BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UG 221

In the Matter of NORTHWEST NATURAL GAS COMPANY, dba NW NATURAL, Request for a General Rate Revision	STAFF PREHEARING BRIEF

I. INTRODUCTION

The Public Utility Commission of Oregon Staff (Staff) takes this opportunity to file its prehearing brief consistent with the schedule established in this proceeding. On July 9, 2012, the parties filed a partial stipulation resolving some issues within this proceeding. On August, 14, 2012, the parties filed a letter advising the Public Utility Commission of Oregon (Commission) of a settlement in principle on many other issues within this proceeding. After the second partial stipulation has been filed and the evidentiary hearing held, Staff will outline the terms of the two partial settlements in its post-hearing opening brief.

In this prehearing brief, Staff will focus on some of the main arguments related to the five remaining contested issues, which are: 1) establishing the appropriate cost of capital; 2) establishing a fair and reasonable environmental cost recovery mechanism; 3) Northwest Natural Gas Company's (NW Natural or Company) proposed future amortization of out-of-period cash contributions to pensions as well as whether or not the Commission should change its established treatment of pensions, which would also potentially impact all other traditionally rate regulated utilities in Oregon; 4) NW Natural's proposed future amortization of out-of-period state taxes; 5) and two prematurely constructed mid-Willamette valley feeder projects.

///

///

///

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

II. DISCUSSION

COST OF CAPITAL

1. NW Natural's proposed 10.0 return on equity (ROE) is overstated and not supported by the record.

In its surrebuttal testimony, NW Natural requests an ROE of 10.0 percent.[1] NW Natural's cost of capital witness, Dr. Hadaway, supports this value with results from three discounted cash flow (DCF) models producing average or "mean" estimated ROEs ranging from 9.6 percent to 10.0 percent.[2] Therefore, the NW Natural 10.0 percent requested ROE is at the top of Dr. Hadaway's DCF model results.

A. The Commission should give little or no weight to the results of Dr. Hadaway's constant growth models.[3]

Dr. Hadaway relies on two DCF models that employ the "Gordon growth" or "constant growth" formulation.[4] The Commission has previously rejected consideration of results from these single-stage DCF models.[5] In order to rely on constant growth models, NW Natural would have to have demonstrated that the required industry stability is present. Instead, NWN asserts that "[t]he long term nature of the DCF model's input requirements simply cannot reflect all the market elements that are currently affecting the cost of equity capital."[6] Consistent with the Commission's past orders and reasoning on this issue, the Commission should reject and give no weight to the results of Dr. Hadaway's single stage DCF models.

///

///

---

[1] *See* NWN/3200; Hadaway/3, lines 4-5; NWN/2900; Anderson/1, lines 16-17.
[2] *See* NWN/3202; Hadaway/1 (These models produce "median" estimated ROEs ranging from 9.4 percent to 10.1 percent).
[3] *See* Staff/1300; Storm/73, lines 3-4.
[4] *See* NWN/500; Hadaway/33, lines 7-14.
[5] *See* Order No. 01-777 at 27; Order No. 01-787 at 24.
[6] *See* NWN/500; Hadaway/10, lines 4-12; *see also* NWN/500; Hadaway/8, line 23 through Hadaway/9 line 5.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

B. The Commission should give little or no weight to the results of Dr. Hadaway's risk premium analysis.

The Commission has long given little or no weight to risk premium analysis (and single stage DCF models), instead preferring multistage DCF models.[7] In Dr. Hadaway's risk premium analysis, he regresses the difference between average values of ROEs authorized primarily in other jurisdictions and contemporaneous averages of Moody's (Mergent) public utility bond yields for companies rated Aa, A, and Baa on those same contemporaneous averages of Moody's public utility bond yields.[8] The incorporation of ROEs authorized primarily in other jurisdictions as an input into Dr. Hadaway's risk premium analysis producing his estimates of ROE for NW Natural represents circular reasoning and an approach the Commission has previously stated "should not be used as an independent method on which to base" and ROE authorized by the Commission.[9] Consistent with the Commission's past orders and reasoning on this issue, the Commission should give no independent weight to the results of Dr. Hadaway's risk premium analyses using as inputs ROEs authorized in primarily other jurisdiction.

C. NW Natural's "outboard" adjustment increasing the results of its multistage DCF by 30 basis points is unwarranted and should be rejected.

Dr. Hadaway makes an implicit "outboard" upward adjustment of 30 basis points to his multistage DCF model results for risks not reflected in the stock prices of the peer utilities he uses.[10] Removal of this unwarranted and insufficiently substantiated adjustment immediately reduces the high-end of Dr. Hadaway's estimated ROE range to the 9.7 percent average result of his multistage DCF model.[11]

---

[7] *See* Order No. 99-697 at 23; Order No. 01-777 at 33-34.
[8] *See* NWN/500 Hadaway/37 line 19 through Hadaway/38 line 2 and NWN/505 Hadaway/3.
[9] *See* Order No. 99-697 at 23; Order No. 01-777 at 33-34.
[10] Dr. Hadaway's 30 basis point upward adjustment to the results of his multistage DCF model was not always implicit. *See* NWN/500; Hadaway/3, lines 17-20 ("under present conditions I believe an ROE above some of the quantitative results is appropriate"); *see also* NWN/2100; Hadaway/12, lines 7-8 ("specific consideration for the unique market conditions").
[11] *See* NWN/3202 Hadaway/1.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

Dr. Hadaway's addition of 30 basis points to the average estimated ROE of his multistage DCF model results requires him to argue that the market assessment of the values of the peer utilities he employed in his sample selection is inaccurate and overstated.[12] Staff fundamentally disagrees that market assessments are inaccurate. Instead, the recent market prices of NW Natural's peer utilities accurately reflect the markets' perspective on the future stream on cash flows and their attendant risks.[13] The Commission should exclude Dr. Hadaway's unwarranted addition of 30 basis points to the results of his multistage DCF results.

