ITEM NO. 4

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: December 18, 2003

REGULAR __X__ CONSENT ____ EFFECTIVE DATE ____December 19, 2003____

DATE: December 17, 2003

TO: Lee Sparling through Ed Busch and Jack Breen III

FROM: Bonnie Tatom and Bill McNamee

SUBJECT: NORTHWEST NATURAL: (Advice 03-24) Modifies a special contract between NW Natural and West Linn Paper Company, originally approved by the Commission in December 1997.

STAFF RECOMMENDATION:

We recommend that NW Natural's Advice No. 03-24 be allowed to go into effect on December 19, 2003, with less than statutory notice, and subject to deferral of one-half of an $89,000 one-time payment.

DISCUSSION:

On December 5, 2003, pursuant to OAR 860-022-0035, NW Natural (NWN or company) filed with the OPUC a revised Schedule 60 (Special Contracts) and a proposed amendment to the Company's Special Transportation Service Agreement with West Linn Paper Company (West Linn). The filing included a request to waive statutory notice under OAR 860-022-0020.

The currently-effective Agreement, approved by the Commission in late 1997, provided West Linn with a transportation service discount, from rates then in effect, to prevent West Linn from receiving transportation service by direct connection ("bypass") with Northwest Pipeline. The Agreement became effective December 23, 1997, for a term of ten years.

The proposed amendment is intended to address West Linn's contention that it has the right to receive service under Rate Schedule 32 (*Large Volume Non-Residential Sales and Transportation Service*), which became effective September 1, 2003. Rate Schedule 32 offers a new rate design stipulated to in the settlement of NWN's recent

General Rate Case (UG 152). Rate Schedule 32 rates are lower than the rates in the current Agreement.[1]

OVERVIEW: West Linn contends that it can terminate the Special Transportation Service Agreement pursuant to Section 5.2 of the Agreement, which states:

> "If, during the term of this agreement, the state regulatory commission having jurisdiction modifies this Agreement or changes NW Natural's general Rules and Regulations, or takes other action affecting the rights, obligations, or economic interests of the Parties to this Agreement, then this Agreement may be terminated by either NW Natural or Customer if such Party's rights, obligations, or economic interests are adversely affected or materially affected by such action."

West Linn states that, if it is forced to continue to pay the higher rates in the Agreement, then the OPUC approval of Rate Schedule 32 essentially creates an adverse and material impact on West Linn's economic interests. In addition, West Linn claims that NW Natural's General Rule 16 (*Termination of Gas Service Account – by Customer*) allows West Linn to switch to Rate Schedule 32 with 30 days notice.

The company disagrees with West Linn's interpretation of both Section 5.2 of the Agreement and Rule 16. NW Natural indicates, however, that it continued to negotiate with West Linn to achieve an alternative resolution that would allow the parties to avoid litigation. The proposed filing is the result of those negotiations.

SUMMARY OF PROPOSED AGREEMENT: The proposed agreement between NW Natural and West Linn modifies the original terms of the Agreement as follows:

- The Agreement would allow West Linn increased flexibility to choose between transportation only service, or sales service;
- The term of the Agreement would be extended for an additional 3 years, through 2010;
- The rates would be modified as follows:
    - The Monthly Service Charge of $38,250 is replaced with a Minimum Monthly Charge of $20,000,
    - For firm or interruptible transportation service, all Rate Schedule 32 charges would apply,
    - For firm or interruptible sales service, all Rate Schedule 32 charges would apply,

[1] For West Linn, the current Agreement's rates are approximately $200,000 per year higher than Rate Schedule 32 rates.

  - Taxes, late payment, telemetry, or other governmental charges would continue to apply, and
  - West Linn would pay NW Natural a one-time payment of $89,000 as an agreement modification fee in part to compensate NW Natural for the loss of revenues and costs incurred to modify the Agreement;
- To reduce future interpretational disputes, modifications to clarify the applicability of Section 5.2 are also proposed; and
- The changes in the service offering and rates under the Amendment required some other modifications throughout the agreement for consistency, including the operating and force majeure provisions.

STAFF REVIEW: The applicable standards for Commission review of special contracts are set forth in ORS 757.230 (as amended by House Bill 2144 in 1987) and Order No. 87- 402. ORS 757.230 lists several issues to be considered when customers are classified on the basis of available energy supply options. Order No. 87-402 identifies rate classification criteria and other legal requirements for price discounts. Generally, these standards for reviewing special contracts require that: (1) Other ratepayers must benefit; (2) Any rate discount should be no larger than necessary; and (3) The offer of a discount must not be unduly discriminatory.

Other ratepayers must benefit: Staff understands that the difference in revenue collection between the current and proposed contract is approximately $200,000 per year. Therefore, if the amendment is approved, NW Natural will forego roughly $800,000 in future revenues (2004-2007). However, in NW Natural's most recent rate case, UG 152, rates were set assuming the loss of these revenues. No additional cost shifting to other customers would occur if the contract were amended as proposed.[2]

The company contends that the amended agreement will provide the following benefits:

- West Linn would pay a minimum of $20,000 per month; Rate Schedule 32 has a customer charge of only $675 per month,
- West Linn revenues would continue to provide a positive contribution to margin (the company estimates $330,000 annually based on recent usage) that would not occur if West Linn left the system through bypass,
- Allows additional margins by extending the agreement not to bypass NW Natural's system for three years (2008-2010),

[2] If the current contract remained in place, and a general rate case reset rates prior to 2007, other customers would be better off due to the higher margins under the current contract.

