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EDWARD A. FINKLEA efinklea@cablehuston.com

December 4, 2007

VIA ELECTRONIC FILING & U.S. MAIL

Oregon Public Utility Commission
Attn: Filing Center
550 Capitol Street, N.E., #215
P.O. Box 2148
Salem, Oregon 97308-2148

Re: UM 1286 – In the Matter of the Public Utility Commission of Oregon Investigation into the Purchased Gas Adjustment (PGA) mechanism used by Oregon' three local distribution companies.
Docket No. UM-1286

Dear Filing Center:

Enclosed please find the original and one (1) copy of INITIAL COMMENTS OF THE NORTHWEST INDUSTRIAL GAS USERS in the above-referenced docket.

Thank you for your assistance with this filing. Should you have any questions, please feel free to contact me.

Very truly yours,

Edward A. Finklea

EAF:
Enclosure(s)
cc: UM-1286 Service List (via email and/or US Mail)

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1286

Investigation into the	)	
Purchased Gas Adjustment (PGA)	)	
Mechanism Used by Oregon's Three Local	)	INITIAL COMMENTS
Distribution Companies	)	OF THE NORTHWEST
	)	INDUSTRIAL GAS USERS
	)	
	)	

As set forth in the September 25, 2007 letter of the parties to the presiding administrative law judge, the parties reached prehearing conference agreement to conduct this proceeding in two phases, with the first phase focused upon cost recovery and incentive mechanisms for Oregon's natural gas utilities and the second phase focusing upon portfolio purchasing practices and guidelines to be followed as a result of the mechanisms determined appropriate by the Commission from phase one. The Northwest Industrial Gas Users ("NWIGU") appreciate this opportunity to submit its initial comments in phase one. NWIGU is not proposing a distinct new mechanism for the recovery of purchased natural gas costs by the local distribution companies ("LDCs"), but is instead outlining certain parameters that industrial customers ask the Commission to consider in evaluating both the current and any new proposed mechanisms brought forward for consideration. NWIGU respectfully reserves its ability to comment upon the specific mechanisms suggested by the other parties to this proceeding in its reply comments and in any oral argument before the Commission.

I. INTRODUCTION

In the Pacific Northwest, prior to the fall of 2000, Oregon consumers historically enjoyed relatively lower natural gas prices due to their access to cheaper Canadian gas, which did not

CABLE HUSTON BENEDICT HAAGENSEN & LLOYD LLP
SUITE 2000
1001 SW FIFTH AVENUE
PORTLAND, OREGON 97204-1136
(503) 224-3092

have access to other sales markets. This Canadian advantage has now permanently eroded with the integration of the pipeline infrastructure between Canada and the Midwest. In addition, access to the growing supplies of Rockies' gas into the Northwest is limited due to pipeline constraints. In the near future, new deliveries of Rockies supplies to the East will exacerbate the problem.

Natural gas end-users have suffered unprecedented high prices and volatility over the past several years. Looking forward, industrial end-users see a period of continued high volatility with natural gas, given the tight balance of supply and demand and growing demands placed upon natural gas use for electric generation as a bridge fuel to support renewable energy sources. While additions to supply bring hope of market relief, substantial price relief can occur only if a significant increase is made in the supply of natural gas available to North America.

In addition to volatility and price pressures, NWIGU sees the potential for significant changes in regional natural gas infrastructure, with three liquefied natural gas terminals proposed in Oregon (Bradwood Landing, Jordan Cove and Oregon LNG), another in British Columbia (Kitimat LNG) along with potential new pipelines, Palomar Pipeline, Pacific Connector Pipeline and the recently announced Bronco (Spectra's proposal to take Rockies supplies to Malin). Each utility serving Oregon customers is unique in the supply options and infrastructure choices that it has to use to serve its sales customers today, and NWIGU's point is that those options will change.

In addition the structure of the products available in the market change as well as the supplier choices change over time. For example, in Docket RM98-1, the Federal Energy Regulatory Commission has just issued a Notice of Proposed Rulemaking on November 15, 2007 that it is proposing to facilitate asset management arrangements by relaxing the

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SUITE 2000
1001 SW FIFTH AVENUE
PORTLAND, OREGON 97204-1136
(503) 224-3092

Commission's prohibition on tying and on its bidding requirements for certain capacity releases. The use of portfolio resource managers through these types of arrangements, if allowed by FERC, may be potentially beneficial for an LDC's customers.