D. The annual average rate of growth of 5.7 percent used by Dr. Hadaway in his multistage DCF model for year 6 through year 150 is overstated and not adequately supported by the record.

Dr. Hadaway's use of a 5.7 percent average annual rate of growth is the most significant difference between Dr. Hadaway's multistage DCF model and Staff's two multistage DCF models.[14] Although Dr. Hadaway attempts to convolute the issue of growth rates in the multistage DCF models in surrebuttal testimony,[15] he previously admitted that "the only substantive difference in our analytical results stems from the alternative long-term growth rates in GDP."[16]

Dr. Hadaway develops his 5.7 percent historical growth rate in nominal Gross Domestic Product (GDP) rate on a weighted average of annual rates over the period 1951 through 2011.[17] Dr. Hadaway's use of 5.7 percent annual rate of growth in nominal GDP for year 5 (2017) through year 150 (2162) in his multistage DCF model significantly overstates expected future growth rates and, thus, unreasonably increases the estimated ROE results of his multistate DCF model.

---

[12] *See generally* NWN/500; Hadaway/9-10.
[13] *See generally* Staff/2200 Storm/26 line 5 through Staff/31 line
[14] *See* Staff/2200; Storm/9, lines 2-8.
[15] *See generally* NWN/3200; Hadaway/9-11.
[16] *See* NWN/2100; Hadaway/12, lines 17-19.
[17] *See* NWN/2105.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

Dr. Hadaway's long-term average annual growth rate of 5.7 percent is significantly overstated due to his 5.7 percent rate having an underlying embedded inflation rate (GDP Price Inflator) of 3.0 percent.[18] Staff demonstrates that a future long-term inflation rate of 3.0 percent is overstated by 89 basis points, or 0.9 percent.[19] Essentially, Dr. Hadaway uses a method that embeds the inflation rates of a historically high inflation period (e.g. 1973 – 1981) and assumes that such periods of high rates of inflation will be proportionately represented in the future, which increases his estimate of ROE, but ignores and materially exceeds well-supported current estimates of future inflation rates.

2. <u>The Commission should adopt Staff's recommended ROE of 9.4 percent, which is at the high end of Staff's 8.8 percent to 9.5 percent recommended range of ROE.</u>

Staff's recommended range of ROE, based upon two multistage DCF models, is 8.8 percent to 9.5 percent. Staff recommends an ROE of 9.4 percent,[20] which is near the top of Staff's range of ROE.[21] Using the Commission preferred multistage DCF models (Staff's two multistage DCF models and Dr. Hadway's multistage model), then removing the unwarranted 30 basis point "outboard" adjustment to Dr. Hadway's results of his multistage DCF model, we are left with the Commission's preferred models resulting in estimates of 9.4 percent and 9.7 percent ROE (i.e. Staff's recommendation of 9.4 percent that is near the top of Staff's recommended range and NW Natural's 9.7 percent, which is its 10.0 recommended ROE minus its unwarranted 30 basis point outboard adjustment). Staff's recommended ROE of 9.4 should be adopted because its multistage DCF models are based upon realistic and fair estimates of long-term

---

[18] *See* NWN/2106 Hadaway/4.
[19] *See* Staff/2200; Storm/20, Table 4.
[20] In addition, Staff recommends a reduction to authorized ROE if the Commission adopts the decouplig mechanism. *See* Staff/200; Storm/4, lines 9-16 and fn 1.

[21] For purposes of its recommended ROE, Staff accepts NW Natural's proposed capital structure, which is 50 percent long-term debt and 50 percent common equity. *See* Staff/2200; Storm/3, lines 4-6. In addition, the Parties have reached a settlement in principle on the cost of long-term debt. *See* Letter filed on August 14, 2012. However, the prudence of NW Natural's hedge is still and issue and will be discussed herein.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

growth rates, whereas Dr. Hadaway's estimated long-term growth rates, as discussed above, are overstated and not adequately supported in the record. The difference between Staff's multistage results of 9.4 percent and NW Natural's multistage results of 9.7 percent are almost solely related to the different estimated long-term GDP growth rate.[22]

A. Staff's multistage DCF models employ the most current information available to estimate a long-term growth rate and is superior to NW Natural's overstated and under-supported long-term growth rates.

