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May 28, 2013

VIA ELECTRONIC FILING AND FIRST CLASS MAIL

PUC Filing Center
Public Utility Commission of Oregon
PO Box 2148
Salem, OR 97308-2148

Re: Docket UM 1635 – Northwest Natural Gas Company's Mechanism for Recovery of Environmental Remediation Costs

Attention Filing Center:

Enclosed for filing in the above-captioned docket are an original and five copies of NW Natural's Reply Testimony of Alex Miller.

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

Please contact this office with any questions.

Very truly yours,

A handwritten signature in blue ink, appearing to read "Vimla Mathi", written over a horizontal line.

Vimla Mathi
Legal Assistant

Enclosure

cc: Service List

NWN/500
Witness: C. Alex Miller

BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

UM 1635

In the Matter of

NORTHWEST NATURAL GAS
COMPANY, dba NW Natural,

Mechanism for Recovery of
Environmental Remediation Costs.

NORTHWEST NATURAL GAS COMPANY

REPLY TESTIMONY OF

C. ALEX MILLER

May 28, 2013

1 I. INTRODUCTION AND SUMMARY

2 Q. Please state your name.

3 A. My name is C. Alex Miller.

4 Q. Have you previously filed testimony in this case?

5 A. Yes, I filed direct testimony in this case on March 29, 2013.

6 Q. What is the purpose of your testimony?

7 A. I provide NW Natural's response to the testimony of Judy Johnson of Staff of the
8 Public Utility Commission of Oregon ("Commission"), Bob Jenks of the Citizens'
9 Utility Board of Oregon ("CUB"), and Michael Deen on behalf of the Northwest
10 Industrial Gas Users ("NWIGU"). Specifically, my testimony:

- 11 • Provides a general policy context for the Company's view of the appropriate
12 role of an earnings test for NW Natural's Site Remediation Recovery
13 Mechanism (SRRM);
- 14 • Responds to the criticisms raised by Staff, CUB, and NWIGU of the
15 Company's earnings test proposal;
- 16 • Responds to the earnings test proposals made by Staff, CUB, and NWIGU;
17 and
- 18 • Addresses additional topics related to the SRRM, including: prudence of the
19 Company's expenses; jurisdictional allocation; NW Natural's proposal for
20 recovery of the costs to build the Gasco Pumping Station; and CUB's
21 proposals related to the scope and duration of the SRRM.

22 II. COMMISSION EARNINGS REVIEW POLICY

23 Q. Please summarize the Company's earnings test proposal.

24 A. The Company proposes that the Commission adopt an earnings test that would
25 allow the Company to recover deferred environmental remediation expenses, so

1 long as the Company does not exceed 100 basis points (bp) above the return on
2 equity (ROE) established in its most recent rate case. For past deferred
3 amounts, the Commission should conduct the earnings test looking at the
4 Company's average earnings during the historical period over which the costs
5 were deferred. For future deferrals, the earnings test should be conducted on an
6 annual basis, as the SRRM each year amortizes one-fifth of the balance of the
7 Company's deferred environmental costs.

8 Alternatively, the Company recommends that the Commission wait to
9 resolve the earnings test issues as applied to the historical deferred balances
10 until the Company's near-term insurance recovery efforts are resolved and the
11 magnitude of the insurance offset is known. Waiting in this fashion makes sense
12 because it is possible that there will be no need to recover from customers the
13 deferrals to date, depending on insurance recoveries.

14 **Q. Did any party respond to the Company's proposal that the Commission**
15 **postpone application of the earnings test to the historical deferred**
16 **balances until the Company's near-term insurance recoveries become**
17 **known?**

18 A. No, they did not. Instead, the parties make proposals that would require the
19 Company to write off a very significant percentage of its deferred environmental
20 remediation expenses. My direct testimony explains that the trial on insurance
21 coverage will occur in the near future. At the time I filed my direct testimony, the
22 trial was set for this June; however due to a conflict on the court's calendar, the
23 trial has now been moved to January of next year. Depending on the outcome of
24 that litigation, within a few months the Company could receive recoveries more
25 than sufficient to entirely offset the deferral balance. If the Commission is
26 considering adopting an earnings test that would result in a disallowance of past

1 deferrals, the Company encourages the Commission to instead defer ruling on
2 the earnings test until these insurance amounts are known. It would be
3 unnecessarily harmful to the Company to order a write-off of expenses that would
4 ultimately have been offset by insurance proceeds.

5 **Q. Staff, CUB, and NWIGU argue that NW Natural’s earnings test proposal**
6 **departs sharply from the earnings review that has been historically applied**
7 **by this Commission. Do you agree?**

8 A. No, I do not agree. But in order to place my response in context, I would first like
9 to address the points on which we do agree. NW Natural agrees that deferred
10 accounting is subject to the deferral statute ORS 757.259, which provides that a
11 “review of the utility’s earnings” will be performed prior to amortization.¹ As I
12 explained in my testimony in Docket UG 221, the Company’s most recent
13 general rate case, the deferral statute specifically exempts amortizations under
14 automatic adjustment clauses (AAC) from the requirement of an earnings review.
15 However, I acknowledge that the Commission has generally conducted earnings
16 reviews even in the case of automatic adjustment clauses, and that the
17 Commission has ordered one in this case. NW Natural also agrees that as an
18 exception to the rule against retroactive ratemaking, the authorization of deferrals
19 raises important policy issues, and that the Commission has an interest in both
20 limiting the circumstances under which deferrals are allowed, and prescribing the
21 terms of any required earnings review.

22 However, NW Natural does *not* agree with the implication by Staff, CUB,
23 and NWIGU that there is only one format for an earnings review, or that NW
24 Natural’s proposal represents a sharp departure from precedent. On the

¹ ORS 757.259(5).

1 contrary, the earnings reviews adopted by this Commission have taken many
2 different forms, depending on a variety of circumstances, including whether the
3 deferral is associated with an AAC, whether it reflects variances from a cost that
4 is already forecasted and recovered in base rates, and the type of cost being
5 deferred.² In some cases, the Commission has allowed utilities to retain deferred
6 amounts in excess of authorized ROE,³ but has indicated that under certain
7 circumstances, such as an emergency deferral, the Commission would allow
8 recovery to the bottom of a reasonable range of rate of return.⁴ Consistent with
9 its discussion in Order No. 93-257, the Commission has always exercised its
10 discretion to tailor its earnings review to suit the circumstances, and to achieve
11 desired policy objectives.

12 **Q. Are there circumstances unique to this deferral that the Commission**
13 **should consider in designing the earnings test in this case?**

14 A. Yes. In this case the stakes are particularly high. The costs that have been and
15 will be deferred are of a magnitude far in excess of most deferrals. The balance
16 of actual environmental expenditures since 2003, with interest, totaled \$97 million
17 at the end of 2012. To put this number in perspective, consider that the
18 Company's Oregon utility net operating revenue reported in its 2012 Results of
19 Operations was \$82.2 million, meaning that the environmental deferrals as a
20 percentage of annual income is 119%. In addition, in the Company's most recent
21 rate case, the final approved revenue requirement was \$298 million. As such,

² The fact that the three parties propose three different earnings reviews undercuts any idea that there is only one approach.

³ 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); *Re PacifiCorp, dba Pacific Power, Request for a General Rate Revision*, Docket UE 246, Order No. 12-493 (Dec. 20, 2012).

⁴ *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) [hereinafter "Order No. 93-257"].

1 the environmental deferrals through 2012 constitute fully one-third of the
2 Company's total revenue requirement. And, importantly, on an annual basis
3 environmental deferrals have consistently exceeded earnings the Company has
4 been able to achieve above its authorized ROE. For this reason, for all practical
5 purposes, the point at which an earnings test might cut off amortization of
6 deferred amounts will become the point at which the Company's earnings are
7 capped.

