

**PUBLIC UTILITY COMMISSION OF OREGON
INTEROFFICE CORRESPONDENCE**

DATE: May 4, 2010

TO: Michael Dougherty

FROM: Dustin Ball

SUBJECT: Staff Audit of NW Natural's 2009 System Integrity Program Expenditures

Summary

Staff reviewed NW Natural's System Integrity Program expenditures from October 1, 2008, through October 31, 2009.

The System Integrity Program (SIP) was established under Commission Order No. 09-067. The purpose of the SIP was to renew the Bare Steel and Transmission Integrity Management Programs (TIMP) and to include the new Distribution Integrity Management Programs (DIMP) into one new consolidated program. NW Natural tracks its SIP costs on a project basis, and the tracking period of costs runs from November 1 to October 31. However, there is an exception of the first year of implementation where the tracker period is extended to October 1, 2008 through October 31, 2009.

In the stipulation establishing the SIP, the parties agree that NW Natural will not seek recovery through the proposed annual rate adjustment for: 1) current O&M funding embedded in rates of approximately \$574 thousand per year; 2) additional O&M costs related to DIMP damage prevention; 3) the first \$3 million in combined Bare Steel and leakage capital cost, and 4) an additional \$250 thousand in SIP capital costs. For purposes of the SIP, total annual expenditures have a soft cap of \$12 million per tracker year (\$8.176 million recoverable through cost of service), expenditures can only exceed this soft cap with written consent of OPUC Staff, NWIGU, and CUB.

Staff completed the audit on April 12, 2010. As part of the audit, Staff sent NW Natural twenty eight data requests, reviewed summary data of all Bare Steel Replacement, and TIMP/DIMP work orders, and reviewed nineteen specific work requests concerning Bare Steel Replacement and Integrity Management programs. As a result of the audit, Staff recommends the following:

Recommendations

1. \$291,329 should be applied in the 2010 PGA as an addition to current program costs. As part of the 2009 PGA, NW Natural submitted estimated Bare Steel, Leakage, and TIMP expenses of \$8,566,000. Actual costs were in excess of \$8,857,329 which is the soft cap for the October 2008 through October 2009 period.

Total recommended adjustments to capital cost for the 2010-11 PGA resulting from Staff's review is an addition of \$291,329, plus carrying charges. NW Natural should calculate and submit the cost of service amount as part of the 2010-11 PGA.

Based on Staff's review, it appears NW Natural's expenditures exceeded the soft cap during the October 2008 through October 2009 period. Staff calculates the soft cap at \$8,857,329 ($(\$8,176,000 / 12 \text{ months}) * 13 \text{ months}$).

Although Staff identified approximately \$21,943 of meal costs, which should have been booked to O&M rather than capitalized, NW Natural incurred costs in excess of the soft cap during the year. Regardless of whether the meal costs are removed, expenditures during the period will still exceed the soft cap. Therefore Staff is recommending that the adjustment to the 2010 PGA be in an amount which will bring the annual expenditures up to the full soft cap amount.

Bare Steel Replacement/Leakage Programs

NW Natural is removing bare steel pipe from its distribution system on an accelerated schedule. The Bare Steel Replacement program was approved by the Commission in 2001 and had an original completing date of 2021. During the October 2008 through October 2009 timeframe NW Natural Completed 3,530 individual work orders associated with the Bare Steel program, one of which was considered a major (>\$100,000) project, and is summarized below:

- Hwy 22, Pacific Hwy 99W and Rickreall Rd. Replacement of 14,000 feet of 4-inch bare steel main operating at 125 MAOP with 8-inch coated, cathodically protected steel main installed along the north side of Highway 22 between Rickreall and Salem Oregon.

Material and Labor

NW Natural purchases pipe in bulk and assigns the costs to general inventory accounting string. The costs for pipe are later assigned to specific jobs after the pipe is installed and the job is closed.

The Company has a long-standing capitalization guideline policy which governs the accounting for such activities. Post-construction auditing confirms the account classification and closes charges as appropriate to capital or O&M. Field personnel allocate time to work orders assigned by the Engineering Department for each project regardless of whether it is new construction, Bare Steel Replacement, or other types of work. If assigned to a Bare Steel project, personnel receive a specific work order number to allocate their time. Staff did not note any areas of concerns in material and labor costs.

Accounts

Bare Steel work is mapped to FERC Account 376, Mains; FERC Account 379, Measuring and regulation station equipment – City gate check stations; and FERC Account 380, Services.

NW Natural Engineers and field supervisors receive direction from corporate management to ensure that only capital work orders are included in the Bare Steel program. In addition, large projects are included in the respective Bare Steel program only with the approval of Manager of Code Compliance.

Since the 2006 Staff audit, NW Natural has implemented additional controls to ensure the appropriateness of charges to Leakage and Bare Steel project accounts. The codes on the construction management system have been restricted to prevent work orders for excavation damage repairs from being charged to Leakage accounts. Work orders for excavation damage repairs are now assigned a unique accounting code.

