BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UG 221

In the Matter of NORTHWEST NATURAL GAS COMPANY, dba NW NATURAL, Request for a General Rate Revision	STAFF POST-HEARING REPLY BRIEF

I. INTRODUCTION

The Public Utility of Commission of Oregon Staff (Staff) takes this opportunity to file its post-hearing reply brief in this docket. In considering the remaining five contested issues,[1] Staff contends that it is important to consider the holistic nature of ratemaking and to explicitly consider these remaining contested issues in context of the overall regulatory structure in place for Northwest Natural Gas Company (NW Natural or Company).

This is NW Natural's first rate case in almost 10 years. After a long process, including numerous rounds of testimony and settlement conferences, it is understandable that the parties feel strongly about the remaining five contested issues. However, it is important to consider that most of the issues in this case were settled through two partial stipulations. NW Natural retains programs such as decoupling, the weather adjusted rate mechanism (WARM) and the system integrity program.

NW Natural's briefs understandably attempts to frame these issues in such a way as to make its position appear reasonable and supported. Instead of allowing the Company to frame the issues, Staff uses this brief to summarize the main points of its positions on the remaining

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[1] There is an additional issue that has been lost in the fray. In opening testimony, Staff recommended that the Commission terminate the current recovery of Industrial DSM expenses through deferred accounting and, instead, implement a permanent tariff rate through a balancing account. *See* Staff/1100; Sobhy/22; *see generally* Staff/1100; Sobhy/2, lines 9-11. In preparation for oral argument, Staff will attempt to resolve this issue with the parties.

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Telephone: (503) 947-4342 Fax: (503) 378-3784

contested issues while also commenting on some of the assertions in NW Natural's post-hearing brief.

II. DISCUSSION

COST OF CAPITAL

In testimony and previously filed briefs, Staff has provided detailed support and explanation for its position on an appropriate authorized return on equity (ROE). Instead of reiterating that information and those arguments here, Staff uses its reply brief to distill this issue to the core of what matters most in determining the appropriate ROE in this proceeding.

Arguments, analyses, and information used by both Staff and NW Natural fall into two categories: quantitative and qualitative.[2] Staff makes no explicit adjustment associated with qualitative information, while NW Natural incorporates material non-quantitative adjustments in supporting of its requested 10.0 percent ROE. Differences between the parties' value for the long-term growth rate of dividends for peer utilities to NW Natural, as used in each witnesses' multistage discounted cash flow (DCF) model/s,[3] counts for 30 basis points (0.3 percent) of the 60 basis point difference between the Company's requested 10.0 percent ROE and Staff's recommended 9.4 percent ROE.[4] Each party acknowledges as much,[5] with the various other differences essentially offsetting between the two parties' multistage DCF models. Each party uses one or (in the case of Staff) more estimates of the long-term growth rate in U.S. Gross Domestic Product (GDP) used as a proxy for the long-term dividend growth rate for the

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[2] *See*; e.g., NW Natural's reply brief at 3.

[3] Dr. Hadaway relies on one multistate DCF model and one long-term growth rate, while Mr. Storm relies on two multistage DCF models and uses three different long-term growth rates in each.

[4] There is a 30 basis point difference between the 9.7 percent estimated ROE resulting from Dr. Hadaway's multistage DCF model and Mr. Storm's 9.4 percent estimated ROE using the latter's multistage DCF models and the *highest* of Mr. Storm's three alternative rates of long-term dividend growth rate. *See;* e.g. Exhibits Staff/2201; NWN/3202; Hadaway/4.

[5] *See*; e.g., Exhibits NWN/2100; Hadaway/12 and Staff/2200; Storm/7.

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companies used as peer utilities to NW Natural by each witness.[6] The table below depicts relevant parameters and results of the Parties' multistage DCF models.[7]

Multistage DCF Model Parameters and Results

Witness / DCF Model	2018 - 2022 Average Dividend Growth Rate	Long-term Dividend Growth Rate	Average Adjustment for Capital Structure	Peer Utilities' Average ROE
Hadaway Multistage (two-stage)	5.70%	5.70%	0.00%	9.7%
Storm Multistage Model 1 (three-stage)	4.60%	4.51%	0.50%	8.8%
Storm Multistage Model 2 (three-stage)	4.60%	4.51%	0.50%	8.9%
Storm Multistage Model 1 (three-stage)	4.80%	4.83%	0.50%	9.1%
Storm Multistage Model 2 (three-stage)	4.80%	4.83%	0.50%	9.1%
Storm Multistage Model 1 (three-stage)	5.00%	5.14%	0.50%	9.3%
Storm Multistage Model 2 (three-stage)	5.00%	5.14%	0.50%	9.4%

