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March 20, 2014

VIA ELECTRONIC FILING AND FIRST CLASS MAIL

Public Utility Commission of Oregon
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Post Office Box 1088
Salem, Oregon 97308-1088

Attn: Filing Center

**Re: Docket UM 1635-Phase II – Northwest Natural Gas Company’s Mechanism
for Recovery of Environmental Remediation Costs**

Northwest Natural Gas Company, dba NW Natural (“NW Natural” or “Company”), files herewith Direct Testimony of Alex Miller in the above-captioned docket. Enclosed are an original and five copies.

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

Please call me with any questions.

Sincerely,

/s/ Mark R. Thompson

Mark R. Thompson

enclosure

cc: UM 1635 Service List

BEFORE THE
PUBLIC UTILITY COMMISSION OF OREGON

UM 1635

Phase II

NW Natural

Direct Testimony of C. Alex Miller

March 20, 2014

**EXHIBIT 800 – DIRECT TESTIMONY – RECOVERY OF ENVIRONMENTAL
REMEDATION COSTS**

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1 A. Previously in this docket (in “Phase I”), NW Natural advocated for an earnings test that
2 would require the Company to contribute all earnings 100 basis points above its
3 authorized return on equity (“ROE”) to the payment of prudently-incurred environmental
4 remediation expenses. We proposed that this same earnings test apply to both past and
5 future deferrals. For past deferrals we also advocated the aggregation of all the years
6 over which deferrals were made to determine the Company’s earnings. Finally, we
7 recommended that the Public Utility Commission of Oregon (“Commission”) consider
8 delaying any decision on an earnings review as applied to past amounts because the
9 insurance litigation trial would be taking place in the near future and we might soon know
10 whether we would have sufficient insurance proceeds to entirely offset past deferrals,
11 making a backward-looking earnings review unnecessary.

12 Staff, the Northwest Industrial Gas Users (“NWIGU”), and the Citizens’ Utility
13 Board of Oregon (“CUB”) each advocated for their own approach; however, in general,
14 these parties recommended both forward- and backward-looking mechanisms that
15 would disallow amortization of prudently incurred environmental expenses even when
16 the Company’s actual earnings are below authorized ROE.

17 After several rounds of testimony had been filed, the parties agreed upon an
18 earnings review for all past and future deferrals. The parties testified that they believed
19 the settlement represented a reasonable compromise, including fair trade-offs of the
20 parties’ positions regarding the forward- and backward-looking earnings review.

21 On November 18, 2013, the Commission issued Order No. 13-424 in which the
22 majority rejected the parties’ stipulation. The Commission did not provide guidance as to
23 how the earnings review should be constructed; nor did it articulate the principles upon
24 which the earnings review should be based. The majority did, however, state that it

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1 viewed the \$7.0 million disallowance of past amounts as too low. The majority also
2 stated that the policy considerations implicated by the earnings review are significant
3 enough that the case should not be settled by stipulation. Chairwoman Ackerman issued
4 a dissent in which she concluded that the stipulation was reasonable. The Commission
5 also ordered further proceedings to provide a more thorough examination of the facts
6 and policy standpoints presented in this case. This Phase II addresses the questions
7 issued by ALJ Memorandum, after the Commission ordered further proceedings.

8 **Q. Please summarize NW Natural's testimony in this Phase II.**

9 A. The Company's environmental remediation expenses are unique—in duration,
10 magnitude, and kind. These expenses are expected to continue well into the future, for
11 perhaps as long as 20 years. Moreover, the amount of the expense is substantial. The
12 Company's deferrals to date, before application of insurance, exceed \$100 million, and
13 future cumulative expenditures are expected to be in the range of \$98 million to \$350
14 million or more. In comparison, NW Natural's *entire net operating revenues*, as
15 authorized in UG 221, are \$68 million.

16 The environmental remediation expenses are also unlike many types of utility
17 expenses in that they are mandated by state and federal environmental regulators.
18 Consequently, NW Natural has limited control over the timing and extent of the
19 expenses.

20 As background, the Company initially asked to defer its environmental
21 remediation expenses because it believed that it likely would soon have enough
22 insurance to offset its costs, and therefore it made no sense to build the expense into
23 base rates. In other words, the decision to defer was made primarily for the benefit of
24 customers. And in fact, had insurance companies made prompt payment, there would

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1 have been no positive deferrals and no amounts subject to an earnings review.
2 Unfortunately, the insurance carriers resisted payment, and the Company was forced to
3 sue.

4 As the insurance coverage litigation dragged on, the Company would likely have
5 been content to continue to defer its expenses, pending resolution, but for the fact that
6 Staff was voicing concern about the amount of the deferral balance. Had the Company
7 declined to seek amortization in the Company's last rate case, the insurance money that
8 ultimately came in would automatically have been applied to the deferral balance and
9 the issue of an earnings review would appropriately never have arisen.

10 It is also important to consider that the SRRM is an automatic adjustment clause
11 and as such, an earnings review is not required by law, but rather is apparently being
12 imposed as a matter of policy by the Commission.¹

13 In light of the foregoing, the adopted earnings review should comport with the
14 following three policy considerations:

15 **1. *Consistent with Commission precedent, the earnings test should be***
16 ***tailored to the nature of the actual costs to which it is being applied.*** The
17 earnings test will apply to significant, ongoing expenses that are mandated by
18 state and federal regulators. For good reason, these expenses have been
19 deferred, rather than collected through base rates: they are substantial, they are
20 subject to offsets, they are difficult to predict, and it is important to all

¹ The parties have disagreed as to whether an earnings review is mandated by law for past deferral amounts, but it is clear that the Commission is not legally required to perform an earnings review for future deferrals through the SRRM. *Re Northwest Natural Gas Co.*, Docket UG 221, Order No. 12-437 at 27, n. 61 (Nov. 16, 2012).

