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March 26, 2009

VIA ELECTRONIC FILING

PUC Filing Center
Public Utility Commission of Oregon
PO Box 2148
Salem, OR 97308-2148

Re: Petition for Declaratory Ruling

Enclosed for filing is Northwest Natural Gas Company's Petition for a Declaratory Ruling. The Petition as been served on the parties to Dockets UM 903 and UM 1286 as indicated in the attached service list. Please contact me with any questions.

Very truly yours,

Amie Jamieson

Enclosure

CERTIFICATE OF SERVICE

I certify that I have this day served the foregoing document by electronic mail and/or first class mail to the following parties or attorneys of parties in Dockets UM 903 and UM 1286:

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Dated March 26, 2009

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Amie Jamieson

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

DR _____

In the Matter of the Petition of NW Natural Gas Company for a Declaratory Ruling Regarding the Application of OAR 860-22-0070	Petition for a Declaratory Ruling

Pursuant to ORS 756.450 and OAR 860-013-0020, NW Natural Gas Company ("NW Natural" or "the Company") petitions the Public Utility Commission of Oregon ("Commission") for a declaratory ruling establishing that pursuant to OAR 860-022-0070, Order No. 99-272 in Docket UM 902,[1] and Order No. 08-504 in Docket UM 1286[2] ("PGA Order"), NW Natural may, when conducting its Spring Earnings Review for its Purchased Gas Adjustment mechanism ("PGA"), exclude from earnings amounts attributable to the Company's portion of gas cost variances.[3]

I. INTRODUCTION

In 1999, when the Commission first adopted the policies and procedures for the Spring Earnings Review, it allowed the local distribution companies ("LDCs") to elect whether they would perform a weather normalization adjustment to their earnings. NW Natural chose to do so and since that time, as part of that adjustment, has excluded gas cost variances from its earnings. No party questioned this practice until the 2008 Spring Earnings Review, when Staff initially told NW Natural that its exclusion of gas cost variances was erroneous. Then, after

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[1] *Re Recovery of Purchased Gas Costs*, Docket UM 903, Order No. 99-272, 193 PUR4th 373 (Apr. 19, 1999) [hereinafter "Order 99-272"].

[2] *Re Investigation into the Purchased Gas Adjustment (PGA) Mechanism Used by Oregon's Three Local Distribution Companies*, Docket UM 1286, Order No. 08-504 (Oct. 21, 2008) [hereinafter "PGA Order"].

[3] For the purposes of this Petition, the Company will refer to the shareholders' portion of the weighted average cost of gas ("WACOG") variances calculated under the PGA simply as "gas cost variances."

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further analysis, Commission Staff issued a letter tentatively approving of NW Natural's methodology. Shortly after this letter, Staff reversed this position, not because Staff changed its position on the policy implications, but rather because of a new interpretation of the PGA Order. Staff has now directed the Company to include gas cost variances in earnings in the Spring Earnings Review and that is the reason for this filing.

Contrary to Staff's current view, the Commission's PGA Order does not require that the Company change its practice. The PGA Order includes no discussion of the issue, and it is illogical to presume that the Commission would have departed from prior practice and procedure without explaining its actions. On the contrary, it appears the Commission did not address the issue in UM 1286 and is therefore free to do so in this case.

Including gas cost variances in the Company's Spring Earnings Review would reverse long-standing Commission policy and practice allowing NW Natural to exclude its gas cost variances from the earnings test as part of its weather normalization adjustment and would dilute the PGA incentive the Commission has found to be appropriate. Therefore, NW Natural requests that the Commission issue a ruling allowing NW Natural to continue performing its earnings review as it has for the past ten years—excluding gas cost variances from earnings.

