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July 20, 2012

VIA ELECTRONIC FILING
& FIRST CLASS MAIL

Oregon Public Utility Commission
Attn: Filing Center
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Re: **Docket No. UG-221** - In the Matter of Northwest Natural Gas Company – Application for a General Rate Revision

Dear Filing Center:

Enclosed please find an original and five (5) copies of the **Rebuttal Testimony of Hugh Larkin, Jr.**, on behalf of the Northwest Industrial Gas Users and Citizens' Utility Board of Oregon.

Thank you for your assistance, and please do not hesitate to contact our office with any questions.

Very truly yours,

Tommy A. Brooks

TAB:sk
Enclosures
cc: UG 221 Service List

CERTIFICATE OF SERVICE

I CERTIFY that I have on this day served the foregoing document upon all parties of record in this proceeding via electronic mail and/or by mailing a copy properly addressed with first class postage prepaid.

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Dated in Portland, Oregon, this 20th day of July 2012.

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Docket UG 221
NWIGU-CUB/200
Larkin

BEFORE THE

PUBLIC UTILITY COMMISSION OF OREGON

REBUTTAL TESTIMONY OF HUGH LARKIN, JR.

ON

BEHALF OF THE NORTHWEST INDUSTRIAL GAS USERS

AND

THE CITIZENS' UTILITY BOARD OF OREGON

JULY 20, 2012

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I. Introduction

Q. Please state your name.

A. Hugh Larkin, Jr.

Q. Are you the same Hugh Larkin, Jr. that filed Direct Testimony in this Docket on May 3, 2012?

A. Yes, I am.

Q. What is the purpose of your testimony?

A. NW Natural ("NWN" or the "Company") filed Reply Testimony on June 15, 2012. The purpose of my testimony is to respond to positions taken by NWN witnesses David Anderson, Natasha Siores, Stephen P. Feltz, John Sohl, Lea Anne Doolittle, and C. Alex Miller. It should be noted that my testimony is not intended to respond to each and every area of Reply Testimony submitted by the Company, and the fact that I have not responded to any given area should not be viewed as an acceptance of the Company's position in that area. I should also note that I reserve the right to respond to any additional testimony the Company may submit.

II. Reply Testimony of David Anderson

Q. Did you review the Reply Testimony of David Anderson?

A. Yes. Mr. Anderson, the policy witness for NWN, briefly addresses the following issues which were discussed in my direct testimony: environmental remediation, deferred tax, and pension. These issues are addressed extensively by NWN witnesses C. Alex Miller,

Natasha Siores, and Stephen P. Feltz, respectively. I will comment on these issues in the sections of my testimony relating to each of these witnesses.

III. Reply Testimony of Natasha Siores

Q. Did you review the Reply Testimony of Natasha Siores?

A. Yes, I reviewed Ms. Siores' Reply Testimony.

Q. Did the Company have Oregon Commission authority, based on an Order to record a regulatory asset in 2009, that it is now seeking to recover from ratepayers?

A. No. The Commission has a procedure for approving deferrals which is set forth in ORS 757.259, which reads in part:

> (1) In addition to powers otherwise vested in the Public Utility Commission, and subject to the limitations contained in this section, under amortization schedules set by the commission, a rate or rate schedule:
>
> (a) May reflect:
>
> (A) Amounts lawfully imposed retroactively by order of another governmental agency; or
>
> (B) Amounts deferred under subsection (2) of this section.
>
> (b) Shall reflect amounts deferred under subsection (3) of this section if the public utility so requests.
>
> (2) Upon application of a utility or ratepayer or upon the commission's own motion and after public notice, opportunity for comment and a hearing if any party requests a hearing, the commission by order may authorize deferral of the following amounts for later incorporation in rates:
>
> ...

> (e) Identifiable utility expenses or revenues, the recovery or refund of which the commission finds should be deferred in order to minimize the frequency of rate changes or the fluctuation of rate levels or to match appropriately the costs borne by and benefits received by ratepayers. (Emphasis added.)

NWN failed to submit an application to the Commission to set up the regulatory asset that it now seeks to recover from ratepayers. No other party had the opportunity to examine this regulatory asset, or object to the proposed recovery of this regulatory asset, prior to the Company's request in this case. The Company has, therefore, lost its opportunity to legitimately bring before the Commission this issue for the recovery of the regulatory asset it illegitimately set up. The Company is now retroactively seeking recovery of a regulatory asset it had no authority to set up in rates that go into effect in the future.

Q. Doesn't the Company state that the requirements of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ("FAS 109") and a Commission-approved stipulation in 1986 are the basis for its establishment of this regulatory asset?

A. Yes. However, neither of these documents are a legitimate basis on which to establish a regulatory asset related to a tax rate change in 2009. First, FAS 109 relates to the recording of income taxes for accounting purposes and financial accounting statements. It provides no authority for establishing regulatory assets for regulatory accounting purposes. The second document is a stipulation which the Commission approved in 1986 regarding the Tax Reform Act of 1986 (which reduced federal income rates) and did not give *carte blanche* authority to the Company to establish regulatory assets. The

stipulation applied to changes in federal income tax rates and their effect on federal deferred income tax balances. It is unrelated to any state deferred income tax and cannot be construed as such.

