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January 28, 2008

VIA ELECTRONIC FILING
& FIRST CLASS MAIL

Oregon Public Utility Commission
550 Capitol St. NE, #215
PO Box 2148
Salem, OR 97308-2148
Attn: Filing Center

Re: 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.

Dear Filing Center:

Enclosed for filing is the original and one copy of the Reply Comments of the Northwest Industrial Gas Users in the above-captioned proceeding.

Thank you for your assistance in this matter. Should you have any questions regarding this matter, please feel free to contact me. Thank you.

Very truly yours,

Edward A. Finklea

EAF:tr
Enclosure(s)
cc: UM 1286 Service List

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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 NORTHWEST INDUSTRIAL GAS USERS

I. Introduction

The Northwest Industrial Gas Users ("NWIGU") submitted its initial comments in phase one outlining certain parameters that the Oregon Public Utility Commission ("Commission") should apply in evaluating both the current purchased gas adjustment mechanism and proposed new incentive mechanisms ("PGA"). In these initial comments, NWIGU did not propose a distinct new mechanism for the recovery of PGA costs by the natural gas local distribution companies ("LDCs"). With its reply comments, NWIGU continues to urge this Commission to apply the following parameters for cost recovery and incentive mechanism structures:

- 100% Pass-Through Requires Heightened Prudence Scrutiny if Allowed by the Commission.
- The Commission Should Consider Allowing Natural Gas Utilities to Have Mechanism Options within Reasonable Boundaries.

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- The Commission Should Move Carefully and Should Favor the Protection of Consumers with Any Mechanism or Cost Recovery Structure by Using the Earnings Review Process.

NWIGU appreciates the opportunity to comment on the specific proposals that have been advanced by others and the efforts by all parties to address these issues in the informal workshops and their written comments. NWIGU looks forward to a continuing dialogue with the Commission and the other parties at the February 4, 2008 workshop and reserves the ability to make additional comments at that time and following the workshop.

II. Summary of NWIGU Reply Comments

The first question to be answered by the Commission and the parties in this process: How do you get a natural gas LDC to perform at an optimal level for their natural gas sales customers in managing their gas supply commodity costs? No matter the purchased gas cost recovery or incentive mechanism(s), the answer is a rigorous review by this Commission of the prudence of the LDC's purchases, costs, and transactions with appropriate opportunities for input on this prudence issue from the Commission Staff and customer groups like NWIGU and the Citizens' Utility Board ("CUB"), and other parties.

The second threshold question for gas customers: What is an optimal level of performance by a LDC for its commodity purchases? Industrial sales customers expect the highest price stability, lowest price and reliability possible for a utility's sales customers given the market conditions that the utility faces. The answer for what is optimal is not entirely lowest commodity price. Natural gas customers also want price stability and reliability coupled with lowest price.

Third: No matter what the mechanism, 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 the customers must be determined in a uniform and externally derived manner among the three Oregon utilities, allowing for differing access to supply basins. A set method 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. Any benchmark for how the utility performance is measured should be based only upon actual market settlement for physical gas trades. The prices charged customers must not be subject to gamesmanship for incentive opportunities or benchmark improvement.

Overarching all of the allowed PGA recovery/incentive options, NWIGU is asking the Staff and Commission to be rigorous in their 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 an option of 100% pass-through of gas costs as advocated by the Staff, Avista and Cascade.

As opposed to CUB's support for a single PGA mechanism, NWIGU believes that the Commission should consider and allow LDCs to have specific mechanism options within reasonable boundaries. With modification to the existing PGA to strengthen the earnings review for consumers, NWIGU can support either of the following options as reasonable alternatives from which a utility may choose: (1) an 80/20 gas cost sharing PGA mechanism as sought by NW Natural in its initial comments but only if it is modified to include an earnings review with excess earnings sharing starting at least at 150 to 175 basis points above the utility's authorized return on equity;

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or, (2) a 90/10 gas cost sharing PGA mechanism as proposed by CUB for gas cost sharing but without CUB's dead band concept, and instead coupling it with an earnings review with excess earnings sharing at a level set commensurate to cover the higher risk shifted to consumers (i.e., a smaller adder of 125 to 150 basis points above the utility's authorized return on equity).

