

NORTHWEST NATURAL GAS CO
Form 10-Q
May 04, 2006
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition period from _____ to _____

Commission File No. 1-15973

NORTHWEST NATURAL GAS COMPANY

(Exact name of registrant as specified in its charter)

Oregon **93-0256722**
(State or other jurisdiction of **(I.R.S. Employer**
incorporation or organization) **Identification No.)**
220 N.W. Second Avenue, Portland, Oregon 97209
(Address of principal executive offices) (Zip Code)

Registrant's Telephone Number, including area code: (503) 226-4211

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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At April 28, 2006, 27,576,846 shares of the registrant's Common Stock, \$3-1/6 par value (the only class of Common Stock) were outstanding.

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NORTHWEST NATURAL GAS COMPANY

For the Quarterly Period Ended March 31, 2006

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NORTHWEST NATURAL GAS COMPANY

PART I. FINANCIAL INFORMATION

Consolidated Statements of Income

(Unaudited)

Thousands, except per share amounts	Three Months Ended March 31,	
	2006	2005
Operating revenues:		
Gross operating revenues	\$ 390,391	\$ 308,777
Less: Cost of sales	255,399	180,608
Revenue taxes	9,528	7,183
Net operating revenues	125,464	120,986
Operating expenses:		
Operations and maintenance	28,247	27,195
General taxes	7,573	6,770
Depreciation and amortization	15,830	15,195
Total operating expenses	51,650	49,160
Income from operations	73,814	71,826
Other income and expense - net	518	65
Interest charges - net of amounts capitalized	9,855	9,128
Income before income taxes	64,477	62,763
Income tax expense	23,444	22,876
Net income	\$ 41,033	\$ 39,887
Average common shares outstanding:		
Basic	27,584	27,578
Diluted	27,632	27,863
Earnings per share of common stock:		
Basic	\$ 1.49	\$ 1.45
Diluted	\$ 1.48	\$ 1.43

See Notes to Consolidated Financial Statements

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NORTHWEST NATURAL GAS COMPANY

PART I. FINANCIAL INFORMATION

Consolidated Balance Sheets

	March 31, 2006 (Unaudited)	March 31, 2005 (Unaudited)	Dec. 31, 2005
Thousands			
Assets:			
Plant and property:			
Utility plant	\$ 1,890,633	\$ 1,814,991	\$ 1,875,444
Less accumulated depreciation	547,635	514,785	536,867
Utility plant - net	1,342,998	1,300,206	1,338,577
Non-utility property	40,953	34,157	40,836
Less accumulated depreciation and amortization	6,221	5,408	5,990
Non-utility property - net	34,732	28,749	34,846
Total plant and property	1,377,730	1,328,955	1,373,423
Other investments	54,432	57,198	58,451
Current assets:			
Cash and cash equivalents	7,522	2,740	7,143
Accounts receivable	97,859	73,776	84,418
Accrued unbilled revenue	47,764	38,880	81,512
Allowance for uncollectible accounts	(4,526)	(3,499)	(3,067)
Gas inventory	35,906	23,139	77,256
Materials and supplies inventory	9,808	8,262	8,905
Income taxes receivable			13,234
Prepayments and other current assets	57,330	21,429	54,309
Total current assets	251,663	164,727	323,710
Regulatory assets:			
Income tax asset	66,757	65,622	65,843
Deferred environmental costs	19,196	7,231	18,880
Deferred gas costs receivable	13,522	12,978	6,974
Unamortized costs on debt redemptions	6,776	7,215	6,881
Other		6,732	
Total regulatory assets	106,251	99,778	98,578
Other assets:			
Fair value of non-trading derivatives	40,879	88,634	178,653
Other	9,102	7,305	9,216
Total other assets	49,981	95,939	187,869

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Total assets	\$ 1,840,057	\$ 1,746,597	\$ 2,042,031
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See Notes to Consolidated Financial Statements

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NORTHWEST NATURAL GAS COMPANY

