

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1286

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

DIRECT TESTIMONY
OF THE
CITIZENS' UTILITY BOARD OF OREGON

July 25, 2008



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1 My name is Bob Jenks, and my qualifications are listed in CUB Exhibit 101.

2 **I. Introduction**

3 The platypus is sometimes referred to as an animal designed by a committee. The
4 Parties' proposed mechanism, much like the platypus, is a collection of various parts that
5 do not fit together. What the Parties did succeed in doing, however, was to arrive at a
6 settlement that would shift the bulk of the current PGA mechanism's risk-reward sharing
7 onto core customers, who are not in a position to manage that risk. Cascade and Avista
8 got a mechanism that would be as close to a 100% pass-through as they could get.
9 Cascade got to maintain its current earnings threshold. NW Natural got a mechanism that
10 would allow it to profit from its use of storage. Staff got a mechanism that would be
11 close to what it proposed in its Opening Comments. Industrial customers who only

1 purchase transportation services would benefit from lower earnings thresholds, which
2 would increase their sharing of utility over-earning, without taking on any new costs or
3 risks. Residential and small commercial customers would receive a great deal of
4 additional risk, when there is no evidence to suggest that this shift in risk would lead to
5 lower gas prices and, in fact, could lead to higher gas prices.

6 The Parties' proposed mechanism is poorly designed. It is an attempt to allow
7 Avista and Cascade to shift nearly all risk to its core customers, and would allow
8 NW Natural to earn a reward on its use of storage gas. It was developed with no analysis
9 to support it, and no attempt to model its effects. It is so complicated that the utilities
10 involved were unable to answer basic data requests that would allow a solid analysis of
11 its potential effects, and the signatories to the agreement are not even in agreement as to
12 at least one key aspect of the proposal. After two weeks of analysis we are unable to
13 align the Stipulation language with the Staff and utility responses to our data requests,
14 and believe that it is unclear how the proposed mechanism would operate.

15 The Parties' proposal should be rejected outright. Instead, we recommend that the
16 Commission modify the current PGA mechanism to simplify it, to make the PGA
17 calculations consistent among the three Oregon gas utilities, and to recognize a more-
18 volatile natural gas market. Most importantly, we recommend that the Commission
19 maintain the current PGA risk-reward sharing incentive, albeit in a reduced form.

20 **II. What Would Customers Pay Under The Parties' Proposal?**

21 Unfortunately, this is not an easy question to answer. We asked the three gas
22 utilities to calculate how this mechanism would have worked in the past, but the
23 responses of all three fail to provide complete information, so it is difficult to determine

1 the full effect that their proposal might have. In Section II, we only describe what we
2 interpret the components of the Parties' proposed mechanism to be, as that is a task in
3 itself. In the following sections, we address how the components function and the
4 problems with them.

5 On the surface, customers would pay the sum of:

- 6 • (embedded WACOG) x (actual volumes) +
- 7 • (95%) x (Monthly WACOG Variance) +
- 8 • (67% or 80% or 90%) x (Unhedged Benchmark Variance).

9 The first bullet is relatively straightforward. It's the cost of customers' actual gas
10 usage at the price established in the PGA process, and this step is essentially the same as
11 how customers are currently charged. Before describing the Monthly WACOG Variance
12 (WACOG Variance) and the Unhedged Benchmark Variance (Unhedged Variance), we
13 need to explain the Unhedged Benchmark Price (Benchmark Price) and the two
14 methodologies for calculating the Benchmark Price.

15 **A. The Unhedged Benchmark Price**

16 We first note that the Unhedged Benchmark Price (Benchmark Price) is largely
17 irrelevant to customers as a concept; it is the practical result of the calculation that
18 matters. More simply put, what matters to customers is:

- 19 • The price that we pay each month throughout the year; and
- 20 • The surcharge or credit that results from whatever mechanism is in place.

21 That being said, the proposed Benchmark Price is used both in the calculation of
22 the WACOG Variance and in the calculation of the Unhedged Variance. The Benchmark
23 Price is used to represent the spot market price of gas (\$/therm), and it is applied in the

1 two Variance calculations to a utility's actual volume of spot purchases, and, possibly
2 also to a utility's volume of storage withdrawals (more on this confusion later).¹

3 There are two different methodologies for calculating the Benchmark Price, one
4 based on a First of Month index (FOM), and the other based on an average of Gas Daily
5 indices. Each year, a utility would choose between these two methodologies for
6 calculating the Benchmark Price that would be used in the calculations of its WACOG
7 Variance and Unhedged Variance. The Benchmark Price would be updated each month,
8 and the WACOG Variance and the Unhedged Variance would be calculated on a monthly
9 basis.