NWIGU remains concerned that any PGA mechanism promotes a gas protocol in an LDC's purchasing that does not discourage long-term contracting when such is in the best interests of customers. NWIGU is concerned that Staff's approach to portfolio purchasing may be too rigid. Over hedging is a prudence question and not a reason to establish policies that promote short-term contracting over long-term contracting. Long-term pricing is not inconsistent with good protocol depending upon the natural gas market conditions. NWIGU also urges the Commission to maintain the PGA as an annual process and to not introduce more frequent price changes to consumers or to institute a more frequent PGA review process even with deferrals only as the market itself can develop too much information on what the utility has to do if the LDCs' PGA process becomes too rigid.

In reviewing Staff's two 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 for incentive 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

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market are optimized to benefit the utility's customers. For example, on November 15, 2007, the Federal Energy Regulatory Commission ("FERC") proposed to permanently remove the rate ceiling on short-term capacity release transactions in a new Notice of Proposed Rulemaking. Essentially the FERC is taking comments on whether to permit market based pricing for short-term capacity releases and proposes to facilitate asset management arrangements ("AMAs") by relaxing the FERC's prohibition on tying and on its bidding requirements for certain capacity releases (FERC Docket No. RM08-1). In addition to lifting the price caps for short term capacity release, the FERC proposes to modify its regulations to facilitate the use of AMAs, under which a capacity holder releases some or all of its pipeline capacity to an asset manager who agrees to supply the gas needs of the capacity holder. AMAs are defined as "any pre-arranged release that contains a condition that a releasing shipper may, on any day, call upon the replacement shipper to deliver to the releasing shipper a volume of gas equal to the daily contract demand of the released transportation capacity." In other words, in the very near term, the FERC would appear likely to be sanctioning a new market tool for Oregon utilities in delivering gas commodity to their sales customers through the use of marketers.

While NWIGU is not advocating that all Oregon utilities should be optimizing all their assets through AMAs, it is but one example of natural gas market development. The Commission will want to be sure that its determinations in this docket do not set up mechanisms that inadvertently foreclose or delay the benefits of market opportunities as they develop for Oregon natural gas consumers.

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III. Reply Comments to Issues Raised by Other Parties

A. Current PGA Mechanism Flaws

NWIGU agrees with CUB, that from an overall general perspective, the gas utilities' current PGA mechanisms appear to be working reasonably well. NWIGU has historically said in this area: do not fix that which isn't broken. Industrial customers urge the Commission to focus on that which is flawed in the current mechanism and to act to protect consumers. At the same time, NWIGU urges the Commission to not react with micromanagement. Instead the Commission should hold the utilities to an expectation of prudent performance in gas purchasing and management.

The flaws that NWIGU sees in the current PGA mechanism are in forecasting for the WACOG determination and in excessive hedging. Both of these flaws are recognized in Staff's initial comments as well. *See* Staff Initial Comments, page 6. It appears that the potential for gamesmanship in the current mechanism is in the forecasting used to set the WACOG. This is an issue of some magnitude under any PGA incentive proposal, current or new, as an incentive or benchmark for sharing has to be defined against a measuring stick. In the current PGA model, the WACOG is built from a forecast, and the utility's gains/losses are measured for sharing against it (i.e., the difference between the WACOG in rates and the actual WACOG from gas purchases). In essence you have the same potential issues of gaming with any benchmark against which a utility's performance is measured unless it is externally derived.

To address this deficiency the WACOG by which gas costs are set for recovery from customers must be done in a uniform manner among the three utilities (allowing for differing access to supply basins). A set formula needs to be determined that fits

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whatever incentive or recovery mechanisms that are allowed in phase one of this docket. For benchmark/incentive rewards, the measuring stick needs to be a market settlement comparison to the prices that were charged. NWIGU would also note that this issue of what to charge the customers for the gas commodity still exists in setting the WACOG even with 100% pass-through PGAs as the Commission should still determine how to set the WACOG as close as possible to the LDC's actual, prudently incurred costs, even if no incentive or sharing structure is provided to the LDC.

The other problem that industrial customers see with the current incentive structure is that the utilities appear to have shown a tendency to financially or physically hedge too large a portion of their natural gas needs to protect utility exposure and that may not coincide with customers' best interests, depending on what is happening in the natural gas market. Excessive hedging when it is not in customers' best interests is a prudence review question and one which NWIGU urges the Commission to require a re-evaluation every year in light of market conditions. This issue can be an important part of the quarterly meetings on portfolio status that Staff has already initiated with the LDCs (and at which customer representatives need to be allowed to participate). From NWIGU's perspective, the specific solution that makes the most sense to address this flaw 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 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.