PART I. FINANCIAL INFORMATION

Consolidated Balance Sheets

	March 31, 2006 (Unaudited)	March 31, 2005 (Unaudited)	Dec. 31, 2005
Thousands			
Capitalization and liabilities:			
Capitalization:			
Common stock	\$ 87,335	\$ 87,244	\$ 87,334
Premium on common stock	296,281	299,900	296,471
Earnings invested in the business	237,205	214,864	205,687
Unearned stock compensation		(809)	(650)
Accumulated other comprehensive income (loss)	(1,911)	(1,818)	(1,911)
Total common stock equity	618,910	599,381	586,931
Long-term debt	501,500	483,875	521,500
Total capitalization	1,120,410	1,083,256	1,108,431
Current liabilities:			
Notes payable	50,400	10,500	126,700
Long-term debt due within one year	28,000	15,000	8,000
Accounts payable	91,185	84,693	135,287
Taxes accrued	25,876	22,074	12,725
Interest accrued	11,623	11,171	2,918
Other current and accrued liabilities	38,703	34,320	40,935
Total current liabilities	245,787	177,758	326,565
Regulatory liabilities:			
Accrued asset removal costs	173,936	157,975	169,927
Unrealized gain on non-trading derivatives, net	23,937	78,205	171,777
Customer advances	1,924	1,592	1,847
Other	4,283		661
Total regulatory liabilities	204,080	237,772	344,212
Other liabilities:			
Deferred income taxes	220,568	206,651	222,331
Deferred investment tax credits	4,479	5,155	5,069
Fair value of non-trading derivatives	17,586	10,429	6,876
Other	27,147	25,576	28,547
Total other liabilities	269,780	247,811	262,823
Commitments and contingencies (see Note 7)			
Total capitalization and liabilities	\$ 1,840,057	\$ 1,746,597	\$ 2,042,031

See Notes to Consolidated Financial Statements

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NORTHWEST NATURAL GAS COMPANY

PART I. FINANCIAL INFORMATION

Consolidated Statements of Cash Flows

(Unaudited)

Thousands	Three Months Ended	
	2006	March 31, 2005
Operating activities:		
Net income	\$ 41,033	\$ 39,887
Adjustments to reconcile net income to cash provided by operations:		
Depreciation and amortization	15,830	15,195
Deferred income taxes and investment tax credits	(3,267)	(5,822)
Undistributed earnings from equity investments	50	137
Allowance for funds used during construction	(133)	(86)
Deferred gas costs - net	(6,548)	(3,427)
Contributions to qualified defined benefit pension plans		
Non-cash expenses related to qualified defined benefit pension plans	1,441	1,159
Deferred environmental costs	(2,014)	(230)
Income from life insurance investments	(1,383)	(452)
Other	4,673	(1,790)
Changes in working capital:		
Accounts receivable - net	(11,982)	(12,077)
Accrued unbilled revenue - net	33,748	25,521
Inventories of gas, materials and supplies	40,447	35,076
Income taxes receivable	13,234	15,970
Prepayments and other current assets	(2,249)	3,644
Accounts payable	(44,102)	(17,785)
Accrued interest and taxes	21,856	20,106
Other current and accrued liabilities	(2,231)	152
Cash provided by operating activities	98,403	115,178
Investing activities:		
Investment in utility plant	(15,002)	(19,958)
Investment in non-utility property	(106)	(194)
Proceeds from sale of non-utility investments		3,001
Proceeds from life insurance	964	
Other	1,475	746
Cash used in investing activities	(12,669)	(16,405)
Financing activities:		
Common stock issued, net of expenses	859	2,569
Common stock purchased	(398)	(2,895)
Change in short-term debt	(76,300)	(92,000)
Cash dividend payments on common stock	(9,516)	(8,955)
Cash used in financing activities	(85,355)	(101,281)

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Increase (decrease) in cash and cash equivalents	379	(2,508)
Cash and cash equivalents - beginning of period	7,143	5,248
Cash and cash equivalents - end of period	\$ 7,522	\$ 2,740
Supplemental disclosure of cash flow information:		
Interest paid	\$ 970	\$ 970
Income taxes paid	\$	\$
Supplemental disclosure of non-cash financing activities:		
Conversions to common stock:		
7-1/4% Series of Convertible Debentures	\$	\$ 152
See Notes to Consolidated Financial Statements		

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NORTHWEST NATURAL GAS COMPANY