- Reduces the chance of a plant closure and the associated harm to customers from the loss of margin.[3] As NW Natural stated in its application, "Additionally, the plant was shut down in 1996 by its prior owners and Customer continues to face challenging economic conditions, including temporary layoffs of 60 employees and a shut down of one of its three paper machines," and
- Avoids continued dispute over the existing contract and possible litigation costs. NW Natural and Staff both disagree with West Linn's interpretation of the current special contract language. Regardless of the ultimate outcome of the dispute, Staff expects that NW Natural would seek recovery of its litigation expense from other customers.

Staff concludes that with the continuation of a positive margin from West Linn and the extension of the no-bypass period, and taking into account the risks associated with potential litigation or plant closure, the amended contract will provide benefits to customers. Staff, however, also believes that the $89,000 Agreement Modification Fee should be accounted for differently than the company proposes and discusses its counterproposal later in this memo.

The rate discount should be no larger than necessary: The Company maintains that the expected annual revenue from the proposed agreement exceeds West Linn's annual bypass costs by approximately $26,000. Therefore, NWN concludes that revenue contributions from the customer should be considered maximized.

Given the nature of the arms-length negotiations with West Linn, Staff has relied on the analysis provided by NWN and on information provided in discussions held with both NW Natural and West Linn to conclude that customer contributions are maximized. It does appear that the proposed agreement will generate sufficient revenue to cover NWN's relevant costs to provide transportation and sales service to West Linn.

The offer of a discount must not be unduly discriminatory: Other similarly-situated customers should be eligible for the same consideration. The Company states that it does not have any similarly-situated customers at this time.

NWN states that, under the circumstances, it believes that the proposed amendment is the best result it could achieve in arms-length negotiations with West Linn Paper, and that, absent the Agreement, further complaint proceedings at the OPUC or in the courts

[3] If the plant were to shut down permanently, the amended agreement contains a provision for a payment of one year's charges equal to $240,000.

would most likely result. NWN indicates that the OPUC should take into consideration that the proposed amendment is intended to settle a contract dispute with a valued customer and to avoid the costs of potential litigation.

OPTIONS: The Commission has two choices with regard to the disposition of this application for an amended special contract. One option is to suspend the special contract amendment for additional investigation under ORS 757.215. Under this alternative, West Linn Paper Company would remain under the current special contract with terms that it disputes. West Linn has provided notice to NW Natural that it intends to seek service under Rate Schedule 32. The company disagrees with West Linn's interpretation of the current special contract language. Staff believes that if the Commission does not approve the amended special contract, these parties could engage in a prolonged dispute and litigation.

The second option is to allow the amended special contract to go into effect. Staff considers this filing to represent a unique situation. Approval of the special contract extends the no-bypass provision of the current contract, assuring the company of additional margin for three more years, and reduces the likelihood of plant closure and the inherent loss of margin contribution of the customer. Staff believes that the additional three years' margins adequately offset the potential margin loss should the Commission approve new rates before the end of 2007. Staff recommends the Commission allow the amended special contract to go into effect.

On December 11, 2003, Staff recommended that if the Commission chose this option, NW Natural be required to place the proceeds from its $89,000 Agreement Modification Fee in a deferred account for later refund. The company purported that this fee is necessary to compensate it for loss of revenues and costs incurred to modify the special contract. Staff disagreed. NW Natural's recent general rate case, approved by the Commission in late August, fairly addressed the company's revenue loss due to rate schedule changes, as would occur if West Linn receives service under Rate Schedule 32. Since September 1, 2003, NWN has effectively double recovered the difference in margins between the current special contract and the proposed amended contract.[4] Customers have fully borne this revenue loss over the past three and one-half months and for that reason, Staff believed that the $89,000 one-time payment should be held in a deferred account for later amortization into these smaller-load customers' rates.

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[4] That is, other customers' rates beginning September 1, 2003 (the effective date of the UG 152 rates), were higher due to the assumed loss of current special contract margins, yet NW Natural has continued to receive revenues under the current special contract.

On December 15, 2003, Staff received a letter from NW Natural stating that Staff's recommendation was unacceptable. The company cited three reasons it sought the $89,000 agreement modification fee: (1) to compensate for revenues lost by NW Natural's shareholders from the time the original special contract was approved to the time the lower revenues were reflected in rates, (2) to recognize costs required to resolve their current dispute with West Linn, and (3) to dissuade others from attempting to renegotiate their special contracts. NW Natural also stated that if the amended special contract were approved with Staff's recommended condition, the company would continue to bill West Linn Paper Company under the existing special contract. This action would likely result in a legal challenge to the contract as discussed earlier in our report.

Staff subsequently reviewed the company's letter and discussed alternative proposals for disposition of the one-time payment. On December 17, 2003, Staff and NWN agreed to recommend a split of the payment between the company's shareholders and customers. Staff believes this is an equitable resolution of the dispute. Upon receipt of the payment in late 2004, NW Natural has agreed to place $44,500 in a deferred account for later refund to Rate Schedule 1, 2 and 3 customers.

PROPOSED COMMISSION MOTION:

The revised Schedule 60 and proposed West Linn Special Contract Amendment be allowed to go into effect on December 19, 2003, with less than statutory notice. NW Natural is directed to place one-half of the $89,000 one-time payment into a deferred account, with interest, for refund to Rate Schedule 1, 2 and 3 customers in a subsequent rate proceeding.