)                                   | (5,022)      |
| Net Increase in Cash and Cash Equivalents   | 5,550                                      | 5,606        |
| <b>Cash and Cash Equivalent:</b>  |  |              |
| Beginning of year   | 1,128                                      | 499          |
| End of period   | \$ 6,678                                   | \$ 6,105     |

The accompanying notes are an integral part of these financial statements.



**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
THREE-AND SIX-MONTH PERIODS ENDED MARCH 31**

The preceding statements were taken from the books and records of the Company and reflect all adjustments which are, in the opinion of management, necessary for a fair statement of the results for the interim periods. Because of the highly seasonal nature of the natural gas distribution business, earnings or loss for any portion of the year are disproportionate in relation to the full year.

Reference is directed to the Notes to Consolidated Financial Statements contained in the 2005 Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

**Note 1. New Accounting Standards**

**FAS No. 151:** As of October 1, 2005, the Company adopted Statement of Financial Accounting Standards (FAS) No. 151, *Inventory Costs*. This standard is an amendment of Accounting Research Bulletin (ARB) No. 43, clarifying the requirement that abnormal amounts of idle facility expense, freight, handling costs, and spoilage be recognized as current period costs. Adoption of this standard did not have a significant impact on the Company's financial statements.

**FAS No. 123 (revised 2004):** As of October 1, 2005, the Company adopted FAS No. 123 (revised 2004), *Share-Based Payment* {FAS No. 123(R)}. This statement is a revision of FAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Under FAS No. 123(R) the Company is required to recognize as expense the fair value of equity instruments, including stock options, to be issued in exchange for goods or services. Adoption of this standard did not have a significant impact on the Company's financial statements, but additional footnote disclosure is required and is included in Note 4 below.

**Note 2. Earnings Per Share**

The following table sets forth the calculation of earnings per share:

|                                     | Three Months Ended                   |             | Six Months Ended |             |
|-------------------------------------|--------------------------------------|-------------|------------------|-------------|
|                                     | Mar 31 2006                          | Mar 31 2005 | Mar 31 2006      | Mar 31 2005 |
|                                     | (in thousands except per-share data) |             |                  |             |
| Net income                          | \$ 8,986                             | \$ 7,352    | \$ 17,026        | \$ 13,984   |
| Weighted average shares outstanding | 11,455                               | 11,312      | 11,441           | 11,296      |
| Basic earnings per share            | \$ 0.78                              | \$ 0.65     | \$ 1.49          | \$ 1.24     |

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|   |         |         |         |         |
|---|---------|---------|---------|---------|
| Weighted average shares outstanding                   | 11,455  | 11,312  | 11,441  | 11,296  |
| Plus: Issued on assumed exercise of stock options     |         | 3       |         | 4       |
| Weighted average shares outstanding assuming dilution | 11,455  | 11,315  | 11,441  | 11,300  |
| Diluted earnings per share                            | \$ 0.78 | \$ 0.65 | \$ 1.49 | \$ 1.24 |

**Note 3. Retirement Plan Information**

The following table sets forth the components of net periodic benefit costs recognized in the three- and six-month periods ended March 31, 2006 and 2005:

**Net Periodic Benefits Cost**

|  | Three Months Ended |             | Six Months Ended |             |
|--|--------------------|-------------|------------------|-------------|
|  | Mar 31 2006        | Mar 31 2005 | Mar 31 2006      | Mar 31 2005 |
| <b>(Dollars in Thousands)</b>                      |                    |             |                  |             |
| <b>DEFINED BENEFIT PENSION PLANS</b>               |                    |             |                  |             |
| Service cost                                       | \$ 216             | \$ 197      | \$ 433           | \$ 394      |
| Interest cost                                      | 965                | 961         | 1,761            | 1,922       |
| Expected return on plan assets                     | (1,101)            | (1,041)     | (1,888)          | (2,081)     |
| Recognized gains or losses                         | 421                | 386         | 738              | 772         |
| Prior service cost                                 | 38                 | 46          | 76               | 91          |
| Net Periodic Benefit Cost Recognized               | \$ 539             | \$ 549      | \$ 1,120         | \$ 1,098    |
| <b>POSTRETIREMENT BENEFITS OTHER THAN PENSIONS</b> |                    |             |                  |             |
| Service cost                                       | \$ 28              | \$ 35       | \$ 56            | \$ 70       |
| Interest cost                                      | 164                | 275         | 329              | 550         |
| Expected return on plan assets                     | (219)              | (211)       | (439)            | (423)       |
| Recognized gains or losses                         | 181                | 187         | 362              | 374         |
| Prior service cost                                 | (615)              | (330)       | (1,231)          | (660)       |
| Net Periodic Benefit Cost Recognized               | \$ (461)           | \$ (44)     | \$ (923)         | \$ (89)     |
| <b>DEFINED CONTRIBUTION PENSION PLAN</b>           |                    |             |                  |             |
| Net Periodic Benefit Cost Recognized               | \$ 203             | \$ 250      | \$ 408           | \$ 492      |

