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VIA ELECTRONIC FILING AND FIRST CLASS MAIL

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Public Utility Commission of Oregon
PO Box 2148
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Re: Docket UG 221 – Northwest Natural Gas Company Application for a General Rate Revision

Attention Filing Center:

Enclosed for filing in the above captioned docket are an original and five copies of Northwest Natural's Reply Brief. A copy of this filing has been served on all parties to this proceeding as indicated on the enclosed Certificate of Service.

Please contact this office with any questions.

Very truly yours,

Wendy McIndoo
Office Manager

Enclosure

cc: Service List

BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

UG 221

In the Matter of

NORTHWEST NATURAL GAS COMPANY

Application for a General Rate Revision.

NW NATURAL'S

REPLY BRIEF

September 19, 2012

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I. INTRODUCTION

Pursuant to Administrative Law Judge (ALJ) Lisa Hardie's Ruling on March 12, 2012, Northwest Natural Gas Company ("NW Natural" or the "Company") submits this Reply Brief to the Public Utility Commission of Oregon ("Commission"). This brief responds to the posthearing briefs filed by Commission Staff ("Staff"), the Citizens' Utility Board of Oregon (CUB), and the Northwest Industrial Gas Users (NWIGU) on September 12, 2012.

II. DISCUSSION

A. The Company's Proposals in this Case Will Result in Just and Reasonable Rates.

Throughout their posthearing briefs, Staff and CUB exhort the Commission to, when setting rates in this docket, consider the "holistic nature of ratemaking in determining what is fair, just and reasonable."[1] On its face, this advice seems to be inarguable. However, after reading these parties' briefs, it is clear that what they are really advising the Commission to do is to consider the Company's past "overearnings," and to disallow legitimate current and future costs to even the score. In so doing, the parties not only significantly exaggerate the Company's past earnings, but also invite the Commission to engage in improper and illegal retroactive ratemaking.

Staff states that "it is imperative to consider . . . the end result when deciding these remaining five issues [in the case]," noting "that between rate cases NW Natural had actually improved earnings even in a depressed economy."[2] More explicitly, Staff encourages the Commission to reject the Company's proposed recovery of environmental remediation expenses, pension contributions, and deferred taxes based on the Company's past earnings.[3] CUB joins in Staff's recommendations, arguing that the Company should not recover pension contributions, environmental remediation expenses, and deferred taxes because of the

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[1] Staff's Post-Hearing Brief at 3; CUB's Opening Brief at 3.
[2] Staff's Post-Hearing Brief at 2.
[3] *Id.* at 37 (environmental remediation expenses); *Id.*at 42 (pension contributions); *Id.* at 44 (deferred taxes).

Company's past earnings,[4] as does NWIGU with respect to environmental remediation expenses.[5]

The parties' proposals to disallow future expenses based on past returns is inappropriate and unlawful. First, the parties are proposing to set future rates lower to account for past profits—which is the essence of retroactive ratemaking. Second, Oregon law mandates that rates are "fair and reasonable if the rates provide adequate revenue both for *operating expenses*. . . and for capital costs."[6] Many of the parties' proposals would deprive the Company of adequate revenue to cover its operating expenses and should therefore be rejected.

CUB also argues that the Company is "trying in this docket to ensure that a regulatory structure that preserves structural over-earning remains intact."[7] CUB's assertion is simply not rooted in facts. Even if the Commission approves all of the Company's proposals, taking into account the issues settled to date, the Company is assured of lower earnings and will have less opportunity for "overearning" going forward. The Company is requesting a lower return on equity (ROE) than its currently-authorized ROE and has agreed to an embedded cost of debt that is about 100 basis points lower than currently authorized. Moreover, the Company has agreed to a full-time employee equivalent level in rates lower than the level it expects to be in place by the rate effective date. The Company will also be investing in rate base items, such as the Corvallis Loop, that will not be complete in time to be included in this case, but will be completed shortly after rates go into effect.[8] These elements all indicate that the Company's ability to overearn, which was already exaggerated by the parties as explained in the

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[4] CUB's Opening Brief at 14 (pension contributions); *Id.*at 31 (environmental remediation expenses); *Id.*at 47 (deferred taxes).
[5] NWIGU's Initial Post-Hearing Brief at 9.
[6] ORS 756.040(1) (emphasis added).
[7] CUB's Opening Brief at 1.
[8] NWN/600, Yoshihara/2, lines 9-12; NWIGU-CUB Exhibit /303 (indicating that the Corvallis Loop has been rescheduled to 2013).

Company's Posthearing Brief, will be reduced or even eliminated after rates are set in this case.[9]

Finally, CUB argues that the Commission should consider decoupling, the Weather Adjusted Rate Mechanism, the System Integrity Program, and the Company's use of storage in setting the Company's cost of capital.[10] CUB did not put on a cost of capital witness to provide evidence about whether these mechanisms make NW Natural less risky than comparable utilities and to quantify any risk reduction. For example, the Company demonstrated that the parties' ROE recommendations already account for the decoupling mechanism and any further adjustment would be unreasonable.[11] CUB's recommendation is not supported by facts in the record and should be rejected.

In fact, a holistic view of the Company's overall request in this case demonstrates that the Company's request will result in fair, just, and reasonable rates. In this case—the Company's first request for a general rate increase since 2003—the Company is proposing a revenue requirement increase of $35.9 million, which amounts to a 5.1 percent increase in base rates.[12] However, the request represents a much smaller increase to current rate levels paid by customers because around $15 million of the $35.9 million is required to reflect in base rates the appropriate use-per-customer actually experienced by the Company pursuant to the decoupling

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[9] CUB argues that the Company has four opportunities to earn on storage, although it is not clear what point CUB is making with this argument. CUB's Opening Brief at 3-4. In any event, the first opportunity referenced by CUB is that the Company can earn a return on storage investments included in rate base. This is not a special opportunity related to storage—utilities are generally allowed to earn a return on rate base. The second and third of the opportunities CUB cites reference the same issue—that the PGA allows the Company to retain a certain amount of gas cost savings. The Company notes that the PGA mechanism adopted by the Commission was the one proposed by CUB. *Re Pub. Util. Comm'n of Or. 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). Finally, the fourth instance CUB cites is that NW Natural shares with customers revenues from its optimization of storage assets in rate base. This subject is, per the forthcoming Second Partial Stipulation, to be reviewed in a separate proceeding outside of this case.

[10] CUB's Opening Brief at 3-4.

[11] NWN/3200, Hadaway/7, lines 11-18.

[12] NWN/1800, Anderson/2, lines 18-21.

mechanism the parties have agreed should continue.[13] To be clear, customers are already paying this $15 million in their bills; this amount would simply be moved to base rates.[14] And, because use-per-customer values are being updated in this case, there is no decoupling deferral to be collected from customers on a forecast basis. Combined with the Company's recent Purchased Gas Adjustment (PGA) filing, which reflected about an eight percent decrease to rates that will go into effect on November 1, 2012,[15] customers will experience an overall significant *decrease* to their existing bills if NW Natural's proposed revenue requirement is adopted in this case. To be clear, NW Natural is not arguing that the Commission should approve a base rate increase *because* of the concurrent PGA-related decrease. Rather, the Company points out these facts because they shows that Staff's view that a "holistic" view of NW Natural's rates should result in the Commission denying NW Natural's request are unsupported.

Moreover, the Company has provided evidence that rates set in this case will reflect the Company's significant cost saving efforts since the last case.[16] The Company demonstrated that, absent the Company's cost saving efforts, operations and maintenance (O&M) expenses would be tens of millions of dollars higher than they are in this case.[17] The Company also showed that its O&M expense level per customer is lower than the average for other utilities.[18] The record in this case shows that over the past decade, the Company has taken specific and effective efforts to keep costs down, even despite the economic turmoil of recent years, and that customers will benefit from these efforts when rates are reset.[19]

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[13] NWN/1800, Anderson/2, lines 1-12. *See* CUB's Opening Brief at 4 (decoupling "subject to some tweaks, will continue after this rate case.")
[14] NWN/1800, Anderson/2, lines 6-9.
[15] *See NW Natural Annual Purchased Gas Cost and Technical Rate Adjustments*, Docket UG 239, Initial Filing (Aug. 31, 2012).
[16] NWN/200, Anderson/3-18.
[17] NWN/700, Sohl/10, lines 1-6.
[18] *Id.* at 11, line 4-Sohl/12, line 2.
[19] NWIGU's implication that the Company has not looked for "opportunities to cut costs . . . rather than to simply request more money from its customers in this economic climate" is undermined by the
(continued...)

Thus, viewed holistically, the rate increase requested by the Company is quite modest, and will result in fair and reasonable rates.

B. The Company's Request of a 10.0 Percent Return on Equity Should Be Granted.[20]

The Commission has established a clear framework for setting ROE. As the Commission has stated, the "determination of the cost of equity is not an exact science."[21] Instead, the Commission has recognized that its "job is to sift through the information presented, and determine a reasonable cost of equity."[22] The Company used this conceptual framework to address ROE in its prehearing and opening briefs, distilling the differences between the Company's 10.0 percent ROE request and Staff's 9.4 percent position to the essential points, including the overall reasonableness of the respective recommendations.

In summary, the Company demonstrated that: (1) a 10.0 percent ROE in the upper end of the discounted cash flow (DCF) range established in the Company's direct and updated filings is appropriate given the current limitations of traditional cost of equity estimation models in the aftermath of the prolonged recession and government intervention to artificially depress interest rates; (2) Dr. Hadaway's DCF analysis is more complete than Staff's and his growth rates are more reasonable; and (3) NW Natural's requested ROE of 10.0 percent is supported by average allowed ROEs awarded in other commissions and Company-specific business risks articulated by NW Natural's Chief Financial Officer David Anderson.

Divorced from pages of technical detail and considered in the larger context, it is apparent that Staff's 9.4 percent ROE recommendation is unreasonably low. In response, Staff

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demonstrated cost cutting efforts set forth in the Company's testimony. *See* NWIGU's Initial Post-Hearing Brief at 1.

[20] The heading to the return on equity section in the Company's Posthearing contains a typographical error and mistakenly refers to the Company's request for a 10.2 percent ROE instead of the 10.0 percent ROE NW Natural is currently requesting.

[21] *Re PacifiCorp's Proposal to Restructure and Reprice its Services in Accordance with the Provisions of SB 1149*, Docket UE 116, Order No. 01-787 at 33 (Sept. 7, 2001) [hereinafter Order No. 01-787].

[22] *Id.*

has returned to the micro-level in its Post-Hearing Brief, with 25 pages on ROE that reads more like an additional (and improper) round of technical testimony, than a posthearing brief. In all of these pages, however, Staff never fully addresses the key problems in Staff's case: why Staff failed to meaningfully consider the impact of current, post-recession capital market conditions on traditional cost of equity modeling; why Staff completely changed and reduced its long-term growth rates between its opening and rebuttal testimony; and why Staff ignored the upward movement of average allowed ROEs between the first and second quarter of 2012 and recommended an ROE so much lower than current, average allowed ROEs. CUB and NWIGU support Staff's ROE recommendation in their posthearing briefs, but offer no new substantive arguments in support of this position.

