**BEFORE THE PUBLIC UTILITY COMMISSION**

**OF OREGON**

**UM 1286**

In the Matter of

THE PUBLIC UTILITY COMMISSION OF OREGON,

Investigation into the Purchased Gas Adjustment (PGA) Mechanism Used by Oregon's Three Local Distribution Companies.

REPLY COMMENTS

OF THE

CITIZENS' UTILITY BOARD OF OREGON

January 28, 2007

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## I. Introduction

From the first round of comments, it seems that most parties feel that the basic PGA structure has worked well, but that the natural gas market has changed to an extent that warrants revising the design of the mechanism. Staff, Avista, and Cascade propose moving to a 100% pass-through mechanism, and Staff would layer its proposed incentive mechanisms on top of this basic structure. NW Natural proposes only shifting its current 67%-33% sharing percentages to 80%-20% sharing, and CUB proposes a deadband with 90%-10% sharing. In these Comments, we further develop the rationale for our proposed changes, and, in particular, explain why a deadband makes sense for the gas utilities' annual purchased gas adjustments (PGA). We also describe the incentives provided by a deadband, and how these incentives then balance with a greater share of gas cost excursions being borne by customers.

## II. Principles

In our Opening Comments, we discuss the current purchased gas adjustment mechanism (PGA) in Oregon and the weakness we see in it, and we propose a modification to the mechanism to address this weakness. In response to other parties' Opening Comments, we structure these Reply Comments around the following principles that we consider essential to a regulatory mechanism such as the PGA:

- Aligned Incentives
- Appropriate Allocation & Distribution of Risk
- Transparency & Ease of Administration
- Long-Term Operation

Though no party is likely to disagree with these principles, parties will, most certainly, differ on how best to achieve them.

## III. CUB's Proposal

The following is the risk-reward sharing mechanism we propose in our Opening Comments for all three Oregon utilities. This risk-reward sharing would apply to the difference between gas commodity costs forecast in the utilities' Fall PGA filing and actual gas costs:

| | |
|---|---|
| Earnings Deadband | ±100 basis points ROE |
| Gas Cost Deadband | -75 to +150 basis points ROE for gas utilities not subject to SB 408<br>-45 to + 90 basis points ROE for gas utilities subject to SB 408 |
| Gas Cost Sharing | 90-10 (customer-utility) |

A number of parties brought up the issue of the price used to establish gas costs in the PGA filing. Currently, there is no set formula, different utilities establish the price used in their individual PGA mechanisms differently, and there is some disagreement as to how this should be done. This is a factor that has a significant impact on rates, and we think it should not be developed as informally as it has been in the past. We do not have a proposal in these Comments for establishing the forward price curve to be used in the PGA filings, but we do think it should be, to the extent possible, based on publicly-available information and calculated the same way for all utilities (or with modifications as appropriate). We recommend that the parties work together to establish one or more proposals for how the price curves should be established, and that the Commission should establish the methodology as part of the PGA mechanism.

## IV. Aligned Incentives

CUB's proposal, NW Natural's proposal, Staff's proposal, NWIGU's recommendations, and the current PGA mechanisms are all based on a fundamental assumption that the utilities can, and do, manage their gas portfolios. This fundamental assumption is also necessary in order to implement an incentive mechanism, as no incentive would be possible if there were nothing a utility could do in response. Avista and Cascade paint a picture of themselves as utterly helpless in the face of today's natural gas market, but we know this is not the case. The first two of the following quotes are from Avista's comments, and the third is from Cascade's.

> Sharing or incentive mechanisms should only be employed where the LDC can affect the outcome through the application of its knowledge, experience and tools available.[1]
>
> The Company's preferred option would be 100% pass through of *prudently* incurred gas costs with no incentive/sharing mechanism …[2]
>
> [I]t simply requires LDCs to absorb a portion of the increased gas costs which are outside its control, regardless of the accuracy of the LDC's forecast or the prudency of its purchasing practices.[3]

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[1] UM 1286 Avista Comments at 2.
[2] *Id.* at 5, emphasis original.

There are a number of problems with Avista's and Cascade's claims. First, if a gas utility had no ability to manage its gas portfolio, then its staff of gas professionals should be fired and replaced with a well-programmed computer. We do NOT recommend this. Second, how could gas costs be prudently or imprudently incurred when the utility has no control over them? We do not consider an unexpected increase in load to be prudent or imprudent, but we certainly examine the prudence of the utility's response to, and management of, that increase. Third, the prudence review of Avista's hedging practices in UM 1282 demonstrates that Staff found the Company's choices to be imprudent, which can only mean that Staff believes the Company could have made other choices.