Stage 2 in Staff's three-stage DCF models is a five-year transition period, beginning in 2018, from the growth rate implied by the dollar amounts of dividends in stage 1 to the long-term explicit growth rate used in stage 3. The stage 2 average growth rates in Staff's multistage DCF models vary because Mr. Storm uses different stage 3 growth rates; i.e., as the stage 1 dividends are identical in each Staff multistage DCF model and long-term growth rate combination, the stage 2 growth rates increase with an increase in the stage 3 (long-term) growth rate.

Dr. Hadaway's multistage DCF model has no "middle" stage over which near- and long-term growth rates converge; i.e., his long-term growth rate applies beginning in 2018.[8]

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[6] Staff explains why this approach results in a conservative estimate of ROE at Exhibit Staff/1300; Storm/62-Storm/63.

[7] Mr. Storm's multistage DCF models appear in Exhibit Staff/2201 of his rebuttal testimony and Dr. Hadaway's in Exhibit NWN/3202 of his surrebuttal testimony.

[8] *See*; e.g., Exhibit NWN/3202; Hadaway/4 columns 22 and 23 and Exhibit NWN/3202; Hadaway/6.

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As the ROE estimates from Mr. Storm's multistage DCF models using only the highest of the three long-term growth rates support Staff's recommended 9.4 percent ROE and ROE estimates from his multistage DCF models using either of the two lower growth rates support an ROE below 9.4 percent. Examining the 5.14 percent highest long-term growth rate used by Staff in rebuttal testimony vis-à-vis the 5.7 percent long-term dividend growth rate used by Dr. Hadaway in his multistage DCF model in both rebuttal and surrebuttal testimony provides additional relevant information. Staff notes that decomposing Mr. Storm's highest long-term growth rate of 5.14 percent used in rebuttal testimony into a growth rate in real economic activity and an inflation rate results in Staff's 2.96 percent value for the former, which is *higher* than the 2.62 percent rate embedded in Dr. Hadaway's 5.7 percent rate.[9] The two witnesses differ regarding long-term expected inflation, as measured by the GDP Price Deflator, and not the long-term rate of real economic growth.

Dr. Hadaway's 5.7 percent long-term growth rate embeds an average annual inflation rate of 3.0 percent.[10] Mr. Storm's 5.14 percent long-term growth rate incorporates an average annual inflation rate of 2.12 percent. Mr. Storm's 2.12 percent is an average of two estimates of long-term inflation: a 2.11 percent rate based on the average of forecasts *for the relevant timeframe* by four federal agencies and the Blue Chip Consensus and a 2.13 percent average estimate based on Mr. Storm's TIPS break-even rate methodology.

There are two things to note regarding Dr. Hadaway's 3.0 percent long-term inflation rate estimate: first, and most importantly, how 3.0 percent compares with published forecasts of the long-term inflation rate from credible institutions (four federal agencies plus Blue Chip) and as established by the financial markets (the GDP Price Deflator inflation rate derived from the TIPS break-even rate of inflation)[11] and, secondly, the timeframe to which his long-term inflation rate

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[9] *See* Exhibit Staff/2200; Storm/19 through Storm/22, including Table 4.

[10] *See* Exhibits NWN/2105; Hadaway/4 and Staff/2200; Storm/20.

[11] Mr. Storm discusses the TIPS break-even inflation rate methodology at Exhibit Staff/1300; Strom/60, line 1 through Storm/62, line 1, including footnotes and an update to this methodology at Exhibit Staff/2200; Storm/11, line 6 through Storm/12, including footnotes.

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applies in his multistage DCF model. Dr. Hadaway's inflation rate is 89 basis points above the former (and 60 basis points above the *highest* individual organization's forecast, the Social Security Administration's 2.4 percent) and 87 basis points above the latter.[12] These are large differences, and account for the large difference between Mr. Storm's highest long-term growth rate and Dr. Hadaway's 5.7 percent average annual long-term growth rate.

Dr. Hadaway's long-term dividend growth rate applies beginning in 2018 and Mr. Storm's long-term rate applies fully beginning in 2023. The Company's testimony negates the applicability of a high GDP growth rate in the near-term, including that "[m]ost economists are forecasting little to no growth until late this decade…"[13, 14] Dr. Hadaway's 5.7 percent long-term growth rate is insufficiently supported by the evidence and is much higher than the published forecasts made by multiple credible organizations. The use of such a high long-term growth rate, in either Dr. Hadaway's multistage or constant growth DCF models, results in estimated ROE values that are not reasonable and are inequitable.