8 Moreover, as explained in my direct testimony, the mechanism will need
9 to be in place for at least the next decade, and could easily be in place for the
10 next 20 years. Thus, given the magnitude of the potential costs involved, the
11 earnings review will constitute a significant component of the regulatory
12 framework under which the Company will operate for a very long time. If the
13 mechanism eliminates the carefully crafted incentives the Commission has
14 adopted for NW Natural over time, customers and the Company could be
15 significantly and negatively affected. For all of these reasons, the earnings test
16 must be designed with care, to respond to the unique circumstances of the
17 deferral and to preserve the balance of policies and incentives that will serve the
18 utility and its customers into the future.

19 **Q. Please explain your statement that the Commission must be careful to**
20 **preserve the balance of policies and incentives it has adopted for NW**
21 **Natural over time.**

22 A. NW Natural currently operates under a framework of cost recovery policies and
23 incentive mechanisms that are intended to encourage cost containment and
24 revenue generation for the benefit of the Company's customers. The first
25 specific mechanism is the Purchased Gas Adjustment mechanism (PGA), which
26 the Commission adopted to provide local distribution companies (LDCs) with a

1 meaningful incentive to minimize their gas costs.⁵ The Commission has altered
2 the PGA on occasion, but it has always provided the LDCs with an incentive to
3 actively seek lower gas prices by allowing them to retain gas savings that could
4 take earnings above authorized ROE. Under the current PGA, NW Natural is
5 allowed to keep gas savings up to 100 bp above authorized ROE (or 150 bp,
6 depending on its sharing election under the PGA)—after which it shares earnings
7 with customers on a 33/67 basis.

8 The second specific mechanism governs the Company's sharing of its
9 interstate storage and pipeline optimization revenues. Under the parties'
10 agreements, which have been approved by the Commission, the Company's
11 shareholders retain a percentage of the profits flowing from the optimization of
12 storage and pipeline capacities. This sharing of profits between the customers
13 and the Company serves to incent NW Natural's optimization efforts to the
14 benefit of customers and shareholders alike.

15 **Q. Does the Commission's ratemaking framework provide a general incentive**
16 **for the Company to contain costs between rate cases?**

17 A. Yes. It is a fundamental Commission policy that between rate cases utilities are
18 allowed to retain savings from cost control measures, in order to incent the
19 utilities to pursue efficiencies that will ultimately inure to the benefit of customers,
20 through their incorporation in subsequent rate cases.⁶

⁵ 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).

⁶ *Re Application of Portland Gen. Elec. Co. for an Investigation into Least Cost Plan Plant Ret.; Revised Tariffs Schedules for Elec. Serv. in Oregon Filed by Portland Gen. Elec. Co.; Portland Gen. Elec. Co.'s Application for an Accounting Order & for Order Approving Tariff Sheets Implementing Rate Reduction*, Docket Nos. DR 10, UE 88 and UM 989, Order No. 08-487 at 7, (Sept. 30, 2008) ("The utility absorbs the expenses if they are higher than expected and benefits

1 **Q. Has the Commission endeavored to preserve these incentives when**
2 **constructing earnings reviews in the past?**

3 A. Yes. The Commission has intentionally preserved these incentives by declining
4 to use the earnings review to micromanage utility earnings. Specifically, when the
5 Commission first adopted the PGA in UM 903 the Commission explained its goal
6 as follows:

7 At the outset, we note that our discussion on this issue is
8 focused on establishing an earnings threshold and sharing
9 percentage of revenues deemed excessive for NW
10 Natural.

11 * * *

12 The objective should be simply to determine whether or not
13 an LDC's earnings are excessive prior to passing through
14 prudently incurred gas cost changes in rates. It should not
15 be structured so as to turn each PGA filing into an annual
16 rate case or show cause hearing where the company's
17 earnings would be subject to detailed review and
18 adjustment. Indeed, such scrutiny may eliminate any
19 incentive for the company to pursue efficiencies.⁷

20 Ultimately, the Commission set the earnings threshold at 300 bp above
21 benchmark ROE,⁸ stating:

22 An earnings threshold set at 300 basis points above the
23 benchmark ROE will protect the interests of ratepayers and
24 allow the company the opportunity to pursue increased
25 earnings through cost management and operating
26 efficiencies.⁹

if the expenses are lower, which gives the utility the incentive to manage its operations efficiently to reduce expenses and attain its authorized return on investment.”).

⁷ *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).

⁸ 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.

⁹ *Id.* at 9.

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

4 **Q. Did any of the other parties in Docket UM 903 recommend that the earnings**
5 **threshold be set at or below ROE?**

6 A. No. All parties to Docket UM 903, including Staff, CUB, and NWIGU, argued for
7 a benchmark above authorized ROE.¹⁰

8 **Q. Does the importance of encouraging low costs and efficient management**
9 **suggest that earnings tests for all deferrals must be set above authorized**
10 **ROE?**

11 A. No, not at all. Most deferrals are for one year only and adopted to address one-
12 time, unexpected costs. For this reason, the Commission's policies against
13 single-issue ratemaking may take precedence and cause the Commission to
14 appropriately set the cut-off at authorized ROE. Note that in the case of a single-
15 year and unexpected deferral, the Company's management and gas cost
16 incentives are unlikely to be affected to any significant extent. However, the
17 deferral at issue in this case presents an entirely different set of concerns. As I
18 have pointed out, this deferral will be in place for a long time—possibly twenty
19 years. And the costs are very significant. For these reasons, a test that cuts off
20 earnings at authorized ROE would remove important incentives for a long time to
21 come.

22 **Q. Is there Commission precedent supporting your view that different types of**
23 **deferrals may call for different types of earnings reviews?**

¹⁰ *Id.* at 5-7.

1 A. Yes. In my direct testimony, I discussed Order No. 93-257 in which the
2 Commission discussed three different types of deferrals, and the earnings tests
3 that might be appropriate for each. In that order the Commission specifically
4 distinguished between deferrals related to an “emergency increase in cost” for
5 which the Commission might “allow a utility to amortize the deferral to the extent
6 that it brings the utility’s earnings for the period up to the bottom of a reasonable
7 range” and, on the other hand, a “deferral . . . of a cost that was intended to be
8 borne by customers, but was delayed for the purpose of more appropriately
9 matching the cost with related benefits to customers” for which the Commission
10 “might allow the utility to amortize the deferral except to the extent that recovery
11 would cause rates to exceed the top of a reasonable range of return.”¹¹ Contrary
12 to CUB’s objections, which I address below, the environmental remediation
13 deferral fits squarely into the latter category.

14 **Q. Does the earnings test proposed by NW Natural retain the Company’s**
15 **incentives to manage gas costs and pursue efficiencies?**

16 A. Yes. By allowing the NW Natural to retain earnings up to 100 bp above
17 authorized ROE, the Company will continue to be incented to seek out gas cost
18 savings and to manage the Company efficiently between rate cases in order to
19 reduce costs and increase earnings. As recognized by Commission precedent,
20 customers will benefit from the retention of these incentives.

21 **III. PARTIES’ CRITICISMS OF NORTHWEST NATURAL’S**
22 **PROPOSAL FOR EARNINGS REVIEW**

23 **Q. What are the parties’ criticisms of NW Natural’s earnings test proposal?**

¹¹ Order No. 93-257 at 11-12. The Commission also referenced deferrals that create a fund for the benefit of customers that would require the utility to refund the deferral up to the amount that would bring the utility’s earnings to the bottom of a reasonable rate of return.

1 A. The parties' criticisms fall generally into three categories: criticisms of the
2 Company's proposal for calculating earnings on which the earnings test will be
3 based; criticisms of the Company's proposal to look at the Company's average
4 earnings during the 2003-2012 period for purposes of the historical earnings
5 review; and criticisms of the Company's proposal for a 100 bp deadband above
6 ROE.

