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ELECTRONIC FILING

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Re: Docket No. AR 499

Enclosed for filing are the original and one copy of Northwest Natural Gas Company's Responding Comments on Straw Proposals.

Very truly yours,

Marcus Wood

M-W:jlf
Enclosures
cc: Service List

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**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

AR 499

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

**NORTHWEST NATURAL GAS
COMPANY'S RESPONDING
COMMENTS ON STRAW
PROPOSALS**

Northwest Natural Gas Company's ("NW Natural") Opening Comments proposed that an Earnings Test be incorporated into the permanent rule implementing SB 408. An Earnings Test is needed in order for the permanent rule to comply with the Attorney General's conclusions that the application of SB 408 must also satisfy the statutory requirement that Oregon utility rates be fair, just, and reasonable. In each general rate proceeding, the Oregon Public Utility Commission (the "Commission") establishes rates that it determines will produce a fair, just, and reasonable after-tax return on utility equity. The Earnings Test would avoid the undermining of this Commission determination, by allowing base rates to be adjusted upward or downward, as needed to prevent either (a) overearnings combined with an SB 408 rate surcharge or (b) underearnings combined with an SB 408 refund. The Earnings Test is an adjustment for excess or deficient earnings, made to the extent needed to avoid an arbitrary and capricious surcharge or refund order that would undermine the Commission's determination of what constitutes a fair, just, and reasonable return.

I. Response to Earnings Test Comments by ICNU and NWIGU

The Industrial Customers of Northwest Utilities ("ICNU") and the Northwest Industrial Gas Users ("NWIGU") commented briefly on NW Natural's Earnings Test proposal, as well as on different but related proposals made by Portland General Electric Company. The

ICNU/NWIGU Comments expressed concern that an Earnings Test would eliminate incentives for utilities to control costs. (ICNU/NWIGU Comments at 20.) However, NW Natural has ample incentive to control costs without the additional penalty of having to pay SB 408 refunds whenever its costs increase. Instead, the ICNU/NWIGU Comments invite the Commission to use SB 408 to penalize utilities for incurring cost increases in order to meet their statutorily-mandated obligations to provide safe and adequate service, equipment, and facilities.

ORS 757.020 imposes such a service requirement on utilities and provides that “the charges made by any public utility rendered or to be rendered in connection therewith shall be reasonable and just.” The ICNU and NWIGU proposal -- that utilities be penalized for incurring increases in the cost of maintaining statutorily-mandated levels of service, when the cost increases never were charged to ratepayers in the first place -- would be unfair, unjust, and unreasonable.

ICNU and NWIGU also argue (ICNU/NWIGU Comments at 18-19) that an Earnings Test should be rejected because purchased gas adjustment (“PGA”) tariffs do not trigger until earnings exceed the authorized return on equity by more than 300 basis points. Their comments state that this limitation is based on the Commission’s conclusion that a tighter trigger might eliminate any incentive for the company to pursue efficiencies.

The PGA example provides no grounds for rejecting NW Natural’s proposed Earnings Test. First, with its proposed Earnings Test, NW Natural’s pre-tax income still would be reduced by any cost overruns not covered by automatic adjustment clauses. This situation hardly eliminates the incentive to pursue efficiencies. Second, increases in purchased gas costs are unrelated to whether or not NW Natural’s other costs are higher or lower than assumed in rates; in contrast, without an Earnings Test, SB 408 would ignore the relationship between taxes and the earnings that produce tax liabilities and would by design operate to worsen the effect of rates

set too low to support the equity return the Commission has found to be fair, just, and reasonable. Third, without an Earnings Test, if the utility did exceed its allowed return by up to 300 basis points, as allowed under the PGA, it would be allowed, as a consequence of such overearning, to impose a substantial surcharge on its customers, a result the customers might think unfair, unjust, and unreasonable to them.

II. Response to Earnings Test Comments by the Commission's Staff

The Commission's Staff ("Staff") acknowledges that "[t]he Department of Justice opinion clearly states that rates must be 'fair, just, and reasonable' under ORS 756.040(1)."