Finally, there is ample evidence of gas utilities changing their strategies to respond to market conditions, and taking advantage of different tools to manage their gas portfolios on behalf of customers. NW Natural describes one of its decisions in the face of changing market trends:

> Then, in 2006, because of the leveling out of prices and despite rapidly fluctuating market prices, NW Natural reduced its hedging level to approximately 75% to better match the company's portfolio to current market conditions.[4]

This is exactly what customers want and expect of the utilities, an engaged and experienced staff of gas professionals whose portfolio management has a direct impact on both customers and the company's shareholders. CUB's interest in highly-qualified gas professionals representing customers and shareholders to the same end is a value also expressed in NWIGU's and NW Natural's Comments.[5] Gas utilities can, and do, actively

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[3] UM 1286 Cascade Opening Comments at 2.
[4] UM 1286 NW Natural Opening Comments at 13.
[5] UM 1286 NWIGU Initial Comments at 3. NW Natural Opening Comments at 22.

manage their supply portfolios and maintain a team of experts whose job it is to procure gas in a manner that, to the extent possible, balances the goals of least-cost and least-risk.

## V. Appropriate Allocation & Distribution of Risk

We use "allocation" in the sense of who-gets-how-much, and we use "distribution" in the sense of where, for a given party, the risk is located. For example, in our Opening Comments, we recommend that the Commission require gas utilities to take the normal business risk of gas cost fluctuations in exchange for customers taking the lion's share of the risk of large gas price excursions. The upshot of CUB's recommendation would be that gas utilities would bear more risk for normal gas price volatility, while customers would bear more of the risk of gas price spikes. Our goal was not to reallocate risk, but to redistribute it.

### A. Current Risk Allocation

The gas utilities unanimously claim that they are bearing too much risk, and that some of that risk (in some cases, almost all of the risk) should be passed to customers.[6] Not surprisingly, we disagree. In our Opening Comments, we use NW Natural's stellar credit ratings to indicate the perceived risk in the marketplace of Oregon's gas cost recovery structure.[7] We look at NW Natural in particular, as it supplies only natural gas and serves primarily Oregon customers. The Company claims that "the level of risk presented is unacceptable to NW Natural's shareholders."[8] It is difficult to understand how NW Natural's credit ratings can be so strong, when it is exposed to such an "unacceptable" level of risk.

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[6] UM 1286 NW Natural Opening Comments at 2. Cascade Opening Comments at 1-2. Avista Comments at 2.
[7] UM 1286 CUB Opening Comments at 7.
[8] UM 1286 NW Natural Opening Comments at 21.

That being said, all parties appear to agree that the natural gas market has changed over the last decade, and that prices have generally risen while price volatility has increased significantly, which is highlighted by a few dramatic price spikes.[9] There have been other changes as well; with increasing prices and volatility have come additional financial instruments, such as hedging, with which a utility can manage the cost of gas, and gas storage continues to be developed as a means of managing gas supply. Additional regulatory mechanisms, such as weather normalization and conservation tariffs, have also been developed to mitigate risk.

Over time, a number of risk factors have changed, and the world in which gas utilities and their customers operate has changed. Each change has brought with it different impacts on the allocation and distribution of risk for shareholders and customers, and we are not convinced that the allocation of risk between shareholders and customers has changed dramatically. As we discuss in our Opening Comments, we think there is a better distribution of risk that could be employed for the PGA mechanisms, but, especially in light of NW Natural's credit rating, it is hard to swallow the idea that Oregon's current regulatory structure is exposing gas utilities to "unacceptable" levels of risk.

Both NW Natural and Cascade present numerical examples to demonstrate the level of risk, which they view as excessive, that the current mechanism exposes them to.[10] NW Natural's example shows how a $40 million cost difference would be shared between customers and the Company. First, we point out that CUB's proposed mechanism would protect the Company under this circumstance better than the

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[9] UM 1286 Staff Opening Comments at 3, Figure 1.
[10] UM 1286 Cascade Opening Comments at 4. NW Natural Opening Comments at 20.

Company's current PGA mechanism would.[11] Second, the larger the gas cost variation, the more CUB's proposed mechanism would protect the utility.

### B. Current Risk Distribution

The current Oregon PGA risk distribution is linear for gas price variations after rates have been set. For each dollar of variation, part of that dollar is refunded or surcharged. This is the case for the first $1 in variation, it is true for the 100th and 1,000,000th dollars, and so on. As the gas utilities have pointed out, the risk of extreme cost increases is real.