Q. Did the Company actually pay any increased state tax as a result of the change in the state tax rates in 2009?

A. No. NWN's state income tax is fully offset with accelerated depreciation and other tax deductions which the Commission has allowed the Company to normalize. By normalizing, I mean that for ratemaking purposes the Company does not reflect the actual state income tax expense paid, but reflects the tax that would have been paid if the accelerated depreciation and other deductions were not taken on the tax return. In other words, ratepayers pay the Company for a tax which the Company is not paying itself. In 2009, due to the change in the state tax rate, the amount of deferred income tax that the company recorded was actually larger than it would have been had the rate remained the same. The Company did not pay additional state taxes. The Company merely made an accounting entry which increased the income tax expense in that period and increased deferred state income tax on the Company's balance sheet. There was no cash paid to the state.

Q. Is it correct then to state that the Company's request is based upon accounting entries and not based upon any cash payment to the state of Oregon?

A. Yes, that is correct.

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Q. Is there any evidence that the Company actually recovered the deferred income tax expense which it is now requesting be included in future rates?

A. Yes. The Company's last allowed return on equity was 10.2%. According to the Oregon Earnings Review Report submitted to the Commission for the twelve months ended December 31, 2009, the Company's actual return on equity was 11.22%, 102 basis points above the authorized return on equity. That indicates that if the Company had not created the unauthorized regulatory asset that the return on equity of 11.22% would have been somewhat lower and closer to the authorized return on equity. I would conclude that the Company could have earned its authorized rate of return on equity and collected the increased deferred state income tax in 2009.

Q. So if the Commission were to authorize what the Company is asking for in this docket, could one conclude that there was a double recovery?

A. Yes.

Q. What is the reasoning that the Company gives for the collection of the $4.48 million in revenue from ratepayers that represents the $2.7 million increase in deferred taxes?

A. Witness Siores states on page 24 that, "[t]his balance represents the amount needed to be collected for taxes that will be paid in the future to the state of Oregon, but which have not been paid due to differences in taxable income and book income (*e.g.*, due to such items as accelerated depreciation for tax purposes, which benefits ratepayers by reducing net rate base)." This would imply that NWN is going to pay these taxes at some time in the future. It has been my experience over the last 42 years in regulatory accounting that

the deferred income tax balances of federal and state taxes, rarely, if ever decrease. In other words, there is rarely a situation where the deferred income taxes do not increase from year to year. This is so because utility plant keeps growing, the Company keeps investing in new plant additions for new customers, replacing old components with new components of plant at higher costs, and the same accelerated tax benefits are still available. Therefore, both the increase in total dollars of plant, as a result of increased number of customers and the replacement and enhancement of facilities, causes total plant assets to increase. These assets are subject to accelerated depreciation and, as a result, the deferred income tax balances keep growing.

Q. Is it unlikely that the State of Oregon will receive any increased tax payments from NWN at any time in the foreseeable future?

A. Yes, that is my opinion.

Q. On page 24 of witness Siores testimony, she states "When NW Natural collects such amounts from customers in advance of paying it to taxing authorities, it applies them as a reduction to rate base to compensate customers for the time value of money." Does this mean that ratepayers will receive a benefit greater than the $4.48 million that the company is requesting that they pay for the increase of $2.7 million in the deferred income tax balance?

A. No, because the $2.7 million is in effect an accounting entry and does not represent any payment of cash for taxes to the state of Oregon, it is therefore not a deduction for federal income tax purposes. Consequently, the Company must collect approximately $1.66 for each dollar it records in the deferred income tax account. The deferred income tax

balance is only used as a reduction of rate base in the year rates are set. So ratepayers would pay $1.66 in revenues to receive $1.00 of rate base reduction when rates are set. The $1.00 in rate base reduction which is considered cost-free capital, would save ratepayers approximately 8-10 cents each year, assuming the overall rate of return is between 8% and 10%. The ratepayer would therefore be paying $1.66 to save approximately 8-10 cents per year. This is hardly a cost effective way of using one's funds.

Q. On pages 25-26, of her Reply Testimony, Ms. Siores refutes NWIGU-CUB's assertion that the Company adjustment to amortize the state tax change is single-issue ratemaking by stating "[i]t is unclear to the Company how its proposal to recover deferred tax balances in the context of a general rate case could be considered 'single-issue ratemaking.'" Can you clarify how the Company's proposal is in fact an example of single-issue ratemaking?

A. Yes. The objective in ratemaking is to review and consider all relevant factors in the test year and the total effect on the revenue requirement in that particular year to allow the utility an *opportunity*, not a *guarantee*, to recover its costs to provide utility service and earn a return on its investment. Rates are calculated based on a "test-year" which is a 12-month period to be *representative* of operating conditions when the rates being established will be in effect. The revenue requirement is a "snapshot" of revenues and expenses expected to occur during the test year. Actual revenues and expenses will differ from those approved, including taxes paid and collected.

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Deferring or singling-out one item from a utility's revenue requirement to be considered at a later date (a 2009 transaction to be considered in the 2013 test year) is single-issue ratemaking. The Company isolated the effect of this tax change resulting from Oregon Ballot Measure 67 in 2009 and recorded that amount in Account 186- deferred debits, which it is requesting recovery of in this case.