B. Protection of Consumers through the Earnings Review

Each spring since 1999, the Commission conducts a general earnings review for each of the LDCs. 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 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 currently sunsets after 2008 earnings reviews. In its Initial Comments, Staff has indicated that it will initiate a review for potential extension at that time and that it recommends that Staff's proposed incentive mechanism not be subject to an earnings test.

NWIGU disagrees with Staff's bifurcated approach to the PGA mechanism and excess earnings review process reviews. Instead of conducting a review next year on the extension of the earnings review mechanism, NWIGU believes the Commission should conduct a coordinated approach in this docket and meld a more appropriate balance for customers with the spring earnings review mechanism and PGA mechanism. Depending

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upon the incentive mechanisms allowed and degree of risk shifting to consumers, NWIGU urges the Commission to strike a balance that protects customers with a tighter sharing of excess earnings as calculated under a reduced equity adder, using 150 to 175 basis points to the utility's authorized return on equity for earnings sharing by any utility that seeks a 80/20 percent sharing of gas cost variances with its customers, a lower adder of 125 to 150 basis points for 90/10 gas cost variance sharing, coupled with an adder of 100 to 125 basis points for those utilities seeking 100% pass through of all gas costs on consumers (if the Commission decides to allow a 100% pass-through option).

C. CUB's Proposed Dead Band Application to the Gas LDCs

Although NWIGU also finds an initial customer attraction with dead bands that force utility absorption of fluctuations so customers get initial price certainty around a band with sharing only in the extremes, in the long run, NWIGU believes that CUB's proposal shifts risk to shareholders in a manner that does not appear to fit the gas industry as well as it does the electric. We applaud CUB's incorporation of earnings reviews and SB 408 impacts in its proposal. Industrial customers agree with CUB that earning sharing needs to be reflected in the PGA mechanism process, but we disagree on how. NWIGU finds the fundamental design behind the shaping of CUB's proposed mechanism is not a best fit for the natural gas industry and the LDCs. We would urge, however, that CUB's proposal of a 90/10 sharing is fair coupled with an appropriate earnings sharing as a solid alternative.

CUB's proposal begins with a premise that does not reflect the fundamental differences between the natural gas distribution utilities and the investor owned electric utilities in Oregon. Oregon's investor-owned electric utilities are vertically

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integrated companies that own generation, transmission, and distribution assets. Through integrated resource planning, these electric utilities determine which generating resources to build to meet future demand. These utilities earn a return on their investment in those generating resources. They control when those generating resources are operating, when they are taken down for routine maintenance and when they are replaced. The cost of electric power for those utilities' customers is a result of decisions about sources of electric generation that are within the control of the electric utilities. Furthermore, many of the generating resources are in the rate base of those utilities, and they are earning returns on those investments.

In sharp contrast, Oregon natural gas local distribution companies do not own any natural gas production wells or synthetic natural gas plants. The integrated resource planning process does not inform the LDCs as to where they should drill for new gas resources. In other words, there are no "drill or purchase" decisions to be made by those utilities. LDCs can buy long or buy short, but they cannot choose to develop their own gas supplies instead of being gas purchasers.

Thus, NWIGU finds little if any guidance from the electric industry in determining how to address the pass-through of purchased gas costs in the future. The PGA mechanism should focus on how to allocate risk between shareholders and customers for a utility that strictly purchases an unregulated commodity that it then distributes to its customers. The "build versus buy" decisions that influence how to address power costs have no relevance to the regulation of the natural gas distribution industry.

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A dead band suggests that a certain degree of gas cost variation is inherently part of the risk of being in the gas distribution business. This has not been the traditional regulatory compact in the gas industry in Oregon or elsewhere. NWIGU considers the LDC business less risky than the electric business for the fundamental reason that LDCs are not in the gas production business. LDC's strictly distribute gas. LDCs are a less risky business than integrated investor-owned electric utilities like PacifiCorp and Portland General Electric. NWIGU believes it is better to pass through to sales customers most gas cost risk and reflect that lower level of risk in the LDC's authorized return than to impose regulatory risk through a complex risk/reward sharing mechanism. If LDCs are put more at risk for most gas cost variation, their risk profile may well increase.

Thus, NWIGU believes the prudent course for this Commission is to continue the pass through of most of the cost of gas to sales customers of the LDCs. Transportation customers take all the risk of their gas cost purchases. If the Commission wants the LDCs to have some economic incentive to minimize gas costs, then a 90/10 type sharing mechanism as proposed by CUB or an 80/20 type sharing as proposed by NW Natural could be appropriate when coupled with an appropriate earnings sharing threshold.

