

1 **Q. Please state your name, address, and position with Northwest**  
2 **Natural Gas Company.**

3 A. My name is Kevin S. McVay. My qualifications are presented in my  
4 testimony regarding establishment of the historic results of operations for  
5 the test period and the allocation of results by state, Exhibit 3 (KSM-  
6 Testimony).

7 **Q. What is the purpose of your testimony?**

8 A. I will describe the adjustments the company has made to the test period to  
9 annualize changes that occurred during the period and to include pro  
10 forma changes that are known and measurable after the end of the period.  
11 The test period that is being evaluated by the company to determine the  
12 need for a rate increase is the 12 months ended December 31, 1999. I  
13 will refer to Exhibit 6 (KSM-Exhibit), which I have prepared for the  
14 explanation of the adjustments.

15 **Q. Please describe Exhibit 6 (KSM-Exhibit).**

16 A. Page 1 of the exhibit presents the company's results of operations for the  
17 test period (column (a)), the results for the test period normalized and  
18 adjusted at present rates (column (c)), and the results for the test period at  
19 the proposed rates (column (e)). Column (b) of the exhibit represents the  
20 sum of all adjustments made to normalize the test period and column (d)  
21 represents the proposed increase to revenues to achieve the company's  
22 appropriate rate of return. Column (b) is explained in detail on pages 2  
23 and 3 of the exhibit. Those pages provide an issue by issue accounting of

1 the adjustments, and each column or adjustment is supported by one or  
2 more workpapers that are included and labeled by the corresponding  
3 column heading letters. Because most of the adjustments are related to  
4 issues that effect the company at a system level, those adjustments are  
5 performed at a system level first, and the amount of the adjustment is then  
6 allocated to Washington with the same factors used to allocate the historic  
7 test period results.

8 **Q. Please describe the adjustments shown on page 2 of Exhibit 6 (KSM-**  
9 **Exhibit).**

10 A. Column (a) on page 2 adjusts the company's revenues and gas costs for  
11 four reasons: 1) residential and commercial usage is normalized to  
12 reflect normal weather, 2) rate schedule migration is annualized for  
13 customers switching to new schedules 90 and 91, 3) delivered volumes  
14 are re-priced to reflect permanent rates currently effective in Washington,  
15 and 4) the cost of gas expense is adjusted to reflect the costs currently  
16 embedded in rates. I will describe the company's normalization of  
17 residential and commercial gas use and the rate schedule migration  
18 adjustment and Dr. Ferguson will explain the repricing of volumes at  
19 current Washington rates, as well as the adjustment to the cost of gas to  
20 reflect costs embedded in current permanent rates.

21 **Q. Please explain the methodology used to normalize residential and**  
22 **commercial gas use.**

1 A. Residential usage and commercial usage were normalized with respect to  
2 the effect of weather (as measured by heating degree days) on gas  
3 consumption. Because the data for the last part of the test period is  
4 unavailable to determine the result of weather normalization, the 12-month  
5 period ended June 30, 1999 has been normalized and the resulting  
6 monthly usage per customer for the months of July through December  
7 have been multiplied by monthly actual and estimated customers for those  
8 months to produce the test period volumes.

9 **Q. Please define heating degree days.**

10 A. The degree day is a unit of measurement based on the difference  
11 between the average temperature for a day and 65 degrees. For  
12 example, if the average temperature is 50 degrees on a given day, the  
13 degree days for that day would be 15. Degree days are additive in that  
14 the sum of the daily degree days over the course of the month are taken  
15 to represent that month's weather. The degree day is a common unit of  
16 measurement that allows for an analysis of increasing usage as a function  
17 of increasingly colder weather. The company uses a 20-year average of  
18 Vancouver degree days to derive normal degree days.

19 **Q. Please explain how usage is normalized.**

20 A. The actual monthly consumption for residential and commercial customers  
21 is statistically compared to actual monthly heating degree days over  
22 several years to determine use per heating degree day factors, as well as  
23 usage factors for deriving base use, or that level of use that would occur

1 regardless of heating degree days. The factors are first applied to  
2 customer counts, the actual monthly heating degree days, and the number  
3 of days in each month to generate what usage would be forecast based  
4 on actual weather. A similar forecast is done using normal degree days,  
5 producing the usage one would expect during a year when normal  
6 weather occurred. The difference between the two forecasts represents  
7 the adjustment to gas usage that is necessary to adjust for non-normal  
8 weather during the test period.

9 **Q. Please explain how rate schedule migration was addressed in the**  
10 **adjustment in column (a) on Page 2.**

11 A. As a result of the addition of transportation rate schedules 90 and 91 on  
12 June 1, 1999, there were four customer accounts that moved from  
13 schedule 4 to schedule 90. While there were provisions in the approved  
14 agreement that protected the company from decreased margin  
15 contributions from migrating customers, the agreement also stated that  
16 “Lost margin attributable to migrating customers will be included in the  
17 company’s permanent revenue requirement” (Memorandum of  
18 Understanding – UG-990511). The adjustment in column (a) includes the  
19 effect of removing the volumes for those migrating accounts from the  
20 original Schedule 4 prior to the rate change and placing the volumes in  
21 Schedule 90, which annualizes the migration between schedules.