NWN has operations in Oregon, California and Washington as well as other business segments. Corporations are subject to a myriad of taxes at the local, state and federal level as well as many other expenses which affect the overall revenue requirement. The Company's jurisdictional operations and business segments may have materially different tax provisions. To isolate the effect of one component of the Company's corporate taxes from a prior period and without considering all the other components in the period that the tax change occurred is single-issue ratemaking. For example, the Company may have had other offsetting factors such as higher revenues and/or lower other operating expenses in 2009, the year the tax change went into effect.

Furthermore, according to CEO Gregg Kantor, "2009 produced record-high earnings for Northwest,"[1] despite the economic downturn. In addition, according to the transcript for NWN's 2010 2nd Quarter Earnings Call, David Anderson, Senior Vice President and CFO, said NWN's "earnings for the second quarter of 2010 were more than double

[1] http://seattletimes.nwsource.com/html/businesstechnology/2011195923_apusearnsnorthwestnaturalgas.html.

2009."[2] If the company is allowed to recover the effect on deferred taxes for this specific tax change in this case, it will have reaped the benefits of higher revenues and/or lower costs in that prior year while also being fully compensated for the effect of the single tax change.

The Company has singled out and deferred the effect of an event in a prior period and is requesting recovery in the current case without recognizing any counterbalancing savings from other revenues and costs from that prior period. The Company should not be allowed total recovery of this specific item without taking into consideration the other cost increases or decreases in that year (2009) which resulted in a record return on equity for the years shown in Table 1 on page 11. As stated in my direct testimony, this is clearly an example of single-issue ratemaking.

Q. On page 27 of witness Siores testimony, she states "… that disallowing such amounts from inclusion in customer rates would mean that NW Natural would be required to pay future taxes for which it would never have any recovery." Is that an accurate statement?

A. No. As I previously pointed out, it is unlikely that deferred tax balances will ever go away. The Company will never be required to pay the federal and state governments the amount of deferred taxes it records on its books. The state or federal governments do not have liabilities recorded on their books showing any future tax due from NWN. Deferred income taxes are an accounting requirement and do not represent an actual liability which

[2] http://seekingalpha.com/article/218660-northwest-natural-gas-company-q2-2010-earnings-call-transcript.

the state and federal agencies will require to be paid. Those agencies compute the tax for companies each year on a stand-alone basis. State and federal taxing agencies do not assume that any future taxes will be paid by any entity. For NWN to pay the deferred income tax balances that it shows on its books, its rate base will have to decline so that no future accelerated depreciation or tax-timing differences exist. As I stated earlier, this is not likely to happen. Even if it did, which I would deem to be highly unlikely, the Company would do what it normally does, which is to come to the Commission and say "we don't have the funds to pay these taxes, so we should be able to collect them from current ratepayers." NWN would not pay any future expense it could argue should be paid by ratepayers.

Q. Also on page 27 of her Reply Testimony, witness Siores states that the concept of retroactive ratemaking does not apply to deferred taxes. Is that a reasonable position?

A. Absolutely not. The Company made this calculation based on changes in the year 2009. It created this regulatory asset in 2009. The regulatory asset was based on deferred income taxes recorded in 2009, not in the test year. To state that the increase in deferred income taxes in 2009, which have been requested to be recovered in future rates, is not retroactive ratemaking flies in the face of common sense. Additionally, witness Siores states on page 27 “[f]inancial accounting standards require the utility to update its estimates of future tax liabilities when tax rates change.” That is true of any expense. Generally Accepted Accounting Principles require that if a company's insurance rates increase, it is required to reflect the current insurance expense and not one based on past

insurance rates. Financial Accounting Standards do not provide an exception to retroactive ratemaking.

Q. Did you review the Company's historical Oregon Earnings Review Reports which the Company submits to the Commission Staff?

A. Yes. Below is a table illustrating the Company's authorized and earned return on equity ("ROE") which was derived from those reports:

Table 1-Summary of NWN's allowed and earned (actual) ROE for the years 2001 - 2011[3]

Year	Allowed ROE	Earned ROE	
2001	10.25%	8.51%	
2002	10.25%	9.40%	
2003	10.20%	8.06%	
2004	10.20%	9.48%	
2005	10.20%	9.76%	
2006	10.20%	10.30%	
2007	10.20%	11.83%	[1]
2008	10.20%	10.91%	[1]
2009	**10.20%**	**11.22%**	
2010	10.20%	11.10%	
2011	10.20%	11.19%	

[1] Revised & Refiled December 2010

As can be seen, the Company has earned close to or over its authorized return on equity in the majority of the years shown, especially in 2009, the year of the tax change. As I mentioned previously, the Company had "record earnings" in 2009 which would lead me to believe it had the financial capability to absorb the effect of the non-cash tax change in that year.

[3] Information was taken from the Oregon Earnings Review Reports submitted to the Commission Staff.

Q. Are the Oregon exceptions to retroactive ratemaking applicable in this docket?

A. No, the exceptions to retroactive ratemaking under Oregon law are not applicable in this docket. The event that triggered the change in the deferred tax balance (Oregon Ballot Measure 67) occurred in 2009 and clearly fits the definition of retroactive ratemaking under Oregon law. The event in question is outside of the test year and constitutes retroactive ratemaking.[4]

Q. On page 28, Ms. Siores references the Order in UM 55 as an example where a regulatory commission clarified that the updating of deferred liabilities is not in violation of retroactive ratemaking principles. Is this order relevant?

