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UG-__ – Test Period & Adjustments

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I. Introduction & Summary

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 the Manager of Revenue Requirements and Business Analysis in the Rates and Regulatory Affairs Department of Northwest Natural Gas Company (NW Natural or company). My qualifications appear at the end of this testimony.

Q. Please summarize the results of the analysis of test period results and adjustments to those results.

A. As shown on Exhibit No. ____ (KSM-2), which I have prepared, the test period results in column a indicate an overall rate of return on rate base of 1.26% at line 16, with a corresponding rate of return on equity of -4.59% on line 17. After adjusting the test period results for normal weather, the addition of new facilities, and other normalizing amounts in column b, the overall rate of return on rate base is shown to be 4.55% in column c. The rate of return on equity is also shown at 2.06%. Finally, to achieve a rate of return on rate base of 8.97%, consistent with a return on equity of 11.00% as shown in column e, the analysis shows that an increase in revenue of \$7,894,383 is required, as shown in column d.

II. Test Period

Q. What is the purpose of this section of your testimony?

A. The purpose of this section of testimony is to establish the company's financial results for its Washington operations for the test period. The test period that is

1 being evaluated by the company to determine the need for a rate increase is the 12
2 months ended June 30, 2003. The determination of actual results for the test
3 period is primarily accomplished by a state allocation of discrete revenue and
4 expense items, as well as the construction of a 13-month average rate base for the
5 period. I will refer to *Exhibit No. ____ (KSM-3)*, which I have prepared for the
6 explanation of the test period results.

7 **Q. Please describe *Exhibit No. ____ (KSM-3)*.**

8 A. Page 1 of the exhibit presents the results of operations for the entire utility for the
9 test period in column (a), and the results of operations for Washington in column
10 (b). The only other jurisdiction in which the company has utility operations is
11 Oregon.

12 The revenues on lines 1 through 4 and the gas cost on line 5 reflect 12
13 month ended results through June 2003. The revenues for Washington are almost
14 completely direct; that is, they are the actual revenues generated from Washington
15 during the 12 months. The exceptions are the allocation of utility property rental
16 income and income for services rendered to producing entities at Mist under
17 Miscellaneous Revenues, which are allocated using the 3-factor rate. The gas
18 costs for Washington are calculated to correspond precisely to the gas costs
19 collected in billing rates over the period, which parallels the deferral treatment
20 accorded gas costs in Washington.

21 Line 6 identifies uncollectible expense and line 7 represents other
22 Operations & Maintenance (O&M) Expense. Because there are substantial
23 common costs within O&M Expense, System amounts for a large number of

1 accounts need to be allocated to Washington. Pages 2 through 25 of *Exhibit*
2 *No. ____ (KSM-3)* show the allocation of O&M Expense to Washington and
3 Oregon. Additionally, the allocation factors used are shown on page 26. *Id.*

4 **Q. Please describe the allocation methodology.**

5 A. The company's method to allocate common costs begins with an initial
6 identification of non-common costs, with a direct assignment of those costs to the
7 appropriate jurisdiction. The remaining costs are then considered with respect to
8 specific "drivers," or elements such as volumes or customers that have a causative
9 effect on costs. If a cost is related to a particular driver, it is allocated on that
10 basis. Lastly, if there is a common cost with a mix of drivers or no apparent
11 single driver, it is allocated on the basis of a multi-part allocation factor, the 3-
12 factor rate. This 3-factor rate is composed of the average of 1) the proportion of
13 one jurisdiction's directly assigned gross plant to the system total, 2) the
14 proportion of one jurisdiction's number of customers to the system total, and 3)
15 the proportion of employees directly assigned to the system total.

16 The total number of allocation factors used in assigning O&M Expense is
17 twenty-one, as shown on page 26. Even though the number is somewhat high
18 when considering the desired simplicity of a method, a review of the nature of the
19 factors shows that most are just refinements of the drivers typically relied on,
20 namely volumes and customers. The derivations of the allocation factors are
21 shown on pages 27 and 28.