II. BACKGROUND

The three LDCs in Oregon are subject to a PGA that 1) provides for pass-through to customers of their actual, prudently-incurred costs of natural gas purchases and 2) calculates differences between an LDC's weighted average cost of gas ("WACOG") included in rates and the actual WACOG recovered in rates and allocates those gas cost variances between shareholders and customers, subject to an earnings review.[4] This mechanism allows LDCs to recover costs associated with natural gas purchases without conducting a general rate case and provides an incentive to LDCs to lower expenses related to natural gas purchases.[5]

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[4] *See* PGA Order at 2; OAR 860-022-0070(8).
[5] *Re Investigation into the Purchased Gas Adjustment (PGA) Mechanism Used by Oregon's Three Local Distribution Companies*, Staff Report: Request to Open and Investigation into the PGA Mechanism (Nov. 21, 2006).

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The Commission's rules governing the PGA earnings reviews are contained in OAR 860-22-0700. These rules prescribe both a Spring Earnings Review, which all LDCs must file by May 1st of each year, and a Fall Earnings Review, which is performed only if an LDC has elected a risk sharing mechanism for variations in gas costs allocating less than 33 percent of the risk to the LDC. In the Spring Earnings Review, if the LDC's normalized earnings are above a particular threshold, a portion of the utility's revenues (33 percent for NW Natural) are shared with customers. The Fall Earnings Review, if applicable, is applied to amortization of deferred gas costs. Historically, NW Natural elected a 33 percent risk-sharing percentage, and as a result, has not been required to perform a Fall Earnings Review.[6] Pursuant to the Commission's directive in the PGA Order, Staff is currently conducting a rulemaking to eliminate the Fall Earnings Review.[7]

The Commission's rules mandating the earnings reviews do not directly address whether amounts retained by the LDC as a result of gas cost variances should be included in earnings. However, in Order No. 99-272—in which the Commission established policies and procedures for the earnings review—the Commission approved a list of required adjustments and specifically directed each LDC to make an election as to whether it would make a weather normalizing adjustment to its earnings for the purposes of the Spring Earnings Review.[8] In addition, the Commission included weather adjustments in the list of normalization adjustments to be made by the LDCs in Spring Earnings Reviews.[9] NW Natural elected to make this adjustment,[10] while Avista and Cascade chose not to make the adjustment.[11]

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[6] OAR 860-022-0070.

[7] *Re Rulemaking to Delete the Sunset Provision in OAR 860-022-0070*, Docket AR 532, Staff Initial Comments on Deleting the Sunset Provision in OAR 860-022-0070 (Jan. 15, 2009).

[8] Order 99-272 at 20. Prior to the date of Order No. 99-272, Cascade and Avista had entered into a stipulation that did not include a weather normalization adjustment. This may explain why historically, Avista and Cascade did include gas cost variances in their earnings review, and NW Natural did not. *See* Order No. 99-272 at 20. NW Natural does not argue in this Petition that the Commission alter its treatment of gas cost variances in Cascade's or Avista's earnings reviews. This Petition requests a declaratory ruling on only NW Natural's Spring Earnings Review.

[9] Order 99-272 at Appendix B.

[10] *Re Recovery of Purchased Gas Costs*, Docket UM 903, Letter from NW Natural Electing to Include Weather Normalization Adjustment (June 3, 1999).

[11] Order 99-272 at 20.

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Accordingly, NW Natural has been including a weather normalizing adjustment each year in its Spring Earnings Review. To normalize for weather, the Company adjusts actual revenues by assuming normal loads and reprices gas costs using tariffed rates. As such, any gas cost variances are adjusted out of financial results for purposes of the Spring Earnings Review. NW Natural has made this adjustment—reviewed and approved by Staff—since it made the election authorized by the Commission in Order No. 99-272.

