BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1286

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In the Matter of	)
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THE PUBLIC UTILITY COMMISSION	)
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Investigation into the Purchased Gas	)
Adjustment (PGA) Mechanism Used by	)
Oregon's Three Local Distribution	)
Companies.	)
	)

OPENING BRIEF

OF THE

CITIZENS' UTILITY BOARD OF OREGON

August 29, 2008

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OF OREGON

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

I. Introduction

In reading the Reply Testimonies of the Joint Parties (Staff, NW Natural, Cascade, Avista, and the Northwest Industrial Gas Users) and NW Natural, one would never know that CUB has, in this case, consistently acknowledged increased volatility in the natural gas markets and proposed changes to the current PGA mechanism in order to address that volatility. In fact, CUB has done both, and offers a proposed mechanism that shifts more risk of gas cost variation onto core customers both than what currently exists, and than what we originally proposed in our Comments in this case. Further, CUB's proposed mechanism in this case contains the very sharing percentage proposed by one of the Joint Parties, NW Natural, in its Opening Comments, and CUB's conclusion with

regard to the basic functioning of the current PGA also matches that of NW Natural. NW Natural Opening Comments at 2, and Reply Comments at 21-22.

We find it ironic that CUB is the only party to have put evidence on the record (not hypothetical examples) to demonstrate that the current mechanism is working reasonably well. Despite this, we acknowledge that gas price volatility has increased and that there are ways to change the current mechanism to further protect the gas utilities from the difference between commodity costs in rates and actual commodity costs, while maintaining the risk-reward sharing mechanism that has been a central tenet of the Oregon PGA.

CUB is also the only party to put on the record any evidence based on actual data (not hypothetical examples) of how the proposed PGA mechanism might actually work. All three utilities responded to our data requests to provide a back-cast of the proposed mechanism using their historical data, and CUB put some of this data on the record. The Joint Parties, however, made no attempt to supplement the record with actual data.

Usually one might think that a mechanism agreed upon between Staff, the utilities, and a customer advocate group would have considerable merit. The proposed PGA stipulation now before the Commission, however, is a mess of a group-accommodation driven largely by the gas utilities' desire to shift risk onto customers and by Staff's shift away from its previous philosophical approach in support of the risk-reward sharing incentive. CUB/100/Jenks/37-38. The result is a proposal that is complicated, open to interpretation, lacks a meeting of the minds on a key component (the earnings review), results in a significant shift of risk to core customers, and was proposed without having been tested using actual historical data.

This last point bears repeating, the Joint Parties did not attempt to demonstrate that the results, using historical data, from their proposed mechanism could reasonably be expected to result in lower gas costs for customers than the current PGA mechanism. We point out, again, that CUB is the only party to have put evidence on the record regarding actual city gate gas prices, as compared to residential, commercial, and industrial rates in Oregon and surrounding states. CUB Opening Comments at 6. While this EIA data is not utility specific, it is certainly informative, and provides some information regarding the prices that customers pay and the city gate cost of gas, which do not always track one another as one might expect. Ultimately, the goal should be a balance of low rates and low risk for customers, and this goal should not be confused with the goal of low commodity costs for the utility, as, depending upon the regulatory mechanism in place, lower costs may or may not make their way into customer rates.

It is not unreasonable to reevaluate the current PGA mechanism in light of changing natural gas markets, but it would be unreasonable to adopt the convoluted two-Variance mechanism proposed by the Joint Parties simply on the basis that natural gas markets have changed and that Staff's philosophy on the incentive provided by Oregon's current risk-reward sharing mechanism has changed. The Citizens' Utility Board offers the following arguments in opposition to the proposed PGA mechanism submitted by Staff, NW Natural, Cascade, Avista, and the Northwest Industrial Gas Users, followed by its proposed PGA mechanism.

II. The Parties' Proposed Mechanism

The basic premise of the current PGA mechanism is to charge customers based on a forecast of gas costs and then share between customers and shareholders the difference

between the actual cost of gas and that which was forecast. This risk-reward sharing serves as an incentive to keep the utility actively managing its gas portfolio by balancing the goals of low cost and low risk. Though customers are responsible for the bulk of commodity costs, the current mechanism keeps a utility's skin in the game, as its shareholders share some of the risk of high gas costs and share some of the reward of low gas costs with customers. It's simple, it's clean, it's understandable, it has been working reasonably well, and there is little room for unexpected regulatory outcomes.

As for the Joint Parties' Proposal, while it is not clear whether all the parties understand all the implications of it, the basic mechanism looks like this: customers would pay the sum of:

- (embedded WACOG) x (actual volumes) +
- (95%) x (Monthly WACOG Variance) +
- (67% or 80% or 90%) x (Unhedged Benchmark Variance).

While the Joint Parties will claim that the new proposal is a response to the changing gas markets, they fail to demonstrate that the incentive in their proposal is better than what we currently have, and fail to demonstrate that the combination of the WACOG Variance, the Unhedged Variance, and the Earnings Test might provide any reasonable balance of risk and reward.