A. No. First, Docket UM 55 is a case pertaining to "The Matter of the Petition of Northwest Natural Gas Company to Enter Into a Short-term Service Agreement for the Transportation of Natural Gas to be Purchased by Cascade Steel Rolling Mills From Northwest Field Services Company." This is the wrong docket number. The case number the company is referring to is Docket No. UG 55, not UM 55. Second, the stipulation encompassed in the Commission's Order in Docket No. UG 55 states "[t]he 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." (Emphasis added.) It does not say anything about deferring the effect of the income tax rate change or setting up a regulatory asset to recover that amount from ratepayers. OPUC-DR-303 requested the Company to "provide any and all evidence of any Commission authorized deferral that would allow NW Natural to create a deferred

[4] Order No. 08-487 (specifically pgs. 36-42); it should also be noted that this order is currently on appeal with the Oregon Court of Appeals.

tax asset that relates to the state tax rate change that occurred in 2009." The Company's response provided a copy of the Stipulation and Agreement in UG 55 and a string of emails discussing the possible recovery of the effect of this tax change between the Company and Staff in 2009. As I stated above, the order and stipulation do not contain any language which authorize the Company to defer the effect of a tax change or recover such an amount from ratepayers. With respect to the email, the Commission is the only body that has the authority to make a decision regarding the treatment of this issue, not the Staff. If the Company was concerned about the ratemaking treatment of this tax change, it should have immediately submitted an application to the Commission requesting approval to set up a regulatory asset with respect to the 2009 tax rate change.

IV. Reply Testimony of Stephen P. Feltz

Q. Did you review the Reply Testimony of Stephen P. Feltz?

A. Yes.

Q. On page 18 of Mr. Feltz's Reply Testimony, he finds it "...significant that neither Staff nor NWIGU-CUB address the *actual numbers* presented by NW Natural that demonstrate that the Company will not in fact be allowed to recover its contributions to its pension funds." Do you agree that these numbers are not addressed?

A. No, I do not agree that the numbers are not addressed. The unrecovered contributions are being addressed and that is why I have recommended that the rate base request and amortization not be allowed. The issue is whether the Company should be permitted to

have a mechanism that adds unrecovered pension contributions to rate base, regardless of the size of the actual numbers. In my opinion, this is a perfect example of retroactive ratemaking that is in violation of traditional ratemaking principles.

Q. At page 27, doesn't Mr. Feltz contend that this is not retroactive ratemaking but simply a recovery of a prepayment similar to an investment in plant?

A. Yes, he does. However, Mr. Feltz is ignoring past ratemaking for pension costs and the evolution of FAS 87. He also ignores the fact that the accounting for the expense and the contributions the Company is seeking separate recovery on, are directly related.

Q. In what way is Mr. Feltz ignoring past ratemaking?

A. Before FAS 87 was introduced, pension expense for ratemaking purposes was typically on a pay-as-you-go methodology. The amount allowed for recovery was based on contributions. Once FAS 87 was implemented, companies argued that the proper way to account for pension costs was to follow FAS 87. During the time following FAS 87, there was typically an expense based on FAS 87 that exceeded the cash contributions, if any, that were being made. This recognition for ratemaking was deemed appropriate. Now, due to changes in the economy and the new PPA requirements, the reverse has occurred and because it is no longer favorable for the Company's shareholders, Mr. Feltz concludes on page 18 that the "FAS 87-based ratemaking methodology is broken and needs to be fixed." To fix the broken methodology, Mr. Feltz proposes the Commission go back to 2004 and capture the net effect of the difference in contributions historically and projected into 2012 and 2013 and allow the Company to recover that difference.

Since FAS 87 became effective in the late 1980s, with adoption and phase-ins, it would appear the Company's request is selective.

Q. Mr. Feltz states on page 18 that the Company is not trying to reach back and claim expenses related to prior periods. Do you agree with his statement?

A. No. The expense requested is based on an accumulation of excess contributions and credits back to 2004. To go back to 2004 is reaching back. On page 27, Mr. Feltz suggests this proposed accounting treatment is akin to recovery of pipes or storage facilities. If this were similar to pipes, storage facilities, or other costs that are capitalized, the Company should have started to amortize the excess when it occurred. Contrary to what M. Feltz has attempted to portray, there is not a tangible asset to depreciate. The fact is, costs related to pension expense in 2004 and beyond are being sought for recovery and that constitutes retroactive ratemaking.

Q. Do you agree with Mr. Feltz's contention that a deferred accounting order was not necessary?

A. Absolutely not. If the Company truly believed special treatment should be allowed for the net excess contributions, the Company should have made a request for deferral back in 2004. Mr. Feltz again suggests, at page 28, that this request is similar to an investment in plant and again I state that they are not the same. The Company begins depreciation of plant when plant goes into service not when the next general rate case takes place. Mr. Feltz is presenting what is typically referred to as an "apples to oranges" comparison. His argument is without merit.

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Q. On page 18, Mr. Feltz states that FAS 87 expense is likely to be negative when it is reset in a future general rate case. Please explain your understanding of Mr. Feltz's reasons for this conclusion.

A. Mr. Feltz himself states that it is only "likely" to be negative. I do not believe that policy should be determined on merely a "likely" outcome. As Mr. Feltz is referring to a future rate case, I suggest that this determination should be made during that future rate case.

