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VIA ELECTRONIC FILING AND FIRST CLASS MAIL

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

Re: Docket UM 903

Enclosed for filing in the above-captioned docket are an original and five copies of NW Natural's Reply Comments and Response to ALJ Ruling.

A copy of this filing has been served on all parties to this proceeding as indicated on the attached certificate of service.

Very truly yours,

Wendy McIndoo

Wendy McIndoo
Legal Assistant

cc: Service List

Enclosure

BEFORE THE PUBLIC UTILITY COMMISSION OF OREGON

UM 903

In the Matter of NORTHWEST NATURAL GAS COMPANY, dba NW NATURAL 2011 Spring Earnings Review	**NW Natural's Reply Comments and Response to ALJ Ruling**

Northwest Natural Gas Company ("NW Natural" or "Company") files these comments with the Public Utility Commission of Oregon ("Commission") in reply to Staff's Opening Comments and Recommendations ("Staff's Opening Comments") and in response to the Ruling of the Administrative Law Judge dated August 3, 2011 ("ALJ Ruling").

I. INTRODUCTION

In NW Natural's Comments on 2010 Results of Operations and Earnings Test ("NW Natural's Opening Comments"), the Company explained the Purchased Gas Adjustment earnings review process ("Earnings Review") adopted by the Commission in Dockets UM 903 and AR 357, including the adjustments to the recorded Results of Operations ("ROO") required by Commission rules and orders. In particular, the Commission's rules require that test period results should be normalized "with a predetermined list of ratemaking adjustments equivalent to those applied in the gas utility's most recent rate proceeding."[1] This list of adjustments, which was adopted in UM 903,[2] referred to as "Type I Normalizing Adjustments," includes removing entries related to prior period activity—or "out-of-period" activity. As discussed in NW Natural's Opening Comments, the Company's removal of the

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

[2] *Re. Recovery of Purchased Gas Costs*, Docket UM 903, Order No. 99-272, Appendix B at 1 (Apr. 19, 1999) [hereinafter "Order No. 99-272"].

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tax refund from 2010 results ("Tax Refund Adjustment") was made in compliance with these Commission rules.

In its Opening Comments, Staff appears to agree that the Tax Refund Adjustment made by the Company constitutes an "out-of-period" Type I Normalizing Adjustment.[3] Nevertheless, Staff argues that NW Natural should not be allowed to make the out-of-period adjustment in this case. Specifically, Staff claims that the Tax Refund Adjustment should be disallowed because it is inconsistent with the Company's past treatment of property taxes in the Earnings Review, in which property taxes are adjusted to actuals. In other words, Staff's argument seems to be that the Commission should depart from the existing requirements applicable to the Earnings Review in order to achieve a result that Staff believes is more consistent with NW Natural's past approach.

Staff's position is without merit. First, contrary to Staff's claims, the allowance of the Tax Refund Adjustment is absolutely consistent with the Company's past treatment of property taxes and will yield a fair and appropriate result. Second, Staff's position is based upon the erroneous premise that the Commission may ignore its own rules in order to achieve a particular result in a particular case. On the contrary, implementing the Commission's rule is fair and equitable, and state and federal law and sound public policy require the Commission to apply its own governing rules consistently in this and every other case.

In addition to responding to Staff's comments, the ALJ Ruling poses two questions that the Company will address in these Reply Comments. First, the Company will explain that the rule against retroactive ratemaking prohibits the Commission from considering an earnings review for a prior year in calculating a refund to customers in the current earnings

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[3] See Staff's Opening Comments, at page 5, the first sentence in the first paragraph (acknowledging that NW Natural made an out-of-period adjustment, but arguing that such an adjustment would only be appropriate if NW Natural had not made certain adjustments in previous ROO filings).

review. Second, the Company responds to the ALJ's request to provide precedent relevant to this case.

II. DISCUSSION

A. The Tax Refund Adjustment is Consistent with the Company's Past Treatment of Property Taxes in the Earnings Review.

Staff's primary argument against the Tax Refund Adjustment is that it is inconsistent with the "true up" to actuals that the Company makes each year to its property expense for the purpose of the Earnings Review. However, in making this argument, Staff mischaracterizes the "true up." Therefore, before addressing the substance of Staff's argument, the Company will provide more background on the issue.

1. Explanation of Accrual Adjustment

As discussed in the Company's Opening Comments, Commission policy requires the Company to make Type I Normalizing Adjustments to the ROO for purposes of the Earnings Review, including the removal of items associated with prior periods. For this reason, the Company removed the tax refund, which was related to overpayments made in 2002-2009. In addition, as described below, NW Natural made an adjustment to correct its *estimates* of property tax expense reflected in the test period in order to avoid an otherwise anomalous result ("Accrual Adjustment"). This adjustment does not have the effect, or serve the purpose, that Staff ascribes to it.