22 Page 25 shows the total amounts of O&M Expense allocated to each state,
23 and the overall percentage of O&M Expense allocated to Washington of about

1 nine percent. These total O&M Expense amounts include uncollectible expense,
2 so when returning to the results of operations on page 1, lines 6 and 7 represent a
3 breakout of the total O&M Expense.

4 **Q. Please continue your explanation of page 1.**

5 A. Lines 9 and 10 of page 1 represent the Federal income taxes and Oregon excise
6 taxes reported for the test period for the system basis, and the Federal taxes for
7 Washington. To calculate the Washington historic tax provision, interest was
8 taken as the cost of long- and short-term debt multiplied by the proportion of rate
9 base supported by those debt components. Calculated in this way, taxes for
10 Washington operations need not be recalculated as an adjustment to account for
11 the exclusion of typically included interest income as well as the revision of the
12 interest expense level to reflect capital structure and rate base.

13 Line 11 details the System and Washington expenses for property taxes
14 during the test period. The Washington amount reflects the direct assignment of
15 property taxes incurred.

16 Other Taxes on line 12 include franchise taxes, which are assigned directly
17 to each jurisdiction. Payroll Taxes are allocated using a payroll factor generated
18 in the O&M Expense allocation model that reflects the weighted average of all
19 other cost allocations as they were used for accounts containing payroll expense.
20 Miscellaneous other taxes are almost all directly assigned.

21 Because of their interdependence, Depreciation and Amortization on line
22 13 can be explained in conjunction with the determination of System and
23 Washington Total Rate Base on line 16, which are detailed on pages 29 and 30.

1 The following explanation of the allocation of gross plant in rate base applies as
2 well to the allocation of depreciation and amortization expense and accumulated
3 depreciation in rate base. As with O&M Expense, the use of direct assignment is
4 the default approach, and is available for the allocation of production, non-storage
5 transmission, and distribution plant in beginning rate base as well as plant
6 additions during the test period. Intangible plant concerning computer software,
7 which is primarily Customer Information System software, is allocated using all
8 customers due to its service to customers generally. Storage and storage
9 transmission plant is allocated on the basis of firm volumes, insofar as it is
10 considered a substitute to pipeline capacity. CNG and LNG facilities are
11 allocated using the 3-factor approach, due to their contribution to various
12 company activities.

13 In Washington, general plant had been allocated using the 3-factor
14 approach prior to this rate case, and the allocation of general plant for Oregon
15 ratemaking purposes also used the 3-factor approach prior to the last rate case in
16 Oregon. Because there are general plant accounts that have sufficient detail that a
17 more category-specific allocation is possible, a more direct identification of plant
18 has been used for those accounts. The accounts in this category are land,
19 structures, transportation, and power operated equipment. The remaining general
20 plant items continue to be allocated using a 3-factor rate.

21 The other elements of rate base are 1) cushion gas in storage which,
22 following the storage plant, is allocated on firm volumes; 2) customer advances,
23 which are directly assigned; 3) unamortized leasehold improvements, which have

1 \$7,894,383. I will refer to *Exhibit No. ____ (KSM-4)*, which I have prepared for the
2 explanation of the adjustments.

3 **Q. Please describe *Exhibit No. ____ (KSM-4)*.**

4 A. As described in the initial section of this testimony, page 1 of the exhibit presents
5 the company's results of operations for the test period (column (a)), the results for
6 the test period normalized and adjusted at present rates (column (c)), and the
7 results for the test period at the proposed rates (column (e)). Column (b) of the
8 exhibit represents the sum of all adjustments made to normalize the test period
9 and column (d) represents the proposed increase to revenues to achieve the
10 company's appropriate rate of return. Column (b) is explained in detail on pages
11 2 and 3 of the exhibit. Those pages provide an issue-by-issue accounting of the
12 adjustments, and each column or adjustment is supported by one or more
13 workpapers that are included in the exhibit and labeled by the corresponding
14 column heading letters. Because most of the adjustments are related to issues that
15 affect the company at a system level, those adjustments are performed at a system
16 level first, and the amount of the adjustment is then allocated to Washington with
17 the same factors used to allocate the historic test period results.