7 ***Calculation of Earnings***

8 **Q. What criticisms do the parties make regarding the Company's proposal for**
9 **calculating earnings?**

10 A. First, CUB and NWIGU criticize the Company for proposing that weighted
11 average cost of gas (WACOG) earnings be removed from the calculation of the
12 Company's earnings for the purposes of the earnings test. However, this
13 criticism is based on the parties' misreading of the Company's testimony. The
14 Company does *not* argue that WACOG incentives be removed from earnings
15 prior to application of the earnings review. On the contrary, in my direct
16 testimony I specifically proposed that the earnings test for the SRRM employ the
17 same results of operations as is used in the Spring Earnings Review.¹² In 2009,
18 the Commission ordered NW Natural to include its share of WACOG savings in
19 its results of operations for the Spring Earnings Review,¹³ and the Company has
20 done so ever since. In my direct testimony I did explain that to the extent the
21 Company has over-earned in specific years, it was largely the result of WACOG
22 savings, and I provided calculations to prove my point. I raised this issue to point
23 out that a 100-bp deadband above ROE is important to preserve NW Natural's

¹² NWN/100, Miller/16.

¹³ *Re NW Natural Gas Co. Petition for a Declaratory Ruling*, Docket DR 43, Order No. 09-180 (May 22, 2009).

1 WACOG incentive incorporated into the PGA. However, my testimony was clear
2 that the calculations were for illustrative purposes only—as is evidenced by the
3 portion quoted by CUB.¹⁴

4 **Q. Do the parties offer any other criticisms of the Company's proposal for**
5 **calculating earnings?**

6 A. Yes. CUB argues that the Company inappropriately proposes to exclude its
7 natural gas storage and pipeline optimization profits from earnings.

8 **Q. Is this a fair criticism?**

9 A. No. CUB suggests that the Company is proposing to exclude optimization
10 earnings as if those revenues had ever previously been included in regulated
11 earnings. On the contrary, optimization profits have always been regarded by
12 the Commission as unregulated earnings and have never been considered in the
13 results of operations used for regulatory purposes. It is CUB who is making the
14 novel proposal.¹⁵ It would be a clear departure from past Commission treatment
15 for a business activity that is unrelated to core utility service to be included in
16 regulated earnings.

17 **Q. Novelty aside, does it make sense from a policy perspective for the**
18 **Commission to include optimization earnings in the earnings test?**

19 A. No, it does not. CUB's proposal to add optimization earnings to regulated
20 earnings—making them subject to non-recovery each year under the SRRM
21 earnings test—together with CUB's recommendation that the Company be forced
22 to give up earnings in excess of authorized ROE, will effectively remove the

¹⁴ CUB/100, Jenks/8.

¹⁵ In a response to a NW Natural data request, CUB has clarified that it is not proposing in this docket to add optimization earnings to regulated earnings for the purposes of the Spring Earnings Review. CUB's proposal applies only to the SRRM. See Exhibit NWN/501, Miller/1.

1 incentive to maximize savings from resource optimization.¹⁶ This incentive is
2 necessary for the Company to continue to justify the risk, additional cost, and
3 innovation required to pro-actively take advantage of changing market conditions.
4 Because these optimization activities have been governed by a “win/win” sharing
5 agreement over the last ten years, customers have benefitted immensely. By
6 removing this incentive, CUB’s proposal would leave both the Company and
7 customers worse off.

8 ***Aggregation of Prior Period***

9 **Q. What criticisms do the parties make of the Company’s proposal to**
10 **aggregate and average its prior years’ earnings during the past deferral**
11 **period for the purposes of the earnings review?**

12 A. Staff, CUB, and NWIGU all object to the Company’s proposal to aggregate the
13 prior years’ earnings during the past deferral period—arguing that the proposal is
14 inconsistent with past precedent and contrary to good public policy.

15 **Q. Do you agree that the Company’s aggregation proposal is inconsistent with**
16 **past Commission precedent?**

17 A. No. It may be that the Commission has never before aggregated earnings for a
18 multi-year deferral period—however, a comparable situation has never presented
19 itself. Most multi-year deferrals are subject to an AAC that requires amortization
20 on an annual basis. As far as I know, the Commission has never before been

¹⁶ The Commission recently opened a docket to consider the appropriate sharing arrangement for the earnings generated by the Company’s optimization docket—UM 1654. Based on the NW Natural’s discussions with the parties, I believe that one of the issues addressed in that docket will be the appropriate level of sharing necessary to incentivize the Company to continue its optimization efforts. A decision in this docket to include optimization earnings in the earnings review would largely moot the Commission’s decision in that case. For this reason, if the Commission wishes to reconsider whether optimization earnings should be considered in regulated earnings, Docket UM 1654 is the correct docket for that issue.

1 presented with a deferral that has been in place for close to 10 years prior to a
2 request for amortization.

3 **Q. Do you agree with the parties' arguments that the Company's aggregation**
4 **proposal is contrary to good public policy?**

5 A. No. Staff claims that the result of the Company's proposal is to "skew the years it
6 over-earned and had substantial environmental costs and use years where it
7 under-earned and had limited environmental costs."¹⁷ However, the Company's
8 proposal does not skew anything. On the contrary, the proposal applies a
9 rational timeframe for judging the Company's earnings over the period that the
10 deferral actually occurred, rather than a year-by-year analysis, which would
11 impose large write-offs because of the coincidence of higher expenses in a year
12 when the Company happens to have had higher earnings.

13 **Q. What about the argument advanced by Staff and NWIGU that if utilities**
14 **were able to average earnings over the deferral period, they could time the**
15 **request for amortization to maximize collection?**

16 A. This concern is misplaced. First, there are no facts to suggest that the Company
17 was attempting to game the timing when it filed to amortize its environmental
18 remediation deferrals in Docket UG 221. As I explained in my testimony in the
19 rate case, the Company decided to request recovery of the deferred balance in
20 its last rate case because both Staff and NW Natural had become concerned
21 regarding the size of the deferrals. Initially, the Company had put off requesting
22 amortization because it believed (incorrectly it turns out) that insurance coverage
23 was imminent that would wipe out most or all of the deferred amounts.

24 Moreover, for the first three years of the deferral, authorization orders specified

¹⁷ Staff/100, Johnson/5.

1 that the Company could apply for amortization only in the context of a general
2 rate case. Subsequently, it became clear to the Company that it would need to
3 litigate in order to recover insurance proceeds. It also became clear that the
4 Company would be financing a growing balance, and that the balance would
5 significantly impact customers' rates. In light of these facts, the Company
6 decided to seek amortization in its next rate case.

7 ***Amortization Threshold***

8 **Q. How have Staff, CUB, and NWIGU responded to the Company's proposal to**
9 **set the amortization threshold at 100 bp above authorized ROE?**

10 A. The parties all object to an amortization cut-off set above authorized ROE.
11 However, for reasons discussed above, allowing the Company to earn at or
12 above its authorized ROE is important to preserve NW Natural's incentive to
13 manage the Company efficiently and pursue gas cost savings. In addition,
14 imposing a cut-off at or below authorized ROE would result in the Company
15 under-earning and deny the Company an opportunity to earn the reasonable
16 return on its investments recently authorized by the Commission. Moreover, as
17 discussed above, in Order No. 93-257 the Commission found that setting the cut-
18 off at the top of a reasonable range of earnings is consistent with Commission
19 precedent for deferrals such as this one, where the costs are appropriately borne
20 by customers.

