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August 20, 2012

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 the original and five copies of Northwest Natural Gas Company's Prehearing 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

Wendy McIndoo
Office Manager

Enclosure

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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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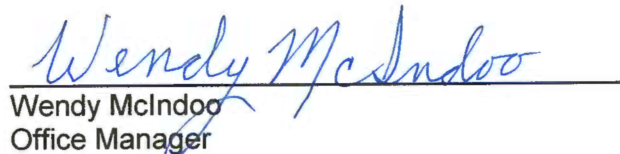

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BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

UG 221

In the Matter of NORTHWEST NATURAL GAS COMPANY Application for a General Rate Revision.	

NW NATURAL'S

PREHEARING BRIEF

August 20, 2012

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Appendix A

BEFORE THE PUBLIC UTILITY COMMISSION OF OREGON

UG 221

In the Matter of NORTHWEST NATURAL GAS COMPANY Application for a General Rate Revision.	**PREHEARING BRIEF**

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 Prehearing Brief to the Public Utility Commission of Oregon ("Commission").

I. INTRODUCTION

This Prehearing Brief provides the Commissioners and ALJ Hardie with a summary of the issues that have been resolved in this case and the parties' positions and supporting evidence on issues that remain for Commission resolution. The Company reserves the right to discuss additional issues in its Posthearing Brief.

II. BACKGROUND

On December 30, 2011, NW Natural filed revised tariff sheets to be effective February 1, 2012, seeking a general rate increase of approximately $43.7 million, or 6.2 percent. In its filing, NW Natural used an historic base period of the 12 months ended December 31, 2011, with adjustments to calculate a future test period of the 12 months ending October 31, 2013 ("Test Year").

In Order No. 12-011, issued on January 19, 2012, the Commission suspended the Company's application for a general rate revision for a period of nine months. Based on the suspension, the effective date of the revised tariff sheets is November 1, 2012.

Pursuant to Administrative Law Judge Hardie's Prehearing Conference Memorandum of January 23, 2012, the parties to this docket convened settlement conferences on April 4

and 5, 2012. NW Natural, Staff, the Citizens' Utility Board of Oregon (CUB), the Northwest Industrial Gas Users (NWIGU), and Northwest Energy Coalition (NWEC) participated in those settlement conferences.[1] The parties again convened settlement conferences on May 22 and 23, 2012 and continued settlement discussions after that date. As a result of those settlement conferences, NW Natural, Staff, CUB, NWIGU, and NWEC reached settlements resolving some of the issues in this case.

III. ISSUES THAT HAVE BEEN RESOLVED

NW Natural, Staff, CUB, and NWIGU entered into a Partial Stipulation that resolves a number of issues in this case.[2] Specifically, the Partial Stipulation resolves:

- The rate treatment of all capital projects, with the exception of the Mid-Willamette Valley Feeder projects (Perrydale to Monmouth and the Monmouth Reinforcement);[3]
- The Company's proposed revenue adjustment related to estimated losses through customer attrition if the Company's rate design proposal was adopted;[4]
- Amortization of rate case expense;[5]
- Uncollectibles;[6]
- Injuries and damages expense;[7]
- Directors and officers insurance;[8]
- Incentive pay;[9]
- Administrative and general expense;[10]

---

[1] Portland General Electric Company, Northwest Pipeline GP, and Community Action Partnership of Oregon are parties to this proceeding but didn't participate in settlement discussions.
[2] NWEC does not object to the Partial Stipulation.
[3] Partial Stipulation ¶¶ 8-19, 21.
[4] *Id.* at ¶ 20.
[5] *Id.* at ¶ 22.
[6] *Id.* at ¶ 23.
[7] *Id.* at ¶ 24.
[8] *Id.* at ¶ 25.
[9] *Id.* at ¶ 26.

- Miscellaneous revenue;[11]
- Advertising expense;[12]
- Research and development expense;[13]
- Materials and supplies;[14]
- Contributions in aid of construction;[15]
- Customer deposits;[16] and
- Injuries and damages reserve.[17]

NW Natural, Staff, CUB, NWIGU, and NWEC also reached an agreement in principle resolving the following issues, and plan to file a second partial stipulation in the near future:

- Rate design;
- Decoupling and the Weather Adjusted Rate Mechanism;
- LRIC study;
- Rate spread, with the exception of rate spread related to the environmental remediation recovery mechanism;
- Cost of long-term debt, with the exception of the interest rate hedge issue;
- Number of Test Year employees;
- Medical benefits, workers' compensation, overtime, payroll tax, and depreciation expense;
- Payroll capitalization;
- Working gas inventory;

[10] *Id.* at ¶ 27.
[11] *Id.* at ¶ 28.
[12] *Id.* at ¶ 29.
[13] *Id.* at ¶ 30.
[14] *Id.* at ¶ 31.
[15] *Id.* at ¶ 32.
[16] *Id.* at ¶ 33.
[17] *Id.* at ¶ 24.

1 • Schedule 31 and 32 rate design;
2 • Interstate storage sharing
3 • System Integrity Program;
4 • Service window guarantee; and
5 • Reconnection charges.

6 ## IV. CONTESTED ISSUES

7 Despite the Partial Stipulation and the agreement in principle, a number of important
8 issues remain for Commission resolution: return on equity; Staff's proposed adjustment to
9 cost of capital for an interest rate hedge loss; recovery of costs associated with the
10 Company's environmental remediation activities; recovery of pension costs; prudence of the
11 Mid-Willamette Valley Feeder; and amortization of certain deferred tax balances.

12 ### A. Return on Equity

13 #### 1. Introduction

14 The Company requests an ROE of 10.0 percent and Staff witness Steve Storm
15 recommends an ROE of 9.4 percent. The range between the parties' ROE recommendations
16 narrowed as this case progressed, with NW Natural reducing its original ROE request of 10.3
17 percent and Staff increasing its original ROE recommendation of 9.2 percent.
18 NW Natural's requested ROE of 10.0 percent is based primarily on NW Natural
19 witness Dr. Samuel C. Hadaway's discounted cash flow (DCF) method analysis,[18] which
20 indicated an ROE range of 9.6 to 10.3 percent in Dr. Hadaway's direct testimony and 9.4 to
21 10.1 percent in his surrebuttal testimony.[19] The Commission usually relies on the most recent
22 information available to estimate the cost of equity because in an "efficient market, the current
23
24
25 [18] Dr. Hadaway also conducted a risk premium analysis, the results of which he discounted because they were unduly influenced by artificially low interest rates. Mr. Storm did not offer a risk premium analysis.
26 [19] NWN/3200, Hadaway/3, line 7.

1 stock price provides the best information of future prices."[20] The Commission has deviated
2 from this approach when faced with wide fluctuations in a utility's stock price or other evidence
3 of "price aberrations."[21] In light of ongoing, unusual conditions in the financial markets, the
4 Commission should continue to consider Dr. Hadaway's original DCF results, as well as his
5 updated results.

6 Dr. Hadaway's DCF analysis is more complete than Staff's and his growth rates are
7 more reasonable and consistent. In addition, Dr. Hadaway's testimony explains that an ROE
8 in the upper end of his DCF range is appropriate given the limitations of traditional cost of
9 equity estimation models in the aftermath of the prolonged recession and government
10 intervention to artificially depress interest rates. Dr. Hadaway demonstrates this point in his
11 alternative approach to Staff's Multistage DCF 2 model, also referred to as the price-to-
12 earnings "P/E Model." Instead of lengthening the time horizon of the model as Mr. Storm
13 proposed in his rebuttal testimony, Dr. Hadaway shortened it to more accurately capture
14 current market conditions. This analysis produces a median ROE of 10.6 percent.

15 NW Natural's requested ROE of 10.0 percent is also supported by average allowed
16 ROEs awarded by other commissions and Company-specific business risks articulated by NW
17 Natural's Chief Financial Officer Mr. David Anderson.

18 **2. Legal Standard**

19 The Commission determination of a utility's authorized return on equity (ROE) is a
20 "fundamental part of utility regulation."[22] The Commission must establish an ROE that is
21 "sufficient to maintain financial integrity, allow the utility to attract capital under reasonable
22 terms, and be commensurate with returns investors could earn by investing in other
23

24
[20] *Re Northwest Natural Gas Co.*, Docket UG 132, Order No. 99-697 at 14 (Nov. 12, 1999).
[21] Order No. 99-697 at 14.
25
[22] *Re PacifiCorp*, Docket UE 116, Order No. 01-787 at 33 (Sept. 7, 2001) [hereinafter Order No. 01-787].
26

enterprises of comparable risk."[23] The "determination of the cost of equity is not an exact science."[24] Instead, the Commission has recognized that its "job is to sift through the information presented, and determine a reasonable cost of equity."[25]

As demonstrated by the testimony and analysis presented in this case, a reasonable ROE for NW Natural is 10.0 percent.

3. Dr. Hadaway's DCF Modeling is More Reasonable and Robust than Staff's DCF Modeling.

There are two key differences in the approaches to DCF modeling employed by Dr. Hadaway and Mr. Storm. First, Dr. Hadaway has developed results from both constant growth (or single-stage) and multi-stage DCF models, while Mr. Storm uses only the multi-stage model. Mr. Storm argues that the Commission should give little weight to Dr. Hadaway's constant growth model, noting that the Commission rejected consideration of the parties' constant growth models in Docket UE 115.[26] Mr. Storm omits to mention, however, that the Commission expressly indicated that it was open to use of single-stage DCF models in future cases.[27] Additionally, in Docket UE 180, the Commission relied on an ROE recommendation from the witness of the Industrial Customers of Northwest Utilities and CUB, whose DCF analysis was based only on a constant growth DCF model.[28] Even Mr. Storm acknowledges that the constant growth DCF model is useful in demonstrating "the key

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[23] *Re Portland General Electric Co.*, Dockets UE 180/UE 181/UE 184, Order No. 07-015 at 28 (Jan. 12, 2007) [hereinafter Order No. 07-015]; ORS 756.040(1).

[24] Order No. 01-787 at 33.

[25] *Id.*

[26] Staff/1300, Storm/73, lines 1-4.

[27] In disregarding the results of the parties' constant growth DCF models in Order No. 01-777 in Docket UE 115, the Commission questioned the model's applicability in light of the ongoing restructuring of the electric industry. The Commission then noted that "[p]arties are free to use the single-stage version of the DCF method in future dockets, but they will be required to show the required industry stability is present." *Re Portland General Electric Co.'s Proposal to Restructure and Reprice Its Services in Accordance with the Provisions of SB 1149*, Docket UE 115, Order No. 01-777 at 27 (Aug. 31, 2001) [hereinafter Order No. 01-777].

[28] Order No. 07-015 at 46-47.

1 variables involved in DCF modeling and their impact on DCF results."[29] Dr. Hadaway's
2 constant growth DCF model with gross domestic product (GDP) growth rates produced a
3 median ROE of 10.3 percent in his direct testimony and 10.1 percent in his surrebuttal
4 update.[30]

5 Second, Dr. Hadaway and Mr. Storm apply different dividend growth rates in their DCF
6 analysis. Dr. Hadaway relies on a GDP-growth rate, the calculation of which has remained
7 constant throughout this case. This growth rate was 5.8 percent in Dr. Hadaway's direct
8 testimony and 5.7 percent in his updated analysis, reflecting the addition of 2011 data. Using
9 these growth rates, Dr. Hadaway's multi-stage analysis produced a median ROE of 10.1
10 percent in his direct testimony and a median ROE of 9.7 percent in his surrebuttal testimony.

11 Staff also used GDP data in two of the three different growth rates Mr. Storm
12 developed in his direct testimony: one based on a composite of government forecasts (4.91
13 percent), a second based on the historical real GDP growth rate since 1980 (5.48 percent)
14 and a third using Dr. Hadaway's GDP growth rate (5.8 percent). Mr. Storm's original ROE
15 recommendation was based upon his 5.48 percent GDP-based growth rate.[31] In Staff's
16 rebuttal testimony, Mr. Storm reduced his GDP growth rate to 5.14 percent.[32] Mr. Storm
17 arrived at this new rate, which is 29 basis points lower than the rate used in his direct
18 testimony, by completely changing the methodology used to determine the long-term growth
19 rate.[33]

20

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21 [29] Staff/1300, Storm/72.

22 [30] Dr. Hadaway's constant growth model with analyst growth rates produced a range of results from 9.6 percent to 10.0 percent in his direct testimony. These results decreased to a range of 9.4 percent to 9.6 percent in his surrebuttal update. The update reflected an overall decline in average
23 analyst growth rates from 5.48 percent to 5.25 percent, notwithstanding the fact that the Value Line growth rate increased from 5.46 percent to 5.65 percent during this same period. Given the fact that
24 current near-term analyst forecasts are depressed and volatile, Dr. Hadaway relied more heavily on long-term GDP-based growth rates in his analysis. See NWN/500, Hadaway/37, lines 1-5.

25 [31] Staff/1300, Storm/64, Table 9.

[32] Staff/2200, Storm/18, Table 3.

26 [33] *Id.* at 16, lines 2-10.

