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April 24, 2006

VIA ELECTRONIC FILING

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

Re: Docket AR 499

Northwest Natural Gas Company ("NW Natural") presented at the April 17, 2006 workshop in this docket a straw proposal addressing the issue of earnings between rate cases. At the workshop, NW Natural was asked by April 24 to provide examples of how the straw proposal would work. All parties also were asked to submit by April 24 any revisions to their proposals in response to questions raised during the workshop or otherwise.

NW Natural submits seven examples of the application of its straw proposal, designed to confirm that the proposal impacts only what has been referred to as the "double whammy" problem and does not have any other collateral impacts on application of SB 408. In preparing the examples, NW Natural realized a revision was needed to the language of the straw proposal, to address the possibility that tax losses of an entity other than the utility might be imputed to the utility in a rate proceeding. While NW Natural does not believe such imputation could be justified, its straw proposal was intended to be neutral on this issue, and as initially drafted incorporated any imputation of tax loss provided pursuant to the permanent rule. The revised language assures that such neutrality also applies to any imputations of tax losses arising in rate case decisions.

Very truly yours,

Marcus Wood

Marcus A. Wood

MW:knp
Enclosure
cc: Service List

CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of the foregoing document in Docket AR 499 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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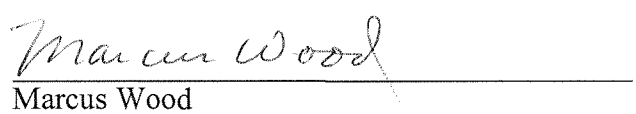

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BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

AR 499

In the Matter of the Adoption	)
of Permanent Rules to Implement SB 408,	)
Relating to Matching Utility Taxes Paid	)
with Taxes Collected.	)

NW NATURAL GAS COMPANY'S STRAW PROPOSAL
EXPENSES BETWEEN RATE CASES (EARNINGS TEST)

Proposal

1. If in any year a utility's taxes paid is greater than its taxes authorized to be collected in rates, the Commission shall determine whether the utility's after-tax return on equity from regulated operations for such year, after adding any surcharge that the utility would be entitled to receive for such year under the permanent rule, is greater than the after-tax return on equity that the Commission had determined to be fair, just, and reasonable in the utility's last general rate proceeding. To the extent that the surcharge would produce an after-tax return on equity in excess of such fair, just, and reasonable level, the utility would be required to credit customers with such excess earnings, in an amount up to the amount of the allowed SB 408 surcharge. In determining the after-tax return on equity for such earnings test, the Commission would apply tax loss allocations, if any, set forth in this rule or as established in the utility's most recent general rate proceeding~~the same determination of taxes paid as properly attributed to the regulated operations under the permanent rule~~.

2. If in any year a utility's taxes paid is less than its taxes authorized to be collected in rates, the Commission shall determine whether the utility's after-tax return on equity from regulated operations for such year, after deducting any refund that the utility would be required to pay for such year under the permanent rule, is less than the after-tax return on equity that the Commission had determined to be fair, just, and reasonable in the utility's last general rate proceeding. To the extent that the refund would produce an after-tax return on equity in that was less than such fair, just, and reasonable level, the utility would be allowed a surcharge to recover the amount of such deficient earnings, in an amount up to the amount of the allowed SB 408 surcharge. In determining the after-tax return on equity for such earnings test, the Commission would apply tax loss allocations, if any, as set forth in this rule or as established in the utility's most recent general rate proceeding~~the same determination of taxes paid as properly attributed to the regulated operations under the permanent rule~~.

Explanation

The Attorney General's letter interpreting SB 408 concluded that the Commission must apply the statute in a manner that still establishes rates that are fair, just, and reasonable. In each general rate case, the Commission establishes rates on such a basis, and in such proceeding

determines an allowed after-tax return on utility equity that would be fair, just, and reasonable. The straw proposal is designed to avoid the undermining of this determination, by allowing rates to be adjusted in the direction, positive or negative, as needed to prevent either (a) overearnings combined with an SB 408 rate surcharge or (b) underearnings combined with an SB 408 refund. The earnings test and adjustment is not an adjustment to the SB 408 tax true-up, but instead is an adjustment for earnings excess or deficiency, to the extent needed to assure that the Commission's rate obligations are met.