> [R]educed hedging also increased the risk of large profits or losses …[12]
>
> This "soft collar" mechanism was intended to protect the shareholders from unusually high losses that could arise under a volatile market …[13]

On the other hand, as we have pointed out, a utility is paid a rate of return for its risk in running the business for customers, and refunding or surcharging part of the first $1 of power cost volatility is absurd for a utility with natural gas procurement experts whose profession it is to manage gas costs.

### C. CUB's Proposed Shift In Risk Distribution

CUB's proposed PGA mechanism addresses both of these points. CUB's mechanism would put more of the risks and rewards of normal gas cost variation onto the utility, but, in exchange, would put almost the entirety of wider gas cost variation onto customers. As described in our Opening Comments, this makes sense.[14] The utility has a staff of professionals who do nothing but manage the company's gas portfolio. This is

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[11] UM 1286 NW Natural Opening Comments at 20: $40 million split 67%-33% is $27 M customers & $13 M shareholders. CUB's proposal, assuming 90 basis points is approximately $7.2 M, would split $40 million into $30 M for customers and $10 for shareholders.
[12] NW Natural Opening Comments at 13.
[13] *Id.* at 14.
[14] UM 1286 CUB Opening Comments at 13-15.

their job, and customers are in no position to do it for them. As with any business, there is a normal variability of risks and rewards which are a part of being in the industry, and a prudently-managed utility should have the financial cushion to absorb these fluctuations.

On the other hand, utilities provide an important service, and, unlike other businesses, it is in the best interest of customers and society that our utilities not only be in business, but that they also be able to serve their customers safely and reliably. Additionally, in aggregate, customers have financially deeper pockets, and are better able to absorb gas price excursions that could otherwise seriously damage a utility. As described by NW Natural, "customers have a far greater capacity to absorb extraordinary losses because they are spread over a much larger group [than shareholders]."[15]

The intent of CUB's proposed PGA mechanism is to shift the distribution of risk within the PGA, such that utilities bear more of the risk of normal cost variation, while customers bear most of the risk of wide cost swings. This makes financial sense, because utilities are responsible for managing the cost of gas, and should be financially able to handle normal business variation. From the other side of the coin, even a seasoned gas professional would be hard-pressed to do much with a gas price spike such as the one that occurred in 2001, and the cost of such an excursion is likely beyond what a utility could absorb. In such a situation, it only makes sense for customers to step in and take the burden.

[15] NW Natural Advice No. OPUC 07-6 NWN/100/Miller/3.

### *i. A Deadband Is A Time-Tested Regulatory Tool*

There appears to be some confusion among the parties about the purpose of, and the incentives provided by, a deadband for gas commodity costs incurred after the PGA filing.

> To hold the LDC responsible for the cost of gas, or to suggest that variations in the cost of gas are a part of the business risk an LDC is expected to absorb, would turn the traditional regulation of the LDC on its head.

UM 1286 NW Natural Opening Comments at 23.

> A dead-band with a gas utility turns [the concept of financial incentives] on its head …

UM 1286 NWIGU Opening Comments at 7.

We realize that a deadband, while commonly used for electric utilities, is a new regulatory tool for the gas utilities' PGA mechanisms in Oregon. That being said, we don't think that acrobatics are required to apply this relatively basic and time-tested regulatory tool to the variation in gas commodity costs after the utilities' PGA filings. A deadband around gas commodity costs would simply serve to account for the expected, normal variation in gas prices that results in a utility over- or under-collecting its gas costs from customers. It is not unreasonable for these variations to be considered a part of a gas utility's ordinary business risk. Some parties point to the differences between electric and gas utilities in their Comments, and point to this as a reason gas utilities should not be subject to a commodity deadband.[16]

In our Opening Comments we, too, differentiate between electric and gas utilities, and adjust our proposed deadband for a gas utility's PGA accordingly.[17] The fundamental theory of normal business risk, however, applies to both electric and gas

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[16] UM 1286 NW Natural Opening Comments at 23. NWIGU Initial Comments at 6-7.
[17] UM 1286 CUB Opening Comments at 10.

utilities, and we see no reason that normal gas cost variations should not be considered part of a utility's normal business risk. Refunding or surcharging a portion of the very first $1 of gas cost variation does not place the responsibility for managing normal gas cost fluctuations with the party that manages gas costs, the utility.

