

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON
UM 903**

In the Matter of
Northwest Natural
2010 Spring Earnings Review

STAFF'S REPLY
COMMENTS

The Citizens' Utility Board and the Northwest Industrial Gas Users (NWIGU) have both pledged support for Staff's comments and recommendations.

Staff's Original Recommendation:

NWN describes Staff's position in its Opening Comments as "disallowing" the adjustment for the property tax refund. In its opening comments, Staff recommended that the Commission require NWN to "reverse" the adjustment for the property tax refund. Staff was incorrect in its analysis and *should have* recommended to the Commission that NWN's adjustment be disallowed, **not** reversed.

The proper recommendation, to disallow the adjustment would require NWN to remove (rather than reverse) the adjustment from the ROO, include the interest associated with the adjustment in the ROO and correct the allocation of Consulting Fees to 100% Oregon ratepayers in the ROO. Doing so would change the sharing from the NWN's proposed \$199,000 to \$2.3 million. This correction changes Staff's original recommendation from a sharing of \$3.6 million to \$2.3 million. Staff submits its corrected Exhibit D in support its recommendation to require NWN to share \$2.3 million of over-earning.

Staff's Reply Comments:

In its opening comments, Northwest Natural Gas Company (NWN) explains why Staff's proposed adjustment is inconsistent with a Type I normalizing adjustment removing out-of-period expenses. Staff's proposed adjustment to NWN's tax expense is also a Type I adjustment. It stems from NWN's 2003 rate case and has been performed by NWN every year since 2003 until this one. By focusing only on its adjustment, NWN has not captured the crux of the dispute—which adjustment best reflects NWN's earnings to allow the Commission to match benefits with burdens.

At the heart of the dispute is the difference between creating a test period and what is appropriate to include in measuring NWN's earnings level in the period.

If we were setting the level of revenues in a test period, we are attempting to *forecast* the appropriate level of revenues that will reoccur year after year. The refund is a one-time event, not likely to be repeated, therefore, including the refund would distort the "on-going" level of revenues.

The purpose of ROO is to measure the utility's level of *earnings* in that period.¹ The essence of this report is-as any other income statement-a measurement of net operating income for a certain period; revenues minus expenses. Thus, the question presented is - *what* revenues and *what* expenses should be measured?

The adjustments that NWN has made distort NWN's 2010 *earnings* and would prevent the Commission from appropriately matching *benefits and burdens*.

Staff's proposed Type I adjustment stems from NWN's 2003 rate case and has been performed by NWN every year since 2003 until this one. In 2003-2009, NWN performed this Type I adjustment to substitute the tax expense initially reported in its results of ROO, which was the amount that NWN was allowed to recover in rates for the year, with NWN's actual tax expense for the year. In each of these years, this Type I adjustment resulted in increased expense for purposes of the earnings test and therefore, **a decrease in NWN's reported earnings.**

In 2010, NWN's *actual* tax expense is lower than the amount included in rates because of the tax refund. However, NWN *increases tax expense in 2010* ROO and as a result, again lowers its earnings claiming that the *refund* qualifies as a different Type I adjustment-an "out-of-period" revenue. Had NWN followed its own precedent set in prior years, the refund would have *lowered* tax expense in the 2010 ROO and as a result, increased NWN's earnings.

NWN claims that ruling in favor of Staff's adjustment would be to abandon long-standing Commission policy.² By claiming that ruling in favor of Staff's adjustment would be an abandonment of long-standing Commission policy, NWN again fails to accurately capture the issue presented. First, NWN has performed the same adjustment now proposed by Staff in the past five ROOs. It is a Type I adjustment, and of the type that the Commission has instructed should be performed in connection with the earnings review for a PGA – a major adjustment from the utility's last rate case.

Second, the Commission's long-standing policies include *consistency* in the manner in which specific expenses have been treated since a utility's last general rate proceeding.

Further, consistency includes matching benefits with burdens. The benefit should be attributed to the party contributing the revenue to pay the expense. In this case, the revenue is solely contributed by ratepayers, therefore, consistency would dictate a continued true-up. A continued true-up would require NWN to remove the adjustment in order to lower property tax expense in the 2010 period, including interest and netting the

¹ Included in the measure of annual earnings are allowable adjustments that will be discussed.

² *Id.* at Pg 2, Lines 18-19.

legal expenses. Doing so would require NWN to share \$2.3 million in the up-coming PGA filing rather than \$199,000 as proposed by NWN.

NWN focuses its comments on complex accounting and the spin of various kinds of adjustments. Rather, Staff recommends that the Commission focus on the single most important aspect of this issue-matching benefits with burdens.

The Commission's policy to base its decisions on the matching of benefits and burdens can be demonstrated in the following scenario:

Let's assume you are the tenant of a building and the rent structure is based on a triple-net lease. The requirement of a triple-net lease contemplates that a tenant will pay whatever monthly rent obligation exists (I.e., dollar per square foot) *in addition to* the requirement to pay other annual expenses; such as property taxes. In this scenario, let's assume the tenant takes possession of the property in 2003 and pays all the monthly and annual obligations (including property tax expense) from 2003 through the end of 2010. At that time it is discovered that property tax expense has been over-assessed because it was based on non-assessable property. The result is a \$5.2 million refund in 2010. The question becomes; who should get the "benefit" of the refund ...the tenant who has paid the tax expense each year, or the owner of the building? The owner of the building may argue that they should receive the benefit because they are the owner of the building and have other costs associated with the maintenance of the building. Staff believes that the tenant should receive the benefit of the refund, because it was actually the tenant who paid the over-assessment.