Staff's multistage DCF models use estimated dividends from Value Line (the Value Line information is from the June 8, 2012 report on each of the peer utilities) for the third quarter of 2012 through 2017. For the next period of 2018 through 2022, the estimated dividends transition from those based upon Value Line's estimates to dividends growing at a rate equaling the estimated long-term growth rate in GDP. Then, from 2023 forward Staff assumes that dividends of each natural gas utility in the peer group will grow at the rate of GDP.[23] Importantly, the only credible source of estimated long-term growth in natural gas retail expenditures has revenues of natural gas utilities growing by materially less than the expected growth of GDP.[24]

In determining the appropriate long-term growth rates, Staff used three different estimates of long-term annual GDP growth rates for the dividend growth rates for the 2023 through 2052 period. First, Staff used 4.51 percent, which represents an average of forecasts from Blue Chip Consensus (4.65 percent), the Congressional Budget Office (4.4 percent), the Energy Information Agency (4.67 percent), the Office of Management and Budget (4.3 percent), and the Social Security Administration (4.55 percent).[25]

---

[22] *See* NWN/2100; Hadaway/12, lines 17-19

[23] *See* Staff/2200 Storm/10 line 19 through Storm/11 line 4.

[24] *See* Staff/1300; Storm/62, line 2 through Storm/63 including Figure 9.

[25] Staff notes that where recent forecasts for multiple years or periods of years are available from one source, Staff uses the forecast most closely matching the 2023 through 2052 period to which the long-term growth rate applies in Staff's DCF models, e.g. uses the Social Security Administration's 2022 forward estimate.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

Second, Staff used 5.14 percent. This estimate of future long-term GDP growth rate is based upon a regression analysis of real GDP for the first quarter of 1951 through the fourth quarter of 2011, which equals a 2.96 percent average annual growth rate in real (without inflation) GDP. Then Staff calculates two estimates of long-term future rates of change in the GDP Price Inflator which is the applicable index of inflation.[26] The first estimate of the long-term future annual rates of change in the GDP Price Inflator is 2.13 percent based upon the TIPS break-even approach.[27] The second estimate of long-term future rates of change in the GDP Price Inflator is 2.11 percent based upon an average of estimated long-term annual rates of change in the GDP Price Inflator from Blue Chip (2.1 percent), Congressional Budget Office (2.2 percent), Energy Information Agency (2.06 percent), Office of Management and Budget (1.8 percent), and the Social Security Administration (2.4 percent).[28]

Third, Staff used an estimated annual rate of 4.83 percent. This annual growth rate was developed using the weighted average of the historical rate (50 percent) and the four federal agencies plus Blue Chip estimated rates (10 percent each).[29]

Each of Staff's three estimates of long-term annual GDP growth rates (4.51 percent, 5.14 percent, and 4.83 percent, respectively) are substantially lower than Dr. Hadaway's estimate of 5.7 percent. As discussed above, the reason that Dr. Hadaway's estimate is higher than the record supports is because he significantly overstates the estimate of long-term future rates of change in the GDP Price Inflator at 3.0 percent, even though Staff's testimony demonstrates that the best estimate is 2.11 percent.[30]

The Commission's preferred multistage DCF models result in estimated ROEs ranging from Staff's 9.4 percent to NW Natural's proposed 9.7 percent (the requested 10.0 percent minus

---

[26] *See* Staff/2200; Storm/11, line 6 through Storm/12, line 12; *see also* Staff/1300; Storm/60-61, fn. 84. Dr. Hadaway gives the appearance of supporting this methodology. *See* NWN/2100; Hadaway/16, lines 9-11.
[27] *See* Staff/2200; Storm/23, lines 1 through Storm/25, line 13.
[28] *See* Staff/2200; Storm/16, lines 2 through 10; Storm/20, table 4.
[29] *See* Staff/2200; Storm/18, table 3.
[30] *See* Staff/2200; Storm/20, table 4.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

the 30 basis point "outboard" adjustment). The difference in Staff's 9.4 percent and NW Natural's 9.7 percent recommended ROE is related to the use of different long-term growth rates in the multistage DCF models. The Commission should establish ROE at 9.4 percent because Dr. Hadaway's use of 5.7 percent as the estimate of long-term growth rates is overstated and not adequately supported in the record. On the other hand, Staff's testimony demonstrates through three separate estimates that the annual long-term growth rate is substantially lower than that proposed by Dr. Hadaway.

3. <u>The Commission should disallow some portion of NW Natural's financial hedge loss</u>

Staff recommends that the Commission disallow $2,248,000 of an interest rate hedge loss.[31] This amount is half of $4,496,000, and therefore reflects equal sharing between ratepayers and the Company for the portion of the hedge loss at issue.[32] If the Commission disallows some portion of the financial hedge loss, the reduction should be implemented by reducing cost of a debt issuance and lower the cost of long-term debt.[33]

At a high level, this issue revolves around whether or not NW Natural made errors in judgment that they knew or should have known about at the time they entered into the interest rate hedge. Staff is not recommending that the entire interest rate hedge loss should be disallowed as imprudent, but instead is recommending that some portion of the interest rate hedge loss should be disallowed to reflect that NW Natural needs to do better. For example, NW Natural did not perform probabilistic, high-impact low-frequency or decision tree analysis prior to entering into the hedge, it did not modify the generic hedge contract to limit losses, and it did not document that it considered alternatives to the interest rate hedge.[34] The Commission should disallow up to one-half of the interest rate hedge loss to establish that NW Natural did not

---

[31] *See* Staff/2300; Muldoon/4, lines 16-17.
[32] *See* Id. at Muldoon/5, lines 1-5.
[33] *See* Id. at Muldoon/5, line 19 to Muldoon/6, line 2.
[34] *See* Id. at Muldoon/5, line 19 to Muldoon/6, line 2; NWN/401; Feltz/1, line 9, 5.370 series that includes in its issuance costs $10,096,000 costs paid in the interest rate hedge.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

conduct the required level of risk analysis when entering into its first financial hedge. Staff's testimony went unrebutted regarding NW Natural using outside consultants for certain risk estimation and yet not undertaking similar analysis for the debt hedging.