1. Staff's ROE Recommendation Does Not Give Sufficient Consideration to the Current Economic Context.

The Commission has previously recognized that "[c]apital market conditions ...determine a utility's cost of equity," and stressed the importance of "an independent analysis of current market conditions and how they affect the particular utility."[23] NW Natural has demonstrated that current capital market conditions warrant an ROE at the top of the quantitative range in this case. The government's ongoing efforts to hold interest rates at record low levels have created an artificial supply and demand relationship in the capital markets. While these efforts have been successful in reducing borrowing costs, they have not had an equal effect in mitigating equity market risks, a fact that traditional cost of equity models do not capture.[24]

The "yield-plus-growth" DCF format is not equipped to deal with current, unusual market conditions. For perspective, the closing yield on the 30-year U.S. Treasury Bond for July 25, 2012, at 2.46 percent, was the lowest close *ever* for the 30-year Treasury Bond, including

[23] *Re Portland General Electric Co.*, Docket UE 115, Order No. 01-777 at 34 (August 31, 2001) [hereinafter Order No. 01-777].

[24] NWN/2100, Hadaway/3, lines 12-16.

during the deep financial crisis in 2008.[25] This result is driven directly by the Federal Reserve System's announced plan to keep interest rates at historically low levels through at least year-end.[26] Such efforts reflect serious economic problems, and they do not mitigate equity market risks.

In this environment, it is not appropriate for Staff to mechanically apply traditional, technical ROE estimates. Such estimates significantly understate the cost of equity capital and should not be the basis for reducing NW Natural's requested ROE.[27] CUB argues that the Company's position is perplexing, implying that low interest rates and low dividend yields automatically equate to lower cost of equity capital.[28] NWIGU similarly supports Staff's position on the basis that the "cost of money" is at an historic low.[29] These views, however, ignore the fact that government monetary policy, not reduced equity market risk, has driven rates and yields downward. Risk and volatility remain high in the post-recession equity markets, and contrary to CUB's and NWIGU's arguments, the cost of equity has not moved downward in lock-step with interest rates and dividend yields.

Mr. Storm's failure to account for current market conditions can be best seen in his mid-case changes to his "Multistage DCF 2" model, also referred to in his workpapers as the "Three-stage Discounted Dividend Model with Terminal Valuation based on P/E ratio" model (P/E

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[25] NWN/3200, Hadaway/2, lines 3-6. During the worst of the financial crisis in December 2008, driven by the "flight to safety" market environment, the 30-year Treasury Bond yield declined to 2.69 percent. *Id.*
[26] *Id.* at lines 6-7. On June 20, 2012, the Fed announced that it is extending "Operation Twist" to the end of the year. In its review of that announcement, Bloomberg offered the following assessment: "The Federal Reserve will expand its Operation Twist program to extend the maturities of assets on its balance sheet and said it stands ready to take further action to put unemployed Americans back to work. The central bank will prolong the program through the end of the year, selling $267 billion of shorter-term securities and buying the same amount of longer-term debt in a bid to reduce borrowing costs and spur the economy." (Bloomberg.com, Fed Expands Operation Twist By $267 Billion Through 2012, Jun 20, 2012; *available at* http://www.bloomberg.com/news/2012-06-20/fed-expands-operation-twist-by-267-billion-through-year-end.html (last visited Sept. 19, 2012).
[27] NWN/3200, Hadaway/2, lines 9-12.
[28] CUB's Opening Brief at 6.
[29] NWIGU's Initial Post-Hearing Brief at 5.

Model).[30] In Mr. Storm's direct testimony, this model presented a 30-year analysis. In his rebuttal testimony, he stretched the analysis out 10 more years, to 2052. Lengthening the model, as Mr. Storm did, lowers the results.[31] Adding 10 more years to the analysis decreases the ROE results by about 10 basis points.[32] To demonstrate how Staff's approach improperly magnified current, distorted market conditions, Dr. Hadaway prepared an alternative study and shortened the analysis, supplying 2016 as the final or terminal year in the P/E model.

Dr. Hadaway's alternative P/E model produces a median ROE of 10.6 percent. The P/E version of the DCF model more accurately captures the cost of equity in current market conditions than traditional models because it directly reflects the "bid-up" utility stock prices that have resulted from the government's ongoing market intervention.[33] In this sense, the P/E based DCF model serves to balance the lower results that come from the traditional "yield plus growth" DCF approach. While Mr. Storm's 40-year P/E approach pushes higher utility stock valuations so far out that they have little effect, the near-term P/E based model reflects current, relatively high utility stock valuations directly and should be considered as a balancing influence relative to the extremely low DCF results produced by traditional approaches.[34]

Staff's testimony and briefs hardly mention post-recession market conditions and completely ignore their impact on traditional cost of equity models. While Staff's Prehearing Brief claims that Mr. Storm did consider "current market conditions," Staff's citations are primarily to Staff's use of current stock prices and dividends.[35] Staff "agree[s] uncertainty exists and investors are widely believed to be risk adverse,"[36] but Staff did not independently analyze

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[30] NWN/3200, Hadaway/5, lines 11-15.
[31] This analysis is shown in Exhibit NWN/3203.
[32] NWN/3200, Hadaway/5, lines 21-22. For Staff's Peer Utilities, the group average ROE (adjusted for divergent capital structures) changes from 9.0 percent to 8.9 percent. For NW Natural's Peer Utilities, the average ROE changes from 8.8 percent to 8.7 percent. *Id.* at 5, line 22-6, line 2.
[33] NWN/3200, Hadaway/6, lines 18-21.
[34] *Id.* at 7, lines 1-7.
[35] Staff's Post-Hearing Brief at 19, n.81.
[36] Staff/1300, Storm/80, lines 14-15.

whether traditional cost of equity models, driven by artificially suppressed interest rates, adequately capture this equity market uncertainty and risk.

Instead of directly reviewing this question, Staff simplistically points to the Chicago Board Option Exchange Volatility Index (VIX) to demonstrate that investors are less risk adverse than they were in the past.[37] This index measure traders' estimates of future volatility. During the course of this case, the VIX index has fluctuated widely, depending on whether the stock market is up or down at a particular time,[38] proving the fundamental instability of current capital markets, not the opposite.

2. The Company Properly Considered a Range of Models, Including the Constant Growth DCF Model, in Support of its 10.0 ROE Request.

Staff continues to argue against any consideration of Dr. Hadaway's constant growth DCF method on the basis that the Commission rejected this model in Dockets UE 115 and UE 116.[39] CUB endorses this argument.[40] Staff and CUB fail to acknowledge that the Commission specifically allowed for future use of the constant growth DCF model in those cases. Additionally, in the most recent cost of capital case litigated before the Commission, Dockets UE 180/UE 181/UE 184, the Commission accepted an ROE recommendation based partially on the constant growth DCF method. In that case, the Commission noted with approval that the results of different estimation models (including the constant growth DCF model) were cross-checked against each other.[41] Here, Dr. Hadaway employed this multiple-model approach, while Staff used only a single cost of equity estimation model.

After erroneously arguing against consideration of Dr. Hadaway's constant growth model, Staff and CUB compound the error by again claiming that Dr. Hadaway made an "outboard" adjustment of 30 basis points to support the Company's 10.0 percent ROE request.

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[37] Staff's Post-Hearing Brief at 27.
[38] NWN/2100, Hadaway/8.
[39] Order No. 01-787; Order No. 01-777.
[40] CUB's Opening Brief at 5.
[41] Order No. 01-777 at 47.

Staff's and CUB's claim that the Company's ROE request lacks quantitative support is based solely upon their incorrect, categorical rejection of the Company's constant growth DCF modeling, which produced ROEs of 10.3 percent and 10.1 percent, respectively, in the Company's original and updated analysis.

3. The Company's Long-Term Growth Rate is More Consistent and Reasonable than Staff's.

Staff indirectly acknowledges the reasonableness of NW Natural's DCF analysis by arguing that the only material difference between the Company's approach and Staff's is the long-term growth rate used in the models.[42]

As summarized in the Company's Prehearing Brief, Dr. Hadaway relies on a nominal (real growth plus inflation) gross domestic product (GDP) growth rate of 5.8 percent in his direct testimony and 5.7 percent in his updated analysis, reflecting the addition of 2011 data.[43] Dr. Hadaway estimated his long-term GDP growth rate using historical nominal GDP data for the period 1950 to 2010, giving more weight to recent data.[44] Dr. Hadaway's use of weighted, long-term historical data for his forecast growth rate is consistent with the derivation of most econometric forecasts.[45]

In contrast, Staff has proposed six different long-term growth rates in this case, three in its direct case (ranging from 4.91 percent to 5.8 percent, with an average of 5.4 percent), and three in its rebuttal case (ranging from 4.51 percent to 5.14 percent, with an average of 4.83 percent).[46] Staff claims that it made the methodological changes significantly reducing its GDP growth rates in its rebuttal testimony after reviewing Dr. Hadaway's reply testimony.[47] Because Dr. Hadaway's long-term growth rate methodology did not change in his reply testimony,

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[42] Staff's Post-Hearing Brief at 5.
[43] NW Natural's Pre-Hearing Brief at 7.
[44] NWN/500, Hadaway/35, lines 12-14.
[45] *Id.* at 36, lines 3-5.
[46] Staff's Post-Hearing Brief at 16.
[47] *Id.*

however, this explanation is questionable. Nor can Staff's major reduction to its long-term growth rates be considered an "update" since the rates are, by definition, long term and subject to small year-to-year changes only. It appears that, as a matter of litigation strategy, Staff simply changed its approach mid-way through this case to produce lower long-term growth rates.

Staff's growth rates are based on current government growth forecasts, which are unreasonably low when used to project long-term growth because they assume permanently low inflation rates.[48] The government forecasts are depressed by the worst economic recession since the Great Depression of the 1930s. Blue Chip Consensus data simply repeats the government forecasts, which are based on an inflation rate of about two percent.[49] This low level of inflation is not consistent with historical experience or with the stimulative monetary policies that the government is pursuing. Dr. Hadaway's data demonstrates that, in all but the most recent periods, periodic average inflation rates have been over three percent.[50] Even during the most recent recession, inflation rates have fluctuated to this range: in 2009, inflation was 2.8 percent; in 2007, inflation was over four percent.[51]

In any event, by channeling the debate solely toward growth rates, Mr. Storm would have the Commission effectively ignore all other factors. For example, by accepting current, historically low utility dividend yields (about 4.3-4.4 percent) without any consideration for the forces causing these low yields, Mr. Storm mechanically argues for a very low ROE.[52] Because current utility dividend yields are artificially depressed by government monetary policy, a more flexible view of growth rates is necessary to provide a reasonable balance.[53] With a dividend yield of 4.4 percent, growth rates of 5.2 percent to 5.7 percent produce a DCF range of 9.6

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[48] NWN/500, Hadaway/36, lines 9-12.
[49] NWN/3200, Hadaway/8, lines 9-14.
[50] NWN/503, Hadaway/1.
[51] NWN/500, Hadaway/36, lines 9-19.
[52] NWN/3200, Hadaway/10, lines 10-12.
[53] *Id.* at lines 15-17.

percent to 10.1 percent (9.6% = 4.4% yield + 5.2% growth; 10.1% = 4.4% + 5.7%).[54] With the 5.43 percent growth rate used by Mr. Storm in his initial testimony, a dividend yield of 4.4 percent would provide an ROE estimate of 9.8 percent (9.83% = 4.4% + 5.43%).[55] These examples illustrate the sensitivity of DCF results to dividend yield and growth rate levels.[56]

Staff devotes several pages of its Opening Brief to discussing how Mr. Storm used Value Line data in his DCF modeling in this case. In the end, Staff acknowledges that Mr. Storm's models used Value Line average earnings per share growth rates of 5.4 percent and 5.7 percent, as compared to Dr. Hadaway's Value Line average growth rate of 5.65 percent and his long-term growth rate of 5.7 percent. Staff leaves it to the "[v]iewers . . . [to] assess the similarity" of these growth rates.[57] The similarity the Value Line analyst growth forecasts to Dr. Hadaway's long-term growth rate is additional evidence of the reasonableness of Dr. Hadaway's long-term growth rate.

