UG-__ – Interstate Storage Services

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I. Introduction & Summary

Q. Please state your name and position with NW Natural.

A. My name is C. Alex Miller. I am employed by NW Natural as Manager of Rates and Regulatory Affairs. My qualifications appear at the conclusion of this testimony.

Q. What is the purpose of your testimony?

A. This testimony supports the company's proposal to revise and update the mechanism for customer sharing of revenue from NW Natural's interstate storage services (ISS). Specifically, I will explain the history of ISS and the treatment of revenue generated by the company's storage and transportation assets. I will then describe the current sharing mechanism in Washington, including some of its impractical aspects, and propose a new mechanism to continue revenue sharing in future years.

Q. Do other witnesses testify about the company's underground storage facilities?

A. Yes. The development of additional distribution infrastructure connected to Mist — specifically, the South Mist Pipeline Extension (SMPE) — is addressed in testimony by Mr. Charles E. Stinson, *Exhibit No. ___ (CES-1)* and Dr. John A. Hanson, *Exhibit No. ___ (JAH-1)*.

II. Background

Q. Please explain interstate storage services.

A. Since 1979, NW Natural has worked to develop and expand its underground storage facilities at the Mist Gas Field. The company developed Mist storage as

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part of a long-range plan to meet the increasing needs of its core customers. The first three phases of Mist expansion, in 1989, 1998, and 1999, were designed to serve core customers and were included in Washington rates. However, at shareholder expense, NW Natural made investments beginning in 2000 to expand Mist capacity beyond the current requirements of core customers, and specifically with ISS in mind. In May 2001, the Federal Energy Regulatory Commission (FERC) granted NW Natural a limited jurisdiction blanket certificate under its regulations at 18 C.F.R. § 284.224 to provide firm and interruptible natural gas storage and related transportation service to and from the Mist storage facilities to customers in interstate commerce. Under the FERC certificate, NW Natural is able to use any of its excess storage capacity at Mist to provide ISS and generate revenue from ISS with FERC approved recourse cost-based rates as the maximum rates that can be charged to ISS customers for such service.

Q. Does NW Natural generate revenue in interstate commerce from activities besides ISS?

A. Yes. NW Natural initiated an optimization program designed to make full economic use of its storage and transportation assets. To accomplish this, over the last three years the company has contracted with two different national commodity trading and marketing companies for them to provide certain asset optimization services. Simply stated, these companies have access to any available company assets on an interruptible, as-available basis after the requirements of NW Natural's core and ISS customers are satisfied. Whatever

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margins can be earned by the optimizer in trading around these assets is shared with the company.

The company also generates revenue in interstate commerce when it engages in any upstream gas commodity sales for resale activities. Such activities take place pursuant to blanket marketing certificates issued by FERC to all persons not interstate pipelines in 1993. The revenues generated from such sales activities are subject to sharing at the state level at a predetermined percentage in the context of the Purchased Gas Adjustment (PGA) process.

Q. To what extent are core utility assets used for ISS or for optimization?

A. For the most part, revenues from ISS are earned through assets that are not yet included in rate base; however, ISS would not be possible without the limited use of other already existing company facilities, such as the North Mist Feeder and North Coast Feeder, that *are* included in rates. Optimization activities, on the other hand, could use any available assets on NW Natural's system. Thus, the revenue from optimization is directly possible through use of core rate base facilities, while ISS revenues are tied primarily to investments that have not been included in rates.

III. Customer Sharing Mechanism

Q. How do core customers currently share in the revenue from ISS?

A. To compensate customers for the limited use of underutilized core assets to provide ISS, NW Natural has entered into customer sharing agreements with its state regulators in both Washington and Oregon. Although the two state programs are administered differently, they are conceptually the same —

customers share proportionately in the income or revenue generated through ISS. The more revenue ISS generates, the bigger the credit to customers.

Q. Please describe the Washington sharing structure in more detail.

A. On September 26, 2001, the WUTC authorized a sharing mechanism, "revenue block sharing," in Docket No. UG-011090. The mechanism was implemented in two stages, for 2001 and 2002, and was scheduled to terminate after December 31, 2002. In 2001, based on forecasted incremental capital investment of $4.9 million, the WUTC approved the following revenue blocks and associated levels of sharing:

First $0.9 million	0 percent
Next $1.3 million	20 percent
Over $2.2 million	50 percent

In 2002, based on a forecasted incremental capital investment of $15.8 million, the revenue blocks and sharing levels were as follows:

First $1.5 million	0 percent
Next $2.5 million	20 percent
Over $4.0 million	50 percent

Shared revenues are credited to customers in the PGA deferral recovery process.

Q. What benefits have Washington customers received from this sharing?

A. In the 2002 PGA filing, Washington customers received $163,507. In the 2003 PGA filing, they received $322,856. Customers will also receive at least three long-term benefits from the ISS program; these are direct results of NW Natural's

pre-building of its storage facility expansion. First, when SMPE goes into service, increasing take-away capacity from Mist, customers will be able to recall capacity at original cost less accumulated depreciation. This will be at lower cost than if these facilities were built today. Second, customers will be able to recall capacity in smaller increments because of the ISS program — increments that are scaled to match customer peak needs instead of grouped into large chunks driven by physical capacity. Third, customers will receive the benefit of larger-capacity storage reservoirs that will eventually be required to serve the core. This is because, by putting into service its depleted reservoirs with gas used for ISS, NW Natural preserved the greatest possible capacity in those reservoirs by keeping them pressurized with gas and thus resisting upward encroachment by the water table.