The nature of property taxes is that while the Company can estimate what they will be during the course of the year, it will not know the exact amount until it receives its tax bill at the end of the year. For that reason, property taxes are recorded on NW Natural's books as expenses using accrual accounting, which requires the Company to book estimated annual property taxes for the year, spread over the 12-month period. While this accrual methodology is consistent with standard accounting practice, it raises a concern for the purposes of the Earnings Review. This concern arises because the Company exercises

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discretion in setting the amount accrued and could, theoretically, distort the Earnings Review by overestimating amounts accrued. As a result, in every year since its 2003 rate case, the Company—with Staff's knowledge and approval—has removed property tax expense *accruals*, or estimates, and replaced them with the actual cash payments made during the test period in its ROO.

The results of both the Tax Refund Adjustment and the Accrual Adjustment for property taxes can be seen in the Company's ROO as follows: In 2010, the Company accrued for property taxes the amount of $19.176 million. Actual property taxes paid were $18.692 million. The net effect of both the Tax Refund Adjustment and the Accrual Adjustment on the accrued amount of $19.176 million can be seen on Line 14 of the Revised 2010 Earnings Review. Column (a) shows the amount accrued for property taxes less the Tax Refund. Column (b) shows the combined Tax Refund Adjustment of $5.248 million, plus the Accrual Adjustment of $-0.484 million, which equals $4.764 million. Column (c) is the sum of columns (a) and (b), which equals the adjusted results of $18.692 million.

In producing these results, the Company followed the same procedures it has followed for many years. However, Staff's summary and analysis of the calculations suggests that Staff misunderstands the methodology. First, on page one and again on page two, Staff states that the "approximately $485,000," referencing the Accrual Adjustment, represents the difference between the property taxes paid by NW Natural and the property tax liability that is "reflected in rates." It appears that Staff is under the impression that the adjustment is an attempt to calculate the variation between the amount of property taxes that the Company has collected in rates and the amount actually paid. However, the amount of property taxes reflected in customer rates is not expressly included in the ROO. Any variations between the amounts paid and the amounts in rates are borne by the shareholders. As stated above, $484,000 represents the difference in the amount of

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property taxes *accrued* for 2010, and the amount *paid*. This amount was properly adjusted out of results to because it prevents the earnings test from being calculated on a property tax amount that is simply an estimate by the Company.[4]

2. The Company's Past Application of the Accrual Adjustment did not Require Customers to Bear Volatility in Property Tax Expense.

As described above, the Commission's current policy regarding the Earnings Review is to remove entries relating to prior period activity, such as the removal of credits associated with other periods. NW Natural's property tax refund was associated with other periods—its taxes paid during the 2002-2009 period.

Staff appears to accept the fact that the Tax Refund Adjustment was made in compliance with the Commission's stated policy, but argues that the Commission should depart from longstanding policy and Commission rules because NW Natural has included what Staff calls a "true-up" for property taxes—or the Accrual Adjustment—in *past* earnings reviews.[5] As a result of past property tax treatment, Staff argues that customers have "borne the volatility related to higher or lower property tax expense by virtue of these annual adjustments."[6] Staff reasons that "since variances related to property taxes have been borne by ratepayers, the refund relating to each of the periods since the rate case should be reflected in the cash flow during the 2010 period."[7] Staff's argument is based upon a misunderstanding of both the intent and impact of the Company's application of the Accrual Adjustment.

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[4] In addition, on page 2, Staff states that the $13.928 million represents the amount of property taxes NW Natural "would have paid" absent the Tax Refund. Staff is incorrect. The Company actually paid property taxes of $18.692 million in 2010. The amount of $13.928 million represents the expense amounts accrued minus the revenue associated with the Tax Refund.

[5] Staff's Opening Comments at 3-4.

[6] Staff's Opening Comments at 5.

[7] Staff's Opening Comments at 4.

As discussed above, the purpose of the Accrual Adjustment is to ensure that the Company cannot artificially decrease earnings by inflating the amount accrued for property taxes. Thus, Staff's characterization of the reason for the Accrual Adjustment is incorrect.

Moreover, Staff's characterization of the impact of the Accrual Adjustment is also incorrect. Staff states that because of this adjustment ratepayers have borne the volatility related to any higher or lower property tax expense. In fact, the opposite is true. In every year since 2003, the amount recovered by Company for property taxes has been the amount authorized by the Commission in 2003 in UG 152, as adjusted for any rate base adjustments that occur through other regulatory mechanisms. Customer rates have *not* been adjusted to reflect actual property taxes paid by NW Natural. And variances between the amount recovered in rates and the amounts actually paid have not been deferred. Thus, there is no basis for Staff's assertions that property taxes paid by customers have been "trued up." Instead, it is NW Natural's *shareholders* and not its customers that have borne the volatility of the Company's property tax expense. The only effect of the Company's Accrual Adjustment in the Earnings Review has been to render the earnings test more accurate and reliable.

