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**VIA ELECTRONIC FILING AND FIRST CLASS MAIL**

PUC Filing Center
Public Utility Commission of Oregon
PO Box 2148
Salem, OR 97308-2148

**Re: Docket UM 1286 – Northwest Natural's Opening Comments**

Enclosed for filing in the above-referenced docket are an original and one copy of a Northwest Natural's Opening Comments.

A copy of this filing has been served on all parties to this proceeding as indicated on the attached certificate of service.

Very truly yours,

Wendy L. McIndoo
Legal Assistant

Enclosure

CERTIFICATE OF SERVICE

I certify that I have this day served the foregoing document in OPUC Docket No. UM 1286 by electronic mail and first class mail to the following parties or attorneys of parties:

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Dated December 4, 2007

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1 **BEFORE THE PUBLIC UTILITY COMMISSION OF OREGON**

2

**UM 1286**

3

| 4 In the Matter of THE PUBLIC UTILITY COMMISSION OF OREGON Investigation 5 into the Purchased Gas Adjustment (PGA) Mechanism Used by Oregon's Three Local 6 Distribution Companies | **NORTHWEST NATURAL'S OPENING COMMENTS** |
|---|---|

7 **I. INTRODUCTION**

8 In the late-1970s, the Oregon Public Utility Commission (the "OPUC" or
9 "Commission") first approved a purchased gas cost adjustment mechanism ("PGA") for
10 Oregon's local distribution companies ("LDCs"). Since that time, the role played by LDCs in
11 purchasing natural gas has undergone several dramatic changes. Through the relatively
12 static and price-regulated 1970's, the gas bubble of the 1980s and the subsequent rising-
13 price markets of the 1990s, the LDCs have been required to continually adapt their
14 purchasing practices to meet market conditions. Similarly, the Commission has continued to
15 evaluate and modify the PGA to encourage best purchasing practices and fairly distribute
16 risk and rewards under evolving circumstances. Now, Commission staff has concluded that
17 the current PGA, which was designed to meet LDC needs in a more stable and lower priced
18 market, no longer serves well either LDCs or Oregon customers.[1] For this reason, the
19 Commission has opened this docket to review the PGA mechanism and consider how it may
20 be redesigned.[2]

21 Through its sharing component, the PGA works to align customer and shareholder
22 interests, encouraging the LDCs to meet purchasing goals that benefit customers with the
23 lowest reasonable cost. In addition, the Commission has allowed LDCs to select sharing

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25 [1] Commission Staff Report for Public Meeting, November 21, 2006 ("Staff Report"), p. 2.

26 [2] *Id.*



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1 percentages at varying levels, including 67/33, 80/20, and 90/10,[3] rendering the PGA flexible
2 enough to serve LDCs with vastly different characteristics[4] and under changing market
3 conditions. Finally, the current mechanism is easy to administer, and, by providing the LDC
4 with natural incentives to pursue a lowest-reasonable-cost purchasing strategy, the PGA
5 lessens the Commission's reliance on prudence reviews as a means of protecting customer
6 interests.

7 That said, Staff is correct in observing that today's gas market presents
8 unprecedented challenges to the LDCs. In particular, today's gas market presents
9 challenges not present when NW Natural chose eight years ago to opt into its 67/33 sharing
10 level. Given the market's current volatility, and in view of NW Natural's reduced reliance on
11 hedging as a means to mitigate risk, a 67/33 sharing balance exposes the Company to an
12 unacceptable amount of risk and is no longer sustainable. *For this reason, while NW*
13 *Natural proposes that the Commission retain the existing PGA, the Company requests that it*
14 *be allowed to modify its sharing levels from 67/33 to 80/20.* With this modification, NW
15 Natural believes that the existing PGA—which has evolved in response to market changes
16 over the past 30 years—is robust and durable enough to continue to serve the LDCs and
17 their customers into the future.

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22 [3] The Commission has approved both 67/33 and 80/20 sharing in the past, and Avista currently has in place a 90/10 sharing percentage. *See* UG 180/UM1346, Order No. 07-477, Staff Report, Appendix
23 A, 13.

24 [4] The Commission has noted the differences between the Oregon LDCs on more than one occasion. *See, e.g.*, UM 903, Order No. 99-272, 193 P.U.R.4$^{th}$ 373, 381, in which the Commission explained the
25 justification for treating the companies differently with respect to earnings reviews: "NW Natural primarily operates in Oregon solely as an LDC. In contrast, Avista is an integrated electric and
26 natural gas utility with the vast majority of its operations in Washington and Idaho. Cascade has the bulk of its gas utility operations in Washington."



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## II. EXECUTIVE SUMMARY

In these Opening Comments, NW Natural will A) enunciate the principles that should govern the development of any PGA mechanism; B) explore the history of Oregon's PGA; C) explain how the Oregon PGA adheres to these principles; and D) explain why certain alternative types of mechanisms should not be adopted.

- ***Principles***

  The Commission's aim in this phase of the UM 1286 docket should be to establish a PGA mechanism that harmonizes and balances the goals of reliability, lowest reasonable cost, price stability for customers, and cost recovery for shareholders. In doing so, the Commission has and should continue to adhere to the following principles with regard to the PGA mechanism: the mechanism should: 1) *seek to align the interests of shareholders and customers*; 2) *recognize the imbalance of risk to which shareholders and customers are exposed*, 3) *adjust as necessary to keep customer and shareholder interests in alignment;* 4) *be simple to administer and easy to review;* and 5) *avoid unintended consequences by application of a reasonable earnings review.*

- ***The History of the Oregon PGA***

  Since the Commission first adopted a PGA in approximately 1977, the natural gas market has undergone a number of changes, most significantly: the gradual federal deregulation of natural market from the 1970's through the early 1990's, the steady increase in gas prices through the 1990s, and the marked recent increase in market volatility.