Qualitative

NW Natural argued in Docket No. UG 132 that the Commission should consider an average of stock prices over a several month period and not base them on a particular day's stock price.[15] The Commission used a 10-day average stock price in Order No. 87-406 due to "wide fluctuations in the utility's stock price."[16] In the matter at hand, both Dr. Hadaway and Mr. Storm use stock price averages of three months,[17] eclipsing the time period of observation nine-

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[12] Exhibit Staff/2200; Storm/21.

[13] Exhibit NWN/200; Anderson/21, lines 4-6.

[14] Staff believes that reliance by the Company on this statement also serves to negate the 10.0 percent average (10.1 percent median) result of Dr. Hadaway's constant growth DCF model using his 5.7 percent long-term estimated GDP growth rate, as the rate applies to next year's dividends; i.e., beginning in 2013. *See* Exhibits NWN/500; Hadaway/26 lines 1-14, NWN/3202; Hadaway/1 and Hadaway/3, Staff/1300; Storm/72 line 2 through Storm/73, line 4, and Staff's post-hearing brief at 12, line 1 through 13, line 2.

[15] Order No. 99-697 at 15.

[16] Order No. 87-406, as cited at 15 of Order No. 99-697.

[17] *See* Exhibits NWN/500; Hadaway/33, lines 16-20; Staff/1300; Storm/58, lines 14-15, Staff/2200; Storm/17, lines 15-21, and NWN/3200; Hadaway/5, lines 1-3.

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fold as compared with the 10-day average stock price used by the Commission in Order No. 87-406 of Docket No. UT 43.[18] There is no evidence in the record of this proceeding regarding any "wide fluctuations" in the stock price of any company used as a peer utility by either Mr. Storm or Dr. Hadaway.

In this proceeding, the Company seeks to go well beyond using the average of stock prices over a period of several months, and requests that the Commission—in effect—impute a lower-than-market stock price for each of the peer utilities used by Dr. Hadaway and a resulting higher dividend yield due to "current, aberrant market conditions."[19] Essentially, NW Natural is requesting that the Commission authorize an ROE 30 basis points above the 9.7 percent estimated ROE result of Dr. Hadaway's multistage discounted cash flow analysis in his surrebuttal testimony.[20] Staff identifies this upward adjustment as an "outboard" adjustment.[21]

The Company not only asserts that Dr. Hadaway's peer utility stock prices are "too high" and resulting dividend yields "too low," both as a result of the U.S. government's monetary policies, but also asserts that the averages of stock prices of the peer utilities used by Dr. Hadaway and Mr. Storm do not accurately reflect investors' risk.[22, 23] Mr. Storm discusses both

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[18] It appears, based on the use of the singular "price" and "stock's price," that the 10-day average stock price used by the Commission in Docket No. UT 43 was for only one company.

[19] Exhibit NWN/2100; Hadaway/3 lines 4-6.

[20] Staff presumes this is Dr. Hadaway's "specific consideration for the unique market conditions that are concurrently affecting the [ROE] results [his ROE] models produce. *See* Exhibit NWN/2100; Hadaway/13, lines 7-8.

[21] *See*; e.g., Exhibits Staff/2200; Storm/3 lines 7-16; Staff/2200; Storm/8 lines 9-15; Staff/2200; Storm/10 lines 3-7; Staff/2200; Storm/25 line 14 through Storm/31, line 17; Staff/2200; Storm/14, line 14 through Storm/36, line 2l; and especially NWN/3200; Hadaway/10, lines 15-17: "[i]f the Commission concludes that current utility dividend yields are artificially depressed by government monetary policy, then *a more flexible view of growth rates would provide a reasonable balance* [emphasis added]. Dr. Hadaway's statement suggests a belief held by himself and the Company that, if the Commission views "current utility dividend yields" as "too low," one way in which the Commission might compensate for this is to use what Staff demonstrates in testimony is a "very high" rate of long-term dividend growth.

[22] *See*; e.g., Exhibits NWN/2100; Hadaway/3, lines 12-19, NWN/2100; Hadaway/6 line 14-Hadaway/8, line 14; NWN/2100; Hadaway/10, lines 5-17; NWN/2100; Hadaway/11, lines 17-26; NWN/2100 Hadaway/13, lines 13-15; NWN/2100; Hadaway/21, lines 3-7; NWN/3200; Hadaway/2, lines 7-8; NWN/3200; Hadaway/8, line 19 through Hadaway/9, line 20 (and especially lines 6-9 of the latter).