Burden:

Noticeably absent from NWN's opening comments is *any* discussion of the fact, NWN has previously included an adjustment in its ROO on an annual basis to replace what was allowed in rates for property tax expense with the *actual* property tax expense. In essence, NWN has "trued-up" property taxes on an annual basis and that true-up has been an *increase* to taxes on an annual basis, therefore lowering the Company's earnings on an annual basis.

NWN fails to point out that included in this list of predetermined ratemaking adjustments is the requirement to "incorporate[ing] significant rate-making adjustments adopted in your most recent Oregon rate order..."³ This is precisely the type of adjustment NWN had adopted from its most recent Oregon rate order.

In 2003, NWN increased property taxes by \$456,000. In 2004, NWN increased property taxes by \$765,000. In 2005, NWN increased property taxes by \$622,000; in 2006, by \$389,000; in 2007, by \$714,000; and in 2008 by \$233,000. None of these are a small

³ See NWN's Exhibit 1, Page 2 of letter dated March 25, 1992

amount of increase. And finally, in 2009 (the last year effected by the refund) NWN increases property tax expense by \$920,000. Each of these adjustments is described in the ROO as a "true-up". Each time NWN takes this adjustment, earnings are lower in the period. However, now that the "true-up" goes the opposite direction, NWN wants to abandon the "true-up" in favor of classifying the refund as an out-of-period revenue.

Out-of-period Adjustments:

The Commission has sole discretion as to whether any of the adjustments outlined in Appendix B of Commission Order No. 99-272 (Appendix B) should, or should not, be included when measuring the utility's earnings review.

Out of period adjustments in a *test period* can be used in order to prevent distortion of the financial picture for purposes of a "test period." This is necessary because in a test period we are measuring the "expectation" of future revenues based upon *estimates*. There is an expectation that an out of period revenue would not reoccur...therefore it may be necessary to remove it from the test period.

In this case we are talking about *actuals*, not estimates. NWN has adjusted its *actual* property tax expense each year. This makes the issue a true-up, and as such we want to know the *actual* cash flows that have occurred in the period. The refund represents a cash flow. In the eyes of the Internal Revenue Service or the Department of Revenue, NWN will report this refund as a cash-flow in the period it is received. For all purposes (except before the Commission) NWN will include this as income in the year it was received. NWN will not attempt to spread the cash-flow back to prior years and request to file amended returns to restate its level of income in the years it was over-assessed. This is true because the Company *actually* received the refund in 2010.

The Interest:

NWN claims that the \$1.9 million in interest received coincident with the refund compensates the Company for over-payments *it* made between 2003 and 2009.⁴ Staff takes exception to this statement in light of the fact that NWN adjusted its earnings year after year, increasing property tax expense each time. In fact, ratepayers have compensated the Company each year for these "over-payments" while shareholders have been held harmless for all volatility, yet NWN wants to claim the benefit of the refund and the interest on behalf of its shareholders.

Staff recommends the Commission require NWN to reflect the interest income in its ROO as it directly relates to the refund and should be included in the measure of the utility's *actual* earnings in 2010 for the purposes of the ROO. This reflects the true cash-flow for the Company and is consistent with the requirement that the Company include

⁴ See NWN Opening Comments, Pg 7, lines 14-16

this in its 2010 tax return. Staff's calculations in Exhibit D reflect adjustments for any tax effects of including this additional income.

A look-back:

In NWN's opening comments the Company claims that it has analyzed its earnings reviews between 2003 and 2009 and has determined that the results of the earnings tests would not have changed *had* the relevant portion of the tax refund been attributed to each year.⁵ Although NWN did not suggest this was a viable option, Staff points out that such an event would be considered retroactive ratemaking and as such, would not be an option that is pertinent in this proceeding.

The result:

Finally, NWN claims that Staff's adjustments would cause an "inequitable result." However, NWN fails to point out that due to the structure of the earnings sharing, NWN retains 66% of its over-earning, leaving only 33% of the benefit of the refund on behalf of ratepayers even though ratepayers bore the burden of all the expense.

For 2010, NWN has already exceeded its authorized ROE by 100 basis points. This is the equivalent of approximately \$1.3 million before tax. Beyond that, even though Staff's adjustments are equivalent to approximately \$7.0 million before tax, NWN is only required to share 33% with ratepayers or approximately \$2.3 million, leaving the shareholders with 66%, or approximately \$4.7 million (of *over-earning*). In Staff's opinion, this is far from inequitable to NW Natural.

Staff firmly believes the Company should be ordered to remove the adjustments related to property tax refund plus include an adjustment to reflect the receipt of interest, net of legal expenses in its ROO. As a result, NWN would be required to share \$2.3 million with ratepayers, which is fair, just, and reasonable and far from an inequitable result for NW Natural.

Dated at Salem, Oregon, this 19th day of August, 2011.



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⁵ *Id.* at Pg 8, lines 13-16.

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CERTIFICATE OF SERVICE

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I certify that I have this day served the foregoing document upon all parties of record in this proceeding by delivering a copy in person or by mailing a copy properly addressed with first class postage prepaid, or by electronic mail pursuant to OAR 860-001-0180, to the following parties or attorneys of parties.

Dated this 19th day of August, 2011 at Salem, Oregon.



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