

**BEFORE THE PUBLIC UTILITY COMMISSION**

**OF OREGON**

**UM 1282**

In the Matter of )  
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 )  
THE PUBLIC UTILITY COMMISSION )  
OF OREGON, )  
 )  
Investigation pursuant to ORS 757.210 and )  
ORS 757.215 to examine Avista Corp., dba )  
Avista Utilities' gas purchasing strategy. )  
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**RESPONSE TESTIMONY**  
**OF THE**  
**CITIZENS' UTILITY BOARD OF OREGON**

March 16, 2007



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1 My name is Lowrey Brown, and my qualifications are listed in CUB Exhibit 101.

2 **I. Introduction**

3 On February 9, 2007, Staff, Avista, and the Northwest Industrial Gas Users (the  
4 Signing Parties) entered into a stipulation purporting to resolve the imprudence of  
5 Avista's gas purchasing strategy for Oregon for the 2006-2007 gas year. CUB did not  
6 sign the stipulation, because we are concerned about the stipulation's change to Avista's  
7 PGA mechanism for the 2007-2008 gas year. The proposed stipulation includes a  
8 provision altering Avista's PGA mechanism to pass 100% of the cost of fixed-price  
9 hedges made after the Company's August 31<sup>st</sup> PGA filing to customers. Currently, any  
10 difference between the Company's gas commodity cost established in the August PGA  
11 filing and the Company's actual cost is shared between customers and the Company 90%  
12 and 10% respectively.

1           We question the appropriateness of altering Avista's PGA mechanism in a  
2 prudence docket, and the wisdom of making piecemeal modifications to a complex  
3 mechanism such as the PGA without consideration for the mechanism as a whole; such a  
4 modification seems particularly ill-timed given that a docket is currently open to examine  
5 the PGA mechanism, UM 1286. This PGA modification is CUB's only objection to the  
6 filed stipulation.

7           This docket was opened to examine imprudence. However, Staff's memo of  
8 October 18, 2006 lays out the case for imprudence quite clearly and the Company signed  
9 a stipulation resolving the issue of imprudence, so we do not find it necessary to examine  
10 that issue in this testimony. Here, we examine only the issue of concern to CUB: the  
11 modification of Avista's PGA mechanism for 2007-2008. Without this modification, the  
12 stipulation would be a reasonable resolution of the original issues in this docket. We  
13 recommend that the Commission reject the stipulation, indicate that the terms of the  
14 stipulation without the provision modifying Avista's PGA mechanism for the 2007-2008  
15 gas year are an acceptable resolution of the prudence issue, and direct the parties to  
16 consider the PGA mechanism in the current PGA docket, UM 1286.

## 17 **II. Is PGA Modification An Appropriate Prudence Resolution?**

18           Is a modification to Avista's PGA mechanism an appropriate remedy for  
19 resolving an issue of imprudence? The mechanism, after all, is not responsible for the  
20 Company's actions, and no one has suggested that a utility has carte blanche to act  
21 imprudently until regulators design the perfect mechanism. It is the Company's actions,  
22 and not its regulatory structure that is at issue in a prudence docket. This then begs the  
23 question of what an appropriate imprudence remedy would be.

1           The stipulation offers two remedies in addition to a mechanistic PGA  
2 modification. The first is a rate credit to customers to compensate them for the financial  
3 impact of the Company's imprudence. The second is a discussion of Avista's proposed  
4 gas purchasing strategy for the 2007-2008 gas year and of the documentation the  
5 Company plans to use to explain its actions and choices to Staff and interested parties.  
6 Both of these remedies are appropriate, as both relate to the prudence issue at hand. The  
7 rate credit compensates customers for the 2006-2007 imprudence, and the discussion of  
8 the Company's gas purchasing strategy and planned documentation aims to avoid any  
9 prudence questions for 2007-2008.

### 10 **III. Is A Prudence Docket An Appropriate Place To Modify A PGA?**

11           In May of 1998, Staff's public meeting memo recommended that the Commission  
12 open an investigation into the policy issues and procedures associated with the gas  
13 utilities' recovery of purchased gas costs. A year later the Commission issued a 22-page  
14 order in that docket, UM 903, updating PGA procedures and standards. During that year,  
15 the parties conducted discovery, submitted direct and rebuttal testimony, signed  
16 stipulations, held a hearing, and filed briefs.