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1 stakeholders that customers pay no more than actual environmental remediation
2 expenses. Imposing an earnings test that does not consider these facts can
3 have severe consequences to the Company and its customers, and could result
4 in an earnings test that implements poor regulatory policy.

5 **2. *The earnings test must fairly and reasonably balance the interests of***

6 ***customers and the Company.*** Consistent with the fundamental purpose of the
7 earnings review, the earnings test should ensure that customers are not required
8 to bear expenses that are deferred when the utility's earnings are unreasonably
9 high. Conversely, the earnings test should also ensure that the Company may
10 recover its prudently incurred remediation expenses when its earnings are within
11 a reasonable range.

12 **3. *The Commission should not adopt an earnings test that undermines the***

13 ***carefully-crafted incentives that the Commission has adopted for the***
14 ***Company.*** The Commission should craft the earnings review in such a way as
15 to avoid unintended consequences or illogical results. In particular, the
16 Commission should avoid an earnings test that erodes the carefully crafted
17 incentive mechanisms that have served customers well in the past, or one that
18 subverts important general regulatory policies.

19 The earnings review originally proposed by NW Natural in Phase I comports with
20 each of these policy considerations; therefore the Company's recommendation in this
21 Phase II is consistent with its initial proposal. NW Natural refers to, and incorporates its
22 testimony from Phase I of this docket, and for that reason does not repeat all of the
23 points made there.

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1 Specifically, NW Natural continues to support an earnings test that would allow
2 the Company to recover all prudently-incurred deferred environmental remediation
3 expenses as long as the Company's earnings are below the top of a reasonable range,
4 which we propose be defined as 100 basis points above its ROE established in its most
5 recent rate case.

6 NW Natural's proposal here is consistent with the important principles that it
7 believes should guide the Commission in this docket. *First*, NW Natural's proposal
8 recognizes the unique nature of the costs that are being subjected to the earnings test,
9 which are difficult to forecast, and therefore inclusion in base rates is problematic. They
10 are also substantial and ongoing in nature. Consistent with Commission precedent, the
11 Company should be allowed to recover such deferrals so long as its earnings are in a
12 reasonable range.

13 *Second*, NW Natural's proposed earnings review treats both customers and the
14 Company fairly. Customers are protected from absorbing deferred expenses when the
15 Company's earnings exceed a reasonable range, and the Company is allowed to
16 recover its environmental costs so long as its earnings are in a reasonable range.

17 *Third*, NW Natural's proposal allows for an earnings test that operates in concert
18 with other important regulatory policies. Specifically, it keeps intact important incentives
19 for the Company that benefit customers, maintaining the Company's overall incentives to
20 manage its business well, and its specific incentives to minimize gas costs and maximize
21 interstate storage and optimization revenues.

22 NW Natural also continues to support the reasoning behind its proposal for the
23 backward-looking earnings test, which is to judge amortizations against the aggregate or
24 average Company earnings over the total deferral period.

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1 However, despite the important questions as to how an earnings test should be
2 applied to past deferrals, these questions are, in this case, now inapplicable. On
3 February 3, 2014, the Company settled the last remaining insurance claims and as a
4 result, will receive a total of \$150.5 million in insurance proceeds. This means that the
5 Company will receive more insurance money than the amounts that have been deferred
6 and that customers do not need to pay for the past deferred amounts. Under the
7 Commission's deferral orders, and the Commission's order in UG 221, NW Natural's
8 deferrals were to be offset by insurance payments. The Company always intended, and
9 believes that the Commission intended, that the Company would use insurance receipts
10 to pay for environmental remediation costs before it relied on customers' rates to do so.
11 As such, it is neither necessary nor appropriate for the Company to seek amortization of
12 amounts deferred to date.

13 If the Commission, for any reason, were to find that the Company should charge
14 customers for past deferred amounts, despite the availability of insurance receipts to
15 cover them, the Commission should conduct the earnings test looking at the average
16 earnings of the Company for the historical period over which the costs were deferred.
17 While the costs can be assigned into the year they were incurred, the offsetting
18 insurance collections do not come with a year assigned-- they cannot rationally be
19 allocated to individual years, as one allocation scheme is not more reasonable than
20 another.

21 For future deferrals, to the extent insurance proceeds are not available to cover
22 such amounts, the earnings test may be conducted on an annual basis.

23 **Q. How is your testimony organized?**

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1 A. First, I will restate the policy considerations that should inform the design of the earnings
2 test, and I will explain why NW Natural’s proposal is consistent with and supports these
3 considerations. In this section I will specifically address how the Commission should
4 determine what constitutes reasonable earnings for NW Natural (both historically and
5 prospectively).

6 Second, I address the specific questions posed in the ALJ Memorandum
7 regarding the historical earnings test—focusing on whether to aggregate past earnings
8 and the treatment of revenues or losses from the Weighted Average Cost of Gas
9 (“WACOG”) incentive mechanism. In this section I also address the appropriate
10 treatment of insurance proceeds.

11 Third, I address the specific questions posed in the ALJ Memorandum regarding
12 the prospective earnings test, including whether and how the Commission should
13 include incentives in the earnings test for NW Natural to minimize costs and maximize
14 insurance recoveries. I also address whether to aggregate future years for purposes of
15 the earning test and the appropriate treatment of WACOG earnings.

16 Fourth, I address the Commission’s questions regarding the inclusion of
17 environmental remediation expenses in base rates.

