

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

UF 4235

In the Matter of)	
)	
NORTHWEST NATURAL GAS)	ORDER
COMPANY, dba NW NATURAL)	
)	
Application for Authorization of Interest)	
Rate Hedging.)	

**DISPOSITION: APPLICATION APPROVED WITH CONDITIONS
AND REPORTING REQUIREMENTS**

On December 19, 2006, Northwest Natural Gas Company, dba NW Natural (NWN or Company) submitted an application to the Public Utility Commission of Oregon (Commission), requesting authorization for the Company to enter into Interest Rate Hedge Products with financial institutions to manage exposure to interest rate fluctuations. The basis for the current request is detailed in Staff's recommendation memo, attached as Appendix A.

Based on a review of the application and the Commission's records, the Commission finds that this application satisfies applicable statutes and administrative rules. At its public meeting on January 23, 2007, the Commission adopted Staff's recommendation and approved NWN's current request.

ORDER

IT IS ORDERED that the application of Northwest Natural Gas Company for the authority to enter into Interest Rate Hedge Products with financial institutions to manage exposure to interest rate fluctuations is granted, subject to the conditions and reporting requirements specified in Appendix A.

Made, entered, and effective JAN 29 2007.

BY THE COMMISSION:



Becky L. Beier

Becky L. Beier
Commission Secretary

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 by filing a petition for review with the Court of Appeals in compliance with ORS 183.480-183.484.

ITEM NO. CA1

**PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: January 23, 2007**

REGULAR _____ CONSENT X EFFECTIVE DATE _____ N/A _____

DATE: January 17, 2007

TO: Public Utility Commission

FROM: Ming Peng *mp.*

THROUGH: *u.* Lee Sparling, *A* Marc Hellman, and *BC* Bryan Conway

SUBJECT: NORTHWEST NATURAL: (Docket No. UF 4235) Application for Authority to Enter into Interest Rate Swaps, Caps, Floors, and Collars.

STAFF RECOMMENDATION:

I recommend that the Public Utility Commission of Oregon ("OPUC" or the "Commission") approve Northwest Natural Gas Company's ("NW Natural" or the "Company") request to enter into interest rate swaps, caps, floors, and collars and other derivative products ("Interest Rate Hedge Products") subject to the following conditions and reporting requirements:

- 1) NW Natural shall file the usual report of all initial and final documents signed by NW Natural and any other party in the matter (including counterparty and agent) clearly providing information on the nature of the product, its maturity, all rates involved, and other pertinent terms and conditions. The documents should be filed as soon as available after each transaction;
- 2) NW Natural shall demonstrate that each hedge transaction was prudent, providing market data and correspondence with agents and counterparties as well as risk analysis, in support of that demonstration;
- 3) The notional¹ principal amount outstanding of Interest Rate Hedge Products entered into pursuant to such authorization does not

¹ Notional: The principal amount of the transaction is called notional because principal is never exchanged; rather, it serves as an assumed principal amount simply used to calculate the actual interest payments.

UF 4235
January 18, 2007
Page 2

exceed \$200,000,000 or more than 30 percent of the total debt outstanding, whichever is less.

- 4) This authority remain effective so long as the Company's senior secured debt has investment grade ratings from two nationally recognized bond rating agencies; and
- 5) For ratemaking purposes, the Commission reserves judgment on the reasonableness of the Company's capital costs and capital structure. The Commission reserves ratemaking treatment for these products until the next rate proceeding. In its next rate proceeding, NW Natural will be required to show that its capital costs and structure are just and reasonable.

DISCUSSION:

NW Natural filed application on December 19, 2006, for an order of the Commission, pursuant to Oregon Revised Statute (ORS) 757.410 and 757.415 and Oregon Administrative Rule (OAR) 860-027-0030, authorizing the Company to enter into Interest Rate Hedge Products with financial institutions to manage exposure to interest rate fluctuations. The notional principal amount outstanding of Interest Rate Hedge Products entered into pursuant to such authorization does not exceed \$200,000,000 or more than 30 percent of the total debt outstanding, whichever is less. The Company requests that this authority remain in effect so long as NW Natural's senior secured debt has investment grade ratings from two nationally recognized rating agencies.

The types of Interest Rate Hedge Products that the Company is likely to use include:

- a. Interest Rate Swaps, Forward Swaps, and Swaptions
- b. Interest Rate Caps, Floors, and Collars

Interest Rate Swaps, Forward Swaps, and Swaptions

A basic interest rate swap transaction is designed to allow two parties to contractually make payment arrangements to each other, where one party's floating rate obligation is effectively converted into a fixed rate payment and the other party's fixed rate obligation is effectively converted into a floating rate payment. These rates are paid on a notional principal amount.