***ii. The Incentives Provided By A Deadband & Sharing***

Before describing the incentive balance provided by a deadband and sharing, we point out that, no matter what the mechanism, there will always be tradeoffs, the incentives will not be perfect, and there will always be a need for prudence reviews. The timing of the current PGA filing, in itself, shifts a utility's incentive from one recovery structure, pre-filing recovery, to another recovery structure, that of the sharing mechanism. Staff has pointed out, as have other parties, that gas utilities, in order to avoid risk, have an incentive to lock-in as much of their supply as possible before the PGA filing deadline. Yes, this has been a problem, but it is not a problem that would be solved by removing the cost-sharing incentive entirely. As described by NW Natural:

> [T]he 100% pass-through PGA would motivate the LDC not to pursue cost savings for customers, but rather to avoid prudence review disallowances. In turn the LDC would be encouraged to spend more resources ensuring that its gas purchasing strategies were considered prudent by Staff than in taking reasonable risks that might benefit customers.[18]

In proposing the PGA structure that we have, we aim to put the strongest incentive where the utility has the most ability to affect the outcome, and a much smaller incentive where a utility is less able to affect the outcome. Thus, a deadband puts the strongest incentive to manage post-PGA filing gas costs, within a reasonable range, on the utility. The rationale for this choice is that it is the utility who manages its gas supply

[18] UM 1286 NW Natural Opening Comments at 22.

on a day-to-day basis, it is the utility who has a staff of professionals who monitor and manage that supply, and it is the utility who should bear the responsibility for this normal business variability. Any gas cost variability that occurs post-PGA filing and falls within the deadband would be the utility's responsibility, and any risks taken and rewards gained would likewise stay with the utility. Under such a structure, the utility would care A LOT about those costs and would be entirely engaged in gas procurement. This is contrary to NWIGU's suggestion that a deadband would somehow remove the utility's incentive to keep its gas costs low.

> From a customer perspective it is NWIGU's concern that gas utilities have no incentive to minimize their costs of gas unless it is part of the express structure imposed in the PGA process … A dead band on a gas LDC does not appear to incite optimum purchasing and planning.[19]

We disagree with NWIGU's assessment. A deadband on gas commodity costs would absolutely "incite optimum purchasing and planning" as it would be the utility who would save or spend based upon their actions. The utility's shareholders would be invested, dollar-for-dollar, on the results of the utility's purchasing and planning operations. Customers would not benefit from cost savings achieved within the deadband, but that is the tradeoff being made in expecting the utility to manage the normal business risk of the gas marketplace. Contrary to NW Natural's assertion, we do not think this would significantly dampen the utility's incentive to seek savings.

> The deadband proposed by CUB would provide management with an incentive to seek gas cost savings beyond the deadband–but only to the extent that savings could be achieved without risk of loss. Thus, the incentive to obtain lower costs for customers would be significantly dampened.[20]

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[19] UM 1286 NWIGU Initial Comments at 6-7.
[20] UM 1286 NW Natural Opening Comments at 23-24.

It is hard to imagine that a gas utility, bearing the responsibility for its gas procurement strategy to the extent of its deadband, would somehow plan to reduce costs by exactly 45 or 75 basis points of return on equity, but no more. NW Natural's suggestion seems a bit contrived. Yes, the incentive certainly changes from the end of the deadband to the beginning of the sharing – for either cost savings or cost control. However, a utility procurement strategy based on where the utility's costs savings would hit the end of the deadband, and then containing a weighting of the risk of losing those savings vs. the benefit of the 10% sharing, would be convoluted at best. This NW Natural criticism of a deadband presumes that a utility knows what its costs will be relative to the deadband at the end of the year before implementing its procurement strategy in the first place.

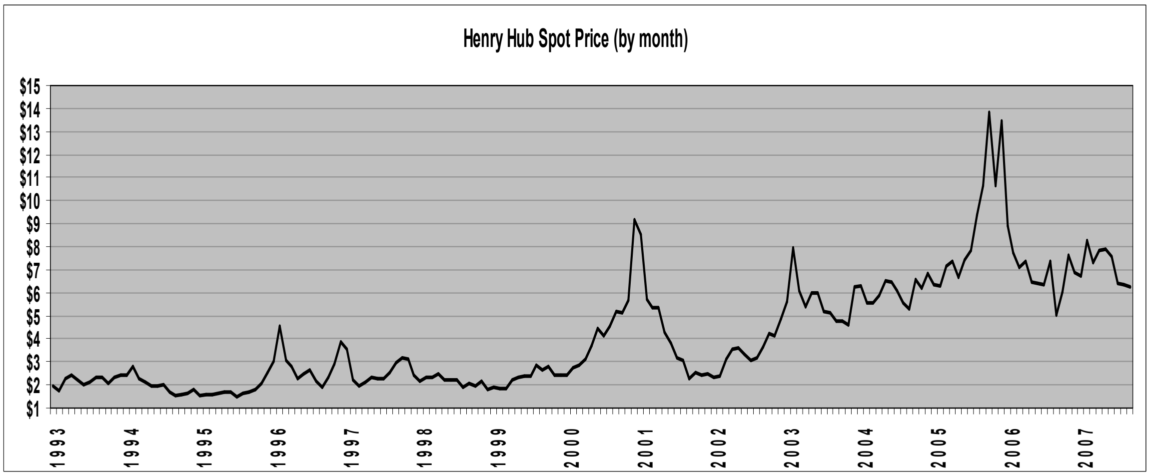
A gas utility that is intimately engaged with its gas procurement strategy, as a utility with a deadband is likely to be, would have a strong incentive to aggressively plan and monitor its gas portfolio. When circumstances are favorable, the utility would enjoy the savings within the deadband and customers would share most, but not all, of the savings beyond. When circumstances get ugly, the utility would bear the costs within the deadband, but customers would bear most, but not all, of the costs beyond. The strongest incentive is applied where the utility has the most control, and the incentive lessens where additional gas cost savings or costs move beyond a normal business range.