The Joint Parties propose to terminate the existing mechanism and replace it with a new, untested mechanism. Such a significant change requires them to bear the burden to show that such a change will be beneficial to customers. But they fail to show that it will minimize costs, simplify regulation or provide any real benefits.

Would the Joint Parties' proposal still be worth it if it minimized gas costs? Perhaps, if that value were passed on to customers and did not simultaneously increase

the risk of higher costs to customers. However, the Joint Parties do not show that the new proposal would minimize gas costs, they simply imply it. Joint/200/Joint/2. Is the Commission really going to rely on an implication that this is going to work better than the existing mechanism, or work at all for that matter? That the utilities support the proposal is not evidence that the proposed mechanism would minimize gas costs for customers, because the utilities may be simply interested in shifting risk. No other showing has been made that the proposal might minimize gas costs for customers.

A. The Proposed Mechanism Would Shift Risk Onto Customers

The Parties' proposal would be a significant shift in risk from the current PGA mechanism without any counterbalancing offset in reduced return on equity or reasonable demonstration that this risk shift might lower gas costs or otherwise benefit core customers.

i. The Bulk Of Financial Sharing In Proposed Mechanism Would Be 95-5

The Joint Parties' Reply Testimony and CUB's Opening testimony both demonstrate that the bulk of the financial risk of the mechanism lies with the WACOG Variance. Joint Parties/201. CUB/100/10. The proposed mechanism would reduce the risk-reward sharing for this Variance amount, to 95-5. Currently two of the three utilities use a 67-33 sharing mechanism. The WACOG Variance would be calculated each month and appears to be:

= (Monthly Benchmark WACOG – Annual Embedded WACOG) x (total actual volumes)

The difference between the Monthly Benchmark WACOG and the Annual Embedded WACOG is multiplied by total actual volumes, and 95% of this is deferred for later collection or refund. The Monthly Benchmark WACOG is a measure of what the

utility's WACOG would have been, had the utility purchased all of its spot gas at the Benchmark Price. Each year the utility gets to decide whether to use the First of the Month Index (FOM) as the Benchmark Price or to use Daily Indices. The bulk of the financial risk would be captured by the WACOG Variance, and shared 95-5 with core customers, which is a material shift from the current PGA sharing percentages. The Parties' Testimony in support of their proposed mechanism offers little support as to why such a shift of risk onto customers is good policy.

ii. Data Provided By CUB And Examples From Parties Demonstrate Risk Shift

That the proposed PGA mechanism would shift additional risk of gas cost variation onto customers is discussed above, and is supported by CUB's Testimony, the Utilities' responses to our data requests, and the Joint Parties' Testimony. CUB/100/Jenks/26-27, CUB/104, Joint/201. The graphs provided by NW Natural in response to our data request, included as CUB Exhibit 104, visually demonstrate the increased magnitude of the gas cost difference that customers would be expected to bear, positive and negative, under the proposed PGA mechanism.

In their Reply, the Joint Parties offer three hypothetical examples of how their proposed PGA mechanism would work if: 1) market prices were lower than forecast, and the utility met the benchmark; 2) market prices were lower than forecast, and the utility did not beat the benchmark; and 3) market prices were higher than forecast, and the utility beat the benchmark. Joint/201. The examples provided by the Joint Parties use 80-20 sharing for the Unhedged Variance, as well as for the current PGA mechanism. However, two utilities currently share at 67-33, not 80-20, so this example minimizes the difference between the two. These hypothetical examples also use the First of the Month

Benchmark Price even though the utility can choose a Daily Benchmark Price. The hypothetical examples provided by the Joint Parties substantiate, not disprove, CUB's point that their proposed mechanism would shift additional risk of gas cost variability onto customers. In all three Scenarios, customers would have been responsible for a larger percentage of the variation, positive or negative, than they would have been under the current mechanism (at 80-20 sharing).

Proposed	**Scenario A**		**Scenario B**		**Scenario C**	
Total	($2,400,000)		($4,800,000)		$4,800,000	
Customers	($2,280,000)	95%	($4,920,000)	103%	$4,920,000	103%
Utility	($120,000)	5%	$120,000	-3%	($120,000)	-3%
Current						
Total	($2,400,000)		($4,800,000)		$4,800,000	
Customers	($1,920,000)	80%	($3,840,000)	80%	$3,840,000	80%
Utility	($480,000)	20%	($960,000)	20%	$960,000	20%

Two of the three hypothetical examples cited by The Joint Parties are examples where actual gas costs are less than forecasted gas costs and one is an example where gas costs are higher than forecast. First, in all three examples, the share of the difference between forecasted and actual gas costs that is allocated to customers is significantly larger than under the current mechanism. Second, in two of the examples customers would be allocated a variance that is greater than the difference between forecasted gas costs and actual gas costs. This kind of result will happen, as we pointed out using the actual data provided by the utilities in response to our data requests, except in the real world we could get more extreme results. According to a data response from NW Natural, applying the Joint Parties' PGA to the partial results from 2007-08 would result in customers receiving 170% of the variance and NW Natural receiving ***negative*** 70%. CUB/100/Jenks/22-23.