Q. Please explain the "feedback loop" that Mr. Feltz describes on pages 20-21 of his Reply Testimony.

A. Mr. Feltz states that due to the market crash and the PPA, higher contributions were necessary from investors. As a result of higher contributions, the pension fund is more heavily funded, generating more income, which reduces FAS 87 expense. Therefore, Mr. Feltz opines, "it is virtually impossible for NW Natural to ever recover its total pension costs using current FAS 87 expense recovery methodology."

Q. Do you agree with this conclusion?

A. I do not. As stated earlier, Mr. Feltz has overlooked past comparisons of expense and contributions since the adoption of FAS 87. This limited analysis by Mr. Feltz is not appropriate.

V. Reply Testimony of John Sohl

Q. Did you review the Reply Testimony of John Sohl?

A. Yes, I reviewed Mr. Sohl's Reply Testimony.

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Q. On page seven, Mr. Sohl states that you did not account for one additional supervisory employee that will be needed for the Service Window Appointment ("SWA") program. Do you agree?

A. As I was not the witness that provided testimony on the issue of the SWA program, I will not respond to that issue in this rebuttal testimony.

Q. Mr. Sohl also states that the Company is in the process of filling 56 positions. Does this change your opinion of the required number of FTEs?

A. No, it does not. As stated in my rebuttal to Ms. Doolittle's Reply Testimony, the Company has demonstrated that it is not likely to hire as many FTEs as it has projected. Accepting the Company's projections could lead to ratepayers paying for "phantom" employees that have not been hired and may never be hired. I will also note that while the opportunity existed for the Company to support its claim that employees will be added, the Company's Reply Testimony filed on June 15, 2012 did not mention what the employee count was as of May 31, 2012. This is important because if employees are purportedly needed, then one would expect some to be hired. Instead, on page four, Ms. Doolittle refers only to two employees who would be starting July 2, 2012. Additionally, Ms. Doolittle's Reply Testimony refers to the posting of jobs on page four. The posting of jobs does not necessarily mean the jobs will be filled. Since the Company has only indicated that two positions will be filled by July 2, 2012, one would have to assume that the current employee complement remains at the same 1,040 FTEs that existed as of March 31, 2012, unless some employees left the Company and the count is even lower.

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Q. Do you consider the Company's failure to mention the current employee complement to be significant?

A. Yes. The Company's Reply Testimony repeatedly refers to expectations to hire and again only mentions that two positions were filled and would be starting July 2. The issue before the Commission is whether positions will be filled. The burden of proof lies with the Company to justify the positions. The fact that no mention was made of an increase in the current employee complement since March 31, is indicative that the Company cannot meet that burden of proof.

Q. Mr. Sohl also disagrees with your adjustment to O&M expense. What is your understanding of his objection?

A. Mr. Sohl objects to the fact that I did not use the 2011 actual expense when calculating my average. I used figures from 2008-2010 because I was confident that they represented actual data for those years. Mr. Sohl stated on page 15 that the 2011 level of 67.2% is closer to the Company's proposal of 69.3%. However, had I calculated a three year average using the data from 2009-2011, instead of 2008-2010, it would have only increased the average by 1.1% reaching a level of 64.8%, which is much closer to my proposed 63.7% than the Company's estimated 69.3%.

Q. Mr. Sohl also argues that your usage of an average is inconsistent with your usage of the current level in your other arguments. Is this true?

A. No. This argument is entirely fallacious. Throughout my testimony, I used current level data where it would be most appropriate and averages where they would be most appropriate. This statement from Mr. Sohl's testimony gives the impression that this was

the only average that I used in making my recommendations. My recommended adjustments to miscellaneous revenues, advertising expense, injuries and damages expense, uncollectibles expense, materials and supplies, contributions-in-aid of construction, injuries and damages reserve and customer deposits were all based on averages. O&M expense as a percentage of total expense is not a percentage that one can assume will simply rise every year. It is based on many factors and can more realistically be expected to fluctuate from year to year as demonstrated in the chart below. This is why an average is most appropriate for determining this level of expense.

Table 2

Year	O&M/Total
2008	0.641
2009	0.650
2010	0.621
2011	0.672

Q. Mr. Sohl also states that the vast majority of construction projects are being done through third-party contracts and would have only an insignificant impact on O&M expense levels. Is this a legitimate argument?

A. It could have some merit if facts were presented to support the assertion made. However, even with the opportunity to provide specific data to support its theory, no such documentation was provided. Again, the burden of proof is on the Company and the Company failed to meet that burden.

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Q. Mr. Sohl also states that your historical calculation "does not account for changes occurring during this period that would have shifted the allocations to O&M." Is this true?

A. I disagree with his conclusion. First, Mr. Sohl fails to show how the shifting of employees from union and non-exempt to exempt created this theoretical shift. Second, Mr. Sohl was aware of the up and down trend of payroll O&M and failed to explain why the up and down trend is not consistent with his claim that the shift in employees would cause this O&M factor to increase. This is especially true in 2010, when the average employee count decreased by 89 positions and the O&M factor decreased by 3%.[5]

Q. On page 16, Mr. Sohl states that your adjustment "fails to add the labor disallowed in O&M to the capital side of labor and depreciating this capitalized labor." Please explain your reasoning.