D. NWIGU's Concerns with Staff, Avista and Cascade Proposals

Staff, Avista and Cascade all want the Commission to incorporate an option of 100% pass through of prudently incurred gas costs to an Oregon LDC's customers. NWIGU finds little demonstrable evidence that a utility with a 100 percent pass-through of gas costs will necessarily have a lower gas cost than one that has some shareholder risk built into the mechanism. CUB and NW Natural appear to be of the same view as

NWIGU. As previously discussed, NWIGU would urge the Commission to couple any approval of a 100% pass-through PGA with a tighter earnings review band to balance the risks shifted to consumers under such a dramatically different structure than the current PGA mechanism.

Industrial customers do agree with Staff that "[w]ith any PGA mechanism, it is important to properly assess the prudence of natural gas purchase planning and execution." Staff Initial Comments, at p. 14. In assessing prudence, Staff's recommendations include the requirement of "best practices" portfolio purchasing. NWIGU agrees with Staff in theory on portfolio purchasing, but is concerned that the development of best practices guidelines in this area not be overly prescriptive.

From an industrial customers' perspective, best practices means following a protocol for purchasing based upon market assessments using a given risk tolerance determination, and in conjunction with ongoing review of market conditions, but it does not mean that long term pricing or financial hedging is inconsistent with good protocol. It may or may not be depending upon natural gas market conditions. Good management also calls for informed reassessment as conditions change.

The fact that natural gas can be stored also has little meaning in the context of the debate about PGA mechanisms and portfolio management. While gas can be stored, it can only be stored economically if a utility has access to a storage field. Access to this resource varies for Oregon utilities. In Oregon, NW Natural has developed the Mist storage field because at one time the company owned a gas field that could be turned into a storage field. The only other underground storage in the Pacific Northwest is at Jackson Prairie, and that field has limited capacity and has existing owners, including

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Avista. Thus, an LDC's ability to use storage is in large part an accident of geography. While an electric utility can build a peaking generator anywhere it can site a combustion turbine, an LDC cannot just dig a whole in the ground and start injecting gas.

In this area of assessing prudence, Staff also recommends semi-annual outside gas audits (paid for ultimately by ratepayers), and more frequent PGA filings (Staff suggests quarterly or even monthly). NWIGU is concerned that any additional audits not be duplicative of outside financial audits already undertaken by the LDCs, and which costs are already reflected in operating expenses recovered by the utilities' rates today. NWIGU is also opposed to more frequent PGA filings. Industrial sales gas consumers do not want PGA rate adjustments more frequently than annually unless the Commission and Staff is willing to structure separate WACOGs for different classes of customers based upon their load factors (winter peaking vs. year round use). Otherwise industrial customers see no merit to more frequent PGAs as suggested by Staff. Sales gas customers value budgeting and price certainty that is embodied in the annual PGA process. The regulatory costs of a structure of monthly or quarterly PGAs would also ultimately be borne by the ratepayers.

NWIGU is, however, most supportive of Staff's quarterly portfolio review meetings with the LDCs, which have been underway, and desires for customer representatives to participate when possible (which can be accomplished readily without disclosure of confidential commercial arrangements by masking vendor names or by confidential and non-confidential designations to the portions of the meetings).

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

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allowed mechanisms utilize robust and evolving portfolio purchasing management strategies and provide for the lowest reasonable cost in a balanced portfolio. That being said, NWIGU is appreciative that Staff is open to other incentive mechanism proposals as industrial customers are concerned that Staff's two particular incentive mechanisms are difficult to implement and are too focused only on short-term pricing as the basis for performance reward coupled with 100% pass-through of costs.

E. NWIGU's Concerns with NW Natural's Proposal

In its Initial Comments, NW Natural says that it seeks only to change one aspect of the current PGA mechanism, moving its own sharing percentage from a 67/33 sharing to 80/20 with its customers. Currently NW Natural and Cascade operate on a 67/33% sharing of gas cost variances, with Avista currently having a 90/10 mechanism in place (although it initially elected an 80/20 sharing). See Order No. 07-477. As previously discussed, NWIGU does not object to an 80/20 gas cost variance sharing provided that it is coupled with a tighter spring earnings review process with an appropriate adder of approximately 150 to 175 basis points to the utility's authorized return on equity. This tightening of an earnings band thereby better balances the risks being shifted to gas consumers for the potential gas cost variance. This shift is why NW Natural seeks the modification. NWIGU accepts the premise of this shift as a reasonable one provided it is balanced by an appropriate tighter spring earnings review.