PART I. FINANCIAL INFORMATION

Consolidated Statements of Capitalization

Thousands	March 31, 2006		March 31, 2005		Dec. 31, 2005	
	(Unaudited)		(Unaudited)			
Common stock equity:						
Common stock	\$	87,335	\$	87,244	\$	87,334
Premium on common stock		296,281		299,900		296,471
Earnings invested in the business		237,205		214,864		205,687
Unearned compensation				(809)		(650)
Accumulated other comprehensive income (loss)		(1,911)		(1,818)		(1,911)
Total common stock equity		618,910	55%	599,381	55%	586,931
Long-term debt:						53%
Medium-Term Notes						
First Mortgage Bonds:						
6.340% Series B due 2005				5,000		
6.380% Series B due 2005				5,000		
6.450% Series B due 2005				5,000		
6.050% Series B due 2006		8,000		8,000		8,000
6.310% Series B due 2007		20,000		20,000		20,000
6.800% Series B due 2007		9,500		9,500		9,500
6.500% Series B due 2008		5,000		5,000		5,000
4.110% Series B due 2010		10,000		10,000		10,000
7.450% Series B due 2010		25,000		25,000		25,000
6.665% Series B due 2011		10,000		10,000		10,000
7.130% Series B due 2012		40,000		40,000		40,000
8.260% Series B due 2014		10,000		10,000		10,000
4.700% Series B due 2015		40,000				40,000
7.000% Series B due 2017		40,000		40,000		40,000
6.600% Series B due 2018		22,000		22,000		22,000
8.310% Series B due 2019		10,000		10,000		10,000
7.630% Series B due 2019		20,000		20,000		20,000
9.050% Series A due 2021		10,000		10,000		10,000
5.620% Series B due 2023		40,000		40,000		40,000
7.720% Series B due 2025		20,000		20,000		20,000
6.520% Series B due 2025		10,000		10,000		10,000
7.050% Series B due 2026		20,000		20,000		20,000
7.000% Series B due 2027		20,000		20,000		20,000
6.650% Series B due 2027		20,000		20,000		20,000
6.650% Series B due 2028		10,000		10,000		10,000
7.740% Series B due 2030		20,000		20,000		20,000
7.850% Series B due 2030		10,000		10,000		10,000
5.820% Series B due 2032		30,000		30,000		30,000
5.660% Series B due 2033		40,000		40,000		40,000
5.250% Series B due 2035		10,000				10,000
Convertible Debentures						
7-1/4% Series due 2012				4,375		
		529,500		498,875		529,500
Less long-term debt due within one year		28,000		15,000		8,000

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Total long-term debt	501,500	45%	483,875	45%	521,500	47%
Total capitalization	\$ 1,120,410	100%	\$ 1,083,256	100%	\$ 1,108,431	100%

See Notes to Consolidated Financial Statements

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NORTHWEST NATURAL GAS COMPANY

PART I. FINANCIAL INFORMATION

Notes to Consolidated Financial Statements

(Unaudited)

1. Basis of Financial Statements

The consolidated financial statements include the accounts of Northwest Natural Gas Company (NW Natural), a regulated utility, and its non-regulated wholly-owned subsidiary business, NNG Financial Corporation (Financial Corporation).

The information presented in the interim consolidated financial statements is unaudited, but includes all material adjustments, including normal recurring accruals, that the management of the Company considers necessary for a fair statement of the results for each period reported. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company's 2005 Annual Report on Form 10-K (2005 Form 10-K). A significant part of the business of the Company is of a seasonal nature; therefore, results of operations for interim periods are not necessarily indicative of the results for a full year.

Certain amounts from prior years have been reclassified to conform, for comparison purposes, with the current financial statement presentation. The current year's presentation of the Consolidated Statements of Income includes the reclassification of revenue taxes as a component of net operating revenues. Revenue taxes are expenses primarily related to the utility's franchise agreements and are based on gross operating revenues. Since revenue taxes are a direct cost of utility sales, the financial statement classification was changed to improve the presentation of net operating revenues and operating expenses. In prior years, revenue taxes were included under operating expenses as part of other taxes. The reclassifications had no impact on prior years' income from operations or net income.