In determining the after-tax return on equity for such earnings test, the Commission would apply any tax allocation requirements as set forth in this rule or extablished in the utility's most recent general rate proceeding~~In making the determination of the after-tax return on equity for the period in question, the Commission would apply as taxes paid in such period attributable to the regulated operations the same number as properly attributed under the permanent rule~~. For example, if the Commission determined for some reason that a tax deduction of a non-utility member of the Affiliated Group should be properly attributed to the regulated operations, the after-tax return on equity would have to be increased to reflect the benefit of such additional tax deduction. This treatment corresponds to what would happen if the same tax deduction was taken into account in a general rate proceeding.

BEFORE THE PUBLIC UTILITY COMMISSION
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AR 499

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NW NATURAL GAS COMPANY'S STRAW PROPOSAL
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1. If in any year a utility's taxes paid is greater than its taxes authorized to be collected in rates, the Commission shall determine whether the utility's after-tax return on equity from regulated operations for such year, after adding any surcharge that the utility would be entitled to receive for such year under the permanent rule, is greater than the after-tax return on equity that the Commission had determined to be fair, just, and reasonable in the utility's last general rate proceeding. To the extent that the surcharge would produce an after-tax return on equity in excess of such fair, just, and reasonable level, the utility would be required to credit customers with such excess earnings, in an amount up to the amount of the allowed SB 408 surcharge. In determining the after-tax return on equity for such earnings test, the Commission would apply tax loss allocations, if any, set forth in this rule or as established in the utility's most recent general rate proceeding.

2. If in any year a utility's taxes paid is less than its taxes authorized to be collected in rates, the Commission shall determine whether the utility's after-tax return on equity from regulated operations for such year, after deducting any refund that the utility would be required to pay for such year under the permanent rule, is less than the after-tax return on equity that the Commission had determined to be fair, just, and reasonable in the utility's last general rate proceeding. To the extent that the refund would produce an after-tax return on equity in that was less than such fair, just, and reasonable level, the utility would be allowed a surcharge to recover the amount of such deficient earnings, in an amount up to the amount of the allowed SB 408 surcharge. In determining the after-tax return on equity for such earnings test, the Commission would apply tax loss allocations, if any, as set forth in this rule or as established in the utility's most recent general rate proceeding.

Explanation

The Attorney General's letter interpreting SB 408 concluded that the Commission must apply the statute in a manner that still establishes rates that are fair, just, and reasonable. In each general rate case, the Commission establishes rates on such a basis, and in such proceeding determines an allowed after-tax return on utility equity that would be fair, just, and reasonable. The straw proposal is designed to avoid the undermining of this determination, by allowing rates

to be adjusted in the direction, positive or negative, as needed to prevent either (a) overearnings combined with an SB 408 rate surcharge or (b) underearnings combined with an SB 408 refund. The earnings test and adjustment is not an adjustment to the SB 408 tax true-up, but instead is an adjustment for earnings excess or deficiency, to the extent needed to assure that the Commission's rate obligations are met.

In determining the after-tax return on equity for such earnings test, the Commission would apply any tax allocation requirements as set forth in this rule or extablished in the utility's most recent general rate proceeding. For example, if the Commission determined for some reason that a tax deduction of a non-utility member of the Affiliated Group should be properly attributed to the regulated operations, the after-tax return on equity would have to be increased to reflect the benefit of such additional tax deduction. This treatment corresponds to what would happen if the same tax deduction was taken into account in a general rate proceeding.

NORTHWEST NATURAL GAS COMPANY

EXAMPLES OF APPLICATION OF PROPOSED EARNINGS TEST

Assume following from last rate case:

Gross Revenues	= 10,000	Rate Base	= 24,000
Expenses + Debt + Pfd Costs	= 8,200	Debt	= 12,000
Net Income	= 1,800	Equity	= 12,000
Effective Tax Rate	= .33...		
Taxes	= 600		
Allowed After-Tax Return	= (1,800 – 600)/12,000 = 10%		

