BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1635

In the Matter of NORTHWEST NATURAL GAS COMPANY, dba NW NATURAL Mechanism for Recovery of Environmental Remediation Costs.	STAFF'S PREHEARING BRIEF

I. INTRODUCTION

In Northwest Natural Gas Company's ("NW Natural") last general rate case the Public Utility Commission of Oregon ("Commission") approved NW Natural's request for an automatic adjustment clause named the Site Remediation Recovery Mechanism ("SRRM"). At the same time, it also opened a future docket (UM 1635) for the purpose of establishing the appropriate earnings test for past deferred amounts and establishing the parameters of how future environmental remediation costs will be treated in the SRRM.

Once Docket No. UM 1635 was established and procedural schedules adopted, NW Natural filed direct testimony. The Public Utility Commission of Oregon Staff ("Staff"), the Citizens' Utility Board ("CUB"), and the Northwest Industrial Gas Users ("NWIGU") filed rebuttal testimony. NW Natural then filed reply testimony. In April and May of 2013, the parties filed two stipulations and in early August supplemented the stipulations with supporting testimony.

On November 18, 2013, the Commission entered Order No. 13-424 ("Order"). In that Order, a majority of the Commission rejected the stipulations submitted by the parties concluding that the stipulations:

> do not fairly and prudently resolve whether and how NW Natural's environmental remediation costs should be shared with its customers. Based upon the record, we believe that a disallowance of $7 million from recovery of incurred costs through the proposed SRRM is too low. Further, the environmental remediation costs at issue raise significant public policy considerations about how the Commission should address the sharing of costs, earnings reviews, deadbands, and other

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> proposals made by the parties to apportion costs fairly. We believe that these issues should not be addressed through a stipulation, but rather through a more thorough examination of the facts and policy standpoints.

Chair Ackerman entered a dissenting opinion stating that:

> I would accept the stipulations, and so dissent from my colleagues' conclusions. The settlement requirement that the company absorb $7 million of the historical period's deferrals seems insufficient to my colleagues. This number, however, is within a range of acceptable resolutions that are available to the Commission based upon the evidence and reasonable interpretations of applicable law. The going forward settlement appears fairly restrictive to the company based on the Commission's precedent governing gas utility earnings reviews, but it, too, is within a range of acceptable resolutions. Therefore, it appears that the parties balanced these two periods in reaching their overall stipulation. The overall balance struck seems reasonable given the facts in this case, and I would therefore accept the stipulations.

In the Order rejecting the stipulations, the Commission included some background on how NW Natural's environmental remediation costs were and will be incurred.[1] After the stipulations were rejected and new procedural schedules were adopted, the parties filed additional testimony in this proceeding.

Since the time the stipulations were rejected, one major event has occurred – NW Natural entered into a settlement of its environmental remediation insurance claims, which resulted in $150.5 million worth of insurance proceeds.[2] NW Natural argues that these new insurance proceeds should be first used to offset the past deferred amounts, which would have the effect of making an earnings test moot because the insurance proceeds are more than the current deferred accounts. Therefore, there would be no balance subject to the earnings test. However, all of the other parties argue that only a portion of the insurance proceeds should be applied to the past deferred account balances based upon arguments such as intergenerational equity, which results in the application of an earnings test on the net amount of deferrals.

With these issues now presented for Commission resolution, it appears that the parties agree regarding the basic facts to be entered into the record. Instead of an argument regarding

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[1] *See* Docket No. UM 1635, Order No. 13-424 at 2.

[2] *See* NWN/800; Miller 7, lines 2-4.

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the facts, the parties offer the Commission an array of policy arguments and considerations related to the facts. Consistent with Staff's understanding of the Order rejecting the stipulations, Staff provides its policy recommendations for the issues in this proceeding. However, Staff also provides evidence of various scenarios and alternatives in order to give the Commission a full record to assist the Commission in making its policy choices.