***iii. An Asymmetric Deadband Is Necessary For Revenue Neutrality***

There is no expectation that a regulatory forecast will unfold as predicted; this is not the intent of the forecast. The forecast is used to set just and reasonable rates based on an estimate of what costs and revenues are likely to be. It has been a fundamental, though perhaps underlying, assumption that some years a utility will over-collect and that some years it will under-collect, but that those fluctuations will balance out over time. If the magnitude of gas cost variations above and below forecast were equivalent, this would be true whether the sharing were 100%-0%, 50%-50%, or 0%-100%.

However, as Staff's figure in its Opening Comments clearly demonstrates, the magnitude of gas cost variations above and below forecast are anything but equivalent.[21]

**Staff Figure 1: History of US Spot Natural Gas Prices at the Henry Hub, 1993-2007**




Since 1993, there have been five significant spikes in gas prices. All five of them were gas price increases. In comparison, there has been only one discernible, wimpy-but-we'll-take-it downward spike in gas prices, in mid-2006. If the past is any indication, the potential for dramatic price increases dwarfs the potential for dramatic decreases, which, as mentioned in our Opening Comments, are limited by a theoretical floor of zero.[22] No calculation is required to see this in Staff's graph of Henry Hub prices. This asymmetric risk exists in both the electric and gas markets, and the Commission agrees "that an asymmetric deadband is necessary to ensure that [the power cost adjustment] is revenue neutral."[23]

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[21] UM 1286 Staff Opening Comments at 3, Figure 1.
[22] UM 1286 CUB Opening Comments at 15-16.
[23] UE 180 OPUC Order No. 07-015 at 26.

### *iv. Sharing*

As mentioned earlier, our proposal is intended to redistribute risk, not to reallocate it. Though the fluidity of changing circumstances makes a fool's errand out of an attempt to quantify units of risk associated with a deadband, we recognize that, in order to maintain the balance of risk between shareholders and customers, the sharing percentages should be adjusted to account for the addition of a deadband. Though CUB's proposed deadband was based on PGE's, we reduced it considerably to account for the differences between the electric and gas industries. In proposing sharing of 90%-10% (customers-utility), we do not think it necessary to further adjust for the gas industry, and look directly to the Commission's rationale in UE 180:

> [F]or any power costs above or below that range, customers will bear 90 percent of the adjustment, and PGE will bear 10 percent of the adjustment. The 10 percent share for PGE should provide it with an incentive to manage its costs effectively, while sharing costs that are beyond normal business risk.[24]

## D. Earnings Band

The Commission proposed an earnings deadband in a PGE power cost adjustment docket, UE 165.[25] At the time, our primary issue with the Commission's proposal was that we didn't think of it ourselves. An earnings deadband serves two important regulatory functions. First, it prevents the unnecessary volatility of exchanging money back and forth when a utility's earnings are reasonable. Second, an earnings deadband serves as a backstop in case a regulatory mechanism is not working as intended. This is especially important for gas utilities, which tend to file rate cases infrequently. Unlike a gas commodity deadband, the earnings deadband doesn't so much allocate risk, as it does act as a reasonableness check.

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[24] UE 180 OPUC Order No. 07-015 at 27.
[25] UE 165 OPUC Order No. 05-1261 at 9-10.

Though gas utilities have been subject to earnings reviews for some time, the earnings thresholds that must be reached to share earnings with customers have been extremely high and are not consistent across the utilities. Avista's earnings threshold is 200 basis points of return on equity, Cascade's is 215 basis points, and NW Natural's is a whopping 300 basis points.[26] This docket provides an opportunity to integrate the traditional earnings test, via an earnings deadband, more directly into the utilities' PGA mechanisms. It also provides the opportunity to examine the appropriate magnitude of an earnings deadband and establish one that is uniform among the utilities.