Example 1: Stand-alone utility has lower expenses and overearns allowed return

Gross Revenues	= 10,000	Rate Base = 24,000
Expenses + Debt + Pfd Costs	= 7,900	
Net Income	= 2,100	
Effective Tax Rate	= .33...	
Taxes	= 700	
Allowed After-Tax Return	= (2,100 – 700)/12,000 = 11.67%	

Temporary Rule			Earnings Test	
Auth in Rates = 10,000 x .18* x .33...	= 600	Return with surcharge = (1,400**+ 100***)/12,000		
Taxes Pd	= 700		= 12.5%	(pass)
Surcharge	**= 100**	**No Surcharge**		

* Rate case Net Income of 1,800/ rate case Gross Revenues of 10,000.
** Net Income of 2,100, less taxes paid of 700.
*** Surcharge amount.
The earnings test does not permit an "overearning" utility to charge a surcharge.

Example 2: Stand-alone utility has higher expenses and underearns allowed return

Gross Revenues	= 10,000	Rate Base = 24,000
Expenses + Debt + Pfd Costs	= 8,500	
Net Income	= 1,500	
Effective Tax Rate	= .33...	
Taxes	= 500	
Allowed After-Tax Return	= (1,500 – 500)/12,000 = 8.33%	

Temporary Rule			Earnings Test	
Auth in Rates = 10,000 x .18 x .33...	= 600	Return with refund = (1,000* - 100**)/12,000		
Taxes Pd	= 500		= 7.5%	(fail)
Refund	**= 100**	**No Refund**		

* Net Income of 1,500, less taxes paid of 500.
** Refund amount.
The earnings test does not require an "underearning" utility to pay a refund.

Example 3: Stand-alone utility has effective tax rate reduced

Gross Revenues	= 10,000	Rate Base = 24,000
Expenses + Debt + Pfd Costs	= 8,200	
Net Income	= 1,800	
Effective Tax Rate	= .25	
Taxes	= 450	
Allowed After-Tax Return	= (1,800 – 450)/12,000 = 11.25%	

Temporary Rule		Earnings Test	
Auth in Rates = 10,000 x .18 x .33...	= 600	Return with refund = (1,350 - 150)/12,000	
Taxes Pd	= 450		= 10% (pass)
Refund	**= 150**	**Refund**	**= 150**

Tax savings resulting solely from changes in the effective tax rate are passed through equally with or without the earnings test.

Example 4: Consolidated utility; utility performs per rate case, but Consolidated Group has lower taxes paid.

Gross Revenues	= 10,000	Rate Base = 24,000
Expenses + Debt + Pfd Costs	= 8,200	
Net Income	= 1,800	
Effective Tax Rate	= .33...	
Taxes	= 600	
Allowed After-Tax Return	= (1,800 – 600)/12,000 = 10%	

Consolidated Group Taxes Paid = 500

Temporary Rule		Earnings Test	
Auth in Rates = 10,000 x .18 x .33...	= 600	Auth in Rates = 500	
Utility Taxes Pd	=600	Return with refund	= (1,300* – 100)/12,000
Consolidated Taxes Pd	= 500		= 10%(pass)
Refund	**= 100**	**Refund**	**= 100**

Net income of 1,800, less lower Consolidated Group Taxes Paid of 500.
The permanent rule, like the statute, would provide that taxes paid be calculated using the lesser of consolidated taxes paid or taxes paid as properly attributed to the regulated operations of the utility. Thus, the Earnings Test in this instance also must use the lower consolidated taxes paid number.

Example 5: Consolidated utility; utility performs per rate case; permanent rule attributes an affiliates tax losses to utility

Gross Revenues	= 10,000	Rate Base = 24,000
Expenses + Debt + Pfd Costs	= 8,200	
Net Income	= 1,800	
Effective Tax Rate	= .33...	
Stand-Alone Taxes	= 600	
Attributed tax loss	= -100	

Allowed After-Tax Return (stand-alone) = (1,800 – 600)/12,000 = 10%

Consolidated Group Taxes paid = 1,000

Temporary Rule			Earnings Test		
Auth in Rates = 10,000 x .18 x .33...		= 600	Return with refund = (1,800 – 500* -100)/12,000		
Taxes Pd	= 600 –100	= 500		= 10%	(pass)
Refund		**= 100**	**Refund**	**= 100**	

* Earnings test uses the net 500 in taxes as attributed under the permanent rule, rather than the 600 in stand-alone taxes.