4. Average Allowed ROEs from Other Jurisdictions Support the Company's ROE Request and Undermine Staff's Position.

In Order No. 01-777, the Commission noted that "other ROE determinations may provide confirmation of a decision."[58] In Order No. 07-015, the Commission affirmed that rates authorized in other jurisdictions may be used to "gauge the reasonableness of [the Commission's] decision.[59] Here a review of average allowed ROEs confirms that the Company's ROE request of 10.0 percent is more reasonable than Staff's 9.4 percent recommendation. The average allowed ROE for LDCs in 2011 was 9.92 percent, and the six-month 2012 average is 9.75 percent.[60]

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[54] *Id.* at lines 17-19.
[55] *Id.* at 10, line 20-Hadaway/11, line 1.
[56] *Id.* at 11, lines 1-2.
[57] Staff Opening Brief at 14.
[58] Order No. 01-777 at 34.
[59] *Re Portland General Electric Company*, Docket UE 180/ UE 181/UE 184, Order No. 07-015 at 47 (Jan. 12, 2007).
[60] NWN/3200, Hadaway/4, lines 3-11.

Mr. Storm acknowledges that his estimated ROE is low compared with regulated utilities' authorized ROEs "in some prior periods."[61] In fact, as shown in the historical returns set forth in Exhibit Staff/1305, Storm/2, Mr. Storm's estimated ROE is lower than regulated utilities' authorized ROEs in <u>any</u> prior period.[62]

Staff's direct testimony relied heavily on the average allowed ROE from the first quarter of this year,[63] but Staff's rebuttal testimony failed to acknowledge that the average allowed ROE increased by 20 basis points to 9.83 percent in the second quarter.[64] Neither Staff's Prehearing Brief nor its Post-Hearing Brief compare Staff's 9.4 percent ROE recommendation to recent average allowed ROEs or acknowledge the second quarter 2012 increase in allowed ROEs. Similarly, CUB's Opening Brief cites only to the first quarter 2012 average allowed ROE, argues that these averages are declining, and omits to mention the increase in average allowed ROEs to 9.83 percent in the second quarter of 2012. These omissions are telling because a cross-check against the most recent data would be unfavorable to Staff's position and supportive of the Company's.

C. The Commission Should Reject Staff's Hedge Disallowance.

As explained in NW Natural's Prehearing Brief and Posthearing Brief, Staff seeks a disallowance of the costs associated with NW Natural's use of an interest rate swap that it entered into in order to mitigate volatility associated with interest rates. The Company determined that it would utilize a swap because interest rates in 2007 ahead of the financial meltdown were demonstrating extreme volatility, and the Company knew that it would need to issue debt at some point in the next year to 18 months.[65] The Company took that decision to the Commission, and the Commission granted the Company "authority to enter into Interest

[61] Staff/1300, Storm/64, lines 4-5.
[62] NWN/2100, Hadaway/4, lines 15-17.
[63] *See e.g.*, Staff/1300, Storm/64-65.
[64] NWN/3200, Hadaway/4, lines 5-7; NWN/3201.
[65] NWN/2000, Feltz/6-7.

Rate Hedge Products with financial institutions to manage exposure to interest rate fluctuations."[66] The Company then studied the market to determine when would be the most advantageous time to enter the swap, and it took bids to obtain the best possible terms.[67]

Because of an unprecedented and unforeseeable departure between the swap rates and AA utility bond interest rates, the hedge did not function as intended.[68] Now Staff, with the benefit of perfect hindsight, claims that the costs incurred by the Company should not be recoverable in rates because they were not prudent.

In its Posthearing Brief, NW Natural recounts the evidence and theories offered by Staff for their adjustment.[69] NW Natural also describes the changes that Staff made to its argument at hearing, and the reasons for which all of Staff's arguments made to date should be discredited.

1. The Commission Should Ignore Statements in Staff's Brief that are Without Factual Support in the Record.

Perhaps because the factual support for Staff's position has been substantially undermined through this proceeding, Staff's counsel now improperly uses Staff's Post-Hearing Brief to insert certain "facts" for which there is no support anywhere in the record—and which NW Natural disputes. Through this approach, Staff would deprive NW Natural of the opportunity for discovery regarding its late assertions, and shield the "evidence" from being scrutinized through the cross-examination process. To ensure that they are not erroneously relied upon by the Commission, the Company points out the unsupported statements here.

1. "In October of 2007, a reasonably prudent financial expert would communicate to the banks bidding on the hedging transactions that no one expects outcomes outside of two standard deviations from the most likely outcome that reduced

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[66] *Re. NW Natural Application for Authorization of Interest Rate Hedging*, Docket UF 4235, Order No. 07-032 (Jan. 29, 2007).
[67] NWN 2000, Feltz/8, lines 16-18.
[68] NWN/2000, Feltz/8, line 19-Feltz/9, line 10.
[69] NW Natural's Posthearing Brief at 7-11.

future correlation is extremely unlikely and the utility is therefore unwilling to pay much to cap losses. This is particularly the case because the utility is willing to accept a hedging transaction with a floor protecting the bank or counterparty from an outsized gain."[70] There is no evidence in the record to support this statement.

2. "A reasonably prudent financial expert knows that investment banks are willing to discuss and bid on the collared hedge because the utility does not need the investment bank to arrange a "plain vanilla" swap or equivalent forward position."[71] This statement goes beyond the evidence in the case and should be disregarded.

3. "Being financial professionals, all parties recognize that the ability to customize the hedge contract to meet the client's needs is a primary reason that the client chooses an investment bank over cheaper sources of plain vanilla swaps or future."[72] This statement goes beyond the evidence in the case and should be disregarded.

NW Natural reiterates that it disagrees that any of the statements above support an adjustment in this case—and in fact, most of these assertions are flatly contradicted or fully addressed by Mr. Feltz' testimony in this case. Given however, that they cannot be regarded as evidence of any sort, and because they are improperly included in Staff's brief, the Company will not take further time or space to address them, other than to point out that the Company's responses in its testimony and previous briefs rebuts Staff's theories inappropriately offered in brief.

Staff has already advanced an argument on this issue that turned out to be unsupported by the record, and in fact retracted this argument when its witness took the stand at hearing. It

[70] Staff's Post-Hearing Brief at 31, lines 13-18.
[71] Staff's Post-Hearing Brief at 31, lines 18-21.
[72] *Id.*, lines 21-23.

is disappointing to now observe Staff attempt to insert in the case additional unsupported arguments as if they were tested facts.

2. Staff's Claim that the Company Should Have Performed Additional Analyses Is Based Upon the False Assumption that Additional Analysis Would Have Provided the Company with Additional Relevant Information.

Mr. Muldoon has made abundantly clear his conviction that the Company should have performed probabilistic analyses that would have better informed the Company's decision to enter into the swap. However, Mr. Muldoon is completely unable to credibly explain what information would have been provided by that analysis that would have been relevant to the loss the Company incurred.[73] Again, the types of analyses that Mr. Muldoon is recommending, like the Monte Carlo study the Company performed, are directed at evaluating risk that interest rates may rise or fall and therefore would not have provided new information helpful to the Company.[74] Indeed, the reason Mr. Feltz was looking at interest rate swaps was because it had already determined that interest rate volatility was outside the Company's tolerance band.[75]

It should be noted that, in arguing that further analysis would not have indicated that the swap was too risky, the Company is *not* accepting Staff's view that the Company did not perform its own analysis prior to entering into the swap. On the contrary, the Company has testified that it performed extensive analysis—monitoring markets, reviewing market data over many months' time—and finally, after researching the available swap products, conducting bidding to ensure the best contract available.[76] Much of this information was provided to the Commission at the time the Company executed the swap, including communications with potential counterparties, bid information, a summary of interest rates on new issues in the utility sector, and a retrospective analysis indicating that the Company purchased the swap when the

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[73] *See* NWN/2003, Feltz/2; Tr. 84, lines 3-15.
[74] NWN/2000, Feltz/19, line 19-Feltz/13, line 5.
[75] *Id.* at 6, lines 18-22.
[76] *Id.* at 7, line 1-Feltz/8, line 18.

market conditions were favorable.[77] Staff, however, continues to overlook that analysis, arguing that "NW Natural should have completed documentation of its analysis for presentation now, at this next rate case."[78]

Staff makes much of the fact that some of the market information reviewed by the Company was provided by the potential counterparties, suggesting that the Company relied on "sales materials," ignoring warnings that such materials did not guarantee favorable results.[79] In presenting such facts, Staff implies that the Company did in fact rely on biased materials and relied solely on counterparties' assessments of the offered swaps. This argument is simply a straw man erected by Staff so that it can conveniently knock it down. In fact, what Staff is accusing the Company of doing is ridiculous on its face, and contrary to Mr. Feltz' testimony. NW Natural has testified that, as one would expect, review and consideration of pricing information and other materials provided by a counterparty is a standard part of negotiating a financial instrument, and the Company did not solely rely on these materials to determine whether it should pursue the transaction.[80]

3. Mr. Muldoon has Provided No Credible Evidence to Support His Erroneous View that the Company Could Have Prudently Limited its Loss.

Mr. Muldoon seemed equally convinced of his view that had the Company understood the risks inherent in the swap, it could have and would have contracted for provisions in the swap agreement that would have limited its losses. The problem is that there is no credible evidence to support this view.