To summarize Staff's position on cost of capital, Staff contends that the Commission should continue its past practice of preferring the results of the multistage DCF models and give no weight to single stage DCF models and risk premium analyses. After removing NW Natural's unwarranted 30 basis point "outboard" adjustment, the difference between Staff's recommended 9.4 percent return and equity and NW Natural's 9.7 percent return on equity revolves around long-term growth rates for GDP. The Commission should adopt Staff's recommendation of 9.4 percent return on equity because the record establishes that NW Natural's estimate for long-term growth in GDP is substantially overstated and under-supported. Finally, the Commission should disallow some portion of NW Natural's interest rate hedge based upon the fact that NW Natural did not prudently manage all of the risks involved in a complex financial transaction.

<u>ENVIRONMENTAL COST RECOVERY</u>

NW Natural proposes a rate adjustment mechanism, which it proposes calling the Site Remediation Recovery Mechanism (SRRM). As of September 30, 2011, NW Natural had deferred about $64.5 million in environmental costs, which includes $51.8 million in total expenditures plus accrued interest of $18.1 million, partially offset by $5.4 million of environmental costs expensed in prior years.[35] In addition, NW Natural makes a low-end estimate of future environmental remediation costs of $58 million.[36]

NW Natural's proposed SRRM would pass through prudently incurred costs of environmental remediation on a five year rolling basis,[37] adjusted for future costs and for the

[35] *See* NWN/1500; Miller/2, lines 13-16.
[36] *See* Id. at Miller/2, line 17 through Miller/3, line 1.
[37] In surrebuttal testimony, NW Natural does state that so long as the Commission allows them to accrue interest at its authorized cost of capital, it would be amenable to modifying the proposed SRRM from the current five year rolling average to a seven year rolling average. *See* NWN/3700; Miller/12, lines 13-18.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

receipt of insurance proceeds and other potential recoveries.[38] The first year the rolling average would include one-fifth of all amounts deferred through September 30, 2012, less any offsetting or other proceeds related to remediation activities. In future years, the SRRM rolling five-year average would be adjusted for future costs and offset by the receipt of insurance proceeds and other recoveries.[39] The SRRM would stay in effect until five years after the year in which the last remediation expenses were incurred.[40]

NW Natural also proposes a schedule to review the prudence of future costs, which results in the inclusion of one-fifth of the balance of the SRRM passed along to customers every year on the Purchased Gas Adjustment effective date.[41] Finally, NW Natural proposes to accrue interest at its authorized rate of return on the deferred environmental remediation balance until the costs (one-fifth of the balance) are transferred to the SRRM account and amortized under that mechanism, NW Natural would collect the Modified Blended Treasury Rate.[42] Therefore, there will be a large balance accruing interest at the authorized rate of return and once one-fifth of that amount (i.e. 20 percent of the total deferred amount plus accrued interest at the authorized rate of return) which will then move to the SRRM where NW Natural would earn the Modified Blended Treasury Rate on that amount (the total deferred amount plus accrued interest at authorized rate of return divided by five).

1. <u>While Staff proposed certain conditions to the proposed SRRM, it was generous in its overall support for a mechanism that would substantially lower NW Natural's risk.</u>

NW Natural proposes a mechanism that would allow it dollar-for-dollar recovery on past and future substantial environmental remediation costs, plus recovery of accrued interest at its authorized rate of return, without any consideration of its overall earnings. Typically, regulated

---

[38] *See* Id. at Miller/8-9.
[39] *See* Id.
[40] *See* Id. at Miller/9, lines 2-3.
[41] *See* Id. at Miller/10.
[42] *See* Id. at Miller/12, line 14 through Miller/13 at line 3.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

utilities experience regulatory lag and file a general rate revision when overall results require an increase in customer rates.

In Oregon, there is a well-known and oft-used statute that provides an exception to retroactive ratemaking and allows deferral of certain items for later inclusion into rates. However, that deferred accounting statute - ORS 757.259 - has certain conditions such as requiring an earnings review be conducted to confirm that amortization of deferred balances are appropriate considering the utilities earnings at the time the deferred amounts were incurred. In this context of traditional rate regulation in Oregon, Staff considers general support of the concept of an environmental cost recovery mechanism during a general rate proceeding to be generous. Because an automatic adjustment clause under ORS 757.210 allows the automatic recovery of expenses without any consideration for concepts such as regulatory lag and the overall earnings level of the utility, Staff deemed it reasonable to suggest modifications to NW Natural's proposed SRRM to account for the type of special risk-reducing treatment an automatic adjustment clause provides.

2. <u>The law requires an earnings review before the currently deferred environmental remediation accounts may be considered for amortization.</u>

ORS 757.259 is the deferred accounting statute. ORS 757.259(e)(5) provides in relevant part:

> Unless subject to an automatic adjustment clause under ORS 757.210(1), amounts described in this section <u>shall</u> be allowed in rates only to the extent authorized by the commission in a proceeding under ORS 757.210 to change rates <u>and</u> upon review of the utilities earnings at the time of the deferral.

