Rates and Regulatory Affairs
Facsimile: 503.721.2516

NW Natural
220 NW 2ND AVENUE
PORTLAND, OR 97209
TEL 503.226.4211
www.nwnatural.com

June 4, 2010

VIA ELECTRONIC FILING

Dave Danner, Executive Director & Secretary
Washington Utilities and Transportation Commission
1300 S Evergreen Park Drive SW
Post Office Box 47250
Olympia, Washington 98504-7250

Re: Conservation Incentive Inquiry, Docket U-100522, NW Natural's Comments on the Commissions Consolidated Issues List

Dear Mr. Danner:

Northwest Natural Gas Company, dba NW Natural ("NW Natural" or the "Company"), hereby submits the attached comments on the Commission's consolidated issues list in the subject docket.

NW Natural appreciates the Commission's consideration of the Company's comments. Please contact me at (503) 226-4211, extension 3590 if you have questions.

Sincerely,

NW NATURAL

/s/ Jennifer Gross

Jennifer Gross
Rates & Regulatory Affairs

1) *Definitions.* What is decoupling? What is lost margin? How is it measured? What are fixed costs?

Response

Decoupling as a generic term generally refers to a rate mechanism that breaks the link between consumption of energy and a utility's collection of its fixed costs. Decoupling may refer to a variety of rate mechanisms and may go as far as a "straight-fixed variable" rate design, which removes all fixed cost recovery from variable charges, to a lost margin mechanism that only addresses declining consumption based on conservation.

Lost margin is generally considered to be the amount that the utility would have recovered had customers consumed a forecasted amount of energy. In other words, it may be considered the difference between actual usage and a calculated baseline for customers. Lost margin is typically calculated based on factors set at the time of the utility's last rate case. The precise structure of a lost margin recovery mechanism can vary greatly based on the purpose of the mechanism.

Fixed costs are the expenses the Company incurs to deliver gas service, regardless of how much gas is consumed; for example, fixed costs include pipeline maintenance, customer billing, meter reading and call center costs.

2) *Recovery of Conservation Program Costs.* Are the utilities' conservation program costs recovered from ratepayers in a timely manner?
   a. If cost recovery is untimely, please describe how and why.
   b. Are there other methods of funding conservation programs that would be more efficient and effective at acquiring conservation resources?

Response

a. NW Natural's energy efficiency program in Washington is in its first year. The Company currently defers its conservation costs with the intent of amortizing these costs for collection during the next Purchased Gas Adjustment (PGA) cycle. The Company accrues interest on the deferred balance. This recovery process creates regulatory lag between when the costs are incurred and when they are recovered; but given the accrual of interest, the method is equitable.

b. NW Natural funds its Oregon energy efficiency program through a public purpose charge which is annually adjusted so that the forecast collections are sufficient to acquire the annual demand side management (DSM) targets established in the Company's most recent Integrated Resource Plan (IRP).

Impact of Conservation Resource Development on Rate of Return

3) Statement of the Issue. Does the development of conservation resources deny the utility an opportunity to earn its allowed rate of return? Would an attrition study be the best way to determine this question? Are there alternative ways of making such a determination?

Response

In a non-decoupled utility, rates are set in such a way that the utility will recover its fixed costs and allowed rate of return if customers consume forecasted volumes. If customers do not consume those volumes, the utility will be unable to recover its fixed costs and earn its allowed rate of return, all else being equal.

This structure creates a clear incentive for the utility to push consumption of volumes. For natural gas utilities that have been experiencing declining usage per customer each year and have stayed out of rate cases for many years at a time, the inability to earn an allowed rate of return is exacerbated. An allowance for attrition and declining use, and a rate mechanism to automatically adjust rates for those factors, could be a means of addressing this concern.

4) Magnitude of the Risk. How much lost margin can be attributed to each utility's conservation programs? How much lost margin can be attributed to the other types of conservation referenced in question 6 below?

Response

The magnitude of risk to gas utilities based on declining use is significant. In its 2009 IRP, NW Natural estimated that residential use per customer will drop by 3.9% over 5 years, commercial by 7.9% and industrial firm sales by 0.4%. The American Gas Association estimates that "Natural Gas use per customer has decreased by about 1 percent per year for

the last 38 years, which means that the average residential customer today uses 39 percent less than they did 38 years ago."[1]

NW Natural finds it difficult, if not impossible, to try to separate the decline in consumption due solely to utility-sponsored conservation and that due to other factors. More importantly, recovery of a *portion* of declining use will not break the link between consumption and fixed cost recovery, and will maintain the utility's incentive to encourage consumption to ensure its ability to recover its fixed costs and earn its allowed rate of return. This is why in their independent review of NW Natural's decoupling mechanism, Christensen Associates Energy Consulting recommended that NW Natural be allowed to recover 100% of the difference between baseline usage and actual usage.