It is true that Mr. Muldoon has offered his own opinion that the Company could have limited its losses by negotiating caps or collars to its swap agreement. However, in response, Mr. Feltz explained why Mr. Muldoon was incorrect on this point. Specifically he testified that

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[77] *Re. NW Natural Application for Authorization of Interest Rate Hedging*, Docket UF 4235, NW Natural Filing (Feb. 26, 2008).
[78] Staff's Post-Hearing Brief at 33.
[79] *Id.* at 29-30.
[80] NWN/2000, Feltz/11, lines 4-23.

given the nature of the risk, there is no evidence to support Mr. Muldoon's claim that the Company could have or should have negotiated contract provisions that would mitigate the risk, and that adding non-standard terms would add significant cost that, at the level of risk involved at the time the swap was entered, would not have been prudent.[81]

In the face of that explanation, Staff has never offered any evidence in support of its point. In fact, the only vigorous defense of its view is offered in Staff's Post-Hearing Brief, which contains a recitation of a litany of actions Staff believes that a "reasonably prudent financial professional" should have done that seems to have been pulled out of thin air. Indeed, Staff's Post-Hearing Brief is most telling when, toward the end of the discussion of the hedge, Staff finally seems to acknowledge the speculative nature of its position, posing the following questions:

> Could the Company have determined that the actual outcome was a possible result? Could the Company have determined that the actual result was unacceptable? Could the Company have considered alternatives to the hedge in 2007? Can we say precisely which mitigation the Company would have selected in 2007, had the NW Natural performed its own robust analysis prior to executing the hedge in a time of functional markets?[82]

Staff's questions suggest that it does not know the answers to these questions. However, the Company has provided them in evidence as follows:

1. Additional analysis would not and could not have predicted the actual outcome of the swap;[83]
2. Any analysis performed would have prudently presumed that the AA utility bond rate and the swap rate would have remained in correlation, so the results would not have been deemed unacceptable;[84]

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[81] NWN/3100, Feltz/5, lines 15-Feltz/6, line 3.
[82] Staff Post-Hearing Brief at 35.
[83] NWN/3100, Feltz/3, line 3-Feltz/5, line 14.
[84] NWN/2000, Feltz/9, lines 2-20.

3. The Company did consider the one alternative to the swap that was available at the time (a Treasury lock) and prudently determined that it was inferior to the interest rate swap;[85] and

4. Whether or not the Company had performed additional analysis such as that suggested by Staff, it would not have selected mitigation provisions for its swap contract.[86]

4. Staff's Hedging Policy Argument Has No Evidentiary Foundation.

Staff reiterates Mr. Muldoon's attacks on the Company's hedging policy that he raised for the first time at hearing, arguing that the policy is too flexible and therefore "precludes reliance on this policy to substitute for performing due diligence and robust analysis prior to entering into the hedging transaction."[87] As the Company explained in its Posthearing Brief, Mr. Muldoon raised the issue of the Company's overall policy being imprudent for the first time at the hearing and never specifically explained what the policy is lacking or how it might be improved.[88] Given that Mr. Muldoon never raised this issue in pre-filed testimony and never explained the basis for his conclusion that the policy is too flexible, his statements do not constitute credible evidence.

In Staff's brief, Staff also seems to imply that NW Natural's financial hedging policy has not been formed with the benefit of experience in doing financial hedges, or that it has not had sufficient review by the Company.[89] Because Staff only raised its concerns about the policy at hearing, the Company did not have a chance to respond to these statements in testimony. Evidence would show, however, that the Company's financial hedging policy has been used for

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[85] NWN/2000, Feltz/8, lines 1-5.
[86] NWN/3100, Feltz/6, lines 1-5.
[87] Staff's Post-Hearing Brief at 32.
[88] NW Natural's Posthearing Brief at 11.
[89] *See* Staff's Post-Hearing Brief at 33 ("The financial hedging policy (not dealing with natural gas) has not been informed by the Company's experience. A review of this policy performed by NW Natural management, with implementation and ensuing recommendations, could better align the policy to NW Natural's utility function and fiduciary responsibilities.")

many years to conduct financial hedging of commodity contracts and foreign exchange transactions, and that it receives regular review by Company executives and the finance committee of the board of directors.

D. The Company's Proposed Site Remediation Recovery Mechanism (SRRM) Is the Appropriate Environmental Remediation Cost Recovery Mechanism.

Staff, CUB, and NWIGU continue to object to allowing the Company to recover all of the environmental remediation expenses it has incurred related to manufactured gas plants (MGPs) that were used to provide service to the Company's customers. The Company has addressed most of the parties' arguments in its Prehearing and Posthearing Briefs, and will address only the new issues raised by the parties in their posthearing briefs below.

1. Staff's Proposal Is Not "Generous."

Staff states three times in its Post-Hearing Brief that Staff's agreement to implement an automatic adjustment clause (AAC) is "generous,"[90] despite the fact that Staff's conditions would disallow ten percent of the Company's prudently-incurred costs, require the Company to finance the environmental remediation costs for many years on behalf of customers while under-recovering carrying costs at the modified blended treasury rate (MBTR) rather than rate of return (ROR), and impose an earnings test that would function, at best, as a cap on earnings for many years, and potentially as a source of significant financial harm to the Company.[91] For the reasons set forth in the Company's Prehearing and Posthearing Briefs, Staff's proposed modifications to the SRRM are contrary to Oregon law and Commission precedent, would significantly damage the Company, and should be rejected.

Staff notes that if the Company is not satisfied with Staff's proposed modifications, the Company could request that costs be recovered through a rate case or deferred accounting.[92]

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[90] Staff's Post-Hearing Brief at 36, 37.
[91] *See* NW Natural's Posthearing Brief at 13.
[92] Staff's Post-Hearing Brief at 37.

As Ms. Johnson testified, an AAC is better for customers than these other options.[93] An AAC mitigates the burden on customers by spreading the cost over time and controlling the size of deferrals.[94] In addition, given that remediation requirements are based on decisions that, in many cases, are not yet made by the Environmental Protection Agency (EPA) or Department of Environmental Quality (DEQ), the Company cannot reasonably predict its environmental remediation expenses on a forward-looking basis for a rate case test year.[95] And, given that insurance recovery issues will be tried in front of a jury, the Company has even less ability to forecast its recovery from insurance. An AAC accommodates the uncertainty associated with future costs and the receipt of funds from third parties in a way that rate case recovery would not.[96] For these reasons, it is unreasonable to disallow prudently-incurred costs simply because the Company is recovering them through the mechanism that is most tailored to the problem, and which will benefit customers.

2. CUB's and NWIGU's Arguments in Favor of Sharing, or No Recovery, of Environmental Remediation Costs Are Unpersuasive.

CUB continues to argue that the Company acted improperly with respect to MGP operations, stating that the message that the Commission should be sending to the Company is "you caused it, you clean up the mess."[97] CUB also states that the Company "benefitted from the damage done."[98] The uncontested evidence in this case shows that the customers benefitted from the MGPs because the plants were used to provide service to the Company's customers and the byproducts of the manufactured gas process were sold for customers' benefit.[99] While NWIGU discounts the testimony on the sale of byproducts,[100] Staff found that

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[93] Tr. 35, lines 1-23.
[94] NWN/1500, Miller/8, lines 8-15.
[95] *See id.* at 8, lines 12-14.
[96] *Id.*
[97] CUB's Opening Brief at 32.
[98] *Id.* at 38.
[99] NWN/2600, Miller/4, lines 9-18.
[100] NWIGU's Initial Posthearing Brief at 7.

byproduct revenues were treated as part of regulated activities after 1946, and Staff's reasonable assumption is that byproduct sales were treated similarly between 1911 and 1946.[101] In addition, there is no credible evidence in this case that NW Natural was aware of the possible environmental effects or future costs associated with MGP operations at the time of their operation, CUB's citation to Mr. Larkin's citation to a quote in a book notwithstanding. CUB's position that the Company should be punished by disallowing environmental remediation costs because the Company acted improperly has no basis in fact.

CUB continues to argue that the Company has insurance to recover all of these environmental remediation costs. This is the second time that CUB has made this statement, despite the fact that the Company's responses to Bench Requests indicate that the Company cannot know what amounts it will recover from its insurers, and CUB has presented no evidence to the contrary. While the Company would welcome such a result, CUB's statements on the topic should not be relied on by the Commission.

CUB also argues that little weight should be given to the Company's arguments about its financial health and that it is inappropriate for customers to pay 50 percent of these costs because the Company is in good financial health.[102] Disallowing prudently incurred costs on the basis of a utility's past earnings is contrary to Oregon law because utilities are entitled to recover their operating expenses.[103] Oregon law also singles out "[a]mounts lawfully imposed retroactively by order of another governmental agency" as amounts that the Commission may include in rates under the deferral statute without a deferral application, indicating that disallowing prudently-incurred expenses required by another government agency, such as those required by EPA and DEQ, would be improper.[104] In addition, disallowing prudently incurred

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[101] Staff/300, Andrus/5, lines 10-16.
[102] CUB's Opening Brief at 31.
[103] ORS 756.040.
[104] ORS 757.259(1)(a)(A).

environmental remediation expenses would be destructive of the financial health of the utility going forward for the reasons set forth in the Company's Posthearing Brief.[105]

Next, CUB argues that the Company's arguments about intergenerational equity are "absurd," because CUB asserts that the costs are from many years ago.[106] CUB continues to ignore the plain facts that the environmental remediation costs are *current* costs, imposed by *current* laws. NW Natural's mechanism actually ensures that these costs are collected from ratepayers close to the time at which these costs are incurred, which is consistent with the concept of intergenerational equity. In addition, CUB and NWIGU continue to use the concept of intergenerational equity as a basis for disallowing costs, rather than a basis for determining how costs should be spread over time. The Commission has never disallowed prudently incurred costs on the basis of intergenerational equity and should not do so in this case.

Finally, NWIGU again claims that if the Company is not required to share costs, the Commission will be issuing the Company a "blank check" for remediation expenses.[107] NWIGU's argument ignores the fact that the Company's incentive to keep environmental remediation costs down is the same incentive it has to keep all other costs down—because if it does not do so, the Commission will disallow the costs as imprudent. Taken to its logical end, this argument would have the Company sharing all of its expenses to ensure that the Company is incented to keep costs down. CUB confirms that the Commission's prudence review process will incent the Company to keep costs down because if the Company "should take [a] foolhardy position, CUB will be there to argue that its actions added imprudence on top of imprudence."[108]

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[105] NW Natural's Posthearing Brief at 13-14.
[106] CUB's Opening Brief at 31.
[107] NWIGU's Initial Post-Hearing Brief at 8.
[108] CUB's Opening Brief at 34-35.

3. Staff's and CUB's Citations to Precedent Do Not Undermine the Company's Position on Environmental Remediation Recovery.

Staff cites to two dockets intended to undermine NW Natural's position that the Commission has allowed other utilities to collect environmental remediation costs without sharing.[109] With respect to the first order cited by Staff, the Trail Mountain Mine order, not only is that citation off base because the Commission was approving a request for deferred accounting, not ratemaking treatment, but more importantly, Staff materially misquotes the Trail Mountain Mine order. The condition in the order as set forth in Staff's brief reads: "[t]here will be no return allowed on the unrecovered costs of Trail Mountain Mine," but the actual quote in the order is "[t]here will be no return allowed on the *unamortized* unrecovered costs of Trail Mountain Mine."[110] The costs here will be amortized, so there are no "unamortized" costs to which the cited condition could apply.