21 **Q. CUB argues that NW Natural has misinterpreted the Order No. 93-257, and**
22 **that in fact, the deferrals at issue in this case were not adopted to match**
23 **costs and benefits, and therefore don't fall into the category for which**
24 **amortization is appropriate up to the top of a reasonable range of earnings.**
25 **What is your response?**

1 A. I disagree. As I discussed in my direct testimony, in Order No. 93-257, the
2 Commission found that it might be appropriate to allow the utility to amortize
3 deferrals up to the top of a reasonable range of earnings where the deferred
4 costs are of the type that are appropriately borne by customers but deferred to
5 match costs and benefits. In this case, the Commission has already found that
6 the environmental costs are appropriately borne by customers. Moreover, NW
7 Natural's environmental deferrals were filed and approved under ORS
8 757.259(2)(e), which allows the Commission to approve rates that reflect
9 "[i]dentifiable utility expenses or revenues, the recovery or refund of which the
10 Commission finds should be deferred in order to minimize the frequency of rate
11 changes or the fluctuation of rate levels or to match appropriately the costs borne
12 by and benefits received by ratepayers." Even CUB recognizes—albeit
13 elsewhere in its testimony—that a deferral such as this one is necessary
14 because the costs are not easily forecasted.¹⁸ In particular, even if the Company
15 could forecast the remediation costs with any accuracy, it has no basis on which
16 to reliably forecast insurance and other third-party recoveries. Thus, if NW
17 Natural attempted to build these costs into base rates, customers would be at
18 substantial risk of significant over- or under-payment. As a result, a deferral is
19 necessary to ensure that customers bear the appropriate level of cost—or, in the
20 words of the statute, to match benefits and costs. Thus, CUB's attempt to
21 remove this particular deferral from the third category discussed in Order No. 93-
22 257 is inappropriate.¹⁹

¹⁸ CUB/100, Jenks/4.

¹⁹ In addition, CUB is incorrect that neither the Commission nor Staff mentioned the matching principle as justification for the deferral. The most recent Staff Memorandum adopted by the Commission in the environmental remediation deferral docket referenced the matching of costs and benefits as a justification for the deferral. *Re Northwest Natural Gas Company Application for*

1 **Q. Has the Commission provided any indication that it has the flexibility to set**
2 **the cut-off for recovery above authorized ROE in this case?**

3 A. During the course of oral argument, NW Natural's attorney emphasized that
4 imposing an earnings review that would cut off amortizations at authorized ROE
5 would effectively cap the Company's earnings at that level. The following
6 colloquy between our attorney and Commissioner Savage ensued:

7 MS. RACKNER: But the most significant [issue] for
8 us is that given the size of the expected costs and the
9 length of time over which they will need to be recovered, if
10 the Commission were to cut off recovery of environmental
11 remediation costs at the Company's authorized rate of
12 return, this would effectively operate as a cap on the
13 Company's earnings for the foreseeable future. And in our
14 view that would be a very significant shift in Commission
15 policy and it would also constitute a significant shift in the
16 regulatory environment in which the Company is operating.
17 So our view is that really under the circumstances we have
18 here, as a matter of policy, it would be damaging to the
19 Company to impose that type of an earnings review.

20 COMMISSIONER SAVAGE: Why is that necessarily -- you
21 made a statement that it was necessary that we would be
22 capping at your rate of return. Why is that true? Depending
23 on the structure of an earnings test it could be structured
24 that that wouldn't necessarily be true.²⁰

25 **Q. What about the criticism offered by both CUB and NWIGU that under the**
26 **Company's proposal, customers would likely bear all costs of**
27 **environmental remediation at manufactured gas plants (MGP)?**

Deferred Accounting of Unrecovered Environmental Costs Associated with Gasco, Wacker, Portland Gas, Portland Harbor and Eugene Water and Electric Board, Docket UM 1078, Order No. 13-081, Appendix A at 2 (Mar. 13, 2013) ("Authorization to defer Environmental Costs and amounts from insurance recoveries can be authorized pursuant to ORS 757.259(2)(d) because they are utility expenses or revenues, the recovery or refund of which the Commission finds should be deferred in order to minimize the frequency of rate changes or to match appropriately the costs borne by and benefits received by ratepayers.")

²⁰ *Re NW Natural Gas Co. Request for a General Rate Revision, Docket UG 221, TR. 20-21 (Oct. 11, 2012).*

1 A. I have two responses to that specific argument. First, regardless of the earnings
2 test set by the Commission, there are no circumstances under which customers
3 bear all of the costs of environmental remediation at MGPs because the
4 Company bore more than \$5 million in environmental remediation expense
5 *before the Company filed a deferral*. Second, and more importantly, this criticism
6 misses the mark. The purpose of earnings review is not to require the Company
7 to shoulder some portion of the costs of environmental remediation; the
8 Commission expressly rejected the parties' sharing proposals which were
9 designed to achieve that result. Rather, the primary purpose of the earnings
10 review is to ensure that Company does not collect amounts that are deferred in
11 periods when it is earning above a reasonable range of ROE. And, as described
12 below, NW Natural's proposed earnings test will provide incentives to minimize
13 costs and maximize recoveries.

14 **Q. Staff argues that for the purposes of the historic deferral period, the**
15 **Commission should consider as reasonable a range the Company's**
16 **authorized ROE of 10.2 to a point 100 bp below authorized ROE of 9.2. How**
17 **do you respond?**

18 A. First, I would observe that Staff's proposal does not appear to be particularly
19 principled, in that Staff argues that earnings below authorized are reasonable,
20 but earnings above authorized are not. In support of this position, Staff offers,
21 without explanation, the opinion that "ROEs between 9.2 and 10.2 during the
22 deferral period is not inconsistent with earnings that are required to attract capital
23 and obtain credit."²¹ However, Staff offers no support for that conclusion, which
24 is inconsistent with the fact that during this same time period, between 2003 and

²¹ Staff/100, Johnson/8.

1 2011, the ROEs approved by the Commission for utilities under its jurisdiction
2 never fell below 10.0.

3 Moreover, I would note that, as discussed below, Staff's proposal would
4 lead to a write-off for the Company of around \$64 million. It is difficult to see how
5 this proposal could allow the Company to attract capital and maintain credit.

6 **Q. All parties argue that the earnings test needs to provide the Company with**
7 **incentives to minimize costs and maximize insurance and third-party**
8 **recoveries—in addition to the incentive provided by the prudence review.**
9 **Does NW Natural's proposal provide such incentives?**

10 A. Yes. NW Natural has proposed that environmental remediation expense be
11 offset by insurance recoveries *prior to* application of an earnings review. Thus, if
12 environmental remediation costs are held down to a level such that they are
13 offset by recoveries, NW Natural could avoid being required to write off any over-
14 earnings to cover expenses. As a result, NW Natural's proposal would provide
15 the Company with a clear incentive to manage costs and maximize recoveries.

16 **Q. Does NW Natural's proposal have additional incentives to manage its**
17 **environmental remediation costs?**

18 A. Yes. Although not specifically a function of the earnings review, the SRRM in
19 itself provides additional incentives to the Company to manage its costs and
20 maximize its recoveries—by allowing the Company a reduced level of interest on
21 deferred amounts after the prudence review has been conducted. As I discussed
22 in my testimony in Docket UG 221, NW Natural finances its environmental
23 remediation expenses in the same way as it finances all of its expenses—with a
24 mix of debt and equity. The Commission has set the Company's authorized
25 ROR at 7.778%. However, once the deferred expenses are deemed prudent,
26 before amortization they will accrue interest at the five-year treasury rate plus

1 100 bp, and once in amortization they will accrue interest at the modified blended
2 treasury rate which is currently only 1.38%. It is therefore in NW Natural's
3 interest to minimize amounts in amortization. This goal can be achieved by
4 keeping the environmental costs, net of insurance, as low as possible.

5 **IV. STAFF AND CUSTOMER GROUP PROPOSALS FOR EARNINGS REVIEW**

6 ***Staff's Proposal***

7 **Q. Please describe Staff's proposal for the earnings review.**

8 A. Staff proposes that for the past deferral balance, environmental expenses that
9 would bring the Company's earnings above 9.2—or 100 bp below authorized
10 ROE—be disallowed. Going forward, Staff proposes sharing bands as follows:

- 11 • If the Company earns within 50 bp below authorized ROE and 50 bp
12 above authorized ROE, environmental remediation costs would be split
13 between customers and shareholders on a 50/50 basis;
- 14 • For results lower than 50 bp below authorized ROE, ratepayers pay 95%
15 of environmental remediation costs while the Company bears 5%; and
- 16 • For results above more than 50 bp above authorized ROE, shareholders
17 would pay 95% of costs while customers bear 5%.

