BEFORE THE

WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

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GENERAL RATE APPLICATION

OF

NORTHWEST NATURAL GAS COMPANY

MARCH 28, 2008

Direct Testimony of David H. Anderson:

Policy

DIRECT TESTIMONY OF DAVID H. ANDERSON

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I. Introduction and Summary

Q. Please state your name, address and position.

A. My name is David H. Anderson. My business address is 220 NW Second Avenue, Portland, Oregon 97209. I am Senior Vice President and Chief Financial Officer for NW Natural.

Q. What are your responsibilities with NW Natural?

A. As Chief Financial Officer I am responsible for all Financial operations of the company; specifically, Accounting, Finance (Budget and Forecasting), Treasury and Investor Relations. In addition, Information Services, Purchasing, and Rates and Regulatory also report to me.

Q. What is the purpose of your testimony?

A. I am the Company's policy witness in this proceeding. My testimony covers the following points:

- I provide background information regarding the Company to give the Commission some context for this rate request.
- I describe the rate increase the Company is seeking in this proceeding, and the basis for that increase.
- I discuss other elements of the Company's filing, including our proposal to implement a partial decoupling and weather adjustment mechanism.
- I introduce the other witnesses who present testimony in the Company's direct case.

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II. Background

Q. Please describe the business of NW Natural.

A. NW Natural provides natural gas service as a local distribution company operating in Oregon and southwest Washington. In the state of Washington, we provide service in 14 cities and neighboring communities in three southern Washington counties bordering the Columbia River, the largest of which is Clark County. NW Natural serves about 590,000 residential customers, 61,000 commercial customers, and 900 industrial sales customers. Approximately 10 percent of our customers are in Washington. In Oregon, NW Natural serves a major portion of western Oregon, including the Portland metropolitan area, most of the Willamette Valley and the coastal area from Astoria to Coos Bay. The Company also owns the Mist underground natural gas storage facility in Mist, Oregon, which has a total working gas capacity of approximately 16 Bcf.

Q. What level of customer growth is the Company experiencing?

A. In 2007, NW Natural added 15,428 new customers, which represents a System-wide growth rate of 2.4 percent. During 2006, we experienced customer growth of 3.1 percent in the residential and commercial sector. In our Washington territory, we added 2,252 new customers in 2007, which represents a Washington customer growth rate of 3.5%. These figures are well above the national average for local gas distribution companies as reported by the American Gas Association. Recent economic conditions, however, have slowed the level of new construction in our service territory.

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Q. How much natural gas does the Company sell and deliver?

A. In 2007, NW Natural gas sales and transportation deliveries, excluding deliveries of gas stored for others, were approximately 1.2 billion therms. About 400 million therms were sales to residential customers while, commercial sales comprise about 250 million therms. Industrial customers (comprising firm sales, firm transportation, interruptible sales and interruptible transportation customers) represent the remainder. In Washington, total gas sales in 2007 was about 88 million therms, or about 7.2% of total system gas sales.

Q. What is the source of the Company's natural gas supply?

A. About 70 percent of the Company's natural gas supply is from Canada (41 percent from Alberta and 27 percent from British Columbia). The remainder is from the U.S. Rockies with a minor amount generated from our Mist storage facilities gas fields.

Q. When was the last time NW Natural received a general rate increase in Washington?

A. The Company's last general rate increase in Washington was effective July 1, 2004 (Docket UG-031885). That proceeding resulted in a revenue increase of $3.5 million, or about 6.5 percent. The outcome in that case was achieved through a full settlement among the parties which involved agreement on the total revenue requirement figure without resolution of individual operating expense, revenue, or rate of return issues. In Oregon, the Company's last general rate case was effective September 1, 2003. In that proceeding, which

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was the last time an allowed return on equity (ROE) was established for the Company, the ROE was set at 10.2 percent.

III. Summary of NW Natural's Rate Increase Request

Q. Please describe the Company's rate request in this proceeding.

A. By this filing, the Company proposes to increase its base rates for Washington customers by about $4.3 million. This represents an increase of about 4.75 percent on total rates, or an increase of about 14.1 percent on non-gas costs.

Q. How was the magnitude of the requested rate increase calculated?

A. Based on the analysis in the direct joint testimony of Mr. Kevin S. McVay and Ms. Natasha C. Siores, the Company is currently earning an ROE of only 7.61 percent on its Washington operations. *See, Exhibit No.___ (KSM/NCS-1, page 2).* The ROE recommendation of Dr. Samuel C. Hadaway, on the other hand, calls for the Company to earn 10.65 percent to adequately compensate the Company's shareholders for the risks associated with its operations in the state of Washington. *See, Exhibit No.___ (SCH-1, page 36).* The requested increase of $4.3 million would bring the Company's earned equity return to the level recommended by Dr. Hadaway.