Staff also cites to a Portland General Electric Company (PGE) Portland Harbor case. It is not clear why Staff cited to this case, because the docket was closed before the utility requested amortization of the remediation expenses and the Commission took no action on the request.[111]

CUB criticizes the Company's testimony on precedent in other states on environmental remediation recovery, stating that the Company argues that "all" commissions have found a sufficient nexus between current remediation expenses and support service to support rate recovery.[112] CUB omits a key part of the Company's brief, that "absent facts to the contrary," this is what commissions have found. Case in point is the Delmarva Power & Light case cited by CUB. In that case, an electric company requested recovery of environmental remediation

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[109] Staff's Post-Hearing Brief at 38.
[110] *Re PacifiCorp Application for an Accounting Order Regarding Deferral of Trail Mountain Mine Unrecovered Closure Costs*, Docket UM 1047, Order No. 02-224 Appendix A at 3 (Mar. 29, 2002) (emphasis added).
[111] *Re Portland Gen. Elec. Co. Application for Deferral of Investigation and Remediation Response Costs Associated with the Portland Harbor and Harbor Oil Superfund Sites Cleanup and Restoration*, Docket UM 1373, Order No. 10-018 (Jan. 19, 2010).
[112] CUB's Opening Brief at 35.

expenses associated with manufactured gas plants that were never used in the provision of electric service.[113] That is not the situation here, where no party has claimed that the MGPs were not used to provide service to NW Natural's customers. As the Company explained in testimony and prior briefing, its review found that a majority of commissions addressing the issue have allowed MGP environmental remediation expenses into rates without sharing.[114] Where the plant that caused the need for remediation was used to provide utility service by the company, commissions have found that there is a sufficient nexus to justify the utility's recovery of costs.[115]

CUB also takes issue with the Company's citation to the Powerdale case, in which PacifiCorp was allowed to amortize the costs of decommissioning the plant, which include environmental remediation costs, in rates.[116] CUB claims that Powerdale and the Company's "circumstances could not be more different" because PacifiCorp's application was "timely" and did not relate to old costs.[117] But in the Powerdale case, past customers received the vast majority of the benefit of the plant, while current customers' rates recovered the remediation

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[113] *Re Delmarva Power & Light Co.*, 278 P.U.R.4th 419 at 427-428, Md. P.S.C. Case No. 9192, Order No. 83085 (Dec. 30, 2009) (on review from *Re Delmarva Power & Light Co.*, 2007 WL 2159659, Md. P.S.C. Case No. 9093, Order No. 81518 (July 19, 2007) (finding that "the evidence indicates that the property was not used for the provision of electric service to Delmarva's customers").
[114] *See* NWN/2600, Miller/15, line 21-16, line 9.
[115] *See, e.g.*, *Re Application of Wash. Gas Light Co.*, Pub. Serv. Comm. of D.C. Order No. 10307, pp. 119, Case No. FC922 (Oct. 8, 1993) (noting that MGP remediation costs "are the result of gas service which was rendered to ratepayers in the normal course of business" and that they are therefore recoverable from current ratepayers); *Pub. Serv. Elec. & Gas Co.*, N.J. Bd. Reg. Comm'rs, BRC Docket No. ER91111698J, slip op. at 14 (Sept. 15, 1993) (finding that past operations and current cleanup efforts were prudent, and that costs should be recovered from current ratepayers; also noting that to do otherwise "would penalize the Company for lacking the prescience to conform to today's ever-exacting environmental standards"). *See also Attorney General v. Mich. Pub. Serv. Comm'n* 618 N.W. 2d 904 (2000) Michigan (finding that the costs are related to the company's current property because that property is the source of contamination, and the fact that the contamination arose from operations to serve past customers does not change the fact that the company is incurring significant expenses in the course of its present business); *Central Ill. Light Co.*, 124 PUR 4th 498 (1991) (Illinois) (finding that costs are recoverable from current ratepayers because the cleanup is mandated by both state and federal law, making them legitimate recurring costs of doing business); *Central Hudson Gas & Elec.*, N.Y. Pub. Serv. Comm'n Case 05-E-0934, Order pp. 69 (July 24, 2006) ("We consider the full recovery of MGP/SIR costs to be a reasonable utility expense").
[116] CUB's Opening Brief at 39.
[117] *Id.* at 39.

costs even though those customers received little or, in some cases, no benefit from the operation of the plant.[118] The timing concerns that CUB raises here would have been equally applicable in the Powerdale case, so CUB's distinction is curious at best.

4. CUB Takes the Same Unreasonable Position as Staff that the Commission Is Not Addressing Prudence in this Proceeding.

CUB argues that "[t]his docket is not meant to determine disallowances or penalties, it is to determine which party should have to pay what proportion of any later determination as to what was in fact prudent and should be recoverable."[119] CUB also accuses the Company of mixing the issues of who should pay for remediation expenses and the issue of prudence in this proceeding "to muddy the waters."[120] As NW Natural explained in its Posthearing Brief, NW Natural's request for a prudence determination on the existing deferred amounts could not have been more explicit and clear. It should not be surprising to the parties that the Company is proposing to evaluate prudence in this case, because a general rate case is the appropriate time to evaluate whether to amortize costs.[121]

5. Staff and CUB Are Incorrect that the Commission Must Impose an Earnings Test.

CUB joins in Staff's argument that the Commission is required to impose an earnings test under ORS 757.259(5). As the Company explained in its Posthearing Brief, because the amounts to be amortized in this case would be subject to an automatic adjustment clause (AAC), this provision does not apply. The Commission has not previously required an earnings review for the amortization of an amount subject to an AAC. The plain language of the statute does not support Staff's new construction of the statute. The statute states that "[u]nless subject to an automatic adjustment clause under ORS 757.210(1), amounts described in this

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[118] Powerdale was constructed in 1922 and 1923. *Re PacifiCorp Application for an accounting order regarding closure of the Powerdale Hydro Generation Plant*, Docket UM 1298, Order No. 07-375, Appendix A at 2 (Aug. 23, 2007).
[119] CUB's Opening Brief at 34.
[120] *Id.* at 34.
[121] ORS 757.259(2).

section shall be allowed in rates only . . . upon review of the utility's earnings at the time of application to amortize the deferral."[122] These amounts will be "subject to an automatic adjustment clause," so the earnings test requirement does not apply. The Company's briefs and testimony have discussed in detail why the Company does not believe that the Commission should apply an earnings test as a matter of policy either.

6. Staff, CUB, and NWIGU Fail to Support Their Proposal for the Company to Accrue Interest at a Rate Lower than ROR.

Staff, CUB, and NWIGU continue to advocate that the Company's environmental remediation deferrals accrue interest at the MBTR in the case of Staff and an unquantified "debt rate" in the case of NWIGU and CUB.[123] None of the parties have demonstrated that the Company's risk of recovery is lower for these costs than for any other types of deferrals or that the deferrals will be over such a short term that they warrant a lower rate. NWIGU, for example, continues to claim that there is "no risk associated with the customer share of the environmental remediation costs" after an order is issued in this case.[124] Even Staff, however, agrees there is some risk associated with recovery of the environmental remediation costs.[125] NWIGU's claim is not borne out by the evidence.

CUB attempts to undercut NW Natural's citation to the exception granted to Idaho Power in Docket UM 1147.[126] CUB states that "contrary to what NWN would suggest, the Commission has already recognized that ROR would not be appropriate given a company's decreased risk with regard to deferrals."[127] CUB is misreading the order. The Commission decided in that case that the MBTR was *too low* of an interest rate to apply to amounts in amortization in the case of Idaho Power; the Commission never found that ROR was not appropriate for amounts prior to

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[122] ORS 757.259(5).
[123] Staff's Posthearing Brief at 39; CUB's Opening Brief at 38; NWIGU's Initial Post-Hearing Brief at 9.
[124] NWIGU's Initial Post-Hearing Brief at 10.
[125] Tr. 30, lines 13-18; Tr. 49, lines 3-10.
[126] CUB's Opening Brief at 40.
[127] CUB's Opening Brief at 40.

amortization.[128] No party in this case is contesting the interest rate to apply during amortization—all parties agree that the rate should be the MBTR. The question is what rate should apply prior to amortization, and the Commission has never found that a rate lower than ROR is appropriate.

E. NW Natural Should Be Allowed to Add Its Prepaid Pension Asset to Rate Base.

By this point in the case, the Staff, CUB, and NWIGU's arguments against the Company's pension proposal have coalesced around two distinct but related ideas: first that the Company's proposal violates the rule against retroactive ratemaking; and second that the Company should not be allowed to recover costs associated with pension contributions that were made during a period when the Company earned at or over its rate of return. All three parties offer arguments based on some version of each of these ideas. None of the arguments are rooted in the facts or an accepted regulatory approach.

1. The Charge of Retroactive Ratemaking Is Inapplicable to Additions of Prepaid Pension Assets to Rate Base.

Throughout their posthearing briefs, the parties have repeatedly taken the position that the pension "expenses" that NW Natural is attempting to recover are "out-of-period."[129] As explained below, and throughout the proceeding by the Company, these claims are both rooted in the parties' failure to understand the concept of a prepaid pension asset or, in particular, to recognize the distinction between (1) *pension expense*, which represents an ongoing expense and is therefore properly the subject of a deferral application; and (2) a *prepaid pension asset*, which represents a shareholder investment benefitting customers that is in excess of collections through rates, and that is appropriately characterized as a component of working capital and not subject to deferral. This misunderstanding dominates the parties' posthearing briefs, and in particular causes CUB to misinterpret virtually every case that it cites.

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[128] *Re Staff Request to Open an Investigation into Deferred Accounting*, Docket UM 1147, Order No. 08-477 at 3 (Sept. 23, 2008).
[129] *See, e.g.*, Staff Post-Hearing Brief at 40; CUB Opening Brief at 16.

Before responding to parties' arguments and discussion of the case law, it may be helpful to review the three aspects of pension costs that are addressed in the cases referred to by the parties, along with the corresponding approaches to pension recovery: (1) FAS 87 pension expense (also referred to as net periodic pension costs, or NPPC) which is included in rates as a component of revenue requirement;[130] (2) prepaid pension assets, which are recovered as an addition to rate base;[131] and (3) cash contributions, which factor into the determination of a prepaid asset, and which, on a forward-going basis, may be separately forecast, tracked, or deferred for true-up purposes.[132] While each of these approaches is distinct, they are not mutually-exclusive, and many states employ some combination of the three.