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.[34] Dr. Hadaway's use of weighted, long-term historical data for his forecast growth rate is consistent with the derivation of most econometric forecasts.[35] Current government growth forecasts are unreasonably low when used to project long-term growth because they assume permanently low inflation rates, in the range of two percent.[36] Dr. Hadaway's data demonstrates that, in all but the most recent periods, periodic average inflation rates have been over three percent.[37] 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.[38]

The reasonableness of Dr. Hadaway's 5.7 percent growth rate can be seen by comparing it to the most recent Value Line growth rate of 5.65 percent.[39] This is the same growth rate used by Mr. Storm in the first stage of his DCF models.[40]

4. Current Market Conditions Support an ROE at the Upper End of the DCF Range.

NW Natural's updated recommended ROE of 10.0 percent is at the upper end of Dr. Hadaway's most recently updated DCF range and slightly above the mid-point of Dr. Hadaway's original DCF range.[41] In a previous case addressing NW Natural's ROE, Docket UG 152, when capital market conditions were considerably different that they are now, Dr. Hadaway recommended, and the Company requested, an ROE at near the bottom of the quantitative range. In that case, as market conditions evolved, the Company agreed to and

[34] NWN/500, Hadaway/35, lines 12-14.
[35] NWN/500, Hadaway/36, lines 3-5.
[36] *Id.* at 36, lines 9-12.
[37] NWN/503, Hadaway/1.
[38] NWN/500, Hadaway/36, lines 9-20.
[39] NWN/3200, Hadaway/10, lines 2-4.
[40] *Id.* at 9, line 26 – Hadaway/10, line 2; Staff/1300, Storm/57, lines 14-15.
[41] NWN/2100, Hadaway/2, lines 19-20; NWN/3200, Hadaway/3, line 7.

1 the Commission approved an even lower ROE below the bottom of Dr. Hadaway's
2 quantitative range.[42] Here where the models and conditions go the other direction, the
3 Commission should show the same willingness to apply quantitative results flexibly to derive
4 the most reasonable ROE.

5 Current government policies designed to maintain interest rates at record lows have
6 distorted the relationship between monetary supply and demand and the models traditionally
7 used to determine ROE (*i.e.*, DCF and equity risk premium models) do not account for this
8 market distortion.[43]

9 The artificially low interest rates have caused income seeking investors to look to
10 dividend-paying stocks, like utilities, which has in turn reduced the dividend yield percentage
11 to historically low levels.[44] Indeed, Value Line has warned that the influx of income-seeking
12 investors to utility stocks has resulted in the industry being overvalued; so "long-term investors
13 should be cautious."[45] The dividend yield percentage is a key component of the DCF model,
14 which means that if this percentage is artificially low due to current expansionary monetary
15 policies, then the results of the analysis are questionable.

16 Staff's analysis fails to consider the government's ongoing intervention in the capital
17 markets.[46] Instead, Staff mechanically ran the traditional analyses, without any consideration
18 of current market conditions.[47] Had Staff considered the current market conditions in its
19 analysis, the results would have been significantly higher. For example, Mr. Storm's
20 Multistage DCF 2 or P/E Model was based on a 30-year analysis, which modeled the sale of
21 the stock in 2042.[48] In Staff's rebuttal testimony, this was modified to 2052, which resulted in
22

[42] NWN/500, Hadaway/3, lines 15-20. *See Re NW Natural*, Docket UG 152, Order No. 03-507
23 (Aug. 22, 2003) (approving Stipulation allowing ROE of 10.2 percent).
[43] NWN/2100, Hadaway/3, lines 12-19.
24 [44] *Id.* at 6, lines 2-12.
[45] NWN/3200, Hadaway/9, lines 8-16.
25 [46] NWN/2100, Hadaway/3, lines 12-19.
[47] NWN/3200, Hadaway/9, lines 3-6.
26 [48] *Id.* at 5, lines 13-17.

a lowering of the ROE.[49] However, lengthening the analysis will decrease its accuracy.[50] To account for current market conditions, in particular the "bidding up" of utility stocks caused by income-seeking investors, it is more reasonable to model a shorter time horizon.[51] Making this adjustment, to account for current capital market conditions, results in an estimated ROE of 10.6 percent.[52] This result should be balanced against the extremely low DCF results produced by traditional approaches.[53]

5. Staff's Recommended ROE is unreasonably Low Compared to Average Allowed ROEs from Other Jurisdictions.

Staff originally recommended an ROE of 9.2 percent,[54] which increased to 9.4 percent in Staff's rebuttal testimony.[55] The unreasonableness of Staff's ROE recommendation is demonstrated by cross-checking it against recently allowed ROEs for LDCs across the country. Going back to 2008, there has not been a single quarter when the average authorized ROEs have been anywhere near as low as Staff's recommendation.[56] Indeed, the lowest quarterly average ROE is a full 23 basis points higher than Staff's recommendation.[57] Even the average ROE for 2011, 9.92 percent, which was the lowest annual average allowed ROE ever recorded, was a full 52 basis points higher than Staff's recommendation here.[58] These facts demonstrate that Staff's recommendation is unreasonably low.[59]

Staff's direct testimony relied heavily on the average allowed ROE from the first quarter of this year,[60] but Staff's rebuttal testimony failed to acknowledge that the average

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[49] *Id.*, lines 16-17, 20.
[50] *Id.* at 6, lines 4-5.
[51] *Id.* at lines 8-23.
[52] *Id.* at lines 8-23.
[53] *Id.* at 7, lines 3-7.
[54] Staff/1300, Storm/53, lines 8-9.
[55] Staff/2200, Storm/3, lines 10-11.
[56] NWN/2100, Hadaway/4, lines 2-5; NWN/2101; NWN/3201.
[57] NWN/2101.
[58] NWN/3200, Hadaway/4, lines 15-17.
[59] NWN/2100, Hadaway/4, lines 8-11.
[60] *See e.g.*, Staff/1300, Storm/64 – 65.

allowed ROE increased by 20 basis points to 9.83 percent in the second quarter.[61] This means that the six-month 2012 average is 9.75 percent, an average level that is closer to the Company's recommendation than it is to Staff's.[62] While the Commission has not used comparable ROEs from other jurisdictions to establish an ROE, in Order No. 01-777 the Commission noted that "other ROE determinations may provide confirmation of a decision."[63] Here, average allowed ROE data is more supportive of the Company's 10.0 percent ROE recommendation than Staff's 9.4 percent ROE recommendation.

6. The Company's Business Risks Support an ROE of 10.0 Percent.

As described by Dr. Hadaway and Mr. Anderson, NW Natural faces specific business risks due increasing competition for residential load, mounting environmental liabilities resulting from its historic MGPs, and unrecovered pension contributions required to be made to its pension fund.[64] In general, the LDC operating environment has become more complex and competitive over the past 15 years, increasing the risk to these companies. The economic slow-down and warmer-than-normal conditions have also negatively impacted NW Natural's cash flow.[65] In an environment of increasing risk, NW Natural needs a reasonable ROE to continue to remain a financially stable company. The Commission has previously recognized adjustments to allowed ROEs in cases such as this to account for company-specific risks.[66]

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[61] NWN/3200, Hadaway/4, lines 5-7.
[62] *Id.* at 4, lines 7-11.
[63] Order No. 01-777 at 34.
[64] NWN/500, Hadaway/14.
[65] *Id.* at 15.
[66] Order 07-015 at 47 (allowing a 10 basis point upward adjustment in ROE to account for risk exposure to the wholesale market).

B. Cost of Debt

1. Introduction

One unresolved issue remains related to the cost of debt—Staff's proposed adjustment based a loss incurred on an interest rate hedge entered into in 2007. Staff proposed a 6.022 percent cost of debt, which reflects a 0.243 basis point reduction to the Company's proposed cost of debt. The 6.022 percent is premised on Staff's argument that the Company should share the loss on the interest rate hedge.[67] No other party has objected to the Company's proposed cost of debt.

Staff claims that the hedge was imprudent primarily because the Company did not perform a probabilistic risk analysis prior to entering into the hedge. Just what type of risk analysis Staff believes the Company should have performed seems to be somewhat of a moving target. However, the bottom line is that no analysis suggested by Staff would have, if performed, indicated that the hedge was too risky. On the contrary, the Company has demonstrated that *had* it performed the risk analyses suggested by Staff, these analyses would have confirmed its decision to enter into the hedge. Indeed, as discussed below, the reason the hedge resulted in a loss for the Company was an unprecedented shift in the market caused by the financial crisis of 2008 and 2009. In order for the Company to have foreseen the unfortunate outcome of the interest rate hedge, it would have needed to predict the financial crisis—something it could not have done.

2. Basis for Entering Into Interest Rate Hedge

The type of hedge at issue in this case is an interest rate swap. Interest rate swaps are transactions where the parties agree to make interest payments to each other calculated using a "notional" principle amount, which is an amount upon which the interest payments are calculated.[68] Under an interest rate swap agreement, each party receives an interest payment

[67] NWN/3100, Feltz/2, lines 7-12; Staff/1200, Muldoon/4, lines 11-13.
[68] NWN/2000, Feltz/6, lines 7-10.

1 based on the "swap rate"; however, one party calculates their payment obligation at a fixed
2 rate, based on the swap rate at the time of the agreement, while at the same time agreeing to
3 receive their interest payment from the other party at the variable swap rate.[69] The net
4 amount between "paying fixed" and "receiving variable" is the net cash settled and is
5 considered the "swap payment."[70] The party sending or receiving swap payments applies the
6 proceeds, or losses, from the net exchange to the costs of a separate debt issuance once it is
7 completed.[71] *The goal of this swap transaction is to achieve an interest cost that is close to*
8 *the effective rate that was hedged under the transaction as of the hedge date.*[72]
9 In the fall of 2007, the Company became interested in an interest rate swap because it
10 was planning to make a significant debt issuance in the near future, and because interest
11 rates were reflecting substantial volatility.[73] The Company was concerned that rising interest
12 rates could harm the Company and its customers with higher interest costs when it made that
13 future debt issuance,[74] and so decided to enter into the interest rate hedge in order to mitigate
14 risk associated with swings that were occurring in corporate debt issuance interest rates.[75]
15 The Company was authorized to enter into the transaction under Order No. 07-032,
16 issued January 29, 2007, which approved the Company's use of interest rate derivatives such
17 as interest rate swaps.[76] Under the order, the Company was limited to interest rate hedges
18 not to exceed a notional amount of $200 million, or 30 percent of total outstanding debt.[77]
19 Further, the Company was required to maintain investment grade ratings from two nationally
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[69] *Id.* at lines 10-12.
[70] *Id.* at lines 12-13.
[71] *Id.* at lines 14-15.
[72] *Id.* at lines 15-17.
[73] *Id.* at lines 18-20.
[74] *Id.* at lines 20-22.
[75] *Id.* at 5, lines 10-13.
[76] *Re. NW Natural Application for Authorization of Interest Rate Hedging*, Docket UF 4235, Order No. 07-032 (Jan. 29, 2007) (hereinafter "Order No. 07-032").
[77] *Id.* Appendix A at 1-2.

1 recognized bond rating agencies.[78] The Company complied with these terms, and the interest
2 rate hedge it entered into was within the parameters allowed by the order.[79] The Company
3 was also required to file reports and supporting documentation regarding any hedge
4 transaction entered into, including documentation demonstrating that the hedge transaction
5 was prudent.[80] The Company did so in its filing dated February 26, 2008.[81]

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7 **3. The Financial Crisis Had an Unanticipated Impact on the Outcome of the Hedge.**

8 Unfortunately, and as a result of the financial crisis, the interest rate hedge did not
9 serve the purpose for which it was designed.[82] An interest rate swap of this type is intended to
10 effectively lock in a target interest rate for a future issuance of debt.[83] However, the economic
11 effectiveness of the hedge depends on the correlation between changes in the "swap rate"
12 and changes in the expected interest rate on the underlying future bond issuance.[84]
13 Historically, the correlation between the AA swap rate and an AA utility bond rate (which
14 would be similar to a NW Natural first mortgage bond rate) had been very close.[85] However,
15 in the midst of the financial crisis, there was a significant, unexpected, and unprecedented
16 variance between these rates.[86] Not only did the change in rates not correlate, they became
17 inversely correlated, which is to say they moved in the opposite direction.[87]

18 For the Company to have known that such a result would occur, it would have needed
19 to predict the outcome of the financial crisis that occurred during 2008 and 2009, which
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21 [78] *Id.* Appendix A at 2.
[79] NWN/2000, Feltz/5, lines 22-23
22 [80] Order No. 07-032 at Appendix A at 1.
[81] *Re. NW Natural Application for Authorization of Interest Rate Hedging*, Docket UF 4235, NW
23 Natural Filing (Feb. 26, 2008).
[82] NWN/2000, Feltz/8, lines 19-21.
24 [83] *Id.* at lines 23-24.
[84] *Id.* at lines 24-9, line 2.
25 [85] *Id.* at 9, lines 2-5; Exhibit NWN/2002.
[86] *Id.* at lines 5-7.
26 [87] *Id.* at lines 8-10.

caused an unexpected and unprecedented variance between the 10-year swap rate and the debt costs of AA utilities.[88]

4. The Company's Interest Rate Hedge Meets the Commission's Standard for Prudence of a Hedging Contract.

To evaluate the prudence of a hedging contract, the Commission first examines the utility's hedging strategy.[89] If the strategy is prudent, the Commission will then examine whether the utility executed its strategy prudently.[90] If the transaction is inconsistent with the strategy, or parties raise issues that appropriately call the transaction into question, the Commission will evaluate whether the utility provided "adequate and contemporaneous analysis and documentation and a sound justification to support the transaction."[91]

a. The Company's Hedging Strategy Was Prudent.