**Retirement Plan Funding**

For the three months ended March 31, 2006, \$630,000 of contributions were made to the Company's defined benefit pension plans, and the six-month total is \$1,260,000. The Company presently anticipates contributing an additional \$2,680,000 to fund its pension plans for a total of \$3,940,000 in fiscal 2006.

**Note 4. Share-Based Payment**

In the first quarter of fiscal 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), (FAS 123(R)), *Share-Based Payment*. See Note 1 above. During the fiscal year-to-date, the Company did not have any share-based payment transactions. Following are disclosures under FAS 123(R) for share-based payment arrangements that were in effect during the three- and six-month periods ended March 31, 2006 and 2005.

Under the Company's 2000 Director Stock Award Plan, each non-employee director is awarded 1,000 shares of the Company's common stock annually following shareholder approval from this year's annual meeting. During the quarters ended March 31, 2006 and March 31, 2005, the Company recognized \$97,000 and \$15,000 as expense under this plan. For the respective six-month periods, the Company recognized \$119,000 and \$37,000. The value of the stock granted under this plan is based on the market value on the date of the award.

Under the Company's 1998 Stock Incentive Plan, 44,000 stock options granted in 2002 are exercisable at \$20.84. The 2002 options expire in 2012. All options are fully vested. When the options were granted and during the vesting periods, the Company applied the intrinsic value method under Accounting Principles Board (APB) Opinion 25, and no expense has been recognized.

The Company's employment contracts with its Chief Executive Officer (CEO) and its Chief Financial Officer (CFO) contain grants of restricted stock. Under the CEO grant, 5,000 shares are restricted until the CEO completes one year of employment, and another 5,000 shares are restricted until he completes two years of employment. Under the CFO grant, 5,000 shares are restricted until he completes one year of employment. During this period, each executive is restricted from selling his shares. The value of the shares granted was based on the market value as of the grant date. During the quarters ended March 31, 2006, the Company recognized \$62,000 as compensation expense under this plan. For the six-month period, the Company recognized \$124,000. No expense was recognized in the first two quarters of fiscal 2005.

#### **Note 5. Commitments and Contingencies**

##### **Environmental Matters**

There are two claims against the Company for cleanup of alleged environmental contamination related to manufactured gas plant sites previously operated by companies that were subsequently merged into the Company.

The first claim was received in 1995 and relates to a site in Oregon. An investigation has shown that soil and groundwater contamination exists at the site. There are parties in addition to the Company that are potentially liable for cleanup of the contamination. Some of these other parties have shared in the costs expended to date to investigate the site, and it is expected that these and other parties will share in the cleanup costs. Several alternatives for remediation of the site have been identified, with preliminary estimates for cleanup ranging from approximately \$500,000 to \$11,000,000. It is not known at this time what share of the cleanup costs will actually be borne by Cascade.

The second claim was received in 1997 and relates to a site in Washington. An investigation has determined that there is evidence of contamination at the site, but there is also evidence that other property owners may have contributed to the contamination. There is currently not enough information available to estimate the potential liability associated with this claim, but the Company and other parties may become more involved in investigations of the nature and extent of contamination and possible remediation of the site as increased interest has been expressed concerning its potential for redevelopment.

Management has recently completed a review of the Company's insurance coverage and believes it has adequate insurance to cover costs of the above two claims. In the event the insurance proceeds do not completely cover the costs, management intends to seek recovery from its customers through increased rates. There is precedent for such recovery through increased rates, as both the Washington Utilities and Transportation Commission (WUTC) and the Oregon Public Utilities Commission (OPUC) have previously allowed regulated utilities to increase customer rates to cover similar costs.