II. PARAMETERS FOR COST RECOVERY AND INCENTIVE MECHANISM STRUCTURES

A. 100% Pass-Through Requires Heightened Prudence Scrutiny.

In this evolving natural gas market context, in any structure, consumers can and should be protected through the rigor of prudence review by the Commission and its Staff (but that prudence review should also be the case today without any regulatory change). NWIGU believes that any gas recovery structure for 100% pass-through of gas costs must be done with heightened scrutiny if such change is allowed by the Commission as a result of this docket. If a mechanism option is allowed that eliminates all direct incentive financially for utility reward/risk, a utility can too easily rely upon strictly market purchases rather than management of gas costs using all available market tools.

Industrial customers' experience with other state regulatory commissions has been that in this context, utilities are so risk averse and that the costs of gas commodity are so substantial that the utilities may fail to be as creative, market responsive, or more long-term in their gas management practice as would be more desirable for the actual consumers. Accordingly, industrial customers look to the Staff and Commission to be rigorous in its prudence review (no matter whether there is or isn't a sharing/incentive or risk/reward mechanism), but particularly if there is a change to allow 100% pass-through of gas costs.

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SUITE 2000
1001 SW FIFTH AVENUE
PORTLAND, OREGON 97204-1136
(503) 224-3092

B. The Commission Should Consider Allowing Natural Gas Utilities to Have Mechanism Options within Reasonable Boundaries.

In this context, one size does not fit all. All of the gas utilities and the resources that they can use to supply natural gas commodity for their sales customers are unique. 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.

Industrial customers do not think that the Commission necessarily has to endorse a singular mechanism from this docket for the recovery of gas costs, provided that all allowed mechanisms utilize robust and evolving portfolio purchasing management strategies and provide for the lowest reasonable cost in a balanced portfolio. NWIGU recommends that the OPUC allow reasonable options but require all three of the utilities to proactively manage their natural gas supply portfolios and acquire a balanced and diverse portfolio of physical and financial contracts with stable and reasonable prices without regard to any incentive mechanism chosen by the utility among the options the Commission deems reasonable.

C. The Commission Should Move Carefully and Should Favor the Protection of Consumers with Any Mechanism or Cost Recovery Structure.

Given the difficult markets that all end-users face in the coming years, industrial customers start from a premise of moving carefully with PGA refinements. In other words, industrial customers are hesitant to fix what isn't broken and are concerned with the potential for unintended consequences.

Oregon's PGA structure currently sets rates based on projected gas costs for the upcoming year and then also reconciles the prior year's actual gas costs with the PGA in effect during the prior year. With respect to any deferrals that are incurred, the utilities historically can

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SUITE 2000
1001 SW FIFTH AVENUE
PORTLAND, OREGON 97204-1136
(503) 224-3092

either accept at 20/80 percentage sharing (20% to the gas company) with additional fall earnings review or accept a 33/67 percentage sharing without the extra fall earnings review. A newer alternative has also been used with Avista on an agreed 10/90 basis.

In reviewing any party's specific new incentive proposals, NWIGU is concerned that (1) mechanisms not be created that induce overly short-term market behavior by the utilities (end-users are concerned that the utilities be encouraged to take a longer-term view in the market because structures that encourage extreme reliance on short-term market behavior drive greater volatility overall to all gas customers); and, (2) that the ultimate structure of PGA review maintains flexibility so that the individual opportunities and assets of the regulated utilities and changing circumstances of the market are optimized to benefit the customers.

D. The Commission Can Balance the PGA Process and Any Change in Mechanism Choices to Protect Consumers through the Earnings Review Mechanism.