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assertions in his rebuttal testimony, indicates those points on which he either agrees or disagrees with Dr. Hadaway, establishes that the Company's "outboard" adjustment in Dr. Hadaway's rebuttal testimony reflects a belief that Dr. Hadaway's peer utilities' stock prices are about 22 percent "too high,"[24] and provides evidence that equity investors' risk aversion—relative to that at the time of the Company's filing—is not only lower, but has for most of 2012 through July 17th been below the average of the last 20-plus years.

The Commission has in earlier proceedings concluded that "[c]apital market conditions, not regulatory decisions, determine a utility's cost of equity."[25] Proceeding as the Company recommends goes to the extreme of *ignoring* capital market conditions and the valuations investors have placed on Dr. Hadaway's and Mr. Storm's peer utilities and substituting some other and lower valuations in determining the appropriate ROE for NW Natural as a result of this proceeding. Staff repeats the recommendation that the Commission exercise considerable caution if contemplating the use of valuations (and resulting dividend yields) other than those made by the market.[26] Staff also cautions against the use of a very high long-term dividend growth rate as some sort of "offset" for current market valuations of the companies used as peer utilities by Mr. Storm and Dr. Hadaway.

Staff's rebuttal testimony discusses the revenue results of NW Natural's decoupling mechanism in that the mechanism over-recovers revenue at the level of $748 thousand per year over the course of three years. Although Staff considers any adjustment the Commission makes to ROE in this proceeding associated with NW Natural's decoupling mechanism to be a

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[23] Both Dr. Hadaway's and Mr. Storm's peer utilities include NW Natural. A belief that the stock price of such utilities is "too high" appears hard to square with the Company's May 24, 2012 announcement that its board of directors extended the company's share repurchase program effective through May 31, 2013. Staff accessed the press release on September 18, 2012 at http://www.snl.com/Cache/1001166511.PDF?D=&O=PDF&IID=4057132&Y=&T=&FID=1001166511 .

[24] If prices must decline by 18 percent, this means they are 1.00/(1.00 – 0.18), or about 22 percent "too high."

[25] Order No. 01-787 at page 32.

[26] *See* Staff's post-hearing brief at 29.

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qualitative adjustment, Mr. Storm equates the level of over-recovery as equivalent to 10 basis points of ROE.[27]

Dr. Hadaway's 9.7 percent ROE result of his multistage DCF model provides for rates that are not fair and are unreasonable. The Company's requested 10.0 percent ROE resulting from an upward adjustment to this value provides for rates that are even less fair and more unreasonable.

<u>Discussion of Certain Facets of NW Natural's Posthearing Brief</u>

<u>Use of the "Constant Growth" Single-Stage DCF Model.</u>

The Commission has favored "use of the multi-stage DCF analysis over the single-stage DCF formula"[28] in prior proceedings, agreeing with "Staff and NW Natural that the multi-stage DCF improves on the implicit assumption in the single-stage DCF model that dividends grow indefinitely at the same rate,"[29] and concluding that "…parties' single-stage DCF analyses [as used in Docket No. UE 116] provide no information not already contained in their complex [multistage] DCF analyses."[30] The Commission cited a *NW Natural ROE witness in the Company's general rate case proceeding Docket No. UG 132*, noting the witness' explanation that "the multi-stage DCF assumes, more realistically, that there can be one rate of growth expected for the immediate future (next year), another rate of growth over a short-term period extending three to five years in the future, and finally, a stabilized "terminal" growth rate over the indefinite future."[31] In other words, the Commission expressed a preference for use of the multistage DCF over the constant growth DCF in a previous NW Natural general rate case proceeding as in doing so, *concurred with NW Natural's own ROE witness on this issue*. The expressed preference had, to Staff's reading of Order No 99-697, nothing to do with electric

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[27] Exhibit Staff/2200; Storm/4, including footnote 1. Staff discusses this analysis at Exhibit Staff/2200; Storm/42, line 8 through Storm/55, line 10.

[28] Order 01-787 at page 24.

[29] Order No. 99-697 at page 23.

[30] Order No. 01-787 at 24, *citing* Order No. 99-697 at page 23.

[31] Order No. 99-697 at page 9.

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utilities, restructuring of the electric industry, "industry stability," financial market instability, or instability in the natural gas utility business.