18 **II. EARNINGS TEST—GENERAL PRINCIPLES**

19 **Q. The ALJ Memorandum asks the parties to address the policy considerations that**
20 **should guide the Commission’s adoption of an earnings test mechanism, as**
21 **applied to expenditures both before and after December 31, 2012? What is your**
22 **response?**

1 A. The Company believes that the same general policy considerations should guide the
2 development of the earnings test that will be applied to historical and future deferrals.
3 On that point, I would note that the suggested demarcation date between past and future
4 costs of December 31, 2012 appears to be an artifact of the parties' settlement, but no
5 longer has any significance. From a principled and policy standpoint, the Commission
6 should simply distinguish between those expenses that have already been incurred and
7 those that will be incurred in the future. With that in mind, first and foremost, the
8 Commission should consider the fundamental purpose of an earnings test, which is to
9 ensure that the Company does not collect amounts that are deferred in periods when it
10 is earning above a reasonable range of ROE.² Given this, the Commission should
11 establish an earnings review that complies with the following policy considerations:

- 12 **1. *Consistent with Commission precedent, the earnings test should be***
13 ***tailored to the nature of the actual costs to which it is being applied.***
- 14 **2. *The earnings test must fairly and reasonably balance the interests of***
15 ***customers and the Company.***
- 16 **3. *The Commission should not adopt an earnings test that undermines the***
17 ***carefully-crafted incentives that the Commission has adopted for the***
18 ***Company.***

19 **Q. You have stated that it is consistent with Commission precedent to tailor the**
20 **earnings review to the specific type of costs deferred. Please explain.**

² *Re PacifiCorp*, Dockets UE 121/UM 995, Order No. 02-410, 2002 WL 1773021 at * 6 (June 20, 2002) (earnings review is intended "to determine whether the utility could have absorbed some or all of the deferred amounts" and still have earned a reasonable ROE).

1 A. The Commission tailors the earnings test to the particular type of deferral under
2 consideration.³ In particular, the Commission has determined that the type of deferral
3 will dictate where the maximum collection level is set within a reasonable range of
4 earnings. In Order No. 93-257, the Commission discussed three types of deferrals and
5 explained the type of earnings test that would be applicable to each as follows:

- 6 1. *For deferrals related to an emergency increase in cost, the Commission may apply*
7 *an earnings test to allow the utility to amortize the deferral to the degree that it raises*
8 *the utility's earnings to the bottom of a reasonable range of rate of return with the*
9 *goal of encouraging the utility to control costs.*
- 10 2. *If the deferral created a fund for the benefit of customers, the Commission could*
11 *apply an earnings test that would require the utility to refund the deferral up to the*
12 *amount that would bring the utility's earnings to the bottom of the reasonable range*
13 *of rate of return.*
- 14 3. *If the deferral was of a cost that was intended to be borne by customers but was*
15 *delayed in order to match costs and benefits, the Commission might apply an*
16 *earnings test that would allow the utility to amortize the deferral **up to the top of a***
17 ***reasonable range of rate of return.***⁴

18 As I explained in my Phase I testimony, the environmental deferral best matches the
19 third category. *First*, in UG 221, the Commission expressly found that the deferred
20 environmental remediation costs are appropriately borne by customers.⁵ *Second*, given
21 the difficulty of forecasting these costs, and the offsetting insurance benefits, the
22 Commission appropriately found that deferral was necessary in order to match costs and
23 benefits⁶—in other words, to avoid over- or under-recoveries. It is reasonable that these

³ *In re Portland Gen. Elec. Co. Application for an Order Approving Deferral of Costs*, Dockets UM 445 and UE 82, Order No. 93-257 at 11 (Feb. 22, 1993) (“[T]he earnings test should be designed to further the purpose of the deferral in the first instance . . . the earnings test could well vary with the circumstances of each case...In the future, the Commission intends to tailor earnings tests to fit the type of deferral.”).

⁴ Order No. 93-257 at 11-12 (emphasis added).

⁵ Order No. 12-437 at 31-32.

⁶ See e.g., *Re Northwest Natural Gas Co.*, Docket UM 1078(11), Order No. 14-015 (Feb. 18, 2014).

1 deferrals fall into the third category because, as discussed in more detail below, these
2 amounts are significant, will be incurred over a long time period, and traditional
3 ratemaking methodology is not well suited to address recovery of these costs.

4 In many ways, these cost deferrals are similar to natural gas cost deferrals that
5 are run through the PGA, which recover ongoing, recurring, significant costs. It is worth
6 noting that commodity cost deferrals are not subject to an earnings test.

7 **Q. How should the Commission determine what constitutes the top of a reasonable**
8 **earnings range for NW Natural?**

9 A. At the outset, I want to recognize that the Commission has never defined the precise
10 points at which a reasonable range of earnings begins and ends; therefore the selection
11 of the correct point to define the top of the range will clearly require judgment and
12 context. That said, the Company recommends that for the purpose of constructing this
13 earnings review, the top of the range of reasonable earnings should be set at 100 basis
14 points above the Company's authorized ROE. In other words, the Commission should
15 allow the Company to amortize its prudently incurred deferred environmental costs so
16 long as the Company's earnings are not above a "cut-off point" that is set at 100 basis
17 points above its allowed ROE.

18 **Q. Why do you suggest that the Commission define the top of the range at 100 basis**
19 **points?**

20 A. The Commission uses 100 basis points above ROE to define the point where the
21 Company begins to share earnings with NW Natural's customers in NW Natural's Spring

1 Earnings Review.⁷ I would note that the Company is allowed to keep a percentage of
2 earnings when earnings are *above* the 100 point band—suggesting that 100 basis points
3 approaches but is not at the very top of a reasonable range of earnings. And if the
4 Company elects 80/20 sharing in the PGA, the Company retains all earnings up to 150
5 basis points above its ROE. Thus earnings more than 100 basis points above ROE
6 should not be considered *per se* excessive. Nevertheless, we suggest that the earnings
7 cutoff be set at 100 basis points above authorized ROE.