**Litigation and Other Contingencies**

Various lawsuits, claims, and contingent liabilities may arise from time to time from the conduct of the Company's business. No other claims now pending, in the opinion of management, are expected to have a material effect on the Company's financial position, results of operations, cash flows, or liquidity.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following is management's assessment of the Company's financial condition and a discussion of the principal factors that affected consolidated results of operations and cash flows for the three- and six-month periods ended March 31, 2006 and 2005.

### **OVERVIEW**

The Company is a local distribution company (LDC) serving approximately 237,000 customers in the States of Washington and Oregon. Its service area consists primarily of relatively small cities and rural communities rather than larger urban areas. The Company's primary source of revenue and operating margin is the distribution of natural gas to end-use residential, commercial, industrial, and institutional customers. Revenues are also derived from providing gas management and other services to some of its large industrial and commercial customers. The Company's rates and practices are regulated by the Washington Utilities and Transportation Commission (WUTC) and the Oregon Public Utility Commission (OPUC).

Key elements of the Company's operating strategy:

Remain focused on the natural gas distribution business.

Pursue appropriate regulatory treatment, including initiatives to decouple the Company's earnings from weather fluctuations and changing customer consumption patterns, and remove other regulatory impediments to effective management of the business.

Economic expansion of its customer base by prudently managing capital expenditures and ensuring new customers provide sufficient margins for an appropriate return on the new investment required to acquire the customers.

Continue to focus on operational efficiencies.

Generate earnings and manage cash flow to maintain and strengthen the Company's ability to attract the funding needed to reliably serve new and existing customers.

### **Opportunities and Challenges**

The Company operates in a diverse service territory over a wide geographic area relative to the Company's overall size and number of customers. The economies of various parts of the service area are supported by a variety of industries and are affected by the conditions that impact those industries. Management believes there are growth opportunities in the Company's service area, especially in the residential and commercial segments. Factors contributing to these opportunities include general population growth in the service area, including some areas of rapid growth, and to a lesser extent, low market penetration in many of the towns served.

Overall revenues and margins are negatively impacted by higher efficiency in new home and commercial building construction, higher efficiency in gas-burning equipment, and customers taking additional measures to reduce energy usage. The increasing cost of energy in recent years, including the wholesale cost of natural gas, continues to encourage such measures. However, the Company continues to believe that energy efficiency and conservation are the most viable near-term tactics for reducing customer bills and influencing wholesale natural gas prices. They also form a vital strategy for stabilizing the cost of gas over the long term. The traditional regulatory establishment of rates ties the recovery of cost to volumetric sales. This traditional rate design creates a financial disincentive for utilities to promote conservation. The Company has filed a rate case in the State of Washington along with a request to decouple the margin recovery from volume. The Company continues to work with the regulatory staff and other stakeholders in this case to develop an acceptable decoupling mechanism that will enable the Company to promote conservation while still recovering its operating costs and earning a fair return on its invested capital. Similar approaches have been implemented in many states, including Oregon (see below), and are endorsed by a variety of organizations, including the recent endorsement by the National Association of Regulatory Utility Commissions. The results of such rate requests and other initiatives for regulatory relief are subject to significant uncertainties.



In April 2006, the OPUC approved the Company's request to implement its Conservation Alliance Program, which effectively decouples operating margin from the impacts of conservation and weather on gas usage by residential and commercial customers in its Oregon service area. The filing provides a mechanism where the Company will adjust its earnings recovery to fully recover the Commission-granted level of earnings per customer. This is done via a deferral mechanism for both conservation and weather. In simple terms, the Company will book the actual earnings and a deferral for both conservation and normal weather each month. The next year, depending on the amount of conservation and level of weather, the Company will adjust its rate either downward or upward to ensure recovery at the allowed level.

Revenues and margins from the Company's residential and small commercial customers in Washington are highly weather-sensitive. In a cold year, the Company's earnings are boosted by the effects of the weather, and conversely in a warm year, the Company's earnings suffer. Peak requirements also drive the need to reinforce our systems (i.e., increase capacity). Our operations group considers innovative approaches such as temporarily utilizing mobile gas supply rather than making large investments in long-term capacity increases which may not be fully utilized.