  The Commission addressed the first shift, federal deregulation, by introducing a sharing component to the PGA intended to give LDCs an incentive to react to new market opportunities. Because prices have shifted since 2000 toward unpredictable volatility and significantly higher prices, the Commission opened this Docket in order to review the efficacy of the current PGA mechanism.

- ***Northwest Natural's Proposal***

  *Current PGA's Soundness:* NW Natural believes that the components of the PGA mechanism are sound and important: Oregon's method for setting its benchmark provides a sound basis for the PGA, particularly by using an exogenous benchmark; the PGA's sharing component provides LDCs with an incentive to pursue cost savings on behalf of their customers; and the earnings test appropriately determines rate adjustments. Significantly, the current PGA adheres both to the Commission's principles and principles expressed in the NRRI Report.

  *NW Natural's Proposal:* NW Natural proposes that the current PGA be retained, with one change: NW Natural requests that it shift its own sharing percentage from 67/33 to 80/20. This shift will rectify the current situation in which the level of risk to



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1 which NW Natural's shareholders are exposed has thrown customer and shareholder interests out of alignment.

2

3 • ***Alternative Mechanisms***

4 *One Hundred Percent Pass Through With Prudence Review:* While a 100% pass-through mechanism does not penalize an LDC for market conditions over which it has no control, this mechanism should not be adopted because it fails to align
5 shareholder and customer interests. Without sharing, the 100% pass-through would motivate the LDC to avoid the risk of disallowances rather than to pursue cost
6 savings.

7 *PGE PCAM-Style Mechanism:* CUB proposes that the PGA include a deadband, and that no adjustment be made if overall earnings are reasonable. CUB's proposal
8 fails to maintain alignment of customer and shareholder interests, and fails to recognize the significant differences between electric and gas utilities, and therefore
9 should be rejected.

10 **III. DISCUSSION**

11 **A. GOALS AND PRINCIPLES**

12 In its 2005 Report (the "NRRI report")[5], the National Regulatory Research Institute

13 found that Gas Purchase Incentive Mechanisms ("GPIMs") – or PGAs, as used in these

14 Comments [6] -- across the country share the same fundamental structure:

15 • a formula is used to determine a benchmark for setting gas costs;

16 • the LDC's actual gas cost is compared to the benchmark; and

17 • the LDC and its customers "share" the variance between the actual and

18 benchmark.

19

20 [5] *See* A HARD LOOK AT INCENTIVE MECHANISMS FOR NATURAL GAS PROCUREMENT, The National Regulatory Research Institute, November 2006 ("NRRI Report").

21 [6] The term PGA is applied to the traditional purchased gas adjustment mechanism, the purpose of
22 which is to ensure that the LDC recovers its gas expenses in customer rates. See Oregon Administrative Rule 860-022-0070. A GPIM, on the other hand, is the term used to refer to any
23 component of a gas cost recovery mechanism the purpose of which is to encourage the LDC to purchase gas at the lowest possible cost. See NRRI Report, p. 5 However, as many state
24 commissions have incorporated GPIM style incentive mechanisms in their LDCs' PGAs, the distinction between the two mechanisms is frequently blurred. Such is the case in Oregon. As
25 discussed below, beginning in 1989 the Commission added a sharing component to the PGA mechanism, thus producing a hybrid PGA/GPIM mechanism. Therefore, for the purposes of these
26 Comments, NW Natural will use the term PGA to refer to a hybrid mechanism seeking Oregon's.



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1 In addition to this basic structure, a GPIM may include a "tolerance band," [7] which is
2 a range of costs that are not shared by the LDC, but are passed through 100% to
3 customers, or a "deadband," which term has been used in Oregon to refer to a range of
4 costs that are not shared by customers, but are passed through 100% to the LDC.[8] What
5 distinguishes one GPIM from the other—rendering some effective and others not—are the
6 details as to how the benchmark is calculated, how sharing is applied, and whether the
7 GPIM includes tolerance bands. Ultimately, the best test of any GPIM is the degree to
8 which it provides incentive to the LDC to meet its gas purchasing goals.

9 Thus, a properly-designed PGA mechanism should incent an LDC to pursue the
10 following goals in developing a gas supply portfolio: *reliability, lowest reasonable cost, price*
11 *stability for customers and cost recovery for shareholders*. While each of these goals is
12 straightforward, the relationship between the individual goals is anything but. Indeed, at
13 specific times and under specific circumstances these goals can be in direct conflict. For
14 example, the Commission has explicitly recognized the inherent conflict between achieving
15 the lowest possible cost and achieving price stability for customers. In such a case, the
16 LDCs are admonished to achieve a balance, so that "[n]either goal [is] pursued to the
17 exclusion of the other." [9]

18 The Commission's goal in this phase of the docket should be to determine the PGA
19 mechanism that, to the greatest extent possible, harmonizes conflicting goals and balances
20 divergent interests. To this end and over the years the Commission has developed a set of
21 specific principles that, while not explicitly reduced to a list, can be inferred from
22

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24 [7] NRRI report, p. 3.

25 [8] *See eg.* UE 180/UE 181/UE 184, Order No. 07-015, pp. 26-27. The NRRI report does not describe a deadband, presumably because they have not typically been applied to LDCs.

26 [9] UM 903, Order No. 99-272, 193 P.U.R.4$^{th}$ at 385.



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1 Commission orders and actions, and may be used to judge the various proposals for a PGA
2 mechanism offered by the Parties to this docket.

