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July 2, 2014

VIA ELECTRONIC FILING AND FIRST CLASS MAIL

PUC Filing Center
Public Utility Commission of Oregon
PO Box 1088
Salem, OR 97308-1088

Re: Docket UM 1635 – Northwest Natural Gas Company's Mechanism for Recovery of Environmental Remediation Costs

Attention Filing Center:

Enclosed for filing in the above-captioned docket are an original and five copies of Northwest Natural Gas Company's Pre-Hearing Brief.

A copy of this filing has been served on all parties to this proceeding as indicated on the enclosed Certificate of Service.

Please contact this office with any questions.

Very truly yours,

Wendy McIndoo
Office Manager

Enclosure

cc: Service List

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1 **BEFORE THE PUBLIC UTILITY COMMISSION OF OREGON**

2

3 **UM 1635**

4 **PHASE II**

5

6 In the Matter of 7 PUBLIC UTILITY COMMISSION OF OREGON, 8 9 Mechanism for Recovery of Environmental Remediation Costs.	**NORTHWEST NATURAL GAS COMPANY'S PRE-HEARING BRIEF**

10

11 **I. INTRODUCTION**

12 Pursuant to the Ruling issued by Administrative Law Judge Shani Pines on February 13 6, 2014, Northwest Natural Gas Company ("NW Natural" or "Company") files this Pre-14 Hearing Brief with the Public Utility Commission of Oregon ("Commission"). The purpose 15 of Phase II of this docket is to determine the earnings test to be applied to recovery of NW 16 Natural's environmental remediation costs under the Site Remediation Recovery 17 Mechanism ("SRRM"). Phase II also addresses the prudence of NW Natural's 18 environmental remediation costs deferred to date, the appropriate rate spread to apply to 19 the amortized costs under the SRRM, and the appropriate Oregon/Washington 20 jurisdictional allocation to apply to cost recovery of remediation expenses.

21 NW Natural has proposed the following framework for the earnings review:

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- NW Natural will apply the roughly $150 million of insurance proceeds to the 23 deferral balance of roughly $100 million, thus eliminating the need to charge customers for the remediation expenses. 24 The Company will continue to offset future expenses with the remaining roughly $50 million of insurance 25 proceeds until the deferral account has a positive balance, at which time the balance will be recovered through the SRRM adopted by the Commission.

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- Going forward, the Company will apply an earnings review that would require the Company to offset environmental expenses with any earnings above 100 basis points above the authorized return on equity ("ROE").

3 This proposal is simple, straightforward, and most importantly, will further the
4 important policy considerations at issue in this case.

5 ***First, the Company's proposal recognizes that there is no net expense,***
6 ***eliminating the need to immediately begin charging customers.*** The Commission
7 orders have always made clear that the Company is to defer environmental remediation
8 expenses only to the extent that they exceed recoveries and that continued deferrals were
9 conditioned on the Company demonstrating that it was aggressively pursuing and
10 maximizing its insurance recoveries.[1] Indeed, in approving the deferral of the
11 expenditures offset by the recoveries, the treatment ordered by the Commission can best
12 be described as a balancing account. Therefore, the Company has appropriately stated
13 that it is no longer seeking amortization of deferred expenses, and there is no reason for
14 the Commission to conduct an earnings review.

15 ***Second, the Company's proposal for a forward-looking earnings review***
16 ***recognizes the nature of the remediation expenses at issue.*** In Order No. 93-257 the
17 Commission issued guidelines for earnings reviews for deferrals, clarifying that the type of
18 earnings review would be tailored to the costs under consideration.[2] The Commission
19 indicated that for deferrals of amounts that should be included in rates but are deferred to
20 better match costs and benefits, it is reasonable to allow amortization up to the top of a
21 reasonable range. The costs under consideration in this case clearly fall into this
22 category. The environmental remediation expenses are costs that are properly included in
23 rates. Indeed, recently the Commission approved the use of balancing accounts and

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25 [1] *See e.g.*, *Northwest Natural Gas Co.*, Docket UM 1078(8), Order No. 11-336, Appendix A at 3 (Aug. 30, 2011).

26 [2] *Portland Gen. Elec. Co. Application for an Order Approving Deferral of Costs*, Dockets UM 445 and UE 82, Order No. 93-257 at 11-12 (Feb. 22, 1993).

1 specific tariff riders to ensure that utilities recover their decommissioning and remediation
2 costs in their entirety and without being subject to an earnings test. Moreover, the deferral
3 was clearly granted to better match costs and benefits. Thus, the Company's proposal,
4 which requires shareholders to assume remediation costs if earnings exceed 100 basis
5 points above the Company's authorized ROE—a level that the Commission has indicated
6 in the past is within the reasonable range—is appropriate. This is particularly reasonable
7 given the level and duration of the remediation costs.

8 ***Third, the Company's proposal reasonably balances the interests of customers***
9 ***and the Company.*** Offsetting the historical deferrals with the insurance proceeds
10 prevents an unnecessary rate spike and avoids the immediate inclusion of remediation
11 expenses in customers rates. For the prospective earnings review, the Company's
12 proposal strikes a fair balance between customers and the shareholders by setting the
13 earnings review at 100 basis points above authorized ROE. Rates will appropriately
14 include remediation expenses, unless the utility is earning above a reasonable range, at
15 which point shareholders will assume a portion of the expenses.

16 ***Fourth, the Company's proposal maintains the incentive for good management***
17 ***inherent in the regulatory construct and the Commission's incentive related to gas***
18 ***commodity cost savings ("WACOG savings").*** By allowing the Company the
19 opportunity to earn more than its authorized ROE the Company's proposal ensures that
20 the Company is still incented to pursue cost savings that ultimately benefit customers. In
21 addition, the Company's proposal protects the ability for shareholders to benefit from the
22 revenue sharing incentive that the Commission has adopted to incent gas commodity
23 savings.

24 The other parties' recommendations vary in their specific terms but all include an
25 earnings test that severely undermines incentives for many years. In the case of Staff and
26 CUB, the proposed earnings tests will result in a de facto cap on the Company's earnings

at or likely below its authorized ROE. All three parties also propose that shareholders pay a portion of the remediation expenses, regardless of the Company's earnings, through sharing. The parties also recommend that the Commission disallow the Company from recovering substantial deferred amounts, even though the Company's aggregate earnings during the deferral period were less than its authorized ROE and doing so could materially and adversely affect the Company's financial risk profile. Unlike the Company's proposal, these recommendations are inconsistent with the policy considerations that should guide the earnings review.

II. BACKGROUND

Beginning in the early 1990s, NW Natural became aware of potential environmental clean-up obligations related to historical manufactured gas plants ("MGP") operated by NW Natural's prior owners. After the Environmental Protection Agency ("EPA") placed the Portland Harbor on the Superfund list, the Company started incurring substantial environmental remediation expenses. By 2003, the Company had incurred approximately $5 million.[3] While the Company had insurance to recover some or all of the costs incurred, and while other "potentially responsible third parties" ("PRPs") may provide contributions that would offset some of the costs, such recoveries were uncertain as to timing and amount. For that reason, the Company began considering appropriate mechanisms for recovering any costs not offset by insurance or PRPs.

After consideration, NW Natural rejected the idea of forecasting the environmental remediation expenses into base rates. First, the Company believed that it would likely soon have enough insurance to offset its costs, and therefore it made no sense to build the expense into customers' rates. Moreover, the environmental remediation expenses did not lend themselves to traditional ratemaking because they were highly variable from

[3] NWN/100, Miller/5-6.

1 year to year, outside of the Company's control, and subject to offsets from insurance
2 recoveries.

3 For these reasons, the Company concluded that the normal approach to estimating
4 test year expenses and recovering these expenses through base rates was unsuitable and
5 could lead to dramatic understatement or overstatement of these costs in rates.[4] Thus the
6 Company determined that the best protection for customers—and the Company—would
7 be the balancing account approach that was adopted by the Commission, whereby the
8 Company would defer environmental remediation expenses, with appropriate offsets for
9 insurance.[5] This approach would permit the Company to fully recover its prudently-
10 incurred costs and give customers the full benefit of all insurance recoveries.[6]
11 Accordingly, in 2003, the Company requested approval to defer its environmental costs
12 and any offsetting insurance proceeds, and to address cost recovery in a future rate case
13 once the magnitude of the amounts became clear. The Commission approved the
14 request.[7]

15 Over the following years the Company's remediation expenses continued to mount.
16 The Company vigorously pursued its insurance carriers; unfortunately, virtually all resisted
17 payment, and in 2007 the Company was forced to sue.[8] As the insurance litigation
18 dragged on, Staff began expressing concern regarding the amount of the deferral balance.
19 Accordingly, in its 2011 rate case, the Company proposed that it begin recovering the
20 deferral balance—net of insurance recoveries—through the SRRM.[9]

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22 [4] NWN/100, Miller/6.