The Commission's reasoning, as reflected in the preceding, is sound. The multistage DCF model does improve upon the constant growth DCF model in that it uses different dividend growth rates in different stages, and this is more realistic than assuming a constant dividend growth rate in perpetuity, as does the constant growth DCF model. Staff notes in its post-hearing brief that Mr. Storm's testimony provides the two parameters necessary to calculate "Staff constant growth DCF results." Staff does not advocate for the Commission to consider these results, but notes that using the reasonable long-term dividend growth rates and the dividend yields in Staff's rebuttal testimony provides ROE values ranging from 8.4 percent to 9.5 percent.[32] Staff recommends the Commission give little weight to the results of Dr. Hadaway's constant growth DCF model.[33]

<u>Requested ROEs in Context.</u>

Regarding the comparability of the Company obtaining an ROE in settlement in Docket No. UG 152 at a level below the bottom of Dr. Hadaway's then "fair ROE range" and currently requesting an ROE "that is near the top of Dr. Hadaway's quantitative DCF range,"[34] Staff notes three things. Dr. Hadaway only has a quantitative DCF range if the Commission considers the results of his constant growth DCF model, to which Staff recommends the Commission give little weight. Furthermore, there is inadequate support in the record of this proceeding for Dr. Hadaway's use of a 5.7 percent long-term average annual dividend growth rate, the use of which provides every one of his DCF results exceeding 9.6 percent.[35]

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[32] Staff's post-hearing brief at 12.
[33] Exhibit Staff/1300; Storm/73, lines 3-4.
[34] NW Natural's post-hearing brief, citing in part Exhibit NWN/4322 at 3-4.
[35] See; e.g., Exhibits NWN/3202; Hadaway/3 and Hadaway/4.

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Staff Did Not Use Value Line's 5.65 Percent Growth Rate.

Staff discusses the Company's claim to this effect, made in its prehearing brief and repeated in its post-hearing brief, in Staff's post-hearing brief.[36]

Staff Improved its Methodologies:

The Company asserts in its posthearing brief that "Staff changed the methodology used to determine its long-term growth rate in rebuttal testimony" without explanation.[37] In reality Staff devoted over eight pages in rebuttal testimony to explaining changes in methodologies.[38] These included several changes in methodology related to calculation of a long-term growth rate based on history. As a result, the real GDP growth rate estimate increased by five (5) basis points from 2.91 percent in Staff's opening testimony[39] to 2.96 percent in Staff's rebuttal testimony.[40]

Dr. Hadaway's rebuttal testimony stimulated some of Mr. Storm's changes in methodologies in Staff's rebuttal testimony. As an example, Dr. Hadaway discussed what he considered to be a flaw in Mr. Storm's TIPS break-even inflation rate methodology.[41] Dr. Hadaway's "flaw" regards the differential liquidity between nominal Treasury bonds and TIPS. Mr. Storm researched the "flaw" identified by Dr. Hadaway, which resulted in Mr. Storm's discussion in Staff's rebuttal testimony.[42] Mr. Storm's research generated a question regarding historical relationship between the Consumer Price Index measure of inflation, used in calculating TIPS parameters and representing the "break-even" inflation rate, and inflation as measured by the GDP Price Deflator, which is used to convert real GDP to nominal GDP and vice-a-versa. Staff based its 2.44 percent estimated inflation rate[43] in opening testimony on direct application of the TIPS break-even rate methodology. This rate declined by 32 basis points

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[36] *See* NW Natural's Prehearing Brief at 8, lines 10-13; NW Natural's Post-Hearing Brief at 7; Staff's post-hearing brief at 13-15.
[37] NW Natural's post-hearing brief at 6.
[38] Exhibit Staff/2200; Storm/10 line 10 - Storm/18 line 9.
[39] Table 8 of Exhibit Staff/1300; Storm/62.
[40] Exhibit Staff/2200; Storm/14 line 7 though Storm/15.
[41] Exhibit NWN/2100; Hadaway/16, line 8 through Hadaway/17, line 9.
[42] Staff/2200; Storm/11, line 6 through Storm/12, line 12.
[43] Table 8 at Exhibit Staff/1300; Storm/62.

