

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

UM 903

In the Matter of

NORTHWEST NATURAL GAS
COMPANY, dba NW NATURAL

ORDER

2011 Spring Earnings Review.

DISPOSITION: APPROPRIATE TREATMENT OF
TAX REFUND CLARIFIED

I. INTRODUCTION

In this order we address whether a \$5.2 million legal judgment in favor of Northwest Natural Gas Company, dba NW Natural, should be included in NW Natural's 2010 revenues for purposes of its spring earnings review. We conclude that the judgment should not be included in NW Natural's 2010 test year revenues, and direct NW Natural to prepare its annual gas cost tracking filing accordingly.

II. BACKGROUND AND PROCEDURAL HISTORY

This docket involves a dispute over the preparation of NW Natural's spring earnings review. Each year, natural gas utility local distribution companies (LDCs) make purchased gas adjustment (PGA) filings. The PGA mechanisms allow rates to be adjusted on an annual basis to reflect prudently incurred changes in a gas utility's gas costs. Before each LDC makes its PGA filing, the Public Utility Commission of Oregon (Commission) conducts a simplified review of the gas utility's prior year's earnings to determine whether the earnings are above a specific earnings threshold. If so, the LDC may be required to share some percentage of its revenues with customers.¹

On May 1, 2011, NW Natural submitted its 2010 Results of Operations report (ROO).² This report reflects the company's financial results from the calendar year prior to the filing and is used for the PGA-related earnings test. Commission Staff (Staff) and other interested parties reviewed the ROO and disagreed with NW Natural's treatment of the tax refund and various amounts related to the refund. Because the parties could not

¹ See OAR 860-022-0070(4).

² We take judicial notice of NW Natural's ROO for 2010 and associated updates.

resolve this dispute, a procedural schedule was set to allow the parties to file comments addressing disputed issues.³

On July 27, 2011, the parties filed opening comments. Staff filed opening comments and recommendations on behalf of Staff, the Citizens' Utility Board of Oregon (CUB), and the Northwest Industrial Gas Users (NWIGU). Staff recommended several adjustments to NW Natural's earnings report, all of which stem from the treatment of a \$5.2 million tax refund received by NW Natural in 2010. NW Natural filed comments defending its position that the tax refund and other related amounts were treated appropriately.

On August 3, 2011, the Administrative Law Judge issued a bench request directing the parties to address specific issues in reply comments. On August 19, 2011, Staff and NW Natural filed reply comments. CUB and NWIGU supported Staff's reply comments. Staff, NW Natural, CUB, and NWIGU (collectively, the "parties") filed separate responses to the bench request.⁴

III. DISCUSSION

A. Issues

1. Tax Refund

The key issue in dispute is whether the \$5.2 million tax refund awarded to NW Natural in 2010 should be included in the company's ROO. If the refund is included, the amount the company would be required to "share" with customers would be increased by approximately \$2 million. Staff and intervenors argue that the refund should be included; NW Natural argues that it must be excluded.⁵

a. Parties' Positions

Staff and Intervenors. Staff, with the support of CUB and NWIGU, argues that NW Natural historically adjusts the property tax expense in its annual ROO to reflect its "actual taxes." NW Natural's receipt of the property tax refund in 2010 lowered NW Natural's actual 2010 tax liability. The ROO should therefore reflect the financial

³ Although Commission rules contemplate that comments on disputed issues will be completed by August 1 and an order issued by August 15, all parties agreed that additional time was needed to properly address the issues in dispute. A schedule was therefore established to accommodate two rounds of comments that extended beyond the dates anticipated by rule. See OAR 860-022-0070(6).

⁴ For purposes of this order, we refer to these entities as the "parties," although there are many other "parties" to docket UM 903. Docket UM 903 is an ongoing docket that remains open from year-to-year to address annual spring earnings reviews for all LDCs. All LDCs and a number of others participate annually in the docket as parties. For purpose of this dispute, however, the only active parties are NW Natural, CUB, NWIGU, and Staff.