A. The reason I did not adjust the capital side is because capital costs in a filing are typically developed independently of the payroll determinations. Based on the project information reviewed, the total labor included in the capital request was not readily available and could not be determined. There is a possibility that labor dollars in the capital projections, along with clearing and construction overhead, exceed the non-O&M payroll in the filing. However, the Company provided no analysis in its Reply Testimony that showed what payroll was included in the non-O&M category or a reconciliation of its payroll request that would justify including the $4.4 million in rate base.

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[5] This information was derived from Table 2 and the response to NWIGU-CUB-DR 122, Attachment 1.

Q. Does Table 1 on page 16 of Mr. Sohl's testimony provide support for his contention that the O&M factor should increase because internal capital dollars and percentages were decreasing?

A. No. The table is inconsistent with other factual information provided, and his table represents only a small portion of the non-O&M costs. First, Mr. Sohl's Table 1 shows a decline each year in the percentage of internal labor capitalized for mains and services. That suggests that the O&M factor should be increasing each year. As my Table 2 above indicates, there was a decrease in O&M in 2010, so there is an unexplained variation. The next fact is that the internal labor for 2009 through 2011, on Mr. Sohl's Table 1, is not representative of non-O&M labor which I have illustrated below:

Table 3

Year	Sohl Table-1	Non-O&M Labor	Mains & Services
2009	$5,606,944	$28,581,332	19.6%
2010	$3,160,462	$30,685,817	10.3%
2011	$2,393,994	$27,462,496	8.7%

The information supplied by Mr. Sohl is only a piece of the pie. What Mr. Sohl does not show is how much the internal labor, not charged to O&M, increased in construction overhead payroll and/or clearing. Again, the information presented by Mr. Sohl suggests a continuous decline in non-O&M payroll, yet in 2010 the non-O&M payroll increased. Mr. Sohl's reasons for ignoring an average are based on piece-meal information and are unsupported. Mr. Sohl has not met the burden of proof in justifying the use of an O&M rate higher than the historical average. The use of an average O&M factor is more representative of what may occur than the highest year of a historical up and down trend. The use of the average presented is reasonable.

Q. **On page 17 of Mr. Sohl's testimony he makes the statement, "the evidence demonstrates that the NWIGU-CUB proposed O&M expense level of 63.7 percent is unreasonably low and cannot be expected to occur in the Test Year." Please respond.**

A. I disagree. Mr. Sohl refers to 63.7% as unreasonably low despite the fact that, only two years ago, the Company's O&M expense level was less than that. At the same time, Mr. Sohl recommends a percentage that is higher than any reported in the last four years. Based on the historical percentages in the chart, it appears to me much more reasonable to project that O&M expense will be closer to 63.7% than 69.3%, as the Company has projected.

Q. On the same page, Mr. Sohl states that your adjustment would prevent the Company from recovering its full labor costs in the test year. Do you agree?

A. Absolutely not. I used the data that was available in this case to determine the most reasonable amount necessary. The Company has not presented any new compelling evidence that shows that its estimate is more probable.

Q. Mr. Sohl states on page 12 of his Reply Testimony that your adjustment to medical benefits and worker's compensation includes 1.78% of double counting. Please respond.

A. Mr. Sohl states that the Company's medical benefits and worker's compensation level, in this case, already reflects the removal of 1.78% of these expenses related to work in unregulated aspects of the Company. Based on Mr. Sohl's statements and exhibit, this would constitute a double count. Therefore, my proposed adjustments of $285,554

($255,571 Oregon jurisdictional) and $25,435 ($22,764 Oregon jurisdictional) for unregulated operations should not be made. It should be noted that removing those adjustments will have a flow-through effect on my other adjustments to Worker's Compensation and Health Benefits for the removal of 5.22% of FTEs. My recommended adjustment to Workers Compensation will increase to $74,590 on a total system basis and $66,758 on an Oregon basis. My recommended adjustment to Health Benefits will increase to $837,411 on a total system basis and $749,482 on an Oregon basis. As stated in my direct testimony, the allocation to Oregon is an estimate based on NWN/Exhibit 312.

VI. Reply Testimony of Lee Anne Doolittle

Q. Did you review the Reply Testimony of Lee Anne Doolittle?

A. Yes.

Q. On page 8 of Ms. Doolittle's Reply Testimony, Ms. Doolittle states that 14 FTEs are required for the SWA program and not 13 as stated in your testimony. Please explain.

A. Ms. Doolittle explains that the 14th FTE is for an additional supervisor position to coordinate and oversee the other 13 FTEs. As I stated in my response to Mr. Sohl's Reply Testimony, because I was not the witness that provided testimony on the issue of the SWA program, I will not respond to that issue in this rebuttal testimony.

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Q. On page seven, Ms. Doolittle states that you have not accounted for additional FTEs that will be in place in the test year. Please address this statement.

A. I made my recommendation based on the number of employees that the Company had in place as of the March 31, 2012, and then added 13 FTEs for the additional SWA program. As of March 31, 2012 the Company was running successfully with the amount of employees that it had. The only demonstrated need for new employees was for the SWA program.

Q. What are your objections to including the 53 positions that Ms. Doolittle states "the Company is currently in the process of filling"?

A. As I explained in my direct testimony, ratepayers should not be required to pay for employees that do not exist and may never exist. On pages 3-5, Ms. Doolittle describes the status of 27 new positions, and 26 backfill positions. On page four, she states that of these 53 positions, only two have actually been hired. Seven of the positions are only in the "planning stage", as described on page four of her Reply Testimony. The Company has not demonstrated that it will hire the level of employees that it has projected. This means that these new positions are only hypothetical at this time.