II. DISCUSSION

<u>1. Intergenerational equity and basic fairness suggest that the total of environmental remediation insurance proceeds should be allocated fairly across the period and costs of expected environmental remediation requirements.</u>

On February 3, 2014, several months after the stipulations were rejected in this proceeding, NW Natural settled the last remaining insurance claims and will receive a total of $150.5 million in insurance proceeds for environmental remediation. According to NW Natural, this means that it will receive more insurance money than the amounts that have been deferred and that the Commission should use these insurance proceeds to erase the deferred balances, making the Docket No. UG 221-ordered earnings test moot.[3]

NW Natural argues that its environmental remediation expenses are unique in duration, magnitude, and kind by noting that the expenses have been deferred for approximately 10 years and are expected to continue well into the future, perhaps as long as 20 additional years. NW Natural notes that its deferrals to date exceed $100 million and future cumulative expenditures are expected to be in the range of $98-350 million or more.[4]

Taken together, NW Natural has environmental remediation expenses that could be $450 million or more and that could encompass 30 or more years. In addition, Staff's knows that all insurance proceeds for environmental remediation will be $150 million.[5] NW Natural proposes

[3] *See* NWN/800; Miller/7, lines 3-8.

[4] *See* NWN/800; Miller/3, lines 8-15.

[5] This amount constitutes settlement agreements with all but one of its insurers, which was a small company that is now insolvent. While NW Natural is working with the insurer's liquidator to see if it can obtain any additional resources, the $150.5 million in insurance proceeds is

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to use the insurance proceeds to first pay all of the historically deferred costs, which would obviate the need for any past earnings test and mean that NW Natural would not have to absorb any of the past expenses. No other party supports this treatment of insurance proceeds and Staff, CUB and NWIGU all recommend some type of allocation of insurance proceeds between past and future periods of environmental remediation costs.

In order to avoid more intergenerational inequity issues than already exist, Staff recommends that a portion of the insurance proceeds be allocated to future customers to offset future expenses. NW Natural has been incurring environmental remediation expenses and placing those costs in deferred accounts since 2003. However, deferred accounting is a statutorily created exception to unlawful retroactive ratemaking. As such, any of the past deferred amounts passed along to customers will be passed along to customers when the deferred accounts are amortized, not to customers during the time of the deferral expenses were incurred. If none of the insurance proceeds were reserved to offset future remediation costs – that could go on for 20 years or more – it would mean that current customers[6] would not only be paying for past and current environmental expenses, but that customers in the future horizon would not be allocated any insurance proceeds even though the insurance proceeds are for the totality of the environmental remediation costs.

Staff offers two proposals for the allocation of insurance proceeds that are aimed at limiting the already existing intergenerational equity issue, while also providing a fair allocation for current and future customers. Staff's primary recommendation is to allocate insurance proceeds roughly proportionally to the time periods when they occur. Environmental remediation expenses have been incurred since 2003 and are expected to continue as long as 20

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unlikely to change much, if at all, so Staff will use that number in this prehearing brief. *See* Staff/200; Johnson-Bahr/7, lines 15-21.

[6] In this context, "current customers" means customers over the five year period following a decision in this proceeding because once environmental remediation expenses, net applicable insurance proceeds, are placed within the SRRM mechanism, they will be amortized over the next five years through the SRRM.

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years. Staff created a 10:20 ratio based upon a past period of ten years and an estimated future period of 20 years, which results in one-third of the insurance proceeds being allocated to the past period and two-thirds of the insurance proceeds allocated to the future period. With $150.5 million in insurance proceeds to allocate, this results in $50.167 million allocated to the past period and $100.333 million allocated to the future period.[7]

Staff also offers an alternative recommendation on the allocation of insurance proceeds based upon the amount of expenses incurred in the past period and a NW Natural-estimated high-end total expected expenses for a future period. With past expenses of $94 million and estimated future expenses of $369 million ($19 million in 2013), this results in a conclusion that approximately 20 percent of the expected total costs occurred in the past period.[8]

The combination of Staff's two recommendations on the allocation of insurance proceeds creates a range of $30.1 to $50.167 million of the insurance proceeds allocated to the past period and a range of $100.333 million to $120.4 million allocated to the future period. Staff employs its primary recommendation of $50.167 million of insurance proceeds being allocated to the past period in its testimony in this proceeding. Staff notes that its primary recommendation allocates more insurance proceeds to the past period, which has the effect of creating lower net expenses that are subject to the earnings test and, thus, resulting in more of the deferred expenses being paid by customers. Generally speaking, the greater the amount of insurance proceeds allocated to the past period, the more customers will pay after the application of an earnings test.