CUB, NWIGU, and Staff all appear at times to lose sight of these fundamental distinctions. However, it is CUB that provides the lengthiest argument that appears to be based on a misunderstanding. In fact, from its Opening Brief it appears that CUB erroneously believes that this is a dispute about whether pension costs in general are expenses ***or*** prepaid pension assets. For instance, CUB states in its Opening Brief: "Several commissions have described pension costs as expenses, *rather than* 'prepaid obligations' appropriately included in rate base."[133] CUB then goes on to cite to three state public utility commissions that purportedly found "pension costs" to be expenses—the Pennsylvania Public Utility Commission, the Maryland Public Service Commission, and the District of Columbia Public Service Commission.[134] Yet, in each of the cases the commission was addressing FAS 87 expense,

[130] NWN/400, Feltz/21, lines 11-16.
[131] NWN/2000, Feltz/27, lines 14-23.
[132] For instance, utilities in Idaho recover pension costs strictly on the basis of cash contributions. *See, e.g., Re Idaho Power Co.*, Idaho Pub. Utils. Comm'n Case No. IPC-E-07-07, Order No. 30333 (June 1, 2007).
[133] CUB Opening Brief at 16 (emphasis added; citation omitted).
[134] *See, Penn. Pub. Util. Comm'n v. Aqua Penn.*, 236 P.U.R.4th 218, Pa. P.U.C. Rulemaking Proceeding 00038805 at 15-19 (Aug. 5, 2004); *Re Application of Delmarva Power & Light Co.*, 278 P.U.R.4th 419, Md. P.S.C. Case No. 9192, Order No. 83085 at 428-429 (Dec. 30 2009); *Re Potomac Elec. Power Co.*, 280 P.U.R.4th 381, D.C. P.S.C. Formal Case No. 1076, Order No. 15710 at ¶¶ 144-154 (Mar. 2, 2010).

and so of course would find that the subject cost is an expense. However, contrary to CUB's implication, these Commissions were *not* concluding that all pension *costs in general* are "expenses." And notably, in none of these cases was the commission attempting to deny, as does CUB, that prepaid pension contributions constitute prepaid assets to be recovered in rate base.[135]

In the end, there is only one case cited by CUB in which a state public utility commission clearly addresses a utility's prepaid pension asset as such, and declines to include that prepaid pension asset in rate base—and that is the case of the West Virginia Public Service Commission's (WVPSC) order regarding the Appalachian Power Company.[136] Consistent with the language quoted by CUB, that commission appears to be making a decision, as a matter of policy, to deny the utility's request. However, the WVPSC also seems to reject the notion that any prepayments belong in rate base at all[137]—a position clearly at odds with Financial Accounting Standards, Richard L. Hahne's text *Accounting for Public Utilities'* and this Commission's policy.[138]

CUB's response to the Commission's Bench Request similarly suffers from its insistence on conflating all aspects of pension costs into expenses. In its own response to the Bench Request, NW Natural provided evidence that *numerous* utilities are receiving rate base treatment of their prepaid pension assets, and that there is no evidence whatsoever that any of these utilities were required to file deferral petitions in order to do so. Since filing its Posthearing Brief, the Company has come across yet another such utility—Xcel Energy, in its

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[135] *See id.* CUB also cites to the *Delmarva* case discussed in its Prehearing Brief for the proposition that "even utilities themselves have described pension costs as expenses appropriate for deferral." CUB's Opening Brief at 16. Again, Delmarva was referring to pension expenses as pension expenses—which of course is correct. Delmarva was not mixing up prepaid pension assets as expenses, as CUB has done in this case. *Delmarva Power & Light Company*, 2011 WL 3863101, Del. Pub. Serv. Comm'n Docket No. 09-414/09-276T, Order No. 8011 at ¶¶ 121-157 (Aug. 9, 2011).
[136] *Re Appalachian Power Co.*, 285 P.U.R.4th 109, W.Va. P.S.C. Case No. 10-0699-E-42T at 30 (Oct. 5, 2010).
[137] *Id.*
[138] *See* NW Natural's Posthearing Brief at 33-34.

Colorado jurisdiction.[139] In its 1993 rate case, Xcel included in rate base certain amounts for prepaid pension asset. The Colorado Public Utilities Commission allowed the company to include in rates the prepaid pension asset, as estimated for the test year, providing the following explanation:

> As Staff witness John Wright explained, prepaid pension assets and Liabilities arise when the level of pension contributions calculated under the actuarial assumptions required by the Internal Revenue Service ("IRS") and the Employee Retirement Income Security Act ("ERISA") differ from the level of annual pension expense calculated under the actuarial assumptions required by Generally Accepted Accounting Principles ("GAAP"). In the Company's case, IRS- and ERISA-mandated pension contributions have exceeded pension expenses derived pursuant to accounting principles. Currently, the Company recovers in rates, pension expenses based upon GAAP, instead of recovering the greater expenses mandated by the IRS and ERISA. Shareholders are required to fund the additional amounts indicated by ERISA and the IRS. In order to compensate investors for the additional funds they supply to meet the higher contribution levels, the resulting prepaid assets are an appropriate addition to rate base.[140]

There is no suggestion in the Colorado commission's decision that the prepaid asset was the subject of a deferral.

CUB, on the other hand, states that it "was unable to locate an example of *any* utility receiving recovery for out-of-period pension contributions absent a deferral or inclusion in a test year."[141] It is not surprising that CUB would have a problem discovering precedent to the contrary. By definition, an "out-of-period" contribution—in and of itself—would not be included in rates absent a deferral or other tracking mechanism. On the other hand, a prepaid pension asset that may be created by the contribution, by its very nature, does not require a deferral.

Similarly, CUB points to the three utilities cited by Mr. Feltz to support his statement regarding the trend that seems to be developing in allowing utilities to recover pension contributions as a component in setting rates—Hawaii Electric Light Company (HELC), Pacific

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[139] *In Re: Investigation and Suspension of Tariff Sheets*, Co. Pub. Utils. Comm'n, Docket No. 93S-001-EG, Order No. C93-1346 (Oct. 14, 1993).
[140] *Id.* at 55.
[141] CUB's Opening Brief at 22.

Gas & Electric Company (PG&E), and Wisconsin Electric (WE). CUB states that "[t]hese three utilities were not seeking to recover past cash contributions or to deal with pension expenses on a retroactive basis."[142] This statement alone reveals the confusion referred to above. As a matter of fact, two out of those three utilities—HELC and WE—*were* allowed by the state public utility commission to add their prepaid pension asset to rate base.[143] That is exactly what NW Natural is asking to do in this case. And while NW Natural does not view the prepaid pension asset as "retroactive" in any way, shape, or form, it is the result of the difference between pension contributions that have been made in the past, and past pension expense collected from customers, and that is what CUB has incorrectly been referring to in this case as "retroactive."

CUB then goes on to refer to cases where, according to CUB, the state public utility commission does indicate that a pension recovery would violate the rule against retroactive ratemaking. However, in each of these cases, as in the *Delmarva* case[144] covered in CUB's Prehearing Brief, the amounts sought for inclusion in rates are in fact expenses for which a deferral *would* be required. For instance, CUB states that the California Public Utility Commission (CPUC) denied San Diego Gas & Electric's (SDG&E) request to recover past pension contributions because it would constitute retroactive ratemaking.[145] However, CUB goes on to clarify that the costs that the CPUC concluded could not be recovered were not prepaid a prepaid pension asset, but rather *expenses* associated with two corporate surety bonds and a letter of credit purchased by the company to guarantee its contributions in order to

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[142] *Id.* at 21.
[143] In agreeing to add HELC's prepaid pension asset to rate base, the Hawaii commission specifically defined a "pension asset is an investment that results when the cumulative funds contributed to the pension fund exceeds cumulative NPPC [FAS 87 expense]." Re Hawaii Elec. Light Co., Inc., 2010 WL 4388929, Hawai'i P.U.C. Docket No. 05-0315 at *22 (Oct. 28, 2010). As described in NWN/400, Feltz/28, the Wisconsin commission agreed to a recovery that allowed a portion of the prepaid asset into rate base as well. *See also* Staff's Post-Hearing Brief at 40-41.
[144] *Delmarva Power & Light Company*, 2011 WL 3863101, Del. Pub. Serv. Comm'n Docket No. 09-414/09-276T, Order No. 8011 (Aug. 9, 2011).
[145] CUB's Opening Brief at 22-23.

avoid benefit restrictions.[146] Similarly, both the Delaware Public Service case regarding Delmarva Power & Light Company, and the Pennsylvania Public Utility Commission case related to Aqua Pennsylvania address attempts by these utilities to recover past pension *expense* in the absence of an order allowing for deferral. The holdings in all of these cases are consistent with the Company's position that past pension *expense* may not be recovered in the absence of a deferral order. On the other hand, as demonstrated by the Company's Posthearing Brief, where the Company seeks to add the prepaid pension asset, the rule against retroactive ratemaking in not implicated and therefore a deferral petition is not required or appropriate.

In support of its view that the Company was obliged to file a deferral petition in order to recover the prepaid asset, NWIGU points out the Company's explanation that the prepaid pension asset would not qualify for deferral, and then states: "This assertion, however, contradicts the live testimony of NW Natural witness Mr. Feltz who stated, 'yes, it's true that we could have—we had the ability to go file for a deferral order.'"[147] By taking Mr. Feltz' comment out of context, NWIGU completely misconstrues his intent. The comment quoted by NWIGU came in response to questioning at hearing by ALJ Hardie. Specifically, ALJ Hardie asked Mr. Feltz to address the language in Order No. 03-507 in Docket UG 152, the Company's last general rate case. ALJ Hardie pointed out that in that case the parties stipulated to an agreed level of FAS 87 recovery, with the proviso that any recovery exceeding actual FAS 87 expense would be deferred for customer benefit, and further that in the event FAS 87 expense recovery exceeded actual FAS 87 expense, the Company could file for a deferral if it wished. In that context ALJ Hardie asked the following question and Mr. Feltz provided the following answer:

> Q. So it looks to me that there was some suggestion even at the time that there could be some symmetry if the deferral application was filed, and I'm just

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[146] *Id.* at 23.
[147] NWIGU's Initial Posthearing Brief at 14.

wondering if there's some reason why one wasn't [made] on these big infusions that were required to be made.

A. . . . Two considerations I would give there. One is the FAS 87 expense did start to climb and for a bit of time was just only slightly above the authorized amount that we were recovering on, but they started escalating, as you can imagine with the crisis. So by 2010 we couldn't afford it anymore. So there was a little bit of this slow burn that was rising up. And, yes, it's true that we could have- - we had the ability to go file for a deferral order. We had talked about it. Did not file it. One other thing I would point out is . . . we're not talking about FAS 87 expense. We're talking about uncovered pension contributions, the ones that are going into prepaid.[148]

Accordingly, in context, the following facts are clear:

1. The deferral contemplated by Order No. 03-507 concerned FAS 87 expense—not contributions and not prepaid pension assets. Thus, there is no suggestion in that order that the Company could have or should have filed a deferral order prior to making pension contributions or requesting the ability to add the prepaid pension asset to rate base.
2. In suggesting that the Company had the ability to file a deferral order, Mr. Feltz was not suggesting that he believed it would have been appropriate for a prepaid pension asset. He was simply stating the unremarkable point that the Company could have so filed if it wished. However, he quickly pointed out that the reason the Company did not file the deferral petition was that "we are not talking about FAS 87 expense" but rather "uncovered pension contributions that are going into prepaid."

2. The Company's Past Earnings Are Not a Reason to Deny the Company's Proposal.

Finally, Staff, CUB, and NWIGU all suggest that the Company's past "overearning" is a reason in and of itself to deny the Company's recovery of its prepaid pension asset. In making this argument, the parties overlook that the prepaid pension asset represents a contribution of

[148] Tr. 152, lines 3-24.

investor capital that the Company continues to finance. As discussed above, these contributions benefit customers through lower FAS 87 expense, as reflected in an ongoing fashion through the balancing account. The rate case is precisely the time to include this asset in rate base. Indeed, when the Company proposes to add other investments to rate base in the context of the rate case, it would not be appropriate for the Commission to deny the addition because it felt that the Company had earned enough during the period of time the investments were made. Nor would it make any sense for the Commission to view the request as "cherry picking." Thus, it is entirely appropriate for the Commission to add the prepaid pension asset to rate base in this case. In fact, it is necessary in order for the utility to be allowed an opportunity to earn a reasonable return on the investments it makes on behalf of customers.