B. Benchmark Price Does Not Improve Mechanism

Besides reducing the base sharing mechanism to 95-5, the primary change in the PGA proposed by the Joint Parties is to add a Benchmark price that is unrelated to forecasted prices or actual prices. An important question is whether this provides any value.

The primary purpose of the benchmark price seems to be to set up a comparison that is as close to possible to the actual cost of the gas utility's purchases:

> The LDCs can purchase unhedged gas on a monthly or daily basis, or some combination of both. If the LDC plans to purchase the majority of this gas on a monthly basis, it only makes sense to use a monthly (FOM) benchmark; similarly, if the LDC plans to purchase the majority of this gas on a daily basis, it only makes sense to use a daily benchmark. The PGA mechanism incentive arrangement thereby continues to carry through its major objective referenced above – comparison of the LDC's gas cost to prices in the actual markets in which the LDC made gas purchases.

Joint Parties/200/12-13

If the gas utility purchases its spot gas on the daily market, then the mechanism would compare the price the gas utility paid to the price that was being offered in the spot market on that day. This is a good mechanism to minimize the variance, but we are not convinced that it is an incentive designed to minimize costs. In fact, the benchmark may determine the purchasing pattern of the utility rather than the purchasing pattern of the utility determining the benchmark. If the LDC has chosen the daily benchmark, then to minimize its risk, it will likely purchase its gas on a daily basis, regardless of whether current market conditions would suggest that purchasing gas on a monthly basis, or some combination of monthly and daily purchasing, would result in the lowest cost supply.

Gas costs are forecasted into rates, but because those rates are set in advance, they do not reflect the actual costs of gas by the utility. The original purpose of the PGA was

to design a mechanism that dealt with this difference between forecasted and actual costs. This is obviously important because customers are paying the forecasted costs and the utility is paying the actual cost. Sharing the difference between these two is simple, straightforward, and can easily be explained to customers. Depending on the volatility and risks in the marketplace, a sharing mechanism that is based on the difference between forecasts and actuals can be adjusted as the risks in the marketplace change.

But this new mechanism no longer compares forecasted costs to actuals, but now compares forecasted costs to a benchmark and then compares actual costs to a benchmark. According to CUB's analysis and to the Joint Parties' Hypothetical Examples, the results of the combination of these two can result in customers paying more than the difference between forecasted cost and actual cost, or customers receiving a refund that is greater than the difference between forecasted and actual. Explaining to customers that they are getting a surcharge because actual costs were greater than forecast, but that the surcharge was greater than the difference between forecasted and actual costs, will not be an easy task.

C. "Optionality" Is Not An Improvement

Under the proposed Joint Parties' PGA, each utility will get to make a choice of 6 variations on the mechanism each year. This is touted as a way to reduce risk to both the LDC and the customer, but since the optionality involves shifting risk from the LDC to the customer and is at the LDC's discretion, it is hard to see how this reduces risk to the customer. According to the Joint Parties:

> A portfolio without optionality places added risks, sometimes quite large added risks (depending on the current market and general societal circumstances) on both the LDC and its customers. CUB seems opposed to most efforts to include optionality in the PGA mechanism. The result is

> increased risks for both customers and their LDCs. CUB is correct that optionality can also be a two-edged sword. Applied incorrectly or not properly monitored, optionality can also be used to shift risks away from the LDC onto its customers.

Joint Parties/200/14

Each year, each utility gets to look at the current market conditions and make an election as to how much risk it will take and how much it will assign to its customers. Customers, the staff and the Commission have no role in this election. It is solely at the gas utility's discretion. At the time of the election, the gas utility will already have made some hedges and purchased some of its storage gas. It will have a forecast (or several forecasts) of future prices. If the market looks risky, it will select the option that places the greatest share of the risk on customers. We do not understand the Joint Parties' claim that "applied incorrectly" it can be used to shift risk from the LDC to the customer, because it seems to us that that is the very purpose of the optionality.

D. The Unhedged Variance Election Could Be About Earnings

Is the unhedged sharing variance choice about spot purchases or is it about how much the utility expects to earn? Given the small amount of money involved for a utility that chooses the daily indices, the percentage of sharing in the Variance is of little relevance. The earnings threshold that accompanies the Variance sharing, however, may be of far greater interest to the utility as it makes its annual selection.

When a utility changes the sharing, it changes the earnings threshold. A utility that expects to over-earn, may select a choice, not based on changing conditions in the marketplace, but instead based on trying to minimize the sharing of their over-earning.

III. Response To Joint Parties and NW Natural Reply Testimonies

Having addressed the weaknesses of the Joint Parties' proposed mechanism, we also find it necessary to address their portrayal of CUB's Testimony as containing "sweeping and unsubstantiated generalizations" and "errors of fact." Joint/200/Joint/2-3. We respond to their criticism of CUB's earnings Review. Finally, we cannot leave unaddressed NW Natural's unfounded accusation that Mr. Jenks' Testimony was disingenuous. NW Natural/100/Miller/1.