17           A number of parties put a considerable amount of time and effort into debating  
18 the appropriate design of the PGA mechanism. It concerns us that the modification to  
19 Avista's PGA mechanism is being proposed without noticing the parties originally  
20 involved in UM 903, and without exploring the PGA mechanism as a unified whole. In  
21 the informal PGA discussions that took place before UM 1286 was opened, NWIGU  
22 expressed a similar concern about the possible pitfalls of casual PGA modifications.  
23 "Given the difficult markets that all end-users face in the coming years, we start from a

1 premise of moving carefully with PGA refinements.”<sup>1</sup> A 100% pass-through of certain  
2 gas commodity costs is not a small change in practice, and should not be made without  
3 thoughtful deliberation.

#### 4 **IV. Signing Parties Provide No Evidence Supporting PGA Modification**

5 Staff’s original imprudence concern relates to both the amount, as well as the  
6 timing, of Avista’s use of hedges. In Staff’s October Memo, Staff demonstrates that  
7 Avista imprudently hedged too much and too soon,<sup>2</sup> because it didn’t want to risk price  
8 increases in the period after its PGA filing when the Company is subject to a sharing  
9 mechanism.<sup>3</sup>

10 The Signing Parties’ proposed PGA modification is intended to encourage Avista  
11 to leave more of the natural gas it purchases for Oregon customers un-hedged at the time  
12 of its PGA filing. The proposed modification is intended to do this by removing the  
13 Company’s sharing incentive for fixed-price hedges, and shifting all risk of post-PGA  
14 price increases captured by fixed-price hedges to customers. However, the Signing  
15 Parties have given no reason that this proposed PGA modification is either necessary or a  
16 good idea in this case, stating only that:

17 The Signing Parties felt that it made sense to extend the hedging period  
18 beyond the 2007 PGA filing date; however, under Avista’s present  
19 mechanism, the Company would be at risk for 10% of the difference in the  
20 actual cost of those hedges compared to the projected cost reflected in the  
21 PGA filing.

22 UM 1282 Stipulating Parties/100/Zimmerman-Thackston-Pyron/6.

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<sup>1</sup> NWIGU Comments on 4/7/2006 Draft for OR PGA Mechanism Changes, p. 2, April 26, 2006.

<sup>2</sup> Staff Memo to the Public Utility Commission, October 18, 2006, p. 10-11.

<sup>3</sup> *Id.* 8, 10, and 15.

1           The argument that Avista’s PGA mechanism should be changed to save the  
2 Company exposure to 10% of the cost difference between the actual cost of hedges and  
3 that projected in its PGA filing is unconvincing. The current PGA sharing of  
4 commodity-related cost differences was established as an incentive mechanism, so that  
5 the Company would share some risk with customers for its gas procurement on behalf of  
6 customers.

7           By Order No. 89-1046, entered August 4, 1989, the Commission  
8 established an 80-20 (customer-LDC) incentive sharing mechanism for  
9 commodity-related cost differences.

10          UM 903 OPUC Order No. 99-272, p.2, footnote 1.

11          Staff continues to recognize the purpose of using sharing as an incentive to help  
12 align the Company’s interests with those of its customers.

13          The sharing percentage component of the PGA mechanism is not meant to  
14 provide an incentive to hedge more, but rather to have the LDCs have a  
15 stake in doing the best job in purchasing natural gas during the PGA year.

16          Staff Memo to the Public Utility Commission, October 18, 2006, p. 15.

17          This brings us back to the question of whether the proposed PGA modification –  
18 removal of the sharing incentive for fixed-price hedges – addresses the parties’ concern  
19 about Avista’s over-hedging. Will passing all risk of fixed-price hedges after the PGA  
20 filing to customers solve the imprudence concern of over-hedging before the PGA filing?

21          The Signing Parties “felt that it made sense” to make the proposed PGA  
22 mechanism change in order to remove the incentive to hedge imprudently, but the  
23 proposed change removes the incentive to hedge prudently. Also, the Company  
24 prematurely over-hedged its Oregon portfolio in order to protect its shareholders from the  
25 risk of increased commodity cost, not to protect its shareholders from the risk of  
26 increased commodity cost associated only with hedges. As the Company’s imprudence

1 resulted from a desire to avoid risk, the Signing Parties' rationale that shifting the risk  
2 balance of fixed-price hedges from the Company to the customers to promote prudent  
3 behavior would suggest that shifting all risk of commodity cost increases to customers  
4 would remove all incentive for imprudence.

5           However, if there is no risk of increased costs or possibility of reward from cost  
6 savings, the Company's only incentive to actively and aggressively negotiate a reliable,  
7 low-cost gas supply for customers is fear of a prudence review. However, the threat of a  
8 prudence review already exists. Under the proposed PGA modification, Avista would  
9 have the threat of a prudence review – which it currently has today – but would not have  
10 the risk and reward incentive provided by the sharing mechanism, at least not as it would  
11 apply to fixed-price hedges. So, the threat of a prudence review would be the same  
12 whether or not fixed-price hedges are subject to Avista's sharing mechanism, but the  
13 Company's incentive to make the most of them would be removed.

