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July 27, 2011

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 Comments on 2010 Results of Operations and Earnings Test.

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

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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DATED: July 27, 2011

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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 COMMENTS ON 2010 RESULTS OF OPERATIONS AND EARNINGS TEST**

I. INTRODUCTION

On May 1, 2011, Northwest Natural Gas Company ("NW Natural" or the "Company") filed with the Public Utility Commission of Oregon ("Commission") its 2010 Results of Operations ("ROO") as part of its 2011 Spring Earnings Review. After discovery and discussions with the parties, NW Natural refiled its ROO on July 22, 2011.[1]

Among the Type I Normalizing Adjustments made by the Company to its 2010 results was the removal of a tax refund received by the Company for property taxes overpaid in years 2003 through 2009. This adjustment (referred to herein as "Tax Refund Adjustment") was made consistent with longstanding and clear Commission directives that, for the purposes of the Spring Earnings Review, the Company is to adjust results by "removing entries related to prior period activity . . .."[2]

After reviewing the ROO, Staff notified NW Natural that it would recommend that the Commission disallow the Tax Refund Adjustment, and instead assign the entire refund—

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[1] In this refiling, NW Natural corrected the amount of stated accumulated depreciation, which had been taken from an erroneous accounting report. NW Natural also removed O&M expenses associated with a "finder's fee" that it paid in relation to the recovery of a property tax refund from prior years, and which is discussed more in this document.

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

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which was intended to compensate the Company for taxes overpaid in years 2003 through 2009—to 2010 results. Staff apparently does not dispute that the Tax Refund Adjustment is consistent with the Commission's directive regarding "out-of-period" adjustments; nevertheless, Staff takes the position that the adjustment should be disallowed.

Specifically, Staff asserts that, for the purposes of the earnings test, property taxes should be trued up to actuals—which, Staff argues, would require the inclusion of all of the tax refund in earnings in 2010. Staff also argues that the Company should include in earnings the interest it received to compensate the Company for the costs of financing the overpayments it had made in the previous years. If adopted, Staff's recommendation would increase the amount of the refund due to customers under next fall's PGA from $0.2 million (as filed by NW Natural) to $2.2 million.

Staff's position is without merit. The Company's Tax Refund Adjustment—and its exclusion of the interest payment—is in compliance with a clear Commission directive, which should not be retroactively waived or revised to NW Natural's detriment. Moreover, the Tax Refund Adjustment is consistent with past treatment of the Company's property taxes in the Spring Earnings Review, and its inclusion will produce a fair and consistent result.

There is simply no reason for the Commission to abandon its longstanding policy regarding out-of-period adjustments. To do so in this case would be manifestly unfair to NW Natural, and would undermine confidence in a stable and consistent regulatory framework.

II. BACKGROUND

In order to understand the parties' positions regarding NW Natural's 2010 ROO, it is helpful to briefly review the PGA earnings review process and the relevant facts regarding the Property Tax Adjustment made by NW Natural.

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A. Earnings Review Process

In UM 903 and AR 357, the Commission adopted Purchased Gas Adjustment ("PGA") procedures and standards for Oregon's three regulated natural gas local distribution companies ("LDC"). In those dockets, the Commission approved detailed and specific policies and rules governing the role and application of earnings reviews. In UM 1286, the Commission considered revisions to the PGA, including the earnings reviews, and as a result adopted the following structure for the earnings review process:

An earnings review is performed each spring based on the most recent fiscal year-end results of operations. If earnings are found to be above an earnings threshold, set at a specified ROE level, a portion of those revenues are booked to a deferred account to be refunded to customers in the upcoming PGA. The earnings threshold for LDCs that elect 90/10 sharing is 100 basis points above the LDC's ROE, adjusted to reflect changes in capital markets; the earnings threshold for LDCs that elect 80/20 sharing is 150 basis points above its ROE, adjusted in the same manner.[3]

In addition to the general structure described above, the Commission has provided clear guidance on the method to be employed by LDCs when calculating earnings for purposes of the earnings review. In AR 357, the Commission concluded 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."[4] This list of adjustments was considered and adopted by the Commission in UM 903 and referred to as "Type I" Normalizing Adjustments. Accordingly, utilities are required to make the following adjustments:

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[3] *See Re. Pub. Util. Comm'n of Or. Investigation into the Purchased Gas Adjustment (PGA) Mechanism Used by Or's Three Local Distribution Cos.*, Docket UM 1286, Order No. 08-504 (Oct. 21, 2008) (adopting revisions to PGA adopted in Order No. 99-272).

[4] OAR 860-022-00705(b).