We see no reason that the Commission's choice of a ±100 basis point deadband bracketing electricity cost refunds or surcharges should be any different for gas cost refunds or surcharges. The purpose of this threshold is to measure regulatory reasonableness, and a measure that is proportional to an investor's return on equity has nothing to do with the commodity being delivered. It does, however, have a great deal to do with the price customers pay for natural gas, as compared to the costs of procuring it.

By the Commission's measure, both Avista and Cascade's earnings thresholds provide the utilities with generous room for over-earning. NW Natural's earnings threshold of 300 basis points, however, stands out as egregious. In NW Natural's Opening Comments, the Company states: "NW Natural agrees that the 300 basis point threshold adopted by the Commission for NW Natural will guard against application of the PGA to produce excessive earnings for the Company…"[27] That NW Natural enjoys its earnings threshold is quite clear from how it describes its "Excess Earnings Test" in its Form 10-K:

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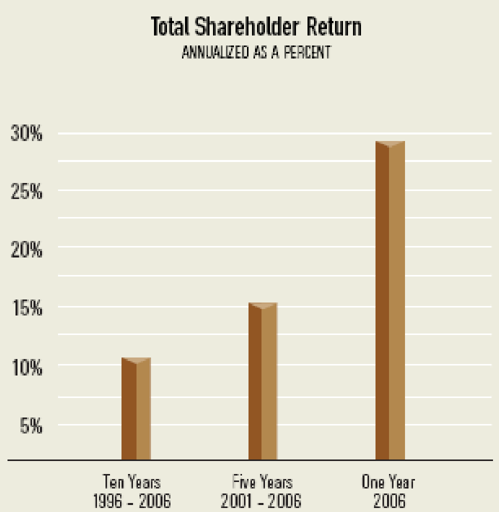
[26] UM 1286 NWIGU Opening Comments at 5.
[27] UM 1286 NW Natural Opening Comments at 19.

No amounts were required to be refunded to customers as a result of the 2005 or 2004 earnings test. We do not expect any amounts to be refunded to customers as a result of the 2006 earnings test …[28]

In NW Natural's 2006 annual report, the Company titles 2006 "An Outstanding Year," and crows that its net operating revenues were "the highest in company history."[29] NW Natural, on the next page, provides shareholders with the following chart:[30]



The company's annualized total return (dividends plus stock appreciation) was 28.91 percent in 2006, 15.42 percent over the past five years, and 10.83 percent over 10 years.

While shareholder return and regulated return on equity are two different things, it does not escape our notice that a regulated gas utility has a 5-year average shareholder return of 15% and a 2006 shareholder return of almost 30%. We take this opportunity to reference CUB's Opening Comments, where we point out that, though Oregon's gas utilities achieve a relatively low city gate price for gas, customer rates do not seem to reflect this.[31]

## VI. Transparency & Ease of Administration

To the extent possible, the manner in which customer rates are established should be transparent and straightforward. In the end, it is the customers who will pay the rates established in the utilities' PGA filings, and they have a right to know the process by which their rates are set. This includes customer access to the information used to set

[28] NW Natural 2006 Form 10-K at 13.
[29] NW Natural 2006 Annual Report at 5.
[30] *Id.* at 6.
[31] UM 1286 CUB Opening Comments at 6.

rates, as well as a rate-setting mechanism that is designed with common regulatory principles.

### A. Transparency: The Public Is Paying The Rates That Result From The PGA

We are concerned by the complexity of Staff's proposed mechanisms, as well as by its reliance on market-sensitive, and thereby confidential, information. Staff's proposed mechanisms involve numerous variables that represent, not regulatory principles, but the structure of the natural gas market. No only do these characteristics serve to distance customers from the mechanisms used to set their rates, they also increase the likelihood that the mechanisms will need to be updated frequently, further disconnecting customers from their annual gas rate changes.

### B. Prudence Reviews Should Not Be First Tier Of Regulatory Oversight

Avista, Cascade, and Staff all propose a 100% pass-through for PGA costs.[32] If the PGA mechanism were to allow a 100% pass-through of post-PGA gas cost variances, then the primary regulatory incentive tool would be the prudence review. We strongly oppose this for a number of reasons. An incentive mechanism based on the risk of a prudence disallowance is far less direct than an incentive mechanism based on the risk of under- or over-recovery of gas costs. As NWIGU points out, as the incentive becomes less direct, the need for regulatory vigilance increases.