8 **Q. What would be the effect of setting the cut-off point for earnings at or below the**
9 **Company's ROE?**

10 A. The effect would be to essentially “cut-off” the Company's total utility earnings at or
11 below its authorized ROE. This deferral is unique—it will continue for many years, and
12 the magnitude of the expenditures represents a significant percentage of the Company's
13 earnings. In fact, in any one year it is highly unlikely that any potential earnings greater
14 than the authorized ROE could ever exceed the amount of the environmental deferral.
15 For this reason, as a practical matter, wherever the earnings test “cuts off”
16 environmental deferrals will serve as the cap on the Company's earnings.

17 To understand this point, it is important to consider the magnitude of past and
18 expected future deferrals. The balance of actual environmental expenditures since
19 2003, with interest, totaled \$113 million at the end of 2013. And the Company forecasts
20 expenditures in the range of \$98 million to \$350 million or more. Importantly, on an

⁷ See, e.g., *Re NW Natural Gas Co. Investigation into the Purchased Gas Adjustment (PGA) Mechanism Used by Oregon's three Local Distribution Companies*, Docket UM 1286, Order No. 08-504 (Oct. 21, 2008).

1 annual basis environmental deferrals have consistently exceeded any earnings the
2 Company achieved above its authorized ROE.

3 Given estimates of future environmental expenditures and the Company's past
4 earnings experience, it becomes clear that the Company's potential earnings over its
5 authorized ROE are highly unlikely to exceed its annual environmental expenditures.⁸
6 As a result, in the future the Company is highly unlikely to earn at a level greater than
7 the cut-off point for amortizations. So, if the cut-off is set at 50 basis points below ROE,
8 for example, the Company will not earn above 9.0 percent. If the cut-off is set at
9 authorized ROE, the Company will not earn above 9.5 percent. As further explained
10 below, this "cap" on utility earnings would have a significant effect on the current
11 regulatory construct, removing the normal incentive and opportunity that utilities have to
12 benefit from good management and actions that are responsive to incentives the
13 Commission has crafted.

14 **Q. Does this mean that the Company can expect to earn its authorized ROE if the**
15 **Commission sets the cut-off for deferral of its environmental remediation costs at**
16 **the Company's authorized ROE?**

17 A. No, in fact this would mean that the Company would, on average, likely not be able to
18 achieve its authorized ROE. Like most utilities, NW Natural's earnings tend to fluctuate
19 from year to year. So, if in some years the Company earns more than its authorized
20 ROE, and is forced to relinquish such earnings down to a level at or below authorized
21 ROE, but is then left to bear the under-earnings in years it is not able to achieve its

⁸ For the 2003-2011 period, the Company's over-earnings never exceeded its environmental expenditures in a given year. See NWN/101 line 41.

1 authorized ROE, then on average the Company will earn below its authorized ROE.⁹
2 This would be the functional equivalent of the Commission deciding to reduce the
3 Company's authorized ROE simply because it is engaged in environmental remediation
4 efforts—an action for which there is no support.

5 This would be a harsh result and one to which investors would react negatively.
6 Indeed, the result would be so harsh that it appears it would violate the fundamental
7 ratemaking principle set forth in *Hope*¹⁰ and codified at ORS 756.040, which provides
8 that a utility must be allowed an opportunity to recover its reasonable expenses and
9 capital costs, including an opportunity to achieve its authorized rate of return.

10 **Q. Are there additional policy implications if the earnings test caps earnings at or**
11 **below the Company's authorized ROE?**

12 A. Yes. In the normal course of business, ongoing utility expenses are recovered through
13 general rates, which are set in rate cases based on the utility's forecast expenses. In
14 between rate cases, the Company bears management decision-making risk, meaning
15 that if the Company manages itself well, it retains the benefit of any costs savings
16 compared to base rates. And, if it does not manage itself well, it bears the expense
17 difference between its actual expenses and the expenses assumed in rates. If the
18 earnings test applied to environmental remediation deferrals effectively caps NW
19 Natural's earnings at a level that is at or below its authorized ROE, then it will undermine
20 this vital regulatory construct.

⁹ Lines 45-53 of Exhibit NWN/101 demonstrate that if the cut off for amortization had been the Company's authorized ROE during the historic deferral period, the Company's 2003-2011 average ROE would have been 9.81 percent.

¹⁰ *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

1 **Q. Would the other parties' proposals in this case result in the same problems you**
2 **describe above?**

3 A. Yes. In fact, the parties' proposals appear to be even more problematic, essentially
4 capping NW Natural's earnings at well below its authorized ROE due to the fact that NW
5 Natural is deferring environmental remediation expenses. The following illustration
6 shows the impacts of CUB's alternative recommendation from Phase I. CUB proposed
7 the following sharing bands:

- 8 • Customers would pay 100 percent of the costs up to 100 basis points below
9 authorized ROE;
- 10 • Customers would pay 80 percent of the costs from 100 basis points below
11 authorized ROE to authorized ROE;
- 12 • Customers would pay 10 percent of costs up to 100 basis points above the
13 authorized ROE; and
- 14 • Customers would pay no costs above 100 basis points above authorized ROE.

15 As applied to future deferrals, the following results at various ROEs are illustrated*:

	8.5%	9.5%	10.5%
NW Natural's over(under)-earnings vs. 9.5%	(\$8.45 million)	\$0	\$8.45 million
NWN contribution of earnings toward environmental spend¹¹	\$0	\$8.45 million	\$11.6 million
Effective ROE after application of sharing	8.5%	8.5%	9.1%

16 *over(under) earnings calculated using the ROEs indicated, 2012 Earnings Test
17 Rate Base and UG 221 cost of capital

¹¹ Assumes \$25 million of environmental spend.