23 [5] NWN/800, Miller/3.

24 [6] NWN/800, Miller/3-4; *see also*, NWN/100, Miller/6-7.

[7] *Northwest Natural Gas Co.*, Docket UM 1078, Order No. 03-328 (May 27, 2003).

25 [8] NWN/800, Miller/4.

26 [9] *Northwest Natural Gas Co.*, Docket UG 221, NWN/1500, Miller/2.

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It was in the context of the 2011 rate case that Staff and the parties first argued that an overly restrictive earnings review should be applied. Throughout that case, the parties voiced disapproval that the Company had earned in excess of its authorized ROE in the three years leading up to the rate case. Consistent with this theme, the parties argued that the Company should use those earnings to pay for a portion of the environmental remediation expenses[10]—despite the fact that, on average, during the period when the expenses were deferred, NW Natural earned below its authorized ROE, and despite the fact that it was likely the Company would ultimately receive insurance sufficient to offset the deferred amounts. The Commission agreed that an earnings review should be applied to the deferred amounts, but deferred a decision on the structure of the earnings review to this docket.[11]

In Phase I, the parties' proposals were far apart, but ultimately the parties resolved their differences with a settlement that they believed was based on sound regulatory policy and would produce fair and reasonable rates.[12] In a split decision, a majority of the Commission rejected the stipulation, stating that they did not believe the stipulation's disallowance of past expenses was sufficient, and further that the parties should not attempt to settle the issue. With those comments, the docket was continued into this Phase II.

[10] *See e.g., Re Northwest Natural Gas Co.*, Docket UG 221, Staff's Post-Hearing Brief at 27 (Sept. 12, 2012); *Re Northwest Natural Gas Co.*, Docket UG 221, NWIGU's Post-Hearing Brief at 3 (Sept. 12, 2012); *Re Northwest Natural Gas Co.*, Docket UG 221, Citizens' Utility Board of Oregon's Opening Brief at 31 (Sept. 12, 2012).

[11] *Northwest Natural Gas Co.*, Docket UG 221, Order No. 12-437 at 31-32 (Nov. 16, 2012).

[12] Joint Testimony/100, Joint Parties/13 ("each Party has reviewed all of the terms contained in the Stipulations, along with the costs resulting from the application of the terms of the Stipulations. The Parties agree that the terms of the Stipulations will result in fair, just, and reasonable rates and that the terms of the Stipulations fall within the 'range of reasonableness' for resolution of these issues.").

Then, in January of 2014, the Company negotiated a "court house steps" settlement with the remainder of the carriers in the insurance litigation. The Company has now resolved all of its insurance claims, with recoveries totaling approximately $150 million. Thus, the total insurance proceeds recorded in the Company's deferral account exceed total environmental remediation expenditures by approximately $35 million,[13] and the Company is no longer requesting amortization of the deferred amounts.

III. ARGUMENT

A. The Commission should Adopt NW Natural's Prospective Earnings Test.

The structure and design of the SRRM's earnings test is not specifically mandated by statute. As an automatic adjustment clause, the Commission is not required to apply an earnings review prior to allowing amortization of the deferred remediation expenses.[14] Indeed, even for ordinary deferrals the Commission has flexibility in fashioning the earnings review to the specific issues presented by each deferral. The Commission has, nevertheless adopted guidelines for earnings tests and has concluded that earnings tests should be designed specifically to address the reasons for the deferral and the nature of the particular costs being deferred.[15] The Commission should adopt an earnings test consistent with this precedent. Here, the remediation expenses represent utility costs that should be included in rates and will be substantial in amount and incurred over a long period of time. Therefore, consistent with the Commission's articulated principles the earnings test should allow NW Natural to amortize the remediation expense up to the top of a reasonable range, which is appropriately defined as 100 basis points above authorized ROE.

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[13] NWN/900, Miller/6.

[14] ORS 757.259(5).

[15] Order No. 93-257 at 11-12.

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1. Commission Precedent Supports an Earnings Test that allows NW Natural to Earn Up to the Top of a Reasonable Range.

The purpose of an earnings test is to ensure that customers are not required to bear expenses that are deferred when the utility's earnings are unreasonably high and also to ensure that the Company can recover prudently incurred expenses when its earnings are within a reasonable range.[16] In this way, the earnings test protects both the Company and customers.[17]

Order No. 93-257, which provides the Commission's framework for deferral earnings reviews, describes three types of deferrals and the type of earnings test applicable to each:

> (1) For deferrals related to an emergency increase in cost, the Commission may apply an earnings test to allow the utility to amortize the deferral to the degree that it raises the utility's earnings to the bottom of a reasonable range of rate of return with the goal of encouraging the utility to control costs.
>
> (2) If the deferral created a fund for the benefit of customers, the Commission could apply an earnings test that would require the utility to refund the deferral up to the amount that would bring the utility's earnings to the bottom of the reasonable range of rate of return.
>
> (3) If the deferral was of a cost that was intended to be borne by customers but was delayed in order to match costs and benefits, the Commission might apply an earnings test that would allow the utility to amortize the deferral up to the top of a reasonable range of rate of return.[18]

The remediation costs here fit squarely into the third category—deferrals of a cost intended to be borne by customers that were delayed to match costs and benefits.[19] *First*,

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[16] *Re Portland General Electric Co.*, Dockets UE 180/UE 181/UE 184, Order No. 07-015 at 26 (Jan. 12, 2007).

[17] *Id.*

[18] Order No. 93-257 at 11-12.

[19] NWN/800, Miller/10.

1 the deferral was adopted to match costs and benefits.[20] As described above, the
2 environmental remediation costs being deferred are highly variable from year to year,
3 difficult to predict, outside the Company's control, and subject to offsets through insurance
4 recoveries and payments by PRPs. As such, any attempt to build them into base rates
5 would almost certainly result in significant over- or under-recoveries.

6 *Second*, in docket UG 221 the Commission specifically rejected sharing proposals,
7 suggesting its view that these are costs that should be borne by customers and not by
8 shareholders.[21] Further, the remediation expenses are mandated by regulatory authorities
9 and are therefore similar to costs that are imposed by other regulators, such as the
10 Federal Energy Regulatory Commission, and regularly passed through to retail
11 customers.[22] In fact, as discussed below, remediation expenses are essentially
12 decommissioning costs, which are costs intended to be recovered in rates.[23]

13 Accordingly, the Company's proposed earnings test appropriately allows the
14 Company to amortize the deferred expenses up to the top of a reasonable range. While
15 the Commission has never set a hard and fast rule for calculating the top of a reasonable
16 range of ROE, that threshold has been set at 100 basis points above ROE for the
17 purposes of the Company's Purchased Gas Adjustment ("PGA") mechanism in each year
18 since 2008.[24] While there are many characteristics that differ between the SRRM and the

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20 [20] When the Commission reauthorized the Company's continuing remediation deferral, Staff's report, adopted by the Commission, states that the deferral is authorized "pursuant to ORS 757.259(2)(d) because they are utility expenses or revenues, the recovery or refund of which the
21 Commission finds should be deferred in order to minimize the frequency of rate changes or to match appropriately the costs borne by and benefits received by ratepayers." *Re Northwest Natural*
22 *Gas Co.*, Docket UM 1078(11), Order No. 14-051, Appendix A at 2 (Feb. 18, 2014).

23 [21] Order No. 12-437 at 31-32.

24 [22] *See e.g.*, *Avista Corp.*, Dockets UG 182/UM 1390, Order No. 08-524 (Oct. 30, 2008) (transportation demand charges established by FERC passed through to customers).

25 [23] NWN/900, Miller/9-10.

26 [24] NWN/800, Miller/11-12; *Investigation into the Purchased Gas Adjustment Mechanism Used by Oregon's Three Local Distribution* Companies, Docket UM 1286, Order No. 08-504 (Oct. 21, 2008).

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PGA, both earnings reviews address the same fundamental question—at what level are the Company's earnings unreasonable and subject to sharing? Thus, the range of reasonable earnings for both mechanisms should logically be the same.[25]

2. The Company's Proposal is Consistent with How Remediation Costs are Recovered from Customers.

The costs at issue in this case are prudently incurred remediation costs of the type that utilities typically recover from customers.[26] Given this fact, it is particularly appropriate for the Commission to impose an earnings review that allows the Company to earn up to the top of a reasonable range.