Staff does not appear to object to the Company's general strategy of entering into an interest rate hedge to mitigate risk associated with swings that were occurring in corporate debt issuance interest rates. Indeed, given that the Commission specifically approved the Company's request "to enter into Interest Rate Hedge Products with financial institutions to manage exposure to interest rate fluctuations,"[92] there is no basis to find that this hedging strategy itself was not prudent.

b. The Company's Decision to Enter into the Particular Interest Rate Hedge Transaction Was Prudent.

Staff's argument focuses instead on the Company's analysis prior to entering into this particular transaction. In opening testimony, Staff first claimed that the Company was imprudent in failing to perform or retain a third party to conduct an independent probabilistic

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[88] *Id.* at lines 13-17.
[89] *Re. PacifiCorp 2012 Transition Adjustment Mechanism*, Docket UE 227, Order No. 11-435 at 7 (Nov. 4, 2011).
[90] *Id.*
[91] *Id.*
[92] Order No. 07-032 at 1.

1 analysis of the risks posed by the hedge.[93] Implicit in this criticism is Staff's belief that *had* the
2 Company performed such an analysis, or paid a third party to conduct an independent
3 probabilistic analysis, such analysis would have demonstrated that the hedge was too risky.
4 However, the Company has demonstrated that the very opposite is the case.

5 First, the Company explained that it thoroughly investigated and analyzed the interest
6 rate hedge before entering into the transaction. Prior to entering into the hedge, the Company
7 spent several months evaluating potential mechanism for hedging interest rates and having
8 discussions with several investment banks.[94] After the Company determined that it would use
9 an interest rate swap, the Company issued a request for proposals and closely monitored
10 swap rates.[95] The Company decided to enter into the swap at a time when swap rates were at
11 the low for the year, and used the bank counterparty with the lowest rate offer in a competitive
12 bid process at that time.[96]

13 In its reply testimony, the Company explained it did not believe that a third party
14 analysis was called for and that it is not common practice to hire an independent third party to
15 analyze hedges.[97] Importantly, the Company explained that it reviewed the same
16 independently verifiable information that a third party would have reviewed, and the
17 Company's review did not show that the hedge was too risky.[98] In addition, the Company
18 pointed out that there was no evidence to suggest that other utilities hired third parties to
19 analyze hedges.[99]

20 Moreover, the Company testified that *had* it performed a probabilistic analysis prior to
21 entering into the hedge, the analysis would have supported the Company's actions in
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23 [93] Staff/1200, Muldoon/4, lines 14-17.
[94] NWN/2000, Feltz/12, lines 1-4.
24 [95] *Id.* at lines 4-8.
[96] *Id.* at lines 7-10.
25 [97] *Id.* at 10, lines 19-22.
[98] *Id.* at 11, lines 4-12.
[99] *Id.* at lines 13-23; Exhibit NWN/2003.
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engaging in the hedge.[100] In support of this position, the Company presented the results of a Monte Carlo simulation that it performed based upon information available to it at the time it entered the hedge.[101] The results of the Monte Carlo simulation demonstrated that within a 95 percent confidence band, the variances in the swap rate would have been expected to produce a maximum potential loss on the swap transaction of $5.6 million, or a maximum potential gain of $7.8 million.[102] *However, and most importantly, the Company explained that either result would have mitigated against any interest rate volatility, had the swap rate and AA bond rate continued to correlate.*[103]

In response to this evidence, Staff changed its position in rebuttal testimony. Given that the result of the probabilistic analysis that Staff had originally called for suggests that the risks presented by the hedge were in an acceptable range, Staff argued in rebuttal testimony that "[i]n addition to analysis of the probability of most likely events, there is analysis of high-impact, low frequency (HILF) events."[104] As an example of a HILF event, Staff uses the example of "an activity [that] could bankrupt the Company, but a priori evidence is that this outcome happened once in every hundred times the Company entered into that activity."[105] Staff claims that that the Company could have and should have performed its own scenario analysis of HILF outcomes; could have and should have negotiated contractual terms such as termination clauses and "other provisions that allowed the Company to meet NW Natural's own standard of care;" and that if the Commission does not require the Company to bear part of the loss, the Company may assume that customers will indemnify the Company for large preventable losses, presumably leading to less care by the Company in the future.[106]

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[100] *Id.* at 12, lines 11-18.
[101] *Id.* at lines 19-22; Exhibit NWN/2005.
[102] *Id.* at lines 22-13, line 1.
[103] *Id.* at 13, lines 2-5.
[104] Staff/2300, Muldoon/9, lines 10-14.
[105] *Id.* at lines 15-20.
[106] Staff/2300, Muldoon/9-14.

1 In surrebuttal testimony, the Company showed that Staff's argument that the Company
2 should have conducted an HILF assessment was baseless, because under Staff's own
3 definition the risk incurred by the hedge was not an HILF.[107] Staff defines an HILF event as
4 one that might bankrupt the Company but has only a one percent chance of occurring.[108] The
5 risk associated with this hedge was not even close—neither the Company's analysis showing
6 that there was a one percent chance of a loss greater than $7.5 million[109] nor the actual losses
7 that occurred were of a type that could bankrupt the Company. This is particularly true,
8 because the gains or losses would have been mitigated by the debt issuance rate, but for the
9 results of the financial crisis. Thus, even if the Company had performed a HILF analysis,
10 which as far as the Company is aware has never been required by the Commission, it would
11 not have shown that the potential impact of the hedge was so high as to be too risky or could
12 have bankrupted the Company, as suggested by Staff that an HILF event could do.
13 In addition, there is no evidence that the Company could have or should have
14 negotiated contract provisions that would have mitigated risk as Staff has suggested.[110]
15 Negotiating non-standard risk mitigation terms to a standard and competitively bid contract,
16 such as this one, would add costs that would not have been prudent, and could only
17 potentially be justified in hindsight.[111] The Commission has clearly held "[w]e cannot use
18 hindsight . . . to judge the utility's decision."[112]
19 Finally, Staff's suggestion that if the Commission does not require sharing in this loss
20 that the Company will assume losses will be borne by customers and take imprudent risks is
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23 [107] NWN/3100, Feltz/5, lines 4-14.
[108] Staff/2300, Muldoon/9, lines 15-20.
24 [109] NWN/3100, Feltz/5, lines 9-10.
[110] *Id.* at lines 15-19.
25 [111] *Id.* at 5, line 19-Feltz/6, line 5.
[112] *Re. PacifiCorp Request for a General Rate Increase in the Company's Oregon Annual Revenues*, Docket UE 170, Order No. 05-1050 at 23 (Sept. 28, 2005).
26

unjustified in this case because Staff has not shown that the Company's actions in entering into the hedge were imprudent.[113]

5. Accepting Staff's Proposal Would be Contrary to the Commission's Objective Standard for Evaluating Prudence.

Staff's proposal is that the Commission find the hedge was imprudent solely on the basis that the Company did not perform a specific type of analysis prior to entering into the hedge. Staff does not contest the fact that the Company provided a significant amount of documentation related to its analysis and other materials in support of the hedge in Docket UF 4235, only that NW Natural did not perform the specific analyses proposed by Staff. Staff's claim that an action can be found imprudent based solely on the fact that the utility did not perform a specific type of analysis is contrary to Commission precedent. The Commission has previously addressed whether contemporaneous documentation was required in order to evaluate the prudence of a utility decision.[114] Intervenors in that case argued that to demonstrate prudence a utility must present evidence on what it actually knew and considered at the time the decision at issue was made.[115] The Commission rejected this argument and noted that the utility accurately set forth the legal standard for determining prudence:

> . . . contemporaneous documentation is useful in a prudence review to show the nature of the information available at the time of the challenged transactions. It is, however, not a prerequisite to establishing the prudence of a utility's actions, because prudence determinations are based on an objective standard of reasonableness . . . the standard does not require [a utility] to prove the factors it actually considered with respect to the decision . . . . Such a showing can help demonstrate what information was available at the time, but evidence of subjective decision making is not otherwise a prerequisite to establishing prudence . . . if the record demonstrates that a challenged business decision was objectively reasonable, taking into

[113] NWN/3100, Feltz/7, lines 8-18.

[114] *Re Application of PacifiCorp for an Accounting Order Regarding Excess Net Power Costs, et* al, Dockets UM 995/UE 121/UC 578, Order No. 02-469 at 5 (July 18, 2002) [hereinafter Order No. 02-469].

[115] *Id.*

1 account established historical facts and circumstances, the utility's decision must be upheld as prudent even if the record
2 lacks detail on the utility's actual subjective decision making process.[116]

3 To support a finding of imprudence, the evidence would need to show that the
4 Company *knew or should have known* something that would cause a reasonable person not
5 to enter into the hedge.[117] Staff never explains what Staff's proposed analysis would have
6 shown that would have demonstrated that the hedge was not a reasonable business decision.
7 The Company has provided evidence that the information available to the Company at the
8 time showed that the hedge could be expected to mitigate against higher interest rates and
9 that the risks presented by the hedge were in an acceptable range. Staff has not provided
10 any evidence rebutting these findings. The Company requests that the Commission reject
11 Staff's invitation to enter into an after-the-fact assessment of the Company's actions based on
12 the outcome of the hedge. Based on what the Company knew or should have known at the
13 time, its actions were prudent, so Staff's adjustment to cost of debt should be rejected.

14 **C. Environmental Remediation Costs**

15 **1. Introduction**

16 Over the past decade, NW Natural has been faced with very significant and growing
17 environmental remediation costs associated with its historic manufactured gas plants (MGPs).
18 These costs have been deferred since 2003, and in this proceeding the Company proposes to
19 begin recovering these costs now for three reasons: *First*, the environmental deferral is
20 already large and is increasing, and further delay on recovery will only increase the burden on
21 customers.[118] *Second*, timely recovery of environmental remediation costs is important to the

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[116] *Id.*
23 [117] *See e.g., Re Portland General Electric Co.*, Docket UE 196, Order No. 10-051 at 6 (Feb. 11, 2010) ("In a prudence review, the Commission examines the objective reasonableness of a utility's
24 actions at the time the utility acted: 'Prudence is determined by the reasonableness of the actions 'based on information that was available (or could reasonably have been available) at the time.'"); *Re Public
25 Utility Commission of Oregon Investigation to consider adoption of new federal standards contained in the Energy Independence and Security Act of 2007*, Docket UM 1409, Order No. 09-501 at 5 (Dec. 18, 2009).
[118] NWN/1500, Miller/4, lines 11-16.
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Company's financial health and stability.[119] The Company has, to this point, financed all the environmental remediation costs, putting pressure on the Company's cash flow.[120] This pressure will only continue to build as new costs are incurred.[121] *Third*, establishing a mechanism now furthers the goal of providing for intergenerational equity by more closely matching the time when the expenditures are made and the time they are collected.[122]

Under the Company's proposed mechanism, the Site Remediation Recovery Mechanism (SRRM), deferral of environmental remediation expenses would continue, and any proceeds recovered from insurance companies or other third parties would be booked as an offset to these deferred expenses, for the benefit of customers.[123] Each year, one-fifth of those deferred expenses after offset would be put into an SRRM account for amortization during the November 1 through October 31 timeframe, after the Commission reviews those costs for prudence.[124] Any under- or over-collection of the balance in the SRRM account at the end of the 12-month amortization period will be used to adjust the amount amortized into rates in the next amortization period.[125]

Although key issues related to the Company's proposed recovery mechanism remain at issue in this case, the parties agree on two important points. *First, no party objects to the implementation of a mechanism for recovery of environmental remediation expenses.* Although Staff and NWIGU-CUB object to certain elements of the Company's proposed recovery of environmental remediation costs, neither party objected to the adoption of a mechanism to facilitate recovery of some level of costs.[126] *Second, no party has questioned the prudence of the expenses.* The Company provided testimony from four witnesses, along

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[119] *Id.* at 5, lines 1-2.
[120] *Id.* at lines 2-4.
[121] *Id.* at lines 5-7.
[122] *Id.* at lines 9-17.
[123] *Id.* at 9, lines 6-8.
[124] *Id.* at lines 8-11.
[125] *Id.* at lines 11-14.
[126] *See* Staff/200, Johnson/7, lines 12-14; NWIGU-CUB/100, Larkin/52, lines 8-10.

1 with detailed explanations of its accounting and cost control for the costs it has incurred,
2 including spreadsheets detailing the specific expenditures and cost categories; and over 2,000
3 invoices related to its remediation efforts. No party claimed that any of these costs were
4 imprudent.