UF 4235
January 18, 2007
Page 3

In addition to a basic interest rate swap transaction, other interest rate swap-type products exist such as forward swaps and swaptions. If the parties decide that the interest rate swap will begin in the future then, it is called a forward swap. If the parties arrange a forward swap contract which is exercisable at only one of the parties' discretion, then the agreement is called a swaption.

Reason for Entering into Interest Rate Swaps

The Company believes that these interest rate swap products can reduce interest rate risk and provide opportunities to lower its cost of existing or prospective debt issues. Swap transactions are expected to provide the Company with enhanced flexibility to manage its exposure to interest rates and volatile market conditions.

The proposed interest rate hedge transactions are intended to provide protection against material adverse market events and provide opportunities to take advantage of favorable market conditions. The Company's use of Interest Rate Hedge Products is not intended for speculative purposes. The Company would only use such Interest Rate Hedge Products after a specific interest rate exposure was identified and deemed to be unavoidable because it related to an existing or expected borrowing requirement with respect to capital structure, working capital, customer growth or capital improvements.

Interest Rate Caps, Floors and Collars

The structure of these products involves two parties that enter into an agreement where one party purchases from the other party protection from interest rate volatility.

Interest rate caps are purchased by an issuer of floating rate obligations to protect against cost increases from higher interest rates, while still benefiting from cost savings when interest rates decline. Conversely, the purchaser of an interest rate floor seeks to establish a minimum rate that its floating rate securities would earn during a declining interest rate period. In both cases, an up-front fee is paid to the party that provides such protection.

From time to time, a party may simultaneously purchase an interest rate cap and sell an interest rate floor to create an interest rate collar, which provides protection from increasing interest rates above the cap but limits the benefit from declining interest rates below the floor. The principal benefit to the Company of selling an interest rate floor to create an interest rate collar is to receive a premium to partially offset the cost of purchasing an interest rate cap. The term for such agreements can range from 3 months to 12 years.

UF 4235
January 18, 2007
Page 4

NW Natural stated in its application that over the past few years, the Company has maintained a balanced capital structure between debt and equity, with long-term debt accounting for roughly 90 percent of total debt outstanding, on average, and virtually all of the Company's fixed-rate debt financing. Long-term debt principally provides funding for the Company's longer-term assets, while short-term debt accounts for all of the Company's floating-rate debt financing and provides funding for working capital and temporary financing in advance of longer-term debt issues. The Company desires the ability to increase its floating-rate debt, up to a target maximum level of 30 percent based on analyses that indicate a higher mix of floating rate debt, on average, will produce lower risk and lower cost. Swaps, caps, floors and collars would provide the Company and its customers the opportunity to benefit from a more efficient use of fixed-rate and floating-rate debt, while hedging the Company from rising interest rates and market volatility.

Use of Proceeds

There are no proceeds from entering into an interest rate swap, only a change in the all-in effective cost of the underlying securities. Swaptions and floors may result in the receipt of cash upon entering into one of these transactions. Caps and collars may result in payment of cash upon entering into one of these transactions.

Even though an Interest Rate Hedge product may not generate normal proceeds, they can be designed to be of such financial benefit for one party that it is willing to pay for the right to that benefit. However, to the extent that up-front fees are received by the Company they will be credited to unamortized premium or discount on long-term debt and used for the following purposes: the acquisition of utility property or the construction, extension or improvement of utility facilities; the improvement or maintenance of service; the discharge or lawful refunding of its debt obligations; or, refunding the Company's treasury for expenditures for utility purposes. NW Natural's stated uses of proceeds are consistent with ORS 757.415. Any ongoing cash received or paid during the term of the hedge transaction, or at settlement, will be accounted for as a decrease or increase in the cost of the underlying securities along with the amortization of up-front fees, if any. These amounts will be amortized to expense over the term of the underlying securities in accordance with generally accepted accounting principles.

Impact

There is no indication that the proposed Interest Rate Hedge Products will impair NW Natural's ability to provide its public utility service. NW Natural expects no significant change in the capitalization of the Company as a result of it using Interest Rate Hedge Products. NW Natural represents that the use of the Interest Rate Hedge Products is to

UF 4235
January 18, 2007
Page 5

provide opportunities where the Company could capture the economic benefits associated with changes in the capital markets while decreasing the risks associated with such changes. Some of the benefits include being able to hedge against adverse changes in interest rates, reduce borrowing costs through a more efficient mix of fixed and floating rate debt, and manage debt duration in response to the yield curve environment.

PROPOSED COMMISSION MOTION:

NW Natural's application to enter into Interest Rate Hedge Products, with Staff's conditions and reporting requirements, be approved.

UF 4235 – NW Natural's Application to Enter into Interest Rate Swaps, Caps, Floors, and Collars.