A. Sweeping Generalizations

The Joint Parties, in their Reply, accuse CUB of making two "sweeping generalizations" about the proposed PGA Mechanism. Joint/200/Joint/2.

i. The Platypus & The Proposed PGA

Our first sweeping generalization is that we compared the proposed mechanism to a platypus. That is a metaphor, not a generalization. Given the amount of our Testimony devoted to describing the mechanism's different components and how those components might work together under different circumstances, we continue to find it an apt metaphor.

ii. Proposed Mechanism Would Shift Risk Of Gas Cost Variation To Customers

Our second supposed sweeping generalization is that "the Stipulated PGA will shift the bulk of gas purchasing risk to core customers." Joint/200/Joint/3. Given that we clearly point out in our Testimony that customers are already bearing the lion's share of gas purchasing risk, we're not sure how the bulk of a risk that is already borne by customers can be shifted to customers. CUB/100/Jenks/26-27,34. CUB does point out,

however, and demonstrate, that the proposed mechanism would shift much of the remaining risk of gas cost variation to customers, as discussed in more detail above.

CUB describes how the "proposed mechanism shifts most of the *remaining* risk of the variability of commodity prices to core customers." CUB/100/Jenks/34 [emphasis added]. NW Natural is correct in saying that CUB agreed to the implementation of WARM and to NW Natural's decoupling mechanism in exchange for tangible energy efficiency benefits. That CUB agreed to a mechanism does not mean that the mechanism does not shift certain risks to customers. These mechanisms are a part of the larger picture into which any PGA would fit. Pointing out the existence of these mechanisms and part of the role that they play in regulation is not an attempt at a good "sound byte" it is a reminder that whatever PGA mechanism the Commission adopts, that mechanism will not operate in a vacuum. NW Natural/100/Miller/4.

B. Errors Of Fact

In addition to "sweeping generalizations," the Joint Parties accuse CUB of a number of "errors of fact." Joint/200/Joint/3. Unfortunately, what the Joint Parties call "errors in fact" are differences in opinion (and in this we are giving the Joint Parties the benefit of the doubt); and though the Joint Parties may disagree with our conclusions, this does not mean that those conclusions are factually in error.

i. The Clarity Of The Stipulation And Testimony Language

The Joint Parties claim that we are factually in error by pointing out that "it is unclear what is included in the two variance calculations." Joint/200/Joint/3. The Joint Parties must mean that it is a *fact* that the language in the Joint Parties' Stipulation and Testimony is clear. First, the meaning of a stipulation is not a fact, it is an interpretation,

which may help explain why there are so many attorneys in the world. Second, if the language is so clear, it is difficult to explain why the textual explanation in NW Natural's response to CUB data request 6 regarding the proposed Unhedged Variance was wrong (as acknowledged by the Company), and Staff's response to CUB data request 8, also regarding the calculation of the Unhedged Variance, is also unclear and subject to interpretation. NW Natural/100/Miller/5, CUB/100/Jenks/14, CUB/106/Jenks/4.

The factual issue here is simple. CUB asked the designers of the mechanism a handful of straightforward questions about how the mechanism would operate and they could not accurately and clearly answer the questions.

ii. Rate Of Return And Risk Profile

The Joint Parties claim that our press release is wrong where we state that "CUB believes that a small percentage of sharing from the company's shareholders is appropriate, since they are being paid a rate of return to manage the company and secure the lowest possible cost." CUB has not issued a press release on this docket. We presume the Parties are referring to CUB's blog of July 25, 2008, (although the Joint Parties did not include either a citation or a copy of it with their testimony). The Joint Parties respond to CUB's statement as follows:

> The implication from this generalization is incorrect. The rate of return ("ROR") authorized for each Oregon LDC is based on the risk profile applicable to an LDC. This ROR, like that for most other LDCs in the nation, does not include consideration of the risk profile involved with purchasing gas in today's market. If it did, the ROR would be higher in recognition of the higher and more diverse risks involved with gas purchasing compared to operating a gas distribution company.

Joint/200/Joint/4.

Oregon currently has a risk-reward sharing mechanism. Under either the Joint Parties' proposed PGA, or CUB's proposed PGA, Oregon would continue to have a risk-

reward sharing mechanism. CUB was not suggesting that the rate of return compensated the utility for the "diverse risks" of the marketplace, as we have already pointed out that most of that risk is already being borne by customers and will continue to be so. CUB/100/Jenks/26-27,34. In our Opening Comments, we point out that, because NW Natural is primarily an Oregon utility, if the Investment community saw the "risk profile applicable to" NW Natural – and part of NW Natural's risk profile includes Oregon's risk-reward sharing – to be too great, then NW Natural's credit rating could be expected to be low. CUB Opening Comments at 7. As NW Natural's credit rating is strong, we can infer that Oregon regulation, including its risk-reward sharing mechanism, is not viewed by credit rating agencies as out of line with the current ROR.