3 **1. A SOUND MECHANISM SEEKS TO ALIGN THE INTERESTS OF THE SHAREHOLDERS AND**
4 **CUSTOMERS.**

5 When viewed broadly and in the long term, the interests of LDC shareholders and
6 customers are naturally aligned. For instance, both groups share an interest in the long-
7 term financial health of the natural gas LDC, in the safety and reliability of the distribution
8 system, and the vitality of the communities served. That said, when it comes to short term
9 financial considerations, the interests of the LDC and its customers may diverge. For
10 instance, in the absence of any sharing of rewards, LDCs may be hesitant to take risks that
11 are likely to benefit consumers—understanding that they will not share in the benefits but
12 may well be penalized if adverse outcomes occur.[10]

13 It makes sense then that a properly designed PGA mechanism would seek to bring
14 divergent interests into alignment by offering the LDC an incentive to pursue benefits for its
15 customers. Indeed, in adding the sharing mechanism to Oregon's PGA in 1989, the
16 Commission specifically noted the benefits that would accrue to customers by granting the
17 LDC a financial reward for securing lower-priced gas for its customers.[11] And the National
18 Regulatory Research Institute recommends that sharing rules should be set to provide for
19 strong, symmetric incentives under all conditions.[12]

20 NW Natural agrees that the alignment of customer and shareholder interests is an
21 essential part of any PGA. This alignment will bring benefits not only to the LDC and its
22 customers, but to the Commission as well. By providing the LDC with a natural incentive to
23 ______________________

24 [10] *See* NRRI Report, p. 3.

25 [11] UG 73, Order No. 89-1046, 105 P.U.R. 4th 365, 368.

26 [12] NRRI Report, p. 17.



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1 maximize the interests of its customers, the Commission need not depend so heavily on
2 time-consuming and adversarial prudence reviews to ensure that customer interests are
3 protected. As explained by the NRRI: "With the utility sharing in the outcomes, good or
4 bad, through an incentive mechanism, it may be more willing to take [ ] risks [in order to
5 benefit customers], and the regulatory authorities may feel less need to second-guess
6 decisions."[13]

7 **2. A SOUND MECHANISM MUST RECOGNIZE THE IMBALANCE OF RISK TO WHICH**
8 **SHAREHOLDERS AND CUSTOMERS ARE EXPOSED, AND ADJUST AS NECESSARY TO**
9 **KEEP CUSTOMER AND SHAREHOLDER INTERESTS IN ALIGNMENT.**

10 NW Natural does not expect shareholders and customers to experience risk at
11 precisely the same levels, and in fact anticipates that shareholders would be expected to
12 shoulder more of the financial risk of variations in gas costs than customers. However,
13 shareholders should not be required to bear so much risk that the alignment of interests—
14 which is the goal of the sharing mechanism—is undermined. For instance, if shareholders
15 are exposed to too little risk, the LDC will have too weak an incentive to pursue savings on
16 behalf of its customers. On the other hand, if shareholders are exposed to too much risk,
17 the LDC might be inclined to mitigate risk to the detriment of customers.

18 The goal then is to strike the best balance of risk between shareholders and
19 customers to ensure that their interests remain in alignment. As will be discussed later in
20 these Comments, NW Natural believes that the correct balance can be best assessed
21 through an analysis of the effect of variations in gas prices on shareholders and customers.

22 **3. THE MECHANISM MUST BE SIMPLE TO ADMINISTER AND EASY TO REVIEW.**

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24 [13] NRRI Report, p. 2. It follows that once the LDC's interests are aligned with those of the customers, the Commission should avoid the application of overly prescriptive purchasing policies in order to
25 allow the LDC to pursue these interests as effectively as possible. This is consistent with the Commission's stated intent in UG 73 to "allow Oregon LDCs to exercise enough control over gas
26 commodity and related prices to be able to make more economical purchases of spot or long term gas." *See* Order No. 89-1046, 105 P.U.R. $4^{th}$ at 372.



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1 In adopting an earnings review process in AR 357, the Commission held that "the 2 process should be designed to be efficient and simple to administer, with some certainty as 3 to what will be considered."[14] And in UM 903, the Commission commented on the same 4 subject: "It [the earnings review] should not be structured so as to turn each PGA filing into 5 an annual rate case or show cause hearing . . . .Indeed, such scrutiny may eliminate any 6 incentive for the company to pursue efficiencies."[15] This principle should apply equally to all 7 aspects of the PGA mechanism. A less complex process will minimize the opportunity for 8 misunderstandings and disputes, and will prevent the harm of unintended consequences.[16]

9 **4. THE MECHANISM SHOULD AVOID UNINTENDED CONSEQUENCES BY APPLICATION OF A**
10 **REASONABLE EARNINGS REVIEW.**

11 In general, once a PGA is adopted it can be administered on an "automatic" and 12 consistent basis. However, as the Commission has recognized in the past, if an LDC's 13 earnings are exceptionally high, it may be required to share an additional portion of its gas 14 cost savings with customers.[17] An appropriate earnings test, like the one currently in place, 15 can ensure that such reasonable additional sharing occurs.

16 **B. THE PGA UNDER OREGON LAW**

17 **1. THE HISTORY OF THE OREGON PGA**

18 In approximately 1977, the Commission first adopted a PGA to permit Oregon's 19 natural gas utilities to adjust revenue annually to reflect actual increases or decreases in gas

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21 [14] Order No. 99-284 at 5.

22 [15] UM 903, Order No. 99-272, 193 P.U.R.4th, at 379.

23 [16] NRRI Report, p. 17.

24 [17] *See* UM 903, Order No. 99-272, 193 P.U.R.4th at 380 (noting that the primary goal in Docket 903 25 was to establish a process to ensure earnings were not excessive prior to passing through increases in gas costs; an appropriate earnings threshold "will protect the interests of ratepayers and allow the 26 company the opportunity to pursue increased earnings through cost management and operating efficiencies").