<u>2. Staff's proposed allocation of insurance proceeds "within" the past and future periods is equitable and fair based upon the information currently known.</u>

For the past period, Staff recommends that the allocated insurance proceeds (*e.g.* $50.167 is Staff's primary recommendation) be apportioned to each year in the past period based upon a

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[7] *See generally* Staff/200; Johnson-Bahr/4, line 13 through Johnson/Bahr/5, line 3.

[8] *See* Staff/200; Johnson-Bahr/5, lines 4-10 (2003-2012 costs of $94 million, 2013 costs of $19 million, and expected future costs of up to $350 million stated as 94 ÷ (94 +19 + 350) = 20.302 percent).

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proportion of the amount of environmental remediation expenses incurred in each year.[9] Before making this recommendation, Staff also reviewed apportioning the allocation of insurance proceeds to the past period equally between each year in the past period. However, this alternative did not appear to fairly allocate the insurance proceeds and the apportionment had no relationship to when the costs were incurred. As a result, Staff discarded this methodology in favor of its current recommendation, which is to apportion the allocated insurance proceeds in the past period by year based upon the amount of expenses incurred in each year.[10]

For the future period, Staff recommends that the allocated insurance proceeds (*e.g.* $100.333 million is Staff's primary recommendation) be apportioned evenly over the next 20 years. This would apportion approximately $5 million of insurance proceeds per year for 20 years.[11] Because NW Natural will be holding the insurance proceeds allocated to the future period, Staff recommends that the insurance proceeds for the future period accrue interest at NW Natural's authorized rate of return, which parallels the rate at which the deferred expenses accrue interest.[12]

On the surface, it appears that Staff's recommendations for apportionment in the past and future periods are inconsistent. For the past period, Staff recommends apportioning the allocated insurance proceeds by year based upon the amount of deferred expense in that year. In the future period, Staff recommends apportioning the allocated insurance proceeds, plus accrued interest, by year equally. However, for the past period the Commission has year-by-year information for the expenses incurred in each year and it is fair and equitable to apportion insurance proceeds based upon expenditures for that year. In fact, it was Staff's preference to make this

[9] *See* Staff/200; Johnson-Bahr/6, lines 1-11.

[10] *See* Staff/200; Johnson-Bahr/6, line 22 through Johnson-Bahr/7, line 6.

[11] *See* Staff/200; Johnson-Bahr/20, lines 1-8.

[12] *See* Staff/200; Johnson-Bahr/5, lines 16-20.

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apportionment for both the past and future periods and we recommended it in earlier testimony in this proceeding.[13]

After reflection, however, Staff recommends that for the future period the allocated insurance proceeds be apportioned equally because it is not known how much will be expended in each future year. In addition, a future year-by-year true-up that apportions insurance proceeds according to the amount of expenses in each future year, while more equitable, seemed difficult to implement and would require a yearly true up. Nonetheless, year-by-year expenditures for the past period are available and Staff recommends making the most appropriate and fair apportionment for the past period, even if the same information for the future period is not available.

3. <u>The purpose of an earnings test when there is a deferred account balance is to determine whether the utility could absorb the deferred expenses during the representative period in which they were incurred.</u>

Ratemaking is a legislative act and generally prospective in nature and is intended to ensure that customers pay rates that reflect the cost of service at the time the service is rendered.[14] Retroactive ratemaking is prohibited, unless expressly authorized by the Legislature.[15] In Oregon, deferred accounting is a statutorily-created limited exception to the prohibition against retroactive ratemaking.[16] Staff notes that in some situations a utility is only allowed to defer a portion of the expenses related to its deferred accounting application.[17] However, in this proceeding, the entirety of NW Natural's environmental remediation expenses has been deferred and the only remaining question is how much of the deferrals should be amortized into future rates.

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[13] *See* Staff/100; Johnson-Bahr/9, line 17 through Johnson-Bahr/11, line 11.

[14] *See Re Portland Gen. Elec. Co.*, Order No. 08-487 at 29-30.

[15] *See In Re Portland Gen. Elec. Co.*, Order 87-1017.

[16] *See* ORS 757.259.

[17] *See e.g.* Docket No. UM 1234, Order No. 07-049 at 19-20.