Staff first questioned NW Natural's practice of excluding gas cost variances from earnings in the context of the 2008 Spring Earnings Review filed in UM 903. In its June 24, 2008 report on NW Natural's 2008 PGA, Staff noted that NW Natural removed the portion of savings retained by shareholders from earnings as a Type 1 adjustment to the results of operations.[12] Staff stated that Staff and the Company disagreed as to whether this adjustment was appropriate and agreed to work together to resolve the issue prior to the Company's next earnings review.[13]

Thereafter, Staff and NW Natural participated in informal discussions to determine how to treat gas cost variances in the earnings review. As a result of these conversations, on September 25, 2008, Staff sent a draft letter to participants in UM 903 concluding that NW Natural had been properly removing the shareholders' portion of gas cost variances. In support of this view, Staff reasoned that this treatment is consistent with (1) the Commission's finding that the gas utility should retain a portion of the PGA gas cost savings and absorb excess gas costs; and (2) the Commission's Order No. 99-272 that removed "non-operating items that were improperly recorded above the line" from the results of operations when performing the Spring Earnings Review. Staff's letter is attached as Attachment A.

Meanwhile, in the summer of 2008, while the UM 903 parties were evaluating the Spring Earnings Review issue, proceedings in UM 1286 were drawing to a close. The Commission

[12] *Re NW Natural Gas Co. 2008 Spring Earnings Review*, Docket UM 903, Order No. 08-374, Appendix at 3 (July 11, 2008).
[13] *Id.*

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had opened UM 1286 in November of 2006 to review, and modify if appropriate, the PGA used by Oregon's three LDCs.[14] After approximately 18 months and numerous workshops, settlement conferences, and comments, Staff, Avista, Cascade, NW Natural, and Northwest Industrial Customers of Gas Utilities had settled on a Stipulation to resolve the issues in the case—with Citizens' Utility Board ("CUB") dissenting.[15] Up to that point the calculation of earnings for the purposes of the Spring Earnings Review had not been raised as an issue in UM 1286, the parties instead focusing on fashioning an appropriate incentive mechanism to motivate the LDCs to engage in lower cost gas purchasing.

Then, in its UM 1286 Direct Testimony opposing the Stipulation, filed on July 25, 2008, CUB raised the issue of whether gas cost variances should be included in the Spring Earnings Review. Specifically, CUB noted that NW Natural and Staff disagreed as to whether gas cost variances should be included in earnings—which at the time accurately reflected their respective positions—and argued that the Commission should order NW Natural to include gas cost variances in earnings for the purposes of its Spring Earnings Review.[16] In its Reply Testimony, NW Natural pointed out that this issue was not specific to the stipulated PGA and should not be resolved in that docket. Instead, the Company argued on behalf of itself and Staff that the Commission should allow the parties to discuss the issue outside the docket.[17]

On October 21, 2008, the Commission issued the PGA Order, establishing the new PGA for Oregon's LDCs. In the PGA Order, the Commission did not include any discussion as to the proper treatment of gas cost variances in the context of the Spring Earnings Review, nor was it mentioned in the Findings of Facts or Conclusions of Law. The Commission provided a summary of the parties' respective positions, but did not specifically address the issue in its

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[14] *Re Investigation into the Purchased Gas Adjustment (PGA) Mechanism Used by Oregon's Three Local Distribution Companies*, Docket UM 1286, Staff Memorandum at 3 (Nov. 14, 2006).
[15] PGA Order at 6, Appendix A.
[16] *Re Investigation into the Purchased Gas Adjustment (PGA) Mechanism Used by Oregon's Three Local Distribution Companies*, Docket UM 1286, CUB/100, Jenks/32-34 (July 25, 2008). CUB's testimony outlined Staff's position prior to Staff issuing its draft letter on September 25, 2008.
[17] *Re Investigation into the Purchased Gas Adjustment (PGA) Mechanism Used by Oregon's Three Local Distribution Companies*, Docket UM 1286, NW Natural/100, Miller/6 (Aug. 8, 2008).