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to 2.12 percent in Staff's rebuttal testimony.[44] The 29 basis point net reduction in the historical growth rate from the 5.43 percent[45] in Staff's opening testimony to the 5.14 percent growth rate in Staff's rebuttal testimony is entirely due to use of a different methodology regarding estimating future inflation, which was stimulated by Dr. Hadaway's rebuttal testimony.[46]

Staff examines Dr. Hadaway's methodologies in both its opening and rebuttal testimonies, taking issue with multiple methodologies and ensuing ROE estimates. The most important for the purpose at hand is that Dr. Hadaway uses a very high 5.7 percent long-term dividend growth rate in his multistage (and one of his constant growth) DCF model. Staff notes that, in the 30-year period "since 1981, the number of times the annual rate of growth in nominal GDP exceeded 5.8 percent for three consecutive calendar years is four: 1985, 1989, 1990, and 2006 (out of 30 possible)."[47] Dr. Hadaway's 5.7 percent growth rate has insufficient support in the record of this proceeding and Staff recommends any consideration of Dr. Hadaway's DCF results based on the use of this growth rate be tempered accordingly.

Staff uses multiple and well-documented methodologies to estimate three different long-term dividend growth rates,[48] incorporating forecasts of nominal GDP growth for relevant timeframes made by multiple credible institutions. Staff recommends the Commission award NW Natural an ROE of 9.4 percent in this proceeding. The 9.4 percent is separate from and does not include Staff's recommended 10 basis point ROE reduction associated with NW Natural's decoupling mechanism.

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[44] *See*; e.g., Exhibit Staff/2200 Storm/20 line 1 through Storm/21, line 17. The average of 2.11 percent and 2.13 percent is 2.12 percent.

[45] The Company's post-hearing brief erroneously has it as 5.48 percent. See page 6 and the actual 5.43 percent historical rate in Table 9 at the Exhibit Staff/1300; Storm/64 location cited by the Company.

[46] See Exhibit NWN/2100; Hadaway/16 line 8 through Hadaway/17, line 9; *see also* Staff's Post-Hearing Brief at 6-7.

[47] Exhibit Staff/1300; Storm/74, line 14 through Storm/75, line 4. Dr. Hadaway used a 5.8 percent growth rate in his direct testimony.

[48] As used in Exhibits Staff/2200 – 2201.

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HEDGE LOSS

NW Natural states that Staff's criticisms of Company hedge analysis are unfounded.

Staff demonstrated that the Company did not address substantial risk in its approach to evaluating the hedge. NW Natural did not meet its fiduciary responsibilities to protect ratepayers from incremental hedging risk and cost. Staff discussed a lack of consideration of low cost and low risk alternatives to hedging. Staff has also noted that the hedging contract was not modified to preclude cost and risk beyond those levels incorporated within the Company's calculations. NW Natural appears to presume that the cost of any high-impact low-frequency outcomes should be entirely born by ratepayers. Staff disagrees.

NW Natural states that, "Mr. Muldoon was forced to admit that the Company's accounting for the Hedge was not inconsistent with FASB".

Actually, Mr. Muldoon stated that the Company was faced with multiple accounting choices and chose the least stringent methodologies, which minimally restricted the Company's actions with respect to hedging activity. Staff noted that the FASB had not ruled on various matters and that the Board has not endorsed the Company's position.

The Company's states that its hedging policy is prudent.

Both Mr. Muldoon and Mr. Feltz note that the Company's hedging policy has not materially changed since incurring the hedge loss. However, the hedging policy should be informed by the hedge loss experience to the benefit of both ratepayers and shareholders. The need for NW Natural to review its hedging policy is supported in Staff's testimony, including the testimony dealing with gaps in analytical process and documentation.

The undisputed facts are that NW Natural did not perform its own probabilistic, scenario and decision tree risk analysis.[49] Additionally, NW Natural did not retain a third party to perform such analysis. The Company did not address excess risk that entering into the hedge represented.

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[49] *See* Staff/2300; Muldoon/4, line 15 through Muldoon/15, line 15.

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Furthermore, Staff notes that NW Natural did consider low cost and low risk alternatives to hedging.[50]

NW Natural states in its post-hearing brief[51] that "[t]he Company requested and received approval from the Commission to enter into the interest rate swap." The Company overstates the Commission's approval. The Company was authorized to use a suite of powerful hedging tools provided it did analysis and was able to demonstrate how it utilized each of these tools prudently at the next rate case. NW Natural then asserts that it complied with all conditions set by the Commission for the use of these hedging tools. Staff's testimony demonstrates the opposite.[52]

NW Natural's surrebuttal testimony and prehearing brief frame the material decision point as taking place during the financial crisis of the last several months of 2008. NW Natural asserts that the Company had to be able to predict the outcome of the financial crisis before the Company could have perform due diligence with respect to review of its contemplated hedging contract. However, the Company fails to note that it had no mechanism by which to constrain losses from exceeding in excess of the maximum $5.6 million resulting from consideration only the range of outcomes cumulatively having a 95 percent likelihood of occurrence,, although it could have done so. Such mechanisms were necessary to actually make the Company indifferent to market movements. NW Natural failed to mitigate or eliminate risk that did not benefit ratepayers or shareholders.