Q. What test year did the Company use for purposes of calculating its rate increase request in this proceeding?

A. As described in the testimony of Mr. McVay and Ms. Siores, the requested rate increase is based on the twelve months ending September 30, 2007, plus known and measurable changes through September 30, 2008.

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Q. What are the primary drivers of the requested rate increase?

A. The primary driver is the reduction in use per customer. Average annual use per residential customer has declined by about 43 therms, or about 5.7 percent since our last rate proceeding. For the commercial class, average annual use per customer has declined by 411 therms, or about 9.3 percent. *See, Exhibit No.___ (KSM-1, page 11).* Resetting rates to account for this lower average usage represents about $2.2 million of the requested increase.

Q. What other factors cause the need for an increase?

A. The return requirement – granting the Company an ROE of 10.65 percent, as recommended by Dr. Hadaway – represents about $600,000 of the requested increase. This calculation is based on an assumption that the ROE resulting from the "black box" settlement from the Company's last Washington general rate case was about 10.1 percent. The remainder of the increase is from other expense and rate base increases, although it is difficult to identify the specific causes due to the “black box” nature of the previous settlement.

Q. How do you justify the requested increase in ROE that the Company is seeking in this proceeding?

A. Dr. Hadaway's testimony presents the analytical support for his ROE recommendation. The increased risks associated with local gas distribution companies (LDCs) require higher returns, for the reasons discussed in Dr. Hadaway's testimony. In addition, a number of circumstances facing the Company in particular suggest that a higher return is warranted to compensate

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the Company's investors for the risks associated with NW Natural. *See, Exhibit No.___ (SCH-1).*

Q. What circumstances suggest that a higher equity return is warranted for the Company?

A. NW Natural in recent years has had to cope with rising and volatile natural gas prices. Rising prices have reduced the price competitiveness of natural gas versus other fuels. In a moderate climate like that in southwest Washington, this could lead to competitive gains for electric heat pumps. Moreover, new pipelines are moving gas from the Rockies – on which NW Natural depends for over 30 percent of its gas supply – to the east. NW Natural will therefore be losing the price advantage it currently has of an accessible supply basin with limited takeaway capacity.

A second circumstance affecting NW Natural in particular is a decline in housing starts and building permits, and current economic uncertainty. NW Natural in recent years has experienced customer growth rates that far exceed the national averages, which has enabled it to avoid seeking rate relief in Washington for over four years. The Company is starting to see lower customer growth rates, however. Lower growth may decrease the market value of NW Natural, and may make it a less attractive investment for investors, thereby increasing its cost of capital. Lower growth also results in a higher proportion of non-revenue producing required capital expenditures, for repair, replacement and moving of facilities.

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A third circumstance facing NW Natural is the impact of concerns about climate change, which is an issue of urgent importance in the Northwest and to NW Natural.

Q. Why is climate change a concern for NW Natural?

A Climate change concerns have evolved over the past few years from being a “fringe" matter to a mainstream issue attracting wide national, regional and local attention, and a real sense of urgency in the Northwest about the need to reduce greenhouse gas (GHG) emissions. The consensus is that federal climate change legislation regulating GHG emissions will be passed and signed into law in the next few years. It is unclear whether and how LDCs will be included in either a carbon tax or cap and trade scheme, but inclusion could increase prices LDCs need to charge, thereby hurting competitiveness with other fuel sources. Another consequence of a "carbon-constrained society" is that the demand for natural gas will likely increase due to greater use of gas fired electric generation, at least in the short term, further contributing to rising and volatile natural gas prices. Although no consensus exists as to the potential outcomes or effects, this uncertainty brings additional risks to NW Natural and other LDCs.

Q. Has NW Natural taken any steps to address the issue of climate change and potential regulation of GHG emissions?

A. Yes. In fact, NW Natural is one of the leaders in the natural gas industry nationally in addressing these issues. For example, NW Natural was the first stand-alone LDC to develop and implement a voluntary, experimental program

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that allows customers to offset the GHG emissions associated with their gas use. Funds for carbon offset projects collected under the program are passed on to The Climate Trust. The Climate Trust, in turn, seeks to use the funds to develop biogas projects at dairy farms in the region. The high quality offset benefits -- from bio-digesters or from other clean energy projects -- are retired by The Climate Trust. The Company implemented this voluntary program (Schedule 400 "Smart Energy") in Oregon in September 2007. Through a separate filing, the Company is proposing to implement this same Smart Energy program in Washington.