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- Making significant ratemaking adjustments not reflected on books (advertising, memberships, uncollectible expense, officers' bonuses and other incentive plans, major ratebase adjustments);
- Removing non-operating items that were improperly recorded above the line;
- *Removing entries related to prior period activity, and including subsequent period transactions clearly related to the test period;*
- Making an interest coordination adjustment to restate income taxes based on interest deductions;
- Removing the effect of any temporary rate adjustment in the period, including any related to a prior earnings review.[5]

The italicized adjustment is commonly referred to as an "out-of-period adjustment" and is relevant in this case.

B. NW Natural's 2010 Results of Operations

On May 1, 2011, NW Natural submitted its 2010 ROO. The filing reflected that NW Natural had selected 90/10 sharing for the applicable gas year, and therefore the earnings threshold would be set at 11.02 percent, which is 100 basis points above the Company's authorized ROE, as adjusted under the earnings test. The report further showed that the Company's earnings exceeded the earnings threshold of 11.02 percent, resulting in credit to customers of $199,000 (as revised for the corrections NW Natural filed on July 22, 2011).

Among the Type 1 Normalizing Adjustments made by the Company, NW Natural included a property tax adjustment to account for a refund it received for taxes paid in prior years—the Tax Refund Adjustment. The refund was the result of a petition it had filed with the Department of Revenue (the "Department") to correct the tax rolls for the 2002-03,

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[5] Order No. 99-272, Appendix B at 1 (emphasis added). In addition, the Commission found that the LDCs could make a one-time adjustment as to whether to make weather normalizing adjustments as well. *Id.*

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2003-04, and 2004-05 tax periods—later expanded to include the following tax periods up to 2009. In that petition, NW Natural sought a reduction to its assessed property value arguing that its gas reserves were exempt from ad valorem property taxes. The case ultimately was appealed to the Oregon Supreme Court, which, on January 28, 2010, affirmed the decision of the Tax Court and ordered refunds to NW Natural in amounts totaling approximately $5.2 million for the 2002-2009 tax periods, and interest on the refund totaling approximately $1.9 million.[6] Because these amounts relate to prior period activity (*i.e.* tax years 2003-2009), NW Natural adjusted them out of its ROO in accordance with the Commission's policy on out-of-period adjustments.

C. Staff's Position

On June 23, 2011, Staff notified the Company that it intended to recommend that the Commission disallow the Tax Refund Adjustment. In addition, after reviewing supplemental information provided by NW Natural, Staff took the position that the Company should have included the interest on refund amounts in 2010 earnings and pointed out that the Company had included a finder's fee connected with the refund as an expense in 2010. This fee totaling $1 million represented the amount paid to a consultant who had originally identified the property tax overpayment. The fee was due when the Company received the tax refund, and was paid and expensed in 2010. The Company acknowledged that the finder's fee had been included in results erroneously, and should have been treated identically to the tax refund itself, and thus removed it as an out-of-period Type I normalizing adjustment.

In the course of discussions with Staff, NW Natural discovered another error in its ROO filing, resulting in an understatement of rate base caused by a mistake in the accumulated depreciation reserve. Staff has stated that it agrees with the Company's position that the amount originally included for accumulated depreciation was in error.

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[6] *NW Natural Gas Co. v. Dep't of Revenue.*, 347 Or. 536 (Jan. 28, 2010) (en banc).

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As a result of Staff's position on the above issues, Staff recommends that the Company's 2010 ROO should reflect the following changes: (1) add the tax refund amounts to 2010 results; (2) add the interest on tax refund amounts paid the Company to 2010 results; and (3) include the finders' fee expenses in 2010. NW Natural believes that Staff agrees to NW Natural correcting the error in rate base due to the mistake in the accumulated depreciation reserve. Staff's proposed modifications to the ROO filing would result in a $2.2 million refund to customers.

D. NW Natural's Amended 2010 Results of Operations

On July 22, 2011, NW Natural filed an updated ROO ("Amended ROO") revised to reflect the following: First, the Company removed the finder's fee from 2010 expenses as a Type 1 Normalizing Adjustment. This had the effect of increasing the sharing with customers over NW Natural's original filing by $0.3 million. Second, the Company corrected the error to rate base caused by the mistake in the accumulated depreciation reserve. The net effect of NW Natural's Amended ROO would result in a $0.2 refund to customers.

III. DISCUSSION

A. The Tax Refund Adjustment, as Well as the Removal of the Interest Payment and Finder's Fee, is Required by Commission Rules that Cannot Be Waived.