NW Natural did not retain any outside legal or financial analytical assistance in structuring this first hedge contract in spite of having the opportunity to do so. The Company has obtained outside help in addressing other complex financial matters as demonstrated in Mr. White's testimony.[53]

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[50] *See* Staff Post-hearing Brief at 31, lines 11-16.
[51] *See* NWN Post-Hearing Brief at 7.
[52] *See* Staff Post-Hearing Brief at 32, lines 1-33; *see also* Order No. 0-032 Appendix A at 1-2.
[53] *See* NWN/2700; White/5, lines 19-22; NWN/2701.

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Without signaling a need for improvement in these areas, through a disallowance of some portion of the hedge loss, the Commission may see similar imperfections with respect to NW Natural's hedging activities in future proceedings. The shareholders and ratepayers should share the hedge loss. While equal sharing of the entire hedge loss is not unreasonable and would result in a 5.549 percent cost of long term debt, Staff recommends that the Commission require NN Natural shareholders to bear a more modest $2,248 thousand which represents approximately 22.3 percent of the actual hedge loss of $10,096,000 and an estimated $222,000 reduction in annual revenue requirement. This amount represents one-half of that portion of the hedge loss exceeding $5,600 thousand, which was the maximum loss the Company now calculates as 95 percent confidence band of most likely hedge results as of the time the Company entered into the hedge contract.[54] Staff intends its proposed sharing to incent the Company to improve its hedging policy and practices.

ENVIRONMENTAL COST RECOVERY

In order to put the request for a Site Remediation Recovery Mechanism (SRRM) in context, we need to consider the alternative ratemaking treatment that would be more typical. NW Natural already has a deferred balance of more than 64.5 million. As stated in testimony and previous briefs, that balance is subject to an earnings and prudence review. Within those normal parameters of deferred accounting, Staff supports amortization of that deferred account because the balance is large and growing because of compounding interest.

NW Natural conservatively estimates that it will incur $58 million in future expenses over a long, but indeterminate, period of time. Under normal circumstances, a regulated utility would file a general rate case or deferred account for such future expenses if it cannot absorb them. In either of those circumstances, the Company would have some risk of regulatory lag and would always have the risk that overall earnings would be reviewed.

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[54] NW Natural's post-hearing brief at 9.

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Instead of these traditional ratemaking means, NW Natural requests that the Commission establish an automatic adjustment clause in which it would receive over time dollar-for-dollar recovery with no review of earnings, with interest accruing at its authorized rate of return. Considering that NW Natural already has more risk-reducing mechanisms than other regulated utilities, such as the system integrity program, decoupling and WARM, Staff believed they were generous to support yet another risk-reducing mechanism that would be beneficial to NW Natural shareholders.

In order to support such a mechanism, Staff stated that there would have to be sharing, a lower interest rate to reflect the lower risk, and an earnings review when future costs were incurred. Apparently and to the surprise of Staff, the Company found these conditions to be punitive and unfair for reasons such as they would not allow the Company to over earn in the future.

Without appropriate conditions, Staff does not support the SRRM. Compared to the alterative of more traditional regulation, Staff views its support of the SRRM with conditions to be generous to the Company. Staff and the Company obviously have a disagreement when it comes to the fairness of risk-reducing automatic adjustment clauses.

In addition to Staff's recommended conditions to the SRRM, Staff notes that the Company summarily states that the plain language of the statute allows NW Natural to move $64.5 million from a deferred account to an automatic adjustment clause without the legally required earnings review. NW Natural offers no textual or other support for this claim. Staff acknowledges that the Commission has the authority to grant NW Natural an automatic adjustment clause. While the Commission has discretion to determine what, if any, conditions should apply to such a mechanism, it does not have the ability to ignore the legal requirements of deferred accounting and the currently deferred environmental remediation costs must be subject to an earnings review before they can be moved to an automatic adjustment clause.