NWIGU also notes that NW Natural appears to be seeking one other change with its initial comments, i.e., the determination of embedded WACOG based upon New York Mercantile Exchange ("NYMEX") forecasts (see NW Natural Opening Comments, at p. 14, footnote 42). NWIGU notes that this benchmark (determination of embedded

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WACOG) is to be set by the Commission and would recommend that it be determined on a uniform basis for all Oregon utilities as part of the second phase of this docket, once all parties know the allowed PGA mechanism(s).

Although NWIGU believes this component will be better determined in the guidelines' development after the Commission makes a decision on PGA mechanism(s), NWIGU feels compelled to respond to this issue in a limited fashion at this time. While a NYMEX price strip has been used by NW Natural to develop its WACOG since 2005, there is actually not a method prescribed by Oregon regulations on how an LDC is to determine expected future price (which NW Natural acknowledges). NW Natural has used a 60-day NYMEX average and NYMEX basis differentials to develop its WACOG for the last two years. While this daily price strip is an independent source, it is one fraught with volatility as it reflects the significant realities of daily, speculative traders (and is buttressed around peak hurricane season).

Averaging for sixty days worth of strips minimizes some of the impact of daily price volatility, but is an average of only 60 days the right window even if this measure is used? Should it be a longer average, say 90 days? Should it be blended with fundamentals forecasts in some fashion as urged by Staff in this past fall's PGA filings? Second, updating of forecast data has to be contemplated as part of the guidelines given the PGA review window in Oregon.

Under the current PGA mechanism, prudently incurred hedged gas supply transactions that are completed in advance of the PGA filing are passed through to the embedded WACOG at 100% of cost. Initial PGA filings are made by Oregon LDCs by August 31 of every year with a November 1 effective date to allow time for review, and

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ordinarily due to the passage of time, it is only reasonable for the forecasts to be updated that underlie the spot market purchases which are embedded in WACOG (as these are based on market forecasts that have become stale by October), as well as inclusion of any additional, prudent hedges. NWIGU submits that updating should be required by all LDCs in the same manner if the updating of the ultimately chosen method of forecasts results in changing WACOG in any significant way, and that threshold for change must be predetermined in the next phase too (e.g., all utilities must provide updating as of October 15, and if there is more than 1% WACOG change, it must be reflected).

In any event, the Commission should direct in this phase that the prices charged customers for gas commodity not be subject to gamesmanship for incentive opportunities or benchmark improvement.[1]

IV. Conclusion

NWIGU appreciates the effort of all parties and Staff in the previously concluded informal workshops and looks forward to the Commission's workshop on February 4, 2008 and the opportunity to submit additional comments on phase one issues following that workshop.

NWIGU urges the Commission to adopt an explicit policy that favors price stability over time combined with the lowest prices and reliability possible for gas sales customers in Oregon. NWIGU looks to the Staff and the Commission to engage in rigorous review and analysis of natural gas procurement decisions, but industrial

[1] It is also important in the next phase of this proceeding that the forecast volumes be determined to avoid any mismatch in setting WACOG. Expected prices should be matched to expected loads (so the numerators and denominators are focused on the same window). Using prior year's loads with a forecast of projected price would create an inherent mismatch. Hopefully after the Commission renders a decision on the PGA mechanism(s), the parties can resolve the application issues for Commission approval.

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customers think any gas cost recovery approach must provide options as outlined above and must avoid being too prescriptive or rigid.

NWIGU continues to urge this Commission to apply the following parameters for cost recovery and incentive mechanism structures:

- 100% Pass-Through Requires Heightened Prudence Scrutiny if Allowed by the Commission.
- The Commission Should Consider Allowing Natural Gas Utilities to Have Mechanism Options within Reasonable Boundaries.
- The Commission Should Move Carefully and Should Favor the Protection of Consumers with Any Mechanism or Cost Recovery Structure by Using the Earnings Review Process.

Dated this 28th day of January, 2008.

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Of Attorneys for the
Northwest Industrial Gas Users

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I caused to be served the foregoing **REPLY COMMENTS OF THE NORTHWEST INDUSTRIAL GAS USERS** via electronic mail and/or prepaid First Class Mail on the attached Service List obtained on January 28, 2008 from the Oregon Public Utility Commission's Website as follows:

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DATED this 28th day of January, 2008.

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