5 Parties' testimony focuses on the three outstanding issues related to the Company's
6 proposed mechanism: whether shareholders should be required to shoulder some of the
7 costs of environmental remediation and, if so, what proportion should be allocated to
8 shareholders; what interest rate should apply to deferred amounts prior to amortization; and
9 whether an earnings test should be applied to the SRRM each year.

10 The Company requests that the Commission reject Staff's and NWIGU-CUB's sharing
11 proposals because there is no reasonable basis to effectively disallow any portion of the
12 Company's prudently incurred remediation costs. With respect to the interest rate to apply to
13 deferred amounts prior to amortization, the Company proposes that, consistent with
14 Commission precedent, the Company's authorized rate of return be used prior to amortization
15 and the Modified Blended Treasury Rate (MBTR) be used during amortization. Finally, an
16 earnings test should not be applied to the deferral because the proposed mechanism is an
17 automatic adjustment clause to which the earnings test requirement does not apply, and
18 because as a policy matter it would not be appropriate to apply an earnings test to an
19 ongoing, rather than a one-time, expense that is imposed upon the utility.

20 **2. Background on Environmental Remediation Costs**

21 As described in detail in the testimony of Robert Wyatt,[127] NW Natural's predecessor
22 Company (Portland Gas & Coke, or "PG&C"), like many other gas companies around the
23 country, manufactured gas for service to its utility customers during the late 1800's through
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26 [127] NWN/1300.

1 1956.[128] During this time period, natural gas was not available in the region, so PG&C
2 manufactured gas at two facilities, primarily at its Gasco facility.[129]
3 In 1980, federal legislation empowered the Environmental Protection Agency (EPA) to
4 require the owner or operator of any facility from which a hazardous substance was released
5 to perform or pay for cleanup of property contaminated by the release.[130] Comparable state
6 legislation provides similar authority to the Department of Environmental Quality (DEQ).[131]
7 Pursuant to these laws and EPA and DEQ oversight, NW Natural has been, and is now
8 engaged in, remediation activities related to the historic operation of these MGPs that were
9 used to create gas for service to utility customers.[132] To date, NW Natural has deferred these
10 costs. As of September 30, 2011, the Company had deferred approximately $64.5 million in
11 environmental remediation expenses that have already been incurred,[133] and estimates $58
12 million in future remediation costs, which is at the low end of potential costs.[134]
13 At the same time that it has been incurring and deferring these costs, the Company
14 has undertaken vigorous efforts to pursue recovery of these expenses from insurance policies
15 that it had in place during the relevant time periods. These efforts have included litigation, and
16 have resulted in some receipt of insurance proceeds, and the Company hopes to receive
17 more in the future.[135]
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21 [128] *Id.* at 3, lines 4-8.
[129] *Id.* at lines 6-8.
22 [130] *Id.* at 5, line 21 - Wyatt/6, line 17.
[131] *Id.* at 6, line 5.
23 [132] *See generally Id.* at 6 – 10.
[133] NWN/1500, Miller/2, lines 11-16. The $64.5 million includes $51.8 million of total expenditures
24 to date plus accrued interest of $18.1 million, partially offset by $5.4 million of environmental costs expensed in prior years.
25 [134] NWN/1500, Miller/2, line 17-Miller/3, line 1.
[135] *See generally* NWN/1400, Hart (testimony providing details of Company's insurance recovery
26 and litigation efforts).

3. There is No Basis to Require the Company to Bear the Cost of Environmental Remediation Expenses.

Staff has proposed conditioning approval of the SRRM on applying 90/10 "sharing" to the costs, with customers paying 90 percent and shareholders paying 10 percent.[136] Staff's rationale for imposing this sharing approach is solely that it would provide NW Natural an incentive to manage remediation costs.[137] Staff cites to comments from intervenors in a New York State Public Service Commission case to argue that other commissions have authorized sharing.[138] NWIGU-CUB recommend applying 50/50 sharing to environmental remediation costs.[139]

a. Sharing Does Not Provide a Sound Cost Management Incentive.

There is no evidence in the record to support that Staff's claim that its proposed 90/10 sharing would provide an appropriate or effective incentive to manage costs. First, Staff's proposal applies to past and future costs, and it is illogical to conclude that a disallowance of 10 percent of *past* costs could create any incentive to manage those costs, since they have already been incurred.[140]

Second, the impact of Staff's proposed mechanism is grossly out of proportion to its stated purpose, penalizing the Company from the very first dollar it spends on environmental remediation regardless of its prudence in managing those costs. Assume, for example, if the utility had a choice between taking two actions with identical effectiveness, one of which cost $10.1 million, and the other which cost $10.0 million. And further assume for the sake of argument that the Company inexplicably selected the $10.1 million action. Application of a fair and reasonable approach would require the Company to bear $100,000. However, under

[136] Staff/200, Johnson/7, lines 16-17.
[137] *Id.* at 7, lines 7-10.
[138] *Id.* at 8, lines 7-23.
[139] NWIGU-CUB/100, Larkin/52, lines 22-24.
[140] NWN/2600, Miller/8, lines 13-14.

1 Staff's proposed sharing, the Company would be forced to bear over $1 million, and $1 million
2 even if it chose the more cost effective option. Applying an incentive mechanism whose
3 results bears little relationship to its stated purpose would act as a penalty rather than an
4 incentive. And no party has provided any support for the notion that the Company should be
5 subject to a penalty for prudently incurring costs related to mandatory remediation obligations.
6 Third, Staff's mechanism is intended to encourage the utility to spend as little as
7 possible on environmental remediation and to put off expenses as long as possible, rather
8 than providing an incentive for prudent management of environmental remediation.[141] It is not
9 appropriate to encourage the utility to take actions that would be detrimental to the quality of
10 the environment, the health of the general public, or the long-term interests of customers.[142]
11 Fourth, the Company provided unrebutted evidence that it has very little control over
12 the requirements imposed by state and federal agencies.[143] EPA and DEQ define the general
13 scope of work and, although the details of the work are generally resolved by technical
14 consensus or negotiations, when the Company cannot reach technical agreement with the
15 relevant agency, the agency will determine the specific obligations.[144] Staff's mechanism is
16 comparable to imposing sharing on utilities' tax payments to incentivize the utility to pay as
17 little taxes as possible, a policy that would be inappropriate to implement.[145] As such, the
18 incentive mechanism to contain costs proposed by Staff would have not only a minimal or
19 non-existent effect on costs that would be incurred, but more likely a negative impact.
20 Finally, under the SRRM, costs would not be included in rates until after they were
21 vetted in a prudence review. As is the case with all of the Company's expenses ranging from
22 payroll expenses to purchased gas expenses to capital investments in its system, the
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24 [141] *Id.* at 9, lines 13-22.
[142] *Id.* at lines 20-23.
25 [143] *Id.* at 10, lines 4-7.
[144] NWN/1300, Wyatt/9, line 18-Wyatt/10, line 2.
26 [145] NWN/2600, Miller/10, lines 8-12.

1 Company has incentive to prudently manage those expenses because if not, they will be
2 disallowed. In sum, the claim that Staff relies upon to propose its sharing mechanism—that
3 sharing will encourage NW Natural to better manage costs—is incorrect and not supported by
4 Staff. Staff did not explain why a prudence review appropriately incents containment of all
5 other costs incurred by the Company, but not environmental remediation costs.

6 **b. NWIGU-CUB Present No Reasonable Basis to Support Sharing.**

7 NWIGU-CUB also propose sharing, but at the 50/50 level. NWIGU-CUB present a
8 number of arguments in support of their proposal, none of which form a reasonable basis to
9 support sharing, and especially not 50/50 sharing.

10 NWIGU-CUB argue that the manufactured gas sites were contaminated decades ago,
11 that the cost of remediation is unrelated to current service, and that including remediation
12 costs in current customers' rates is therefore unwarranted.[146] This argument is based on
13 flawed logic—there is no question that the Company is currently incurring these expenses and
14 that these expenses relate to current activity performed under current laws. There is no basis,
15 therefore, to find that the costs are not appropriately charged to current ratepayers. This
16 conclusion has been confirmed by commissions across the country, all of whom have found
17 that, absent facts to the contrary, there is a sufficient nexus between current remediation
18 expenses and utility service to support the recovery of these costs through rates.[147]
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21 [146] NWIGU-CUB/100, Larkin/51, lines 8-9.
[147] *See* NWN/1500 Miller/6-7. *See also, e.g., Attorney General v. Mich. Pub. Serv. Comm'n*, 618
22 N.W. 2d 904, 905 (Mich. 2000) (finding that the fact the contamination arose from a utility service provided to different customers in past years does not change the fact the company is incurring a
23 significant expense in the course of its business in the present); *Central Illinois Light Co.*, 124 PUR 4th 498, 512 (Ill. 1991) (finding that costs incurred in cleaning up MGP sites are deemed a reasonable and
24 current cost of doing business for a gas utility and are recoverable from current ratepayers, and that the costs, mandated by both state and federal law, are legitimate, recurring costs of doing business);
25 *Peoples Natural Gas Co.*, 144 PUR 4th 333, 335 (Minn. 1993) (finding that there is a sufficient nexus between remediation costs and present ratepayers from the fact the property had been used and useful
26 at the time the pollution of the land occurred).

1 NWIGU-CUB also argue that it is unfair to require customers to pay for damage that
2 they did not have knowledge of and could not affect.[148] NWIGU-CUB's argument that
3 customers should not be required to pay costs if they do not know about the costs is
4 nonsensical and contrary to accepted utility regulation. Customers may be not be aware of
5 the specifics of and unable to affect many costs, such as franchise taxes and pipeline fees,
6 that are included in rates.[149] The standard for recovery is that the expenses be prudent and
7 relevant to providing utility service.[150] Environmental remediation expenses meet this
8 standard.
9 NWIGU-CUB offer the testimony of their witness Hugh Larkin who makes the
10 inflammatory claim that the Company knew the risks of MGPs and planned on pushing the
11 consequences of remediation onto customers.[151] However, Mr. Larkin provides nothing of
12 substance to support his position.
13 First, Mr. Larkin is not qualified to make the statement he tosses out so cavalierly. Mr.
14 Larkin is not an environmental engineer or an historian. There is no evidence in the record
15 that he has earned any relevant degrees, studied the historic operations of MGP, or
16 interviewed anyone who has ever worked at an MGP.
17 Second, the only evidence Mr. Larkin provides to support his opinion is a quotation by
18 an author—Dr. Hatheway—of a book on MGPs, who states that the operators of MGPs knew
19 about the contamination they were causing. However, when the Company filed a Motion to
20 Strike that section of Mr. Larkin's testimony as inadmissible hearsay, NWIGU-CUB confirm
21 that the quotation was not offered for the truth of the matter asserted.[152] In other words, the
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23 [148] NWIGU-CUB/200, Larkin/25, lines 18-21.
[149] NWN/3700, Miller/2, line 18-Miller/3, line 3.
24 [150] *See,* ORS 756.040(1); Order No. 02-469 at 4, *Re Fish Mill Lodges Water System Request for a General Rate Increase*, Docket UW 123, Order No. 08-235 at 4 (Apr. 24, 2008).
25 [151] NWIGU-CUB/200, Larkin/27, lines 8-11.
[152] *Re. NW Natural's Request for a General Rate Revision*, Docket UG 221, NWIGU's and CUB's Response to NW Natural's Motion to Strike at 7 (Aug. 8, 2012).
26

quotation was not offered in support of the notion that operators of MGPs knew about the contamination they were causing. This being the case, the quotation fails to support Mr. Larkin's uninformed conclusion as to what NW Natural's predecessor companies either knew or did not know.

Moreover, the quotation is rebutted by extensive testimony from Dr. Andrew Middleton, a recognized expert in MGP operations and history, who testified that the operations at the Company's MGPs were prudently conducted, consistent with the standards and practices at the time.[153] Moreover, Dr. Middleton also specifically provided surrebuttal testimony, describing the reasons for which NWIGU-CUB's reliance on the quote is unfounded, and the reasons why the quote should be discounted and not applied to NW Natural in any event.[154]

Finally, NWIGU-CUB's position that sharing should be imposed on the Company appears to be based in part on the belief that the historical production of manufactured gas was a "misdeed."[155] As Dr. Middleton testified, during historic MGP operations (1) there was widespread reliance on the manufacturing of gas to provide utility service (in fact, natural gas was not available in the region at the time) and (2) the potential environmental consequences of the operations were not understood.[156] This evidence undermines NWIGU-CUB's implication that manufactured gas operations were imprudent, or somehow a misdeed that the Commission should punish through imposing sharing. NWIGU-CUB present no reasonable basis to find that 50/50 sharing of the costs of environmental remediation is appropriate.

[153] NWN/1600.
[154] This testimony is filed confidentially as NWN/4100.
[155] *See, e.g.*, NWIGU-CUB/200, Larkin/27.
[156] NWN/1600, Middleton/3, 19, 38-39.

4. The Commission Policy on the Interest Rate to Apply to Deferrals Set Forth in Order No. 06-507 Should Also Apply to Deferrals under the SRRM.