F. The Parties Have Not Rebutted the Company's Evidence Demonstrating the Prudence of the MWVF.

1. The Facts Demonstrate that the Development of the MWVF Was Prudent.

The parties' posthearing briefs do not undermine the following basic facts that demonstrate that the Company's decision to develop the MWVF for reliability purposes was prudent:[149]

- NW Natural provided reply testimony explaining the reliability issue that exists in the Albany-Corvallis area,[150] and explained the reliability issue further at the hearing.[151]
- In rebuttal testimony, no party argued that a reliability issue does not exist in the Albany-Corvallis area. At hearing, Mr. Zimmerman conceded that single-feed

[149] CUB claims that the Company was incorrect when stating that "no other party has testified on the [MWVF] issue." CUB's Opening Brief at 8. For support, CUB cites to Mr. Larkin's entire rebuttal testimony. Mr. Larkin raised the issue of the in service date and known and measurable costs and never even used the word prudence when discussing the MWVF phases at issue in this case. NWIGU-CUB/100, Larkin 9-11. In service timing and known and measurable costs are distinct from the issue of prudence, so CUB's claim that NW Natural misrepresented Mr. Larkin's position is wrong.
[150] NWN/2200, Yoshihara/7-12.
[151] Tr. 214-221.

systems concern Staff, and specifically mentioned the Grants Pass Lateral in this context.[152]

- The Company provided testimony that it cannot predict when a disruption may occur on the Grants Pass Lateral,[153] and Mr. Zimmerman agreed that the IRP cannot be used to predict when a disruption could occur.[154]
- The Company explained that the only other theoretical alternative to address the single feed issue is satellite storage, which is not feasible because it is extremely difficult to site and permit, is too small of a resource to address the reliability issue, and would require additional distribution system enhancements.[155] No party claimed that the Company's findings with respect to alternatives were in error.
- The Company provided the parties with voluminous bidding, engineering, and construction information related to the MWVF.[156] No party raised concerns with respect to the Company's bidding process or other aspects of the construction of the MWVF.

The parties' continued reliance on incorrect characterizations of IRP modeling and their claim that the Company did not perform a specific, yet undefined, analysis do not rebut the Company's substantial evidence demonstrating prudence.

2. The Parties' IRP Argument Continues to Ignore Fundamental Facts Related to the IRP.

Both Staff and CUB continue to recommend disallowance of the MWVF based on the fact that the MWVF was not selected by the IRP for construction in 2012.[157] This argument

[152] Tr. 189, lines 4-15; Tr. 195, line 13-Tr. 196, line 4; Tr. 204, line 24-Tr. 205, line 8.
[153] Tr. 213, line 24-Tr. 214, line 22.
[154] Tr. 195, lines 10-12.
[155] NWN/2200, Yoshihara/13, lines 1-18; Tr. 225, line 22-Tr. 226, line 7.
[156] *See* CUB Exhibit 307; Exhibit NWN/2204; Exhibit NWIGU-CUB/301, 302, 307.
[157] Staff's Post-Hearing Brief at 45; CUB's Opening Brief at 8.

continues to overlook the Company's explanation that its IRP is not used to model distribution reliability, which is the reason why the Company proceeded with construction.

As pointed out by the Company, the Commission's IRP process "requires consideration of all known resources *for meeting the utility's load*."[158] Nothing in Commission precedent or the IRP Guidelines indicates that every pipe that a utility is building for reliability purposes should be modeled in the IRP. Notably, the IRP has never been used to select which projects need to be built for reliability considerations. And consistent with this fact, the Company's 2011 Modified IRP explicitly states that a different model than the IRP model is used to model distribution reliability.[159] The fact that the Company's preferred portfolio of resources needed to serve demand did not select the MWVF is irrelevant to the question of whether the project is needed for reliability.

As all parties agree, the MWVF *was* included in the IRP to model additional capacity needed to serve incremental load growth and selected on that basis for 2025. However, clearly, that scenario was developed to serve incremental demand, and so does not undercut the Company's testimony that the MWVF is needed for reliability today.[160] And similarly, while the IRP is not used to model reliability, the Company did model various disruptions, including the one on the Grants Pass Lateral, that resulted in the selection of the MWVF for 2019. As explained in previous testimony and briefing, that modeling was forced on the IRP to test

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[158] *Re Least Cost Planning for Resource Acquisitions* Order No. 89-507, 102 P.U.R.4th 301 (Apr. 20, 1989) (emphasis added).
[159] *Re NW Natural Gas Co. 2011 Integrated Resource Plan*, Docket LC 51, 2011 Modified Integrated Resource Plan at 3.17 (Sept. 1, 2011) ("System expansions or reinforcements accompany the need to increase resources to meet load growth. . . .. The Company's Engineering Department, in close collaboration with the Construction and Marketing departments, and using input from outside economic development and planning agencies, plans for the expansion, reinforcement and replacement of the distribution system. The Company uses the Synergy software package to evaluate infrastructure requirements."). The SENDOUT model is used by the Company for IRP modeling. NWN/2200, Yoshihara/3, line 21-Yoshihara/4, line 5.
[160] NWN/2200, Yoshihara/5, line 22-Yoshihara/6, line 2.

reliability assumptions, and at Staff's request, and confirms the value of the MWVF for reliability purposes.

Mr. Yoshihara explained all of these facts in his reply testimony and that testimony was uncontradicted on rebuttal. However, at hearing, Mr. Zimmerman indicated that he has a different view of the IRP process, one that would include modeling of distribution reliability resources.[161] Mr. Zimmerman's observations should be taken with a grain of salt. Staff also asked the Company in this case to explain how vehicles and sheds "were considered and examined in the current pending IRP."[162] Given that there is no reasonable interpretation of Commission precedent that would suggest that vehicles and sheds should be included in the IRP, it would appear that Mr. Zimmerman's understanding of the scope of the IRP is unclear and problematic. Indeed, Staff has cited no IRP guidelines or orders supporting Mr. Zimmerman's broad interpretation of the process. The fact is that the Company's IRP, which clearly states that system reinforcement and reliability projects are modeled outside the IRP, was acknowledged as compliant with the IRP guidelines.[163] Staff's after-the-fact attack on the Company's modeling of reliability projects should be disregarded.

Although Staff has argued that the selection of the MWVF for reliability purposes in 2019 indicates that the project should not have been developed until that date, CUB claims that the IRP's selection of the MWVF for reliability purposes in 2019 has "no relevance."[164] As Staff agrees, the selection of the MWVF to respond to a disruption in 2019 does have relevance because it means that the MWVF was selected as the least cost resource in the event of a disruption on the Grants Pass Lateral.[165] And further, the Company explained in testimony that

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[161] Tr. 204, lines 2-19.
[162] Staff/1002, Zimmerman/1. The cover letter to this data request indicates that Mr. Zimmerman generated the request.
[163] *Re NW Natural Gas Co. 2011 Integrated Resource Plan*, Docket LC 51, Order No. 12-161 at 2 (May 9, 2012).
[164] CUB's Opening Brief at 10.
[165] Tr. 188, lines 12-24.

the IRP would have selected the MWVF to address a Grants Pass Lateral disruption in any year prior to 2019.[166]

3. The Parties' Selective Use of One Data Response Does Not Indicate that the Company's Analysis of the Project Was Imprudent.

Staff criticizes the Company's analysis of the project on two levels. First, for the first time ever in this case, Staff states in its brief that the Company has not provided evidence that bidding was conducted and conducted properly.[167] This is an incredible assertion, because the Company provided Staff with all of the bidding information Staff requested[168] and not once has Staff criticized any aspect of the Company's bidding process or questioned whether the Company chose the appropriate bidder. Staff's claim that the Company has not provided this information and "apparently considers [it] unnecessary"[169] is a misrepresentation of the facts.

Second, Staff, CUB, and NWIGU argue that the Company did not conduct a quantitative financial analysis of the project, so the Company's analysis was imprudent.[170] In making this argument, Staff refers to a data request response in which the Company indicated, in response to Staff's request for a "financial analysis" of the project, that it did not have documents responsive to that request. The type of analysis Staff was seeking in that request was not clear, and continues to become less clear in light of the evidence gathered at hearing of what type of "financial analysis" the parties are looking for, given that the "benefit" associated with reinforcing this area of the system is not reasonably quantifiable in terms of dollars.[171] Staff can point to one data request response from the Company stating that it did not perform a "financial analysis," but substantial evidence shows that the Company performed the type of analysis that is appropriate for a reliability project. Specifically:

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[166] NWN/3300, Yoshihara/4, lines 6-8; Tr. 212, line 10-Tr. 213, line 7.
[167] Staff's Post-Hearing Brief at 46-47.
[168] *See* CUB Exhibit 307; Exhibit NWN/2204; Exhibit NWIGU-CUB/301, 302, 307.
[169] Staff Post-Hearing Brief at 47.
[170] *Id.* at 47; CUB's Opening Brief at 10; NWIGU's Initial Post-Hearing Brief at 17.
[171] *See* Tr. 191, line 16-Tr. 195, line 9.

- The Company conducted a reliability study in 2008 that identified the Albany-Corvallis area as the largest population in the Company's service territory at risk of a disruption due to being served by a single-feed system.[172]
- Given the number of customers that would be affected (30,000 customers in this case), and the length of time required to restore service (potentially weeks), the Company decided that this risk needed to be addressed to comply with the Company's obligation to provide safe and reliable service.[173]
- The Company's only real choice for addressing this reliability need was an alternative means to provide existing gas to the area. The Company identified the MWVF as the most cost effective choice for moving gas to this part of the system because parts of the pipeline have already been reinforced (because of safety-related bare steel replacement efforts), it is an existing alignment in which the Company has existing easements, and it is the shortest distance between the Albany-Corvallis area and a feeder other than the Grants Pass Lateral.[174]
- The IRP disruption modeling confirms that this is the least-cost resource for meeting the reliability need.[175]
- The Company then engaged a company to select the least-cost route and conducted a bidding process for the construction work to ensure the work was conducted on a least-cost basis.[176]

The parties' citation to one data request response relating to a "financial analysis," the content of which no party has credibly articulated, does not outweigh the evidence that the Company conducted the appropriate analysis for this project and chose the appropriate

[172] *See* Exhibit Staff/1115, Sobhy/3.
[173] NWN/2200, Yoshihara/7-12.
[174] *Id.* at 13-16.
[175] Tr. 188, lines 12-24.
[176] NWN/2200, Yoshihara/16, lines 3-7; NWIGU-CUB Exhibit 307.

resource. As the Company explained in its Prehearing and Posthearing Briefs, the Company's decision to develop the MWVF was an objectively reasonable business decision and should therefore be found to be prudent.

4. The Fact that the Two Phases at Issue in this Case Are Not Bare Steel Does Nothing to Undercut the Company's Reliability Evidence.