Prospects for continuing strong residential and commercial customer growth are excellent. The pace of new home and commercial construction remains steady in communities served by the Company. Good potential also exists for converting homes and businesses located on or near the Company's current lines to gas from other fuels, as well as for expanding the system into adjacent areas. Customer count growth in this sector has been about double the average of U.S. gas utilities.

The Company earns approximately one third of its operating margin from industrial and electric generation customers. Loss of major industrial customers, or unfavorable conditions affecting an industry segment, would have a detrimental impact on the Company's earnings. Many external factors over which the Company has no control can significantly impact the amount of gas consumed by industrial and electric generation customers and, consequently, the margins earned by the Company.

Our customer service call center organization recently voted to accept union representation. The Company is attempting to negotiate an agreement that will support our effort to cost-effectively provide superior customer service. The timing and results of negotiations are uncertain.

During April, the company entered into a three-year agreement, commencing April 1, with the union representing its field operations personnel. The highlights of our agreement with the International Chemical Workers Union (ICWU) that represent our field employees are: a) a 3 year agreement, b) reduced medical benefits consistent with our non-bargaining unit employees, c) modifications to the pension plan including that employees hired into the Union after January 1, 2007 will not be eligible for the pension plan, but will be under the Company's defined contribution plan via its 401(k), and d) annualized wage increases of 2.5%, 2% and 2%.

We continue to pursue operating efficiencies and cost reductions. During fiscal 2004, we completed the implementation of automated meter reading capability covering our entire service area. This reduced our staffing needs by 27 full-time equivalent positions. During fiscal 2005, the centralization of our customer service activities and other organization changes, enabled by a variety of other improvements, reduced our staffing from 428 to 375, more than a 12% reduction. Our current organization is able to service more customers at a lower cost than in prior years. Changes completed during fiscal 2005 alone resulted in improving our customer-per-employee ratio from 500 to 600. We continue to look for additional operating improvements.

We carefully analyze the economics of our spending to support growth. When justified under our tariffs, we work with developers, business owners and residents to share certain construction costs to assure a fair return to the Company. Non-revenue-generating spending is also managed to assure that we use the most economically attractive solutions while providing for a safe and reliable system. Improvements implemented during the current year have contributed to an average cost per service line reduction of at least 12%, while the number of new

meters installed remained about level. These changes, combined with a

reduction in non-revenue-generating initiatives as compared to a year ago, are expected to result in a significant reduction in capital spending over the current fiscal year.

Management continuously seeks improvement opportunities in all areas. Our discussion above covering regulatory change, labor relations, operating practices, our organization and our investment to maintain and expand our gas delivery system are examples. To assist the Company in evaluating all available options to maximize shareholder value, the Company has retained J.P. Morgan Securities, Inc., to provide strategic and financial advice as well as regulatory support. In addition, the Company is considering other strategic alternatives, including a possible business combination.

## RESULTS OF OPERATIONS

The Company's net income was \$8,986,000, or \$0.78 per share, basic and diluted, for the fiscal 2006 second quarter (quarter ended March 31, 2006), compared to \$7,352,000, or \$0.65 per share, basic and diluted, for the quarter ended March 31, 2005. Year-to-date net income was \$17,026,000, or \$1.49 per share, basic and diluted, compared to \$13,984,000, or \$1.24 per share, basic and diluted, for the same period last year. The largest factors influencing the quarterly comparisons were:

|   | Earnings per Share<br>Effect |              |
|---|------------------------------|--------------|
|   | Quarter                      | Year-to-date |
| <b>Operating Margin Increases (Decreases):</b>  |                              |              |
| Residential & commercial customers              | \$ 0.15                      | \$ 0.24      |
| Electric generation customers                   | \$ 0.04                      | \$ 0.06      |
| Mark-to-market valuations                       | \$ (0.03)                    | \$ (0.03)    |
| 2005 reversal of Oregon earnings sharing        | \$ (0.03)                    | \$ (0.03)    |
| <b>Cost of Operations Decreases (Increases)</b> |                              |              |
| Cost-savings initiatives                        | \$ 0.10                      | \$ 0.20      |
| Reduction in capitalization of expenses         | \$ (0.03)                    | \$ (0.04)    |
| Accrual of incentive compensation               | \$ (0.08)                    | \$ (0.11)    |

These above items are discussed in more detail in the paragraphs that follow.