⁵ The parties all agree that this dispute requires us simply to resolve whether existing rules and precedent require NW Natural to include the tax refund and associated amounts, or exclude them. They agree that the prohibition on retroactive ratemaking prevents the Commission from recalculating the results of prior earnings tests using the corrected tax amounts as determined by the court judgment.

impact of the refund. Staff argues that including the 2010 refund is both consistent with NW Natural's prior practice of "truing up" its tax liability to reflect its actual tax liability for the year, and fair and appropriate under the circumstances.

In reply comments, Staff and intervenors argue that there are good policy reasons to include the tax refund in the earnings review. They emphasize that there is a conceptual difference between a "test period" used for purposes of setting rates prospectively, that is, in a rate case, and a review period used to assess a utility's earnings for purposes of an earnings review. A test year used to set rates prospectively is intended to *forecast* future costs, so the test year should be normalized to eliminate nonrecurring items. A tax refund would not be expected to recur, so it should be excluded from a test year used for prospective ratemaking.

An earnings review, by contrast, is intended to measure the level of earnings in a particular period. In this case, Staff argues, NW Natural's 2010 earnings were higher because of the tax refund, a fact reflected in the company's reports to the Internal Revenue Service and Securities Exchange Commission. To ignore, during an earnings review, the fact that the tax refund lowered NW Natural's 2010 tax liability and increased its overall earnings is simply unfair and inappropriate.

NW Natural. In response, NW Natural points out that the Commission's rules and prior orders require the normalization of test year results for purposes of the annual earnings test. In Order No. 99-272, the Commission adopted an explicit, predetermined list of adjustments that LDCs are required to make to their ROOs for purposes of the earnings tests. NW Natural is required to make those adjustments whether they benefit NW Natural or ratepayers. One required adjustment is the removal of all entries "related to prior period activity." NW Natural explains that the tax refund it received in 2010 relates to tax overpayments made between 2002 and 2009. It is therefore an entry "related to prior period activity" that must, under existing legal requirements, be removed.

NW Natural takes issue with Staff's arguments that its practice of "updating" its tax liability requires it to remove the refund from its ROO. The company explains that its use of accrual accounting requires it to book estimated taxes for the year in advance. Once it knows what its actual tax payments for the year will be, it removes the estimates and replaces them with the actual tax liability incurred during the test period. This update ensures that the earnings review is not distorted by inaccurate estimates. Moreover, NW Natural explains, the update has no effect on the amount the company collects for property taxes in customer rates. That amount is set in a rate case, so any variance between the amount NW Natural actually pays to taxing authorities and the amount collected in rates is borne by shareholders.

Finally, NW Natural points out that even if the taxing authorities had correctly assessed NW Natural for property taxes between 2002 and 2009, and the annual earnings tests conducted for each of those years had taken into account the company's lower level of

tax liability for each year, the earnings tests in those years would not have resulted in any additional “sharing” for customers.

b. Resolution

We acknowledge Staff’s and intervenors’ concerns about the treatment of NW Natural’s tax refund in this docket. Staff and intervenors express concern that ratepayers will be deprived of the benefit of the tax refund by virtue of NW Natural’s proposed adjustment. Further, because NW Natural recognized the benefit of the tax refund in its 2010 IRS and SEC filings, Staff and intervenors argue that the company should recognize the refund in its 2010 earnings test. Despite these arguments, however, we find that the tax refund is an entry “related to prior period activity” and, therefore, NW Natural correctly removed the tax refund from its 2010 ROO.

Order No. 99-272 details the adjustments that must be made to an LDC’s ROO for purposes of the earnings review. The order explicitly states that a company’s results of operations should be adjusted by “removing entries related to prior period activity[.]”⁶

NW Natural rightly argues that the refund is “related to prior period activity”; namely, the overpayment of taxes from 2002 to 2009. We have considered the matter closely, and find no rationale supporting the case that the refund is not an entry related to activity from prior years. We therefore conclude that NW Natural must remove the tax refund from its financial results.