14           There is an additional ironic twist to the proposed PGA modification. The  
15 proposed modification rewards Avista for imprudent actions the Company took in order  
16 to avoid risk, by altering the Company's PGA mechanism to shift risk from the Company  
17 to customers. Put another way, because the Company acted imprudently to avoid risk for  
18 its shareholders, it is being rewarded with a mechanism that shifts its risk to the customer.

19           The current PGA docket has not yet addressed the issue of the PGA mechanism  
20 itself, and we expect that all the parties will have ideas and analysis to share. In this  
21 prudence review docket, the Signing Parties fail to provide any reasonable justification  
22 for modification of Avista's PGA mechanism in their testimony, and should they provide  
23 another rationale in their rebuttal, we will not have a chance to respond to it in testimony.

1 **V. Implications Of The Proposed PGA Modification**

2 It is important to first point out that this docket does not examine the PGA  
3 mechanism as a whole or the proposed PGA modification within that whole. Therefore,  
4 the potential impacts and incentives provided by the proposed modification have not been  
5 explored, and neither CUB nor the Signing Parties have put time or resources into  
6 analyzing the possible results of the proposed PGA modification. We aren't sure whether  
7 the proposed modification is an improvement or not, but therein lies the problem with the  
8 proposed PGA modification. The proposed modification has not been vetted in this  
9 docket; exploration of the PGA mechanism is supposed to take place in the PGA review,  
10 UM 1286.

11 **A. Viewing The World Through Hedge-Colored Glasses**

12 As mentioned earlier, the PGA modification in the proposed stipulation has not  
13 been explored for its possible consequences. The proposed stipulation would allow  
14 Avista to pass through 100% of the cost of fixed-price hedges signed after its August  
15 PGA filing, while cost differences from other gas transactions post-PGA would be shared  
16 90/10 with customers. What incentive might this change provide? Suddenly, after its  
17 PGA filing, Avista would be able to play different procurement options against one  
18 another for the protection or benefit of its shareholders.

19 If, after its August PGA filing, the Company were to predict a \$1 price increase,  
20 the Company could hedge that potential increase for something greater than \$1 and pass  
21 100% of that increase to customers. From Avista's vantage point, that would be  
22 preferable than simply paying the \$1 increase, because then the Company would have to  
23 share 10% of that cost increase with customers.



1           If, on the other hand, gas prices were to drop, the Company's incentive would be  
2 to take no action, as it would keep 10% of that price decrease, absent a hedge. If the  
3 Company were to hedge those lower prices, it would get no benefit under the proposed  
4 PGA mechanism change. Under such a circumstance, it might be better for the Company  
5 to gamble that the lower prices will not rise, waiting to hedge them only when they reach  
6 the cost established in the August PGA filing.

7           This suggests that customers would lose the up-side reward of fixed-price hedges  
8 for lower gas prices, and take on the down-side risk of fixed-price hedges for higher gas  
9 prices. What is the policy choice behind this PGA mechanism modification? What will  
10 the likely results of such a mechanistic change be? While no one can see the future, it is  
11 important to at least attempt to answer these questions before implementing a change to  
12 any regulatory mechanism. Again, a prudence review is not the place to do this, and the  
13 record in this case addresses none of these questions.

#### 14 **B. Shifting The Balance Of Risk**

15           CUB is also concerned that the proposed PGA modification has been tacked onto  
16 Avista's PGA mechanism without consideration for the balance of risk and reward that  
17 was originally established in the Commission's Order in UM 903, Order No. 99-272.

18           The primary issues for review include the appropriate structure of the risk-  
19 reward sharing incentive mechanism for gas cost differences and the role  
20 and structure of earnings reviews. These issues, and the determination of  
21 whether changes should be made to current practices, represent significant  
22 policy matters relating to the local distribution companies' (LDCs)  
23 recovery of purchased gas costs.

24           UM 903 OPUC Order No. 99-272, p. 1.

25           The Signing Parties' proposed mechanistic modification to Avista's PGA  
26 mechanism changes the Company's risks and rewards for the 2007-2008 gas year. The

1 Company can shift risk and cost it otherwise would have borne onto customers, and reap  
2 rewards it otherwise would have shared with customers though its use of fixed-price  
3 hedges, as opposed to other procurement options. After the Company's August PGA  
4 filing, 100% of fixed-price hedge costs will be passed to customers, but only 90% of  
5 other gas commodity costs will be passed to customers. The proposed stipulation and  
6 accompanying testimony do not address this shift in risk, or how having different sharing  
7 percentages applied to hedges as opposed to other procurement options will affect  
8 incentives and, ultimately, behavior.