1 As illustrated, CUB's proposal results in contributions to environmental deferrals
2 that ultimately cap the Company's earnings at the *bottom* of the band, or 8.5 percent.

3 **Q. How would Staff's proposal from Phase I impact the Company's effective ROE?**

4 A. During Phase I, Staff proposed an earnings test with the following sharing bands:

- 5 • If the Company earns within 50 basis points below authorized ROE and 50 basis
6 points above authorized ROE, environmental remediation costs would be split
7 between customers and shareholders on a 50/50 basis;
- 8 • For results lower than 50 basis points below authorized ROE, ratepayers pay 95
9 percent of environmental remediation costs while the Company bears 5 percent;
10 and
- 11 • For results above more than 50 basis points above authorized ROE,
12 shareholders would pay 95 percent of costs while customers bear 5 percent.

13 Although some of the precise details about how Staff's proposed sharing would work are
14 unclear, NW Natural estimates that it would produce the following results at various
15 ROEs the Company may otherwise realize.

	8.5%	9.5%	10.5%
NW Natural's over(under)-earnings vs. 9.5%	(\$8.45 million)	\$0	\$8.45 million
NWN contribution of earnings toward environmental spend	\$1.25 million	\$5.05 million	\$12.86 million
Effective ROE after application of sharing	8.35%	8.9%	8.98%

16 *over(under) earnings calculated using the ROEs indicated, 2012 Earnings Test Rate Base and
17 UG 221 cost of capital; assumes \$25 million of environmental expense.
18
19

1 As illustrated, the effect of Staff's proposal would also reduce the Company's
2 earnings to well below its authorized ROE.

3 **Q. Could you address how the remaining policy considerations apply to your**
4 **proposal?**

5 **A.** I believe my comments above fairly address the second policy consideration. That is,
6 setting the earnings test cut-off at 100 basis points above ROE balances customer and
7 Company interests by (a) preventing customers from absorbing expenses deferred
8 during periods where the Company was earning above a reasonable range, while (b)
9 allowing the Company a fair opportunity to earn at or above its authorized ROE, thereby
10 avoiding the depression of its earnings.

11 **Q. What about the third policy consideration regarding incentives?**

12 **A.** In addition to allowing the Company to achieve a reasonable range of earnings, the
13 mechanism should preserve the balance of policies and incentives that have served and
14 will continue to serve both NW Natural and customers into the future. The mechanism
15 will likely need to be in place for at least the next decade, and could easily be in place for
16 the next 20 years. Thus, given the magnitude of the potential costs involved, the
17 earnings review will constitute a significant component of the regulatory framework
18 under which the Company will operate for a very long time. If the mechanism eliminates
19 the carefully crafted incentives the Commission has adopted for NW Natural over time,
20 customers and the Company could be significantly and negatively affected. For all of
21 these reasons, the earnings test must be designed to respond to the unique
22 circumstances of the deferral and to preserve the balance of policies and incentives that
23 will serve the utility and its customers into the future.

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1 **Q. Please explain your statement that the earnings test should preserve the balance**
2 **of policies and incentives it has adopted for NW Natural over time.**

3 A. Like other utilities in Oregon, NW Natural currently operates under a framework of cost
4 recovery policies and incentive mechanisms that are intended to encourage cost
5 containment and revenue generation for the benefit of the Company's customers. The
6 most important of these flows from the general rate recovery principle inherent in the
7 regulatory compact—that is, to the extent a utility exercises good management to reduce
8 costs between rate cases, the utility retains the benefits of that good management, and
9 customers realize these benefits when reduced costs are built into rates in future rate
10 proceedings. If the SRRM earnings test effectively caps the Company's earnings at or
11 below its authorized ROE, this "good management incentive" would be significantly
12 undermined.

13 **Q. Has the Commission endeavored to preserve this important aspect of the**
14 **regulatory compact when constructing earnings reviews in the past?**

15 A. Yes. The Commission has intentionally preserved the "good management incentive"
16 aspect of the regulatory compact by declining to use the earnings review to
17 micromanage utility earnings. Specifically, when the Commission first adopted the PGA
18 sharing mechanism in UM 903 the Commission explained its goal as follows:

19
20 At the outset, we note that our discussion on this issue is focused
21 on establishing an earnings threshold and sharing percentage of
22 revenues deemed excessive for NW Natural.

23 * * *

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

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1 ***subject to detailed review and adjustment. Indeed, such***
2 ***scrutiny may eliminate any incentive for the company to***
3 ***pursue efficiencies.***¹²

4 Ultimately, the Commission set the earnings threshold at 300 basis points above
5 benchmark ROE,¹³ stating:

6 An earnings threshold set at 300 basis points above the
7 benchmark ROE will protect the interests of ratepayers and allow
8 the company the opportunity to pursue increased earnings
9 through cost management and operating efficiencies.¹⁴
10

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

14 **Q. Have other commissions likewise attempted to preserve this incentive when**
15 **designing earnings tests?**

16 A. Yes. The Washington Utilities and Transportation Commission recently recognized that
17 this principle is an important part of the regulatory construct when it rejected a provision,
18 agreed to by Avista, that would have essentially capped that utility's earnings at
19 authorized ROE.¹⁵ The Commission observed that such a cap "would send the wrong
20 signal to the Company." The Commission continued:

21 Under ratemaking theory applied by this and other state
22 commissions for decades, companies should have every
23

¹² *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).

¹³ 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.

¹⁴ *Id.* at 9.

¹⁵ *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).