Since 1999, the Commission conducts a general earnings review each spring for the local distribution companies. If earnings are found to be above a specified return on equity level, a portion of those revenues are booked to a deferred account with 33% of earnings exceeding the threshold shared with customers on an equal margin basis at the time of the next PGA. Based on Commission Order 04-203 (as modified by Order No. 07-019), the earnings threshold for NW Natural for 2007 was 13.20 % under a 300 basis point adder, plus an adjustment for inflation, yielding a total of 13.44 %. Avista operates under a 200 basis point adder to its last authorized ROE (under Order No. 05-1053), resulting after inflation to a 12.49% threshold for 2007, and Cascade operated under a 175 basis point adder with inflation adjustment for 2007 sharing of 2006 earnings, yielding a threshold of 12.24% (under Order No. 06-191) that has been modified to 215 basis points on top of a 10.1 base ROE for determinations of earnings sharing from 2007

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SUITE 2000
1001 SW FIFTH AVENUE
PORTLAND, OREGON 97204-1136
(503) 224-3092

earnings and continuing to 2012 unless otherwise modified by the Commission (under Order No. 07-221). For both Avista and NW Natural, the earnings sharing mechanism sunsets after 2008 earnings reviews.

NWIGU urges the parties and Commission to consider a melding of a more appropriate opportunity for customer benefit under this earnings review mechanism with the recovery of gas costs and to set a threshold for each Oregon utility's customers to benefit from excess earnings as calculated under a reduced equity adder of 150 to 175 basis points under any incentive mechanism options or 100% pass-through mechanism. NWIGU would urge the Commission to apply an appropriate adder in this range depending upon the gas cost recovery and incentive structure options that it approves in this docket.

E. NWIGU Does Not Support a PGE Dead Band Application to the Gas LDCs.

In other contexts, other parties have suggested that a "dead band" like that approved by the Commission for Portland General Electric ("PGE") and other electric utilities would be appropriate for the LDCs to address recovery of gas costs. While NWIGU does not know if such a dead band approach will be suggested by a party in this proceeding (i.e., that within the bounds of the dead band the LDCs would not be allowed to make any adjustments in the gas costs placed into rates for recovery from customers), NWIGU is concerned that the Commission not approve a dead band option given the fundamental differences between the natural gas LDC and electric utilities.

From a customer perspective, it is NWIGU's concern that gas utilities have no incentive to minimize their cost of gas unless it is part of the express structure imposed in the PGA process. That is the function of prudence review. Industrial customers agree that benchmarks set in the wrong place do not motivate proper behavior or worse yet, reward mediocre

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SUITE 2000
1001 SW FIFTH AVENUE
PORTLAND, OREGON 97204-1136
(503) 224-3092

performance. A dead band on a gas LDC does not appear to incite optimum purchasing and planning. A benchmark should be tied to achieving the best deal for consumers, and we see some financial incentive potential as being the best way at this time to achieve that goal. A dead-band with a gas utility turns this concept on its head, and in comparison makes the gas utility more risky than it is today (and potentially leading to such assertions for increased cost of capital in the next general rate case, which NWIGU is not conceding but would be concerned with such claims arising).

From a customer's perspective, gas utilities do not control the commodity market, or weather, or many other factors that influence natural gas commodity costs. With this docket the Commission and parties are trying to explore the best way(s) to have the LDC manage gas supply costs. Unlike an electric utility, a gas utility does not produce any of the commodity that it is selling.

F. Defects in Current Mechanisms Appear in the Potential for Forecast "Gaming" and in Creating an Incentive to Hedge Excessively.

The problem that NWIGU sees with the current incentive structure is that the utilities have a tendency to financially or physically hedge too large a portion of their natural gas needs to protect their exposure and that may or may not coincide with customers' best interests depending on what is expected to happen in the natural gas market. From NWIGU's perspective, the specific solution that makes the most sense to address this issue is to set a percentage (80% for example), above which the utilities must meet a burden of proof for specific customer benefit when such threshold is exceeded in order for costs to be deemed prudent whether or not the utility is operating with an 80/20, 67/33 or 90/10, 100% pass-through or any

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SUITE 2000
1001 SW FIFTH AVENUE
PORTLAND, OREGON 97204-1136
(503) 224-3092

other incentive/risk plan. This threshold needs to be evaluated annually in light of market conditions with sufficient time to bring any disputes to the Commission.

Second, in any cost recovery or incentive structure the forecast of gas costs or benchmark for how the utility's performance is measured and how gas costs are set for recovery from customers must be determined in a uniform and externally derived manner among the three utilities, allowing for differing access to supply basins and storage assets. A set formula should be determined by the Commission as part of the next phase of this proceeding that fits whatever incentive or recovery mechanisms that are allowed.