At Staff's request, NW Natural provided Staff with a list of work requests used for the Bare Steel program. Staff reviewed, in detail, nine Bare Steel work requests from the same period.

Staff identified meal costs totaling \$10,328 which should have been booked to O&M accounts rather than capital accounts. This is a diminutive amount considering the total costs of these programs.

Per NW Natural, the Company did not receive any government funding (transportation, economic development, etc.) or private business funding, or any insurance settlements for any Bare Steel projects during the timeframe from October 2008 through October 2009.

Internal Audit

NW Natural has not conducted a formal, written audit of the Bare Steel program. However, company personnel routinely audit Bare Steel work orders during the design process and again during the post construction process to ensure the appropriateness of charges and charge numbers.

Program Costs

Staff examined estimated Bare Steel/Leakage costs that were included in the 2009 PGA against actual costs for the October 1, 2008 through October 31, 2009 timeframe. The following table highlights the difference.

Table 1 – PGA vs. Actual Costs

Program	PGA Costs	Actual Costs	Difference
Bare Steel/Leakage	\$7,278,000	\$8,052,988	\$774,988

TIMP & DIMP Program Expenditures

TIMP was initiated in response to the Pipeline Safety Improvement Act of 2002 which requires NW Natural to develop an Integrity Management program for gas transmission pipelines located where a leak or rupture could do the most harm. NW Natural currently has 205 miles of pipe in high consequence areas, 130 miles of which are in the Portland Metropolitan area. The Pipeline Inspection, Protection, Enforcement and Safety Act of 2006 expanded the requirements of the 2002 act to prescribe minimum standards for DIMP. These standards cover the integrity and broader aspects of distribution mains, services, and other gas related appurtenances.

Pursuant to Commission Order No. 04-390 effective June 4, 2004, the Commission approved the Company's request to classify the Integrity Management program costs as capital expenditures. Each integrity management project is required to pass the "Used and Useful" test before being considered complete for the purposes of recovery in rates. This means that the inspection and any required repair must be completed for a project to be included as a capital expenditure for that tracking period. Any project overlapping the tracking period would be carried over for recovery beginning in the following year.

NW Natural began incurring costs for this program in May 2003. During the October 2008 through October 2009 time period 351 active and completed TIMP, and 42 active and completed DIMP work orders were completed.

The Company reported the following major TIMP projects were completed during the October 1, 2008, through October 31, 2009, period.

- Southeast Transmission 12", from SE Gate to Bell Rd Station:
 - Modified Pipeline to allow for inline inspection
 - Cleaned and assessed pipeline with inline inspection tool
 - Evaluated inline inspection data
 - Excavated and remedied required anomalies on pipeline
- Clackamas to West Linn Transmission 12", from Hwy 212 to West Linn
 - Modified pipeline to allow for inline inspection
 - Cleaned and assessed pipeline with inspection tool
 - Evaluated inline inspection data
 - Excavated and remedied required anomalies on pipeline
- Browns Landing Pipeline Replacement.
 - Installation of approximately 3000 feet of 8" steel class D main
 - Replacement of exposed pipeline in the waterway due to channel scouring

At Staff's request, NW Natural provided a list of work requests for TIMP and DIMP projects. Staff reviewed, in detail, 9 work requests from the same period.

Staff identified TIMP meal costs totaling \$11,615 which should have been booked to O&M accounts rather than capital accounts. This is a diminutive amount considering total project costs.

According to NW Natural, the Company did not receive any federal, state, local, other type of government (transportation, economic development, etc), private business funding, or any insurance settlements for any Integrity Management projects.

Internal Audit

To date, NW Natural has not conducted a formal, written audit of the TIMP/DIMP programs. However, company personnel routinely audit work orders during the post construction process for accuracy and appropriate charges.

To ensure that operational and maintenance projects are not charged to TIMP/DIMP projects, work is charged to accounts created for specific projects and work orders are audited on a monthly basis by TIMP/DIMP Staff.

Program Costs

Prior to being included in the annual PGA filing, TIMP and DIMP projects must pass the “used and useful” test. As a result many individual projects may extend over a period of several years prior to being included in rates. In order to calculate the amount to include in the current years PGA, NW Natural compares its current total investment (actual costs through June and estimates for the months July, August, and September) to the amount included in its previous PGA filing. Through this process the Company is able to add the cost of all projects which passed the “used and useful” test in the current year regardless of whether or not the related expenses were incurred in the current or a previous year. Additionally, this method automatically “true’s up” any variances from prior estimates.

The following table highlights the difference between NW Natural’s estimated total project cost and actual project costs, which were considered “used and useful” for purposes of being included in the annual PGA.

Table 2 – PGA vs. Actual Costs

Program	PGA Costs	Actual Costs	Difference
TIMP	\$4,538,000	\$4,985,396	\$447,396
DIMP	\$0	\$0	\$0
Total	\$4,538,000	\$4,985,396	\$447,396

2009 SIP Audit
May 4, 2010
Page 6

Other

Staff appreciates the promptness and thoroughness of NW Natural in responding to Data Requests during the audit process.

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