> NWIGU believes that any gas recovery structure for 100% pass-through of gas costs must be done with heightened scrutiny …[33]

We are also concerned that using prudence reviews as the first line of regulatory oversight would mean more time-consuming and contentious prudence reviews, less

[32] UM 1286 Avista Comments at 5. Cascade Opening Comments at 1. Staff Opening Comments at 9.
[33] UM 1286 NWIGU Initial Comments at 3.

oversight in the interest of avoiding such proceedings, or both. NW Natural describes our concerns in the Company's Opening Comments.

> By providing the LDC with a natural incentive to maximize the interests of its customers, the Commission need not depend so heavily on time-consuming and adversarial prudence reviews …[34]

> [P]rudence reviews are typically burdensome and often adversarial processes. For this reason, it is unwise to depend upon them as the primary means for the protection of customer interests.[35]

### C. With Complexity Comes Contention & Increased Workload

Our concern about the complexity of Staff's proposal goes beyond the issue of transparency and customer access. We are also concerned that it not only removes the basic risk-reward sharing incentive that customers have relied upon, but that it also creates a web of complexity that would require an enormous number of personnel hours to manage. The incentive mechanisms that Staff proposes to layer on top of its proposed 100% pass-through, involve charts of variables and different weightings with benchmarks for storage and different treatment of hedges as opposed to other procurement options. Each of these variables would need to be established in what would likely be a contentious proceeding, they would need to be examined regularly as market conditions changed, and each utility's proceeding would likely be lengthy and contentious.

### D. Utility Regulation Vs. Utility Management

In addition to its mechanical complexity, Staff's proposal envisions quarterly, if not more frequent, PGA filings.[36] Staff also proposes detailed involvement with each utility in the utilities' gas purchasing strategies.[37] This Commission has not shown any inclination toward such micro-management of utility business, and we strongly support

[34] UM 1286 NW Natural Opening Comments at 6-7.
[35] *Id.* at 22.
[36] UM 1286 Staff Opening Comments at 15.
[37] *Id.* at 8.

that position. We also point out that the time and staff expertise needed for this level of involvement at the Commission, as well as for the utilities and the other intervenors would be enormous, and would increase all the parties' costs – with ratepayers ultimately bearing most of this burden.

### E. Real-Time Pricing

It its Opening Comments, Staff suggests that one of the advantages of its proposal to have quarterly PGA filings would be "providing nearer to 'real-time' pricing signals to customers."[38] This was never a topic in any of the workshops, it has never been a goal of gas price regulation, and there are a number of reasons that we strongly oppose such a strategy. If this is a path the Commission would like to explore, then we, and we presume other parties, would like the opportunity to address it directly.

## VII. Long-Term Operation

The Commission stated that long-term operation was a critical component of a hydro-related power cost adjustment mechanism for PGE.[39] Though a hydro-only PCA and the gas utilities' PGA mechanisms serve different purposes, the rationale the Commission based its criterion upon applies broadly enough to encompass both.

> [W]e believe that a PCA may be an appropriate way of *permanently* allocating the risks and benefits of hydro variability. The first design criterion identified above--that a hydro-related PCA should allow adjustment for conditions that are unusual but not necessarily extraordinary--depends on the mechanism being in effect for an extended period. Furthermore, in order to achieve revenue neutrality, the PCA must be able to operate over the range of varying hydro conditions.[40]

The gas utilities' PGA mechanisms have been in place, in varying forms, for a number of decades. This continuity has, we think, been to everyone's advantage, though

[38] *Id.* at 9.
[39] UE 165 OPUC Order No. 05-1261 at 8 and 10.
[40] *Id.* at 10, emphasis original.

changes have been made over time and are being proposed in this docket. In the interest of establishing an annual PGA mechanism with the best chance of functioning over the long-term without need for adjustment, we recommend a mechanism that uses benchmarks that are proportional within and between utilities. Benchmarks based on the natural gas market – which is mercurial at best – are unlikely to remain appropriate from season to season, let alone over years. We agree with the Commission that revenue neutrality is needed if a mechanism is to stay in place for a long period, and a uniform application of that mechanism to all three gas utilities stands to fairly represent both customers and shareholders over time.

### A. Revenue Neutrality & Thresholds That Follow A Changing Utility

We believe it is in all the parties' interest to have a mechanism that can stay in place over a number of years. By this, we mean not only the structure of the mechanism, but also the thresholds and balances established in the mechanism. There are any number of reasons for this, the primary ones being regulatory stability and the balancing of risks and rewards over time, which is needed to achieve revenue neutrality. There is no way to measure a mechanism's revenue neutrality if its thresholds and sharing percentages change every few years. That being said, whatever thresholds are established in the docket will certainly need to be monitored carefully in the event outcomes are significantly different than expected.