### Operating Margin

Operating margins by customer category for the second quarter and year-to-date for fiscal years 2006 and 2005 are set forth in the following tables:

**Residential and Commercial Margin**

|   | Quarter Ended Mar 31 |           | Percent<br>Change<br>(dollars in thousands) | Year-to-Date |           | Percent<br>Change |
|---|----------------------|-----------|---|--------------|-----------|-------------------|
|   | 2006                 | 2005      |   | 2006         | 2005      |                   |
| <b>Degree Days</b>                        |                      |           |   |              |           |                   |
| Actual                                    | 2,269                | 2,230     | 1.7%  | 4,520        | 4,175     | 8.3%              |
| 5-Year Average                            | 2,299                | 2,271     |   | 4,406        | 4,362     |                   |
| <b>Average Number of Customers Billed</b> |                      |           |   |              |           |                   |
| Residential                               | 205,537              | 196,094   | 4.8%  | 203,371      | 193,597   | 5.0%              |
| Commercial                                | 31,149               | 30,475    | 2.2%  | 30,868       | 30,157    | 2.4%              |
| <b>Average Therm Usage per Customer</b>   |                      |           |   |              |           |                   |
| Residential                               | 268                  | 266       | 0.8%  | 542          | 517       | 4.8%              |
| Commercial                                | 1,354                | 1,328     | 2.0%  | 2,680        | 2,491     | 7.6%              |
| <b>Operating Margin</b>                   |                      |           |   |              |           |                   |
| Residential                               | \$ 16,043            | \$ 14,231 | 12.7%                                       | \$ 31,512    | \$ 28,455 | 10.7%             |
| Commercial                                | \$ 8,602             | \$ 7,724  | 11.4%                                       | \$ 16,490    | \$ 15,185 | 8.6%              |

**Quarter-to-Quarter**

Residential and commercial margins increased by \$2.7 million for the quarter. Customer growth at 4.5% contributed \$1.1 million to margins and higher average consumption contributed \$544,000. Slightly colder weather drove the increased consumption. Reductions in incurred gas costs absorbed under our Oregon tariff contributed another \$1.6 million and miscellaneous services added \$221,000. These benefits to margin were partially offset by changes to the Company's Oregon purchased gas adjustment filing (PGA) last fall, which has the effect of reallocating certain demand charge recoveries within each fiscal year. For the second quarter, this change reduced the reported margin by \$696,000 when compared to the same quarter in fiscal 2005, but it is not expected to impact full year earnings.

The primary use of gas by residential customers is for space and water heating; therefore, average consumption per customer is very sensitive to weather, particularly during the Company's first and second fiscal quarters. Consumption by commercial customers is also sensitive to weather. The sensitivity is more difficult to isolate and measure than for residential customers because of a variety of uses in addition to space and water heating.

**Year-to-Date**

Residential and commercial margins increased by \$4.4 million for the year-to-date period. Primary contributors were customer growth adding \$2.1 million and higher consumption per customer adding another \$2.1 million. Average consumption was 5.1% higher for the period primarily due to colder weather than last year. Reductions in incurred Oregon Gas cost of \$948,000, and \$374,000 of increased services revenue further contributed to the improvement. Partially offsetting these items were \$1.2 million resulting from the Oregon PGA changes.