iii. An Incentive To Lower Costs Or To Beat A Benchmark

The final error of fact claimed by the Joint Parties is that CUB comes to the conclusion that the proposed mechanism's incentive for a utility to "seek a gas supply portfolio that is well balanced in terms of overall cost of gas and gas price volatility" is not a "real incentive." Joint/200/Joint/4. First, CUB did not testify as to whether the incentive provided was "real" or not; rather, we examined the behavior it might produce under certain circumstances and compared that to the incentive in the current PGA mechanism. Second, the Joint Parties go on to state that "CUB could be correct in its conclusion if there was no one monitoring both the LDCs' overall gas supply portfolio and their decision making regarding both short-term and long-term gas purchasing." Joint/200/Joint/4. So after telling the Commission that we stated a falsehood, the Joint Parties then admit that we are right except for a condition that borders on the fantastical: the presence of perfect oversight. If the regulatory oversight over the gas supply portfolio

and the gas purchasing strategy is less than perfect, then we are correct and the Joint Parties must agree. Hardly an error of fact. Here, we make the point that the better the mechanism aligns parties' interests, the less the need for perfect oversight. In fact, if oversight were perfect, we may never need incentive regulation. Our point is that the design of the incentive regulation should account for the inherent limitations of oversight, and should therefore get the incentives right. Not only is this not a factual error, we also think we are correct.

Both the current PGA mechanism and CUB's proposed revision to it rely on two costs: the costs that were forecast, and the costs that actually materialized. Under the current PGA, or the PGA as revised with CUB's recommendations, after prices have been forecast, the utility would always have an incentive to minimize gas commodity costs, since the utility would be in the same boat with customers (though to lesser extent under CUB's proposal). Period.

Under the Joint Parties' proposed mechanism, however, after prices have been forecast, the utility has an incentive, not necessarily to minimize the overall cost, but to minimize the WACOG and Unhedged Variances that are calculated using the Benchmark Price. As demonstrated in our Testimony, in some circumstances, beating the benchmark does not lead to lower costs. CUB/100/19-20. The fact remains, however, that the goal of the risk-reward sharing in the current PGA – to lower gas costs for customers by keeping the utility's skin in the game – has been shifted in the Joint Parties' Proposal to a goal of beating benchmarks. We agree with the Joint Parties that oversight is always important, but that the Joint Parties point only to prudence reviews as protection, and not to how their proposed mechanism would direct a utility to seek the lowest cost gas in a more-

effective manner than the current PGA, suggests that our point is well taken, and that the incentive in the proposed mechanism does not necessarily provide a direct incentive to keep costs as low as possible. More-closely aligned incentives, lessen, though do not eliminate, the need to rely on oversight.

C. The Earnings Review

The Joint Parties propose a trade-off. Implement a new mechanism, or a new variation on the old mechanism, which shifts risks to core customers, and offset that risk by reducing the earnings threshold, over which earnings are shared with all customers. There are several issues involved in the earnings sharing: what is included in the earnings; what is the sharing percentage above the threshold; and how that should be allocated.

i. Staff and NW Natural Do Not Agree On What Is Included In The Earnings.

Staff believes that earnings related to gas supply count when it comes to the earnings review. NW Natural believes that earnings related to gas supply should be removed from the earnings review. CUB agrees with Staff. Earnings above the threshold should count. However, this may not even be the most important point. The bigger point is that this is an issue that should be resolved as part of the mechanism so that we can understand it in its entirety.

This is a significant issue. In the July 8, 2008 NW Natural Earnings Review, NW Natural calculated its earnings as 10.15%, while Staff calculated it at 12.84. This is a difference of approximately 270 basis points of ROE. CUB/100/Jenks/34. While the earnings were not enough to trigger sharing of over-earning under the existing

mechanism, under either the Joint Parties' PGA or CUB's PGA, the Staff's earnings calculation would have triggered sharing of over-earning.

The Joint Parties do not address this disagreement, but NW Natural does on behalf of NW Natural and Staff:

> Staff and NW Natural agree that the Commission need not resolve this issue in this proceeding and instead should allow the parties an opportunity to resolve the disagreement outside of this docket.

NW Natural/100/Miller/6

CUB believes that this needs to be resolved in this docket in order to evaluate the proposed mechanism. Both the Joint Parties and CUB are proposing mechanisms which shift risk to core customers and, in exchange, reduce the threshold for earnings sharing. However, because the difference between including all costs and excluding commodity costs can be as high as 270 basis points, CUB believes that it is impossible to evaluate the trade-off without knowing how commodity related earnings will be treated. The earnings threshold side of this trade-off is much different, depending on whether Staff or NW Natural's position is adopted.

ii. What Is The Sharing Percentage Above The Threshold And Should It Be Adjusted For SB 408?

The Joint Parties recommend that 33% of the earnings above the threshold be shared with customers for Cascade. For NW Natural and Avista, 20% of the earnings above the threshold would be shared. This is done in order to ensure that NW Natural and Avista are treated the same as Cascade in spite of SB 408. Joint Parties/200/Joint Parties/15.