9 The Commission has recently devoted a significant amount of time to considering  
10 the balance of risk and reward between customers and a utility. Much of this debate took  
11 place in reference to electric utilities, which, though different than gas utilities in many  
12 respects, share the same basic push-and-pull between investors and customers. For  
13 purposes of comparison, after PGE's final RVM filing that establishes PGE's base net  
14 variable power cost, the Company is subject to a power cost deadband from 75 basis  
15 points of return on equity below the level included in rates to 150 basis points above.<sup>4</sup>  
16 Only outside of that deadband does PGE share power cost variations with customers. In  
17 addition PGE is subject to an earnings deadband of 100 basis points of return on equity.<sup>5</sup>  
18 In its Order in PGE's rate case, UE 180, the Commission is quite clear that there is a level  
19 of variable power cost risk that a utility should be subject to.

20 We conclude that a [power cost adjustment mechanism] should be adopted  
21 to capture power cost variations that exceed those considered part of  
22 normal business risk.

23 UE 180 OPUC Order No. 07-015, p. 26.

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<sup>4</sup> UE 180 OPUC Order No. 07-015, p. 26.

<sup>5</sup> *Ibid.*

1 [Regarding UM 995] We allowed no recovery of costs or refunds to  
2 customers within that deadband, reasoning that the band represented risks  
3 assumed, or rewards gained, in the course of the utility business.

4 UM 1071 OPUC Order No. 04-108, p. 9.

5 There has been a great deal of discussion in regulatory settings about normal  
6 business risk as it relates to electric utilities, and we expect that discussion as it relates to  
7 gas utilities will take place in UM 1286. In regard to this docket, however, an alteration  
8 to Avista's PGA mechanism that further shifts risk from shareholders to customers is ill-  
9 advised both because the specific implications of the change have not been explored, and  
10 also because the parties have not had a chance to examine the fundamental risk and  
11 reward policy basis for the change.

## 12 **VI. Conclusion**

13 The proposed stipulation's modification to Avista's PGA mechanism for the  
14 2007-2008 gas year is not appropriate, because:

- 15 • This docket addresses imprudence, not regulatory mechanisms;
- 16 • Other parties with an interest in how PGA mechanisms are designed have not  
17 been invited to participate;
- 18 • The implications and incentives of the proposed PGA modification have not  
19 been explored; and
- 20 • The PGA mechanism as a whole has not been considered.

21 We recommend that the Commission:

- 22 • Reject the proposed stipulation, as filed;
- 23 • Indicate that the proposed stipulation without the proposed PGA modification  
24 would be an acceptable resolution to the prudence issue in this docket; and
- 25 • Encourage the parties to examine the PGA mechanism in UM 1286.

## WITNESS QUALIFICATION STATEMENT

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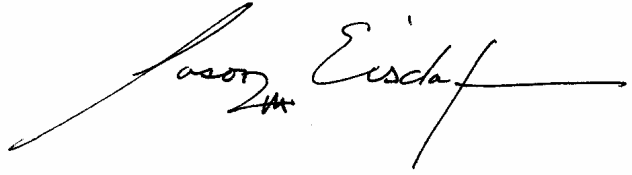
**EXPERIENCE** Provided comments and participated in settlement discussions in OPUC dockets AR 495, UE 161, UE 173, UM 1014, UM 1147, UM 1158, UM 1169, UM 1206, and UM 1209. Presented testimony and engaged in settlement proceedings in UE 165, UE 167, UE 170, UE 179, UE 180, UM 1121, UM 1187, and UM 1271. Participated in technical subcommittees for the Governor's Advisory Group on Global Warming, and in the Regional Representatives Group for Grid West. Currently involved in the development of PacifiCorp's and PGE's integrated resource plan.

Prior to this, worked as a consultant with KEMA-Xenergy in Portland from 2002 to 2003 on energy and energy efficiency issues. Between 1997 and 2001, freelanced in Colorado for The Valley Journal, Solar Energy International, Energy Systems Engineering, and Resource Engineering providing writing and technical assistance.

**CERTIFICATE OF SERVICE**

I hereby certify that on this 15<sup>th</sup> day of March, 2007, I served the foregoing Response Testimony of the Citizens' Utility Board of Oregon in docket UM 1282 upon each party listed below, by email and, where paper service is not waived, by U.S. mail, postage prepaid, and upon the Commission by email and by sending 6 copies by U.S. mail, postage prepaid, to the Commission's Salem offices.

Respectfully submitted,



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**W=Waive Paper service, C=Confidential, HC=Highly Confidential**

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