**Industrial and Other Margin**

|                                       | Quarter Ended Mar 31 |          | Percent<br>Change<br>(dollars in thousands) | Year-to-Date |           | Percent<br>Change |
|---------------------------------------|----------------------|----------|---|--------------|-----------|-------------------|
|                                       | 2006                 | 2005     |   | 2006         | 2005      |                   |
| <b>Average Number of Customers</b>    |                      |          |   |              |           |                   |
| Electric Generation                   | 11                   | 13       | -15.4%                                      | 12           | 13        | -7.7%             |
| Industrial                            | 696                  | 724      | -3.9%                                       | 699          | 730       | -4.2%             |
|                                       | 707                  | 737      | -4.1%                                       | 711          | 743       | -4.3%             |
| <b>Therms Delivered (thousands)</b>   |                      |          |   |              |           |                   |
| Electric Generation                   | 98,115               | 113,977  | -13.9%                                      | 219,308      | 231,342   | -5.2%             |
| Industrial                            | 113,756              | 114,913  | -1.0%                                       | 222,962      | 225,327   | -1.0%             |
|                                       | 211,871              | 228,890  | -7.4%                                       | 442,270      | 456,669   | -3.2%             |
| <b>Operating Margin (\$thousands)</b> |                      |          |   |              |           |                   |
| Electric Generation                   | \$ 2,771             | \$ 2,027 | 36.7%                                       | \$ 5,038     | \$ 4,034  | 24.9%             |
| Industrial                            | 5,048                | 5,190    | -2.7%                                       | 10,182       | 10,497    | -3.0%             |
| Gas Management Services               | 625                  | 324      | 92.9%                                       | 963          | 714       | 34.9%             |
| Mark-to-Market Valuations             |                      | 549      | -100.0%                                     | (579)        | (119)     | 386.6%            |
| Other                                 | 142                  | 272      | -47.8%                                      | 416          | 473       | -12.1%            |
| Oregon Earnings Sharing               |                      | 525      | -100.0%                                     |              | 525       | -100.0%           |
|                                       | \$ 8,586             | \$ 8,887 | -3.4%                                       | \$ 16,020    | \$ 16,124 | -0.6%             |

**Quarter-to-Quarter**

Margins from sales to electric generation plants were \$745,000 higher for the quarter as the result of a settlement for early termination of a sales agreement. No Mark-to-Market adjustment was recorded in the second quarter of fiscal 2006 as compared to a positive adjustment of \$549,000 in the same period in the prior year. Prior year second fiscal quarter operating margins benefited from a \$525,000 accrual reversal in connection with management's assessment that no earnings sharing would be required in Oregon related to fiscal 2004.

The primary driver over the rest of the fiscal year for changes in gas usage by generation customers will be Southwest power demands due to air-conditioner usage.

**Year-to-Date**

Margins from sales to electric generation plants were \$1.0 million higher year-to-date as the result of settlements for early termination of sales agreements with two customers. Offsetting these items were year-to-year changes in Mark-to-Market valuations of \$460,000 and the \$525,000 Oregon earnings sharing accrual reversal in fiscal 2005.

**Cost of Operations**

**Quarter-to-Quarter**

Cost of operations (operating expense, depreciation and amortization, and property and miscellaneous taxes) is down by \$185,000, compared to the second quarter of fiscal year 2005. Management initiatives resulted in \$1.8 million in reduced quarterly operating costs. Last fall's reduction in force, combined with other reduction opportunities, a continued focus on managing overtime and last year's one-time executive transition costs resulted in reduced direct labor spending of \$1.1 million. Outsourcing our retiree medical obligations to an insurance company contributed toward the \$462,000 million in reduced benefit costs. Another \$206,000 in year-to-year cost reductions was achieved in various corporate and administrative areas. These cost savings are offset by a \$518,000 reduction in capitalized costs, incentive compensation accruals of \$1.4 million and \$155,000 of increased depreciation and amortization. Bad debt expense was \$327,000 lower, primarily due to unusual commercial account bad debt experience last year.

**Year-to-Date**

Year-to-date cost of operations was down \$725,000 reflecting management initiatives delivering \$3.6 million in direct labor, benefits and other overhead spending reductions. Reductions in bad debt expense of \$147,000 were due to unusual prior year experience. Incentive compensation accruals of \$2.1 million, reflecting the 22% earnings improvement; reduced capitalized operating costs of \$735,000 and increased depreciation of \$364,000 partially offset these savings.

**LIQUIDITY AND CAPITAL RESOURCES**

The seasonal nature of the Company's business creates short-term cash requirements to finance customer receivables, deferred gas costs and other business needs. To provide working capital for these requirements, the Company has a \$60 million bank revolving credit commitment. This agreement has a variable commitment fee and a term that expires in October 2007. The Company also has a \$10 million uncommitted line of credit. As of March 31, 2006, there was no outstanding debt under these credit lines.