Of course, the purpose of SB 408 was not to treat all utilities the same way. Small utilities like Cascade were exempted by the Legislature. More importantly, the Joint

Parties' Proposal fails to treat the utilities the same. The Joint Parties attempt to address the SB 408 effect on the share of the earnings that flows to customers, but ignore the SB 408 effect of the share of the over-earning that is retained by the utility, or the SB 408 effect on the earnings threshold.

When a utility that is subject to SB 408 refunds money to customers, that reduces the utility's net income and reduces its tax liability. Since we true up the tax liability, customers ultimately benefit from the reduction in the tax liability. This is the effect that the Joint Parties address.

But they fail to recognize that what is being shared is utility *over-earning*. When a utility subject to SB 408 earns above its authorized rate of return, this increases its tax liability above what was forecast in rates and results in a tax surcharge to customers. Under the Joint Parties' Proposal, customers would receive a tax surcharge for the 80% of the over-earning retained by the utility, that would be partially offset by the tax effects of the customers' 20% share of the over-earning. In addition, customers would be charged a tax surcharge for the over-earning between the company's authorized rate of return and the earnings threshold.

When a utility is over-earning, SB 408 creates additional benefits, by allowing it to charge customers for the additional taxes on that over-earning. Sharing a portion of the over-earning with customers does not change this; SB 408 continues to provide benefits to the utility. In NW Natural and Avista's case, they will be able to surcharge customers for the additional taxes that they have to pay. A SB 408 adjustment, rather than reducing the percentage of sharing to customers, would seem to require an additional

sharing to customers in order to compensate them for the additional amount of taxes that they will be charged.

This is just another example of the one-sided nature of the Joint Parties' Proposal. It is also an example of the Joint Parties (at least the non-utility parties) not thinking the mechanism all the way through. As the proposal now stands: where SB 408 has a negative effect on the LDC, customers must step in and absorb that effect; where SB 408 has an even greater benefit to the LDC, the company gets to retain it.

iii. How Should The Over-Earnings Be Allocated To Customers?

The Joint Parties propose that over-earning be allocated to all customers on an equal percentage of margin because "excess earnings are not generated in a defined manner by any specific source of revenue generation or cost savings." Joint Parties/200/17.

As we pointed out, however, earnings can be attributed to specific sources of revenue generation. In this year's earnings review, the amount of over-earning attributed to gas purchasing and sales to core customers was 270 basis points. If the Joint Parties' mechanism had been in place this year, there would have been sharing of over-earning above the earnings threshold and it would have been entirely attributed to gas purchasing CUB/100/Jenks/34. Taking over-earning that is paid by core customers on natural gas purchases and using that over-earning to reduce the rates of non-core customers who do not purchase gas through from the LDC does not make sense.

More importantly, is the trade-off that is being made in this docket. Additional risk is being placed onto core customers, and in exchange we are lowering the earnings threshold for earnings sharing. However, the Joint Parties are not proposing that the

additional earnings that are being shared go to the customers who are taking the additional risk. If core customers are the ones being assigned additional risk, then those customers should receive the additional benefits that are being offered as a trade-off. CUB/Jenks/100/34.

The Joint Parties make the point that "industrial firm sales customers are not different than any other 'core customers.'" Joint Parties/200/17. We agree, which is why our proposal was based on a core/non-core split, not a residential-commercial/industrial split. CUB/Jenks/100/34.

D. NW Natural: "Mr. Jenks' testimony … strikes me as disingenuous."

In its separate Reply Testimony, NW Natural stated:

> It is impossible to dispute that the scale of prices and volatility in gas markets today is dramatic and unprecedented. Indeed, as Jason Eisdorfer of CUB stated at the Commission recent Gas Outlook meeting: "We are in a whole new world." In this light, Mr. Jenks' testimony suggesting that there is no need to change the existing PGA strikes me as disingenuous.

NW Natural/100/Miller/1, footnote omitted.

Our introduction to this Brief was spurred, in large part, by this comment in NW Natural's Testimony. In our Comments and in our Testimony, CUB has consistently acknowledged an increase in the volatility in the natural gas markets and, while concurrently putting evidence on the record that the current PGA mechanism does not appear to be damaging NW Natural's credit rating or resulting in higher city gate prices in Oregon, CUB has also proposed modifications to the current mechanism to address the increased volatility and protect the utilities from large gas cost variations. Not coincidentally, in protecting utilities from risk, CUB's proposals would shift additional risk onto customers. In case that wasn't absolutely clear, we have proposed mechanistic

changes that increase the risk of gas cost volatility borne by the residential customers that we represent. The following are from CUB's Comments and Testimony.

> **December 2007:** [T]he current mechanisms fail to account for the normal risks and rewards of the utility business, and they fail to adequately account for the fact that extraordinary events may place too great a risk on the utility … Extreme gas spikes that are outside of the normal range of variability, however, can weaken a utility's financial integrity; and customers, with their wide financial base, are in a better position to absorb these large cost variances.