18 Alternatively, Staff proposes that the Company share environmental remediation
19 costs with customers on a 90/10 basis.

20 **Q. What is Staff's proposal for the application of insurance proceeds?**

21 A. Staff proposes that insurance proceeds and third-party recoveries be allocated to
22 both the historic and future periods on a pro rata basis, proportional to the
23 amount deferred each year.

24 **Q. What is your general response to Staff's proposal?**

25 A. Overall, my response is that Staff's proposal results in illogical outcomes, would
26 impose an unfair burden on the Company, would remove significant incentives

1 the Commission has fashioned in the past to incent good management, and is
2 contrary to good public policy and to Commission orders.

3 **Q. What is your response to Staff's proposal for the earnings test to be**
4 **applied to the past deferral balance?**

5 A. This part of Staff's proposal imposes an unfair burden on the Company in two
6 respects. First, the proposal is essentially to cap the Company's earnings at 100
7 bp *below* authorized ROE for the entire decade during which the deferral was in
8 effect. This proposal is punitive on its face. When NW Natural requested and
9 was granted deferrals of environmental remediation costs, it did so because
10 deferral appeared to be the most rational approach to recovery of these
11 significant, ongoing, but unpredictable costs. However, there was nothing in the
12 Commission orders adopting the deferrals, or the Company's conversations with
13 Staff, that indicated that for the length of time the deferral was in place Staff
14 would seek to cap the Company's earnings in this way. If Staff had made their
15 intentions clear, the Company might have proposed to include forecasted costs
16 into base rates—an approach that would have imposed more risk on the
17 Company and its customers, but which would have avoided the surprising and
18 harmful consequences Staff is advocating today.

19 Moreover, because Staff proposes that only a portion of past costs be
20 offset by insurance and third-party recoveries prior to the operation of the
21 earnings review, we see the absurd result that the amount borne by shareholders
22 is greater than the net deferrals after the application of insurance. Specifically, of
23 the \$97 million in environmental remediation expense and interest deferred since
24 2003, Staff's proposal results in \$64 million to be borne by shareholders—even
25 though the actual total amount in the deferral account, net of insurance receipts,
26 as of year-end 2012 is \$57 million.

1 **Q. What is your response to Staff’s proposal for the earnings test to be**
2 **applied in the future?**

3 A. Staff proposes an earnings test with a 50/50 sharing of environmental costs
4 within a band of +/- 50 basis points around the Company’s authorized ROE. If
5 earnings are above that band, costs are shared 5/95 customers/Company. If
6 earnings are below that band, costs are shared 95/5 customers/Company. It is
7 not clear whether Staff’s proposal intends a sharing of the environmental costs or
8 a contribution of the Company’s earnings relative to the bands; however, for
9 purposes of illustrating the impact of the proposal, I have assumed the latter for
10 the following analysis. Assuming an annual environmental spend of \$12 million,
11 the following table summarizes the impact of Staff’s proposal at different ROEs
12 within and outside of the band:

13 **Impact of Staff’s proposal at various ROEs, assuming annual \$12 million**
14 **environmental spend:***

| | 8.5% | 9.5% | 10.5% |
|---|-----------------|---------------|----------------|
| NW Natural’s over(under)-earnings vs. 9.5% | (\$7.4 million) | \$0 | \$7.4 million |
| NWN contribution of earnings toward environmental spend | \$0.6 million | \$3.7 million | \$11.1 million |
| Effective ROE after application of sharing | 8.42% | 9.0% | 9.0% |

15 *over(under) earnings calculated using the ROEs indicated and Docket UG 221 rate
16 base and cost of capital

17
18 As illustrated, assuming that environmental spend is greater than any over-
19 earnings—which is the highly likely outcome based on the Company’s historical
20 performance—the effect of Staff’s proposal would be to cap the Company’s
21 earnings at 9%. In the case where the Company is already under-earning, the
22 under-earning would be exacerbated by the requirement to share 5% of
23 environmental costs. In the case where the Company was over-earning,

1 amounts *in excess of the Company's actual over-earnings* would be contributed
2 toward the environmental spend and earnings would be capped at 9%.

3 If, on the other hand, Staff's proposal intended a sharing of costs and not
4 a contribution of earnings relative to the bands,²² the impact would be as follows,
5 again assuming a \$12 million annual environmental spend and assumed ROEs:

| | 8.5% | 9.5% | 10.5% |
|--|-----------------|--------------|----------------|
| NW Natural's over(under)-earnings vs. 9.5% | (\$7.4 million) | \$0 | \$7.4 million |
| Annual environmental spend | \$12 million | \$12 million | \$12 million |
| Ratepayer share of spend | \$11.4 million | \$6 million | \$0.6 million |
| NW Natural share of spend | \$0.6 million | \$6 million | \$11.4 million |
| Effective ROE after application of sharing | 8.42% | 8.69% | 8.96% |

6 As shown, the Company would share expenditures beyond any amount of
7 over-earnings that would cause the Company to fall within or above the earnings
8 band. The Company then has little opportunity to earn its authorized ROE.

9 **Q. What is your response to Staff's proposal for application of insurance and
10 third-party recoveries?**

11 A. As I point out above, Staff's proposal going backward, together with its
12 amortization threshold being set at 100 bp below authorized ROE, yields absurd
13 results. And, going forward, Staff's proposal cannot really be implemented.

²² Staff's Response to the Company's Data Request 3 on this issue did not help to clarify the intent of the proposal. In part, Staff's response was:
"Staff proposal going forward is based upon earnings. The application of the earnings bands would determine how many of the environmental remediation expenditures are paid for by ratepayers and how many of the expenditures are absorbed by the Company. If the Company is earning within 50 basis points below or above authorized return on equity, ratepayers would pay 50 percent of the **costs** of environmental remediation and the Company would pay for 50 percent of the **costs** until the allocation of such costs causes NWN earnings to no longer be within 50 basis points." Exhibit NWN/502 (emphasis added).

1 Specifically, Staff recommends that 50 percent of insurance proceeds be
2 allocated to future deferral periods, but does not state how they should be
3 allocated on a yearly basis. For this reason, NW Natural served a data request
4 on Staff asking Staff to “please describe how the 50 percent of already-received
5 insurance amounts would be applied on a year-by-year basis going forward.”

6 The answer Staff provided is as follows:

7 The insurance proceeds would apply on a going forward
8 basis depending on what the company spent on
9 environmental remediation in that year. Because we do
10 not know the amount of environmental remediation costs
11 for future years, it is speculative to state how insurance
12 proceeds would be allocated on those future, unknown
13 costs.²³

14 **Q. Is this response satisfactory?**

15 A. No, because it does not answer the question of how the proposal could be
16 implemented. In any future year, it would still not be known what the ultimate
17 future spend will be, so the Company could not determine the portion of future
18 spend that is being incurred in that year, or the appropriate insurance offset for
19 purposes of the earnings test. For this reason, Staff’s proposal is not workable.

20 **Q. What is your response to Staff’s alternative proposal that the Commission
21 impose 90/10 sharing on all environmental remediation costs?**

22 A. The Commission should reject the alternative proposal. The Commission
23 refused the parties’ arguments in favor of sharing in Docket UG 221, and Staff
24 has not provided any rationale as to why it should revisit this decision in this
25 case.

26 ***CUB’s Proposal***

27 **Q. What is CUB’s earnings test proposal?**

²³ Exhibit NWN/503.

1 A. CUB recommends that the Commission disallow recovery of deferred
2 environmental remediation costs that would take Company above authorized
3 ROE. This proposal appears to be intended to apply both forward and backward.
4 Alternatively, CUB proposes sharing bands as follows:

- 5 • Customers pay all of deferred costs up to 100 bp below authorized
6 ROE;
- 7 • Customers pay 80% of costs from 100 bp below authorized ROE to
8 authorized ROE; and
- 9 • Customers pay 10% of costs up to 100 bp above authorized ROE.