Q. Ms. Doolittle states that it is inaccurate to state that new hires could be offset by employees leaving the Company, as you suggested in your direct testimony. Please explain.

A. On page seven of her Reply Testimony, Ms. Doolittle states that under normal circumstances, this argument could be valid. However, she claims that it is not applicable to this case because the "the Company has demonstrated that it is currently in

the process of hiring for 27 new positions in addition to replacing 26 backfill positions. The 27 new positions will not be canceled out by natural attrition."

Q. Do you agree with this line of reasoning?

A. No. The Company has not demonstrated that it will hire these employees, other than to claim that it will. In fact, the Company has already established that it does not hire as many employees as it projects. As pointed out in my direct testimony, the Company stated that it would have 1,072 FTEs for the base period but had only 1,040 as of December 31, 2011. This disparity of 32 employees is quite large. This gives me very little confidence that NWN will fill all of the positions that it plans to fill.

VII. Reply Testimony of C. Alex Miller

Q. Did you review the Reply Testimony of C. Alex Miller?

A. Yes, I reviewed Mr. Miller's Reply Testimony.

Q. On page five of his Reply Testimony, Mr. Miller states that NWIGU-CUB's proposals are "inexplicably punitive" in nature. Do you agree with this characterization?

A. No. An underlying principle of ratemaking is to assign cost based on who was responsible for the incurrence of such. It is not punitive to expect the Company responsible for the environmental contamination to be the one to clean it up. If anyone is being punished unfairly, it is today's ratepayers who are expected to foot the entire remediation bill for damage that they did not have any knowledge of, and could not affect. This to me is at the heart of the issue.

Q. On page 11 of his Reply Testimony, Mr. Miller states "the Company and its regulators therefore could not have anticipated either the health or environmental harms we recognize today or the cleanup obligations that exist under today's current laws." Why do you believe differently?

A. Dr. Allen W. Hatheway, Geologist Professor of Engineering at the University of Missouri, has studied this issue for over 15 years and has over 47 years of professional experience. He discusses this issue in his recent book titled *Remediation of Former Manufactured Gas Plants and Other Coal-Tar Sites.* According to Dr. Hatheway, the companies operated with awareness of the damage that they were inflicting on the environment. The following quotes are from Dr. Hatheway's book:

> The manufactured gas industry, from its earliest years, was well aware of the dangerous properties and characteristics of its products, residuals and wastes. Gas industry management, including plant managers and superintendents, who were in command and control over the options selected for handling and management of these toxic substances, had knowledge of the damage that was sure to come from discharge of such to the ground and to surface waters and subsurface waters. These choices were made with deliberation and the body of evidence supporting the wide availability of both knowledge and penalty is laid out in this book and can be further substantiated from the historic literature.[6]
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> Throughout the era of gas manufacturing, there was a high level of awareness of the nature and general properties of the toxic residuals. Examples of the degree of awareness are quite common throughout the vast literature of manufactured gas.[7]
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[6] Allen W. Hatheway, *Remediation of Former Manufactured Gas Plants and Other Coal-Tar Sites* (Florida, CRC Press, 2012), p. 618.
[7] Ibid. pg. 691.

> Evidence of the high state of gas-industry knowledge, relating to the inherently dangerous and damaging properties and characteristics of gasworks products, residuals, by-products, and wastes are to be found throughout the literature of the manufactured gas industry, and, for that matter, in the historic press.[8]

Based on the statements in Dr. Hatheway's book, it appears that the Company likely knew the risks involved and planned on doing just what it is attempting to do now, take the rewards and push the consequences onto innocent ratepayers. In light of these facts, these costs should be borne by the Company.

Q. On pages five through seven of his Reply Testimony, Mr. Miller states that Staff and NWIGU-CUB's proposals "would impose grave financial consequences on NW Natural..." and describes what some of these consequences would be. Do you find this to be a satisfactory argument against your proposal?

A. Absolutely not. My proposal is based on foundational ratemaking principles, as well as fundamental principles of right and wrong. The issues in this case need to be decided on these merits, not on what would be the best financial outcome for the Company.

Q. On page six, Mr. Miller claims that your proposal would be an unfounded departure from the regulatory compact. Do you agree?

A. No. Again, I think that forcing current customers to pay for environmental misdeeds that occurred many years ago, and were the responsibility of the Company operating the Manufactured Gas Plant ("MGP"), would be the real departure from the regulatory compact. The witness states "[u]nder the regulatory compact, utilities are required to provide safe, adequate and reliable service, and in return, they are allowed to recover

[8] *Id.*

prudently incurred costs, as well as a return on their investment." I do not agree that current ratepayers are the appropriate source from which the remediation clean-up costs should be recovered. The cost should be borne by those who are responsible for the pollution. Neither current, nor past, customers had any knowledge of how the MGPs were operated. They, therefore, could not object to how these plants were affecting the environment.