UM 1286 CUB Opening Comments at 7-8.

> **January 2008:** [A]ll parties appear to agree that the natural gas market has changed over the last decade, and that prices have generally risen while price volatility has increased significantly … CUB's mechanism would put more of the risks and rewards of normal gas cost variation onto the utility, but, in exchange, would put almost the entirety of wider gas cost variation onto customers.

UM 1286 CUB Reply Comments at 6 and 7.

> **July 2008:** We recognize that [CUB's] proposal is a significant shift of risk onto customers. Under the current PGA, the risk sharing begins at 67-33. Under this proposal, it begins at 80-20. That is a large change that would shift considerable risk of post-PGA gas cost variations onto core customers…

UM 1286 CUB/100/Jenks/40.

We also note that NW Natural's accusation of disingenuousness comes despite the Company's own agreement with CUB's position that the basic foundation of the current PGA mechanism is sound, and, even more strikingly, CUB's proposal contains the very sharing percentage option that NW Natural advocated in its Opening Comments, 80-20. NW Natural Opening Comments at 2.

> In the end, NW Natural has concluded that the current mechanism is the best. Through its sharing component, the Oregon PGA successfully aligns customer and shareholder interests in motivating the LDCs to reasonable least cost purchasing. … NW Natural does agree with those parties who note that the LDCs are currently exposed to an undue level of risk.

> However, that failing can be remedied by adjusting the PGA's sharing percentages, as proposed by NW Natural in its Opening Comments.
>
> The fact is that no party has made a compelling argument as to why the Commission should adopt a brand new incentive mechanism; on the contrary, there are compelling reasons why it should not. … This is not a time to discard a PGA that is working in favor of an untested "experiment" or complete paradigm shift, particularly in a docket intended to reduce, rather than create, uncertainty.

UM 1286 NW Natural Reply Comments at 21-22.

If a Party has been disingenuous, it most certainly was not CUB.

E. First of the Month Benchmark and Storage.

NW Natural's change of heart may come from the fact that the new mechanism allows them to use their storage to arbitrage the price difference between the daily spot market and the first of the month index. When NW Natural opposed changing to an "untested 'experiment,'" that experiment was based on a daily index, which the company rightly said reflected more on "luck than skill." NW Natural Reply Comments at 11.

The stipulated PGA, however, allows the utility to pick the First of the Month Benchmark and share the difference between the cost of actual spot purchases and the cost if those purchases were done at the FOM price. For a utility such as NW Natural with a significant volume of storage, including some storage that can be used to arbitrage price, it allows them to increase storage withdrawals when the spot price is above the FOM and reduces storage withdrawals when the spot price is below FOM. Rather than attempting to manage its storage to minimize costs over the winter heating season, NW Natural will have an incentive to manage its storage to beat the benchmark on a monthly basis. CUB/100/19-20.

The Joint Parties suggest that this could be a problem, but can be prevented by prudence reviews and cost pass-through disallowances:

> …CUB claims that an LDC with storage, assumed by CUB to be the lowest cost option in the LDC's supply portfolio, might choose to make spot purchases, for which it could earn a share of any savings vs. using storage gas, which does not have this opportunity attached. CUB could be correct in its conclusion if there was no one monitoring both the LDC's overall gas supply portfolio and their decision making regarding both short-term and long-term gas purchasing. But this is not the case. Commission Staff and other interested parties meet with the LDCs at least quarterly to consider and discuss just such topics as the one CUB brings up. Based on the results of these meetings and related analyses, the Commission always has the option to hold LDCs accountable if such problems occur through prudence reviews and cost pass through disallowances.

Joint Parties/200/5.

NW Natural agrees that the stipulated PGA will allow NW Natural to benefit from storage: "the Stipulated PGE *does* allow NW Natural to benefit from its storage capability and intentionally so." NW Natural/100/Miller/5. Storage is a rate based asset. NW Natural earns a rate of return on its storage investment and is expected to use that investment prudently to benefit customers. Under the current mechanism, NW Natural has done exactly that and they have done so exceptionally well according to an independent analysis that was conducted in 2007. Staff described the study in its Public Meeting Memo of October 30, 2007:

> With regard to storage, last year Staff raised concerns about NW Natural's recovery of 100% of its commodity storage costs. Staff was not certain NW Natural was operating its storage in the most effective ways to secure both reliable service and reasonable price arbitrage between off-peak and on-peak natural gas prices. Staff suggested and NW Natural agreed to have an independent, outside qualified party perform a study to answer these questions. That study was performed by Altos Management Partners, Inc. (Altos), an experienced and knowledgeable analyst of natural gas questions and issues. Altos' report of its analysis of NW Natural's storage operations concluded that:
>
> - …
> - Finally, NW Natural's storage operations during the past few years realized through price arbitrage a net savings of over $40 million. Storage was efficiently dispatched to capitalize on price arbitrage

> opportunities, as well as meet load. NW Natural's strategy to capitalize on arbitrage opportunities, provided that there are adequate storage inventories, has paid off for its ratepayers. The amount saved represents almost half of the theoretical maximum savings with perfect foreknowledge of future prices and loads which we find is truly impressive
>
> Altos' report answers the operational questions about storage Staff raised during its review of the Company's 2006 PGA portfolio.