Staff's assertions that the Accrual Adjustment somehow necessitates a departure from the Commission's rules on prior period adjustments are, therefore, puzzling and unexplained. The Accrual Adjustment and the Tax Refund Adjustment serve very different purposes, are both in accordance with the Commission's rules and sound regulatory and accounting principles, and are not at all in conflict with each other.

Staff also argues that NW Natural should be required to reverse the Tax Refund Adjustment in order to better "match" the actual cash flow for 2010. Staff reasons that because in the past the Company has applied the "true up" to property tax expense, it is not appropriate to make a Type 1 Normalizing Adjustment to the same amounts. Again, Staff's position is not supportable. The purpose of the Type 1 Normalizing Adjustments is not to reflect cash flow, but rather to reflect the results that would exist under normalized circumstances. Consistent with this approach, the Accrual Adjustment made by the Company since 2003 was not designed to allow NW Natural to recover actual property taxes paid, but to avoid Staff's concerns related to the use of accrued taxes. It appears by this last argument that Staff is concerned that if NW Natural is allowed to remove the property tax refund from results in 2010, then "actual property tax expense" experienced by the Company over the 2003-2010 period will never be recognized in the Earnings Review. This may be true, because as discussed below, the Company cannot attribute the refund to past Earnings Reviews and reflect that impact in prospective rates. However, as pointed out in NW Natural's Opening Comments, customers are not disadvantaged by this result. Even if the Company could reflect the property tax refund in prior Earnings Reviews and account for the impact in rates, the results would not have changed in those years. Despite the fact that Staff's concern that the actual property expense would not have been reflected in prior years is moot, Staff proposes to assign the entire Tax Refund Adjustment to the one year where the Company is already sharing, thus increasing tenfold the sharing amount that would otherwise apply. This approach is inconsistent with current policy and would cause an inequitable result, and should therefore be rejected.

B. State and Federal Law and Sound Public Policy Require NW Natural's Removal of the Property Tax Refund from 2010 Results

Under the Commission's current rules, NW Natural is required to make out-of-period adjustments to its ROO for the purpose of the Earnings Review.[8] As explained in the Company's Opening Comments, those rules are binding on the Commission until repealed in accordance with the Administrative Procedures Act.[9] Therefore, contrary to Staff's

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[8] OAR 860-022-0070(5)(b); Order No. 99-272, Appendix B at 1.

[9] *See, Burke v. Children's Services Div.*, 288 Or. 533 (1980).

inference, the Commission is not free to disregard its rules to achieve Staff's favored result in this case.

Moreover, Staff's proposed departure from the Commission's rules raises constitutional concerns. As noted by the Supreme Court in *Duquesne*, state public utility commissions should not be free "to switch arbitrarily back and forth between methodologies" in order to deprive investors of earnings.[10]

Finally, as a matter of sound public policy the Commission should not depart from its rules on a retroactive basis. Utilities and customers are entitled to predictability and certainty in their business relationship, and must be able to count on a consistent application of regulatory requirements. Moreover, the consistent application of the Earnings Review methodology is the only way to ensure a balanced result over time. It is true that in this case the Company's out-of-period adjustment for the tax refund acts to decrease earnings and thus decrease sharing (compared to Staff's proposal). However, in other cases the very opposite would be true. For instance, if, instead of a refund, the Company would have been hit by a $5.2 million tax penalty for years 2003 through 2008, Staff's position would have the Company avoid any sharing because the Company would be required to include that penalty in its 2010 results even though it would clearly relate to a prior period. Thus, the Commission should be confident that over time the consistent application of its rules for the Earnings Review will produce an equitable and appropriate result.

C. The Interest Payment on the Refund was Properly Removed from 2010 Results

As described in the Company's Opening Comments, the interest on the tax refund was properly removed from 2010 results on two grounds. First, the interest, like the refund itself, was associated with 2003 through 2009 tax payments, and therefore properly

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[10] *Duquesne Light Co. v. Barasch*, 488 US 299, 314 (1989). Specifically, the Court stated: "[A] State's decision to switch arbitrarily back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions."

removed as an out-of-period adjustment. Moreover, interest income—which in this case is intended to compensate the Company for financing the tax overpayments—is properly booked to FERC Account 419, which is reserved for utility non-operating activity and as such should not be included in the test period results. For this reason, whether or not the Commission agrees with the Company that the tax refund itself must be removed from 2010 results as an out-of-period adjustment, the interest income cannot be included in the ROO.

Staff concedes that NW Natural would "typically" exclude interest income from its ROO, but states that in this case "the adjustment that Staff suggests is for regulatory purposes."[11] However, this treatment for "regulatory purposes" is based on the same misunderstanding of the Company's past treatment property taxes through its Accrual Adjustment[12] and should therefore be rejected.