In docket UG 221, the Commission specifically rejected proposals that called for the Company to assume some portion of the remediation expenses through a sharing arrangement.[27] In rejecting these proposals, the Commission confirmed that it is appropriate to recover these environmental remediation costs in rates.

Moreover, the recovery of remediation expenses from customers is consistent with the usual treatment of costs associated with decommissioning and remediating former utility plants.[28] The Commission has frequently authorized utilities to recover decommissioning costs through balancing accounts or other mechanisms that have allowed the utility to recover the entirety of its costs—without an earnings review or sharing.[29]

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[25] NWN/900, Miller/29-30.

[26] NWN/900, Miller/9.

[27] Order No. 12-437 at 31-32.

[28] NWN/900, Miller/9-10. In Order No. 95-322 the Commission adopted Staff's usage of the term "decommission" to "include all activities related to removing total plant from service and restoring the site to unrestricted use." *Portland General Elec. Co.*, Docket UE 88, Order No. 95-322, 160 P.U.R.4th 201, 1995 WL 261532 (Mar. 29, 1995).

[29] *See e.g., Portland General Elec. Co.*, Docket UP 274, Order No. 11-204 (June 23, 2011) (approving PGE's use of Property Transaction Balancing Account to ensure full cost recovery of decommissioning costs associated with Bull Run Hydro Plant); *PacifiCorp*, Docket UE 246, Order No. 12-493 at 3 (Dec. 20, 2012) (approving stipulation allowing PacifiCorp to recover

1 For example, the Commission recently allowed recovery of decommissioning costs
2 for the Boardman plant.[30] For PGE, the Commission approved a special tariff that will be
3 updated annually based on changes in expected decommissioning costs.[31] Thus, it
4 appears that PGE will recover the entirety of the Boardman remediation expenses from
5 customers through a mechanism similar to a balancing account. In Idaho Power's case,
6 the Commission approved a balancing account—supported by both Staff and CUB—that
7 allows Idaho Power to recover dollar-for-dollar the remediation expenses from customers
8 without an earnings review of any kind.[32]
9 The Commission ordered similar treatment of PacifiCorp's decommissioning costs
10 for its Powerdale plant, thus ensuring full recovery. Specifically, in Order No. 07-375, the
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12 decommissioning costs for Carbon plant, including monthly fluctuations in decommissioning costs);
13 *PacifiCorp*, Docket UE 246, PAC/1100, Dalley/12-13 (Mar. 1, 2012); *Portland General Elec. Co.*, Docket UP 232, Order No. 06-184 (Apr. 14, 2006) (approving PGE's sale of utility property that was
14 no longer necessary for utility service after deducting from the gain allocated to customers the costs of environmental remediation of the site). Pursuant to OAR 860-001-0460(1)(d), the Company
15 requests that the Commission take official notice of the referenced testimony from docket UE 246 as a document "in the files of the Commission that [has] been made a part of the files in the regular
16 course of performing the Commission's duties."

[30] NWN/900, Miller/9-10.

17 [31] *Portland General Elec. Co.*, Docket UE 230, Order No. 11-242, Appendix A at 4 (July 5, 2011)
18 ("During further discussions, PGE agreed to separately track the incremental decommissioning costs (approximately $20.7 million) in sub-accounts to FERC Accounts 108, 230 and 254. This
19 separate accounting will serve as an easy means by which to audit the balance and will separately track revenues intended to cover decommissioning costs. In addition, beginning June 15, 2012,
20 PGE has agreed to submit an annual informational report to all UE 230 parties that will include the current balance of dollars collected for decommissioning and any relevant changes to PGE's
21 forecasts of future decommissioning costs. This informational report will provide Staff and intervenors the opportunity to review any changes PGE may request in advance of its November 1
22 annual update. Finally, PGE also agrees to submit its November 1 annual update as a supplemental filing in this docket (UE 230).").

23 [32] NWN/900, Miller/9-10; *See Idaho Power Co.*, Docket UE 239, Joint Explanatory Brief at 8-9 (May 24, 2012) ("the Stipulating Parties agree that the Company's proposed balancing account is
24 reasonable and will ensure that customers pay no more and no less than the full revenue requirement impacts of early Boardman retirement over the remaining nine years of the plant's life,
25 and will ensure that the Company is provided an opportunity to experience the full recovery of Boardman-related costs by Boardman's scheduled life end of 2020."). The stipulation was
26 ultimately approved by the Commission in Order No. 12-235.

Commission allowed PacifiCorp to record decommissioning costs of $6.3 million "with provisions for a final true up for actual expenditures."[33]

The fact that the remediation expenses here relate to plants that are no longer operating does not alter the fundamental nature of the expense.[34] On the contrary, the Commission has specifically allowed utilities to recover decommissioning costs associated with plants even after the plant is no longer in service. Allowing such recovery is appropriate here—particularly where the remediation expenses are required by current environmental laws and regulations, not laws and regulations that were in effect when the MGPs were operational or retired.[35]

3. The Company's Proposal Recognizes that Remediation Costs are Substantial in Amount and Long-term in Nature.

The earnings test in this case must account for the amount and duration of the remediation expenses and the long-term impact of the earnings test on NW Natural. The Company has incurred nearly $100 million in remediation expenses over the last 10 years and may incur an additional $350 million over the next 20 years.[36] By way of comparison, in 2013 the Company's net revenues were $81 million—meaning that the remediation expenses could approach significant percentages of the Company's annual earnings and,

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[33] *PacifiCorp*, Docket UM 1298, Order No. 07-375 Appendix A at 3 (Aug. 23, 2007). PacifiCorp then amortized the decommissioning regulatory asset in subsequent rate cases. *See PacifiCorp*, Docket UE 246, PAC/1100, Dalley/34 (Mar. 1, 2012) ("Powerdale was decommissioned after it was damaged by a flood in November 2006. Deferred accounting for the unrecovered plant balance was authorized by the Commission in Docket UM 1298 and was fully amortized December 2010. Consistent with Dockets UE 210 and 217, the Company amortized the decommissioning regulatory asset beginning January 1, 2010.") Pursuant to OAR 860-001-0460(1)(d), the Company requests that the Commission take official notice of the referenced testimony from docket UE 246 as a document "in the files of the Commission that [has] been made a part of the files in the regular course of performing the Commission's duties."[33] .

[34] NWN/900, Miller/10-11.

[35] NWN/900, Miller/9.

[36] NWN/800, Miller/3.

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in any one year will very likely exceed any earnings in excess of ROE.[37] If the earnings test is designed such that the Company is required to use all earnings in excess of ROE in good years to offset remediation expenses, it will have a significant and negative impact on the Company's ability to earn a reasonable return.[38]

Moreover, any earnings limitations imposed by the SRRM earnings review become the Company's regulatory reality for many years to come. Indeed, the long-term nature of the SRRM distinguishes it from more conventional deferrals, which typically involve a less significant amount and are in place for one or two years, and thus have a limited impact on earnings.[39] However, in this case, an overly restrictive earnings test may materially impact the Company's risk profile, as perceived by investors, and may result in significant adverse financial impacts.[40]

4. The Company's Proposal Retains Incentives.

Like other utilities in Oregon, NW Natural currently operates under a framework of cost recovery policies and incentive mechanisms that are intended to encourage cost containment and revenue generation for the benefit of the Company's customers. The Company's proposed earnings review maintains these incentives by allowing it to retain a reasonable range of earnings above its authorized ROE.

a. The Company's Proposal Maintains the Incentive for Good Management.

As recognized by this Commission, as well as several other commissions around the country, the primary incentive mechanism under which the Company operates flows from the general rate recovery principle inherent in the regulatory compact—that is, to the

[37] NWN/900, Miller/16, 28; NWN/800, Miller/12.

[38] NWN/800, Miller/12-13.

[39] NWN/900, Miller/14-15.

[40] NWN/900, Miller/35.

1 extent that a utility exercises good management to reduce costs between rate cases, the
2 utility retains the benefits of that good management. Customers likewise benefit when
3 these reduced costs are built into rates through future rate proceedings.[41] As the
4 Commission described in Order No. 09-316:

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> A utility must operate with the rates in effect until future rates are approved in the next rate case. It is expected that the utility will manage its operations to balance and offset unexpected expenses in a fiscal year with operating efficiencies and unexpected revenues in that same year, **with the understanding that the utility keeps all revenues in excess of its expenses in any year**.[42]

9 The Commission has intentionally preserved this incentive for "good management"
10 by declining to use the earnings review to over-scrutinize a utility earnings. Specifically,
11 when designing the PGA sharing mechanism in UM 903, the Commission explained its
12 goals as follows:

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> At the outset, we note that our discussion on this issue is focused on establishing an earnings threshold and sharing percentage of revenues deemed excessive for NW Natural.