5) *Direct Conservation Incentives and Rate of Return.* What is the rationale for making incentive payments to utilities for acquiring conservation resources? Is it to encourage conservation? (See questions 14-17 below relating to conservation mandates.) Is it to ensure that the utility earns a sufficient rate of return? Does an incentive program act as an effective substitute for decoupling?

Response

Conservation incentives can be used for many purposes, such as incenting or rewarding conservation activities. If fixed costs are recovered through volumetric rates, recovery of fixed costs and earned return on equity (ROE) will depend on the number of therms sold. Decoupling breaks this link. Conservation Incentives indirectly have a similar effect by providing a financial reward for implementing demand side management. Assuming incentives are used instead of decoupling, the magnitude of the incentive may or may not produce a result equal to decoupling, and if it does not, the utility will under earn.

Details of a Conservation Incentive Mechanism

6) *Categories of Lost Margin Due to Conservation Eligible for Recovery.* Identify which, if any, of the following declines in customer use should be subject to recovery by the utility and how each could be calculated or measured:

[1] *See http://www.aga.org/Legislative/RatesRegulatoryIssues/ratesregpolicy/Issues/energyefficiency/NaturalGasUtilitiesandTheirCustomers.htm*

a) Margin decline from company-sponsored conservation programs that provide a rebate or that provide direct assistance with conservation-measure deployment (such as site visit evaluation).
b) Information provided by the utility to the customer, such as educational programs, bill inserts, or information on the utility's website.
c) A company's share of Northwest Energy Efficiency Alliance (NEEA) regional conservation savings including market transformation that is not counted in the utility's programmatic or informational efforts. If yes, how can NEEA savings be separated from other conservation savings that occur for the purposes of a cost recovery mechanism?
d) Independent customer conservation efforts (no rebate or direct utility assistance documented).
e) Conservation due to codes and standards.
f) Elasticity (i.e., heating fewer rooms, lowering thermostat, et cetera).
g) Substitution, such as switching from electric to gas, gas to electric, or to other heating sources, such as wood or thermal-solar hot water heaters.
h) Other (describe).

Response

NW Natural believes that utilities should receive recovery for all lost margin as measured by the difference between actual usage and the forecasted baseline used to establish rates.

7) *Impact of Conservation Incentive Mechanism on Utility Incentives to Encourage Consumption.* If a utility recovers lost margin as calculated by installed conservation measures, does it still have an incentive to encourage customers to use more energy in some other application? Are any utilities promoting the use of more energy by its customers?

Response

Yes, it does. Without decoupling, a utility has a tendency to want to increase volumes sold.

8) *Offsets.* To what extent should any recovery of lost margin be offset by revenues associated with new load (sometimes referred to as "found margin"), including:
a) New customers,
b) Additional load for existing customers,
c) Other?

Response

New customers are added to the system by virtue of incremental construction costs as well as other operating costs. If the revenues from these customers were used as an offset, the addition of the customer would be one-sided-- that is all cost and no revenue. A decoupling mechanism can factor in the requirement for incremental revenue by resetting the baseline level of usage for the actual numbers of customers served. Determining added load for existing customers would be nearly impossible without rigorous point–of-sale data or exhaustive surveys. Certainly, decoupling factors in any incremental load.

9) *Application to Industrial Customers.* Should large customers be treated differently than residential or commercial customers with regard to lost revenue recovery or incentives? If so, please explain the rationale for excluding large customers.

Response

NW Natural is open to considering different approaches for the recovery of lost margin from industrial customers. In Oregon, the parties agreed in a settlement to exclude industrial customers from the Company's decoupling mechanism. However, the lost margin associated with an industrial energy efficiency plan can be significant and may need to be addressed either through a conservation incentive or a DSM lost margin mechanism.