Staff proposes that the MBTR be applied to environmental remediation deferrals, and NWIGU-CUB propose that a "debt rate" be applied.[157] NW Natural proposes that deferrals under the SRRM earn at the Company's authorized rate of return (ROR) prior to amortization and earn at the MBTR during the year of amortization.[158]

NW Natural's proposal is consistent with established Commission policy and should therefore be approved. The Commission's well-established policy is to allow a utility to earn its authorized ROR on deferred amounts prior to amortization, and to earn the MBTR on amounts approved for amortization.[159] The Company's proposed mechanism is consistent with this precedent—deferred amounts would earn at the Company's ROR until the Commission has conducted a prudence review and determined the specific amount to be amortized each year. At that point, the amount approved for amortization would earn at the MBTR. Staff and NWIGU-CUB have not presented any basis for deferrals under the SRRM to be treated any differently than other deferrals.

The Commission has explained the basis of applying the ROR prior to amortization: "deferral of certain expenses . . . separates such funds from the general ratemaking process, but does not necessarily eliminate the risks incumbent to the general ratemaking process. . . . *Until a deferred account is authorized for collection by amortization, we recognize that there are attendant risks*."[160] In this case, the deferred amounts will be subject to a prudence review which can always result in a disallowance. Moreover, given the length of time over which the SRRM will be in effect, there is a risk that a future Commission could change the recovery mechanism—resulting in less reliable recovery. Thus, until a specific amount is approved for

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[157] Staff/200, Johnson/8, lines 1-6; NWIGU-CUB/200, Larkin/29, lines 11-13.
[158] NWN/1500, Miller/14, lines 3-11.
[159] *Re Staff Request to Open an Investigation Related to Deferred Accounting*, Docket UM 1147, Order No. 06-507 at 5-6 (Sept. 6, 2006).
[160] *Id.* at 4 (emphasis added).

amortization, the recovery of that amount is at risk. Finally, in addition to being contrary to Commission precedent, Staff's and NWIGU-CUB's proposals are especially harmful in this case. The environmental remediation deferrals are long-term liabilities. The Company cannot be reasonably expected to finance these significant and long-term liabilities at the MBTR.[161]

5. The SRRM Should Not Be Subject to an Earnings Test

Staff proposes that amortization of environmental remediation expenses be limited by an annual earnings review under ORS 757.259(4), using the years when the costs were incurred.[162] An earnings test is not appropriate for the SRRM, because it will be a mechanism authorized under ORS 757.259(5), which specifically states that an annual earnings test is not required for automatic adjustment clauses. An automatic adjustment clause is a "rate schedule that provides for rate increases or decreases or both, without prior hearing, reflecting increases or decreases or both in costs incurred . . . [or] the collection of ongoing current expenses . . . that is subject to review by the commission at least once every two years,"[163] which the SRRM will be.

Even if the statute authorizing the SRRM did not exempt such a mechanism from the application of an earnings review, it would be poor policy to prevent recovery through the application of an earnings test. An earnings test may be appropriate in the case of one-time deferrals when it is appropriate to evaluate whether the utility could have borne the cost of the unexpected expense in that year. In contrast, these environmental remediation costs represent significant and ongoing expenses, and as a result, the application of an earnings test could act as a permanent cap on earnings.[164] Finally, if the Commission adopted Staff's proposal to conduct an earnings test using the years in which the costs were incurred, the environmental expenses should be included in the test to accurately gauge whether the

[161] *See* NWN/2600, Miller/17, lines 20-22.
[162] Staff/200, Johnson/7, lines 18-23.
[163] ORS 757.210(1)(b).
[164] NWN/2600, Miller/19, lines 8-13.

Company was in fact overearning in those years.[165] Doing so is even further complicated by the fact that the Company is proposing to apply to customers' benefit all insurance payments received, which would need to be applied to past expenses in some way in order for the earnings test to be applied in an even-handed manner.

6. The Company Offered Additional Ideas for Addressing Issues Raised by the Parties.

In surrebuttal testimony, the Company provided additional ideas for the Commission to consider in response to the issues raised by the parties on the topic of environmental remediation. First, the Company noted that if the Commission believes that further work should be done to address the parties' arguments that NW Natural lacks sufficient incentives to perform environmental remediation in a cost effective manner, NW Natural suggests opening a follow up docket once the agencies' final Records of Decision or orders on clean-up obligations are established.[166] At that time, the Commission could determine whether it could develop cost and timing targets for completion of the work and whether a fair incentive mechanism could be established.[167] Second, the Company suggested that as long as the Commission allows recovery of its carrying costs at the Company's authorized rate of return, the Company would be open to decreasing the amortization level from one-fifth to one-seventh, in order to mitigate the impact to customers from the establishment of the SRRM.[168]

D. Recovery of Pension Costs

1. Introduction

Currently, the Company recovers its pension expenses based on the Financial Accounting Standard (FAS) 87 expense methodology that was adopted by the Commission in 1986. This FAS 87 recovery methodology no longer allows the Company an opportunity to

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[165] *Id.* at lines 14-18.
[166] NWN/3700, Miller/11, line 15-Miller/12, line 12.
[167] *Id.* at 12, lines 3-12.
[168] *Id.* at lines 13-20.

recover its prudently-incurred costs, and for this reason, the Company has proposed that the current recovery mechanism be altered.

As described in more detail below, FAS 87 expense represents an actuarial estimate of a company's pension contributions, smoothed to reduce volatility; up until recent years, a recovery based on FAS 87 expense provided a utility with a reasonable opportunity to recover the costs of its actual contributions to its pension plans. However, since the passage of the Pension Protection Act of 2006 (PPA), which requires accelerated contributions to pension plans, and the financial crisis of 2008 and 2009, which drastically reduced the value of plan assets and significantly increased the present value of future retiree benefit obligations, the Company has been required to make very significant contributions to its pension plans, largely in the form of pre-paid pension costs, that it can never hope to recover under the current ratemaking framework. For that reason, NW Natural has proposed to recover the balance of its pre-paid pension asset resulting from pension contributions made in excess of FAS 87 expense.[169] Specifically, NW Natural proposes to include the Test Year pre-paid pension asset balance to rate base, and to recover the asset balance over a period of eight years.[170] This amount is estimated to be $39.2 million, or $23.5 million net of deferred taxes, amortized over eight years.[171]

Staff and NWIGU-CUB make several arguments as to why the Company's proposal should be rejected and why the current FAS 87 treatment should be continued as the sole recovery mechanism. They incorrectly argue that the Company's proposal would violate the rule against retroactive ratemaking; they claim—without support—that the Company will

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[169] NWN/3100, Feltz/9, lines 5-6.
[170] *Id.* at lines 6-8.
[171] NWN/2000, Feltz/25, line 22-26, line 2. The recently enacted 21st Century Act may affect Test Year contributions, the average amount of which is included in this case. If contributions in the Test Year are lower than projected, the Company will offset that amount with a reduction to the UM 1475 balancing account, which will have the same impact on customers because balances in the balancing account accrue carrying costs at the Company's overall cost of capital.

ultimately be made whole under the current ratemaking treatment; and they make the erroneous suggestion that the Company's current and future under-recovery might be balanced out by over-recoveries in the past. None of these arguments hold water. In the end, none of the parties provide any concrete explanation as to how the current mechanism will allow the Company to recover its prudently-incurred, legally-required contributions made on behalf of customers.

2. The Existing Ratemaking Methodology for Pension Costs No Longer Allows the Company to Recover its Prudently Incurred Pension Costs.

a. Current Ratemaking Methodology

To understand the dispute in this case, it is important to review some basic facts regarding pension contributions and expense. Pension contributions are made by companies to pay current benefits, or are invested to meet future benefits.[172] The amounts contributed each year are determined based on a number of factors, including the valuation of plan assets and liabilities and federal standards for minimum funding requirements, as set forth in the Internal Revenue Code (IRC).[173] The goal of contribution requirements is to provide for sufficient assets in a defined benefit pension plan so that the assets are sufficient to meet future obligations.[174] If plan assets are less than plan liabilities, then the plan is considered underfunded, and the shortfall must be made up over a period of time.[175]

Currently, the Company's pension costs are included in rates based solely on the accounting expense as calculated by the FAS 87 accounting methodology.[176] FAS 87 expense is calculated based on: (1) an estimate of future liabilities, which are benefit

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[172] NWN/400, Feltz/20, lines 20-21.
[173] *Id.* at 21, lines 1-3.
[174] *Id.* at lines 5-7.
[175] *Id.* at lines 7-9.
[176] *Id.* at lines 12-16.

1 obligations created by employee service, and (2) plan assets.[177] Because FAS 87 expense is
2 estimated using assumptions, such as expected retirement ages and life expectancies, any
3 differences between actual and estimated results are captured as actuarial gains and
4 losses.[178] These actuarial gains and losses are not immediately recognized in the Company's
5 income statement, but rather are amortized to expense over an extended period, typically 12
6 to 14 years.[179]
7 The Company's cash contributions to its pension plans have an impact on the level of
8 FAS 87 expense. When contributions are invested, plan assets increase, which in turn
9 reduces the FAS 87 expense.[180] For example, a $1,000,000 contribution invested in the plan
10 decreases annual FAS 87 expense by $82,500 based on an assumed investment return of
11 8.25 percent.[181]
12 In 2010 the Company filed a petition related to pension costs to address two significant
13 issues related to its pension recovery. First, the Company wished to address its concerns
14 about its chronic under-recovery of FAS 87 expense.[182] In the Company's 2002 rate case, the
15 Commission had approved FAS 87 expense with the proviso that the Company defer for
16 customers' benefit any recovery in excess of the rate case approved expense, but did not
17 have a symmetrical provision in the event of under-recoveries.[183] In fact the Company *had*
18 under-recovered its FAS 87 expense in six out of seven years and projected that it would
19 continue to do so. For that reason, the Company requested permission to defer FAS 87
20 expenses that it expected to be substantially in excess of those recovered in rates.
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22 [177] *Id.* at lines 19-21.
[178] *Id.* at 22, lines 3-15.
23 [179] *Id.* at lines 11-15.
[180] *Id.* at lines 16-20.
24 [181] *Id.* at 20-23.
[182] *Re. NW Natural Gas Co. Application to Defer Pension Costs*, Docket UM 1475, Application at
25 3-4 (Mar. 15, 2010).
[183] *Re. NW Natural Gas Co. Application for a General Rate Revision*, Docket UG 152, Order No.
26 03-507 at 3 (Aug. 22, 2003).

1 Second, the Company also requested that it be allowed to recover its investment costs
2 associated with the very substantial cash contributions that it had been and would continue to
3 make until its plans were fully funded.[184] However, the parties were unable to agree upon
4 recovery of cash contributions and after negotiations, the parties entered into a stipulation that
5 created the current balancing account—which addresses only the FAS 87 pension
6 expense.[185] Specifically, the current balancing account allows the Company to defer FAS 87
7 expense both below and above the amounts recovered it rates. It does not, however, address
8 the recovery of financial costs related to the Company's cash contributions.

9 **b. Why the Current Ratemaking Methodology No Longer Works.**

10 As mentioned above, changes in pension law and the financial markets since 2006
11 have required the Company to make substantial contributions to the pension plans that are
12 not recovered through the FAS 87 methodology.[186] First, in 2006 Congress passed the PPA,
13 which established a new set of funding requirements for defined benefit pension plans.
14 Specifically, PPA set new rules for calculating the value of plan assets and plan liabilities and
15 for accelerating contributions of underfunded plans.[187] As a result, the Company has been
16 required to make large cash contributions to its plans to ensure the required levels of
17 funding.[188]

18 Second, the need to make accelerated contributions required by the PPA was
19 exacerbated by the financial crisis of 2008 and 2009, in which the equity and bond markets
20 collapsed, which led to a significant decline in the value of the plans' assets.[189] The recession
21 that followed also caused a significant reduction in interest rates to historic lows, which

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[184] *Re. NW Natural Gas Co. Application to Defer Pension Costs*, Docket UM 1475, NWN/100,
23 Miller/7 (Sept. 20, 2010).

[185] *See Re. NW Natural Gas Co. Application to Defer Pension Costs*, Docket UM 1475, Order No.
24 11-051 (Feb. 10, 2011).

[186] NWN/400, Feltz/23, lines 3-5.

25 [187] *Id.* at lines 7-10.

[188] *Id.* at lines 15-16.

[189] *Id.* at lines 18-19.