Q. Do you take issue with Mr. Miller's characterization of your testimony as it relates to the rate of return?

A. Yes, I do. In my direct testimony, I stated "it seems apparent that the Company's management accepted the risk from the operation of manufactured gas that was reflected in the rate of return that they received." On page 10 of his Reply Testimony, Mr. Miller states that my implication is that, "the Company must have been rewarded by a high rate of return that recognized the environmental risks associated with their operations." This is a mischaracterization of my testimony. My testimony points out that, as part of the regulatory compact, the Company accepted a rate of return which includes compensation for the unknown risks of running a utility. If there were not risks, the Company's return would be the same as government securities. Mr. Miller's misunderstanding of this part of my testimony led to the statements at the top of page 11 of his Reply Testimony. Because these statements are based on an erroneous assumption, they are incorrect.

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Q. At the bottom of page 11, Mr. Miller states that you are ignoring the fact that "the expenses NW Natural is incurring are current expenses, required by regulatory agencies that are exercising their authority under current laws." Please respond to this statement.

A. Not all current costs that are incurred by utilities are recoverable from customers. Examples include the costs for advertising that simply enhances the image of the Company, and also political lobbying expenses. Although the remediation expense is being paid currently, it is related to past actions by the Company and it is not directly related to providing current service to current customers; it should not, therefore, be recovered from them.

Q. On page 17, Mr. Miller also takes issue with your suggestion that the Company should receive only a "debt rate" on carrying costs. Please explain your understanding of his position.

A. Mr. Miller's position relates to how the Company finances major expenses. He states that "...where financed expenses are large and recovery extends for many years, the utility cannot fund them with debt alone, and must rely, as is the case with all major capital investments, on a mixture of debt and equity to finance them." He goes on to state that "This is the very definition of the Company's cost of capital, and it is the cost that should be recovered by the utility."

Q. Do you agree with Mr. Miller's position?

A. No. My position is not concerned with how the expenses are financed but instead the level of risk involved and, the resulting rate at which the investment should be recovered.

As stated in my direct testimony, the rate of return allowed to the Company is related to the level of risk involved. If the Commission issues an order determining that a certain amount is recoverable for environmental remediation, recovery of that amount is guaranteed with virtually no risk. Clearly, this is different than the authorization of rates which include a rate of return. The Company does not have a guarantee that it will earn the rate of return authorized in rates. The Company is only authorized the opportunity to earn that return.

Q. Does Mr. Miller agree about the level of risk involved?

A. No, Mr. Miller does not agree about the level of risk involved. He states that "the Company does not have a surety that it will recover its costs, because such costs are subject to ongoing prudency reviews." The fact that the Company cannot recover imprudent costs, does not increase its risks. Imprudent costs are never recoverable.

Q. On pages 11-12 of his Reply Testimony, Mr. Miller indicates NWIGU-CUB's recommendation of the 50/50 sharing is not supported by the fact that regulatory commissions have allowed these historical costs to be recovered from current ratepayers. What is your response to his argument?

A. What Mr. Miller fails to mention is that several commissions have required sharing of these costs between ratepayers and shareholders. The Company was asked in NWIGU-CUB DR No. 162 to "provide a list of utilities that the Company is aware of in which remediation costs related to MGP are shared between ratepayers an shareholders." The Company's response stated that during its research it came across the following utilities in which MGP costs were shared between ratepayers and shareholders:

- Southern California Gas
- Indiana Gas Co.
- Kansas Public Service
- Delmarva Power & Light
- Niagara Mohawk
- Wisconsin Power & Light
- Northern States Power
- Public Service Co. of North Dakota

Q. Have you also identified cases where utilities were required to share remediation expenses between shareholders and ratepayers?

A. Yes. Though not an exhaustive list, below are cases I was able to identify where shareholders and ratepayers shared a portion of the remediation expenses:

- Washington Gas Light Company, Case No. 922 (District of Columbia PSC)
- Interstate Power & Light Company, Docket Nos. RFU-03-2/RPU-02-7 (Iowa Department of Commerce-Utilities Board)
- Central Illinois Public Service Company, Docket No. 03-0164 (Illinois Commerce Commission)
- Midwest Gas (division of Midwest Power Systems, Inc., predecessor to MidAmerican), Docket Nos. RFU-94-2, DRU-95-3 (Illinois Commerce Commission)
- Northern Utilities, Inc. Docket No. 1996-678 (Maine PUC)
- Michigan Consolidated Gas Company, Consolidated Case Nos. 13898, 13899 (Michigan PSC)
- Energy North Natural Gas, Inc. d/b/a Keyspan Energy Delivery New England, Docket No. DG 07-093 (New Hampshire PUC)
- Delmarva Power & Light, Docket No. 05-356 (Delaware PSC)

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Q. Were you also able to identify utilities in addition to the one Mr. Miller identified where commissions disallowed remediation costs to be recovered from ratepayers?

A. Yes. Again, though not an exhaustive list, I was able to identify the following cases where the utility was not permitted to recover the remediation expense from ratepayers:

- Northern States Power, (Wisconsin PSC)
- Delmarva Power & Light, Docket No. 9192 (Maryland PSC)

Q. Do you take issue with any other parts of Mr. Miller's Reply Testimony?

A. Yes. Even though it was directed at Staff, I'd like to respond to a statement that Mr. Miller makes on page four of his Reply Testimony. Mr. Miller states "...byproducts from its historic operations were sold and the revenues were used to reduce the cost of gas to customers at the time of the manufactured gas plant operations." The fact that previous ratepayers may have benefitted from the sale of operation byproducts does not mean that current ratepayers should be responsible for the Company's past mistakes.

Q. Does this conclude your Rebuttal Testimony?

A. Yes, it does.