

The application was filed as a response to Finding No. 17 of Staff's Audit Report of NW Natural, dated March 18, 2003. During the audit, staff discovered that NW Natural had sold the utility property (Port Block) without Commission approval as required by ORS 757.480. After discussion with the Company, staff directed it to file a retroactive application for approval of the sale. Pursuant to this meeting and the information available at that time, NW Natural and staff agreed to advocate the following accounting treatment:

1. NW Natural would continue to defer the gain on the sale of the Port Block, recorded on September 30, 2000, in Account 186. NW Natural started booking the amount to that account and staff initially agreed to have NW Natural maintain that accounting treatment. NW Natural re-calculated the entry on an after-tax basis consistent with previous orders issued by the Commission.
2. NW Natural would continue deferring necessary replacement parking costs to Account 186 on a month-to-month basis.
3. NW Natural would re-calculate interest and apply interest monthly to the account from March 1998, using NW Natural's authorized return on rate base (ROR) as the interest rate.
4. NW Natural would analyze its replacement parking costs and estimate the remaining balance in the account as of September 30, 2005. Based on the estimate, NW Natural would calculate what portion of the capital gain to be debited as of September 30, 2003 (amortized commencing October 1, 2003, as part of the PGA) to ensure that the estimated balance in the account as of September 30, 2005, would be zero. NW Natural returned \$345,000 to customers in that manner.
5. As of September 30, 2005, NW Natural would close out the deferred account and record any remaining balance as a debit or credit to operating expenses. As of October 1, 2005, NW Natural would commence charging its replacement parking costs to the appropriate operating account rather than to a deferred account.

In its application, the Company indicated that the transaction was beneficial to customers since the initial value of the property (\$145,000) was removed from rate base and that "customers will not have had to support, through rates, the Company's costs of employee parking necessary to replace the parking on the Port Block from March 1998 at least until October 2005."

The application did not sufficiently address the on-going need for the parking that the property had provided employees of the Company, nor was an economic analysis provided that would clearly show that the transaction was in the best interests of

customers. The Company further indicates that the transaction and accounting treatment is in the public interest because the Port building development is a positive contribution to the working environment in the neighborhood.

Port of Portland Building

During the application review, staff discovered that the land was sold as part of a "build-to-suit" seven-story office building development for the Port of Portland. The deal provided about \$700,000 of developer's profit, with an after-tax gain of about \$427,000. Staff, NW Natural, CUB and NWIGU later agreed that \$150,000 of the after-tax development fee (\$427,000) would be placed in a deferred account for refund to customers because (1) The construction of the building on the Port Property Block was an integral part of the Agreement; (2) The building was constructed on land that was paid for through rates; and, (3) NW Natural used its regulated utility creditworthiness to secure a low interest rate loan for the construction.

NW Natural agreed to apply its authorized rate of return to this amount, resulting in approximately \$201,000 to be returned to customers as part of the 2004 PGA.

Unresolved Issues:

Pretax Gain versus After-tax Gain

The Company knew replacement parking would be required as early as 1997, yet did not actively pursue seeking replacement property until late 1999. This coincided with the receipt of a deposit from the Port of Portland on the building it was buying. According to the Company, once the cash was received, it was too late to enter into a 1031 tax-deferred exchange. At issue is whether the tax on the gain should have, or could have, been deferred through an exchange and whether the Company's inability to defer the capital gain was imprudent. The dollar value of this issue is approximately \$550,000¹.

Fish Block Property

The Fish Block (described below) was purchased and placed into regulatory accounts, even though the Company indicated that the property was not "held as property, neither utility or non-utility." The statement was not clear and was made by one of the Company's primary contacts in the Fish Block transaction, according to a letter written by the eventual partner in the transaction, Mr. Brian McCarl.

¹ The amount of the land transaction was \$1,526,000 and the book value was \$125,000, indicating a net capital gain of \$1,401,000. Assuming a tax rate of 39%, indicates an approximate capital gain tax of \$550,000.

However, during the course of our investigation, it was determined that the Company did replace the parking property with the Fish Block property, valued at a nearly identical value (\$1,500,000), and entered it into rate base accounts. It appears as if the replacement parking land was specifically from the proceeds of the Port of Portland transaction. This replacement property was included in utility plant in the Company's recently concluded rate case, UG 152. The property included both land and improvements on the land, which consisted of nearly an entire block of three conjoined buildings that had been used for several decades as a fish processing plant.

Fish Block Transaction

The parking land (Fish Block) was sold to a Limited Liability Company (Fish Block Investors, LLC) in which NW Natural has a 50% ownership interest. Of the total funds invested into the LLC, NW Natural contributed an initial amount in the range of 80%. The purpose of the Operating Agreement that originated the Fish Block Investments, LLC (FBLLC) was "to acquire, own, improve, operate, lease and develop the real estate... and to engage in any business activities related to the foregoing."

According to the Multnomah County Assessor's office, the deed recorded on March 6, 2000, for the property sale to the FBLLC was reported at a price of \$1,831,000. The NW Natural portion for its interest in the FBLLC was reportedly \$1,500,000. NW Natural indicates that it "believed at the time of the investment that the underlying property had a value of at least \$3,000,000." Further data requests are seeking information on appraisals and due diligence undertaken at the time of the transaction.