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> The objective should be simply to determine whether or not an LDC's earnings are excessive prior to passing through prudently incurred gas cost changes in rates. ***It should not be structured so as to turn each PGA filing into an annual rate case or show cause hearing where the company's earnings would be subject to detailed review and***

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[41] NWN/800, Miller/18.

[42] *Utility Reform Project*, Docket UM 1224, Order No. 09-316 at 13 (Aug. 18, 2009) (emphasis added); *see also Re Application of Portland Gen. Elec. Co. for an Investigation into Least Cost Plan Plant Ret.; Revised Tariffs Schedules for Elec. Serv. in Oregon Filed by Portland Gen. Elec. Co.; Portland Gen. Elec. Co.'s Application for an Accounting Order & for Order Approving Tariff Sheets Implementing Rate Reduction*, Docket Nos. DR 10, UE 88 and UM 989, Order No. 08-487 at 7 (Sept. 30, 2008) ("The utility absorbs the expenses if they are higher than expected and benefits if the expenses are lower, which gives the utility the incentive to manage its operations efficiently to reduce expenses and attain its authorized return on investment.").

adjustment. Indeed, such scrutiny may eliminate any incentive for the company to pursue efficiencies.[43]

Ultimately, the Commission set the earnings threshold at 300 basis points above benchmark ROE,[44] stating:

> An earnings threshold set at 300 basis points above the benchmark ROE will protect the interests of ratepayers and allow the company the opportunity to pursue increased earnings through cost management and operating efficiencies.[45]

The reverse implication is that an earnings threshold set too low will eliminate the utility's incentive to pursue increased earnings through cost management and operating efficiencies.

Similarly, the Washington Utilities and Transportation Commission ("WUTC") rejected a proposal *by the utility* to cap its earnings as part of a rate case settlement.[46] The WUTC reasoned that earnings caps were poor regulatory policy and inconsistent with "ratemaking theory applied by [Washington] and other state commissions for decades[.]"[47] Specifically, "companies should have every incentive to manage the company efficiently in order to earn more for the company shareholders," and such incentives are diminished

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[43] *Re Investigation Into Policy Issues and Procedures Associated with Recovery of Purchased Gas Costs by Oregon's Regulated Gas Distribution Utilities*, Docket UM 903, Order No. 99-272 at 7-8 (Apr. 19, 1999) (emphasis added).

[44] The benchmark ROE is calculated using the authorized ROE as a baseline, adjusted for the amount of change that is experienced for the year in the average yield on U.S. Treasury debt securities. *Id.* at 8-9.

[45] *Id.* at 9.

[46] *WUTC v. Avista Corporation d/b/a Avista Utilities,* Dockets UE-120436 and UG-120437 (consolidated), Order 09, Dockets UE-110876 and UG-110877 (consolidated), Order 14 ¶ 75 (Dec. 26, 2012).

[47] *Id.*

with earnings caps.[48] The WUTC also recognized that earnings caps can ultimately hurt customers by denying them the benefit of the utility's savings in the next rate case.[49]

The Colorado Public Utilities Commission ("CPUC") likewise rejected a rate case settlement provision that would have effectively capped the utility's earnings at 100 basis points above its authorized ROE.[50] Like the WUTC, the CPUC reasoned that the utility's "ability to occasionally and temporarily over earn without automatic refund provisions offsets periods of under earning and is a strong incentive for efficiency."[51] The CPUC further observed that such a cap "can act as a perverse incentive for the utility."[52]

NWIGU recognizes the importance of the incentive for good management, testifying that "NW Natural and all utilities should always have a strong incentive to minimize cost and lower rates to retail customers."[53] Unlike Staff and CUB, NWIGU recommends that there be "[n]o earnings sharing if the Company's actual earned [ROE] is less than or equal to its authorized [ROE]."[54] Instead, NWIGU recommends a tiered earnings test that will allow the Company to earn greater than its authorized ROE because "if exceptional management [cost saving] efforts are achieved, then NW Natural should retain a larger share of excess earnings for investors."[55] NW Natural does not agree with NWIGU's tiered levels, but appreciates its recognition of this important incentive.

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[48] *Id.*

[49] *Id.*

[50] *Re Public Service Co. of Colo.*, 2009 WL 5155322, 18-19 (Colo.P.U.C. 2009).

[51] *Id.*

[52] *Id.*

[53] NWIGU/100, Gorman/14.

[54] NWIGU/100, Gorman/6.

[55] NWIGU/100, Gorman/7-8.

1 **b. The Company's Proposal Maintains the Commodity Cost Savings Incentive.**

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3 In addition to the incentive for good management, NW Natural also operates under
4 an additional incentive, which is likewise protected under the Company's earnings review
5 proposal. The PGA was developed by the Commission to encourage local distribution
6 companies ("LDCs") to minimize gas costs.[56] Currently, the PGA allows an LDC to retain,
7 at its election, either 10 or 20 percent of the commodity cost savings (or increased costs)
8 resulting from its gas procurement activities.[57] While the Commission has, over time,
9 made adjustments to the mechanism, it has retained the PGA as a successful incentive
10 since 1989.[58]

11 If the PGA is to remain effective, the SRRM threshold must be set above authorized
12 ROE, at the same level elected by NW Natural for the PGA. Since 2005, the Company's
13 lowest level of remediation expenses exceeded the Company's WACOG savings, and
14 remediation expenses are expected to continue to increase.[59] Thus, for the foreseeable
15 future, it is highly likely that the remediation costs incurred in any one year will be greater
16 than any commodity cost savings the Company achieves.[60] To the extent that commodity
17 cost savings result in the Company earning more than its authorized ROE, the Company
18 would be required to use the commodity cost savings to pay remediation expenses.
19 Therefore, the Company's incentive to minimize its gas costs—an incentive that provide

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23 [56] *See Ratemaking Policies for Natural Gas Purchased by Local Distribution Companies*, Docket UG 73, Order No. 89-1046, 105 P.U.R.4th 365, 1989 WL 418697 (Aug. 4, 1989).

24 [57] NWN/800, Miller/20; Order No. 08-504 at 18.

[58] Order No. 08-504 at 2.

25 [59] NWN/800, Miller/21.

26 [60] NWN/800, Miller/13.

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benefits to both the customers and the Company—will be compromised if the Company is not provided an opportunity to earn greater than its authorized ROE.[61]

5. Including Remediation Expenses in Base Rates is Problematic.

The Company recommends that future remediation expenses be excluded from base rates. The remediation expenses have been and will be difficult to forecast, are mandated by regulatory authorities, and are outside the Company's control.[62] Therefore, these expenses are not well suited to traditional test year estimation.[63]

If the Commission is inclined to include some amount of remediation expenses in base rates, it should do so based on actual forecasts of expected expenses as it does for all other utility expenses.[64] However, even if the Commission were inclined to take this approach, it should wait until the EPA issues its Record of Decision ("ROD"), as the ROD should enable the Company to more accurately forecast expected remediation expenses.[65]

B. The Commission Should Recognize that there are No Net Deferrals.

Through its settlement of insurance claims, NW Natural has now received more money in insurance recoveries than it has incurred in environmental expense and thus has no net expense today and does not expect to have a net expense for some number of years. This means that the Company is not requesting amortization of the historical deferrals. Therefore, it is improper to apply the earnings test today because under ORS 757.259(5) the earnings test is applied "at the time of application to amortize the deferral."[66] Moreover, offsetting the historical deferrals with the insurance recoveries is

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[61] NWN/800, Miller/20-21.

[62] NWN/800, Miller/29-30.

[63] NWN/800, Miller/29-30.

[64] NWN/900, Miller/31.

[65] NWN/900, Miller/7.

[66] ORS 757.259(5) (earnings test applied "at the time of application to amortize the deferral").

consistent with Commission orders, and represents the most sensible and fair ratemaking approach.