Both Staff and CUB appear to view Mr. Yoshihara's statement at hearing that the two phases of the MWVF included in rates in this case are not bare steel as a harmful admission of some kind.[177] The fact that the Perrydale to Monmouth and Monmouth Reinforcement phases are for system reinforcement, not replacement of bare steel, should not be news to the parties. From the beginning, NW Natural described the MWVF as a "major combined system reinforcement and bare steel replacement project"[178] that is "broken into . . . four phases because of permitting and easement acquisition timelines along the route, with one phase specifically focused on the removal of bare steel main."[179] The Company also made it clear that the bare steel phase was scheduled for completion in 2013, not the test year.[180] The fact that certain phases of the MWVF have been or will be completed because they are bare steel is, however, relevant to the prudence of the MWVF, because that fact makes the integrated project more cost effective to complete fully for reliability purposes.[181]

5. The Commission Should Strike the Portion of Staff's Brief Attempting to Introduce New Evidence.

Staff's counsel attempts to introduce new evidence through Staff's Post-hearing Brief on the topic of the MWVF. On page 47, lines 18-22, Staff criticizes NW Natural for not including an assessment of certain fixes that it asserts could be made to the Grants Pass Lateral to reduce the probability of failure or the costs and risks of building a different pipeline to address the

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[177] Staff's Post-Hearing Brief at 44; CUB's Opening Brief at 9.
[178] NWN/600, Yoshihara/2, lines 12-13.
[179] *Id.* at 4, lines 15-18.
[180] *Id.* at 5, lines 13-17.
[181] NWN/2200, Yoshihara/7, lines 4-11 and Yoshihara/15, line 8-Yoshihara/16, line 2.

reliability issue in the Albany-Corvallis area.[182] Staff's brief for the first time mentions its ideas of possible alternatives, looping by Northwest Pipeline and a building out of NW Natural's system to connect with GTN's system—neither of which are supported by testimony or other evidence in the case.[183] Staff had the opportunity in testimony to raise the issue of alternatives to the MWVF and did not do so. Staff's argument on these unsubstantiated facts should be stricken from the brief, or at least dismissed by the Commission.

To the extent that the Commission is inclined to consider new evidence, offered for the first time in Staff's brief, NW Natural would respond that the Company has considered the options referenced by Staff, and they are not viable or sound alternatives to the MWVF.

G. The Parties' Arguments Related to the Company's Deferred Tax Balances Fail to Acknowledge the Fact that Deferred Taxes Will Be Paid in the Future.

1. The Parties' Own Arguments Demonstrate that the Company's Proposal Does Not Constitute Retroactive Ratemaking.

The parties continue to object to the Company's amortization of the deferred tax balances on the basis that it constitutes retroactive ratemaking and single-issue ratemaking.[184] While arguing that the amortization of deferred tax balances is retroactive ratemaking, Staff, CUB, and NWIGU all agree that the deferred tax balance *does not reflect taxes that the Company has previously paid.*[185] This is exactly the reason why retroactive ratemaking is not relevant—the change in the deferred tax balance reflects the Company's calculation of taxes that will be paid in the future, not taxes the Company has already paid. The rule against retroactive ratemaking is implicated when the Commission "after determining expected costs and revenues, supplements that determination by employing past profits or losses in setting the

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[182] Staff's Post-Hearing Brief at 47.
[183] *See id.* at 47.
[184] *Id.* at 43-44; CUB's Opening Brief at 45-46; NWIGU's Initial Post-Hearing Brief at 16-17.
[185] The regulatory asset is "a book expense versus money changing hands." Staff's Post-hearing Brief at 43-44. The proposed amortization is not based "upon any cash payment to the state of Oregon." CUB's Opening Brief at 47. NW Natural "never actually paid any increase in state tax as a result of changes in the tax law." NWIGU's Prehearing Brief at 5.

future return the utility will be authorized to earn."[186] The Company has not paid the deferred taxes at issue here, and therefore has not incurred past losses that would implicate the rule against retroactive ratemaking.

NWIGU's argument—that the fact that "the event for which the Company is seeking recovery occurred prior to the test year" means that the Company's proposed amortization of the deferred tax balance is retroactive ratemaking—is flawed.[187] Events that occur in the past that result in changes to costs in the future are in fact reflected in rates. While the tax law change occurred in the past, the impact of the law is to change the amount of taxes the Company will pay in the future, not the amount of taxes the Company paid in the past, and the Company's proposed adjustment is therefore appropriate.

2. Staff's Arguments About the Nature of the Company's Deferred Tax Balance Are Based on a Misunderstanding of the Facts.

The arguments Staff puts forth in support of its claim that amortization of the deferred tax balance should not be allowed appear to be based on an incorrect understanding of deferred taxes. Staff argues that NW Natural is attempting to "reconcile previous rates"[188] and "cherry pick an expense that went up between rate cases, ignore earnings, and ask for future recovery of a past expense."[189] Contrary to Staff's position, the deferred tax balance is not an expense, like current taxes, that was previously included in rates. The regulatory asset was established to properly estimate the deferred taxes the Company will pay in the future, not to reconcile taxes paid in the past.[190]

Staff's argument is also premised on its notion that "NW Natural did not propose to change its deferred taxes based upon changes to its deferred tax expense."[191] The evidence

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[186] Oregon Attorney General Opinion, Opinion Request OP-6076, 1987 WL 278316 at *1 (Mar. 18, 1987).
[187] NWIGU's Initial Post-Hearing Brief at 16.
[188] Staff's Post-Hearing Brief at 43.
[189] *Id.* at 44.
[190] NWN/1900, Siores/26, lines 18-20.
[191] Staff's Post-Hearing Brief at 43.

demonstrates that the Company *did* change its deferred tax balances, which gave rise to the regulatory asset that represents the impact the tax change had on its deferred tax balance.[192] In this case, the Company is proposing to use the correct deferred tax balance to set rates, not a deferred tax balance that fails to reflect the tax law change, which is what the other parties propose.

Finally, Staff states that "NW Natural's arguments convolute the issue."[193] The Company has been attempting to clarify the issue, because the parties' arguments are not based on the reality of what deferred taxes are, and have been instead arguing as if the deferred tax balance was a prior period expense. It is not just the Company's testimony that supports the Company's view on the nature of deferred taxes and how changes to deferred taxes should be reflected in rates. The Company has cited to Commission precedent, Internal Revenue Service guidance, Federal Energy Regulatory Commission guidance, and case law in other states supporting the Company's arguments.[194] The other parties have cited no supporting precedent at all.

3. SB 408 Did Not Address NW Natural's Deferred Taxes.

Staff argues that SB 408 was in effect at the time the regulatory asset was created, and implies that SB 408 took care of the problem.[195] This is not the case. NW Natural did not recover through SB 408 the change in deferred taxes that was caused by the Oregon state tax law change. Moreover, no party has testified that NW Natural's deferred tax change should properly have been included in the Company's 2009 SB 408 filing.

4. CUB's Arguments Conflate Deferred Taxes With Taxes Paid in the Past.

CUB's new arguments on the deferred tax issue further demonstrate that its arguments fail to account for the nature of deferred taxes.[196] For example, CUB claims that the Company

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[192] NWN/1900, Siores/24, lines 2-4.
[193] Staff's Post-Hearing Brief at 43.
[194] NW Natural's Prehearing Brief at 51-52, 54-55; NWN/1900, Siores/28-31.
[195] Staff's Post-Hearing Brief at 44.
[196] CUB claims that the Company raises UM 1147 in relation to deferred taxes. CUB's Opening Brief at 47. CUB does not provide a citation to the Company's brief, so it is not clear what CUB is referring to.
(continued...)

"knows that it has to file for deferrals even when dealing with taxes," because the Company previously filed a deferral in regard to the Oregon "Tax Kicker."[197] The Tax Kicker provided a refund of income taxes that the Company already paid.[198] Deferred taxes, on the other hand, reflect the timing differences between book income on the Company's books and the taxable income on the Company's tax return (book-tax difference).[199] These timing differences arise because an expense may be taken for tax purposes earlier than it may be recognized for book purpose.[200] By their very nature, deferred taxes represent future tax liabilities.[201] The Tax Kicker, therefore, is not relevant to the argument.

Next, CUB claims that the Company "tries . . . to use accelerated depreciation to confuse this issue."[202] Deferred taxes arise *because* utilities reflect in rates accelerated depreciation; the difference between the straight-line depreciation allowed by the IRS and state and accelerated deprecation gives rise to deferred taxes.[203] CUB's statement that NW Natural is "confusing" the issue is especially troubling, given that the "confusion" it points to is the Company's explanation of what deferred taxes actually represent.

Finally, CUB reiterates the charge that allowing the Company's proposed amortization would constitute "double recovery."[204] No party has argued that the disputed amount is in past rates, so CUB's argument is baseless, and it is unclear what theory CUB uses to arrive at this erroneous conclusion.

The Company raised UM 1147 in the context of the environmental remediation mechanism, not deferred taxes.

[197] CUB's Opening Brief at 44.

[198] *Re NW Natural Gas Co. Application for Authorization of Deferred Accounting of Oregon's "Tax Kicker" Income Tax Reduction*, Docket UM 1245, Order No. 06-099, Appendix A at 1 (Feb. 28, 2006).

[199] NWN/3000, Siores/13, lines 6-8.

[200] *Id.* at lines 8-10.

[201] *Id.* at line 13.

[202] CUB's Opening Brief at 46.

[203] NWN/1900, Siores/24, lines 1-11.

[204] CUB's Opening Brief at 47.

5. Even If Retroactive Ratemaking Were to Apply to Updates to Deferred Tax Balances, the Adjustments that Staff and NWIGU-CUB Seek Are Inappropriate.

As the Company explained in further detail in its Prehearing Brief, even if the Commission were to strike out, into what NW Natural perceives to be unprecedented territory, and find that retroactive ratemaking principles apply to updates to deferred tax balances, Staff's and NWIGU-CUB's proposed adjustments are inappropriate.[205] The parties propose that NW Natural be prevented from recovering *any* of the amounts that were added to NW Natural's deferred tax balance from the updating that was required after the Oregon state tax change.[206] This is because their adjustment is based on a removal of NW Natural's ability to collect appropriate taxes for years that occur even after it filed this rate case.[207] No application of retroactive ratemaking principles could have such a result.

If the Commission were to agree with the parties' retroactive ratemaking argument, that argument could only apply to the "reversals" (*i.e.* where book depreciation is greater than tax depreciation for those assets) that occurred between 2009 and 2012.[208] And, as explained in testimony, increases in NW Natural's deferred taxes during that time more than offset those reversals.

III. CONCLUSION

For the reasons set forth in the Company's Prehearing and Posthearing Briefs and above, the Company respectfully requests that the Commission: (1) set the Company's ROE at 10.0 percent; (2) reject Staff's proposed adjustment to cost of debt based on the interest rate hedge loss; (3) adopt the Company's environmental remediation cost recovery mechanism with no sharing provision or earnings test, and allowing interest to accrue on deferred amounts consistent with Order No. 06-507; (4) adopt the Company's proposed pension contribution

[205] NW Natural's Prehearing Brief at 52-53.
[206] NWN/3000, Siores/14, lines 19-22.
[207] *Id.* at lines 3-9.
[208] *Id.* at 15, lines 13-17.

ratemaking methodology; (5) find that the development of the MWVF was prudent and allow into rates the costs associated with the Perrydale to Monmouth and Monmouth Reinforcement phases; and (6) allow the Company to amortize the regulatory asset associated with deferred tax balances.

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CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of the foregoing document in UG 221 on the following named person(s) on the date indicated below by email addressed to said person(s) at his or her last-known address(es) indicated below.

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