Two further agreements took place, one was a Ground Lease to Chinatown Investors, LLC (controlled by Mr. McCarl) and the other was a parking lease agreement from Chinatown Investors, LLC to NW Natural.

The Ground Lease required a one-time fee of \$10.00 for the right to use the land for six years. It did not note a specific use for improvements that were included in the lease, and only specified that *about* 100 parking spaces would be made available to NW Natural, either through a building modification or surface parking. Around \$250,000 was subsequently invested into the building by Mr. McCarl to make the property ready for parking. Additionally, Mr. McCarl, though Chinatown Investors, LLC, pays property taxes from the rental receipts from NW Natural.

The Parking Lease was for just over a six-year term (March 2000 through April 2006) at a cost of \$85.00 per space, per month. The aggregate lease payment appears to have been roughly \$7,500 per month. Additionally, NW Natural receives its "ownership interest" pass-through of a *loss* for tax purposes of about \$20,000 per year, based on its

ownership interest of about 80 percent. Further data requests will determine from what sources the loss is being accrued, since the parking receipts should cover the property taxes and provide a net taxable *profit*.

Another concern that is being addressed is whether the investment in the LLC was properly recorded as a Land investment. Neither the IRS nor the Code of Federal Regulations (Chapter 18 CFR) appears to suggest that an ownership interest in a business is a real property transaction. The Company agrees that they did not purchase the real property, but only an interest in the Limited Liability Company.

The purchase of an interest in Fish Block created an affiliated transaction for which an informational filing should have been made. It is unclear to staff if the parking lease NW Natural entered into with Chinatown Investors, LLC also created an affiliated transaction.

Chinese Garden Block

On April 2, 2004, staff had a meeting with the Company, CUB and NWIGU to discuss staff's concerns. During this meeting, the Company volunteered information pertaining to another block in the vicinity that was leased to the City of Portland. The Company represents that this block has also not been removed from rate base and has been earning a return for its shareholders. During the course of the investigation begun in this docket, any additional issues pertaining to any related issues will be explored and resolved.

Staff Data Requests

During the course of the investigation into the Port of Portland Block (UP 205), Staff submitted a number of data requests. The most recent series included 71 requests that were due by March 11, 2004. To date, only 26 of those requests have been answered. During the April 2, 2004 meeting with the Company, there were several verbal requests for information that have yet to be provided to staff.

Issues for Investigation

The following issues have been identified for possible consideration in this investigation:

- 1) What is the extent of the affiliated interest transactions?
- 2) Should the deferral on the capital gains tax be returned to customers since the tax could have been deferred, or was there a tax deferral on the property, as indicated in the application?

- 3) What were the exact contributions to Fish Block Associates, LLC?
- 4) Is it appropriate for the parking expenses paid to Chinatown Investors by NW Natural to be offset against customers' portion of the gain from the Port of Portland transaction?
- 5) Should NW Natural's \$1.5M investment in Fish Block have been put into rate base?
- 6) Did NW Natural misrepresent its involvement in the Fish Block parking property?
- 7) What was the value of the Fish Block property and did NW Natural pursue adequate due diligence at the time of the transaction?
- 8) Are there other uses of LLCs that should be investigated?
- 9) Should an alternative accounting treatment of the gains and associated expenses identified above be determined?
- 10) Are there other unacknowledged transactions that require modification to rate base or expenses?
- 11) What action is required by the Commission to compel the Company to answer all staff data requests without undue delay?
- 12) Are sanctions or penalties against NW Natural warranted as result of these transactions?

Following the opening of a formal investigation staff will continue to explore the issues that have been uncovered and will await the receipt of outstanding data requests. Staff also anticipates that the parties may ultimately reach a satisfactory stipulation that will be presented for adoption in a Commission order.

PROPOSED COMMISSION MOTION:

An investigation related to the Fish Block Property be opened.

Timeline for Real Estate Events

1992

- First negotiations between NW Natural and the City of Portland to lease property for the creation of a Classical Chinese Garden

1996

- Jan-96 - Permission to lease property for the Chinese Garden granted by City of Portland

1997

- April - NW Natural approached by Insignia Forum about bidding on the Port of Portland relocation
- Summer - NW Natural awarded the contract to construct Port of Portland Headquarters Building

1998

- May - Construction begins on the Port building
- NW Natural employees begin parking in the Old Town Parking Garage
- Summer - Construction begins on the Classical Chinese Garden

1999

- June - Construction on the Port building deemed substantially complete and undisputed portion of the purchase price remitted by the Port to NW Natural - \$18.75 million.
- Ground Lease with City of Portland for Classical Chinese Garden is signed
- Summer - Construction on the Classical Chinese Garden is completed
- November - Brian McCarl approaches NW Natural with an offer for NW Natural to participate in the ownership of the Fish Block, a property for which he had a purchase option

2000

- February - Purchase of Fish Block closes
- March - Fish Block Associates, LLC is formed between NW Natural and Chinatown Investors, each owning a 50% interest (The Operating Agreement)
- Chinatown Investors LLC leases the Fish Block property from Fish Block Associates (The Ground Lease)
- NW Natural enters into the Parking Lease under which NW Natural agrees to lease parking in the Fish Block from Chinatown Investors LLC
- September - Port of Portland sale closes and title is transferred, balance of proceeds remitted to NW Natural
- December - Fish Block construction completed and NW Natural employees begin parking there, most having been relocated from the Old Town Parking