1 incentive to manage the company efficiently in order to
2 earn more for the company shareholders. We should not
3 set an artificial cap on earnings that could diminish that
4 incentive for efficient management. Further, if Avista were
5 to “overearn” through savings efforts, those savings would
6 become the new norm in the next rate case which would
7 serve to benefit ratepayers in the future. Indeed, the
8 Company’s efforts to save money through efficiency are a
9 key element to earning its allowed rate of return.¹⁶

10 **Q. What are the other incentive mechanisms that could be affected by the earnings**
11 **test?**

12 A. The other obvious mechanism that could be undermined by a poorly constructed
13 earnings review is the WACOG incentive. The Commission has adopted the Purchased
14 Gas Adjustment mechanism (PGA) to provide local distribution companies (LDCs) with
15 an incentive to minimize their gas costs.¹⁷ The Commission has altered the PGA on
16 occasion, but it has always provided the LDCs with an incentive to actively seek lower
17 gas prices by allowing them to retain gas savings that could take earnings above
18 authorized ROE. Under the current PGA, NW Natural is allowed to keep gas savings up
19 to 100 basis points above authorized ROE (or 150 basis points, depending on its sharing
20 election under the PGA)—after which it shares earnings with customers on a 33/67
21 basis. If the SRRM earnings test effectively caps the Company’s earnings at or below its
22 authorized ROE, both of these policies would be significantly undermined.

23 As I have explained, an earnings test that cuts off amortization of environmental
24 deferrals at the Company’s authorized ROE would essentially cap the Company’s
25 earnings at that level. In fact, if the amortization threshold is set at authorized ROE, as a

¹⁶ *Id.*

¹⁷ See *Re. Pub. Util. Comm’n of Or. Investigation into the Purchased Gas Adjustment (PGA) Mechanism Used by Oregon’s Three Local Distribution Companies*, Docket UM 1286, Order No. 08-504 at 4 (Oct. 21, 2008).

1 practical matter it is highly likely that on average the Company will earn below its
2 authorized ROE.¹⁸ In this way, if the earnings are cut off at the authorized ROE, year
3 after year the Company can expect to give up through the SRRM earnings test all
4 earnings it might have otherwise achieved through WACOG incentives (as well as other
5 incentives and efficiency measures)—thus significantly muting the incentives present
6 under current Commission policy.

7 In Phase I of this docket, CUB argued that the Company can still expect to earn
8 more than its authorized ROE in some years—pointing to the fact that in some years in
9 the past environmental expenses were as low as \$5.3 million, while the Company
10 retained \$4.4 million in PGA savings.¹⁹ However, this point actually demonstrates that
11 even at its lowest expense level since 2005, the Company’s environmental expenses
12 easily exceeded WACOG sharing, while at the same time, environmental expenses have
13 been ramping up over time. And, more fundamentally, CUB overlooked the fact that the
14 Company’s share of the WACOG keeper is already included in the Company’s results of
15 operations. Given this, CUB’s proposal would merely require the Company to contribute
16 its entire share of WACOG savings toward environmental deferrals, rather than giving
17 the Company an opportunity to potentially earn greater than its authorized ROE.

18 **Q. What other incentives should the Commission consider when designing an**
19 **earnings test?**

20 A. The treatment of the Company’s natural gas storage and pipeline optimization revenues
21 is relevant to the prospective earnings test. In both this docket and Docket UM 1654,

¹⁸ See NWN/100, Miller/20-21.

¹⁹ CUB/100, Jenks/10.

1 CUB has argued that the Company should include its natural gas storage and pipeline
2 optimization profits in earnings for purposes of earnings tests.²⁰

3 **Q. Does the Company agree with CUB's suggested approach?**

4 A. No. And in fact CUB suggests in this docket that the Company is proposing to exclude
5 optimization earnings as if those revenues had previously been included in regulated
6 earnings. On the contrary, optimization profits have always been regarded by the
7 Commission and the Company as unregulated earnings and have never been
8 considered in the results of operations used for regulatory purposes. It would be a clear
9 departure from past Commission treatment for a business activity that is not fairly
10 characterized as a core utility service to be included in regulated earnings.
11 CUB's proposal to add optimization earnings to regulated earnings—making them
12 subject to non-recovery each year under the SRRM earnings test—together with CUB's
13 recommendation that the Company be forced to give up earnings in excess of
14 authorized ROE, would effectively remove the incentive to maximize savings from
15 resource optimization. This incentive is necessary for the Company to continue to justify
16 the risk, additional cost, and innovation required to pro-actively take advantage of
17 changing market conditions. Because these optimization activities have been governed
18 by a "win/win" sharing agreement over the last ten years, customers have benefitted
19 immensely. By removing this incentive, CUB's proposal would leave both the Company
20 and customers worse off.

21 **III. EARNINGS TEST—PAST EXPENDITURES**

²⁰ In docket UM 1654 Staff also recommends that the storage and optimization revenues be included in the Company's results of operations reports.

1 **Q. Is it necessary for the Commission to conduct an earnings review on past**
2 **deferrals?**

3 A. No. The Company now has sufficient insurance recoveries to offset all deferrals to date.
4 Therefore, consistent with Commission orders, those recoveries should function to
5 entirely offset the deferral accounts and as such, the Company will not be seeking to
6 amortize any deferred amounts. Because it does not need to recover these deferrals
7 from customers, it does not need to add these amounts to rates, and no earnings test
8 should be applied to them.