As Staff and the parties' agree, the utilities are operating in a shifting market; therefore, it follows that any benchmark set to market conditions will require regular updating. To this end, we also think it would be wise to avoid setting any benchmarks or thresholds that are based on market conditions, as they would, inherently, need frequent adjustment. This includes benchmarks based on natural gas hubs, storage levels, hedging percentages, *etc*. Not only would such benchmarks increase workload, their frequent fluctuations would also mean that the revenue neutrality of the mechanism could not be monitored over time, as the mechanism itself would be constantly changing.

**B. The Mechanism Should Be Uniform For All The Utilities**

A significant advantage of thresholds based upon a utility's return on equity is that such a threshold would be proportional within a utility, as the utility changed over time, as well as among the utilities, which are themselves different in size and scope. In being proportional between utilities, thresholds based on basis points of return on equity allow for the same mechanism to be used for all three utilities. There is a basic fairness in this both for customers in different service territories and for shareholders of different utilities. Though many parties point to differences between the utilities, we are not convinced that those differences are best addressed in the PGA mechanism.

The primary difference cited, by all parties, is storage.[41] Certainly, storage is an important gas portfolio tool, and one that gives a gas utility an extra buffer when market prices swing. That being said, gas storage capability is very much a part of a utility's integrated resource planning process. As stated by NWIGU:

> Market area storage options are limited in the Pacific Northwest, and infrastructure additions are lumpy and belong in the integrated resource process for potential additions to an LDC's resource mix.[42]

We also point to Avista's recently-filed 2007 Integrated Resource Plan which addresses the Company's current and future storage position. This includes a portion of the Jackson Prairie storage and the Mist storage. Avista has been managing its storage needs by selling and recalling its position in these assets, including a release to BC Hydro

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[41] UM 1286 Staff Opening Comments at 11. NWIGU Initial Comments at 4. NW Natural Opening Comments at 18. Avista Comments at 3. Cascade Opening Comments at 3.
[42] UM 1286 NWIGU Initial Comments at 4.

in 1982, a continuation with Terasen (successor to BC Hydro) in 1996, and a termination of that release in 2006.[43] For future storage needs, Avista has been participating in capacity expansions of Jackson Prairie.

> It was determined that the additional capacity for core utility customers was not needed at that time, and the expansion went under the management of Avista Energy, Avista's non-regulated energy marketing and trading affiliate. In June 2007, Avista Energy sold substantially all of its energy contracts and ongoing operations to Shell Energy North America, (U.S.), L.P. The sale included Avista Energy's contractual rights to Jackson Prairie through April 30, 2011.[44]

We are certainly open to discussions of why a particular PGA mechanism is not appropriate for an individual utility, or how a mechanism should be adjusted for an individual utility's position. However, we are not currently convinced that this is necessary or that the annual PGA mechanism is the best place to address a utility's infrastructure.

## VIII. Conclusion

We continue to propose the PGA mechanism from our Opening Comments, and recommend that the Commission adopt the redistribution of risk that we propose therein.

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|---|---|
| Earnings Deadband | ±100 basis points ROE |
| Gas Cost Deadband | -75 to +150 basis points ROE for gas utilities not subject to SB 408<br>-45 to + 90 basis points ROE for gas utilities subject to SB 408 |
| Gas Cost Sharing | 90-10 (customer-utility) |

Though a deadband is a new tool for the Oregon PGA mechanisms, there is no reason normal gas cost fluctuations within a reasonable range should not be considered part of a utility's normal business risk. In recognition of this shift in risk, we propose that customers take the lion's share of post-PGA gas cost excursions, as such sizeable cost

[43] Avista 2007 Natural Gas Integrated Resource Plan, December 31, 2007 at 5.3.
[44] *Ibid.*

variations are more-easily absorbed by the wide base of customers. We see a long-term advantage in using thresholds calculated with basis points of return on equity, as these stay proportional within a changing utility, as well as between different utilities. For the same reason, we have not been convinced that the same mechanism would not work for all three utilities. Finally, we recommend that the Commission direct the parties to propose a standardized process for establishing the forward price curves to be used in the utilities' PGA filings.

Respectfully Submitted,
January 28, 2008

Lowrey Brown
Utility Analyst

## CERTIFICATE OF SERVICE

I hereby certify that on this 28th day of January, 2008, I served the foregoing Reply Comments of the Citizens' Utility Board of Oregon in docket UM 1286 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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The Citizens' Utility Board of Oregon

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

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