D. Commission Discretion/Retroactive Ratemaking

The ALJ Ruling notes the two opposing positions offered by Staff and the Company and asks whether there is any middle ground. In particular, the ALJ asks whether (1) the Commission has discretion to determine an equitable result based on the facts presented in a given docket; and (2) the Commission may consider how ratepayers and shareholders would have been impacted had the tax refunds from the court judgment been allocated to prior periods and the earnings reviews in those years reanalyzed. On this second question, the ALJ asks whether such an analysis would constitute retroactive ratemaking.

As described by the Commission in Order No. 08-487, "[t]he rule against retroactive ratemaking prohibits the Commission from setting rates to allow a utility to recover past

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[11] Staff's Opening Comments at 6.

[12] Here again, Staff incorrectly states that NW Natural has reflected actual tax expense on an annual basis, "thereby shifting to ratepayers the burden of any variance between actual tax expense and tax expense in rates." As discussed above, the amount of property tax included in rates is not even referenced in the Earnings Review, and NW Natural, and not customers have borne the burden of any variances between taxes paid and the amount recovered in rates.

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losses or require it to refund past profits."[13] In the context of the rule against retroactive ratemaking, "'[p]ast losses' means earnings lower than the utility's authorized revenues; 'past profits' means earnings in excess of the utility's authorized revenues."[14] The Commission has recognized that the rule against retroactive ratemaking protects customers by ensuring that they are paying rates that reflect the cost of service as the service is rendered, while protecting utilities because the use of past profits to reduce future rates may violate constitutional safeguards against confiscatory rates.[15]

Here, the ALJ asks whether, in applying the Earnings Review for 2010, the Commission can consider the Company's earnings for years 2003 through 2009. The answer is clearly "no." The Company's earnings for years 2003 through 2009 were calculated in accordance with Commission rules in effect at the time based on all of the information the Company had available to it. Any re-analysis of those earnings, based on new information, cannot be used to set rates (in this case, a surcharge or refund through the PGA) for the future.

NW Natural has already explained that, under the facts presented in this case, the Company would *not* have reached its earnings threshold in prior periods even if the tax refund amounts had been included in each of the years to which they were attributable. NW Natural pointed out this fact in order to respond to Staff's position that a prior period adjustment is somehow unfair. NW Natural did not raise this point to advocate that the Commission should engage in a retroactive recalculation of rates.

The Company understands that the ALJ is concerned that alternative factual scenarios might yield a different result. This may be true. But adjustments to earnings for

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[13] *Re Portland Gen. Elec. Co.*, Dockets DR 10, UE 88, and UM 989, Order No. 08-487 at 36 (Sept. 30, 2008).

[14] *Id.*

[15] *Id.*

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out-of-period expenses and revenues can either benefit the utility by decreasing earnings—such as in the case of an out-of-period tax refund—or it can benefit customers by increasing earnings—as in the case of an out-of-period tax penalty. For this reason, a balance between the interests of utility customers and utility shareholders can be achieved only through a consistent application of the rules.[16]

E. Applicable Precedent

The ALJ Ruling also asked parties to provide citations to any relevant precedent in Oregon or other jurisdictions that might inform the Commissioners' analysis of how a court judgment should be treated for regulatory purposes. NW Natural reviewed relevant precedent in Oregon and other jurisdictions and did not find material that it believes will be particularly helpful to the Commission's analysis of the treatment of revenues from court judgments or how other out-of-period revenues should be treated in an earnings review.[17] NW Natural emphasizes, however, that the Commission's rules themselves provide the

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[16] The Commission's question might also be understood to ask whether the Commission might adopt a compromise between the Staff and Company positions by allowing some portion of the refund to be included in 2010 results. The Company believes that no such compromise is possible. Although the Commission may reach a result that differs from the results advocated by either party, such a result would have to be based on an appropriate application of the Commission's existing rules and accurate accounting. NW Natural believes that its position is the one that is dictated from an appropriate application of these rules and principles, and does not see, in this case, how the Commission could reach a result that is partially between the Company's and Staff's positions, given that those positions are based simply on differing positions about the applicability of the Commission's rules.

[17] The Hawaii Public Utilities Commission removes out-of-period adjustments from the earnings sharing calculations in a utility's decoupling mechanism. *Re. Public Utils. Comm'n*, Docket No. 2008-0274, 2010 WL 3458626 (Hawaii PUC Aug. 31, 2010). However, NW Natural could not find precedent on how tax refunds are treated under this construct.

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relevant precedent in this case that revenues or costs related to prior periods are to be adjusted out of utilities' ROOs for purposes of the earnings review.

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CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of the foregoing document in UM 903 on the following named person(s) on the date indicated below by email and first-class mail addressed to said person(s) at his or her last-known address(es) indicated below.

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