9 **Q. Is such an offsetting of the deferrals with insurance proceeds consistent with**
10 **Commission orders?**

11 A. Yes. The Commission orders always made clear that the Company is to defer
12 environmental remediation expenses only to the extent that they exceed recoveries.
13 From the beginning, the Commission's orders approved deferrals of "unrecovered
14 environmental costs."²¹ Moreover, the Commission made its intent clear in its
15 Preliminary Order issued in NW Natural's last rate case—Order No. 12-498. In that
16 docket, the Commission first considered NW Natural's proposal to recover deferred
17 environmental remediation expenses through the SRRM. While the Commission
18 adopted the general framework of the proposal, it left a number of issues—including the
19 appropriate earnings review—unresolved. For that reason, pending the resolution of all
20 issues, the Commission concluded: ***"We agree with the company that deferral of***
21 ***environmental remediation expenses should continue as they are now, with***

²¹ See *Re Northwest Natural Gas Co.*, Docket UM 1078(1), Order No. 04-244 at1 (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 . . ."

1 **appropriate offsets when insurance proceeds are recovered.”**²² In other words, the
2 Commission certainly did not appear to intend that the Company would request
3 amortization of expenses if they could be offset by insurance recoveries.²³

4 Moreover, as a practical matter, NW Natural believes that its customers would
5 object to being burdened with payment of accumulated environmental remediation
6 expenses at a time when the Company has enough insurance to cover them.

7 **Q. The ALJ Memorandum asks the parties to address whether the earnings test**
8 **mechanism as applied to past deferrals should consider earnings and**
9 **expenditures on an annual or aggregate basis. What is your response?**

10 A. In the event that the Commission was to impose an earnings review on past deferrals,
11 the earnings test should be conducted for the full deferral period, using the Company's
12 average earnings over that time period, with adjustments to the deferred amounts to
13 reflect offsetting insurance recoveries. This review will show that NW Natural actually
14 under-earned during this time period, meaning that it makes little sense to impose any
15 disallowance on the basis of its actual earnings during this time.

16 Further, as noted above, while the costs can be assigned into the year they were
17 incurred, the offsetting insurance collection does not correspond to any particular
18 expenses and therefore cannot rationally be allocated to years, as one allocation
19 scheme is not more reasonable than another.

²² *Re Northwest Natural Gas Co.*, Docket UG 221, Order 12-408 at 5 (Oct. 26, 2012).

²³ In addition, the Company has always treated the insurance as an offset to the deferred environmental remediation expenses, Interest accruals on the deferred amounts have always been made net of insurance.

1 **Q. Is it consistent with Commission rules to conduct the earnings review on a total**
2 **period basis, as proposed by NW Natural?**

3 A. Yes. Under OAR 860-027-0300, the period the Commission uses for the earnings
4 reviews includes all or part of the period during which the deferral occurred or must be
5 reasonably representative of the deferral period. The rule specifies review of earnings
6 during the deferral “period” and does not specify that the period must be one year.²⁴

7 **Q. Has the Commission ever applied an earnings test based on an average basis**
8 **before?**

9 A. Yes. In Order No. 13-416 the Commission applied an earnings test based on a review
10 of Idaho Power Company’s (“Idaho Power”) average earnings over a historical 23 year
11 period.²⁵ In that case, the Commission stated that the unique circumstances of each
12 case determine whether to apply an earning test on an annual or average basis.

13 **Q. What unique circumstances warrant the use of an average basis for the earnings**
14 **test?**

15 A. In Order No. 13-416, the Commission averaged Idaho Power’s earnings, in part,
16 because the amounts subject to amortization were best regarded as a whole. In that
17 case the “whole” referred to a lump sum tax refund; that tax refund could have been
18 broken down and allocated on a year-by-year basis— however it had come in as one
19 lump sum adjustment to taxes and the Commission believed it was best considered as

²⁴ OAR 860-027-0300(9) (“Upon request for amortization of a deferred account, the . . . utility shall provide the Commission 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.”).

²⁵ *Re Idaho Power Co.*, Docket UE 233, Order No. 13-416 at 12 (Nov. 12, 2013).

1 one amount.²⁶ In our case the past environmental remediation expenses are also best
2 regarded as a whole. While the expenses can be allocated to the years in which they
3 were incurred, the offsetting insurance receipts were received in lump sum amounts. In
4 this sense the deferrals are most comparable to a balancing account. And, Commission
5 orders require the Company to offset the total amount of recoveries against the total
6 deferred expenses to produce the amount for amortization. Consistent with this
7 approach, the Company has calculated accrued interest on the deferral accounts net of
8 insurance proceeds.

9 **Q. The ALJ Memorandum also asks the parties to address the question of whether**
10 **revenue gains or losses from the WACOG incentive sharing mechanism should be**
11 **included in earnings for purposes of the earnings test. What is your response?**

12 A. The Commission has found that revenue gains and losses from the WACOG incentive
13 should be included in the Spring Earnings Review, and the Company will not argue here
14 that they should be removed for the purposes of the SRRM—so long as the SRRM
15 earnings review incorporates a cut-off for amortizations at 100 basis points above ROE.

16 **Q. How would a different earnings review for the SRRM compromise the WACOG**
17 **incentive?**

18 A. The WACOG incentive is included in earnings and in many years in which the Company
19 has earned over its rate case-established ROE, it has been in conjunction with WACOG
20 savings.²⁷ If the Company's ability to earn its ROE is cut off at some level at or below its

²⁶ Order No. 13-416 at 12.

²⁷ As demonstrated on line 15 of Exhibit NWN/101, between 2003 and 2011, the results of NW Natural's Spring Earnings Reviews demonstrate that NW Natural under-earned by approximately \$0.8 million (netting under- and over-earnings for the period). Reviewing earnings after removal of the WACOG incentive demonstrates that, on a period basis, NW Natural under-earned by \$12.8 million (line 28).

1 authorized ROE, then the incentive will be eliminated. If this treatment is applied to the
2 historical period, the Commission will be “stripping” the Company of the incentive that
3 was allowed in the past. Therefore, the cut-off for amortizations at least 100 basis points
4 above the Company’s authorized ROE is necessary if the WACOG revenue is included
5 in the Company’s earnings.