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1 costs.[18] At that time Congress and the Federal Energy Regulatory Commission ("FERC")
2 had just begun the lengthy process of deregulating the nation's natural gas markets, which
3 would not be complete until 1993. In 1977 those markets were still subject to tight
4 regulations; LDCs purchased virtually all of their gas supplies under bundled sales tariffs
5 regulated by FERC, and the companies had little or no contact with suppliers and pipelines
6 companies other than those physically connected to the LDC's system. Moreover, most gas
7 purchase contracts were very long term in nature.[19] Because LDCs purchasing natural gas
8 had little to no ability to influence gas costs, and acted solely as a purchasing agent for LDC
9 customers, there was no perceived need to structure PGA mechanisms to give LDCs cost
10 incentives.[20] As a result, from the late 1970s to 1989, the Oregon PGA mechanism required
11 that LDC customers pay 100 percent of gas cost changes.[21]

12 However, by 1989 the federal steps toward deregulation had resulted in a more open
13 and competitive market, allowing LDC's to purchase gas at market prices while
14 necessitating changes to state regulations.[22] To provide LDC management with the
15 incentive to react to these opportunities to control and reduce commodity costs, Commission
16 Staff proposed that the Commission incorporate a sharing component into the Oregon
17 ______________________

18 [18] UG 73, Order No. 89-1046, 105 P.U.R. 4th 365, 367 (noting in 1989 that the PGA then in effect had
19 been in effect in Oregon for at least 12 years). *See also* Oregon Administrative Rule 860-022-0070.

20 [19] *See* UM 903, Order No. 99-272, 193 P.U.R.4th, at 385.

21 [20] *See, e.g.*, UG 73, Order No. 89-1046, 105 P.U.R. 4th at 370 (noting that the regulations that existed
prior to 1989 eliminated any incentive on the part of an LDC to "shape, direct and minimize its gas
22 supply costs").

23 [21] *See* UG 73,.Order No. 89-1046, 105 P.U.R. 4th at 367

24 [22] *See, e.g.*, Natural Gas Policy Act of 1978, 92 Stat. 3350, 15 U.S.C. § 3301 et seq. (providing for
escalation of controlled prices and eventual elimination of price controls on certain natural gas sales),
25 FERC Order No. 436 of 1985, 50 Fed. Reg. 42408 (containing 'open access' rule providing incentives
for pipelines to offer gas transportation services), Natural Gas Wellhead Decontrol Act of 1989, 15
26 U.S.C.A. §§ 3301 et seq. (eliminating FERC's authority to set wellhead prices and leaving
determination of natural gas prices at the wellhead to market forces).



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1 PGA.[23] In adopting Staff's proposal, the Commission noted that the newly unregulated
2 market was "much more open so as to allow Oregon LDCs to exercise enough control over
3 gas commodity and related prices to be able to make more economical purchases of spot or
4 long-term gas."[24] Accordingly, the Commission modified the PGA and ordered that instead
5 of assigning 100% of all cost variance to the LDC's customers, the LDCs would share such
6 variances on an 80/20 basis.[25]

7 In the 1990s, Congress and FERC continued to deregulate the natural gas industry,
8 most notably in FERC's Order No. 636, which was intended to facilitate the creation of a
9 competitive national gas market by requiring all interstate pipelines to "unbundle" their
10 transportation services.[26] The 1990's also saw the beginning of a long period of generally
11 increasing gas prices. As noted by Commission Staff in 2005, over the last decade the price
12 of natural gas had "risen over 300% and, barring a dramatic reduction in demand or huge
13 new supplies, will rise further."[27] As a result of these forces, gas purchasing by the LDCs
14 became an increasingly complex affair. The LDCs were purchasing a greater percentage of
15 their gas supplies directly from suppliers; the contracts they entered were of a shorter
16 duration, and over time they developed contracts designed to closely match the pattern of
17 usage requirements over a seasonal, monthly, and even daily basis.[28] Finally, the LDCs
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21 [23] *See* UG 73, Order No. 89-1046, 105 P.U.R. 4th at 367.

22 [24] *Id.* at 372.

23 [25] *Id.* at 373.

24 [26] *See Union Pacific Fuels, Inc. v. F.E.R.C.*, 129 F.3d 157, 160 (C.A.D.C., 1997).

25 [27] Staff Report, Appendix A to UG 164/UM 1214, Order No. 05-1054 (September 2005).

26 [28] UM 903, Order No. 99-272, 193 P.U.R.4th at 385.



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1 began to use hedging instruments to reduce the overall variability of the cost of gas and to
2 replace fixed price contracts formerly entered into directly with suppliers.[29]
3 During this period, the Commission made several adjustments to the PGA intended to
4 bring it in line with market conditions and LDC purchasing practices. In 1999 the
5 Commission adopted a formal earnings test to ensure that deferred amounts under the PGA
6 did not result in excessive profits for the LDCs.[30] The Commission adopted an earnings
7 threshold for NW Natural of 300 basis points, which it found would protect the interests of
8 customers while allowing the company the opportunity to pursue increased earnings through
9 cost management and operating efficiencies.[31] The Commission also adopted a sharing
10 component for the earnings review providing that any earnings in excess of the benchmark
11 would be shared between customers and shareholders on a 67/33 basis.[32]
12 In that same order the Commission also allowed the LDCs to accept increased exposure
13 to market risks and rewards by adjusting the PGA sharing allocation from 80/20 to 67/33. In
14 exchange for accepting this additional risk, the LDC would be excused from application of
15 the fall earnings test.[33] NW Natural and Cascade opted for the 33/67 sharing level, while
16 Avista chose to continue its 80/20 sharing levels.[34]
17 Then, beginning in 2000, natural gas prices shifted from a steady increase to
18 unpredictable volatility. The "California Energy Crisis" of 2000-2001 saw gas prices soar,
19 ______________________

20 [29] *Id.*

21 [30] *Id.* at 375. Prior to 1999, the determination of reasonable earnings levels for PGA reviews had
22 taken place through an informal process, with, as noted by the Commission, sometimes contentious results. *Id.*

23 [31] *Id* at 380.

24 [32] *Id.*

25 [33] *Id.* at 388.

26 [34] *Id* at 376, fn. 1.