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Ratemaking is holistic and based upon a reasonable "end result."[18] For example, the expenses established in rate cases are an estimate of what expenses will be in the future and are very rarely accurate _ some expenses could be more and some expenses could be less. The result, however, is still reasonable if the end result is reasonable, even if there are wide variances between certain estimated and actual expenses.

Even though deferred accounting creates a limited exception to the prohibition of retroactive ratemaking, ratemaking remains holistic and based upon a reasonable "end result." Specifically, the deferred accounting statute requires that the utility's earnings be reviewed before any amortization of deferred expenses is allowed.[19] As Commissioner Davis testified in support of the deferred accounting statute:

> The earnings review will allow the Commission to determine whether amortization of deferred income or expense amounts is warranted based on the utility's earnings; if earnings are higher than authorized, expense amortization through rates will not be appropriate.[20]

In testimony in this proceeding, NW Natural and Staff have both cited a Commission Order from 1993.[21] Besides the fact that the order is more than 20 years old, it is of limited actual guidance to the decisions in this proceeding. The order lists three classifications of when different earnings reviews may be conducted, but still uses discretionary language and vague terms such "bottom of a reasonable range," and "top of a reasonable range." Staff agrees that it is a policy decision for the Commission in this proceeding to determine the level of deferred

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[18] *See Fed. Power Comm'n v. Hope Natural Gas Pipeline*, 320 U.S. 591 (1944) ("Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling.")

[19] *See* ORS 757.259(5) ("amounts described in this section shall be allowed in rates only to the extent authorized by the commission in a proceeding under ORS 757.210 to change rates and upon review of the utility's earnings at the time of application to amortize the deferral.")

[20] Testimony of Commissioner Davis, Before the House Committee on Environment and Energy regarding HB 2145 at 5 (March 11, 1987).

[21] *See In Re Portland Gen. Elec. Co.*, Docket No. UE 82, Order No. 93-257 at 11-12.

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expenses NW Natural should be able amortize into future rates to bring NW Natural to a reasonable range of earnings.

NW Natural and Staff part ways, however, on the appropriate policy for amortization of deferred expenses and what constitutes a reasonable range of earnings. NW Natural proposes that it should be allowed to amortize deferred expenses up to a 100 basis points above its authorized rate of return.[22] Based upon Staff's understanding of deferred accounting as an exception to retroactive ratemaking that still contains protections to prevent deferred accounting from being applied as single issue ratemaking with no consideration for the holistic nature of ratemaking, Staff believes it is sacrosanct that deferred accounting should not be used to require customers to bear costs when the utility is earning more than its authorized return on equity. Furthermore, Staff argues that a reasonable range of earnings is 100 basis points below authorized return on equity, not 100 basis points above. For reasons discussed below, Staff recommends that the earnings test be set at 50 basis points less than authorized return on equity in this proceeding, but testifies that a range of up to 100 basis points below authorized return on equity is reasonable before customers start to contribute to the environmental remediation costs.

If the past is prologue, this proceeding could establish the foundation for the future policy considerations related to earning test ranges and earnings test periods. We are not without a past, however, because a fortuitously timed Oregon Court of Appeals case was issued only a few months ago. This decision affirms a Commission order in Docket No. UM 1224, and Staff believes it outlines the appropriate background for both the policy decision related to earnings test thresholds and the time period earnings are reviewed for an earnings test.

Docket No. UM 1224 involved an application for deferred accounting related to taxes Portland General Electric Company collected in rates, but did not pay to governmental taxing authorities. The deferral would have returned up to $26.5 million to customers. However, the Commission found, based upon an earnings test based upon the earnings at the time of the

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[22] *See* NWN/800; Miller/11, lines 7-17.

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deferral, that the deferred amount should not be amortized into rates.[23] The Utility Reform Project and Ken Lewis had raised issues related to the appropriate period to review earnings for the purpose of an earnings test. Because of the ambiguous language in the deferred accounting statute, the Commission went into a fair amount of detail regarding the context for ratemaking and the meaning of an earnings test and which period of earnings the Commission reviews in an earnings test. On February 26, 2014, the Oregon Court of Appeals affirmed the Commission's order in Docket No. UM 1224.[24] More importantly for the purposes of this proceeding, the Court of Appeals discussed the Commission's understanding of ratemaking and deferred accounting and relied on it to affirm the Commission's order. Because this Court of Appeals order illuminates the issues in this proceeding related to the earnings test for the past deferrals, Staff quotes from it at some length.