The earnings test attributes in calculating "taxes paid" whatever attribution of tax losses the permanent rule provides.

Example 6: Consolidated utility; utility performs per rate case; rate case imputes affiliate taxes to utility

Revised rate case assumptions:

Gross Revenues	= 9,850	Rate Base = 24,000
Expenses + debt + pfd costs	= 8,200	Debt = 12,000
Net income	= 1,650	Equity = 12,000
Effective Tax Rate	= .33...	
Taxes	= 550	
Imputed tax loss	= -100	
Allowed After-Tax Return	= (1,650 – 450)/12,000 = 10%	

Actual Results

Gross Revenues	= 9,850	Rate Base = 24,000
Expenses + debt + pfd costs	= 8,200	
Net income	= 1,650	
Effective Tax Rate	= .33...	
Stand-Alone Taxes	= 550	

Attributed tax loss = -200*
Allowed After-Tax Return (stand-alone) = (1,650 – 550)/12,000 = 9.16%
Consolidated Group Taxes Paid = 1,000

Temporary Rule			Earnings Test		
Auth in Rates = 9,800 x .168376 x .33...= 450			Return with refund = (1,650 – 350* -100)/12,000		
Taxes Pd	= 600 –100	= 350		= 10%	(pass)
Refund		**= 100**	**Refund**	**= 100**	

* In earnings test, if an affiliate's expected tax losses are imputed in a rate case, I assume its actual tax losses would be used in computing Taxes Paid. In this example, the rate case imputation was –100, but the actual tax loss was –200.
** Earnings test uses the net 350 in taxes paid as imputed, rather than the 550 in stand-alone taxes.

The earnings test attributes in calculating "taxes paid" consistent with the applicable the rate case attribution. Because the effect of the attribution from the rate case already would be in base rates, if the attributing entity has the same actual tax loss as assumed for rate case purposes, after the applicable attribution of tax losses, there should be no refund. In this example, the attributing entity had a tax loss of -200, rather than -100 as assumed for rate case purposes. Therefore, the refund (of attributed tax losses not already reflected in rates) would be 100. The earnings test would include all of the actual attributed tax loss and shows that the earnings has been met.

Example 7: Stand-alone utility attempts to "game" the Earnings Test by increasing its expenses to move out of an overearning situation.

Gross Revenues = 10,000 Rate Base = 24,000
Expenses + Debt + Pfd Costs = 7,900
Net Income = 2,100
Effective Tax Rate = .25...
Taxes = 525
Allowed After-Tax Return = (2,100 – 525)/12,000 = 13.125%

Temporary Rule			Earnings Test		
Auth in Rates = 10,000 x .18 x .33... = 600			Return with surcharge = (1,575- 75)/12,000		
Taxes Pd		= 525		= 12.5%	(pass)
Refund		**= 75**	**Refund**	**= 75**	

To avoid payment of a refund because the utility after any refund would underearn its allowed return, the utility must increase its expenses by 500, with the following results:

Gross Revenues = 10,000 Rate Base = 24,000
Expenses + Debt + Pfd Costs = 8,400
Net Income = 1,600

Effective Tax Rate	=	.25...
Taxes	=	400
Allowed After-Tax Return	=	(1,600 – 400)/12,000 = 10.00%

Temporary Rule		Earnings Test	
Auth in Rates = 10,000 x .18* x .33... = 600		Return with surcharge = (1,200- 200)/12,000	
Taxes Pd	= 400		= 8.33%* (pass)
Refund	**= 200**	**Refund**	**= 0**

* Note that the 1200 Net Income level is the highest level that will cause any level of refund to fail the Earnings Test.

The bottom line is that in this example, the utility must reduce its after tax income from (2,100 –525) = 1,575 to (1,600 – 400) = 1,200, or by 375, in order to avoid a refund of 75. No utility would have an incentive to pay 375 to avoid 75. As a mathematical matter, NW Natural is confident that there is no situation in which a utility could achieve an net benefit under the Earnings Test by spending itself out of an overearning situation.