1. Offsetting Past Deferrals with Insurance Recoveries is Consistent with Commission Orders.

The Commission orders have always made clear that the Company is to defer environmental remediation expenses only to the extent that they exceed recoveries. From the beginning, the Commission's orders approved deferrals of "unrecovered environmental costs."[67] Moreover, the Commission made its intent clear in the Preliminary Order issued in NW Natural's last rate case. In that docket the Commission adopted the SRRM. However, in deferring the earnings review issue to another docket, the Commission stated as follows: ***"We agree with the company that the deferral of environmental remediation expenses should continue as they are now, with appropriate offsets when insurance proceeds are recovered."***[68] Thus, consistent with the Commission's order, the deferrals are entirely offset by the insurance recoveries; no deferrals remain to amortize. This approach is simple and reasonable. NW Natural believes that its customers would object to being burdened with payment of accumulated environmental remediation expenses at a time when the Company has enough insurance to cover them.[69]

2. Offsetting the Historical Deferrals Furthers Intergenerational Equity.

If the historical deferrals are offset with the insurance recoveries, then future customers will pay only those remediation costs incurred in the future as they are

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[67] *See Northwest Natural Gas Co.*, Docket UM 1078(1), Order No. 04-244 at 1 (May 12, 2004). In fact, the Company's requests for deferrals were captioned "NW Natural Gas Company's ... Application for Deferred Accounting of Unrecovered Environmental Costs . . ." (emphasis added).

[68] *Northwest Natural Gas Co.*, Docket UG 221, Order 12-408 (Oct. 26, 2012).

[69] NWN/800, Miller/24.

incurred.[70] This approach prevents current customers from paying the deferred remediation expenses today, even though the Company has received sufficient insurance proceeds to offset all of the historical, deferred expenses.[71]

In addition, the Company's proposal protects customers from the immediate rate impact that would occur if rates included amortization of both the historical deferrals and current remediation expenses.[72] By withholding the insurance proceeds for future expenses, the parties would require customers today to prepay the utility for future remediation expenses, which leads to an unnecessary rate impact to current customers, who will have to bear the brunt of past remediation expenses that can be covered by insurance.[73]

3. If the Commission does perform an Earnings Review on Past Deferrals, Earnings over the Deferral Period Should be Considered in Aggregate.

If the Commission chooses to charge customers now, despite the fact that NW Natural has sufficient insurance to fully offset the costs, the Commission should apply the Company's proposed earnings test with a 100 basis point threshold. For purposes of determining the Company's historical earnings, the Commission should examine the earnings for the entire deferral period on an aggregate basis. This review will show that, on average, the Company earned below its authorized rate of return; therefore no disallowance should be imposed.[74]

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[70] NWN/900, Miller/31-34.

[71] NWN/900, Miller/32.

[72] NWN/900, Miller/31-33.

[73] NWN/900, Miller/31-33.

[74] NWN/900, Miller/24.

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1 During the deferral period, the Company's earnings were under the authorized ROE
2 in six years and over the authorized ROE in four.[75] On average, the Company's earnings
3 were seven basis points less than its average authorized ROE.[76] Therefore, even if the
4 Commission were to conduct an earnings test on past deferrals, assuming that the
5 Commission were to cut off earnings above, or even at authorized ROE, no disallowance
6 would be required.

7 Reviewing the Company's historical earnings on a year-by-year, piecemeal basis, as
8 proposed by the parties,[77] is fundamentally inconsistent with the nature of this deferral.[78]
9 Going backward there is no principled basis for separating out earnings on a year-by-year
10 basis.[79] All of the costs relate to a single overarching project—environmental remediation.
11 So rather than viewing the historical period as ten individual, one year deferrals, it is more
12 reasonable to view the entire historical period as a single deferral period.[80] This approach
13 is consistent with the way the Company filed its deferral applications, which sought
14 reauthorization to continue a single deferral rather than requesting a new deferral for every
15 year.[81] And this approach is consistent with how the insurance proceeds were received as
16 a single, lump sum payment that cannot be reasonably allocated to specific years.

17 Moreover, the Company's proposal to examine the deferral period as a whole, rather
18 than piecemeal, is consistent with the approach taken by the Commission in Order No. 13-
19 416. In that order, the Commission applied an earnings test based on a review of Idaho

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21 [75] NWN/900, Miller/24. Moreover, the Company exceeded its authorized ROE by more than 100 basis points only once and only by one basis point. In 2009 the Company's actual ROE was 101 basis points greater than authorized.
22 [76] NWN/900, Miller/24.
23 [77] Staff/200, Johnson-Bahr/11; CUB/200, Jenks/16.
24 [78] NWN/900, Miller/21.
[79] *Id.*
25 [80] *Id.*
26 [81] *Id.*

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1 Power's average earnings over a historical 23 year period—in part, because the amounts
2 subject to amortization were best regarded as a whole.[82] In that case the "whole" referred
3 to a lump sum tax refund; that tax refund could have been broken down and allocated on a
4 year-by-year basis to the "deferral period"—however, it had come in as one lump sum
5 adjustment to taxes and the Commission believed it was best considered as one
6 amount.[83] Importantly, in the Idaho Power case, Staff argued, "[i]t would be unfair to the
7 utility to treat each year of the refund period separately and cherry-pick years where
8 earnings were higher to return refunds to customers."[84] Staff argued in its brief that "it is
9 appropriate to review Idaho Power's earnings over the entire Tax Period [1987-2009] to
10 check the overall reasonableness of the results of applying a year-by-year earnings test."[85]
11 There is no principled reason to take a different approach in this case.

12 **C. Staff's Proposals are Unreasonable and Contrary to Commission Precedent.**

13 Staff recommends different earnings tests for historical and prospective deferrals.
14 For the historical deferral period, Staff recommends a year-by-year test that would allow
15 amortization up to 50 basis points below the Company's authorized ROE. Prospectively,
16 Staff recommends a 90/10 sharing and an earnings test with a threshold set at the
17 Company's ROE. Unlike the historical test, which would prevent disallowances from
18 causing NW Natural's earnings to drop below 50 basis points less than its authorized
19 ROE, Staff's prospective test has no floor. Instead, if the Company's earnings exceed its
20 authorized ROE, the Company bears the remediation expenses in that year regardless of
21 the amount and regardless of the final impact on the Company's earnings.

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23 [82] *Id.*

[83] *Idaho Power Co.*, Docket UE 233, Order No. 13-416 at 12 (Nov. 12, 2013).

24 [84] NWN/900, Miller/23; *Re Idaho Power Co.*, Dockets UM 1562/1582, Staff/100, Garcia/9 (July 13,
25 2012).

[85] NWN/900, Miller/23; *Re Idaho Power Co.*, Docket UE 233, Staff's Opening Brief at 10 (July 16,
26 2013).

Staff also recommends that base rates include remediation expenses of between $3 million and $5 million, an amount that is far below what the Company actually expects to incur.

For both periods, Staff also recommends that the Company's calculated earnings include its gas commodity cost savings and 90 percent of the revenues generated by its Optimization Activities.

Staff recommends allocating between 20 and 33 percent of the insurance proceeds to the historical deferrals, with the remaining amounts being allocated prospectively on a levelized, annual basis.

Staff's earnings test—both historically and prospectively—fails to consider the amount and long-term nature of the remediation expenses that will be subject to the SRRM.[86] In doing so, Staff recommends an overly restrictive test and unreasonable sharing arrangement that will have a negative long-term impact on the Company's ability to earn its authorized ROE.[87]

1. Staff's Earnings Test is Contrary to Order No. 93-257.

Staff acknowledges the applicability of the Order No. 93-257 framework, but characterizes the remediation expenses as "emergency costs."[88] Accordingly, Staff recommends that the Company be allowed to amortize past environmental deferrals up to the ***bottom*** instead of the top of a reasonable range, which Staff sets at 50 basis points below authorized ROE.[89] Staff's prospective earnings review allows the Company to amortize deferrals up to authorized ROE, only because it is also recommending that the Company assume additional remediation costs through sharing.[90]

[86] NWN/900, Miller/14.

[87] NWN/900, Miller/16-17.

[88] Staff/200, Johnson-Bahr/10.

[89] Staff/200, Johnson-Bahr/10.

[90] Staff/200, Johnson-Bahr/20.

1 Staff is misapplying the Commission's earnings review framework. An "emergency" 2 is an unforeseen event requiring immediate action.[91] Here, the remediation expenses 3 have been incurred for the past 10 years and may be incurred for an additional 20 years.[92] 4 The events giving rise to the remediation expenses are certainly not unforeseen, and 5 given the length of time they have been incurred, it cannot be said that at any point they 6 required immediate action. On the contrary, the Commission has addressed the recovery 7 of these costs with an automatic adjustment clause—in itself, a long-term solution—with 8 due deliberation. As such, Staff's proposal to set the threshold at the bottom of the range 9 is in error.