The Court of Appeals stated in part (emphasis added):

> Under ORS 757.259, in exceptional circumstances, the PUC has authority to permit the retroactive adjustment of rates through a 'deferral' of costs or revenues for later incorporation in rates.[25]
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> Under the limited circumstances listed in ORS 757.259, the PUC may exercise its discretion to defer expenses or revenues to a subsequent rate or rate schedule. 'Amortization' is the process by which a deferred expense or revenue becomes incorporated into a subsequent rate or rate schedule. ORS 757.259(5) provides that, unless subject to an automatic adjustment clause, the deferral and amortization of amounts described in subsection (2) 'shall be allowed into rates only to the extent authorized by the commission in a proceeding under ORS 757.210 to change rates and upon review of the utility's earnings at the time of the application to amortize the deferral. . .'[26]
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> ORS 757.259(5) expressly provides for consideration of a utility's earnings in making a determination whether to amortize the amount deferred.[27]
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[23] *See In Re Utility Reform Project,* Docket No. 1224, Order No. 09-316.

[24] *See generally Utility Reform Project v. PUC,* 261 Or.App. 338, 323 P.3d 430 (2014).

[25] *Id.* 261 Or.App. at 392.

[26] *Id.* at 393.

[27] *Id.* at 396.

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ORS 757.259(5) provides that the PUC may allow deferred amounts in rates only 'upon review of the utility's earnings at the time of application to amortize the deferral.' OAR 860-027-0300(9) provides in turn that upon request for amortization of a deferred amount, a utility must provide the PUC with 'its financial results for a 12-month period or for multiple 12-month periods to allow the Commission to perform an earnings review. The period selected for the earnings review will encompass all or part of the period during which the deferral took place or must be reasonably representative of the deferral period.'[28]

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[T]he PUC stated the question thusly:

> 'When there is a significant gap between the period of deferral and a utility's request for amortization, should the earnings that are reviewed, for the purpose of determining whether it is appropriate to reset rates to account for an unforeseen past event, be contemporaneous earnings or earnings contemporaneous with the deferral period?'

In resolving the question, the PUC broadened its inquiry, and asked what interpretation would be most consonant with the principles of utility ratemaking, **especially the principles that rates must be reasonable and that a utility's earnings must be within a reasonable range**. The PUC discussed the fundamental ratemaking goal of setting future rates, which provides the utility with the opportunity to collect revenue sufficient to recover reasonable operating expenses, and to earn a reasonable return on investments made to provide service. Necessarily, future rates must be based on the utility's best estimates of its future expenses and revenues and the utility must operate with rates in effect until future rates are approved in the next rate case. Because of the rule against retroactive ratemaking, as a general matter, adjustments to rates can only compensate the utility on a going-forward basis only. The general rate case does not provide a utility with an opportunity to recoup expenses beyond those forecast in prior rates; nor is the utility expected to remit revenues higher than those previously forecast.

The PUC explained that, in contrast, the deferred accounting process set forth in ORS 757.259, is a mechanism intended to deal with unanticipated expenses and revenues for future recovery in rates. It allows rates to be tracked in a balancing account and adjusted outside of the general rate case when certain expenses or revenues arise that are deemed to be exceptional.

The PUC explained that:

> 'Amortization permits the utility to recover or return an amount in a deferred account in future rates, over some period of time. **ORS 757.259 directs us to review a utility's earnings before we authorize the amortization of a deferred account, but the current statute does not elaborate with regard to the purpose of or the process for review.**'
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> **'We find, however, that the general principles of ratemaking guide us**. If a utility has the responsibility, under general ratemaking, to operate within a fixed level of rates