10 **Q. What is your general response to CUB's proposal?**

11 A. CUB's proposal would place an unfair burden on the Company, would remove
12 significant incentives the Commission has fashioned in the past to incent good
13 management, and is contrary to good public policy and to Commission orders.

14 **Q. How does CUB propose that earnings be calculated for the earnings test?**

15 A. CUB proposes the revenues flowing from the Company's optimization activities
16 be included in earnings, as well as WACOG earnings. In particular, CUB
17 suggests that WACOG sharing be included in the Company's earnings both for
18 the period after the Commission began requiring WACOG sharing to be
19 included—which is consistent with the Company's proposal—as well as the years
20 in which WACOG sharing was not included in earnings, from 2003 through 2007.

21 **Q. How do you respond to CUB's proposal to add optimization profits to
22 earnings for the purpose of the earnings review?**

23 A. Given that CUB's proposal would eliminate the incentive established by the
24 sharing mechanism adopted by the Commission, CUB's proposal is contrary to
25 Commission policy.

1 **Q. Do you agree that the Company's portion of WACOG savings should be**
2 **added to earnings prior to 2006 for the purpose of applying the earnings**
3 **test?**

4 **A.** No. Prior to 2008 the Commission approved the Company's filed results of
5 operations each year without the inclusion of WACOG sharing. It would not be
6 appropriate for the Commission to require the Company to recalculate those
7 earnings based on a subsequent ruling.

8 **Q. How do you respond to CUB's proposal to set the amortization threshold at**
9 **authorized ROE?**

10 **A.** As I have explained, an earnings test that cuts off amortization of environmental
11 deferrals at the Company's authorized ROE will essentially cap the Company's
12 earnings at that level. In fact, if the amortization threshold is set at authorized
13 ROE, as a practical matter, it is highly likely that on average the Company will
14 earn below its authorized ROE.²⁴ In this way, under CUB's proposal, year after
15 year the Company can expect to give up through the SRRM earnings test all
16 earnings it might have otherwise achieved through WACOG incentives and
17 efficiency measures—thus significantly muting the incentives present under
18 current Commission policy.

19 CUB argues that the Company can still expect to over-earn in some
20 years—pointing to the fact that in some years in the past environmental
21 expenses were as low as \$5.3 million, while the Company retained \$4.4 million in
22 PGA savings.²⁵ This is a rather weak point given the fact that even at its lowest
23 expense level since 2005, the Company's environmental expenses easily
24 exceeded WACOG sharing, while at the same time, environmental expenses

²⁴ NWN/100, Miller/20-21.

²⁵ CUB/100, Jenks/10.

1 have been ramping up over time. And, more fundamentally, CUB overlooks the
 2 fact that the Company's share of the WACOG keeper is already included in the
 3 Company's results of operations. Given this, CUB's proposal would merely
 4 require the Company to contribute all of its share of WACOG savings toward
 5 environmental deferrals, rather than giving the Company an opportunity to
 6 potentially over-earn.

7 **Q. How do you respond to CUB's alternate sharing band proposal?**

8 A. CUB proposed the following sharing bands:

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

17 Under this proposal, the Company estimates write-offs of past amounts (2002-
 18 2012) of \$38.6 million. As applied to future earnings tests, assuming that
 19 environmental spend is greater than any Company over-earnings, the following
 20 results at various ROEs are estimated*:

| | 8.25% | 8.75% | 9.75% | 10.75% |
|--|---------------------|---------------------|-------------------|--------------------|
| NW Natural's over(under)- earnings vs 9.5% | (\$9.25 million) | (\$5.55 million) | \$1.85 million | \$9.25 million |
| NWN contribution of earnings toward environmental spend | \$0 | \$1.85 million | \$9.25 million | \$16.65 million |
| Effective ROE after application of sharing | 8.25% | 8.5% | 8.5% | 8.50% |

1 *over(under) earnings calculated using the ROEs indicated and UG 221 rate base and
2 cost of capital

3
4 As illustrated, CUB's proposal results in contributions to environmental deferrals
5 in excess of actual over-earnings from authorized ROE and ultimately caps the
6 Company's earnings at the bottom of the band, or 8.5%, assuming that
7 environmental spend is greater than over-earnings.²⁶

8 **Q. How does CUB propose insurance and other third-party recoveries be**
9 **applied to deferral balances for purposes of the earnings test?**

10 A. CUB proposes that the earnings test be conducted on deferred amounts without
11 regard to any insurance receipts.

12 **Q. What is your response to CUB's proposal for application of insurance and**
13 **third-party recoveries?**

14 A. CUB's proposal is inconsistent with the Commission's deferral orders and its
15 decision in Docket UG 221—both of which require the Company to net insurance
16 proceeds against deferrals in the balancing account prior to amortization.
17 Moreover, CUB's proposal is unsound from a policy perspective.

18 **Q. Why do you say that Commission orders require that insurance be netted**
19 **against expense prior to the application of the earnings test?**

20 A. This is the only reasonable interpretation of the Commission's orders in the
21 underlying deferral dockets and in Docket UG 221. The underlying deferral
22 dockets approved a balancing account approach in which deferred environmental

²⁶ If the environmental spend is less than any over-earnings, then the contribution would be smaller, as the write-off is the lesser of the applicable percentage of actual environmental spend or the over-earnings in the applicable band. Because future spending is not known, for simplicity in illustrating the impacts, we assume that environmental spend exceeds the earnings related to each band.

1 remediation expenses are offset by insurance recoveries.²⁷ Similarly, in adopting
2 the SRRM, the Commission made clear that prior to amortization, deferred
3 environmental remediation expenses are to be offset by insurance and other
4 third-party recoveries in the deferral account itself—prior to the point at which
5 deferrals are moved into amortization. Thus, it would be contrary to the
6 Commission's orders for the Commission to apply the earnings test to amounts
7 that have not been offset.

8 **Q. Why do you say that CUB's insurance proceeds proposal is unsound from**
9 **a policy perspective?**

10 A. This point is best made by way of a simple hypothetical:

11 *Assume that this year the Company defers \$10 million in environmental*
12 *remediation expenses, and that the Company earns in excess of authorized ROE*
13 *by \$1 million. Then, assume further that the Company wins the insurance*
14 *coverage at trial, and recovers a total of \$350 million in insurance recoveries.*
15 *Under the Commission's order in the deferral dockets and in Docket UG 221, that*
16 *amount would be netted against the approximately \$100 million in the deferral*
17 *account, bringing the balance in that account to negative \$250 million. As a*
18 *result of that recovery, there will be no expenses to amortize into customer rates.*
19 *Nevertheless, if the earnings test is performed for this before netting, the*
20 *Company will be required to write off \$1 million—even though customers will not*
21 *be required to pay any environmental remediation expense, and even though*
22 *they may never be required to do so.*

²⁷ See, e.g., *Re NW Natural Gas Co. Application for Deferred Accounting of Unrecovered Environmental Costs Associated with Gasco, Wacker, Portland Gas, Portland Harbor and Eugene Water and Electric Board*, Docket UM 1078, Order No. 03-328, Appendix A at 1 (May 27, 2003).

1 While the parties disagree on any number of issues in this case, we all
2 concur that the purpose of the earnings review is to prevent the Company from
3 amortizing deferred expenses incurred in periods when it is otherwise earning an
4 unreasonably high return. It would be nonsensical to twist the earnings review
5 into a mechanism that requires the utility to write off expenses that are otherwise
6 covered by insurance and that it has no intention of asking customers to cover.

7 **Q. Are there other problems with CUB's insurance proceeds proposal?**

8 A. Yes. CUB's proposal removes any incentive for the Company to maximize its
9 insurance recoveries, as the Company would be subject to an earnings test as
10 though there were no insurance offsets.