2. New Accounting Standards
Adopted Standards

Share Based Payment. Effective Jan. 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123R, Share Based Payment, using the Modified Prospective Application method without restatement of prior periods. Prior to implementation of SFAS No. 123R, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123R requires companies to recognize compensation expense for all equity-based compensation awards issued to employees that are expected to vest. Under this method, the Company began to amortize compensation cost for the remaining portion of outstanding awards for which the requisite service was not yet rendered at Jan. 1, 2006. Compensation cost for these awards was based on the fair value of the awards at the grant date as determined under the intrinsic value method. The Company will determine the fair value of and account for awards that are granted, modified or settled after Jan. 1, 2006 in accordance with SFAS No. 123R. The adoption of SFAS No. 123R did not have a material impact on the Company's financial condition, results of operations or cash flows. See Note 3 for a detailed discussion of stock-based compensation.

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Accounting for Changes and Error Corrections. Effective Jan. 1, 2006, we adopted SFAS No. 154, *Accounting for Changes and Error Corrections* a replacement of APB Opinion No. 20 and FASB Statement No. 3, which provides guidance on the accounting for and reporting of accounting changes and error corrections. The statement requires retrospective application to prior periods' financial statements of changes in accounting principles, unless it is impracticable to determine the period-specific effects or the cumulative effect of the change. The guidance provided in APB Opinion No. 20 for reporting the correction of an error in previously issued financial statements remains unchanged and requires the restatement of previously issued financial statements. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after Dec. 15, 2005. The adoption of SFAS No. 154 did not have a material impact upon the Company's financial condition, results of operation or cash flows.

Inventory Costs. Effective Jan. 1, 2006, we adopted SFAS No. 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4, which amends the guidance on inventory pricing to require that abnormal amounts of idle facility expense, freight, handling costs and wasted material be charged to current period expense rather than capitalized as inventory costs. The adoption of SFAS No. 151 did not have a material impact upon the Company's financial condition, results of operations or cash flows.

Recent Accounting Pronouncements

Purchases and Sales of Inventory with the Same Counterparty. In September 2005, the Financial Accounting Standards Board's (FASB) Emerging Issues Task Force (EITF) reached a final consensus on Issue 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*. EITF 04-13 requires that two or more legally separate exchange transactions with the same counterparty be combined and considered a single arrangement for purposes of applying APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, when the transactions are entered into in contemplation of one another. EITF 04-13 is effective for new arrangements entered into, or modifications or renewals of existing arrangements, in interim or annual periods beginning after March 15, 2006. Adoption of this standard is not expected to have a material impact on the Company's financial condition, results of operations or cash flows.

Accounting for Certain Hybrid Instruments. In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Instruments*, which amends SFAS Nos. 133 and 140. SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. The statement is effective for all financial instruments acquired or issued after Jan. 1, 2007. The Company is in the process of evaluating the effect of the adoption and implementation of SFAS No. 155, which is not expected to have a material impact on its financial condition, results of operation or cash flows.

Variable Interest Entities. In April 2006, the FASB issued a staff position (FSP) interpreting variable interest entities (VIE) under FASB Interpretation No. (FIN) 46(R)-6, *Determining the Variability to be Considered in Applying FIN 46(R)-6*. This staff position emphasizes that preparers should use a *by design* approach in determining whether an interest is variable. A *by design* approach includes evaluating whether an interest is variable based on a thorough understanding of the design of the potential VIE, including the nature of the risks that the potential VIE was designed to create and pass along to interest holders in the entity. FSP No. FIN 46(R)-6 must be applied prospectively to all entities with which the Company first becomes involved and to all entities previously required to be analyzed under FIN 46(R) when a reconsideration event has occurred effective on or after July 1, 2006. The Company is in the process of evaluating the effect of adoption and implementation of FSP No. FIN 46(R)-6, which is not expected to have a material impact on its financial condition, results of operations or cash flows.

Table of Contents**3. Stock-Based Compensation**

Effective Jan. 1, 2006, we adopted SFAS No. 123R, Share Based Payment, to account for all stock-based compensation plans. Our stock-based compensation plans consist of the Long-Term Incentive Plan (LTIP), the Restated Stock Option Plan (Restated SOP), the Employee Stock Purchase Plan (ESPP) and the Non-Employee Directors Stock Compensation Plan (NEDSCP). These plans are designed to promote stock ownership in NW Natural by employees and officers, and, in the case of the NEDSCP, non-employee directors. See Part II, Item 8., Note 4, in the 2005 Form 10-K for a discussion of the Company's stock-based compensation plans.