[28] *Id.*

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> despite actual costs or revenues while striving to earn a certain level of return, then it seems appropriate to determine under deferred accounting, whether the utility actually operated within in fixed rates despite the deferral of certain funds. **If the utility operated within its fixed rates, then the need to amortize the deferred funds is obviated. Reviewing the earnings of a utility during the deferral period provides the Commission with an opportunity to confirm whether costs or revenues that were deferred were truly exceptional, or whether they were absorbed by the utility.**'
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> 'Based on this reasoning, we conclude that ORS 757.259 [(5] directs us to review a utility's earnings for an interval that includes the deferral period. Reviewing earnings that are entirely distinct from a deferral period would be inconsistent with general principles of ratemaking and deferred accounting. It is appropriate to review a utility's recent earnings when forecasting rates for the future. In contrast, in the extraordinary situation of deferred accounting, it is appropriate to review the utility's earnings during the deferral period in order to determine whether retroactive ratemaking is appropriate to address the exceptional revenues or expenses that were deferred. **If past ratepayers paid an appropriate amount of rates for services received, it is inappropriate to burden or enrich further ratepayers based on retroactive events.**'

> As we understand the PUC's reasoning, amortization is an exception to the rule against retroactive ratemaking, because it allows an adjustment to future rates based on past earnings or expenses; for that reason, it is permitted only in exceptional circumstances. **A review of a utility's earnings allows the PUC to inquire whether the extraordinary measure of amortization of the deferred amount is justified, i.e., despite the deferred costs or revenues, did the utility earn a reasonable return on equity during the period of the deferral and did ratepayers pay an appropriate rate for services received? If, despite the deferred costs or revenues, the utility earned a reasonable return on its equity and ratepayers paid a reasonable rate for services, then, according the PUC's reasoning, the deferred amounts were not exceptional and should not be amortized**. Necessarily, that means that the period of the deferral must be part of the earnings review because that is the only way to determine whether the deferred amounts were indeed exceptional. OAR 860-027-0300(9) is consistent with that reasoning to the extent that it requires that '[t]he period selected for the earnings review will encompass all or part of the period during which the deferral took place or must be reasonably representative of the deferral period.'[29]
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> We are persuaded by the PUC's reasoning.[30]

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[29] *Id.* at 399-402.

[30] *Id.* at 402.

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The language from Order No. 09-316 and the recent Court of Appeals order that affirms and adopts the Commission's reasoning related to the purpose of the earnings test in the deferred accounting statute is the best prologue we have to the earnings test issues presented in this proceeding. It is possible that Staff suffers from confirmation bias, but our reading of this language suggests that amortization of deferred balances were not intended to de facto guarantee that a utility would earn its authorized rate of return through the amortization of deferrals. At a minimum, employing deferred accounting and amortization of deferred balances to allow a utility to earn more than its authorized return on equity appears to be inconsistent with the general ratemaking considerations discussed in quoted language.

In addition, the quoted language supports the application of an earnings test through a year-by-year review of earnings. At first blush, OAR 860-027-0300(9)'s language that the earnings review "must be reasonably representative of the deferral period" could be used to contend that the "deferral period" is the years 2003 through 2013. However, as the general ratemaking principles make clear, the exercise should determine whether or not the utility could absorb the deferred expenses in the year they were incurred. Staff notes that deferrals are only granted for up to 12 months and that if a deferral goes longer than 12 months a utility or party must request a deferral up to another 12 months and so on.[31]

<u>4. Staff's recommended earnings test for the past deferred environmental remediation expenses is consistent with good regulatory policy and general ratemaking principles.</u>

Staff's primary recommendation for an earnings test applied to the past deferred account expenses is to perform an annual earnings test on the net deferral (deferred expenses minus apportioned insurance proceeds) and allow NW Natural to collect 100 percent of its prudently incurred costs up to 50 basis points below its authorized return on equity.[32] Staff notes that in

[31] *See* OAR 860-027-0300(2) ("Expiration: Any authorization to use a deferred account shall expire 12 months from the date the deferral is authorized to begin. If a deferral under ORS 757.259 or 759.200 is reauthorized, the reauthorization shall expire 12 months from the date the reauthorization becomes effective.")

[32] *See* Staff/200; Johnson-Bahr/9, lines 13-18.

