ORDER NO: 04-203

ENTERED APR 06 2004

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 903

In the Matter of An Investigation into Policy Issues and Procedures Associated with Recovery of Purchased Gas Costs by Oregon's Regulated Gas Distribution Utilities.	)))))))	ORDER

DISPOSITION: ORDER NOS. 98-543 AND 99-272 AMENDED

In Order Nos. 98-543 and 99-272, the Commission adopted standards governing recovery by Oregon's natural gas local distribution companies (LDCs) of purchased gas costs through a Purchased Gas Adjustment (PGA). PGAs are "automatic adjustment clauses," as defined in ORS 757.210(1), that adjust LDCs' revenue annually to reflect changes in certain gas costs. A primary feature of the PGA is an annual earnings review in the spring for each LDC that allocates any earnings over an established threshold between the LDC and its customers in accordance with a specified sharing percentage. Order No. 98-543 set forth a formula to determine the earnings threshold number and the sharing percentage for Avista Corporation (Avista) and Cascade Natural Gas Corporation (Cascade). Order No. 99-272 established a threshold and sharing percentage calculation for Northwest Natural Gas Company (NW Natural).

On February 19, 2004, Commission Staff filed a motion, pursuant to ORS 756.568 and OAR 860-013-0031, requesting amendment of Order Nos. 98-543 and 99-272 to modify the PGA earnings threshold and sharing calculations set forth in those Orders on an interim basis from 2004 until 2006. The purpose of the proposed amendments is to ensure that earnings threshold calculations better reflect the relationship between changes in interest rates and the cost of equity for LDCs in the years 2004, 2005 and 2006.

Staff represents that Avista, Cascade, NW Natural and consumer groups, the Citizens' Utility Board (CUB), and the Northwest Industrial Gas Users (NWIGU), support the motion. Consistent with Staff's representation of agreement among Staff, the LDCs and the consumer groups, none of the parties to this docket filed written objections to the motion or requested a hearing.

Background

As set forth in Order No. 98-543, the earnings threshold number for Cascade and Avista is calculated by adding 7.1 percent (%) to the risk free rate, defined in the order as the rate case adjusted average yields of 5-, 7-, and 10-year U.S. Treasury debt securities. When the LDC's rate of return on equity (ROE) from utility operations falls below the threshold number, the LDC is not required to share earnings with customers. When the LDC's ROE is above the threshold, revenues representing thirty-three percent (33%) of the earnings exceeding the threshold are shared with customers.

The earnings threshold calculation authorized in Order No. 99-272 for NW Natural is tied closely to the company's authorized ROE, but is adjusted by the amount of change experienced for the year in the average yield on U.S. Treasury debt securities. NW Natural's earnings threshold is its ROE plus 300 basis points higher, adjusted annually by the difference between the base rate, defined to be the risk free rate used to determine the previous ROE or change in ROE, and the average for the test year of the annual yields reported monthly, and rate-case adjusted, on 5-, 7-, and 10-year constant maturity U.S. Treasury security rates as reported by the Federal Reserve Statistical Release H.15.

Substance of Proposed Amendments

Staff's motion asserts that the established earnings threshold formulas "are predicated, in part, on an implicit assumption of a constant relationship between yields on a particular package of U.S. Treasury Securities and the costs of equity for public utilities generally." The motion explains that the capital markets in recent years have proven this assumption to be inaccurate, however.

An opportunity to modify the earnings threshold and sharing mechanisms to better reflect market realities will be available in 2006 when a general investigation of the PGA is scheduled to occur. Asserting that market circumstances warrant an interim change until 2006, however, Staff's motion requests that the Commission approve modified earnings threshold calculations for the years' earnings reviews conducted in 2004, 2005 and 2006.

Staff represents that the parties agree that new earnings thresholds, based on revised underlying calculations, should be implemented for 2004 for each LDC as follows:

- NW Natural: 13.20 percent (%). Staff indicates that this threshold is calculated based on the 10.20 percent (%) ROE authorized in Order No. 03-507, plus 300 basis points. Pursuant to that order, NW Natural would make adjustments to remove the effects of its decoupling and WARM[1] mechanisms.