Staff proposed both that the currently deferred costs and proceeds of the environmental remediation deferral and that future amounts that go into the SRRM deferral would be subject to

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

an earnings test using the years when the costs were incurred.[43] NW Natural replied that an earnings test should not be required for either past or future amounts.[44]

NW Natural's reply testimony relies on ORS 757.259(e)(5) to argue that earnings tests do not apply to automatic adjustment clauses.[45] Staff agrees that an earnings test is not lawfully required after an automatic adjustment clause is established under ORS 757.210(1). However, NW Natural's response ignores the fact that no such automatic adjustment clause has been established.

As of September 30, 2011, NW Natural had approximately $64.5 million in a deferred account related to environmental remediation costs and proceeds. There is no automatic adjustment clause for those past amounts. Even if the Commission creates an automatic adjustment clause in the future, it cannot lawfully move previously deferred accounts into a newly established automatic adjustment clause account without following the legal requirements of ORS 757.259(e)(5). The Commission has no lawful option but to require an earnings review prior to amortizing the deferred amounts.

3. <u>If the Commission establishes an automatic adjustment clause mechanism for environmental remediation, it should order that the balance accrue interest at the Modified Blended Treasury Rate.</u>

Under NW Natural's proposed SRRM, the Commission would be agreeing to allow for certain cost recovery, subject to an abbreviated prudence review. Similarly, if the Commission adopted Staff's recommended modifications, NW Natural would receive certain cost recovery of 90 percent of the prudently incurred future costs of environmental remediation offset by proceeds, subject to an earnings test. An automatic adjustment clause that allows for certain recovery of all or some portion of prudently incurred costs means substantially less risk for NW Natural. The risk associated with an automatic adjustment clause is more akin to risk once amortization is approved than the risk related to uncertain recovery in an uncertain and

---

[43] *See* Staff/200; Johnson/7 at line 18 through Johnson/8 at line 3.
[44] *See* NWN/2600; Miller/18, line 16 through Miller20, line 8.
[45] *See* NWN/2600; Miller/19, lines 1-7.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

potentially long period of time. Consistent with the rationale of the Commission in Order No. 08-263 on appropriate interest rates for deferred accounts, if the Commission approves an automatic adjustment clause it should require that the Modified Blended Treasury rate adopted in that Order apply to the account balance in the new mechanism.

4. <u>If the Commission establishes an automatic adjustment clause mechanism for environmental remediation, it should require some level of sharing.</u>

Staff recommends that the balance of past and future environmental remediation costs offset by insurance and other proceeds be shared in a manner that 90 percent of the costs are paid for by ratepayers and 10 percent of the costs are borne by NW Natural's shareholder.[46] In support of its recommendation on sharing, Staff attached an exhibit demonstrating what some other state commissions have determined relative to sharing of environmental remediation costs.[47]

In addition to Staff's recommendation on sharing percentages, NWIGU-CUB's expert witness, Mr. Larkin, supports a sharing percentage of 50 percent ratepayer and 50 percent to be borne by NW Natural's shareholders. If the Commission was to approve an environmental remediation cost recovery mechanism, it should apply sharing percentages within the range suggested by the parties in this proceeding.

5. <u>If the Commission establishes an automatic adjustment clause mechanism for environmental remediation, it should require an earnings test before amortizing future amounts as a matter of policy.</u>

Staff recommends that future costs added to an automatic adjustment clause should be subject to an earnings test based upon regulatory policy.[48] As discussed above, the law requires that past deferred accounts be amortized subject to an earnings review. Although not legally required, Staff also recommends that future costs be subject to an earnings test.[49] Without such a

[46] *See generally* Staff/200; Johnson/7-8.
[47] *See* Staff/202; Johnson/12-15.
[48] *See* Staff/200; Johnson/8, lines 1-3.
[49] Staff also proposed a condition that recovery would be limited to an amount equal to three percent of NW Natural's revenues for the preceding year. *See* Staff/200; Johnson/7, lines 21-22. Based upon the legal requirements of ORS 757.259, this is already required for the deferred account amounts. As far as

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

condition, NW Natural would have the ability to recover its prudently incurred remediation costs regardless of its overall earnings. Creating automatic cost recovery mechanisms that substantially reduce NW Natural's risk in conjunction with allowing recovery regardless of total earnings would be inappropriate.

NW Natural seemingly offers three arguments against making future cost recovery subject to an earnings test. First, NW Natural argues "that limiting recovery of such expenses in the event that the Company exceeded its return on equity would be inappropriate and punitive, and that given the magnitude of the costs in would affect a permanent cap on earnings."[50] Staff does not believe a mechanism that substantially reduces NW Natural's risk of future recovery, but limits recovery of such expenses if the Company is exceeding its return in equity is inappropriate or punitive in a regulated environment.

Second, NW Natural argues that if an earnings test is applied it would be necessary to include the environmental expenses in the earnings tests for the applicable years in order to gain an accurate picture of whether or not NW Natural was over-earning in the applicable year.[51] It is not necessary to resolve this issue in this proceeding, but it seems that NW Natural misconstrues the purpose of an earnings test in that an earnings test is necessary to determine whether or not expenses incurred outside of a general rate review could or should have been absorbed by the utility because overall rates were sufficient to satisfy ORS 756.040. The entire objective is an overall review of earnings, not an account-by-account comparison.