III. CONCLUSION

NWIGU appreciates the effort of all parties and Staff in the previously concluded workshops, and we applaud Staff's desire to take a more rigorous review of utility portfolios and believe the implementation of quarterly portfolio review meetings among the customers, Staff and utilities has been a beneficial addition to the gas cost recovery process in Oregon.

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CABLE HUSTON BENEDICT HAAGENSEN & LLOYD LLP
SUITE 2000
1001 SW FIFTH AVENUE
PORTLAND, OREGON 97204-1136
(503) 224-3092

NWIGU urges the Commission to adopt an explicit policy that favors price stability over time and engages in rigorous review and analysis of natural gas procurement decisions, but industrial customers think any gas cost recovery approach must provide options as outlined above and must avoid being too prescriptive or rigid (as that will stifle creativity and effort that we all seek to apply to better outcomes for consumers). We look forward to submitting additional reply comments to respond to the specific proposals brought forward.

Dated in Portland, Oregon, this 4th day of December, 2007.

Edward A. Finklea, OSB # 84216
Chad M. Stokes, OSB # 00400
Cable Huston Benedict Haagensen & Lloyd LLP
1001 SW 5th Avenue, Suite 2000
Portland, OR 97204
Telephone: (503) 224-3092
Facsimile: (503) 224-3176
E-Mail: efinklea@cablehuston.com
cstokes@cablehuston.com

Of Attorneys for the
Northwest Industrial Gas Users

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I caused to be served the foregoing **INITIAL COMMENTS OF THE NORTHWEST INDUSTRIAL GAS USER** via electronic mail and/or prepaid First Class Mail on all Pre-certified Intervenors, NW Natural and on the attached Service List obtained on December 4, 2007 from the Oregon Public Utility Commission's Website as follows:

Lowrey R Brown **Citizens Utility Board of Oregon** 610 SW Broadway - STE 308 Portland, OR 97205 lowrey@oregoncub.org	Jason Eisdorfer **Citizens Utility Board of Oregon** 610 SW Broadway - STE 308 Portland, OR 97205 jason@oregoncub.org
Bob Jenks **Citizens Utility Board of Oregon** 610 SW BROADWAY - STE 308 Portland, OR 97205 bob@oregoncub.org	Ken Zimmerman **Public Utility Commission of Oregon** 550 Capitol St. NE, STE 215 Salem, OR 97301 ken.zimmerman@state.or.us
Rates & Regulatory Affairs **NW Natural** 220 NW 2ND AVE PORTLAND OR 97209 efiling@nwnatural.com	Inara K. Scott **NW Natural** 220 NW 2ND AVE PORTLAND OR 97209 iks@nwnatural.com
Katherine Barnard Director-Regulatory Affairs **Cascade Natural Gas** PO Box 24464 Seattle, WA 98124 kbarnard@cngc.com	Jon T. Stoltz SR Vice President 0 Regulatory & Gas **Cascade Natural Gas** PO Box 24464 Seattle, WA 98124 jstoltz@cngc.com
David Hatton Assistant Attorney General **Department of Justice** Regulated Utility & Business Section 1162 Court St. NE Salem, OR 97301-4096 David.hatton@state.or.us	David J. Meyer Vice President & Chief Counsel **Avista Corporation** PO Box 3727 Spokane, WA 99220-3727 David.meyer@avistacorp.com

Paula Pyron **Northwest Industrial Gas Users** 4113 Wolf Berry Ct. Lake Oswego, OR 97035-1827 ppyron@nwigu.org	Lawrence Reichman **Perkins Coie LLP** 1120 NW Couch St. – 10 Floor Portland, OR 97209-4128 lreichman@perkinscoie.com

DATED this 4th day of December, 2007.

Edward A. Finklea, OSB # 84216
Chad M. Stokes, OSB #00400
Cable Huston Benedict Haagensen
& Lloyd LLP
1001 SW Fifth Ave., Suite 2000
Portland, OR 97204-1136
Telephone: (503) 224-3092
Facsimile: (503) 224-3176
E-Mail: efinklea@cablehuston.com
cstokes@cablehuston.com

Of Attorneys for the
Northwest Industrial Gas Users