Accordingly, Staff does not dispute that an Earnings Test may be required in the application of SB 408, but argues instead that any Earnings Test should be applied on a case-by-case basis, rather than be defined in the permanent rule. (Staff Comments at 6.)

Although such a case-by-case adjudication of an Earnings Test is one possible approach, inclusion of an Earnings Test standard in the permanent rule would be administratively cleaner and more even-handed. If the Commission left the Earnings Test standards to be determined in individual utility adjudications, it would merely postpone the setting of the standards, and move consideration of the applicable standards into a more time-consuming and complex quasi-judicial setting. Moreover, any Earnings Test standard should be based on principles applicable to all utilities on a comparable basis, a result best achieved in rulemaking.

Staff also suggests that rates are not necessarily confiscatory if the utility earns less than its authorized return, pointing to situations in which the utility may earn or absorb 250 to 300 basis points more or less than its authorized return on equity. (Staff Comments at 6.)

However, the application of SB 408 has a feature that makes these examples inapplicable. NW Natural understands that it faces business risks that may cause it to earn more or less than its

allowed return and that the Commission does not guarantee that NW Natural will earn its allowed return. However, absent an Earnings Test, SB 408 would be unique in expressly penalizing a utility for underearning its return, thereby worsening any underrecovery situation. This feature of the statute, if not ameliorated by an Earnings Test, would be arbitrary and capricious.

Moreover, NW Natural respectfully disagrees with Staff's arguments that appear to equate fair, just, and reasonable rates with rates that are barely above a confiscatory level. (Staff Comments at 6.) To the contrary, ORS 756.040 states that "[t]he commission shall balance the interest of the utility investor and the consumer in establishing fair and reasonable rates," which is a far different standard than barely above confiscatory. In setting fair, just, and reasonable utility rates of return, the Commission is charged with performing the balancing of interests required by ORS 756.040. The allowed rate of return certainly is not guaranteed to the utility. However, if SB 408 were applied without NW Natural's proposed Earnings Test, the Commission could find itself in the position of ordering rate reductions designed to exacerbate a utility's inability to earn the return the Commission has found fair, just, and reasonable. Such an intentional action to damage an underearning utility cannot be squared by the overriding statutory mandate of ORS 756.040.

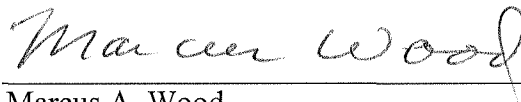
III. Conclusion

The Commission retains its obligation to set utility rates in accordance with its all of its constitutional and statutory mandates. Nothing in SB 408 justifies entering into a regulatory "Never-Never-Land," wherein the rate treatment of income taxes is totally divorced from utility earnings and from the revenues and costs that give rise to income taxes.

Whether or not constitutional, SB 408 expressly requires the Commission, when consolidated taxes are lower than taxes properly attributable to the utility, to appropriate non-utility tax benefits for rate purposes. However, SB 408 does not repeal the constitutional requirement that the end result of ratemaking be reasonable or Oregon's statutory mandate that the Commission set rates that are fair, just, and reasonable. The Commission is not required by SB 408 to ignore utility cost increases and a utility's inability to earn its allowed return at the time it considers requiring a refund for reduced taxes arising precisely out of such increased costs or such inability to achieve the return the Commission has found to be fair, just, and reasonable. NW Natural proposes the Earnings Test as one means of implementing SB 408, while also maintaining rational ratemaking in Oregon.

DATED: May 19, 2006.

STOEL RIVES LLP

A handwritten signature in cursive script, reading "Marcus A. Wood". The signature is written in dark ink and is positioned above a horizontal line.

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CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of the foregoing document in Docket AR 499 on the following named person(s) on the date indicated below by electronic mail and first-class mail addressed to said person(s) at his or her last-known address(es) indicated below.

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