Q. What benefits does the Smart Energy program produce?

A. Our experience with Smart Energy has a number of benefits, including: 1) providing our customers and the Company with a means of reducing their "carbon footprint," or carbon emissions associated with their natural gas use; and 2) providing the Company with experience in the complex and rapidly developing world of carbon offsets. For more information about Smart Energy and NW Natural's commitment to reducing GHG emissions, please see our Smart Energy tariff filing, dated March 21, 2008 under NWN Advice No. WUTC 08-1.

Q. What other steps has NW Natural taken to address issues of climate change?

A. One of the simplest and most effective ways to reduce GHG emissions is to use less fuel. In Oregon, the Company's decoupling program has led to significant gains in energy efficiency. Approval of the decoupling mechanism the Company

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proposes in this filing is key to removing barriers to adopting similar energy efficiency programs in Washington.

Q. What steps has the Company taken to reduce its costs and thereby avoid or postpone the need for rate relief?

A. In the interests of efficiency, and in the face of increasingly competitive conditions, NW Natural is constantly searching for new ways to manage capital and operating costs without compromising reliability, customer satisfaction or safety. In 2006, we initiated an evaluation of our operating and business practices that ultimately resulted in a corporate restructuring. This restructuring was not simply about cost cutting, though that was certainly one result. More importantly, however, we were searching for a better way to deliver services – a model that would position NW Natural to be competitive in the marketplace in the years ahead, provide the greatest value possible to customers, and deliver the stability and growth shareholders expect. We believe our redesign delivers on all accounts.

Q. Can you describe how operations were redesigned?

A. In our evaluation of our operating model, and comparison with best practices at other high-performing utilities, we found that our core business could be defined by three key processes: acquiring customers, serving customers, and delivering gas. We redesigned our operations around these core processes to better align accountabilities, create greater centralization, and ensure increased standardization – all of which lead to greater efficiency. Using our resources and

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personnel more efficiently allows us to continue to deliver safe, reliable utility service and maintain or even improve our already-excellent levels of customer service. Since early 2006, the Company decreased its workforce by almost 13% as a result of this operational model redesign.

Q. Has NW Natural realized cost savings as a result of the business redesign?

A. Yes. In 2006, we held core O&M expenditures to an approximate one percent increase over 2005 levels. In 2007, we were also able to hold core O&M to an approximate one percent increase over 2006 levels.

Q. Can you measure the increase in efficiency that resulted from the business redesign?

A. An excellent metric for determining the efficiency of our business is to compare the number of customers each of our operating employees serves today to the number they served in the past. In 2003, each operating employee served 724 customers. Today, each operating employee serves 924 customers.

Q. Has the business redesign compromised NW Natural's commitment to customer service and corporate citizenship?

A. Absolutely not. In fact, I'm proud to say just the opposite has occurred. In 2007, for the first time, a J.D. Powers survey of gas utilities ranked NW Natural as best in the west, and second-best in the nation, for customer service satisfaction.

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IV. Other Issues in the Case

Q. What are the other major issues addressed in the Company's direct case in this proceeding?

A. The Company's direct case features three other major issues that are explored further in the testimony of the other Company witnesses. These issues are (1) rate design, (2) decoupling and conservation, and (3) consumer communications.

Q. What does the Company propose with respect to rate design?

A. Unlike the Company's preceding Washington general rate case, NW Natural does not propose any substantive rate redesign in this case. As described in the testimony of Mr. Ronald J. Amen, the Company proposes to increase the customer charge on the residential and small commercial rate schedules to cover more of the customer-related costs. For example, the customer charge, currently $5.00 per month for residential Schedule 2 customers, is proposed to increase to $12.00 per month. The Company also proposes to eliminate Rate Schedule 21. Rate Schedule 21 was retained following the rate redesign implemented in the Company's last Washington general rate case out of concerns for high bill impacts on those customers. Today, the bill impacts of migrating to Schedule 3 or Schedule 41 are more manageable for the customers that are currently served under Rate Schedule 21.

Q. What does the Company propose with respect to decoupling?

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A. NW Natural proposes a decoupling mechanism that includes three components: (1) a partial decoupling component, (2) a weather adjustment component, and (3) a conservation program component.