Our analysis is not changed by Staff and intervenors’ argument that there is a conceptual distinction between a ratemaking proceeding and an earnings review that makes exclusion of the tax refund inappropriate as part of an earnings test. OAR 860-022-0070(5) indicates that the Commission does, by rule, treat the earnings review test period much like a test period in a rate case:

The standards to be applied in an earnings review under this rule for each LDC are as follows:

[* * *]

(b) *Normalization and adjustments*: The test year results will be adjusted with a predetermined list of rate-making adjustments *equivalent to those applied in the gas utility's most recent general rate proceeding*.

OAR 860-022-0070(5)(emphasis added).

Finally, we do not believe that NW Natural’s practice of updating of its estimated tax liability with actual tax liability each year changes our analysis. NW Natural explains

⁶ Order No. 99-272, Appendix B at 1 (identifying the “[a]djustments to recorded results of operations” that must be made for purposes of an LDC’s earnings review) (the adjustments were adopted in 1999 as part of a stipulation among various parties. NW Natural, Staff, and NWIGU were participants in the original proceedings).

that accrual accounting requires it to estimate its tax liability each year before the liability is actually incurred. This annual update replaces the company's estimated tax liability with actual tax liability to ensure that the company's tax liability is accurately reflected in the ROO. We see no issue with this practice, as it ensures the ROO includes an accurate entry for taxes incurred during the period. There is no allegation that this updating of tax liability brings into the ROO amounts related to prior period activity, so the practice appears to be consistent with our rules.

2. *Interest Income Related to Tax Refund*

a. Parties' Positions

In addition to the \$5.2 million award for overpayment of taxes, NW Natural was also awarded approximately \$1.9 million in interest related to the award. As noted above, Staff and intervenors argue that the award should be recognized in NW Natural's earnings review. Consistent with that position, they argue that the interest associated with the award should also be recognized in the earnings review.

NW Natural, by contrast, argues that both the award and the interest should be excluded from the earnings review test period. NW Natural explains that the interest compensates the company for expenses incurred to finance the overpayment of its property taxes from 2003 until the date the refund was paid.

b. Resolution

We find that the resolution of this issue flows from our resolution of the first issue. The interest income at issue here is, like the tax refund itself, related to prior period activity and must be removed from the company's results of operation.

3. *Fees Related to Refund Recovery*

a. Parties' Positions

NW Natural originally included in its ROO amounts for "finders' fees" paid to a consultant who identified the tax overpayments at issue here. In its updated filing, the company removed this fee, arguing that it was incurred in 2004 and is therefore, like the refund itself, "related to prior periods." Because Staff believes the tax refund should be included in the company's results of operations, Staff argues that the fees are appropriate expenses that should be included in the ROO.

b. Resolution

Like the award of interest, the correct treatment of the finders' fee, in our view, turns on the treatment of the tax award itself. Because we have concluded that the tax refund should be excluded from the company's earnings test period, the finders' fee should also

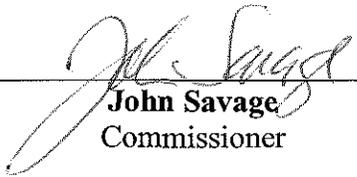
be excluded. The finders' fee did not benefit ratepayers, and it should be borne by shareholders.

IV. ORDER

IT IS ORDERED that:

1. The 2011 spring earnings review for Northwest Natural Gas Company should be conducted in a manner consistent with this order.
2. Northwest Natural Gas Company shall prepare its annual gas cost tracking filing accordingly.

Made, entered and effective SEP 22 2011.



John Savage
Commissioner



Susan K. Ackerman
Commissioner



A party may request rehearing or reconsideration of this order under ORS 756.561. A request for rehearing or reconsideration must be filed with the Commission within 60 days of the date of service of this order. The request must comply with the requirements in OAR 860-001-0720. A copy of the request must also be served on each party to the proceedings as provided in OAR 860-001-0180(2). A party may appeal this order by filing a petition for review with the Court of Appeals in compliance with ORS 183.480 through 183.484.