10 11 **2. Staff's Sharing Proposal is Unnecessary and Contrary to the Nature of the Remediation Costs.**

12 The Commission rejected sharing proposals in UG 221 and there is no basis for a 13 reversal of that conclusion here.[93] Staff supports its sharing proposals by claiming that the 14 Company requires an incentive to efficiently manage its remediation expenses.[94] 15 However, again, when the Commission rejected sharing in UG 221 it did so after 16 concluding that the earnings test and prudence reviews provided sufficient incentives.[95] 17 Moreover, the type of remediation work that will be required, the timeline for the work, and 18 the required outcome of the remediation efforts will all be dictated by federal and state 19 agencies, and it is these factors that will largely drive the expense.[96] Thus, there is simply 20 no need for additional sharing to incent prudent cost management.

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22 [91] Merriam Webster defines "emergency" as "an unforeseen combination of circumstances or the resulting state that calls for immediate action." www.merriam-webster.com

23 [92] NWN/900, Miller/18.

24 [93] Order No. 12-437 at 31-32.

[94] *See e.g.*, Staff/200, Johnson-Bahr/21.

25 [95] Order No. 12-437 at 32.

26 [96] NWN/900, Miller/30-31.

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Finally, as discussed above, remediation expenses are costs that are typically paid by customers without sharing. Here, de facto sharing may occur through the earnings test. However, it is unreasonable to propose that shareholders share in these expenses prior to the application of an earnings test when customers pay remediation expenses in the normal course.

3. Staff's Earnings Tests Fail to Reasonably Consider the Financial Integrity of the Company.

The Company acknowledges that it is not for the Commission to protect the financial integrity of the Company under all circumstances. However, as part of the balancing of interests required by ORS 756.040(1),[97] the earning test applied in this case, both to the historical deferrals and prospectively, must consider the interests of the Company and protect it from undue harm. This is particularly true when the remediation expenses were mandated by government regulators and prudently incurred and NW Natural's deferral accounting was consistent with other utilities. Staff's proposal fails in this regard.

Staff's recommended historical earnings review would result in a disallowance of $38.7 million.[98] For context, the Company's average annual earnings between 2003 and 2012 were $80.1 million and the Company's 2013 earnings were $81.7 million.[99] Therefore, Staff's proposed disallowance would constitute up to half of the Company's 2013 earnings—reducing the Company's 2013 ROE to approximately 4.77 percent, or 473 basis points below authorized ROE.[100] A disallowance of that magnitude would have a significant impact on the Company's financial health and would likely result increase the Company's financial risk, as perceived by investors, and could negatively affect the

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[97] ORS 756.040(1) ("The commission shall balance the interests of the utility investor and the consumer in establishing fair and reasonable rates.").

[98] NWN/900, Miller/16.

[99] NWN/900, Miller/16.

[100] NWN/900, Miller/16.

1 Company's credit rating.[101] This could harm customers by increasing the Company's
2 borrowing costs.[102] The proposed disallowance is particularly unreasonable given that the
3 Company's earnings during the historical period were, on average, below its authorized
4 ROE.[103]

5 Staff's prospective earnings review, together with its proposed sharing levels would
6 effectively cut-off NW Natural's earnings at or below its authorized ROE.[104] Such a
7 restrictive earnings test could, as a practical matter, result in persistent, and potentially
8 significant, under-earning for the foreseeable future.[105] Indeed, if the cut off for
9 amortization during the historical period had been the Company's authorized ROE, then
10 the Company's average ROE from 2003 to 2011 would have been 9.81 percent—well
11 below the Company's authorized ROE of 10.2 percent.[106] Limiting the Company's
12 opportunity to earn its authorized return in this way is contrary to the requirements of
13 Oregon law.[107] As the Court of Appeals has said:

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> the PUC sets rates so as to provide a utility with an opportunity to recover its revenue requirement, which is the amount of money the utility must collect to cover its reasonable operating expenses incurred in providing

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[101] NWN/900, Miller/25-26.

19 [102] NWN/900, Miller/26.

20 [103] NWN/900, Miller/24.

21 [104] NWN/900, Miller/28 (Staff's proposal cuts-off earnings at less than authorized ROE); NWN/800, Miller/16 (Staff's tiered sharing proposal from Phase I cuts-off earnings).

22 [105] NWN/900, Miller/14.

23 [106] NWN/800, Miller/14, n. 9; NWN/101.

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[107] ORS 756.040 states: "Rates are fair and reasonable for the purposes of this subsection if the rates provide adequate revenue both for operating expenses of the public utility or telecommunications utility and for capital costs of the utility, with a return to the equity holder that is: (a) Commensurate with the return on investments in other enterprises having corresponding risks; and (b) Sufficient to ensure confidence in the financial integrity of the utility, allowing the utility to maintain its credit and attract capital."

services, as well as a reasonable return on investments made to provide that service.[108]

Such a limitation will also increase the Company's risk profile as perceived by the investor community, which may well limit the Company's access to capital in contravention of ORS 756.040(1)(b).[109]

Moreover, Staff's prospective test in particular will harm the Company because it lacks a floor and may require the Company to bear significant, prudently incurred remediation expenses even when the Company's earnings only modestly exceed its authorized ROE.[110] With no mechanism to limit the impact of Staff's test, after application of Staff's sharing and earnings test, the Company's final ROE could be unreasonably low. For example, assume the Company's earnings in a particular year were less than its authorized ROE but with the inclusion of WACOG savings the earnings were 1 basis point above its authorized ROE (or 9.51 percent). Further, assume that the remediation expenses in that year totaled $20 million, which was the level of expenses incurred in 2012.[111] In this example, $9 million would be subject to the earnings test.[112] Because the Company's earnings exceeded its authorized ROE, albeit by only 1 basis point, the Company would bear the entire $9 million, reducing its ROE to 102 basis points less than its authorized ROE.[113] If the total environmental costs were $32.2 million in a particular year, the Company's actual ROE would be 227 basis points less than its authorized ROE.

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[108] *Gearhart v. Pub. Util. Comm'n of Oregon*, 255 Or. App. 58, 61, 299 P.3d 533, 537 *review allowed*, 354 Or. 386, 314 P.3d 964 (2013) and *review allowed*, 354 Or. 386, 314 P.3d 964 (2013).

[109] NWN/900, Miller/35.

[110] NWN/900, Miller/27-29; NWN/901.

[111] *See* Staff/201.

[112] Staff/200, Johnson-Bahr/23. $20 million less $5 million in base rates less $5 million of insurance proceeds equals $10 million. Staff's 90/10 sharing would then apply to the $10 million, resulting in $9 million being subject to the earnings test.

[113] Staff/200, Johnson-Bahr/23; NWN/901.

1 Staff's proposal has no floor that would ensure that the Company's ROE remained within a
2 reasonable range. Such a result will create significant risks to the Company's financial
3 health going forward and will likely be viewed adversely by the investor community.[114]

4 The application of Staff's all-or-nothing approach also results in an absurd scenario
5 where the Company's earnings after application of the earnings test can be greater if it
6 under-earns.[115] For example, as set forth in NWN/901, assume that $5 million of
7 remediation expenses were subject to the earnings test. If the Company earned 1 basis
8 point less than its authorized ROE, or 9.49 percent, then customers would pay the $5
9 million and the Company's actual ROE would remain 9.49 percent.[116] However, if the
10 Company's actual ROE was 1 basis point above its authorized ROE, or 9.51 percent, the
11 Company would bear the $5 million and its actual ROE would be reduced to 8.94 percent.
12 By earning 1 basis point less than authorized, the Company's earnings will be 55 basis
13 points greater. Thus, Staff's prospective earnings test not only undermines the incentive,
14 it actually creates a disincentive by allowing a better result for shareholders if the
15 Company under-earns.

16 Further, the long-term nature of the SRRM makes it all the more important that the
17 Commission decline to impose an overly restrictive earnings test. It may be reasonable to
18 effectively cap a utility's earnings in a single year or even a couple of years through a
19 deferral earnings test.[117] Accordingly, in Order No. 93-257 the Commission contemplated
20 this type of scenario for one-time, emergency deferrals.[118] However, for a long-term
21 automatic adjustment clause like the SRRM, it is unreasonable to cap earnings through an

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[114] NWN/900, Miller/35.

23 [115] NWN/901.

24 [116] Staff's proposal would also have the Company automatically assume 10 percent of the amounts remaining after the application of insurance and the amount in base rates.

25 [117] NWN/900, Miller/14-15.

26 [118] Order No. 93-257 at 11-12.