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dramatically increased plan liabilities.[190] As a result, the Company went from being underfunded by several million dollars at the end of 2007 to being underfunded by $98 million at the end of 2008, despite the Company having contributed nearly $40 million into the plans in 2004 and 2005.[191] The underfunded pension balance triggered several rounds of Company contributions, totaling $57 million between 2009 and 2011 in accordance with PPA funding requirements.[192]

In the past, FAS 87 accounting allowed for the amortization of actuarial gains and losses over a number of years, which tended to smooth out the FAS 87 expense amount from year-to-year.[193] With respect to pension contributions, the IRC also allowed the use of smoothing techniques allowing the employer to make contributions over time that more closely matched the FAS 87 expense recognized over time.[194] With a relatively similar smoothing of both FAS 87 expenses and pension contributions, the difference between these two amounts tended to even out.[195] However, the combination of the PPA funding changes and the timing of the financial crisis required the Company to make significant cash contributions.[196] The large contributions made by the Company in recent years significantly lowered the Company's FAS 87 expense and have made it virtually impossible for NW Natural to ever recover its cash contributions using the current recovery methodology.[197] Under the current FAS 87 balancing account, the Company is estimated to experience a loss of approximately $91 million in unrecovered pension contributions by the time the pension balancing account goes to zero.[198]

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[190] *Id.* at lines 20-21.
[191] *Id.* at line 21-24, line 1.
[192] *Id.* at 24, lines 1-4.
[193] *Id.* at line 20-Feltz/26, line 1.
[194] *Id.* at 26, lines 1-3.
[195] *Id.* at lines 3-5.
[196] *Id.* at lines 5-7.
[197] NWN/2000, Feltz/20, line 22-Feltz/21, line 2.
[198] NWN/3100, Feltz/9, lines 10-13.

1 The current ratemaking methodology must be changed to allow the Company the ability to
2 recover its prudently incurred pension costs.

3 **3. The Company's Proposal Does Not Constitute Retroactive Ratemaking.**

4 Staff and NWIGU-CUB argue that including past contributions in future rates would
5 constitute retroactive ratemaking.[199] Their argument is inapt because the cash contributions
6 at issue are not accounting expenses and therefore are not subject to the rule against
7 retroactive ratemaking.

8 Although the Oregon courts have not adopted a rule prohibiting retroactive
9 ratemaking,[200] the Commission and the Oregon Attorney General have argued that such a
10 rule applies in Oregon.[201] The rule against retroactive ratemaking prohibits utilities from
11 including past profits or losses in future rates.[202] The rule is implicated when the Commission
12 "after determining expected costs and revenues, supplements that determination by
13 employing past profits or losses in setting the future return the utility will be authorized to
14 earn."[203]

15 The cash contributions are not subject to the rule against retroactive ratemaking
16 because they are pre-paid costs—investments that are financed by the Company like any
17 long-term asset.[204] The contributions were made to the pension fund and continue to work in
18 customers' favor to reduce future FAS 87 expense.[205] Just as the rule against retroactive
19 ratemaking is irrelevant to investments in other rate base items such as pipes or facilities, it is
20 irrelevant to pension contributions.

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22 [199] Staff/900, Cimmiyotti/5, lines 1-9; NWIGU-CUB/100, Larkin/48, lines 22-23.
[200] *Dryer v. Portland Gen. Elec. Co.*, 341 Or. 262, 271 n.10 (2006).
23 [201] *See, e.g.*, *Re Portland Gen. Elec. Co.*, et al, Dockets UE 165/UM 1887, Order No. 05-1261 (Dec. 21, 2005); Or. Op. Atty. Gen. OP-6076, 1987 WL 278316 (Mar. 18, 1987) [hereinafter "AG Opinion"].
24 [202] AG Opinion, 1987 WL 278316 at *1.
[203] *Id.*
25 [204] NWN/2000, Feltz, 27, lines 15-20.
[205] *Id.* at 19-20.
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1 NWIGU-CUB object to the Company's analogy of the pension contribution to plant
2 investments, because "there is not a tangible asset to depreciate."[206] While the pre-paid
3 pension asset is not a tangible asset, this does not mean that the pre-paid asset should not be
4 added to rate base. The Commission has allowed other intangible assets to be included in
5 rate base, including pre-paid insurance premiums.[207]
6 NWIGU-CUB argue that the Company should have filed an application for deferred
7 accounting related to the pension contributions.[208] The plain language of the deferral statute,
8 ORS 757.259,[209] supports the conclusion that pension contributions are not expenses and
9 therefore not subject to the rule against retroactive ratemaking. The only section of the
10 deferral statute that is arguably relevant to the cash contributions is ORS 757.259(2)(e), which
11 allows for deferral of "Identifiable utility *expenses* or revenues, the recovery or refund of which
12 the commission finds should be deferred in order to minimize the frequency of rate changes or
13 the fluctuation of rate levels or to match appropriately the costs borne by and benefits
14 received by ratepayers." The fact that the deferral statute applies to expenses, not pre-paid
15 obligations, supports the finding that retroactive ratemaking does not apply to the cash
16 contributions and that a deferred accounting application was not required.
17 Finally, Staff suggests that because the Company earned its authorized ROE in some
18 of the years between 2004 and 2010, there is no need to address the pension cost recovery
19 problem.[210] The Commission does not withhold recovery of rate base items based on a
20 utility's past ROE and should not do so in this case. The fact that the Company has earned
21 around its authorized ROE in past years is also not a reasonable basis to continue a
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23 [206] NWIGU-CUB/200, Larkin/15, lines 3-12.
[207] NWN/3100, Feltz/15, lines 12-15.
24 [208] NWIGU-CUB/200, Larkin/15, lines 13-21.
[209] ORS 757.259 is "a statutorily authorized exception to the general prohibition against
25 retroactive ratemaking. *Re Investigation Related to Deferred Accounting*, Docket UM 1147, Order No. 05-1070 at 2 (Oct. 5, 2005).
[210] Staff/900, Cimmiyotti/6, lines 1-10.
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1 ratemaking methodology that has been shown to prevent the Company from recovering
2 prudently incurred costs of providing utility service.
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4 **4. The Problem with the Current Pension Ratemaking Methodology is Not Temporary.**

5 Staff and NWIGU-CUB argue that the problem with the current pension ratemaking
6 methodology identified by the Company is temporary and that additional contributions will no
7 longer be necessary when the value of plan assets increases.[211] The Company has
8 demonstrated that the Company will *not* ultimately recover the costs of its pension
9 contributions when the market turns around.[212] This is because although the Company may
10 be required to make lower contributions in the future, increases in interest rates will benefit
11 customers by reducing FAS 87 expense.[213] NW Natural is expected to contribute $102 million
12 over the next five years, excluding the $28 million contribution due this year.[214] Over that
13 same period, FAS 87 expense will total only $47 million, and pre-paid assets are expected to
14 grow to $87 million.[215] Moreover, when FAS 87 is reset in a future general rate case after the
15 balancing account goes to zero, FAS 87 expense is likely to be negative, resulting in refunds
16 to customers.[216] It is notable that no party has offered any real challenge to NW Natural's
17 evidence on this point.
18 NWIGU-CUB argue that the Company's position ignores past comparisons of expense
19 and contributions since the adoption of FAS 87, claiming that the Company's proposal is
20 selective because in the past the FAS 87 ratemaking methodology worked in shareholders'
21 favor, but no longer does.[217] In particular, NWIGU-CUB suggest that if the Company were to
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23 [211] NWIGU-CUB/100, Larkin/48, lines 15-19.
[212] NWN/2000, Feltz/32, lines 1-4.
24 [213] *Id.* at lines 5-8.
[214] *Id.* at lines 8-10.
25 [215] *Id.* at lines 10-11.
[216] *Id.* at 18, lines 1-3.
26 [217] NWIGU-CUB/200, Larkin/14, lines 9-19.

look back to pension recoveries prior to 2003, it would find that the Company over-recovered rather than under-recovered its pension costs. While unstated, NWGU-CUB seem to suggest that such past over-recovery should be considered to balance out the current and future under-recoveries. However, as NW Natural demonstrated, that is not the case. In fact, over the period from 1998 to 2003, the Company had a negative FAS 87 expense (the result of an overfunded plan) and so was refunding over half a million dollars a year to rate payers, while at the same time the Company did not have the benefit of the overfunding because such overfunding is always restricted to the benefit of plan participants.[218] Moreover, it appears that the Company also recovered less than it contributed to its pension plans from 1986, which was the year when FAS 87 went into effect, through 2003.[219] Thus, NWIGU-CUB's implication that the Company benefitted in the past by collecting more in pension expense than it contributed is not supported by the facts.

5. The Fact that the Financial Accounting Standard Governing Pension Accounting Has Not Changed Is Irrelevant to the Commission's Ability to Change Pension Ratemaking.

Staff claims that it would be inappropriate for the Commission to deviate from using FAS 87 for pension cost recovery in rates because FAS 87 has not been rescinded by the Financial Accounting Standards Board.[220] While financial accounting standards inform the Commission's ratemaking, they do not and cannot limit the Commission's ability to craft a ratemaking mechanism that allows for recovery of the Company's prudently incurred pension costs. Indeed, the Commission's obligation is to "balance the interests of the utility investor and the consumer in establishing fair and reasonable rates," meaning rates that "provide adequate revenue both for operating expenses of the public utility . . . and for capital costs of

[218] NWN/3100, Feltz/12-13.
[219] *Id.* at 12, lines 12-14; Feltz/14, lines 4-11.
[220] Staff/900, Cimmiyotti/3, line 17-4, line 2.

the utility, with a return to the equity holder."[221] Financial accounting standards cannot be used to limit the Commission's ability to craft just and reasonable rates.

6. NW Natural's Presented Alternative Proposals for Recovery.

NW Natural presented two alternative proposals for recovery if the Commission does not agree with the Company's proposed treatment of pension contributions. First, if the Commission agrees with Staff and NWIGU-CUB that the pension contributions are expenses that are subject to the rule against retroactive ratemaking, the appropriate treatment would not be to remove the contributions entirely, but to include the amount of contributions that the Company will make to the pension fund in excess of FAS 87 expense during the Test Year, and track that recovery in a regulatory asset account so that recovery of pre-paid contributions will not exceed pre-paid pension asset balance in the future. The Test Year contributions amount, minus FAS 87 expense, was previously estimated to be $8 million.[222] If these contributions are lower than projected, the Company will offset that amount with a reduction to the UM 1475 balancing account.[223]

Second, NW Natural proposed that if the Commission were not inclined to adopt the Company's proposal, it could revise the balancing account so that once the balance turns negative, the Company could suspend refunds to customers and allow the negative account balance to equal the excess shareholder contributions.[224] While this approach should not change the Company's request for a "return on" the cash contributions, it would allow the "return of" the contributions in a different way. If this approach were adopted, the Commission should make an adjustment to future earnings tests to prevent such recovery of investment

[221] ORS 756.040(1).
[222] NWN/2000, Feltz/28, lines 10-16.
[223] NWN/3100, Feltz/16, line 21-Feltz/17, line 2.
[224] NWN/2000, Feltz/33, lines 1-6.

dollars from being counted as "income" for earnings test purposes, since these contribution amounts do not count as "expenses" for earnings test purposes when made.[225]

E. Mid-Willamette Valley Feeder

1. Introduction

The Mid-Willamette Valley Feeder Project (MWVF) is a combined system reinforcement and bare steel replacement project designed to move high pressure gas south from the Central Coast Feeder near Perrydale to a connection on the Albany-Corvallis Feeder east of Corvallis.[226] The Company has broken the project into these four phases because of permitting and easement acquisition timelines along the route.[227] The Company completed a portion of the MWVF in September 2005 and began engineering design on the remaining four phases of the project in April of 2009.[228]

The first phase, "Perrydale to Monmouth," is the installation of transmission line from the existing Central Coast Feeder located east of Perrydale south along U.S. Highway 99 to Rickreall.[229] This first phase provides a critical north-end connection between the Central Coast Feeder and the Mid-Willamette Valley Feeder and is currently scheduled for completion in mid-October.[230]

The second phase, "Monmouth Reinforcement," is the installation of transmission line from a location just north of Monmouth to a location at the intersection of Haley Road and Albany Road (Granger-Independence Highway) south of Independence.[231] This second

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[225] *Id.* at lines 6-9.
[226] NWN/600, Yoshihara/4, lines 10-14.
[227] *Id.* at lines 15-18.
[228] Staff/1002, Zimmerman/5.
[229] NWN/600, Yoshihara/5, lines 3-5. Appendix A is a map of the MWVF. A map of the MWVF was previously filed as Staff/1102, Sobhy/2. The attached map is the same as the map previously filed, but is in color and has sections of the MWVF and other relevant pipelines labeled to facilitate review.
[230] NWN/600, Yoshihara/5, lines 5-7. The in service date of August 3, 2012 provided earlier in this case (Staff/1002, Zimmerman/13) has since been updated.
[231] NWN/600, Yoshihara/4, lines 20-22.

