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

A. My name is Kevin S. McVay. My business address is 220 N. W. Second Avenue, Portland, Oregon 97209. I am a Senior Rate and Financial Analyst in the Rates and Regulatory Affairs Department of Northwest Natural Gas Company (NW Natural or company).

Q. What are your duties and responsibilities as a Rate Analyst?

A. I assist in the design and preparation of the Company's rate schedules and tariffs in Washington and Oregon. I also aid in the interpretation of rules and regulations governing the application of the company's tariffs.

Q. What is your educational background?

A. I graduated from George Mason University, Fairfax, Virginia, in 1981 with a Bachelor of Science Degree in Accounting. In 1986, I received a Master of Business Administration degree from George Washington University, Washington, D.C..

Q. Please describe your business experience.

A. From 1981 to 1987, I held positions as an Accountant, Staff Auditor, and Forecasting Analyst for Washington Gas Light Company in Washington, D.C.. In 1987, I joined Northwest Natural Gas as a Budget Analyst and was subsequently promoted to Senior Financial Analyst. As Senior Financial Analyst, responsibilities included compiling capital and operating budgets, budget variance analyses, earnings projections, monthly margin analysis by customer class, and financial analyses of subsidiary projects. I joined the rates staff of Northwest Natural Gas Company in May, 1991.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to establish the company's financial results for its Washington operations for the test period. Part of the process of establishing those results is explaining the state allocation methodology that the company is proposing to use in this rate case. The test period that is being evaluated by the company to determine the need for a rate increase is the 12 months ended December 31, 1999. Because the final results for the test period are unavailable in time to be included in the company's initial testimony, I will explain the process by which the company has estimated the results for the 12 months ended December 31, 1999. I will also explain the method proposed by the company to allocate amounts to each state in which the company has utility operations. I will refer to Exhibit 4 (KSM-Exhibit) which I have prepared for the explanation of the test period results.

Q. Please describe Exhibit 4 (KSM-Exhibit).

A. Page 1 of the exhibit presents the estimated results of operations for the entire utility for the test period in column (a), and the results of operations for Washington in column (b). The only other jurisdiction in which the company has utility operations is Oregon. The amounts on this page are primarily based on 12 month ended results for November or actual results through November 1999 added to December's estimate of activity. The company will replace the proxy information used in its determination of revenue requirement as early as practicable, to allow for a formal connection to the test period revenues and costs.

The revenues on lines 1 through 4 and the gas cost on line 5 reflect 12 month ended results through November, except industrial revenues included in Sales of Gas and Transportation in Washington. Those amounts are included at the 12 month ended October level, due to previously unavailable customer specific data for November which would have undermined the normalization of industrial volumes. The revenues for Washington are almost completely direct; that is, they are the actual revenues generated during the 12 months. The single exception is the allocation of Utility Property Rental under Miscellaneous Revenues, which is allocated on the same basis as the underlying rental assets. The gas costs for Washington are calculated to correspond precisely to the gas costs collected in billing rates over the period, which parallels the deferral treatment accorded gas costs in Washington.

Line 6 (Uncollectible expense) and line 7 (Other Operating & Maintenance Expense) were derived by adding 11 months actual through November to the December estimate for O&M. Because there are substantial common costs within O&M, System amounts for a large number of accounts need to be allocated to Washington. Pages 2 through 22 of Exhibit 4 (KSM-Exhibit) show the allocation of Operations & Maintenance Expense to Washington and Oregon, using the allocation methodology proposed by the company. Additionally, the allocation factors used are shown on page 23.

Q. Please describe the allocation methodology.

A. The company's proposed method to allocate common costs begins with an initial attempt to determine non-common costs, and directly assign those to the appropriate jurisdiction. The costs are then considered with respect to specific "drivers", or elements such as volumes or customers that have a causative effect on costs. If a driver is evident for a cost, it is allocated on that basis. Lastly, if there is a common cost with a mix of drivers or no apparent single driver, it is allocated on the basis of a multi-part allocation factor, the 3-factor rate, composed of the average of 1) the proportion of one jurisdiction's directly assigned gross plant to the system total, 2) the proportion of one jurisdiction's number of customers to the system total, and 3) the proportion of employees directly assigned to the system total.