Finally, NW Natural argues that "[i]t would be unfair to cut off recovery of these amounts through application of an earnings test, when the Company could have opted to seek recoveries through rate base additions which would not be subjected to an annual earnings review."[52] This is a perplexing argument. Presumably, NW Natural means it could have filed a

---

future balances in the proposed mechanism, NW Natural agrees with this condition. *See* NWN/2600; Miller/20, lines 10-19.

[50] *See* NWN/2600; Miller/19, lines 8-13.

[51] *See* NWN/2600; Miller/19, lines 14-18.

[52] *See* NWN/2600, Miller/20, lines 1-8.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

deferred account or general rate case and requested that the Commission include these costs through rate base additions. In fact, if the Commission does not approve an automatic adjustment clause in this proceeding, NW Natural is able to request future rate treatment and the Commission can make a decision at that time. In any event, whether it is a deferred account or a general rate revision to consider additions to rate base, both would consider the overall earnings of NW Natural. It is specifically because NW Natural is requesting a special regulatory mechanism that does not contain the protections of deferred accounting or general rate revisions that Staff recommends the Commission require an earnings test on the future amounts in an SRRM, if it establishes such a mechanism.

To summarize Staff's position on environmental cost recovery mechanism, it is important to consider the context of typical rate-making in Oregon. In this context, Staff's conditions on NW Natural's proposed environmental cost recovery mechanism are reasonable and could be viewed as generous. First, the Commission is legally obligated to require an earnings review on the costs currently in deferred accounts. Second, the Commission should require an earnings test on future amounts, even though not legally required, based upon solid regulatory policy. Third, if the Commission approves an environmental cost recovery mechanism, the balance should accrue interest at the Modified Blended Treasury Rate established in Order No. 08.-263. Finally, if the Commission approves an environmental cost recovery mechanism, it should include a level of sharing within the range supported by the parties to this proceeding.

<u>OUT-OF-PERIOD PENSION COSTS</u>

Since 1986, the Commission has established the appropriate level of pension expenses[53] included in rates by relying upon the actuarial calculation of the applicable utility's Net Periodic Pension Cost (NPPC). The NPCC is calculated as of December 31st of the previous year by

---

[53] Although NW Natural repeatedly refers to cash contributions to pensions as an investment, Staff notes that the annual expense of the pension contribution should be (and currently is through FAS 87) treated as an expense and included as such in the revenue requirement model.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

using the standards established by the Federal Accounting Standards Board (FASB) in its Financial Account Statement (FAS) 87.[54]

The NPPC calculation is made by an independent actuary and includes consideration of variables such as the fair value of the plan, actual/estimated value of the plan, benefits paid, funding status, service costs, interest costs, expected return on assets, amortization of the transitions asset, amortization of prior service cost, and recognition of gains or losses. A primary benefit of the NPCC calculation is that it smoothes out the losses and gains over time associated with some of the market volatility in equity markets.[55]

In addition to the Commission's use of NPCC for the last 25 years to determine appropriate pension expenses to be included in rates, the Commission recently approved a stipulation in Docket No. UM 1475 that allowed NW Natural to establish a balancing account to track differences between its actual pension expense and the amount recovered through rates.[56] In this balancing account, NW Natural records its FAS 87 expense, net of amounts recovered in rates for pension expense, and the account accrues interest at NW Natural's currently authorized rate of return.[57] The parties to the stipulation explained that this balancing account would benefit both NW Natural and customers by allowing NW Natural the opportunity to collect its actual pension expenses while maintaining rate stability for customers.[58]

Staff's recommendation is to continue the Commission's established practice, as applied consistently to other utilities, of calculating NW Natural's 2013 test year pension expense consistent with the actuarially calculated NPPC according to FAS 87. In addition, Staff recommends that the balancing account established in Docket No. UM 1475 continue, which

---

[54] *See* Staff/900; Cimmiyoti/2, line 22 through Cimmiyoti/3, line 7.
[55] *See* Staff/900; Cimmiyoti/3, lines 7-16.
[56] *See* Order No. 11-051 at 1.
[57] *See* Id. at 3.
[58] *See* Id.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

allows NW Natural to account for, and earn a rate of return on, the differences between pension costs in rates and actual pension costs.[59]

NW Natural proposes changes to the calculation of appropriate pension expense in this general rate case to account for out-of-period cash contributions it has made to its pension fund. First, NW Natural argues it should be allowed to add to rate base the average unrecovered investor contribution amount of $21,930,000 net of deferred taxes, which represents contributions that NW Natural made to its defined benefit plans in the years 2004 through the test year.[60] Second, NW Natural argues that it should be allowed to include in rates an annual revenue requirement for the return of unrecovered investor contributions amortized over eight years, which it estimates that annualized amount to be $4,569,000.[61]

Finally, NW Natural argues that if the Commission declines to adopt its primary proposal then the Company should still be allowed to recover the return of its past contributions through a revision of the balancing account approved in Docket No. UM 1475. In this proposal, NW Natural argues that the balancing account should be changed to suspend refunds to customers once the balance becomes negative at which point the negative balance would be allowed to grow until it equals the excess shareholder contributions.[62]

1. <u>The Commission should not allow the recovery of out-of-period pension cash contributions.</u>