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principle it would recommend a threshold of 100 basis points below authorized return on equity for amortization of deferred expenses. However, Staff was uncomfortable making its principled recommendation in this proceeding because it would result in NW Natural bearing approximately 90 to 95 percent of the historic environmental remediation costs, a result that made Staff uncomfortable. As a result, Staff moderated its approach and recommended a threshold of 50 basis points below authorized return on equity. However, Staff's earlier testimony in addition to its most recent testimony, would support an earnings test threshold of between 100 basis points below authorized return on equity up to authorized return on equity.[33]

Staff's primary recommendation for an earnings test applied to the past deferred account expenses is to perform an annual earnings test on each year's earnings rather than an earnings test applied on NW Natural's cumulative or average earnings from the historic period because this method is consistent with Commission principles and good regulatory policy. If the purpose of deferred accounting is to allow recovery of extraordinary costs that could not fairly be absorbed by the utility, it should be recognized that environmental remediation costs were incurred in different years at different amounts and the NW Natural had different earnings in each year. The only method to fairly determine whether or not NW Natural could have absorbed some or all of the costs is to review the earnings during the year the costs were incurred.[34] As an example, if a utility deferred $10 million in deferred expenses in year X and also over-earned by $15 million in year X, then in year Y the same utility deferred $0, but under-earned by $25 million largely related to a prudence disallowance, should the utility be allowed to combine the years to demonstrate overall the utility should be able to amortize $10 million? If the Commission were to allow utilities to use cumulative or average earnings, it could potentially be subject to gamesmanship. Staff is not suggesting that NW Natural has engaged in gamesmanship, only that the creation of such a policy may result in utilities timing amortization

[33] *See* Staff/200; Johnson-Bahr/9, line 19 through Johnson-Bahr/10, line 16; Staff/200; Johnson-Bahr/12, lines 1-9.

[34] *See* Staff/200; Johnson-Bahr/11, lines 13-22.

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requests when cumulative or average earnings result in a more favorable outcome than an earnings test on each year's earnings.

Staff's primary recommendation for the application of an earnings test is to include Weighted Adjusted Cost of Gas ("WACOG") revenues and 90 percent of AMA Optimization revenues[35] in the earnings test each year. NW Natural's earnings from WACOG and AMA Optimization are directly attributable to regulated operations and an accurate and meaningful earnings test should include all revenue attributable to regulated operations. If NW Natural were to earn large AMA optimization revenues, customers should not be forced to pay for environmental remediation costs when NW Natural's earnings from regulated operations result in overall rates that are just and reasonable. However, in order to recognize that there is no upfront sharing in the application of an earnings test on the historic deferred expenses, Staff recommends only including 90 percent of the AMA Optimization revenues to assure NW Natural will retain at least a portion of the revenues.[36]

Staff also provided an alternative recommendation for the application of an earnings test and apportionment of insurance proceeds to the past period. Under Staff's alternative approach, the insurance proceeds allocated to the past period are apportioned after, not before, the earnings test is performed. After the earnings test is performed, and without first applying the apportioned insurance proceeds, the apportioned insurance proceeds would then be allocated between customers and NW Natural based upon the cumulative sharing percentage determined by the earnings test, *e.g.* the apportionment of insurance proceeds would be determined by the results of the earnings test, rather than factored into the earnings test. Under this approach, Staff included Table 4, which indicates potential results given various earnings test thresholds.[37]

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[35] "AMA Optimization" is intended to have the same meaning as the term is used in UM 1654 – income derived or made possible by the use of customer-funded assets. *See* Docket No. UM 1654; Staff's Prehearing Brief at 2, lines 22-23.

[36] *See* Staff/200; Johnson-Bahr/13, line 3 through Johnson-Bahr/14, line 7.

[37] *See* Staff/200; Johnson-Bahr/15, line 9 through Johnson-Bahr/16, line 10.

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In addition to providing a primary and alternative recommendation, Staff provided additional information for the record to allow the Commission to view results under different scenarios, such as different earnings test thresholds, inclusion and exclusion of WACOG and AMA Optimization.[38] Staff also provided this type of additional information for its alternative recommendation.[39]

<u>5. Staff's recommended treatment of future environmental remediation costs in the SRRM's automatic adjustment clause is based upon good regulatory policy and general ratemaking principles.</u>

Staff's recommendation for determining customers' responsibility for future environmental remediation costs is to conduct an earnings test each year using revenues, including 100 percent of WACOG and 90 percent of AMA Optimization revenues. Staff would then reduce the environmental remediation costs for that year by $5 million, plus accumulated interest. Of the environmental remediation costs remaining at that point, 10 percent would be allocated to shareholders to ensure that NW Natural has an incentive to control costs. The remaining 90 percent would be paid by customers through the SRRM.[40]