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1 followed by 9/11, recession, the collapse of Enron, and the withdrawal of many companies
2 from gas marketing. These events caused general uncertainty in the outlook for the
3 industry. By 2003, prices were on the rise. Then, as Staff noted in 2006, "2005 was a very
4 eventful year for natural gas in the US. Prices rose to unprecedented levels and price
5 volatility was rampant."[35] Staff pointed to numerous factors that could lead to the volatility,
6 including imports into the US, weather (including the most active summer hurricane season
7 ever recorded), changes in industrial production or use of natural gas for electric generation,
8 and the futures markets for natural gas.[36] In that same year the Commission adopted a
9 specific formula for calculating the weighted average cost of gas ("WACOG") that serves as
10 the mechanisms benchmark and provided additional guidance for the treatment of certain
11 WACOG components.[37] The Commission's stated purpose was to "align the PGA filing
12 requirements with current conditions in the natural gas market, which has changed
13 considerably since the Order was issued."[38]

14 In November 2006, Staff recommended that the Commission open an investigation to
15 review and modify as appropriate, the PGA mechanism used by Oregon's three LDCs. Staff
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20 [35] UG 175/UM 1278, Order No. 06-608 (October 2006), Appendix A, Staff Report. As noted earlier, Avista currently employs a 90/10 sharing mechanism, while Cascade's sharing rate is 67/33. *See* UG
21 176/UM 1279, Order No. 06-610; UG 175/UM 1278, Order No. 06-608.

22 [36] *Id.*

23 [37] UG 73, Order No. 05-852, pp. 1-3. In that Order, the Commission amended Order No. 89-1046 to provide a specific WACOG formula, in order to ensure consistency among the LDCs regarding the
24 calculation and reporting of each LDC'.

25 [38] UG 73, Order No. 05-852, p. 1. *See also* HIGH NATURAL GAS PRICES: THE BASICS, Edition 2, February 1, 2006, Federal Energy Regulatory Commission (noting that natural gas prices rose
26 significantly in 2005 after hurricanes Rita and Katrina, and that since then prices fluctuated strongly with changing weather).



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1 specifically recognized changes in the market that resulted in less stability and more risk for
2 the LDCs.[39] The Commission accepted Staff's proposal, resulting in this Docket.

3 **2. NW NATURAL'S REQUEST FOR AN INTERIM ADJUSTMENT**

4 NW Natural currently shares any variance between its WACOG benchmark and
5 actual costs on a 67/33 basis. This arrangement made a great deal of sense at the time NW
6 Natural initially agreed to increase its sharing percentage; in 1989 gas markets were
7 relatively stable, and NW Natural was able to rely on its storage capacity to take advantage
8 of market conditions to the benefit of both customers and shareholders. Over time, as gas
9 prices began steadily rising, the Company was able to continue to manage this relatively
10 high degree of market exposure by hedging a significant percentage of its gas purchases.
11 In the years leading up to 2006, the Company "hedged" roughly 90% of its gas costs,
12 including gas in storage, in anticipation that gas costs would continue to rise. Then, in 2006,
13 because of the leveling out of prices and despite rapidly fluctuating market prices, NW
14 Natural reduced its hedging level to approximately 75% to better match the company's
15 portfolio to current market conditions. Both the Company and Staff agreed that this
16 reduction in hedging was the prudent course. However, reduced hedging also increased the
17 risk of large profits or losses, thus exacerbating the increased risks caused by the changes
18 in the market. At the same time, Staff began to express its own view that LDCs should
19 never hedge more than 75 percent of its purchases, regardless of market conditions.[40]

20 In hopes of limiting the Company's unreasonable market exposure, in August of this
21 year NW Natural filed an application for an Interim PGA Mechanism. In its filing NW Natural
22 noted that market conditions and hedging practices had placed an unreasonable and
23 ______________________

24 [39] *See* Staff Report, November 21, 2006, Request to Open PGA Investigation, p. 2 ("The Oregon
25 PGA mechanism in place today was designed to meet LDC needs in a stable, lower priced, and more predictable natural gas market. That market no longer exists.").

26 [40] *See, e.g.*, Commission Staff Report for Public Meeting Date 10/25/06, UM 1286, at 8.



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1 disproportionate amount of financial risk on the Company. Therefore, the Company
2 proposed--on a temporary basis, and until this docket was completed--to retain its 67/33
3 structure for the first $15 million difference between actual costs of gas and WACOG, while
4 differences that exceeded $15 million would be shared with customers on a 90/10 basis.[41]
5 This "soft collar" mechanism was intended to protect the shareholders from unusually high
6 losses that could arise under a volatile market, and similarly to prevent the Company from
7 retaining a disproportionate amount of unusually high gains.

8 The Commission acknowledged that the increased risk facing the LDCs needed to
9 be addressed. However, in the Commission's view this was best accomplished in the
10 course of this investigative docket.

11 **C. NW NATURAL'S PROPOSAL**

12 The current PGA furthers this Commission's goals for LDC gas purchasing, adheres
13 to the Commission's principles for PGAs, and comports with NRRI's design principles for
14 GPIMs. It has served the LDCs and their customers well for over 30 years. For these
15 reasons, NW Natural proposes that the current PGA be retained. The only alteration
16 requested by NW Natural is to shift its sharing percentage from 67/33 to 80/20; this change
17 can easily be accommodated under the current mechanism.

18 **1. PGA COMPONENTS**

19 Under Oregon's current mechanism, each LDC sets a benchmark, which is reviewed
20 and approved by the Commission in the annual PGA filing. This benchmark will later be
21 compared to the actual cost of gas purchased by the LDC.[42] The benchmark, or embedded
22 WACOG, is incorporated into the LDC's rates through the annual PGA tariff filings. Subject

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24 [41] *See* NWN Advice No. OPUC 07-6, p.2.

25 [42] Note that regulations do not currently prescribe the method an LDC must use to determine the expected future price to be used in the development of the LDC's embedded WACOG. NW Natural
26 proposes that the guidelines issued in this docket prescribe the method that the Company currently uses, employing the NYMEX forecasts.