The total number of allocation factors used in assigning O&M is 21, as shown on page 23. Even though the number is somewhat high when considering the desired simplicity of a method, a review of the nature of the factors shows that most are just refinements of the drivers typically relied on, namely volumes and customers. The derivation of the allocation factors are shown on pages 24 and 25. The total amount of O&M costs allocated directly are about $23 million, or 31.4% of the total, the amount of costs allocated on the basis of the 3-factor rate are $22.5 million, or

30.7%, the amount of costs allocated on customers are $16.4 million or 22.4%, and the amounts allocated on volumes are $4.8 million or 6.6%. The remaining 8.9% of costs were allocated based on several other factors.

Page 22 shows the total amounts of O&M allocated to each state, and the overall % of O&M allocated to Washington of about 7.4%. These total O&M amounts include uncollectible expense, so when returning to the results of operations on page 1, lines 6 and 7 represent a breakout of the total O&M.

Q. Please continue your explanation of page 1.

A. Lines 9 and 10 of page 1 represent the federal income taxes and Oregon excise taxes using the tax provision model for year-end 1999 with expected permanent and temporary differences at the time the case was prepared. Pre-tax net income includes the elements on page 1 and interest expense is taken as 11 months actual and one month estimate for the System calculation. To calculate the Washington historic tax provision, interest was taken as the cost of long- and short-term debt multiplied by the proportion of rate base supported by those debt components. Calculated in this way, taxes for Washington operations need not be recalculated as an adjustment to account for the exclusion of typically included interest income as well as the revision of the interest expense level to reflect capital structure and rate base.

Line 11 details the System and Washington expenses for property taxes during the test period. The amounts reflect 11 month actual costs through November and an estimate for December. The Washington amount reflects the direct assignment of property taxes incurred.

Other Taxes on line 12 include franchise taxes which use the 12 months ended November 1999 expense amounts as the proxy for the test period to match the revenues adopted on the same basis. Franchise taxes are assigned directly to each jurisdiction. Payroll taxes, regulatory commission fees, and other taxes, are taken as the 11 month actual amounts plus an estimate for December, primarily to match payroll tax to the amounts incurred in O&M. Payroll Taxes are allocated using a payroll factor generated in the O&M allocation model that reflects the weighted average of all other cost allocations as they were used for accounts containing payroll expense. Miscellaneous other taxes are almost all directly assigned.

Because of their interdependence, Depreciation and Amortization on line 13 can be explained in conjunction with the determination of System and Washington Total Rate Base on line 16, which are detailed on pages 26 and 27. The following explanation of the allocation of gross plant in rate base should be considered as consistent with the allocation of depreciation and amortization expense and accumulated depreciation in rate base. As with O&M, the use of direct assignment is the default approach, and is available for the allocation of production, transmission, and distribution plant in beginning rate base as well as plant additions during the test period. Intangible plant concerning computer software, which is primarily Customer Information System software, is allocated using all customers due to its service to customers generally. Storage and storage transmission plant is allocated on the basis of firm volumes, insofar as it is considered a substitute to pipeline capacity. CNG and LNG facilities and general plant are allocated using the 3-factor approach, due to their contribution to various company activities.

The other elements of rate base are 1) cushion gas in storage which, following the storage plant, is allocated on firm volumes, 2) customer advances which are allocated directly, 3) the unamortized balance related to the company's now terminated high efficiency water heater incentive program in Washington which is directly assigned to Washington, 4) unamortized leasehold improvements which are directly assigned to Washington for those related to the Vancouver district office and allocated on a 3-factor approach for improvements in One Pacific Square and the district office in The Dalles, and 5) deferred taxes which are directly assigned in the case of state deferred taxes and allocated on the basis of percentage of total gross plant for federal deferred taxes, after grossing up for the effect of state deferred taxes on the federal amount. End of period amounts are included in both the System and Washington rate base, consistent with the treatment for deferred taxes in the company's latest rate case.

Q. Please explain lines 17 and 18 on page 1.

A. For System results in column a and Washington specific results in column b, line 17 represents the overall return on rate base using the Net Operating Revenue on line 15 divided by the Total Rate Base on line 16. Line 18 is the resulting return on equity when the debt and preferred cost components of the capital structure are removed from the overall return.

Q. Does this complete your testimony?

A. Yes, it does.