10) *Other Characteristics of an Incentive Mechanism.* What characteristics should an incentive mechanism include?

a) Should it allow the utility to recover an absolute dollar amount? If so, how should the amount be calculated? Should recovery be based on all conservation that occurs over a given period, or be proportional to the conservation that occurs as a result of a utility's actions?

b) For electric utilities, should the incentive targets be different and greater than the Energy Independence Act (EIA or I-937) targets?

c) Should there be penalties for failing to achieve the incentive mechanism's target or rewards for achieving only a percentage of the target?

d) Should there be an earnings test to determine if the utility is over earning?

e) Should the incentive include all customer classes in the target and in the collection of the incentive payments?

f) Are there other complementary rate making policies that should be matched with an incentive mechanism such as a pro forma adjustment to account for

lower loads? Please provide details of any such proposals.

Response

a) Yes, the utility should be allowed to recover an absolute dollar amount based on conservation that occurs as a result of the utility's actions.
b) Not applicable to NW Natural
c) NW Natural is not in favor of penalties for failing to meet incentive programs as it seems this could have unintentional consequences. For instance, utilities will manage the risk of being penalized by setting conservative targets. Conversely, stagnated incentives would likely encourage the setting of farther reaching targets.
d) Earnings tests could provide a reasonable check and balance depending on how they are developed and applied.
e) All customers who are eligible to receive conservation services should contribute to paying for the conservation incentive.
f) Yes, any regulatory mechanism needs to consider that gas utilities are experiencing diminishing usage per customer.

Impact on Rates

11) *Impact on Various Classes of Customers.* How should the costs of an incentive mechanism be spread among the various rate classes? Are transport customers appropriately protected from a recovery mechanism's costs?

Response

The incentive mechanism should be collected from all customers applicable for conservation programs. For NW Natural, this would eliminate transportation customers. Costs should be allocated to the various rate classes proportional to the gas savings experienced per rate class.

12) *Impact on Low Income Households.* Should the design of an incentive mechanism consider its impact on low-income customers? Would a lost margin recovery mechanism cause low-income households to bear a higher percentage of system costs? Are existing utility conservation programs for the residential class accessible to low-income customers? If not, is the relationship between bill impacts and access to programs for low-income equitable?

Response

If the DSM funded by utility conservation programs is the least cost resource, than low income customers should not be harmed; they will not be paying more than they otherwise would be for the acquisition of supply-side resources. However, low income customers may have less ability to take advantage of utility-sponsored conservation incentives. To this end, NW Natural currently offers a conventional energy efficiency program and a low income energy efficiency program. Low income customers have access to either. The low income program assesses the customer's whole home and installs all cost-effective measures at no direct cost to the customer.

13) *Impact on Utility Incentives.* Does the recovery of lost margin from conservation provide an incentive for the utility to control costs? What is the incentive to minimize purchased gas adjustment (PGA) costs (within some risk level) if the utility is compensated for any decline in sales from conservation?

Response

Lost margin or decoupling mechanisms do not in any way diminish the utility's incentive to control its costs. Decoupling mechanisms only address the recovery of fixed costs as originally forecast in the utility's last rate case. If the utility does not control its fixed costs after rates are set, it will not recover those costs, with or without a decoupling mechanism.

It is not entirely clear what "PGA costs" means. Presuming this means the actual cost of the commodity included in the natural gas utility's PGA mechanism, then decoupling again has no relationship to the utility's incentive to control costs. Actual commodity costs are currently recovered on an annual basis through the PGA mechanism. A decoupling mechanism would not alter this rate structure. Decoupling mechanisms only preserve the utility's ability to recover fixed costs as forecast in a rate case, not commodity costs set at the time of the annual PGA.

Relationship of Incentives to Conservation Mandates

14) *Impact of Conservation Mandate in I-937.* In light of the legal requirement for an electric utility to pursue all available conservation that is cost-effective, reliable and feasible under I-937, is it appropriate to provide an incentive to electric utilities for conservation?

Response:
Not applicable to NW Natural.

14.5) *State greenhouse gas emission reduction goal (70.235.020).* How would removing the linkage between the number of kilowatt hours sold and financial returns for utilities impact the state's ability to meet its statutory greenhouse (GHG) emission reduction limits (RCW 70.235.020)?

Response:
Not applicable to NW Natural.

15) *Incentives to Exceed I-937 Targets.* Under the EIA, the Commission may consider providing positive incentives for an investor-owned utility to exceed the conservation targets established in RCW 19.285.040. Do ratepayers benefit from encouraging the utility to pursue conservation that is not cost-effective and therefore beyond its target?

Response:
It may be possible, in some circumstances, to show that while a conservation or renewable resource investment is not cost-effective in the short term, it may produce long-term benefits to utility customers. NW Natural believes these situations should be addressed on a case-by-case basis, and that the WUTC should have the authority to consider conservation above established conservation targets.