18 **Q. Please describe the adjustments shown on page 2 of *Exhibit No. ____ (KSM-4)*.**

19 A. Column (a) on page 2 adjusts the company's revenues and gas costs for four
20 reasons: 1) residential and commercial usage is normalized to reflect normal
21 weather and the pricing that would be in effect following an order in this rate
22 case; 2) rate schedule migration for industrial customers is annualized and the use
23 for particular industrial customers is normalized; 3) delivered volumes are re-

1 priced to reflect permanent rates currently effective in Washington; and 4) the
2 cost of gas expense is adjusted to reflect the costs currently embedded in rates.
3 An explanation of the company's normalization of residential and commercial gas
4 use is presented by Dr. Hanson; I will describe adjustments for rate schedule
5 migration, and Dr. Ferguson will explain the re-pricing of volumes at current
6 Washington rates, as well as the adjustment to the cost of gas to reflect costs
7 embedded in current permanent rates.

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

10 A. Because residential and commercial customers are considered as a class, rate
11 schedule migration is considered with respect to industrial customers only. Rate
12 schedule changes were handled by placing all the monthly volumes for a specific
13 customer on the rate schedule that particular customer was on at the end of the
14 test period.

15 **Q. Please explain how volume normalization for industrial customers was**
16 **addressed in the adjustment in column (a) on Page 2.**

17 A. Normalization for industrial customers was required for only one customer, where
18 a significant previous load had been reduced since April 2003. The information
19 from the customer indicates that it is unlikely that a return to the prior operating
20 level would occur. To normalize load for the customer, the previous level of
21 volume was removed and replaced by the current lower volume demanded by that
22 customer.

23 **Q. Please explain the other adjustments on Page 2.**

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

6 Column (c) adjusts health and life insurance expenses allocated to O&M
7 for end-of-period premium rates and employee counts, net of offsets for employee
8 contributions to those benefits. Payroll taxes are adjusted for normalized payroll
9 as provided in adjustment (b). Pension expense is adjusted to reflect the most
10 recent indication of expense that will be recorded in 2004. Additional support for
11 the health and life and pensions expense levels is provided in Ms. Doolittle's
12 Total Compensation testimony, *Exhibit No. ____ (LAD-1)*.

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

16 Column (e) produces an offset to the increment that is currently in rates to
17 recover costs related to enhancements to computer software for the year 2000 date
18 fields. Because there are now less than 14 months of amortization remaining for
19 these costs, the company proposes to move the revenue requirement associated
20 with this expense to a temporary increment with the effective date of rates from
21 this rate case.

1 Column (f) adjusts uncollectible expenses to reflect the average of the past
2 three years of actual net write-off percentages, partially eliminating any anomaly
3 that may have been present during the test period.

4 Column (g) is an adjustment to rate base for working capital, which
5 generates a return on investments in storage and other critical assets necessary to
6 perform the utility function.

7 Column (h) adjusts O&M to reflect disallowances of marketing and
8 promotional expenses for regulatory purposes. The adjustment also proposes an
9 increased expense for consumer information as described in the Advertising
10 testimony of Ms. Heiting, *Exhibit No. ____ (KAH-1)*.

11 **Q. Please explain each adjustment on page 3 of Exhibit No. ____ (KSM-4).**

12 A. Column (i) adjusts O&M and rate base to include actual ordinary claims for the
13 test period, replacing the expense accrual activity that is used for claims reserve
14 accounting. The adjustment also serves to include a three-year average of
15 extraordinary claims (claims potentially exceeding \$250,000). The use of the
16 three-year average is meant to mirror the treatment of normalizing uncollectible
17 expense, which corrects for year-to-year anomalies in expense levels.