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1 to the application of an earnings review, the difference between the embedded and actual
2 WACOG, multiplied by the sharing percentage applicable to the LDC (i.e. 33% for NW
3 Natural), is deferred for later inclusion in rates.

4 **a. The Benchmark**

5 As stated by NRRI: "The central element of GPIM design is the benchmark formula,
6 which determines to what costs and revenues incentives apply, the strength and nature of
7 incentives, the likelihood of an award or penalty, and the utility's exposure to risk as a result
8 of the GPIM."[43] Oregon's method for setting its benchmark – in particular as calculated by
9 NW Natural -- provides a sound basis for its PGA.

10 First, the Oregon benchmark is designed to provide incentives for the LDC to apply
11 its expertise to produce the optimum purchasing strategy. Hedged gas supply transactions
12 that are completed in advance of the PGA filing are passed through to the embedded
13 WACOG at 100% of cost. On the other hand, spot market purchases are embedded in
14 WACOG at the beginning of the gas year based on market forecasts. An LDC like NW
15 Natural can seek to manage its spot purchase volume and price volatility – due to weather
16 and other market fluctuations – relative to the PGA forecast by optimizing its use of storage.

17 *Second*, the forecasts used to set WACOG for spot market purchases are based
18 upon a sound and independent source. Beginning in 2005 NW Natural began using a New
19 York Mercantile Exchange ("NYMEX") price strip to develop its embedded WACOG.[44] For
20 the 2007-2008 PGA, NW Natural used a 60-day NYMEX average (i.e., two calendar months
21 of data), and NYMEX basis differentials to develop its weighted average cost of gas. For
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24 [43] See NRRI Report, p. 6

25 [44] Until 2005, the expected future price was derived from the prior year's actual gas prices. In
26 recognition of the limited value of using the prior year's prices to determine future prices, NW Natural modified its method.



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1 the 2007-2008 PGA, this price was applied to a normalized load based on the prior year's
2 sales. NW Natural used a similar method to develop its WACOG in the 2006-07 PGA.

3 The NYMEX daily price strip reflects the actual prices at which natural gas futures
4 have traded on the NYMEX and thus constitutes a wholly independent (or "exogenous")
5 basis for setting WACOG, a methodology recommended by NRRI.[45] Moreover, by using
6 actual forward market prices averaged over a period of time the NYMEX strip forecast
7 minimizes the impact of daily price volatility.

8 **b. The Sharing Component**

9 The second key aspect of the Oregon PGA is the sharing component which the
10 Commission adopted in 1989, and which provides the LDCs with an incentive to pursue cost
11 savings on behalf of their customers. The operation of the sharing component is very
12 simple: if the cost of gas is higher than that contained in the benchmark, the LDC shares the
13 cost "increase"; if the cost of those purchases is lower, the LDC shares the cost "decrease".

14 From the beginning, the Commission adopted the sharing mechanism as a flexible
15 structure, and has approved differing sharing percentages for different LDCs at different
16 times. When the Commission first adopted a sharing component in 1989, Cascade and NW
17 Natural chose to share at a 67/33 level while Avista chose to share at 80/20. Since that time
18 the Commission has approved 90/10 sharing for Avista. This flexibility is critical to the
19 success of the sharing mechanism which must be adapted to an evolving market. Section D
20 below will explore the impact of different sharing percentages under changing market
21 conditions.

22

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25 [45] See NRRI Report, page 17. As noted by NRRI, the current method used in the Oregon PGA
26 includes an exogenous benchmark: once WACOG is set through the operation of the PGA, it cannot be altered by utility purchasing decisions. Id. at 10-14



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### c. The Earnings Test

Each spring, the Commission conducts an earnings review for each LDC. Based upon the utility's results of operation filed each May for the previous year, the Commission determines whether the PGA will result in a rate adjustment. If adjusted earnings are below the LDC's earnings threshold, there will be no rate adjustment. If adjusted earnings are above the earnings threshold, the amount of revenue in the test year representing 33 percent of the earnings exceeding the threshold level will be shared with customers. Finally, for LDCs that adopt a 67-33 risk-reward sharing mechanism for commodity cost differences under the PGA mechanism, there is no fall earnings test prior to amortizing deferrals. For LDCs with an 80-20 sharing mechanism, an earnings test will be applied prior to amortizing deferrals.[46]

## 2. The Current PGA Adheres to Key Principles

### a. PGA Principles

NW Natural believes that the Oregon PGA adheres to each of the principles enunciated in Section III, above, and best advances the Commission's goals of ensuring that the LDCs provide natural gas to their customers reliably, at the lowest cost and stable pricing.

***Principle 1: The Oregon PGA aligns customer and shareholder interests.***

The most important feature of the NW Natural proposal is the sharing of costs between shareholders and customers. NW Natural believes that the sharing mechanism remains the best way to meet the policy goals described above. The Oregon PGA acts as a true incentive, encouraging the LDC to keep its gas costs as low as possible for its customers and rewarding the LDC when it is successful. In this way, the sharing mechanism aligns the interest of its shareholders with those of its customers.

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[46] UM 903, Order No. 99-272, 193 PUR 4th at 380



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1 In NW Natural's case, the proof lies in the Company's results. In the 2007 study of
2 NW Natural's use of storage, the study authors found that NW Natural's use of storage for
3 price arbitrage, without sacrificing the primary goal of maintaining storage to ensure
4 reliability of supply, was "truly impressive".[47] The 2006 Natural Gas Procurement Study by
5 Commission analyst Steve Chriss similarly found that for the years studied, NW Natural paid
6 4.5% less than market prices, on average, and overall, NW Natural's purchasing strategies
7 out-performed the market.[48]

8 While NW Natural believes that its sharing percentages need to be altered, it is
9 convinced that the sharing component itself has and will continue to provide it the incentive
10 to continue to seek savings for its customers.