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conclusions.[18] In the end, the Commission adopted "CUB's proposal, as modified."[19] With respect to the Spring Earning Review the Commission only stated:

> The spring 2009 earnings review will be conducted under the ground rules applicable under the now current mechanism, in recognition that ten months of the year 2008 will have been conducted under the current rules.[20]

Thus, the Commission explicitly stated that it was not altering the LDCs' Spring Earnings Review. Because of the Commission's retention of the current ground rules for the 2009 Spring Earnings Review—without further mention of CUB's position on including gas cost variances—NW Natural interpreted the Commission's Order as retaining the status quo on the Spring Earnings Review. Accordingly, NW Natural did not request reconsideration and planned to continue discussion with the parties.

On February 5, 2009, Staff issued a second letter on the question as to whether gas cost variances should be included in earnings for the Spring Earnings Review, this time revising its position in light of the PGA Order. The letter states that Staff's attorney "has concluded that he believes the PGA Order is clear that the LDC's portion of gas cost sharing should be included 'above the line' and therefore, NW Natural's treatment would be improper in future filings." The letter continues "Staff's counsel advises that CUB's recommended treatment [of gas cost variances] was adopted." Although Staff's letter cited the portion of the PGA Order accepting CUB's proposal as modified, it did not reconcile the Commission's ruling that the 2009 Spring Earnings Review will be conducted under the ground rules of the current mechanism, or the complete absence of any analysis of the issue. A copy of this letter is attached as Attachment B.

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[18] PGA Order at 14.
[19] *Id.* at 18.
[20] *Id.*

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III. DISCUSSION

To ensure that the PGA operates as an appropriate incentive and the current balance of risk is maintained, the Commission should find that for NW Natural, which has chosen to weather normalize its results, gas cost variances should be excluded from earnings for purposes of the PGA earnings review. The Commission did not rule on this issue in the PGA Order and is therefore free to make a determination in this proceeding.

A. The Commission Did Not Rule on the Treatment of Gas Cost Variances in the Earnings Review in the PGA Order.

Based on Staff's draft letter on September 25, 2008 and its February 5, 2009 letter, it appears that Staff is now directing NW Natural to include gas cost variances in Company earnings for purposes of the Spring Earnings Review because it believes the PGA Order requires such an outcome. In fact, while the PGA Order does not take up the issue explicitly, the better interpretation is that the Commission rejected or did not address CUB's proposal to include gas cost variances.

Aside from simply repeating the parties' respective positions, the Commission provided no discussion of the merits of the issue. As described in further detail below, NW Natural has been applying the weather normalization adjustment to—and thus removing gas cost variances from—earnings for the past ten years, *with the Commission's and Staff's approval*. Staff's current proposal to include gas cost variances would reverse this long-standing practice shifting the PGA's risk allocation balance and diluting the level of incentive provided by the 80/20 or 90/10 sharing mechanism. Given these facts, it is seems unlikely that the Commission would have intended to depart from past policy and practice in the absence of a full analysis of the relevant law and policy supporting its decision.[21]

In addition, in the Discussion section of the PGA Order, the Commission explicitly addresses the new earnings thresholds that will correspond to permitted sharing levels (100

[21] In fact, Oregon law requires an agency to provide an explanation of any departure from the agency's prior policy or practice. ORS 183.482(8)(b)(B).

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basis points ROE for 90/10 sharing and 150 basis points for 80/20 sharing), and specifically states that the LDCs should conduct the 2009 Spring Earnings Review under the same procedures in effect prior to the UM 1286 order.[22] In so doing, and by omitting any mention of gas cost variances, it would appear that the Commission intended to retain the status quo or at least did not address the issue.

Under these circumstances, the only reasonable conclusion is that the Commission chose not to adopt CUB's proposal on the earnings review, and is free to consider the issue raised in this Petition.

B. The Commission Should Continue to Allow NW Natural to Remove Gas Cost Variances from Earnings for the Spring Earnings Review.

NW Natural's practice of excluding gas cost variances from earnings is consistent with the Commission's policies and precedents underlying the Spring Earnings Test and the PGA and should therefore be continued.