Q. What has happened to the sharing mechanism in 2003?

A. For now, we are using the same sharing structure for 2003 as we used for 2002. However, the cumulative incremental capital investment currently amounts to $18.4 million, which implies an adjustment to the revenue blocks for 2003.

Q. Could the existing mechanism be preserved in future years if the revenue blocks were updated?

A. Yes. The mechanism could be recalculated and adjusted each year to reflect the amount of investment. This annual updating is administratively burdensome, however, and will become more problematic as NW Natural's load grows and core customers begin recalling capacity. Although the block sharing mechanism is straightforward once it has been negotiated, the proper setting of block sizes

involves sensitivity to key assumptions about revenues, operations and maintenance expense, and capital investment. All of these issues and assumptions have the potential to become contentious, and this only adds to the administrative burden of resetting the sharing mechanism every year.

Q. What alternative does NW Natural propose?

A. NW Natural recommends that beginning in 2004 we replace the Washington ISS revenue sharing mechanism with optimization sharing. Specifically, NW Natural proposes to credit to Washington core customers the PGA sharing percentage applied to all optimization net revenues, presently 100 percent in Washington. The company would cease to share ISS revenues in Washington, and this would obviate the need for the annual adjustment process.

Q. Would optimization sharing need to be adjusted annually?

A. No. The advantage to optimization sharing is that all net revenues would go to customers, which requires only tracking of those revenues. Specifically, Washington core customers would annually receive the Washington allocated share of optimization net revenues at 100 percent. The formula would not need to be updated.

Q. Would the timing of the credit remain the same?

A. Yes, customer credits could be tracked in the annual PGA. As an additional matter, costs associated with recalled capacity will also need to be tracked through to rates as part of the PGA.

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Q. Would this alternative be fair to customers?

A. Yes. The mechanism would credit customers with the optimization revenues earned on both utility assets and on storage assets (currently not included in rate base), but, as discussed above, optimization revenues are earned primarily through use of core facilities. It makes more sense, actually, to share with customers the revenues from use of core facilities than it does to share ISS revenues. As discussed above, an additional benefit is that core customers would continue to be able to recall capacity as needed, and could do so at original cost less accumulated depreciation. In this way, they will continue to benefit from the company's ISS business activities.

Q. Would this alternative send the company appropriate economic signals for storage development?

A. Yes, the company would be making investment decisions based on marginal revenue and costs. Without the need for annual adjustments to the revenue sharing mechanism, the company would also have a better ability to predict revenues and plan accordingly without an added element of regulatory uncertainty.

Q. Are there other alternatives to the optimization sharing plan?

A. Yes, the existing ISS sharing mechanism could be converted to an embedded cost allocation with an annual cost-of-service filing.

Q. Why doesn't NW Natural recommend this alternative?

A. First, embedded cost allocation would be even more burdensome, from an administrative standpoint, than the revenue block sharing now in place, because it

would require an annual cost-of-service filing. Such a filing would be fraught with complexities, such as possible inconsistencies between FERC and WUTC methodology, as well as the difficulty of allocating storage investment between core customer requirements and ISS, particularly because the fundamental design of storage development has been driven by the long-term needs of core customers. Aside from administrative complexities, under an embedded cost model core customers would lose the ability to recall capacity; they would be required to purchase future storage capacity under FERC tariff pricing. The rolled-in treatment inherent in updating an embedded cost methodology would also distort the company's decision-making on ISS development. If incremental expansion costs are higher than average embedded costs, the core customers would end up subsidizing interstate customers.

Q. Please summarize the practical and policy reasons that support NW Natural's optimization sharing proposal.

A. As a practical matter, optimization sharing is easy to administer because it is based on net revenues — Washington core customers would receive the Washington allocated share of net revenues at 100 percent. There would be no need to revisit the mechanism annually. In terms of policy, it makes sense for core customers to share in optimization revenues, which are earned primarily through the use of underutilized core facilities. It makes less sense for customers to share in ISS revenues because those revenues are earned, for the most part, on assets not included in rate base. Even without revenue sharing, customers will still receive benefits from ISS activities, as discussed above. Finally, the

company's proposal would support good decision-making on storage development by sending appropriate investment signals and removing an element of regulatory uncertainty from the process.

IV. Qualifications

Q. Please describe your educational and professional background.

A. I received a B.A. in economics from the University of Oregon in 1980. I received an M.B.A. from the Claremont Graduate School in 1984. From 1981 through 1997, I worked at Southern California Edison as Vice President and Treasurer. From 1997 to 2001, I worked at PacifiCorp in various positions, including Vice President of Business Development. I joined NW Natural in 2003. I have previously testified before the WUTC.

Q. Does this conclude your direct testimony?

A. Yes.

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