11

12 ***Principle 2: By offering flexible sharing levels, the Oregon PGA ensures that***
13 ***risk will be shared by customers and shareholders on a fair and sustainable***
14 ***basis.***

15 While the Oregon PGA properly mandates some degree of sharing between
16 customers and shareholders, it wisely allows for varying sharing levels that can be tailored
17 to each LDC's particular characteristics, as well as market conditions. NW Natural
18 maintains significant storage capacity and therefore is better able to manage short-term
19 market volatility than the other LDCs who have less access to storage. Moreover, as
20 discussed below, changes in market conditions may also mandate changes in sharing
21 levels. The fact that the Oregon PGA allows flexible sharing levels ensures that it can
22 remain effective over time.

23

24

25 [47] Final Report: Assessment of the Effectiveness and Efficiency of Northwest Natural Storage Operations, Altos Management Partners Inc., September 4, 2007, at 4-5.

26 [48] See Public Utility Commission of Oregon Natural Gas Procurement Study, Steve W. Chriss.



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1 ***Principle 3: The Oregon PGA is simple to understand and easy to administer***

2 Oregon's current PGA has been administered by the Commission for approximately 3 30 years, under varying market circumstances and with varying levels of sharing. The 4 Commission and parties understand the current mechanism and it is applied without 5 difficulty.

6 ***Principle 4: The Oregon PGA avoids unintended consequences by applying an*** 7 ***earnings review.***

8 The Oregon PGA has included formal earnings reviews for the LDCs since 1989. At 9 that time the Commission approved differing thresholds and sharing percentages for NW 10 Natural than those approved for the other LDCs—another salutary example of the flexible 11 nature of the mechanism. NW Natural agrees that the 300 basis point threshold adopted by 12 the Commission for NW Natural will guard against application of the PGA to produce 13 excessive earnings for the Company which encourages the Company to use its expertise to 14 pursue customer benefits.[49] The 67/33 sharing contained in the earnings test is also 15 "significant enough to ensure that the LDCs earnings are not excessive, while allowing 16 LDCs to benefit from productive management of the business."[50]

17 **D. NW NATURAL'S SHARING PERCENTAGE**

18 While the Oregon PGA itself does not need to be altered, NW Natural's sharing 19 percentage does. As the Company explained in its Application for an Interim 2007-08 20 Purchased Gas Cost Adjustment Mechanism, NWN Advice No. OPUC 07-6, commodity 21 costs represent the lion's share of an LDC's annual expenditures.[51] Therefore, in order to 22 remain viable, NW Natural must be accorded a reasonable certainty of recovering a

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24 [49] UM 903, Order No. 99-272, 193 P.U.R.4th, at 380.

25 [50] UM 903, Order No. 99-272, 193 P.U.R.4th at 380.

26 [51] *See, e.g.*, NWN Advice No. OPUC 07-6/NWN/100, Miller/2 (noting that in 2006 NW Natural's earnings were $63.4 million, while $648 million was spent on gas).



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1 significant portion of those costs. Under the current sharing percentages, NW Natural's
2 shareholders are exposed to an unacceptable – and unsustainable—level of risk. This
3 increased risk encourages the utility to be overly conservative in seeking savings on behalf
4 of its customers, thus undermining the proper alignment of customer and shareholder
5 interests.

6 The imbalance between NW Natural's shareholders and customers is best
7 understood by reviewing the effect of an increase in the price of gas with this simplified
8 example based upon the Company's 2006 results of operations:

9 In 2006, NW Natural's pretax earnings were approximately 100,000,000, and
10 customer bills were approximately $1,000,000,000.[52] Gas requirements were approximately
11 80,000,000 Bcf, 25% of which was unhedged; as a result 20,000,000 Bcf was exposed to
12 the market. Given these circumstances, assume that the price of gas increased by $2.00—
13 a reasonable movement under current market conditions. These conditions, and the
14 resulting effect on customers and shareholders can be expressed as follows:

15 $100M pretax earnings $1000M total customer bills
16 80 Bcf gas requirement X 25% unhedged = 20 Bcf exposure
17 $2 swing x 20 Bcf = $40M ($27M customers/$13M shareholder)
18 $13 / $100 = 13% shareholder earnings at risk
19 $27 / $1,000 = 2.7% customer bills at risk (approx. $.03 per therm)

20 Thus, under conditions roughly equivalent to current market conditions, the potential
21 gas cost variance is $40,000,000. Under the Company's existing PGA sharing percentages
22 of 67/33, this variance will result in a 13% loss of earnings to shareholders and an increase
23 in customer bills of 2.7%.

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26 [52] See NW Natural 2006 Annual Report, at 18.



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1 It is hardly surprising that the level of risk presented is unacceptable to NW Natural's
2 shareholders. As a result, and as a means of mitigating this risk, the shareholders would
3 have an interest in hedging more that 25% of the portfolio. Customers on the other hand,
4 who face only a 2.7% risk, would be best served by leaving 25% of gas supplies unhedged.
5 Thus, the interests of the two parties have been thrown out of alignment.

6 It is worth noting here that in the past, under different market conditions, the 67/33
7 sharing percentage presented acceptable risk levels to both customers and shareholders.
8 In 2002, NW Natural's load was roughly equal to today's 80,000,000 Bcf. However, in that
9 year, the Company hedged roughly 85% of its gas purchases, and the Company could not
10 have reasonably anticipated gas swings of more than $1.00. Moreover, in 2002 NW
11 Natural's pretax net earnings and customers bills were roughly 60% of what they are today
12 at $67,000,000 and $641,000,000 respectively. Under this scenario, the anticipated
13 variability was only $12,000,000, with shareholders facing a 6.0% risk while customers
14 faced a 1.2% risk—acceptable exposure for both groups.