Due to the nature of the Company's business, which is characterized by predictable payments from a growing customer base, and our expectations that capital spending will be reduced from the last few years, we expect to have limited need for additional capital during fiscal year 2006. For this reason, management believes it has adequate liquidity and borrowing lines to meet our anticipated needs and estimates that cash flow will be sufficient to support operations, fund capital spending, and pay dividends at their current level.

**Operating Activities**

For the six-month period, cash provided by operating activities improved \$4.5 million over last year. In addition to improved net income, the primary factor was the net result of purchasing natural gas at lower cost than the corresponding amounts paid by customers, thus reducing our net deferred gas cost asset. These improvements were partially offset by the funding of working capital requirements, and higher current year income tax payments. The working capital requirement was primarily driven by growth in accounts receivable, reflecting higher gas costs.

**Investing Activities**

Year-to-date capital spending is down to \$7.5 million from \$15.5 million when compared to fiscal year 2005. Part of the difference was due to \$2.0 million of one-time specific system reinforcement expenditures and \$1.0 million relating to the completed AMR and call center centralization projects in the first half of fiscal year 2005. The remainder reflects the Company's new investment evaluation process implemented in the first quarter to assure that all capital spending provides an adequate return or is required for safety or regulatory compliance. Our current expectation is that we will end the year below our fiscal 2006 capital budget of \$22.0 million.

**Financing Activities**

Other than the payment of dividends, the Company's primary financing activity year-to-date in fiscal 2006 was the \$12.5 million net reduction in short-term debt. This reduction in debt was facilitated by favorable operating cash flow and reduced capital spending.

**CRITICAL ACCOUNTING POLICIES**

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). In following GAAP, management exercises judgment in selection and application of accounting principles. Management considers critical accounting policies to be those where different assumptions regarding application could result in material differences in financial statements. The Company's critical accounting policies were described in its Annual Report on Form 10-K



for the year ended September 30, 2005, under Part II, Item 7, and have not changed significantly since that report.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company has evaluated its risk related to financial instruments whose values are subject to market sensitivity. The Company has fixed-rate debt obligations but does not currently have derivative financial instruments subject to interest rate risk. The Company makes interest and principal payments on these obligations in the normal course of its business and may redeem its debt obligations prior to normal maturities if warranted by market conditions.

The Company's natural gas purchase commodity prices are subject to fluctuations resulting from weather, congestion on interstate pipelines, and other unpredictable factors. The Company's Purchased Gas Cost Adjustment (PGA) mechanisms generally result in the recovery in customer rates of prudently incurred wholesale cost of natural gas purchased for the core market. The Company primarily utilizes financial derivatives, and to a lesser extent, fixed price physical supply contracts to manage risk associated with wholesale costs of natural gas purchased for customers.

With respect to derivative arrangements covering natural gas supplies for core customers, periodic changes in fair market value are recorded in regulatory asset or regulatory liability accounts, pursuant to authority granted by the WUTC and OPUC, recognizing that settlements of these arrangements will be recovered through the PGA mechanism.

For derivative arrangements related to supplies for non-core customers, which are not covered by a PGA mechanism, periodic changes in fair market value are recognized in earnings or in Other Comprehensive Income.

### **Item 4. Controls and Procedures**

The Company maintains controls and procedures designed to provide reasonable assurance that required disclosure information in the reports the Company files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time period specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those controls and procedures as of the end of the quarter covered by this report, the Chief Executive Officer and Chief Financial Officer of the Company concluded that the Company's disclosure controls and procedures were effective. There were no changes in internal control over financial reporting that occurred during the quarter covered by this report that have materially affected, or are reasonably likely to affect, the Company's internal controls over financial reporting.

### **FORWARD-LOOKING STATEMENTS**

The Company's discussion in this report, or in any information incorporated herein by reference, may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, are forward-looking statements, including statements concerning plans, objectives, goals, strategies, and future events or performance. When used

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in Company documents or oral presentations, the words anticipate , believe , estimate , expect , objective , projection , forecast , goal , or words are intended to identify forward-looking statements.