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overly restrictive earnings test.[119] Indeed, this is why it makes sense that automatic adjustment clauses are exempt from the mandatory deferral earnings test.[120]

4. Staff's Proposal for Allocation of Insurance Proceeds Will Not Further Intergenerational Equity

Staff proposes allocating insurance proceeds proportionally to the time period in which the remediation costs have been and will be incurred.[121] Staff's proposal is needlessly complicatedly and will not promote intergenerational equity. Staff's proposal would have customers pre-pay for future credits they will potentially receive down the road and Staff's proposal would result in an immediate and unnecessary rate impact to current customers.[122] And in the long-term the rate differential between the Company's proposal and Staff's is unlikely to be substantial.[123]

Staff also recommends that the insurance proceeds held by the Company accrue interest at the Company's authorized rate of return, even though the Company's deferred remediation expenses accrue interest at a much lower rate. Staff's proposal is unreasonably one-sided and should be rejected.

5. Staff's Recommendations will Significantly Undermine the Incentive for Good Management.

Staff's recommendation capping the Company's ROE at or below authorized will also undermine the incentive for good management. As discussed above, such a cap is poor regulatory policy and effectively undermines the incentives that have worked well for both

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[119] NWN/900, Miller/14-15.

[120] ORS 757.259(5) ("Unless subject to an automatic adjustment clause under ORS 757.210(1), 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. . .").

[121] Staff/200, Johnson-Bahr/4

[122] NWN/900, Miller/33.

[123] NWN/900, Miller/33, Graph 2.

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the Company and customers.[124] While a limited, one-time adjustment to a utility's normal earnings opportunities would be unlikely to interfere with the typical regulatory incentives, the long-term nature of the SRRM coupled with the substantial expenses would undermine these incentives for years to come.[125]

Staff appears to recognize the importance of the good management incentive and claims that their 90/10 sharing proposal is intended to "provide the Company an incentive to minimize costs and maximize revenues even with the prospect of an earnings test that has a benchmark set at the Company's authorized rate of return."[126] It is unclear how sharing incents NW Natural to maximize revenues or how sharing somehow preserves the good management incentive, given that Staff pairs sharing with an earnings test that undermines this incentive. Staff's sharing proposal further eliminates the benefits to shareholders of revenues above authorized ROE because those revenues will be used to offset remediation costs that, in the normal course, should be included in rates.

Staff's prospective earnings test presents further problems because it actually creates a strong disincentive for efficient management.[127] As discussed above, the Company can obtain better results by under-earning than by over-earning.[128] Under Staff's proposal, the Company assumes the remaining remediation costs left after insurance, sharing, and the amount in base rates if its earnings exceed its authorized ROE by any amount.[129] And, importantly, as described above, there is no floor limiting the impact on the Company's earnings.[130] So it is possible that by assuming the remaining

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[124] NWN/800, Miller/19-20.

[125] NWN/900, Miller/14.

[126] Staff/200, Johnson-Bahr/21.

[127] NWN/900, Miller/27-29; NWN/901.

[128] NWN/900, Miller/27-28; NWN/901.

[129] NWN/900, Miller/27-28.

[130] NWN/900, Miller/27-28.

remediation costs the Company's ultimate ROE could be extremely low.[131] On the other hand, if the Company under-earns, by whatever amount, customers pay the remaining remediation costs.[132]

6. Staff's Proposed Earnings Test will Undermine the WACOG Savings and Optimization Activity Incentives.

Staff recommends that the SRRM earnings test include WACOG savings and Optimization Activity revenues in the calculation of the Company's earnings. If the revenues from these activities are subject to the SRRM earnings test, then these revenues may be used to offset remediation expenses. This could undermine the Company's incentive to continue to aggressively pursue commodity cost savings and Optimization Activities.[133]

As discussed above, if the SRRM earnings test has a lower threshold than the PGA earnings test, as Staff proposes, then the SRRM earnings test will effectively eliminate the Company's incentive to achieve gas commodity cost savings.

Similarly, the Company currently retains a portion of the revenues achieved through its Optimization Activities.[134] This revenue sharing has been in place since the Company began engaging in the Optimization Activities and is intended to incent the Company to engage in these discretionary activities that exceed the scope of normal LDC utility service.[135] Consistent with current practice, the Commission should reject Staff's recommendation and continue to exclude Optimization Activity revenues from NW Natural's regulated earnings for the purposes of this earnings review.[136] Doing so will

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[131] NWN/900, Miller/27-28.

[132] NWN/900, Miller/27-28.

[133] NWN/900, Miller/13-14.

[134] NWN/800, Miller/21-22.

[135] NWN/900, Miller/20.

[136] NWN/800, Miller/22; NWN/900, Miller/19.

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1 maintain the Company's incentive to engage in these activities to the benefit of customers
2 and shareholders.

3 Moreover, inclusion of the pre-2009 WACOG savings and all Optimization Activity
4 revenues in the historical earnings test is particularly unreasonable because the
5 Company's ROOs have never included Optimization Activity revenue and WACOG
6 savings were included only after 2009.[137] If adopted, the net effect of Staff's
7 recommendation would be to retroactively strip the Company of this revenue through an
8 overly restrictive earnings test. Such an action would amount to an unlawful retroactive
9 rule.

10 Agency application of retroactive rules is "invalid if their retroactivity is unreasonable
11 in the circumstances."[138] The United States Supreme Court observed that "retroactivity
12 must be balanced against the mischief of producing a result which is contrary . . . to legal
13 and equitable principles."[139] The considerations frequently relied on to determine whether
14 to apply a new rule retroactively includes:

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> (1) whether the particular case is one of first impression, (2) whether the new rule represents an abrupt departure from well-established practice or merely attempts to fill a void in an unsettled area of law, (3) the extent to which the party against whom the new rule is applied relied on the former rule, (4) the degree of the burden which a retroactive order imposes on a party, and (5) the statutory interest in applying a new rule despite the reliance of a party on the old standard.[140]

20 Here, all five factors weigh heavily in favor of rejecting the proposed inclusion of
21 post-2009 WACOG savings and Optimization Activity revenues in the historical earnings

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23 [137] NWN/900, Miller/19.

24 [138] *Gooderham v. Adult & Family Servs. Div. of State of Or.*, 64 Or. App. 104, 108-09 (1983) (citing *Public Serv. Co. of Colorado v. Andrus,* 433 F.Supp. 144 (D.D.C.1977); *General Telephone Co. of Southwest v. United States,* 449 F.2d 846, 863 (5th Cir.1971)).

25 [139] *Securities Comm'n v. Chenery Corp.,* 332 U.S. 194, 203 (1947).

26 [140] *Retail, Wholesale and Department Store U. v. N.L.R.B.,* 466 F.2d 380, 390 (D.C.Cir. 1972).

1 test. *First*, this is the first time the Commission has considered retroactively modifying the
2 Company's filed ROOs to include these revenues. Therefore, the Company had no prior
3 notice that these revenues would be included in earnings tests for the deferral period.
4 *Second*, inclusion of these revenues in the ROO is not "filling a void"—Optimization
5 Activity revenues have never been included in the ROO and WACOG savings have been
6 included only since 2009. Retroactively including these revenues now is an "abrupt
7 departure" from past requirements.
8 *Third*, the Company's decisions to invest shareholder dollars and assume additional
9 shareholder risk to facilitate the Optimization Activity was based, in part, on the exclusion
10 of these revenues from the Company's ROOs. Optimization Activity revenue is subject to
11 sharing as set forth in the Company's tariffs, but has never been subject to sharing
12 through an earnings test or otherwise included for purposes of determining the
13 reasonableness of the Company's earnings.
14 *Fourth*, if these revenues are retroactively included in the ROOs then it will
15 potentially have a significant adverse impact on NW Natural. Staff's recommend
16 disallowance of the deferred amount is nearly $40 million and this recommendation is
17 informed by Staff's inclusion of these revenues in the historical earnings test. A
18 disallowance of this magnitude will have a significant and adverse impact on NW Natural.
19 *Fifth*, there is no statutory interest implicated by the proposal to retroactively modify
20 the Company's ROOs. As discussed above, by statute the Commission is not required to
21 perform an earnings test for an automatic adjustment clause.
22 Considering that all five considerations weigh heavily against the Commission
23 retroactively modifying the Company's ROOs, the Commission should reject proposals to
24 include Optimization Activity and pre-2009 WACOG savings in the ROO.
25
26

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1 **7. Staff's Base Rates Recommendation is Unreasonable.**

2 Staff recommends that base rates include between $3 and $5 million for remediation
3 expenses.[141] Staff's proposal has no rational relationship to the Company's actual
4 forecast of remediation expenses, other than it appears to be designed to include
5 expenses that fall well below actuals.[142]

6 **D. CUB's Recommended Earnings Test is Without Merit.**

7 For the historical deferrals, CUB recommends a year-by-year earnings test with a
8 threshold at the Company's authorized ROE. Prospectively, CUB recommends that the
9 Company offset the remediation expenses using the Company's revenues from its
10 Interstate Storage business and Optimization Activities related to Mist, after the Company
11 earns its authorized ROE on the storage investments. Like Staff, CUB also recommends
12 that the Company's earnings include WACOG savings and Optimization Activity revenues.
13 CUB recommends that one-third of the insurance proceeds also be allocated to the
14 historical deferral, with the remaining two-thirds being used to offset future remediation
15 expense.