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As Staff noted in its post-hearing brief, Commission decisions in other dockets are irrelevant here because they were made in different contexts and none of them involved the granting of an automatic adjustment clause. The Commission should ignore NW Natural's attempt to distract and frame the issue around the recovery of prudently incurred costs. Context matters and this issue is about the recovery of prudently incurred costs through a risk-reducing automatic adjustment clause, for a Company that already has many such mechanisms.

PENSIONS AND STATE TAXES

NW Natural has attempted to make these issues revolve around an argument related to punishment for past excessive earnings and unfairness that it does not get to recover past expenses. Although Staff has noted that NW Natural had often earned at or over its authorized ROE, the fundamental issue is that these are NW Natural-selected single issues from a past period. Typical ratemaking does not allow for selectively picking single issues from a past period (colloquially referred to as "cherry-picking") and asking for a recovery in a future period. NW Natural chose not to address these issues during the periods where the expenses were incurred because normal ratemaking would have considered overall earnings. Regardless of what NW Natural's earnings were in the past, it should not be able to self-select a few expense categories where expenses were higher than included in rates and ignore expense categories where actual expenses were lower than were included in rates. The issue is not whether or not to punish NW Natural for excessive past earnings. Rather, the issue is fundamental ratemaking and that utilities should not be able to cherry-pick past expenses, ignore other changes in expenses, and ask for future recovery at a later time. It completely ignores that ratemaking is holistic and overall results driven, not a line-by-line true up of past rate case estimates of specific expense categories.

In spite of NW Natural's distortion of the issue, Staff does not argue that the Commission is bound by FASB 87 going-forward. Ratemaking drives accounting, accounting does not drive ratemaking. However, Staff notes that the Commission has a long history of calculating pension

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expense according to FASB 87 and that there is no persuasive reason to change that policy in this proceeding. If a policy change is made on a going-forward basis, it should be to reflect future estimates of pension expenses and not to capture past expenditures. Furthermore, Staff has argued that if the Commission changed that long-standing precedent in this proceeding, it would impact other utilities and that the record in this proceeding does not provide a context for that overall impact.

As Staff discussed in its post-hearing brief, it is inappropriate to rely on other state commissions actions regarding pensions because it ignores the context of why other commission's made those decisions. For example, states may have different regulatory constructs than Oregon or the inclusion of pension contributions may be part of a settlement of numerous issues. Again, Staff does not assert that the Commission cannot change its pension policy from FASB 87, it asserts that the Commission should not do so. As related to past pension contributions, Staff argues it is inappropriate to include single item expenses from a past period.

PREMATURELY CONSTRUCTED MID-WILLAMETTE FEEDER PROJECTS

The Company obfuscates the core issue. When simmered down to its core, the issue is that NW Natural did not support the prudence of these two segments of the project either through the Integrated Resource Plan (IRP) process or through any quantitative analysis. Instead, NW Natural offers qualitative assertions to support the prudence of the projects.

It is possible that construction of these projects could be the least cost/least risk alternative. However, based upon the record provided by NW Natural there is no way to know if this is in fact the case because it was not selected in the IRP nor did NW Natural support the construction of a multimillion dollar project with any cost/benefit analysis.

Aside from the histrionics, this issue is very basic. In order to recover from ratepayers, a regulated utility has a burden of demonstrating through the IRP process and quantitative analysis that a project is the least cost/least risk alternative for the appropriate time period. Based upon

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the evidence supplied, we do not know the answer to this question. As a result, Staff believes that the Commission should decline to include these projects in ratebase until such a time as NW Natural can support their inclusion based upon the results of IRP analysis and quantitative cost/benefit analysis.

III. CONCLUSION

For the foregoing reasons, Staff respectfully requests that the Commission consider the five contested issues in the context of the stipulated issues and order that:

- ROE be set at 9.4 percent;
- a ten basis point reduction to ROE be adopted recognizing the earnings-enhancing structure of the decoupling mechanism given its parameters;
- shareholders share $2.248 million of the $10.096 million hedge loss, resulting in a 6.007 percent cost of long term debt;
- the SRRM is approved only with reasonable conditions;
- the currently deferred environmental remediation costs are subject to an earnings review;
- past pension and state tax expenses/regulatory assets are not recoverable in future rates;
- continue to employ FASB 87 for estimating pensions costs;
- disallow the two contested segments of the mid-willamette valley feeder projects as imprudent.

DATED this _____ day of September 2012.

Respectfully submitted,

s/Jason W. Jones_______________
Jason W. Jones, #00059
Assistant Attorney General
Of Attorneys for the Public Utility Commission of Oregon Staff

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784