These forward-looking statements reflect the Company's current expectations, beliefs and projections about future events that we believe may affect the Company's business, financial condition and results of operations, and are expressed in good faith and are believed to have a reasonable basis. However, each such forward-looking statement involves risks, uncertainties and assumptions, and is qualified in its entirety by reference to the following important factors, among others, that could cause the Company's actual results to differ materially from those projected in such forward-looking statements:

prevailing state and federal governmental policies and regulatory actions, including those of the Washington Utilities and Transportation Commission, the Oregon Public Utility Commission, and the U.S. Department of Transportation's Office of Pipeline Safety, with respect to allowed rates of return, industry and rate structure, purchased gas cost and investment recovery, acquisitions and dispositions of assets and facilities, operation and construction of plant facilities, the maintenance of pipeline integrity, and present or prospective wholesale and retail competition;

weather conditions and other natural phenomena;

unanticipated population growth or decline, and changes in market demand caused by changes in demographic or customer consumption patterns;

changes in and compliance with environmental and safety laws, regulations and policies, including environmental cleanup requirements;

competition from alternative forms of energy and other sellers of energy;

increasing competition brought on by deregulation initiatives at the federal and state regulatory levels, as well as consolidation in the energy industry;

the potential loss of large volume industrial customers due to bypass or the shift by such customers to special competitive contracts at lower per-unit margins;

risks, including creditworthiness, relating to performance issues with customers and suppliers;

risks resulting from uninsured damage to the Company's property, intentional or otherwise, or from acts of terrorism;

unanticipated changes that may affect the Company's liquidity or access to capital markets;

unanticipated changes in interest rates or in rates of inflation;

economic factors that could cause a severe downturn in certain key industries, thus affecting demand for natural gas;

unanticipated changes in operating expenses and capital expenditures;

unanticipated changes in capital market conditions, including their impact on future expenses and liabilities relating to employee benefit plans;

potential inability to obtain permits, rights of way, easements, leases, or other interests or necessary authority to construct pipelines, or complete other system expansions;

changes in the availability and price of natural gas; and

legal and administrative proceedings and settlements.

In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report, or in any information incorporated herein by reference, may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. All subsequent forward-looking statements, whether written or oral and whether made by or on behalf of the Company, also are expressly qualified by these cautionary statements.

Any forward-looking statement by the Company is made only as of the date on which such statement is made. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of any unanticipated events. New factors emerge from time to time, and the Company is not able to predict all such factors, nor can it assess the impact of each such factor or the extent to which such factors may cause results to differ materially from those contained in any forward-looking statement.

**PART II. Other Information**

**Item 4. Submission of Matters to a Vote of Security Holders**

At the annual meeting of shareholders on February 17, 2006, the following items were submitted to a vote of security holders:

Proposal No. 1: Election of Directors

The following directors were elected by the vote indicated for terms of office expiring in 2007:

|                   | <b>For</b> | <b>Withheld</b> |
|-------------------|------------|-----------------|
| Scott M. Boggs    | 9,260,384  | 514,740         |
| Pirkko H. Borland | 9,085,838  | 689,286         |
| Carl Burnham, Jr. | 9,244,308  | 530,816         |
| Thomas E. Cronin  | 9,465,459  | 309,665         |
| David E. Ederer   | 9,248,053  | 527,071         |
| Larry L. Pinnt    | 9,225,099  | 550,025         |
| Brooks G. Ragen   | 9,263,882  | 511,242         |
| David W. Stevens  | 9,290,016  | 485,108         |
| Douglas G. Thomas | 9,479,521  | 295,603         |

Proposal No. 2: Approval of Shareholder Proposal to Combine the Director Stock Award Plan with the Stock Incentive Plan

Votes for 5,581,783; withheld or against 948,138; exception or abstain 220,978

Proposal No. 3: Approval of Shareholder Proposal to Increase Annual Director Stock Award to 1,000 shares from 500 shares

Votes for 5,251,993; withheld or against 1,332,342; exception or abstain 166,564

**Item 6. Exhibits**

| <b>No.</b> | <b>Description</b>  |
|------------|---|
| 12         | Computation of Ratio of Earnings to Fixed Charges   |
| 31.1       | Certification of Principal Executive Officer Accompanying Periodic Report Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2       | Certification of Principal Financial Officer Accompanying Periodic Report Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32         | Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002              |

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**CASCADE NATURAL GAS CORPORATION**

By: */s/ Rick A. Davis*

Rick A. Davis  
Chief Financial Officer  
(Principal Financial Officer)

Date: May 9, 2006