Q. Please describe the proposed partial decoupling mechanism.

A. The partial decoupling mechanism mirrors the mechanism currently in place in the Company's Oregon service territory. As described in the testimony of Mr. C. Alex Miller, the partial decoupling proposal has two features: monthly deferral of customer usage differences due to non-weather events, and a price elasticity adjustment. *See, Exhibit No. ___ (CAM-1, page 21).*

. **Q. Please describe the Company's weather adjustment mechanism.**

A. The Company proposes to use the same mechanism, known as the Weather Adjusted Rate Mechanism, or WARM – as it does in Oregon. Under this mechanism, customers see adjustments on each month's bills to reflect the actual weather in the billing period. As described in Mr. Miller's testimony, WARM provides immediate benefits for customers through reduction in bill volatility. In a colder-than-normal month, for example, the rate per therm would be adjusted downward under WARM, thereby softening the impact on customers of the increased usage required during cold weather. *See, Exhibit No.___ (CAM-1, page 24).*

Q. What is the Company's conservation program proposal?

A. In connection with the implementation of the partial decoupling and WARM mechanisms, which combined comprise the Company's proposed decoupling

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mechanism, the Company would ramp up its conservation programs in Washington. This is discussed more fully in the direct testimony of Mr. William R. Edmonds. *See, Exhibit No.___ (WRE-1).* Among other things, NW Natural proposes to contract with Energy Trust of Oregon, Inc. (Energy Trust) – which currently administers the Company's conservation programs in Oregon – to "cross over" the Columbia River into Washington and offer the same array of conservation services to the Company's Washington customers. Energy Trust is considering the Company's proposal to perform work in the Company's southwest Washington service territory. A contract with Energy Trust would provide the most efficient and economical means of expanding the Company's conservation program in Washington.

Q. What are the Company's plans for consumer communications?

A. As detailed in the testimony of Kimberly A. Heiting, the need for communicating with our customers has increased because of additional safety communications, conservation, gas prices and climate change. *See, Exhibit No.___ (KAH-1).* In her testimony, Ms. Heiting describes the Company's communications strategy, which focuses on topics related to natural gas use and on the education of customers about the variety of services and programs available to them.

V. <u>The Company's Direct Case</u>

Q. Please list the Company's witnesses and their areas of responsibility for testimony in the Company's direct case.

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A. The other witnesses offering testimony in the Company's direct case, and the subjects addressed in their testimony, are as follows:

- **Dr. Samuel C. Hadaway**, Principal, FINANCO, testifies concerning the Company's requested ROE of 10.65 percent. *See, Exhibit No. ___ (SCH-1).*
- **Mr. C. Alex Miller**, Assistant Treasurer and Managing Director of Regulatory Affairs, presents testimony on the Company's proposed capital structure and embedded cost of debt. He also presents testimony on the proposed decoupling mechanism. *See, Exhibit No. ___ (CAM-1).*
- **Mr. William R. Edmonds**, Manager of Environmental Policy and Sustainability, presents the Company's proposal for conservation programs that would go along with the implementation of the proposed decoupling mechanism. *See, Exhibit No.___ (WRE-1).*
- **Mr. Kevin S. McVay**, Financial Consultant, and **Ms. Natasha C. Siores**, Rate Analyst, present the Company's overall revenue requirement based on the test period of the twelve months ended September 30, 2007. Mr. McVay and Ms. Siores also discuss known and measurable changes to the test year results. *See, Exhibit No.___ (KSM/NCS-1).*
- **Ms. Kimberly A. Heiting**, Director, Corporate Communications, discusses the need for additional expenses for consumer communications. *See, Exhibit No.___ (KAH-1).*
- **Mr. David A. Heintz**, Assistant Vice President, Concentric Energy Advisors, Inc. performed the Company's embedded cost of service study that shows

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how costs are allocated to the various customer classes. *See, Exhibit No. DAH-1).*

- **Mr. Ronald J. Amen**, Vice President, Concentric Energy Advisors, Inc. presents testimony on the Company's rate design proposal. *See, Exhibit No. ___ (RJA-1).*

VI. Qualifications

Q. Please describe your education and employment background.

A. I received my Bachelors in Business Administration in Accounting from Texas Tech University. I am a Certified Public Accountant in Washington (License 25035) Oregon (License 11003) and Texas (License 51277).

I worked in Public Accounting from 1984 to1988 providing Audit, Compilation, Tax and Financial Planning services to individuals, C and S corporations and partnerships. From 1988 to 2004 I worked for TXU Corporation (formerly known as Texas Utilities) in various management positions. Specific areas of responsibility were as follows:

- 1988-1992 – Internal Audit
- 1992-1995 – Financial Reporting and Research
- 1995-1997 – Principal Financial Officer, TXU Mining Co.
- 1997- 2003 – Vice President of Investor Relations and Shareholder Services, TXU Corp.
- 2003-2004 – Senior Vice President, Controller and Principal Accounting Officer, TXU Corp.

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- 2004 – Senior Vice President and Chief Financial Officer, TXU Gas Co.

In 2004, I joined NW Natural as Senior Vice President and Chief Financial Officer.

Q. Does this conclude your direct testimony?

A. Yes.

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