16) *Impact of Disincentive.* As investor-owned electric utilities currently acquire more than their share of the Northwest Power and Conservation Council's assessment of conservation potential, does a disincentive to encourage conservation actually exist?

Response:
Not applicable to NW Natural.

17) *Natural Gas Planning.* Does the lowest cost mix of resources described in WAC 480-90-238(2)(a)-(b) (natural gas integrated resource planning) require a gas utility to pursue all cost-effective conservation, i.e., conservation that has costs equal to or

less than supply side resources?

Response:
Yes, the mandate for gas utilities to acquire the lowest reasonable cost resource is stated in WAC 480-90-238(1). The definition of lowest reasonable cost, found in WAC 480-90-238(2)(b), establishes demand side resources as a resource to be included in the IRP analysis.

Evaluation, Measurement and Verification

18) *Use Per Customer as a Metric.* Is use-per-customer for individual rate classes a useful metric for identifying conservation effects?

Response:
Yes.

19) *Load Forecasting.* Load forecasting is a key input for calculating conservation effects. How can load forecasting become more reliable? How does conservation get accurately incorporated into a company's load forecast?

Response
Forecasting will never be exact, but NW Natural constantly updates and refines its forecasts in the course of its bi-annual IRPs and its annual PGA filings.

Conservation is incorporated into the Company's load forecast when the utility develops its IRP. The Company assesses both technical and achievable potential in the course of its IRP. Cost-effective DSM is deducted from the Company's load requirement.

20) *Methods for EM&V.* Should the Commission establish a method, or general guidelines for an evaluation, measurement and verification (EM&V) methodology?
- a) What role should a third party evaluator of EM&V play?
- b) Are EM&V methods accurate enough to use the history of individual customer usage as the basis for determining the payments in an incentive mechanism?
- c) What role should the Regional Technical Forum play in EM&V issues?

Response

a) A third party evaluator may be used to verify deemed savings by performing pre-and post-bill analysis. Any requirement to use a third party should consider the cost this will incur.

b) Yes, using historical usage as a baseline is appropriate. When studying savings, the program participants' usage data should be compared with a control group's so the analysis of therms saved can be adjusted for any anomalies in usage as determined by looking at the control groups historic and current usage data.

c) NW Natural has not worked with the RTF and has no opinion on what its role should be.

21) *Impact on Cost-Effectiveness of Conservation Measures.* If lost margin is recovered in rates, should the cost be included in the cost-effectiveness test? How much would the inclusion of those costs decrease the amount of conservation achievable under the cost-effective threshold?

Response

No, it would be inappropriate to include the costs for lost martin in the TRC test since lost margin includes costs unrelated to demand side management.

Relationship of Conservation Incentives to Utility Return on Equity

22) *Effect of Incentive Mechanism on Allowed Return on Equity.* Should adoption of an incentive or lost margin/decoupling mechanism require a downward adjustment in the utility's return on equity?

Response

No. Decoupling mechanisms are becoming ubiquitous across the utility landscape. According to the latest AGA survey, "17 utilities in 10 states have implemented decoupling tariffs that serve 15 million residential customers. Decoupling programs are pending in another 10 states, plus the District of Columbia, potentially serving another 6 million residential customers"[2] The utility's allowed return on equity should be determined with reference to an appropriate peer group of utilities. If those utilities share decoupling

[2] *See http://www.epa.state.il.us/air/climatechange/documents/subgroups/power-energy/aga-update-on-revenue-decoupling-mechanisms.pdf*

mechanisms, it would be inappropriate to adjust allowed return on equity downward based on the presence of a decoupling mechanism. In contrast, a utility without decoupling should be awarded a higher return on equity in relation to a group of peers that have decoupling.

23) *Incentive Rate of Return.* Should a utility's rate of return be increased for sponsoring and administering conservation programs? If so, please explain. Should a utility earn a return on monies collected from ratepayers to fund its conservation programs? If so, please explain. Would the amount of energy efficiency offered by the utility increase under either of the above circumstances?

Response

In the absence of decoupling, utilities should receive an increased rate of return for promoting conservation. Utilities should be compensated for the risk of reducing demand for their product. If conservation programs are funded by the utility prior to the collection of amounts from ratepayers, the activity would be much like any deferral account and a return on the deferred account balance would be appropriate.

Other Issues

24) *Other Issues.* Comment on any other issue relevant to this inquiry that is not covered above.

Response

NW Natural has no other comments at this time.