As discussed above, in order to normalize for weather, the Company reprices actual gas costs to reflect normal weather conditions. The Company has made this adjustment since Order 99-272 first granted the LDCs the right to adopt a weather normalization adjustment in the PGA.

In Order 99-272 the Commission did not explain its policy reasons for allowing the LDCs to elect to "weather normalize" earnings, and in truth, its intentions are not altogether clear. In particular, NW Natural acknowledges that while the Commission allowed NW Natural to choose to make a weather normalizing adjustment to its earnings, it also allowed Cascade and Avista to make the opposite choice. However, in NW Natural's view, allowing for weather normalization—and the exclusion of gas cost variance from earnings—best maintains Commission precedent and policy with respect to the earnings test.

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[22] PGA Order at 17.

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First, the result is consistent with the Commission's general directive that earnings are to be normalized with adjustments equivalent to those made in a general rate case.[23] Taken together with the specific inclusion of weather normalization as a permitted adjustment, this rule supports the notion that the purpose of the PGA earnings review is not to assess earnings as a function of anomalous and unforeseen events, but rather to assess earnings resulting under normal conditions. This interpretation is reasonable, given that the earnings test determines whether the LDC's earnings are far enough above the LDC's authorized return on equity as to require the LDC to share a portion of its revenues with customers. If this determination were made on the basis of anomalous and unforeseen events, such as abnormal weather conditions, LDCs would be in the position of engaging in revenue-sharing for events over which they have no control, which would undercut the incentive mechanism the earnings review is intended to complement.

Second, ordering NW Natural to include gas cost variation in its earnings will inappropriately limit the Company's ability to recover costs. The Spring Earnings Review, and associated revenue-sharing mechanism, already operates in an asymmetrical manner. If the Company's earnings exceed the pre-determined threshold, they are shared. There is no similar provision for revenue collection if earnings dip below a threshold. Including gas costs variances would exacerbate this existing asymmetry, narrowing the Company's ability to earn a reward in low gas cost years while at the same time offering no corresponding risk mitigation in high gas cost years. While it may be argued that the Company could file a general rate case to adjust rates if the Company is under-earning, because weather and gas cost movements are one time in nature, they cannot be recovered through a rate case. Including gas cost variances in revenue sharing would provide the Company with no opportunity to recover these lost revenues.

Finally, requiring NW Natural to include gas cost variances in earnings would inappropriately limit the incentive component of the PGA. The main goal of the incentive portion

[23] OAR 860-022-0070(5)(b).

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of the PGA mechanism is to align the interests of the LDC with those of its customers by encouraging the LDC to keep gas costs as low as reasonably possible, and rewarding the LDC when it succeeds in doing so.[24] The earnings test balances this mechanism, returning to customers a portion of the LDC's revenues if its earnings exceed a given threshold. The threshold, in turn, is tied to the particular sharing percentages an LDC elects. When originally designing the earnings review, the Commission deliberately set the threshold for NW Natural at 300 basis points, so as to avoid "micro-managing" the Company's earnings.[25]

NW Natural's sharing is currently set at 80 percent to customers and 20 percent to shareholders.[26] In the PGA Order, the Commission set the threshold applicable to this sharing level to 150 basis points, dramatically reducing the threshold for Company earnings before sharing. Including gas cost variances in earnings will further reduce this incentive portion of the PGA. In the PGA Order, the Commission found that the PGA mechanism as adopted provides LDCs a meaningful incentive to minimize gas costs.[27] The Commission should not mute the incentive that it has already deemed appropriate by changing NW Natural's established procedure for conducting its earnings review.

IV. CONCLUSION

For the reasons explained above, NW Natural respectfully requests that the Commission rule that NW Natural may remove amounts attributable to gas cost sharing in the results of operations when conducting its Spring Earnings Review under OAR 860-022-0070.