16 CUB also continues to support its prior proposals in this case, including a 50/50
17 sharing proposal of all remediation expenses, an earnings test with a threshold at
18 authorized ROE, an earnings test with three tiers, and the earnings test included in the
19 stipulation that was filed and rejected in Phase I.

20 Many of CUB's proposals have the same flaws as Staff's. With the exception of the
21 earnings test included in the rejected stipulation, all of CUB's earnings tests will result in a
22 de facto cap on NW Natural's earnings.[143] For the reasons discussed above, earnings
23 caps are poor regulatory policy and should be rejected. CUB's sharing recommendation

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[141] Staff/200, Johnson-Bahr/22.

25 [142] NWN/900, Miller/31.

26 [143] NWN/800, Miller/15-16; NWN/900, Miller/12.

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also suffers from the same flaws as Staff's—sharing is unnecessary to incent cost management and therefore there is no reasonable basis to disallow recovery of prudently incurred remediation costs. CUB's recommended historical disallowance of nearly $20 million is massive—representing roughly a quarter of the Company's annual earnings.[144] Finally, CUB's recommendation that the SRRM earnings test include WACOG savings in the calculation of the Company's earnings should also be rejected for the same reasons discussed above.[145]

CUB's unique proposal involves using Mist storage and optimization revenues to offset remediation expenses. CUB argues that Mist, like the former MGPs, is a site that was formerly used to provide utility service.[146] CUB's proposal is unreasonable.

First, the Mist Interstate Storage and Optimization Activity is attributable to discretionary shareholder investments resulting from the incentive mechanisms discussed above, which are designed to encourage shareholders to assume risk and invest in storage facilities.[147] This incentive has allowed revenue sharing to compensate shareholders for their discretionary investments that are necessary to allow the Company to provide these services. Using revenue generated by discretionary shareholder investments to offset costs that should properly be included in rates is fundamentally unfair and unreasonable.

Second, CUB's proposal results in the "taking of property for public use without just compensation," which is unconstitutional.[148] CUB's proposal would force the Company to

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[144] NWN/900, Miller/16.

[145] NWN/900, Miller/13-14.

[146] CUB/200, Jenks/4.

[147] NWN/900, Miller/35.

[148] *Pac. Tel. & Tel. Co. v. Wallace*, 158 Or. 210, 224 (1938) (quoting *St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 51, 56 S. Ct. 720, (1936)) ("the Constitution fixes limits to the rate–making power by prohibiting . . . the taking of private property for public use without just compensation.")

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1 transfer to customers the portion of the revenues derived from discretionary shareholder
2 investments that have always been allocated to the shareholders as reasonable
3 compensation for their investment. To now use those revenues to offset prudently
4 incurred utility expenses that should be paid by customers is unreasonable and not just
5 compensation for the shareholder investments.

6
7 **E. NWIGU's Sharing Recommendation for Non-Regulated Affiliates should be Rejected.**

8 Both historically and prospectively NWIGU recommends a tiered earnings test with
9 the threshold beginning at the Company's authorized ROE. If the Company's ROE was
10 up to 50 basis points higher than its authorized ROE, then 80 percent of the difference
11 between the actual and authorized ROE would be credited to remediation expenses. If
12 the actual ROE is greater than 50 basis points above authorized, then 80 percent of the
13 earnings between authorized and 50 basis points above will be credited to remediation
14 expenses and 50 percent of the earnings in excess of 50 basis points above authorized
15 would be credited to remediation expenses.

16 In addition, NWIGU recommends two levels of sharing. First, NWIUG recommends
17 that 11 percent of the remediation expense be attributed to NW Natural's non-regulated
18 affiliates. Second, NWIGU recommends 90/10 sharing of the amounts remaining after 11
19 percent is allocated to affiliates. NWIGU further recommends that prospective base rates
20 include remediation expenses based on a five-year forecast, which will be set in a general
21 rate case.

22 NWIGU also recommends that the insurance proceeds be used to offset the
23 amounts that customers would otherwise pay. NWIGU recommends that approximately
24 52 percent of the insurance proceeds should be allocated to historical deferrals and the
25 remaining 48 percent allocated to future expenses. However, if the Commission rejects
26 NWIGU's sharing proposal, then NWIGU recommends that only one-third of the insurance

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1 proceeds should be allocated to historical deferrals, with the remaining two-thirds
2 allocated to future expenses.

3 NWIGU's testimony fails to justify its sharing proposal, which would attribute 11
4 percent of the remediation expenses to NW Natural's non-regulated affiliates.[149] NWIGU's
5 failure is significant, particularly in light of the fact that the remediation expenses arise
6 from costs associated with MGPs that were used to provide utility service. Therefore, as
7 both the Company and Staff agree, NWIGU's recommendation is completely without
8 merit.[150]

9 Further, although NWIGU's earnings test is preferable to the tests proposed by Staff
10 and CUB, NWIGU recommends an earnings test that would allow the Company to retain
11 some earnings in excess of its authorized ROE.[151] In this way, NWIGU does allow NW
12 Natural to earn up to the top of a reasonable range. However, when coupled with
13 NWIGU's sharing proposals, NWIGU's multi-tiered sharing proposal is still overly
14 restrictive.

15 NWIGU's proposal to use the insurance proceeds to offset only the portion of the
16 remediation expenses that will be paid by customers is also unreasonable. If the
17 Company is going to bear some of the remediation expenses, even though in the normal
18 course the cost is one that customers would bear, then the Company should also receive
19 the benefit of the insurance. Thus, the insurance proceeds should be used first to offset
20 the remediation expenses before the earnings test is applied.

21

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[149] NWIGU/100, Gorman/4.

23 [150] NWN/900, Miller/41; Staff/300, Johnson-Bahr/2 ("Staff's direct testimony analyzes the historical
24 ratemaking treatment of revenues from the sales of non-gas by-products produced from the natural gas manufacturing process. The analysis concludes that such revenues were credited to regulated
25 operations thereby reducing the rates of regulated operations. Therefore, it seems unreasonable to allocate some of the costs to non-regulated operations.").

26 [151] NWIGU/200, Gorman/6-7.

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F. The Company Agrees with Staff's Conclusions Regarding the Prudence of the Historical Remediation Costs.

Staff concluded that all but roughly $33,000 of the historical remediation costs were prudently incurred. The Company agrees with Staff's analysis and conclusions.[152] The Company relies on the testimony filed in Phase I of this proceeding to support the prudence of the historical remediation efforts.[153]

G. The Company's Interstate Cost Allocation Proposal is Reasonable.

Consistent with its proposal in Phase I,[154] the Company continues to support the allocation of costs between Oregon and Washington based on the historical allocation factors that more accurately reflect the service received by customers in each state from the MGPs.[155] However, for the Portland Gas Manufacturing site, all of the remediation expense should be allocated to Oregon because that MGP served only Oregon customers.[156]

IV. CONCLUSION

The Commission should adopt the Company's proposed earnings test—it is consistent with the Commission's earning test framework, recognizes the nature and extent of the costs at issue, reasonably balances the interests of the Company and customers, and preserves the incentive inherent in the regulatory construct and incentives designed by the Commission for customer benefits. Conversely, the parties' proposals significantly and materially depart from standard utility ratemaking by proposing a long-term cap on NW Natural's earnings at or below its authorized ROE. The Commission

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[152] NWN/900, Miller/41.

[153] *See* NWN/200.

[154] NWN/100, Miller/26-27.

[155] NWN/900, Miller/42.

[156] NWN/900, Miller/42.

1 should reject the parties' proposals as inconsistent with its own precedent and contrary to
2 well-established ratemaking principles.
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4 Respectfully submitted this 2nd day of July, 2014.
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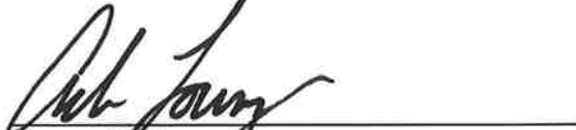

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1 **CERTIFICATE OF SERVICE**

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

3 1635 on the following named person(s) on the date indicated below by email addressed to said

4 person(s) at his or her last-known address(es) indicated below.

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