Taken together, NW Natural proposes in future rates to recover a return "on" and "of" out-of-period cash contributions to pensions made between rate cases. The return "on" would be amortized over eight years. As an alternative, NWN proposes in future rates to recover a return "of" out-of-period cash contributions to pensions through changes to the balancing account approved in Docket No. UM 1475. NW Natural requests this future recovery in rates "on" and

---

[59] *See* Staff/2100, Cimmiyoti/1 at line 22 through Cimmiyoti/2, line 13.
[60] *See* Staff/900; Cimmiyoti/2; *see also* NWN/400; Feltz/31, lines 8-9; NWN/409; Feltz/1.
[61] *See* Staff/900; Cimmiyoti/2, lines 16-21; *see also* NWN/400; Feltz/31, lines 10-12.
[62] *See generally* NWN/2000; Feltz/33.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

"of" past cash contributions from 2004 through the test year irrespective of a review of its earnings at the time the past expenses were incurred.

The Commission's practice of establishing pension costs included in rates based upon the NPPC and FAS 87, in conjunction with the approved balancing account in Docket No. UM 1475, constitute an appropriate amount of pension costs from ratepayers. Staff's fundamental objection to NW Natural's proposal is that it constitutes "cherry picking" of a single issue used to establish overall reasonable rates without any consideration for overall rates at the time the costs were incurred. NW Natural's proposal would take out-of-period cash contributions - ignoring both the financial stability of the Company at the time the cash contributions were made and ignoring every other aspect that made up past rates – and collect these past cash contributions from future customers, including a rate of return.

When rates are established in a general rate proceeding, it is to be expected that some of the costs and expenses may go up, while others may go down. For example, after the last NW Natural rate case in 2003, NW Natural restructured and reduced levels of full-time equivalent employees,[63] but ratepayers did not receive refunds for the higher amount of full-time equivalents included in rates. Presumably, NW Natural would not agree that its future revenue requirement should be lowered based upon these past savings and would correctly argue that while the costs and expenses for full-time equivalents decreased, other costs and expenses increased. And that is exactly the same point that Staff makes regarding out-of-period cash contributions to pensions. It is not appropriate to choose a single expense category, while ignoring all other categories, and argue that because that single item increased it should be amortized in future rates with a rate of return, even though at the time the item increased the Company was financially stable and doing financially well overall.[64] Rate-making is holistic in nature and the Commission should decline to consider a single cost item in a vacuum.

---

[63] *See generally* NWN/200; Anderson/10-13.
[64] *See* Staff/900; Cimmiyoti/5, lines 1-9; *see also* Staff/900; Cimmiyoti/5, line 16 through Cimmiyoti/6, line10.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

2. <u>Changing Commission policy on an issue that has far-reaching impacts on other Oregon rate-regulated utilities and customers of those utilities should not been done in the context of this general rate proceeding.</u>

As discussed above, the NPPC and FAS 87 calculation that Staff employs for Oregon regulated utilities remains appropriate and should be continued. In requesting a change to the Commission's historic use of NPPC and FAS 87, NW Natural acknowledges that other utilities may currently be collecting less in rates than their current contributions to their pension plans.[65] If the Commission were inclined to give NW Natural special treatment for past cash contributions to pensions, it is probable that other utilities will request similar treatment. At a minimum, the Commission should consider the impact that this decision may apply as well to other utilities.

To summarize Staff's position on out-of-period pension expenses, Staff maintains that the Commission's historic reliance on NPPC and FAS 87 to determine the appropriate pension expense to be included in customer rates remains appropriate. Furthermore, removing one expense that increased between rate cases without considering expenses that decreased is inappropriate and unfair to future ratepayers. Finally, through the use of the balancing account, NW Natural is able to reasonably recover pension accounts above and beyond that present in rates.

<u>OUT-OF-PERIOD STATE TAXES</u>

NW Natural proposes an adjustment to allow it to collect $4.48[66] million over a five year amortization schedule, or approximately $895,000 annually.[67] The $4.48 million represents a

---

[65] *See* NWN/2000; Feltz/25, lines 7-9.
[66] Staff/500, Garcia/9, line 4 states the amount is $4.8 million. However, NWN/1900; Siores/24, line 12 states the amount to be $4.48 million. Staff accepts the $4.48 million number and it is consistent with the annual amount requested to be amortized of $895,000.
[67] *See* Staff/500; Garcia/9, lines 2-6.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

regulatory asset that NWN created in 2009.[68] NW Natural states that the adjustment is necessary to reflect the impact of the 2009 Oregon state income tax rate change on the accumulated deferred tax balance.[69] During the 2009 tax year, Senate Bill 408, which has since been repealed, was in effect.[70] When Senate Bill 408 was in effect, there were automatic adjustment clause mechanisms that were responsible for establishing the appropriate tax expense. This process was used for NW Natural's 2009 tax year and the appropriate tax expense was established in Order No. 11-117.[71]

1. The Commission should not allow the recovery of an out-of-period regulatory asset.

Similar to out-of-period pension expenses, NW Natural requests that the Commission allow recovery for a regulatory asset that occurred between rate cases. As discussed regarding out-of-period pension expenses, the Commission should not allow NW Natural to self-select single issues where the cost increased between rate cases and strip them out for future recovery. The exception to collecting expenses between rate cases is deferred accounting. But here, NW Natural did not file an application for a deferral to create this regulatory asset. Furthermore, at the time the regulatory asset was created SB 408 and its automatic tax adjustment clause was in effect. Finally, the Commission should not allow NW Natural to self-select single items where expenses increased between rate cases and provide for future recovery when NW Natural's overall earnings at the time the expenses were incurred is ignored.[72]

To summarize Staff's position on out-of-period state taxes, the Commission should not allow amortization of a regulatory asset that occurred between rate cases and for which no deferred accounting application was granted.