The Commission's rules governing the earnings test specifically directs utilities to normalize test year results using a *"predetermined list of ratemaking adjustments."*[7] The Commission adopted that list of normalizing adjustments in UM 903, including the requirement that utilities adjust earnings to remove entries "related to prior period activity."[8] This list of normalizing adjustments has not been changed since that time. On the contrary, as recently as 2010, Staff reminded representatives of Oregon's regulated utilities that they

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[7] OAR 860-022-00705(b).

[8] Order No. 99-272, Appendix B at 1.

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should make all required adjustments to earnings results, including "removing entries related to prior period activity, and including subsequent period transactions clearly related to the test period." Examples of such out-of-period items included "*removal of credits or charges related to other periods.*"[9]

In this case, the refund that NW Natural received was to correct overpayments made in the 2002 through 2009 tax years and was completely unrelated to taxes due or paid in 2010. The fact that the Company *received* the refund in 2010 was simply a result of the length of the appeal process, and had nothing to do with the refund being attributable to NW Natural's 2010 property taxes. For that reason, Commission rules require that NW Natural remove the tax refund from its 2010 ROO for purposes of the Spring Earnings Test.

For these same reasons, Commission rules require NW Natural to remove from results both the finder's fee and the interest on the refund. The finder's fee compensates the Company's consultant for work it performed in identifying the overpayment—which occurred in 2004 and relates specifically to the refund—attributable to prior years. And, the interest compensates the Company for expenses incurred to finance the overpayment of its property taxes—from 2003 until the refund was paid.[10] These amounts are properly excluded or removed from 2010 results in accordance with the Commission's directive to remove out-of-period expenses from earnings test results.

The Commission's rules are plain, and cannot be waived or altered retroactively to suit Staff's purpose.[11] Staff's proposal to disallow the Tax Refund Adjustment—as well as Staff's positions on the interest payment and the finder's fee—should be rejected.

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[9] Letter from Judy Johnson to Utilities, dated January 14, 2010. A copy of the letter is attached as Exhibit 1.

[10] The interest on the refund was booked as interest income in Account 419 Interest and Dividend Income, which is considered utility non-operating income and excluded from the ROO. This is consistent with prior ROOs.

[11] *Burke v. Children's Serv. Div.*, 288 Or. 533, 538 (1980).

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B. Staff's Proposal is Contrary to Sound Public Policy.

Even if the Commission *did* have discretion to alter the rules regarding normalizing adjustments after NW Natural's filing, it should not do so as a matter of public policy. Since 1999, the Commission has made it clear that for the purpose of the Spring Earnings Test utilities are to make Type 1 Normalizing Adjustments to results, including the removal of expenses associated with out-of-period activity. These adjustments allow the Commission to view the utility's earnings under "normal" conditions—and thus to make a determination as to the appropriate level of rates. The utilities understand and make these adjustment on a consistent basis, regardless as to whether they increase or decrease earnings. Thus, Staff's argument that the Commission should retroactively disregard years of precedent, resulting in a loss of over $2 million to the Company, threatens to undermine regulatory consistency and stability and should not be adopted.

It should be noted that customers are not disadvantaged by the Tax Refund Adjustment, and in fact are placed in the same position as they would have been if the Company was able to go back in time and allocate the relevant portions of the tax refund to the relevant years' results. The Company has analyzed its earnings reviews since 2003 and has confirmed that *had* the relevant portion of the tax refund been attributed to each year, the results of the earnings test would not have changed. The Company did not reach the earnings threshold in any of those years, and would not have reached the earnings threshold *even if the tax refund attributable to that year had been included*. Yet, despite this fact, **Staff now proposes that *all* of the refund be assigned to 2010, the single year in which NW Natural's earnings are above the threshold, and the one year to which the property tax refunds do not relate.** This approach is inconsistent with current policy, would cause an inequitable result, and should therefore be rejected.

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IV. CONCLUSION

For all of the reasons discussed above, the Commission should reject Staff's proposed disallowance of the Tax Refund Adjustment and should confirm that the Company's Amended 2010 Results of Operations is correct and proper as filed.

DATED: July 27, 2011

MCDOWELL RACKNER & GIBSON PC

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UM 903

Exhibit 1

To

NW NATURAL'S COMMENTS ON 2010 RESULTS OF OPERATIONS AND EARNINGS TEST

Oregon
Theodore R. Kulongoski, Governor

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RE: RESULTS OF OPERATIONS REPORTS

Attached please find a letter dated March 25, 1992 outlining the principles for the reporting format and appropriate work papers that should be included in a utility's annual results of operations report ("ROO") due each May 1st. The basis of the letter outlines the proper format for the Earnings Test Results and the Total Pro Forma Results as well as the appropriate work papers that should be included.