Long-Term Incentive Plan. A total of 500,000 shares of the Company's common stock has been authorized for awards under the terms of the LTIP as stock bonus, restricted stock or performance-based stock awards. At March 31, 2006, performance-based awards on 105,000 shares, based on target, were outstanding, a restricted stock award for 5,000 shares was outstanding, and the remaining 390,000 shares are available for future grants.

Performance-based Stock Awards. At March 31, 2006, the aggregate number of performance-based shares awarded and outstanding under the Company's LTIP at the threshold, target and maximum levels were as follows:

Year	Performance			
	Period	Threshold	Target	Maximum
Awarded				
2004	2004-06	6,750	27,000	54,000
2005	2005-07	8,750	35,000	70,000
2006	2006-08	10,750	43,000	86,000
	Total	26,250	105,000	210,000

For each of the performance periods shown above, awards will be based on total shareholder return relative to a peer group of gas distribution companies over the three-year performance period and on performance results relative to the Company's core and non-core strategies. For awards granted prior to Jan. 1, 2006, the Company recognizes compensation expense and liability for the LTIP awards based on performance levels achieved, and expected to be achieved, and the estimated market value of the common stock as of the distribution date. For awards granted on or after Jan. 1, 2006, the Company recognizes compensation expense in accordance with SFAS No. 123R, based on performance levels achieved and an estimated fair value using a lattice valuation model. For the quarter ended March 31, 2006, the amount accrued and expensed as compensation under the three LTIP grants was negligible. On a cumulative basis, \$0.7 million, \$0.6 million and a negligible amount have been accrued for the 2004-06, 2005-07 and 2006-08 performance periods, respectively.

Restricted Stock Awards. Restricted stock awards also have been granted under the LTIP. A restricted stock award consisting of 5,000 shares was granted in 2004, which will vest ratably over the period 2005-09.

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Restated Stock Option Plan. The Company has reserved a total of 2,400,000 shares of Common Stock for issuance under the Restated SOP. At March 31, 2006 options on 1,132,600 shares were available for grant and options to purchase 393,700 shares were outstanding at March 31, 2006. Options are granted with an exercise price equal to the market value of the common stock at the date of grant, have 10-year terms and vest ratably over a three or four-year period following the date of grant. Shares issued under the Restated SOP upon the exercise of stock options are original issue shares. The fair value of the Company's stock-based awards were estimated as of the date of grant using the Black-Scholes option pricing model based on the following weighted-average assumptions:

	2006	2005
Risk-free interest rate	4.5%	4.2%
Expected life (in years)	6.2	7.0
Expected market price volatility factor	22.8%	24.6%
Expected dividend yield	4.0%	3.6%

The simplified formula for plain vanilla options was utilized to determine the expected life as defined and permitted by Staff Accounting Bulletin No. 107. The risk-free interest rate was based on the implied yield currently available on U.S. Treasury zero-coupon issues with a life equal to the expected life of the options. Historical data was employed in order to estimate the volatility factor, measured on a daily basis, for a period equal to the duration of the expected life of the option awards. The dividend yield was based on management's current estimate for dividend payout at the time of grant. A forfeiture rate of 3 percent was applied to the calculation of compensation expense.

The following table presents the effect on net income and earnings per share for outstanding stock options and stock awards prior to the adoption of SFAS No. 123R for the quarter ended March 31, 2005 in addition to the impact on reported earnings in the quarter ended March 31, 2006:

	Three Months Ended	
	2006	2005
Pro Forma Effect of Stock-Based Options and ESPP:		
Thousands, except per share amounts		
Net income as reported	\$ 41,033	\$ 39,887
Add: Actual stock-based compensation expense included in reported net income under SFAS No. 123R, net of related tax effects	193	
Deduct: Pro forma stock-based compensation expense determined under the fair value based method, net of related tax effects	(193)	(92)

Pro forma earnings applicable to common stock - basic