Staff recommends that the threshold for the earnings test in future years be established at authorized return on equity. Staff recommends a higher earnings threshold on a going-forward basis than that recommended for past costs because Staff's recommendation going forward includes 90/10 sharing of costs prior to the application of the earnings test.[41] If the Commission desired to treat the historic costs in this same manner, it could use the evidence in the record to calculate 90/10 sharing of deferred environmental remediation costs prior to application of the earnings test and then establish the earnings threshold at authorized return on equity.[42]

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[38] *See generally* Staff/200; Johnson-Bahr/12-15; Staff Exhibit 201.

[39] *See generally* Staff/200; Johnson-Bahr/15-18; Staff Exhibit 201.

[40] *See* Staff/200; Johnson-Bahr/20, lines 1-18.

[41] *See* Staff/200; Johnson-Bahr/20 line 19 through Johnson-Bahr/21, line 2.

[42] *See* Staff/201; Johnson-Bahr/3. Based upon Staff's calculation using the information is this exhibit, beginning with 90/10 sharing then applying an earnings test up to authorized return on

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6. The results of Staff's prudence review should be adopted in this proceeding.

Staff maintains its position as outlined in opening testimony that NW Natural's environmental remediation costs through 2012, except for $33.4 thousand that NW Natural insufficiently explained and failed to support, should be deemed prudent and placed in the SRRM.[43]

7. The historic allocation factor between Oregon and Washington should be used to allocate environmental remediation costs because it appropriately matches the benefits and burdens of the site.

Staff maintains the position it outlined in opening testimony that using the historic allocation factor, rather than the current allocation factor, is more consistent with the benefits and burdens of the site.[44] Specifically, the benefits of the plant when it was in operation were allocated to Oregon under the historic allocation factor. As a result, matching the benefits and burdens would suggest that because customers were given the benefit under the historic allocation factors, they should also be responsible for the historic allocation of the burden of site remediation.

8. The environmental remediation costs that are charged to customers should be based upon an equal percentage margin basis.

Staff recommends that the rate allocation be based upon equal percentage margin basis as discussed in testimony supporting the rejected Stipulation.[45] As summarized in the Commission Order rejecting the stipulations:

> The parties agreed that the rate spread will not change from an equal percent of margin basis during the period over which the costs are collected through the SRRM, although the actual percentages billed may vary. . . . To the extent insurance proceeds or other recoveries reduce the amounts charged to customers

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equity would result in customers bearing approximately $2.4 million more of the deferred environmental remediation costs than reflected in Staff's primary recommendation.

[43] *See* Staff/200; Johnson-Bahr/3, lines 8-15.

[44] *See* Staff/200; Johnson-Bahr/4, lines 1-6.

[45] *See* Staff/200; Johnson-Bahr/4, lines 7-12.

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through the SRRM, those receipts will reduce costs to each customer class based on the same equal percentage of margin basis.[46]

9. The Commission should adopt a cap on time or costs before which NW Natural's environmental remediation costs should be reviewed again.

Staff recommends that the decision in this proceeding be reviewed in five years or when future expenditures reach $100 million, whichever occurs first.[47] There is much uncertainty about the scope and magnitude of future environmental remediation costs. In addition, it would be insightful to look back and view how the policy decisions made in this proceeding are working in fact. As a result, Staff contends it makes sense to adopt a time and cost cap that would allow review of how the SRRM operated and whether alterations are warranted.

III. CONCLUSION

For the reasons set forth herein, Staff respectfully requests that the Commission adopt its primary recommendations in this proceeding.

DATED this 2nd day of July 2014.

Respectfully submitted,

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Of Attorneys for Staff of the Public Utility Commission of Oregon

[46] *See* Docket UM 1635; Order No. 13-424 at 5.

[47] *See* Staff/200; Johnson-Bahr/21, lines 13-18.

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CERTIFICATE OF SERVICE

I certify that on July 2, 2014, I served the foregoing Staff Prehearing Brief upon the following parties in this proceeding by sending a true, exact and full copy by electronic mail only as all parties waive paper service.

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