15 2002 $67M net pretax earnings $641 total customer bills
16 80 Bcf gas requirement X 15% unhedged = 12 Bcf exposure
17 $1 swing x 12 Bcf = $12M ($8M customers/$4M shareholder)
18 $4 / $67 = 6.0% shareholder earnings at risk
19 $8 / $641 = 1.2% customer bills at risk

20 Thus, a sharing level that was appropriate in 2002 is no longer sustainable today.
21 Assuming NW Natural continues to hedge approximately 75% of its gas supply, the simple
22 way of bringing customer and shareholder interests back into alignment is to modify the
23 shareholder sharing portion to a lower level. If the 2006 example is repeated with an 80/20
24 sharing structure, shareholders are only at risk for an 8.0% shift in earnings, while
25 customers are at risk for a 3.2% variation in total bills. These risk levels are acceptable to
26 both customers and shareholders, so their interests are in alignment.



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## E. RESPONSE TO ALTERNATIVE MECHANISMS

### 1. ONE HUNDRED PERCENT PASS-THROUGH WITH PRUDENCE REVIEW:

NW Natural acknowledges that 100% pass-through mechanisms offer certain benefits to the LDCs. In particular, given the LDCs' limited ability to influence gas costs, a 100% pass through will never threaten to penalize the LDC for market conditions over which it has no control.

That said, a 100% pass-through mechanism fails to align shareholder and customer interests and therefore should not be adopted. Without any sharing, the 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. Over time the LDC would be less likely to rely on its own expertise, and would instead substitute Staff's judgment as to what is prudent—thus undercutting one of the central aims of incentive mechanisms which is to encourage the LDC to employ more highly qualified staff and acquire superior market intelligence.[53] Finally, prudence 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.

Since 1989, the sharing component of the PGA has served as a durable and effective incentive to LDCs to pursue benefits for their customers. While NW Natural recommends that its own sharing percentages be adjusted, the sharing component in itself is crucial to the alignment of shareholder and customer interests and therefore should be retained.

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[53] NRRI Report, p. 2.



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1 **2. PGE PCAM-STYLE MECHANISM**

2 In the informal workshops scheduled for this docket, Citizen's Utility Board ("CUB")
3 has argued that the LDCs should be subject to a PGA that is fashioned after the power cost
4 adjustment mechanism ("PCAM") that the Commission adopted for Portland General Electric
5 Company ("PGE") in UE 184. In particular, CUB has argued for a PGA that includes a
6 significant deadband within which no adjustment would be made for costs over or under the
7 benchmark; in addition, CUB's proposal provides that no adjustment will be made if overall
8 earnings are reasonable. However, the principles and purposes of a PCAM adopted for an
9 electric utility are inapplicable to an LDC. The Commission should therefore reject such a
10 proposal.

11 First, LDCs and electric utilities have traditionally had vastly different operating and
12 cost recovery models. Historically, electric utilities have been vertically integrated, with the
13 utility owning the generation, transmission, and distribution functions. Under this model, the
14 electric utility's rates were set based on the total cost of production and distribution. In direct
15 contrast, the traditional LDC has owned only the means of distributing the gas is sells. LDCs
16 traditionally passed through the cost of gas because public utility commissions recognized
17 that the LDC played little or no role in setting the cost of that gas; LDCs act simply as
18 purchasing agents for their customers.[54] To hold the LDC responsible for the cost of gas, or
19 to suggest that variations in the cost of gas are a part of the business risk an LDC is
20 expected to absorb, would turn the traditional regulation of the LDC on its head.

21 Second, by eliminating the sharing until specific variances have been reached, the
22 imposition of a deadband would mute or remove altogether the incentives that the PGA is
23 intended to provide. The deadband proposed by CUB would provide management with an
24 incentive to seek gas cost savings beyond the deadband—but only to the extent that
25

26 [54] This principle is implicit in the Commission's move from a pass-through PGA to the introduction of sharing—exposing the utility to some degree of risk as it gained some opportunity to control its costs.



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1 savings could be achieved without risk of loss. Thus, the incentive to obtain lower costs for
2 customers would be significantly dampened.

3 Third, the earnings test in the current PGA is used to ensure the LDC seeking gas
4 cost recovery shares extraordinary returns with its customers. The earnings test does not
5 reduce the incentive to improve the efficiencies of operations. If NW Natural's return is 300
6 basis points above its authorized level, it shares 33% of the earnings exceeding that level
7 with customers. With a dead band and limited sharing above the band, there is little
8 incentive to increase returns above the top of the dead band. And with gas costs included in
9 the formula, the hard choices required to improve efficiencies may not be worth the effort if
10 they can be wiped out by unavoidable gas cost increases.

11 Thus a PCAM-style PGA is not well suited to the LDCs and would likely result in
12 unintended and undesirable consequences.

13 **IV. CONCLUSION**

14 The Oregon PGA mechanism is well designed to encourage LDC gas purchasing
15 goals. Its greatest strength is its sharing component, which is robust enough to provide the
16 LDCs with significant incentives to pursue low costs for customers, and flexible enough to
17 adapt to the needs of different LDCs and under different market conditions. For this reason,
18 NW Natural encourages the Commission to retain the Oregon PGA as currently in force.

19 NW Natural does agree that the gas market today is significantly different from the
20 market that existed thirty years ago when the Commission first adopted a PGA, or any
21 market that has existed since. However, the PGA's flexible sharing component lends it the
22 durability required by changing market conditions.

23 As part of this investigation, NW Natural is asking the Commission to modify the
24 Company's present sharing level from 67/33 to 80/20. It is a testament to the efficacy of
25 /////
26 /////



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1 the current PGA that, by modifying LDCs' sharing levels, it can continue to respond to the
2 challenges of an evolving natural gas market.
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1 the current PGA that, by modifying LDCs' sharing levels, it can continue to respond to the
2 challenges of an evolving natural gas market.
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4 DATED: December 4, 2007
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