22 Q. Please explain the other adjustments on Page 2.

1 A. Column (b) adjusts payroll expense to include costs attributable to end of  
2 period employee counts and the wages for those employees given the  
3 known and measurable increases that have occurred and will occur due to  
4 CPI adjustments and bargaining unit negotiations.

5 Column (c) adjusts health and life insurance expenses allocated to  
6 O&M for end-of-period premium rates and employee counts, including  
7 offsets for employee contributions to those benefits. Payroll taxes are  
8 adjusted for normalized payroll as provided in adjustment (b). Pension  
9 expense is adjusted to reflect a three-year average for those costs to  
10 reduce any anomaly present during the test period that results from the  
11 significant volatility that occurs in this expense. The adjustment for  
12 pensions also includes the effect of an increased benefit in the non-  
13 bargaining plan and an offset of expense from the recognition of gains on  
14 premiums paid for the company's non-utility program of life insurance.

15 Column (d) adjusts the test period expenses for bonuses. The  
16 amount accrued during the year is removed and replaced by the three-  
17 year average of amounts paid.

18 Column (e) reflects the increased O&M expense for the higher  
19 corporate match to the non-bargaining unit employee retirement plan,  
20 effective January 1, 2000. The percentage of salary match changed from  
21 50 percent of the first four percent of salary invested to 50 percent of the  
22 first six percent.

1 Column (f) is an adjustment to O&M to reflect the elimination of the  
2 company's district office in Vancouver, and the subsequent consolidation  
3 of personnel in the Vancouver service center. The adjustment eliminates  
4 the rental payments for the office, as well as some rent receipts from the  
5 sublease of the building. Because the discontinuance of the office is a net  
6 ratepayer benefit resulting from efficiency efforts by the company, and  
7 because the company had to invest in some leasehold improvements to  
8 attract a new tenant, the company proposes to retain the amortization of  
9 all of the office leasehold improvements in allowed O&M.

10 Column (g) includes an amount in rate base for the company's  
11 investment in Year 2000 issues. An adjustment is made to O&M to  
12 provide for an approximate five-year amortization of the amounts deferred  
13 related to Year 2000.

14 Column (h) adjusts uncollectible expenses to reflect the average of  
15 the past three years of actual net write-off percentages, partially  
16 eliminating any anomaly that may have been present during the test  
17 period.

18 **Q. Please explain each adjustment on page 3 of Exhibit 6 (KSM-Exhibit).**

19 A. Column (i) on page 3 is an adjustment to rate base such that a return is  
20 generated on investments in storage and other critical assets necessary to  
21 perform the utility function.

22 Column (j) adjusts O&M to annualize the effect of a rent increase  
23 effective May 1, 1999 for the company's One Pacific Square offices.

1 Column (k) adjusts O&M to reflect marketing, promotional, and  
2 advertising expense disallowances for regulatory purposes.

3 Column (l) adjusts rate base and depreciation expense to reflect  
4 the disallowance of a portion of the company's investment in its Customer  
5 Information System (CIS). The adjustment corresponds to the December  
6 1999 write-down of Washington's allocated portion of the CIS investment.

7 Column (m) adjusts rate base and depreciation expense for  
8 amounts related to the company's recently completed addition of an  
9 Industrial and Commercial customer module for the CIS. Part of the  
10 adjustment is required to reverse the inadvertent inclusion of the multi-  
11 year project in plant prior to its completion date.

12 Column (n) adjusts the company's results of operations to include  
13 the segment of Mist pipeline placed in service on December 1, 1999.

14 Column (o) adjusts O&M and rate base to include actual ordinary  
15 claims for the test period as well as a three-year average of extraordinary  
16 claims (claims potentially exceeding \$250,000). The use of the three-year  
17 average is meant to mirror the treatment of normalizing uncollectible  
18 expense. The adjustment also serves to eliminate accruals related to  
19 environmental claims for this rate case.

20 **Q. What is the total effect of the above adjustments on the company's**  
21 **actual results of operations for the test period?**

22 A. As shown on Page 1 of Exhibit 6 (KSM-Exhibit), column (c) represents the  
23 results of operations for the company once annualizing and pro forma

1 adjustments have been included. Line 16 of column (c) shows that the  
2 company is earning an overall rate of return on rate base of 4.63 percent  
3 and line 17 details the corresponding return on equity of 1.31 percent.

4 **Q. Considering these results, what revenue increase is supported by**  
5 **the company's cost of equity capital?**

6 A. The operating revenue increase required to allow the company its  
7 appropriate rate of return on equity of 11.25% in Washington is  
8 \$6,204,367, as shown in column (d) of Page 1. This amount, net of  
9 income taxes and other revenue sensitive expenses, is added to the  
10 company's adjusted results, resulting in column (e). Column (e)  
11 represents the normalized and adjusted results for the company at the  
12 proposed rates, with an achieved return on equity of 11.25%.

13 **Q. Does this conclude your testimony?**

14 A. Yes, it does.