18 Column (j) adjusts O&M to reflect expected insurance premiums that will
19 be in effect on and after January 1, 2004.

20 Column (k) adjusts O&M to include ratepayer support for the Gas
21 Technology Institute (GTI). GTI was created through the merger of the Gas
22 Research Institute (GRI) and the Institute of Gas Technology (IGT). GTI is a
23 leading research, development and training organization serving energy and

1 environmental markets. Historically, Northwest Pipeline Corporation (NPC) and
2 other pipeline companies have funded GTI through a FERC-approved increment
3 in their rates. That component of NPC's rates has been approved by the
4 Commission for collection from NW Natural's ratepayers. The increment is
5 decreasing each year and will eventually be eliminated. The company believes
6 the GTI should continue to be funded and has added \$35 thousand to its test
7 period for that purpose.

8 Column (l) adjusts the company's results of operations to include the
9 segments of the South Mist Pipeline Extension scheduled to be placed in service
10 during 2004. Additional support for the pipeline, including an allocation between
11 Washington and Oregon, is provided in the South Mist Pipeline Extension
12 testimonies of Mr. Stinson and Dr. Hanson, *Exhibit Nos. ____ (CES-1)* and
13 *____ (JAH-1)*.

14 Column (m) adjusts expenses and rate base to reflect the replacement of a
15 service center/district office in Clark County. Additional support for this facility
16 is provided in the joint testimony of Ms. Hart and Mr. Milam, *Exhibit No.*
17 *____ (SKH/SAM-1)*.

18 Column (n) adjusts O&M and rate base for excess amounts that were
19 expensed through the clearing process. On a calendar year basis, utilization rates
20 are adjusted to assure that clearing accounts are brought to zero. For the 12
21 months ended on June, however, it is normal to have a slight mismatch in the
22 amounts subject to clearing and the amounts cleared.

1 Column (o) shows the total of all adjustments on Pages 2 and 3. This
2 column is replicated on Page 1 as column (b), where rate base is shown in total.

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

5 A. As shown on Page 1 of *Exhibit No. ____ (KSM-4)*, column (c) represents the results
6 of operations for the company once annualizing and pro forma adjustments have
7 been included. Line 16 of column (c) shows that the company is earning an
8 overall rate of return on rate base of 4.55 percent and line 17 details the
9 corresponding return on equity of 2.06 percent.

10 **Q. Considering these results, what revenue increase is required to support the**
11 **cost of equity being requested by the company?**

12 A. The operating revenue increase required to allow the company its requested rate
13 of return on equity of 11.00% in Washington is \$7,894,383, as shown in column
14 (d) of Page 1. This amount, net of income taxes and other revenue sensitive
15 expenses, is added to the company's adjusted results, resulting in column (e).
16 Column (e) represents the normalized and adjusted results for the company at the
17 proposed rates, with an achieved return on equity of 11.00%.

18 **IV. Qualifications**

19 **Q. Mr. McVay, please state your educational background and experience.**

20 A. I received a Bachelor of Science Degree in Accounting in 1981 from George
21 Mason University, Fairfax, Virginia. In 1986, I received a Master of Business
22 Administration degree from George Washington University, Washington, D.C.
23 From 1981 to 1987, I held positions as an Accountant, Staff Auditor, and

1 Forecasting Analyst for Washington Gas Light Company in Washington, D.C. In
2 1987, I joined NW Natural as a Budget Analyst and since then, I have held
3 positions as a Senior Financial Analyst, Senior Rate and Financial Analyst, Senior
4 Revenue Requirements and Business Analyst, and I currently hold the position of
5 Manager of Revenue Requirements and Business Analysis.

6 **Q. Does this conclude your direct testimony?**

7 A. Yes, it does.