1 phase is an extension of the existing transmission line that runs from State Highway 18 at
2 Rickreall south to just north of Monmouth is scheduled for completion in mid-October.[232]
3 The third phase, "South of Monmouth Bare Replacement," is the installation of
4 transmission line from the Albany Road location south of Independence to the intersection of
5 Highway 20 and Granger-Independence Highway.[233] This third phase includes the
6 replacement of multiple segments of bare steel main along Granger-Independence Highway
7 and is scheduled for completion in 2013.[234]
8 The fourth phase, "Willamette Crossing," is the installation of transmission line from the
9 intersection of State Highway 20 and Granger-Independence Highway, crossing the
10 Willamette River, and connecting to the existing Albany-Corvallis Feeder.[235] This fourth phase
11 is currently scheduled for completion in 2013.[236]
12 The Company has included in rates in this case costs associated with the two phases
13 of the MWVF that will be used and useful by the rate effective date: the Perrydale to
14 Monmouth and Monmouth Reinforcement phases. Staff objects to the inclusion of these
15 phases in rates. No other party has testified on the issue.
16 Staff's primary objection to the MWVF is that the Company developed the project
17 before it was selected in the preferred portfolio in the Integrated Resource Plan (IRP). As will
18 be discussed below, the Company has explained that (1) there are a number reasons of why it
19 is necessary to develop the project now—separate and apart from the reasons modeled in the
20 IRP; and (2) the fact that the IRP selected the MWVF when a disruption on the Grants Pass
21 Lateral was modeled supports the Company's contention that the MWVF is necessary now to
22 address reliability issues in the Albany-Corvallis area. The Company has further explained
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[232] NWN/600, Yoshihara/4, line 22-Yoshihara/5, line 2. The in service date of October 31, 2012 provided earlier in this case (Staff/1002, Zimmerman/13) has since been updated.
[233] NWN/600, Yoshihara/5, lines 13-15.
[234] *Id.* at lines 15-17.
[235] *Id.* at 5, lines 8-11.
[236] *Id.* at lines 11-12.

that Staff's objections to the MWVF appear to be the result of a misunderstanding between the Company and Staff as to the appropriate role of the IRP in determining distribution system reliability projects. The Company hopes that through briefing and clarification at the hearing, the parties will develop a mutual agreement on this matter. However, in no case should this disagreement distract from the clear facts in this case—the MWVF is prudently planned and developed by the Company and the two phases that will be complete by the rate effective date should be recovered through the rates set in this case.

2. The MWVF is Needed for Distribution Reliability Purposes, Which is Not Generally Modeled in the IRP.

Staff's primary argument on the MWVF is that the Company's modified 2011 IRP did not select the MWVF until 2025/2026 for purposes of demand growth in the base case model or until 2019 when a disruption of service on the Grants Pass Lateral was imposed, and for that reason should not be built currently.[237] This argument is based on a fundamental disconnect on Staff's part as to why the Company is building the MWVF and what the IRP is for.

a. The MWVF is Needed for Distribution Reliability.

The primary reason for developing the MWVF in 2012/2013 is to address distribution reliability issues in the Albany-Corvallis area. Currently, Albany-Corvallis is a "single-feed system," meaning that it is fully dependent upon receiving its natural gas supply from one source, in this case a single gate station delivering gas from the Northwest Pipeline Grants Pass Lateral.[238] Being a single-feed system makes the area vulnerable to customer outages because there is no ability to deliver gas through an alternate transmission pipeline network.[239] In a 2008 study, the Company identified the Albany-Corvallis area as having the largest

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[237] Staff/1100, Sobhy/10, lines 1-16.
[238] NWN/2200, Yoshihara/8, lines 3-8
[239] *Id.* at lines 9-15.

1 potential customer outages on NW Natural's distribution system that would result from a
2 disruption of service through a single-feed system.[240] The Company began planning
3 additional phases of the MWVF to address this reliability concern.[241]
4 Staff has attempted to undermine the Company's argument that the MWVF is needed
5 to address reliability concerns by arguing that the three disruptions on the Grants Pass
6 Lateral, in 1990, 2004, and 2009, did not impact firm customers.[242] Staff also argued that the
7 2004 and 2009 outages occurred during peak events, indicating that the Company can meet
8 firm demand during disruptions on the Grants Pass Lateral even during cold weather.[243]
9 However, the Company demonstrated that Staff's analysis of these outages was inaccurate.
10 *First,* the 2009 disruption did affect firm customers.[244] *Second*, the weather experienced on
11 the dates of the service disruptions was warmer than design peak, so service disruptions
12 could be more significant in the future if they occur on days closer to design peak.[245] *Finally*,
13 customer growth since the 2004 disruption indicates that the Company's ability to meet peak
14 demand during a similar disruption is now lower than in 2004.[246]
15 In reply testimony, Staff did not contest the Company's evidence that the area served
16 by the MWVF is vulnerable to service outages due to being a single-feed system and that it
17 was prudent to develop the MWVF to address this concern. Staff did not respond to the
18 Company's evidence showing that the past service disruptions on the Grants Pass Lateral
19 indicate that without the MWVF, the Company's ability to meet firm demand during future
20 service disruptions is in jeopardy. Staff also did not respond to the other benefits of the
21 MWVF discussed in NW Natural's reply testimony, specifically: the Company needs to
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[240] *See* Exhibit Staff/1115, Sobhy/3.
[241] The Company completed a portion of the MWVF in September 2005. Staff/1002, Zimmerman/5.
[242] Staff/1100, Sobhy/12, line 3-Sobhy/13, line 2.
[243] *Id.* at 12, lines 3-12.
[244] NWN/2200, Yoshihara/10, lines 14-19.
[245] *Id.* at 8, line 16-23.
[246] *Id.* at 11, lines 10-17.

1 replace existing bare steel along the MWVF alignment in accordance with its bare steel
2 program[247] and Mist storage is the Company's primary, low-cost resource, and the MWVF
3 brings this low-cost resource to customers in the south.[248] Staff simply argued that the
4 Company offers no evidence to contradict the results of the 2011 Modified IRP.[249]

5 **b. The IRP Does Not Model Distribution Reliability.**

6 The Staff's focus on the IRP in this case appears to be based upon a
7 misunderstanding of the role that the IRP plays in the Company's distribution system planning.
8 For this reason, NW Natural provides below some background on these issues.

9 The purpose of the IRP is to develop long-term resource plans for meeting resource
10 needs on a least-cost, least-risk basis.[250] For NW Natural, the IRP provides a long-term
11 forecast of the gas purchases and capacity contracts for bringing sufficient gas supplies *to the*
12 *boundary of the utility's distribution system.*[251] As such, the current IRP model used by NW
13 Natural, as well as Avista Corporation and Cascade Natural Gas Company, is not used to
14 model the distribution of gas *within* the utility's system, system expansions, or system
15 reinforcements.[252] In fact, NW Natural uses an entirely separate modeling software to model
16 its distribution infrastructure requirements, and the discussion of that modeling has been
17 limited to a short discussion in the IRP.[253] This process is consistent with the Commission's
18 IRP Guidelines, which do not require the inclusion of distribution planning, and all of the
19 Company's IRPs have been acknowledged by the Commission as meeting the Guidelines.[254]
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[247] *Id.* at 7, lines 7-9.
22 [248] *Id.* at lines 17-20.
[249] Staff/1900, Zimmerman/5, lines 13-15.
23 [250] NWN/2200, Yoshihara/3, lines 17-19.
[251] *Id.* at lines 19-21.
24 [252] All three utilities use the SENDOUT model to determine the resources needed to meet future load growth, which is not used to model the distribution of gas within the system, system expansions, or
25 system reinforcements. NWN/2200, Yoshihara/4, line 21-5, line 5.
[253] NWN/2200, Yoshihara/4, lines 6-15.
26 [254] *Id.* at lines 19-21.

The confusion in this case occurs because—despite the fact that the MWVF is being developed by the Company for reliability purposes—it was included in the 2011 IRP for two separate reasons. First, it was included in the 2011 Modified IRP as a supply resource to model increased peak day delivery of low-cost Mist and potentially Newport liquefied natural gas (LNG) gas to the Company's southern region.[255] The 2011 Modified IRP determined that new capacity would be needed in the 2025/2026 timeframe for these purposes.[256] However, as explained above, the Company is not developing the MWVF at this time to meet load growth or peak day deliverability requirements. It is developing the MWVF to address distribution reliability issues that are not modeled in the IRP. For this reason, Staff's argument that the MWVF was imprudent because the 2011 Modified IRP preferred portfolio did not select it until 2025 is off target.

Second, in disruption scenario modeling, the 2011 Modified IRP does select the MWVF for 2019 for reliability purposes—the same purpose for which it is in fact being built today. The reason the 2011 Modified IRP selects the MWVF for 2019, when reviewed in context, supports the Company's decision to build the MWVF today.

As stated above, NW Natural's IRP does not typically address distribution reliability issues. However, during the public process of developing the 2011 Modified IRP, Staff requested that the Company model service disruptions to test the reliability of its plan for bringing gas to its system.[257] To comply with Staff's request, the Company "forced" the IRP model to respond to such disruptions. The Company applied various scenarios to one model run consisting of five disruptions that were staggered in two-year increments.[258] Two service disruption scenarios included disruptions on the Grants Pass Lateral, arbitrarily modeled in

[255] NWN/2200, Yoshihara/5, line 9-Yoshihara/6, line 2.
[256] *Id.* at 6, lines 12-14.
[257] *Id.* at lines 5-7.
[258] *Id.* at lines 7-9.

2020.[259] Under these scenarios, the MWVF was chosen to serve customer demand during a disruption on the Grants Pass Lateral—thus supporting the decision that the Company had already made based on the 2008 single-feed study.[260] Staff's argument that these disruption models indicate that the MWVF is not necessary until 2019 is inapt. The disruption modeling was not intended to predict *when* a disruption would occur—it was intended to evaluate how the Company could bring gas supply to its system in the event of disruptions. The Company could have modeled a service disruption in any gas year before or after 2020, and the model would have chosen the MWVF in the year prior.[261] Because a service disruption could happen at any time, the fact that the IRP selected the MWVF in the case of a service disruption on the Grants Pass Lateral actually supports the Company's argument that the MWVF is needed for reliability purposes.[262]

3. The MWVF is the Most Cost Effective Option for Meeting Reliability Needs.

Staff also argues that the Company did not show that the MWVF was cost effective relative to the benefits of the pipeline, citing the fact that the Company did not provide a financial analysis as envisioned by Staff to be necessary.[263] The Company explained that there are no other feasible solutions for meeting increased need for capacity in the area other than a pipeline like the MWVF, because satellite storage and expanding the Grants Pass Lateral are not feasible alternatives for meeting the reliability needs the Company had identified.[264] The Company found that enhancing the existing pipeline alignment is a more cost effective solution than developing a new pipeline in a new pathway.[265] The Company explained the elements of the MWVF route that make it more cost effective than developing a

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[259] NWN/3300, Yoshihara/4, lines 2-4.
[260] *Id.* at 4-6.
[261] *Id at* 4, lines 6-8.
[262] *Id.* at lines 8-11.
[263] Staff/1100, Sobhy/17, lines 6-8.
[264] NWN/2200, Yoshihara/13, lines 1-8.
[265] *Id.* at 14, lines 13-17.

new pipeline, such as the fact that the MWVF will help the Company meet future load increases by transporting low-cost Mist gas to the south, a portion of the route needed to be replaced through the bare steel program, and the route is the shortest alternative to move gas from Mist and Newport LNG to the Albany-Corvallis area.[266] The Company also explained how it evaluated alternative routes and provided the related feasibility report.[267]

Staff did not respond to the Company's testimony that the MWVF is the only feasible solution for meeting the needs of reliability in the area. Staff also did not address the Company's testimony that the MWVF is more cost effective than developing a new pipeline. The Company's testimony supporting the cost effectiveness of the MWVF and demonstrating that the MWVF is needed for distribution reliability purposes on the 2012/2013 timeframe is unrebutted, and Staff's proposed adjustment instead rests solely on an argument about the IRP, which is misapplied. Staff's proposal to remove the two relevant phases of the MWVF from rates should be rejected.

F. Amortization of Deferred Tax Balances

1. Introduction

The Company included in its revenue requirement in this case the amortization of a regulatory asset related to Oregon state tax rate changes that occurred effective with the 2009 tax year.[268] Staff and NWIGU-CUB propose removing this amount from revenue requirement.[269] This regulatory asset is related to Oregon Ballot Measure 67, which was signed into law on July 20, 2009 and provided for an increase in the corporate excise tax rate beginning in tax year 2009.[270] The law required NW Natural to increase its deferred tax liability by a net of $2.7 million.[271] To recognize the increase, NW Natural booked a regulatory

[266] *Id.* at 14, line 18-Yoshihara/16, line 2.
[267] *Id.* at 16, lines 3-7.
[268] NWN/1900, Siores/23, lines 10-12.
[269] *Id.* at lines 10-15.
[270] *Id.* at lines 16-23.
[271] *Id.* at lines 22-23.

asset of $4.48 million—representing the $2.7 million change in its deferred tax balance, plus an appropriate gross up for taxes.[272] This balance represents the amounts needed to be collected for taxes that will be paid in the future to the state of Oregon, but that have not yet been paid due to differences in taxable income and book income.[273] The Company seeks to amortize this $4.48 million over a five-year period to ensure that it collects an appropriate amount for taxes that the Company will pay in the future. The parties do not disagree that the appropriate Generally Accepted Accounting Principle (GAAP) was followed, only that the Company should not be allowed to recover the increased deferred tax liability.