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[24] In adding the incentive mechanism to the PGA in 1989 the Commission specifically noted the benefits that would accrue to customers by granting the LDC a financial reward for securing lower priced gas. *Re Ratemaking Policies for Natural Gas Purchases by Local Distribution Co.*, Docket UG 73, Order No. 89-1046, 105 PUR4th 365, 368 (Aug. 4, 1989).

[25] Order No. 99-272 at 9.

[26] NWN Advice No. 08-9 (Oct. 27, 2008).

[27] PGA Order at 17.

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Dated this 26th day of March 2009.

MCDOWELL & RACKNER PC

Lisa Rackner
Amie Jamieson

Of Attorneys for NW Natural

NW NATURAL GAS COMPANY

Alex Miller
Inara Scott

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Attachment A

To NW Natural's Petition for a Declaratory Ruling

March 26, 2009

Draft

September 25, 2008

To: UM 903 Participants

Staff of the Oregon Public Utilities (OPUC) has discovered that the three natural gas utilities have been doing their Spring Earnings Reviews differently. This difference entails the handling of the portion of gas cost variations retained by a company's shareholders through the PGA sharing mechanism. Avista and Cascade have included the sharing as part of their Spring Earnings Review, and NW Natural has excluded the sharing.

Staff has investigated this discrepancy and based on this further review, we believe that NW Natural has been handling the sharing appropriately by making an adjustment that moves the shareholders' portion "below the line" for purposes of the Spring Earnings Reviews. This treatment is also consistent with the Commission's decision for the LDC to retain a portion of the PGA gas cost savings and absorb excess gas costs, as well as with the earnings review adjustment adopted by Appendix B of Order 99-272 to remove "non-operating items that were [improperly] recorded above the line." Accordingly, OPUC Staff would like all utilities to make this adjustment in future results of operations reports.

If you have any questions, please call Judy Johnson at 503-378-6636.

Ed Busch
Administrator
Electric & Natural Gas Division

Attachment B

To NW Natural's Petition for a Declaratory Ruling

March 26, 2009

Oregon
Theodore R. Kulongoski, Governor

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1-800-522-2404
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503-373-7394

February 5, 2009

To: UM 903 Participants

Staff of the Public Utility Commission of Oregon (OPUC) discovered an inconsistency in the treatment of certain costs by the three natural gas utilities for purposes of their Spring Earnings Reviews. This difference entails the handling of the portion of gas cost variations retained by a company's shareholders through the PGA sharing mechanism. Avista and Cascade have included the company's portion of the sharing in regulated operations, and NW Natural has made an adjustment to exclude this portion.

Staff investigated this discrepancy and sent out for parties' comments a draft position on this issue that sided with NW Natural. Subsequent to the letter, Commission Order 08-504 in Docket UM 1286 was issued. Staff's attorney, David Hatton, has concluded that he believes the Order is clear that the LDC's portion of gas cost sharing should be included "above the line" and therefore, NW Natural's treatment would be improper in future filings. Cascade and Avista have handled the issue correctly.

Specifically, page 14 of Order 08-504 states: "CUB states that Staff and NW Natural do not agree whether earnings related to gas costs are counted in an earnings review. Staff proposes to include the earnings; NW Natural proposes to exclude them. CUB agrees with Staff." Page 15 of the Order states: "CUB states that it shares Staff's view that commodity cost differences, positive or negative, retained by the company are properly accounted for in the company's earnings for purposes of the earnings review." Finally on page 18 of the Order, under Conclusions of Law, the order states: "CUB's proposal, as modified above, should be adopted." Because the Order did not modify this aspect of CUB's proposal, Staff's counsel advises that CUB's recommended treatment was adopted. Accordingly, all utilities should account for commodity cost differences, including the utility's share, above the line in future results of operations reports.

If you have any questions, please call Judy Johnson at 503-378-6636.

Ed Busch

Ed Busch
Administrator
Electric & Natural Gas Division