11 ***NWIGU's Proposal***

12 **Q. Please describe NWIGU's earnings test proposal.**

13 A. Like CUB, NWIGU recommends that the Commission disallow recovery of
14 deferred environmental remediation costs that would take the Company above
15 authorized ROE. Also like CUB's, this proposal appears to be intended to apply
16 both forward and backward.

17 **Q. How does NWIGU propose that earnings be calculated for the earnings
18 review?**

19 A. NWIGU explicitly proposes that WACOG sharing be included in the earnings
20 review, which as I have explained, is consistent with NW Natural's proposal.
21 NWIGU does not appear to support CUB's proposal that optimization incentives
22 be included, given that NWIGU asks only that "all sources of earnings from
23 regulated operations should be considered in establishing the Company's ROE

1 for a given year.”²⁸ Optimization activities are not part of our regulated
2 operations.

3 **Q. How does NWIGU propose insurance and other third-party recoveries be**
4 **applied to deferral balances?**

5 A. NWIGU’s proposal is similar to CUB’s; that is, NWIGU proposes that insurance
6 proceeds be flowed through to customers outside of the SRRM, and therefore
7 not be netted against deferral balances. NWIGU adds its view that recoveries
8 should be flowed through directly to customers. NWIGU does advance an
9 alternative under which the Company would be allowed to offset expenses
10 previously written off by retaining 5% of insurance proceeds.

11 **Q. What is your response to NWIGU’s proposal?**

12 A. While in some ways more moderate than the Staff and CUB proposals, NWIGU’s
13 proposal would place an unfair burden on the Company, would remove
14 significant incentives the Commission has fashioned in the past to incent good
15 management, and is contrary to good public policy and the Commission’s orders.
16 Like the Staff and CUB proposals, NWIGU’s proposal would cap the Company’s
17 earnings at authorized ROE, and as a practical matter, will require the Company
18 to give up all WACOG incentives and other earnings it achieves through good
19 management.

20 **Q. What is your response to NWIGU’s proposed application of insurance and**
21 **other third-party recoveries?**

22 A. Because NWIGU’s primary proposal and rationale parallels CUB’s, I have the
23 same objections. I appreciate that in NWIGU’s alternate proposal provides the
24 Company with an incentive to maximize recoveries; however, it provides only

²⁸ NWIGU/100, Deen/5.

1 limited incentive, and remains contrary with the Commission's orders, which
2 require netting of insurance proceeds. It also provides little to no hope for the
3 Company to be able to recoup enough insurance to offset the disallowances
4 NWIGU proposes.

5 V. OTHER ISSUES

6 *Prudence Review*

7 **Q. Do you have any comments on the outcome of Staff's prudence review?**

8 A. The Company appreciates Staff's efforts to review the materials the Company
9 produced to demonstrate the prudence of its remediation expenses and its
10 pursuit of insurance recoveries to date, and its recommendations to the
11 Commission on this topic. We note that Staff's proposal for a disallowance of
12 \$33,400 is the only recommendation for a disallowance on the basis of prudence,
13 and NW Natural does not object to this recommendation.

14 *Jurisdictional Allocation*

15 **Q. Do you have any comments on the parties' testimony on NW Natural's**
16 **jurisdictional allocation proposal?**

17 A. NW Natural proposed jurisdictional allocation based on usage during the
18 historical period when MGPs were used to provide service. All parties agree with
19 this jurisdictional allocation except CUB, who argues that *current* usage should
20 drive the responsibility for clean-up costs. The Company disagrees. The
21 environmental remediation costs are directly related to historical service. Given
22 the fact that Washington customers accounted for just over three percent of the
23 Company's (predecessor's) load during the relevant period, the Company cannot
24 agree to allocate to them 10 percent of the clean-up costs. However, if the
25 Commission does not agree with NW Naturals proposal, I would suggest the

1 issue be tabled so that all interested parties (including Washington Staff and
2 customer groups) can participate to adopt a consistent allocation between states.

3 **Q. Do you have any additional clarifications regarding NW Natural's**
4 **jurisdictional allocation proposal?**

5 A. Yes. In our testimony, we proposed that the costs related to the Company's
6 environmental remediation activities be allocated between Oregon and
7 Washington on a basis that reflects the historical manufactured gas deliveries to
8 each state. In the case of the remediation for the Gasco plant, this results in an
9 allocation of 96.68% / 3.32% allocation to Oregon and Washington, respectively.
10 However, a portion of NW Natural's environmental remediation activities have
11 been, and will be related to remediation for the Portland Gas Manufacturing site,
12 which was not used to serve our Washington customers at all, because it pre-
13 dated the time at which we even had a physical connection to Washington. For
14 this reason, the Company proposes that all deferred costs incurred to clean up
15 that specific site should to be allocated to Oregon customers. Through 2012,
16 these costs have been \$2.5 million, out of the total of \$97 million of expenses
17 and interest in total.

18 ***Gasco Pumping Station***

19 **Q. What treatment did the Company propose for the Gasco Pumping Station?**

20 A. The Company proposed clarification from the Commission that once that plant is
21 constructed and operational, that it would be included in rate base, subject to a
22 prudence review. If the Commission is not comfortable with rate base treatment
23 for that plant, the Company can treat the Gasco Pumping Station expense like all
24 other environmental remediation expenses, and include them in the SRRM.

25 **Q. If the project is not yet completed, why is the Company seeking**
26 **clarification now?**

1 A. The Company is seeking clarification to allow appropriate accounting for the
2 costs, as they are incurred. To be clear, the Company is not requesting
3 preapproval—simply direction from the Commission as to whether it would rather
4 the plant be included in rate base or the SRRM. As I explained in my direct
5 testimony, the plant is expected to costs between \$11 and \$30 million. Adding
6 the plant to rate base would allow the Company to amortize the costs to
7 customers over the life of the plant, as opposed to the five-year period adopted
8 by the Commission for the SRRM.

9 ***Limiting the Scope of the SRRM***

10 **Q. CUB has proposed that future deferrals be limited to environmental
11 remediation costs associated with MGP remediation. Does NW Natural
12 agree such a limitation is appropriate?**

13 A. We believe it is appropriate to limit the scope of the costs that are recovered
14 through the SRRM to environmental remediation costs. Currently, our only
15 significant liabilities relate to MGP site remediation, and we would request
16 approval of the Commission before seeking to expand the application of the
17 SRRM to cover any other new significant environmental expenses in the future.

18 ***Proposal to Cap Costs***

19 **Q. CUB has also proposed to limit the SRRM by allowing the mechanism to
20 expire after \$250 million in costs (net of insurance proceeds) have been
21 passed through to customers, or 10 years has elapsed. Do you agree?**

22 A. No, I do not. The earnings test proposed by NW Natural provides the Company
23 with the incentive to both maximize recoveries and minimize costs, and therefore
24 will serve customers and the Company for as long as the remediation efforts
25 continue. I especially take issue with a proposal to allow the mechanism to
26 expire based on the passage of time. Adopting such a provision would provide

1 the Company with a perverse incentive to spend up to the \$250 million limit
2 before the 10-year expiration can occur. Finally, in Docket UG 221, the parties
3 spent an enormous amount of time litigating the appropriate mechanism,
4 including earnings review, and the Commission has given full consideration to
5 the SRRM generally, and will expend more time and effort in adopting an
6 appropriate earnings review. It would be inefficient to impose an arbitrary sunset
7 date or dollar limit. In the event that sometime down the road the Commission is
8 dissatisfied with the workings of the mechanism, it clearly has authority to make
9 any changes it deems necessary or appropriate.

10 **Q. Does this conclude your reply testimony?**

11 **A. Yes.**

NWN/501

Witness: C. Alex Miller

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

UM 1635

NW NATURAL

Exhibit Accompanying Reply Testimony of C. Alex Miller

CUB Response to NW Natural Data Requests 1-4 in Docket UM 1635

May 28, 2013



Citizens' Utility Board of Oregon

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May 21, 2013

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Re: UM 1635 CUB Responses to NWN Data Requests 1-4

1. In CUB/100 Jenks/8, Mr. Jenks mentions that the "Company also does not want to include optimization revenues as regulated earnings." Please clarify whether CUB's understanding is that the Company is proposing a change in UM 1635 to how optimization revenues are treated in the earnings test (or Results of Operations). If so, please indicate where in the record of Docket No. UM 1635 CUB understands that the Company has proposed a change. Alternatively, please clarify whether Mr. Jenks is representing how the Results of Operations for earnings test purposes is currently calculated.