Critical to understanding the parties' arguments on this issue is an understanding of the nature of deferred taxes. It is standard practice for state taxes, and in fact required under the Internal Revenue Service's (IRS) tax normalization principles, for a utility to include in rates its current tax expenses, plus deferred taxes.[274] Deferred tax balances represent the cumulative tax effect of the temporary differences between book income on the Company's books and the taxable income on the Company's tax return (book-tax difference).[275] These temporary differences are timing differences, typically because an expense may be taken for tax purposes earlier than it may be recognized for book purpose.[276] Eventually the same amount of expense will be recognized for book purposes, but the timing difference results in taxable income and tax payments that are lower than book amounts for early years and higher than book amounts in later years.[277] Thus, deferred taxes represent future tax liabilities.[278]

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[272] *Id.* at 24, lines 2-4.
[273] *Id.* at lines 4-8.
[274] NWN/1900, Siores/25, lines 8-10.
[275] NWN/3000, Siores/13, lines 6-8.
[276] *Id.* at lines 8-10.
[277] *Id.* at 13, lines 10-13.
[278] *Id.* at line 13.

2. Amortization of the Deferred Tax Balances Does Not Constitute Retroactive Ratemaking because those Balances Will be Paid in the Future.

Staff and NWIGU-CUB object to the Company's amortization of the deferred tax balances on the basis that it constitutes retroactive ratemaking, because it would include in future rates past expenses.[279] Staff and NWIGU-CUB argue that the Company should have filed a deferral to avoid the rule against retroactive ratemaking and be able to recover the deferred tax balances.[280]

The rule against retroactive ratemaking does not prohibit the Company from including in rates the deferred tax balances at issue. The deferred tax balances reflect taxes that will be paid in the future, not taxes that were paid from the period 2009-2012.[281] Deferred taxes arise due to a timing mismatch between income on a company's books and income that is taxable by a jurisdiction.[282] The change in deferred tax balances at issue here represent a change in estimate that is forward-looking, not backward-looking, so by its very nature the change does not implicate retroactive ratemaking.[283]

IRS guidance supports the conclusion that adjusting deferred tax balances does not constitute retroactive ratemaking. The IRS has explained, citing Federal Energy Regulatory Commission precedent:

> The balance in the deferred tax reserve is . . . a residual of past tax costs over past tax payments and may or may not be sufficient to cover future tax payments over future tax costs, depending on the statutory tax rates in the future. Any excess or deficiency in the deferred tax reserve does not, however, result in a windfall to either shareholders or ratepayers since the balances will systematically be subject to a reconciliation in future rates.[284]

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[279] Staff/500, Garcia/9, lines 8-10; NWIGU-CUB/100, Larkin/29, line 1.
[280] Staff/1800, Garcia/12, lines 3-13; NWIGU-CUB/200, Larkin/3, lines 7-14.
[281] NWN/1900, Siores/26, lines 18-20.
[282] *Id.* at 27, lines 14-16.
[283] *Id.* at lines 19-20.
[284] *Available at* http:www.irs.gov/businesses/article/0,,id=181906,00.html.

The IRS guidance goes on to explain that state regulatory bodies have taken an approach to deferred tax recoveries that generally waits until general rate proceedings before updating rates for changes in deferred tax liabilities, and that such proceedings are used to ensure full recoveries of deferred tax amounts from customers. It states:

> State regulatory bodies appear to have taken a similar approach as that embraced by FERC. Excess deferred taxes have not caused retroactive rate adjustments nor refund orders *but rather have been subject to reconciliation in future ratemaking proceedings.*[285]

In sum, adjusting deferred tax balances on a forward-looking basis does not implicate the rule against retroactive ratemaking because by their nature deferred taxes reflect taxes that will be paid in the future.

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

Even if the Commission were to find that retroactive ratemaking principles apply to updates to deferred tax balances, Staff's and NWIGU-CUB's proposed adjustments are inappropriate. Staff and NWIGU-CUB 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.[286] However, the amounts that were added to its deferred tax balance represent the sum of the incremental future tax payments NW Natural expects to pay over a number of future years.[287] In other words, their proposed adjustment is not based on taxes paid (or amounts by which NW Natural's deferred tax balance changes) between the time NW Natural updated its deferred tax balance and the time it filed this rate case. Instead, their adjustment is based on a removal of NW Natural's ability

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[285] *Id.* (emphasis added).
[286] NWN/3000, Siores/14, lines 19-22.
[287] *Id.* at 15, lines 1-2.

1 to collect appropriate taxes for years that occur even after it filed this rate case.[288] No
2 application of retroactive ratemaking principles could have such a result.

3 NW Natural evaluated its deferred tax balance to try to isolate the changes that
4 occurred with respect to the assets for which these balances were updated in 2009 between
5 2009 (when the update was made based on the tax change) and 2012 (when NW Natural filed
6 its rate case seeking recovery of the updated deferred tax amounts). It found that the
7 "reversals" (i.e. where book depreciation is greater than tax depreciation for those assets) that
8 occurred during those years were limited to $530,350.[289] Further, it found that, in light of
9 bonus depreciation and other upward drivers of deferred taxes, these reversals were more
10 than offset by additional deferred taxes that occurred during that time.[290] This reinforces that
11 retroactive ratemaking principles do not apply to these amounts because the reversals of NW
12 Natural's deferred taxes will occur in the future, and that they do not represent past expenses
13 for which current recovery should be barred. This also reinforces that Staff's and NWIGU-
14 CUB's proposed adjustments (which would prevent NW Natural from amortizing any of a
15 $4.48 million balance)[291] are inappropriate and should be rejected.

16 **4. Amortization of the Deferred Tax Balances is Not Single Issue Ratemaking**
17 **Because All of the Company's Expenses and Revenues are Being Evaluated in this Case.**

18 NWIGU-CUB also argue that the amortization is single-issue ratemaking, because the
19 Company has singled out an item and is requesting cost recovery for this item.[292] NWIGU-
20 CUB's single-issue ratemaking argument is off base. Single-issue ratemaking occurs when
21 the Commission singles out "a rate component without considering whether other factors
22 offset this amount."[293] This proceeding is a general rate case, in which all of the Company's

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[288] *Id.* at lines 3-9.
[289] *Id.* at lines 13-15.
[290] *Id.* at lines 15-17.
[291] NWN/1900, Siores/24, lines 12-14.
[292] NWIGU-CUB/100, Larkin/28, lines 18-22.
[293] *Re. Portland Gen. Elec. Co.*, DR 10 *et al.*, Order No. 04-597 at 6 (Oct. 18, 2004).

costs and revenues are evaluated, so the concept of single-issue ratemaking is inapplicable. NWIGU-CUB's argument that evaluating a deferred tax balance from a prior period is impermissible absent a review of all costs and revenues from that period is simply a reiteration of their retroactive ratemaking argument, rather than a separate issue.

5. The Company's Recovery of the Deferred Tax Balance That Reflects the State Tax Change is Consistent with the Commission's Past Practices.

The argument that the deferred tax balances are subject to retroactive ratemaking is undermined by a prior Commission order allowing for changes in deferred tax balances absent a deferred accounting application. In Docket UG 55, this Commission adopted a stipulation in which NW Natural agreed to provide refunds to customers related to a 1986 federal tax law change. The stipulation provided that "[i]n the future, if there is a change in the federal income tax incremental rate . . . that results in the company's deferred tax accounts having been understated or overstated due to the amortization agreed to by the parties [in the stipulation], then the company may apply for, and the OPUC Staff and other parties agree to support, appropriate rate increases or decreases designed to restore its deferred tax balances to the necessary levels."[294] Although this stipulation does not govern in this case, it shows that the Commission has endorsed the concept that future rates may need to be increased or decreased to account for updates to deferred tax amounts caused by tax rate changes that occurred in the past. If the rule against retroactive ratemaking had applied to the adjustment of deferred tax balances, the Commission could not have approved the stipulation. To not apply this same standard to NW Natural in this case would be inconsistent with the Commission's past treatment of deferred tax balances.

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[294] *Re. the Investigation into the Effect of the Federal Income Tax Reform Act of 1986 on NW Natural Gas Co.*, Docket UG 55, Order 87-721 (June 29, 1987).

1 Recently enacted legislation, Senate Bill 967, provides additional support for the
2 Commission in determining that the recovery of deferred taxes proposed in NW Natural's
3 direct case is appropriate. It states:

4 When establishing schedules and rates under ORS 757.210 for an
5 electricity or natural gas utility, the Public Utility Commission shall act to balance the interests of the customers of the utility and the
6 utility's investors by setting fair, just and reasonable rates that include amounts for income taxes. Subject to subsections (2) and
7 (3) of this section, *amounts for income taxes included in rates are fair, just and reasonable if the rates include current and deferred*
8 *income taxes and other related tax items that are based on estimated revenues derived from the regulated operations of the*
9 *utility.*[295]

10 It also provides that in setting utilities' rates, the Commission must ensure that the
11 income taxes included in rates are fair and reasonable and that such amounts may reflect
12 considerations the Commission "deems relevant to protect the public interest."[296] If NW
13 Natural were disallowed amounts necessary to pay future tax expenses, such a result would
14 not be fair and reasonable, or consistent with protecting the public interest, especially
15 considering that the Commission has previously allowed for refunds of deferred tax balances,
16 and considering that any other approach would result in a significant mismatch between taxes
17 paid by the utility and taxes collected.

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19 **6. NWIGU-CUB's Argument that the Company Will Not Pay Taxes Associated with the Deferred Income Tax Expense is Unsupported.**

20 NWIGU-CUB provide additional arguments related to deferred taxes. First, NWIGU-
21 CUB argue that the Company did not actually pay any increased state tax as a result of the
22 deferred tax change.[297] Because deferred tax balances reflect timing differences that will be
23 settled out in *future* years, it is expected that these deferred tax balances would not have

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25 [295] ORS 757.269(1) (emphasis added).
[296] ORS 757.269(2)(f).
26 [297] NWIGU-CUB/200, Larkin/4, lines 4-6.

1 increased the Company's past taxes paid.[298] NWIGU-CUB's point reinforces the Company's
2 position that the revaluation of future expectations is not retroactive ratemaking.
3 Second, NWIGU-CUB argue that the Company already recovered the deferred income
4 tax expense because the Company's ROE in 2009 was higher than its authorized ROE.[299]
5 NWIGU-CUB's argument is illogical. No party has claimed that the deferred tax change was
6 ever reflected in rates. Moreover, deferred tax balances reflect timing differences settled in
7 the future, so it is not reasonable to take the Company's past ROE into account when
8 evaluating deferred tax balances.
9 Third, NWIGU-CUB argue that the Company will not pay taxes associated with the
10 deferred income tax expense in the future.[300] This is simply not the case. As the Company
11 explained, deferred taxes reflect timing differences between book income and taxable income.
12 In future years, these timing differences naturally reverse and the Company will have higher
13 tax payments in later years than in earlier years, as expenses that were recognized early for
14 tax purposes conclude. If the Company did not expect to pay the taxes in the future, there
15 would be no basis to book the deferred taxes under Generally Accepted Accounting
16 Principles. In addition, there would be no basis for the Commission to allow for deferred taxes
17 to be included in rates. NWIGU-CUB's argument is baseless.

18 **V. CONCLUSION**

19 For the reasons set forth above, the Company respectfully requests that the
20 Commission: (1) set the Company's ROE at 10.0 percent; (2) reject Staff's proposed
21 adjustment to cost of debt based on the interest rate hedge loss; (3) adopt the Company's
22 environmental remediation cost recovery mechanism with no sharing provision or earnings
23 test, and allowing interest to accrue on deferred amounts consistent with Order No. 06-507;
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25 [298] NWN/3000, Siores/15, lines 15-17.
[299] NWIGU-CUB/200, Larkin/5, lines 1-10.
26 [300] *Id.* at line 14-Larkin/6, line 12,

1 (4) adopt the Company's proposed pension contribution ratemaking methodology; (5) find that
2 the development of the MWVF was prudent and allow into rates the costs associated with the
3 Perrydale to Monmouth and Monmouth Reinforcement phases of the project; and (6) allow the
4 Company to amortize the regulatory asset associated with deferred tax balances.
5
6 DATED: August 20, 2012

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APPENDIX A

NEWPORT/PERRYDALE COMPRESSOR STATION (FUTURE)

TO Newport LNG

To SMPE

Central Coast Feeder

North Willamette Valley Feeder

MWVF PERRYDALE TO MONMOUTH (2012)

MWVF RICKREALL TO MONMOUTH (2005)

MWVF MONMOUTH REINFORCEMENT (2012)

MWVF SOUTH OF MONMOUTH BARE REPLACEMENT (2013)

MWVF WILLAMETTE CROSSING (2013)

CORVALLIS LOOP (2012/2013)

Albany to Corvallis Feeder

Grants Pass Lateral

Grants Pass Lateral

Sheridan

Amity

Gervais

Yamhill

Polk

Yamhill

Marion

Keizer

Dallas

Salem

Polk

Marion

Monmouth

Independence

Turner

Aumsville

Stayton

Polk

Linn

Polk

Benton

Jefferson

Marion

Linn

Scio

Millersburg

Adair Village

Benton

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Albany

Corvallis

Tangent

Philomath

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NW Natural

Mid-Willamette Valley Feeder & Corvallis Loop

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August, 2012

Williams Gate Station

Williams Pipeline West

NW Natural High Pressure Pipelines

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