As it has been a considerable amount of time since these principles were formally discussed with each company and because this letter provides considerable clarification on many issues, Staff believes it is appropriate to provide a copy of the letter to each of you. We believe it is likely many current utility personnel are performing different tasks from that time period or possibly the utility may not have retained a copy of the letter from so long ago.

If you have questions or need further clarification, please feel free to call me, Carla Owings at 503-378-6629, or Deborah Garcia at 503-378-6688.

Judy Johnson

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March 25, 1992

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RE: Semiannual Adjusted Results of Operations Reports

My letter of February 17, 1989, outlined several principles for making adjustments to your semiannual results of operations reports. Based on our review of recent filings, I believe it would be useful to restate those principles along with the rationale behind them.

As you know, we have asked each energy company to file its semiannual report using a two-stage adjustment process. Each stage provides operating results which can be evaluated for a specific purpose.

Earnings Test Adjusted Results

The first stage takes into account certain normalizing and rate-making adjustments and results in "Earnings Test Adjusted" results of operations. The purpose of this stage is to produce an earnings picture that can be used to perform earnings

Barbara Roberts
Governor

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tests required by ORS 757.259. Such tests are necessary for evaluating potential amortization of deferred costs and revenues. Accordingly, the operating results at this stage of the report should reflect as closely as possible the company's actual earnings for the reporting period and its ability to absorb a deferred cost or its need to retain deferred revenues.

Under current policy, therefore, **the first stage of the report should include adjustments to actual recorded results as follows:**

1. Normalizing for weather, streamflows, and plant availability;

2. Incorporating significant rate-making adjustments adopted in your most recent Oregon rate order if not reflected on your books (for example, advertising, memberships, payroll escalation, bonuses, and nonoperating expenses); and

3. Removing entries relating to prior period activity, and including subsequent period transactions clearly related to the test period. Examples include corrections of estimates or errors, and removal of credits or charges associated with other periods.

To avoid confusion, refer to these as "Type I" adjustments, as shown in the attached tables.

No other adjustments should be made at this stage of the report. Common adjustments which have been misclassified here include annualizing revenues and expenses and removing entries related to nonrecurring events. Although such adjustments are reasonable when constructing a test year, for example, they distort the company's earnings position for deciding whether a deferred amount should be amortized.

<u>Total Pro Forma Results</u>

The second stage of adjustments is intended to provide results of operations on a more forward-looking basis, by reflecting known and measurable changes occurring before the end of the 12-month period. These results help us to assess each company's current earnings situation and whether a rate change may be needed. The following "Type II" adjustments should be included in this stage of the report:

1. Annualizing adjustments to reflect end-of-period customers, tariff rates, employee levels, wage rates, tax rates, supply contracts, rate base, etc.

2. Restating adjustments to remove recorded entries related to significant nonrecurring events.

The most common error in this second stage has been to make adjustments for plant or expense changes occurring <u>after</u> the end of the recorded period. All "future" events--even if known and measurable--should be excluded from this report. (Note the exception above, however, for Type I adjustments to incorporate subsequently recorded error or estimate corrections.)

<u>Workpapers</u>

Each company should provide the following supporting documentation for its semiannual report:

- A table consisting of a columnar summary for the adjustments; with a total for both Types I and II. (Tables 2 and 3 of the attached sample illustrate some typical adjustments.) Also include in the same form the calculation of income taxes associated with each adjustment. (Not shown here)

- A short narrative description of each adjustment. (See attachment for sample; provide additional detail as needed.)

- Backup workpapers supporting actual recorded results by revenue, expense, income tax and rate base categories, tying Oregon allocated data to system data, if applicable. Note that the report is to be prepared showing Oregon allocated adjustments as well as summary data.

- Summary workpapers supporting each adjustment.

- The information used to calculate the cost of capital and the implied rate of return on equity--that is, average actual capital structure (describe any other formulation) and average actual debt and preferred stock costs for the 12-month period. The appropriate data may be included with the summary table as shown or by reference to a separate workpaper.

- For companies with jurisdictional allocations, a summary of the allocation factors used and a description of any material changes in the method from the prior report.

Unless we hear from you otherwise, we will expect adjustments in subsequent semiannual reports to be classified according to the above criteria. Call me, Ed Busch (378-6625), or Ed Krantz (378-6117) if you have any questions regarding these reports.

T. Ray Lambeth

T. Ray Lambeth
Manager
Energy Revenue Requirements
(503) 378-6917

18/20/3718HH

Attachment

cc: Mike Kane
Bill Warren
Phil Nyegaard
Scott Girard
Ed Busch
Ed Krantz
Les Margosian