Response to NWN DR 1 to CUB:

The Company is not proposing a change in how optimization revenues are treated in the Results of Operations. The Results of Operations as currently reported by NW Natural do not include optimization revenues and have been used for the Earnings Test associated with the PGA sharing mechanism.

An earnings test has not been established for calculation of environmental remediation cost recovery and the PUC has wide discretion to design such an earnings test. CUB believes that including optimization revenues is necessary to produce fair, just and reasonable rates.

2. In CUB/100 Jenks/9, Mr. Jenks explains the current optimization sharing agreement. Is Mr. Jenks proposing a change to the current earnings test whereby optimization revenues and expenses income would be included in utility income on a going forward basis?

Response to NWN DR 2 to CUB:

Mr. Jenks' testimony refers to an earnings test associated with environmental remediation cost recovery. Such an earnings test has yet to be designed and implemented, thus Mr. Jenks is not proposing a change to an earnings test. Mr. Jenks does, however, believe that optimization revenues that are derived from customer assets, such as ratebased storage or pipeline capacity charged to

customers, should be included in an the environmental remediation cost recovery earnings test when it is designed.

3. In CUB/100 Jenks/9, Mr. Jenks, referring to the Company's portion of WACOG earnings and optimization income, states that "Excluding both of these from an earnings test is unusual." Please provide all known examples of instances in which the Oregon Commission or any other Commission requires other LDCs to include their shared portions of optimization activities as part of their reported regulated earnings, or as part of an earnings test.

Response to NWN DR 3 to CUB:

Regulated utilities are expected to manage assets in the best interests of customers. This policy requires regulated utilities to optimize their assets. Electric utilities dispatch generating assets to the market when doing so will generate revenue without causing reliability risks to customers. Electric utilities and telecommunication utilities rent space on poles when doing so does not create safety concerns. In these cases the revenue (or a forecasted or a trued-up basis for the revenue, depending on the circumstances) goes back to customers and is accounted for in a utility's Results of Operations.

Mr. Jenks believes that excluding revenue that is generated from assets, that are part of a utility's revenue requirement, is unusual.

As for NW Natural's request that CUB "provide all known examples of instances in which the Oregon Commission or any other Commission requires other LDCs to include their shared portions of optimization activities as part of their reported regulated earnings, or as part of an earnings test", Mr. Jenks has not undertaken an extensive review of the practices of other utilities because, to his knowledge this is a common practice for a utility managing its assets to the best interest of customers. However, Mr. Jenks is specifically familiar with Massachusetts where the Department of Public Utilities requires the LDC to "maximize the value of their gas resources for the benefit of firm customers" using a variety of mechanisms, including Capacity Release, Off-System Sales, and Third-party Asset Management. These are called "optimization transactions" and 90% of the margin is provided to customers, with 10% retained by the Company. (see D.P.U. 10-62-A)

4. Please provide the supporting research mentioned in CUB/100 Jenks/20 that historical operations served more non-residential customers and explain how this understanding is applicable to how the Oregon and Washington state allocation should be determined.

Response to NWN DR 4 to CUB:

As part of this docket CUB did some historical research to determine the early uses of natural gas. That research was focused on historic uses of gas in the US, and suggested that the early use of natural gas was primarily street lighting and some commercial and industrial uses, and it wasn't until after gas furnaces came along in 1918 that residential heating use began.

However, a review of NW Natural's data responses to CUB, including annual reports going back to 1920, shows that there was a significant amount of residential lighting use in 1920 and that since 1920 residential heating load has grown. Based on these reports which are specific to NW

Natural's predecessor, CUB accepts that residential usage was significant from at least 1920 forward.

The purpose of CUB's testimony was to point out that while costs are being allocated to customer classes based on current usage, costs are being allocated between the states based on historic operations. CUB does not think that this distinction has merit. It is CUB's position that NW Natural's Oregon and Washington customers should receive equal treatment. Costs should be spread to the states based on current operation levels.

Sincerely,

A handwritten signature in black ink, appearing to read "Bob Jenks", with a stylized flourish at the end.

Bob Jenks
Executive Director
Citizens' Utility Board of Oregon
610 SW Broadway, Suite 400
Portland, OR 97205
(503) 227-1984, x15
bob@oregoncub.org

NWN/502
Witness: C. Alex Miller

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

UM 1635

NW NATURAL

Exhibit Accompanying Reply Testimony of C. Alex Miller

Staff Response to NW Natural Data Request 3 in Docket UM 1635

May 28, 2013

NWN Data Request No. 3:

3. For the earnings test going forward Staff proposes 50/50 sharing of “results” within an earnings band of 50 basis points above and below and then 95/5 sharing (5 percent borne by the Company) of “costs” below the band and 5/95 sharing of “costs” above the band (Staff/100 Johnson/12). Is Staff proposing that any **earnings** within the band would be shared and that environmental **expenditures** would be shared outside of the band? Please provide examples of how the sharing would be calculated under Staff’s proposal using scenarios in which the Company is earning below, within, and above the deadband. Specifically, please demonstrate that the proposal does or does not result in a situation where larger amounts could be disallowed when the Company is earning under the band than when it is earning within the band.

Response to NWN Data Request No.3:

3. Staff proposal going forward is based upon earnings. The application of the earnings bands would determine how many of the environmental remediation expenditures are paid for by ratepayers and how many of the expenditures are absorbed by the Company. If the Company is earning less than 50 basis points below authorized return on equity, ratepayers are responsible for 95 percent of the environmental remediation costs until the earnings reach 50 basis points below authorized return on equity and the Company would pay 5 percent of the costs. If the Company is earning within 50 basis points below or above authorized return on equity, ratepayers would pay 50 percent of the costs of environmental remediation and the Company would pay for 50 percent of the costs until the allocation of such costs causes NWN earnings to no longer be within 50 basis points. If the Company is earning more than 50 basis points of authorized return on equity, ratepayers still pay for 5 percent of the environmental remediation costs above the 50 basis points of authorized return on equity, but the Company pays 95 percent of the environmental costs after 50 basis points above authorized return on equity.

Staff has not performed the scenarios described in Question 3.

NWN/503
Witness: C. Alex Miller

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

UM 1635

NW NATURAL

Exhibit Accompanying Reply Testimony of C. Alex Miller

Staff Response to NW Natural Data Request 2 in Docket UM 1635

May 28, 2013

NWN Data Request No. 2:

2. Staff proposes to apply half of any insurance proceeds to currently deferred costs and half to future costs for purposes of the earnings test (Staff/100 Johnson/9-11). Please explain how the proceeds to be allocated to future costs would be applied. Specifically, please describe how the 50 percent of already received insurance amounts would be applied on a year-by-year basis going forward.

Response to NWN Data Request No. 2:

2. The insurance proceeds would apply on a going forward basis depending on what the company spent on environmental remediation in that year. Because we do not know the amount of environmental remediation costs for future years, it is speculative to state how insurance proceeds would be allocated on those future, unknown, costs.

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CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of the foregoing document in Docket UM 1635 on the following named person(s) on the date indicated below by email addressed to said person(s) at his or her last-known address(es) indicated below.

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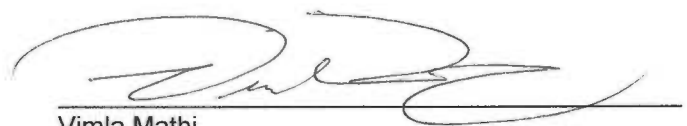
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DATED: May 28, 2013



Vimla Mathi
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