---

[68] *See* NWN/1900; Siores/24, lines 1-4.
[69] *See* NWN/300; McVay-Siores/8, lines 8-10.
[70] *See* Staff/1800; Garcia/13, lines 12-13.
[71] *See* Staff/1800; Garcia/13, lines 13-16.
[72] *See* Staff/200; Johnson/4; Staff/900, Cimmiyoti/5, line 19 through Cimmiyoti/6, lines 1-10; NWIGU-CUB/200; Larkin/11.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

THE TWO PREMATURELY CONSTRUCTED MID-WILLAMETTE VALLEY FEEDER PROJECTS

NW Natural proposes to include the Perrydale to Monmouth and Monmouth Reinforcement segments of the Mid-Willamette Feeder (MWVF) project into rates in this proceeding.[73] NW Natural's recently acknowledged Modified Integrated Resource Plan (Modified IRP) considered the MWVF project and NW Natural admits that the earliest date that the Modified IRP would select the MWVF would be 2019 based upon reliability and 2025/2026 based upon load growth.[74] While NW Natural attempts to explain why constructing the projects now is not premature despite the conclusions of the Modified IRP, it offers no financial analysis, benefit-cost analysis or other studies to support a conclusion that the MWVF is a cost-effective solution to meet peak day demand, i.e. improve system reliability,[75] in contradiction to the results of the Modified IRP. Instead, NW Natural generally refers to certain sections of the Modified IRP and stated that the additional benefits of building the project prematurely are qualitative in nature.[76]

1. <u>NW Natural has failed to meet its burden of proof that these two segments of the MWVF project are prudent during this timeframe when the recently acknowledged Modified IRP does not demonstrate a need until at least 2019.</u>

These two segments of the MWVF are built prematurely. The recently Modified IRP does not select this project until at least 2019. To understand why NW Natural would build a project that is seemingly premature, Staff requested additional information from NW Natural to justify the need of the projects.[77] In spite of the fact that the Modified IRP does not select this project until at least 2019, when asked for financial analysis of the need for constructing the projects now Staff was told that "[a] financial analysis of the investment was not conducted by

---

[73] *See* NWN/2200; Yoshihara/1, lines 20-21.
[74] *See* Staff/1900; Zimmerman/5, lines 1-4; NWN/2200; Yoshihara/6, lines 3-14.
[75] *See* Staff/1100; Sobhy/15, lines 16-21.
[76] *See* Id. at lines 21-23.
[77] *See* Staff/1100; Sobhy/8, lines 11-21; Staff/1104; Staff/1100; Sobhy/15, lines 16-23; Staff/1103; Staff/1106; Staff/1107.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784

the Company of these projects. The decision to invest in these projects is based upon system reliability, replacement of bare steel and system reinforcement."[78]

Staff recommends that the Commission adopt its alternative recommendation and disallow these projects from rates at this time, but preserve NW Natural's ability to ask for inclusion of these projects when it can demonstrate that the projects are needed based upon an IRP analysis or when it can meet its burden of proof through provision of other quantitative analysis.[79] Allowing the inclusion of these projects at this time, which are inconsistent with the conclusions of the Modified IRP and are not supported by any quantitative analysis, would send the wrong message that utilities could ignore the results of their recently acknowledged IRP, offer no quantitative support for deviating from the results of the IRP, and expect recovery based solely upon qualitative considerations.

To summarize Staff's position on the prematurely built segments of the MWVF project, Staff recommends that the Commission disallow inclusion of these costs in this rate proceeding, but preserve NW Natural's ability to ask for inclusion when it can demonstrate that IRP results or quantitative analysis support the need for the project.

III. CONCLUSION

For the foregoing reasons, Staff respectfully requests that the Commission:

1) Establish the appropriate ROE of 9.4 percent and disallow up to half of NW Natural's interest rate hedge;
2) Order reasonable conditions to NW Natural's proposed environmental recovery mechanism, if the Commission approves such a mechanism;
3) Continue to follow its past policies of relying on NPPC and FAS 87 to calculate pension costs included in rates and deny NW Natural's request to include out-of-period pension costs in future rates;

---

[78] *See* Staff/1107; Sobhy/2.
[79] *See* Staff/1900; Zimmerman/6, lines 10-14.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342   Fax: (503) 378-3784

4) Deny NW Natural's request to amortize an out-of-period regulatory asset on state taxes;

5) Exclude the costs of prematurely built segments of the MWVF until such a time as NW Natural can demonstrate through IRP or quantitative analysis that the projects are needed and prudent.

DATED this 20th day of August 2012.

Respectfully submitted,

s/Jason W. Jones________________
Jason W. Jones, #00059
Assistant Attorney General
Of Attorneys for the Public Utility Commission of Oregon Staff

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
Telephone: (503) 947-4342 Fax: (503) 378-3784