6 **IV. EARNINGS TEST—FORWARD-LOOKING**

7 **Q. The ALJ Memorandum asks whether the Commission should provide an incentive**
8 **for NW Natural to minimize environmental remediation costs and pursue**
9 **insurance remedies going forward. How do you respond?**

10 A. Given that the Company has settled with virtually all existing insurers, the question
11 regarding incentives to pursue insurance remedies is no longer relevant. I will therefore
12 confine my response to the incentives to minimize environmental remediation costs. On
13 that subject, in his testimony in Phase I, NW Natural witness Bob Wyatt explained that
14 the Company has very little control over the environmental costs it will incur. Mr. Wyatt
15 testified that the Environmental Protection Agency (“EPA”) and Oregon Department of
16 Environmental Quality (“DEQ”) exercise almost complete control over the studies that
17 NW Natural is required to perform and the remediation measures it will ultimately
18 adopt—and any noncompliance on NW Natural’s part would be met with penalties.²⁸

19 On the other hand, we have also discussed the fact that the Company has and
20 will continue to exercise what limited control it does have, by “pushing back” on agency
21 directives when we believe that there may be a less expensive solution.²⁹ So the bottom

²⁸ See NWN/200, Wyatt/16.

²⁹ See NWN/200, Wyatt/18-20.

1 line is that it is appropriate for the Commission to consider the Company's incentive to
2 minimize costs going forward, but that we all need to be realistic as to the Company's
3 ability to control the costs to any great degree. In fact, given the limited control the
4 Company can exercise, we would suggest that the current incentives are sufficient.

5 **Q. What current incentives does the Company have to minimize costs?**

6 A. The SRRM provides an incentive to the Company to manage its costs by allowing the
7 Company a reduced level of interest on deferred amounts after the prudence review has
8 been conducted. NW Natural finances its environmental remediation expenses in the
9 same way as it finances all of its expenses—with a mix of debt and equity. The
10 Commission has set the Company's authorized ROR at 7.78 percent. However, once
11 the deferred expenses are deemed prudent, before amortization they will accrue interest
12 at the five-year treasury rate plus 100 basis points, and once in amortization they will
13 accrue interest at the modified blended treasury rate which is currently only 1.38
14 percent. It is therefore in NW Natural's interest to minimize amounts in amortization.
15 This goal can be achieved by keeping the environmental costs as low as possible.

16 I also note that NW Natural competes for its customers, who have the choice
17 between using natural gas or other energy sources in their homes and business
18 processes. It is in NW Natural's interest to keep customers' rates as low as possible,
19 and we will continue to have a strong incentive to manage all costs that affect our
20 customers' rates, including environmental remediation costs.

21 **Q. The ALJ Memorandum also asks about how the Commission should address the**
22 **inclusion or not of WACOG earnings in prospective earnings calculations. How**
23 **do you respond?**

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1 A. For the same reasons discussed above, WACOG earnings should be included in the
2 earnings calculations only if the earnings test uses the same 100 basis point cut-off as
3 the Spring Earnings Review.

4 **Q. For future earnings reviews, the ALJ Memorandum asks whether the Commission
5 should address average versus aggregate earnings tests. How do you respond?**

6 A. On a going forward basis, the Commission should conduct annual earnings tests based
7 on the previous 12-month period. This is appropriate because it will be necessary to
8 conduct the earnings test each year before deferred amounts can be put into the SRRM
9 to be amortized.

10 **Q. The ALJ Memorandum also asked about how the Commission should address
11 treatment of insurance proceeds. How do you respond?**

12 A. As described above, the Company proposes that the insurance proceeds be allocated to
13 the past deferrals. Excess proceeds should offset future expenses as they are incurred.

14 **V. INCLUSION IN RATES**

15 **Q The ALJ Memorandum asks the parties to address whether the Commission
16 should continue to defer all environmental remediation expenses, or place a
17 certain amount in rates each year on a forward-looking basis without subjecting
18 that amount to deferral. How do you respond?**

19 A. The Company appreciates the opportunity to address this question because it highlights
20 the fact that the environmental remediation expenses are ongoing costs that should be
21 borne by NW Natural's customers—and would be appropriately built into base rates if
22 they could be forecast with reasonable accuracy. However, as we have discussed,
23 given the Company's lack of control over these expenses, they are exceedingly difficult

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1 to estimate. Thus, these expenses do not lend themselves to traditional ratemaking test
2 year estimation. The normal approach to estimating test year expenses and recovering
3 these expenses through base rates could lead to the dramatic understatement or
4 overstatement of these costs in rates, and we do not believe that any stakeholder would
5 tolerate this result.

6 Including some amount of these expenses in base rates would also lead to
7 frequent rate changes to update the test year expense estimate, which is contrary to the
8 basic purpose of the deferrals to minimize the frequency of rate changes to better match
9 the costs borne by and benefits received by customers.

10 **Q. If the Commission should place a certain amount of expenses in rates each year**
11 **without subjecting that amount to deferral, what should the amount be or what**
12 **process should the Commission use to determine that amount?**

13 A. If the Commission were to take this approach, we believe that the Commission should
14 engage in a process each year to review estimated expenses for the upcoming year.
15 This would be the most reliable method for including the appropriate amount of costs in
16 rates each year, for what could be a highly variable ongoing expense. This process
17 should be similar to setting gas costs in rates.

18 **Q. Does this conclude your testimony?**

19 A. Yes.



CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing DIRECT TESTIMONY OF ALEX MILLER, upon all parties of record in the UM 1635-Phase II proceeding by electronic mail.

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DATED at Portland, Oregon, this 20th day of March 2014.

/s/ Kelley C. Miller

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