- Avista Utilities: 13.25 percent (%). Staff indicates that this threshold is calculated based on the 10.25 percent (%) ROE authorized by Order No. 03-570, plus 300 basis points.

[1] This is an acronym for "Weather Adjusted Rate Mechanism."

- Cascade: 13.25 percent (%). Staff indicates that the intent is to apply the same threshold number to Cascade and Avista consistent with the adoption of the same threshold number for both companies in Order No. 98-543.

The parties further agree that earnings thresholds would be adjusted in 2005 and 2006 by twenty percent (20%) of any change in the risk free rate for the 12-month calendar year preceding the annual earnings review. For example, if the Treasury yields increased by 100 basis points during 2004, the 2005 threshold calculation to review NW Natural's earnings in 2004 would increase by twenty (20) basis points, from 13.2 percent (%) to 13.4 percent (%).

In Order No. 99-272, the Commission expressed intent to "keep the earnings review mechanism consistent with changes in market conditions" and anticipated doing so annually by adjusting the baseline ROE by the amount of change experienced for the year in the average of yields on U.S. Treasury debt securities. The Commission noted that "[b]oth Staff and NW Natural propose[d] the use of these securities to adjust the benchmark earning level" and concluded that "[t]he change in the risk free rate represents a reasonable proxy for the change in the company's cost of equity capital."

If market circumstances undermine this conclusion, the Commission is authorized, pursuant to OAR 860-027-0070(5)(c)[2] to consider other factors to keep the PGA-related earnings review mechanism consistent with market changes. Staff's motion to amend Order Nos. 98-543 and 99-272 to modify the earnings threshold calculations used in LDCs' PGA related earnings reviews for 2004, 2005, 2006 is granted.

ORDER

IT IS ORDERED that:

1. For purposes of the PGA-related earnings threshold calculation for Avista and Cascade, Order No. 98-543 is amended to apply, on an interim basis for 2004, a threshold of 13.25 percent (%) calculated as the sum of 10.25 percent (%), the ROE authorized for Avista by Order No. 03-570, plus 300 basis points. Order No. 98-543 is further modified to adjust the 2004 earnings threshold calculation, on an interim basis for 2005 and 2006, by twenty percent (20%) of any change in the risk free rate for the 12-month calendar year preceding the annual earnings review.

2. For purposes of the PGA-related earnings threshold calculation for NW Natural, Order No. 99-272 is amended to apply, on an interim basis for

[2] OAR 860-022-070(5)(c) provides in pertinent part: "The Commission will update the value for the earnings threshold annually for each LDC, pursuant to a mechanism established by order of the Commission for each LDC to reflect changes in conditions in the capital markets. Upon a showing of good cause, the Commission may consider other relevant factors in addition to changes in the capital markets."

2004, a threshold of 13.20 percent (%) calculated as the sum of 10.20 percent (%), the ROE authorized for NW Natural by Order No. 03-507, plus 300 basis points. Pursuant to Order No. 03-507, NW Natural will make adjustments to remove the effects of its decoupling and WARM mechanisms. Order No. 99-272 is further modified to adjust the 2004 earnings threshold calculation, on an interim basis for 2005 and 2006, by twenty percent (20%) of any change in the risk free rate for the 12-month calendar year preceding the annual earnings review.

All other provisions of Order Nos. 98-543 and 99-272 shall, to the extent not modified by this order, remain in full force and effect.

Made, entered, and effective ______________________________.

Lee Beyer Chairman	**John Savage** Commissioner
	Ray Baum Commissioner

A party may request rehearing or reconsideration of this order pursuant to ORS 756.561. A request for rehearing or reconsideration must be filed with the Commission within 60 days of the date of service of this order. The request must comply with the requirements in OAR 860-014-0095. A copy of any such request must also be served on each party to the proceeding as provided by OAR 860-013-0070(2). A party may appeal this order to a court pursuant to applicable law.