CUB 100/Jenks/17.

Our regulatory incentives with regard to storage are working extremely well. In 2006, Staff believed that NW Natural was not operating its storage in the most prudent way, so an independent study was performed which concluded that NW Natural's use of storage "has paid off for its ratepayers," and is "truly impressive." It makes little sense to change an incentive that is working well, for a new mechanism, whose proponents admit will require prudent reviews and disallowance in order to protect customers from the incentives created by the mechanism.

To paraphrase NW Natural, this is not a time to discard a PGA that is working extremely well with regard to storage in favor of an untested "experiment" or complete paradigm shift, particularly in a docket intended to reduce, rather than create, uncertainty.

IV. CUB Proposal

From our Direct Testimony, CUB proposes the following adjustments to the current PGA mechanism.

Post-PGA Sharing of Commodity Cost Difference	Earnings Sharing Threshold
90-10, customer-utility	100 basis points ROE
80-20, customer-utility	150 basis points ROE

Each utility would make a one-time election as to which of the two options it prefers, and would not be allowed to switch year-to-year, based upon what it thinks market conditions might be. The utility would have the option of applying to the Commission for an exception, should its circumstances change, and any party can propose that the Commission open a docket to consider changes to the mechanism.

A counterbalance to the increased risk of commodity cost variation to be borne by customers would be the lower earnings thresholds for the Earnings Review. In recognition that a utility's earnings, all other things equal, would improve when gas costs were lower than forecast, and that those earnings would, therefore, directly result from commodity costs, the sharing of over-earning should be adjusted to recognize that non-core (transport and special contract) customers are not taking any of the increased risk of commodity cost variation. It is the customers who are taking the increased risk who should benefit from the increase in earnings sharing. As we discuss in our Testimony, the Joint Parties do not agree as to whether over-earnings resulting from commodity costs should be considered in the Earnings Review. CUB/100/Jenks/32-34. CUB shares Staff's view that amounts, positive or negative, shared by the utility are properly accounted for in the utility's earnings. With that in mind, of earnings above the threshold, 33% would go to customers. Of that 33%, half would be shared with core customers on an equal ¢/therm basis, and the other half would be shared with all customers on an equal percent of margin.

We support the Parties' proposals for establishing, when setting a utility's embedded WACOG, consistent methods for establishing a utility's load (forecasted basis), and for calculating the forward prices that will be used for spot market purchases (basis-adjusted NYMEX strips). Stipulation at 3-4.

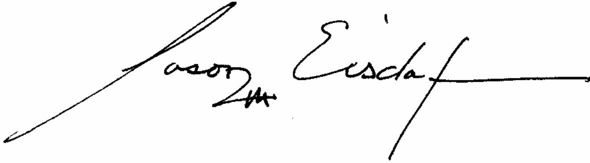
CUB's proposal accounts for increased volatility in natural gas markets, is responsive to the Commission's feedback in this docket, adjusts an already working and time-tested PGE mechanism, is conceptually and mechanically straightforward, and would result in consistent application of the PGA mechanism across all three utilities, so that customers of all the gas utilities would be charged for gas commodity costs in a consistent manner. We urge the Commission to reject the Joint Parties' proposal, and adopt the adjustments to the existing PGA as set out above.

V. Conclusion

The Commission should reject the Joint Parties' proposed PGA mechanism. Parts of the mechanism are unclear, parts are left undetermined, and as a whole it shifts risk on to customer. The Joint Parties have not shown that this mechanism is superior to simple adjustments to the existing PGA. The Commission is not in a position to fix the lack of clarity, resolve the earnings review dispute amongst the stipulating parties, and create information not currently on the record to support the proposal.

In contrast, CUB's proposed adjustments to the existing PGA recognizes the changes in gas markets, is supported by data on the record, uses a tool that is known to be workable, and is clear. The Commission should adopt CUB's proposal.

Respectfully Submitted,
August 29, 2008



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UM 1286 – CERTIFICATE OF SERVICE

I hereby certify that, on this 29th day of August 2008, I served the foregoing Opening Brief of the Citizens' Utility Board of Oregon in docket UM 1286 upon each party listed by email and, where paper service is not waived, by U.S. mail, postage prepaid, and upon the Commission by email and by sending 6 copies by U.S. mail, postage prepaid, to the Commission's Salem offices.

Respectfully submitted,

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Summary Report

UM 1286 INVESTIGATION INTO PURCHASED GAS ADJUSTMENT MECHANISM

Category: Miscellaneous

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.

(Staff report for November 21, 2006 Public Meeting (Item No. 4); filed by...

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Law Judge(s): POWER, PATRICK

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Summary Report

UM 1286 INVESTIGATION INTO PURCHASED GAS ADJUSTMENT MECHANISM

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