10 The Joint Parties' Testimony makes clear that the FOM Benchmark Price is
11 included for NW Natural, and that the Daily Benchmark Price is included for Avista and
12 Cascade.²

13 **B. The Monthly WACOG Variance**

14 The Monthly WACOG Variance (WACOG Variance), 95% of which core
15 customers would be responsible for, is the first of two sharing components that the
16 Parties propose. The WACOG Variance would be calculated each month and appears to
17 be:

18 $= (\text{Monthly Benchmark WACOG} - \text{Annual Embedded WACOG}) \times (\text{total actual volumes})$

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

¹ Throughout this Testimony we refer to spot gas and spot purchases. This is intended to include all market purchases that are considered unhedged in calculating the embedded WACOG.

² UM 1286 Joint Parties/100/Joint Parties/8.

1 utility's WACOG would have been, had the utility purchased all of its spot gas at the
2 Benchmark Price, and would be calculated as follows:

3 Variables

4 V: Volume (therms)

5 P: Spot Market Price (\$/therm)

6 H: Embedded Hedge Price (\$/therm)

7 S: Embedded Storage Price (\$/therm)

8
$$WACOG_{benchmark} = \frac{(V_{actual-spot})(P_{benchmark}) + (V_{hedged})(H) + (V_{actual-storage})(S)}{V_{actual}}$$

9 Taking a step back, the benchmark WACOG would take on the role that is played
10 by the actual WACOG in the current PGA mechanism, except that the utility's actual cost
11 of spot market purchases would be replaced with the utility's actual volume of spot
12 purchases priced at the Benchmark Price. It replaces an actual cost with a benchmark.

13 While the second variance, the Unhedged Variance, has larger sharing bands, the
14 WACOG Variance is really the heart of the proposal in terms of financial magnitude. It
15 is where we would expect to see the bulk of any costs or savings to be shared. Therefore,
16 though the Unhedged Variance contains wider sharing options, the bulk of the financial
17 risk would be captured by the WACOG Variance, and shared 95-5 with core customers,
18 which is a material shift from the current PGA sharing percentages. The Parties'
19 Testimony in support of their proposed mechanism offers little support as to why such a
20 shift of risk onto customers is good policy. We understand why the utilities would like it,
21 but it would considerably weaken the risk-reward sharing incentive, and the Parties offer
22 no evidence to support that this would reduce gas costs.

23 **C. The Unhedged Benchmark Variance**

24 The Unhedged Benchmark Variance (Unhedged Variance) is the second Variance
25 that the Parties propose. After reading the Stipulation and Testimony, after reading data

1 responses, and after discussions with the parties, it is still not entirely clear how the
2 Unhedged Variance (of which core customers would pay 67%, 80%, or 90%) would be
3 calculated. Is storage gas included or isn't it? We will discuss this confusion in detail
4 later, but for purposes of this overview, the formula for the Unhedged Variance is:³

$$5 = (\text{actual unhedged gas cost}) - (\text{actual unhedged volumes})(\text{Benchmark Price})$$

$$6 = (V_{\text{actual-unhedged}})(P_{\text{actual}}) - (V_{\text{actual-unhedged}})(P_{\text{benchmark}})$$

7 As mentioned earlier, there are 2 methodologies for calculating the Benchmark
8 Price (FOM and Daily), and, for the Unhedged Variance, there are 3 options for sharing
9 percentages, 67-33, 80-20, or 90-10, between which a utility may choose annually (plus
10 an additional option for Cascade). This means that, every year, each utility would get to
11 choose one of 6 options for calculating the Unhedged Variance. The Parties' Testimony
12 makes clear that one Benchmark Price methodology is for Cascade and Avista and the
13 other is for NW Natural; therefore, we will refer to the Cascade-Avista Unhedged
14 Variance and the NW Natural Unhedged Variance. As mentioned earlier, it is unclear
15 from our data requests whether storage gas is considered unhedged gas in this formula,
16 and this is not a minor distinction.

17 *i. The Cascade-Avista Unhedged Variance*

18 As we will discuss below, the Cascade-Avista Unhedged Variance seems
19 designed to make it look as though there is a meaningful sharing mechanism, while not
20 really sharing much. What we are comparing here is the difference in cost between the

³ In the Stipulation, the Parties describe the WACOG Variance as the "difference between the Annual Embedded WACOG and the Monthly Benchmark WACOG..." We think the parties intend this to mean the Benchmark WACOG *minus* the Embedded WACOG (*i.e.*, the 2nd factor minus the 1st factor). However, the Parties describe the Unhedged Variance as "[d]ifferences between actual costs for the Unhedged Gas and the product of the Unhedged Benchmark Price multiplied by actual unhedged volumes..." In this case, we presume the parties mean Actual Unhedged Costs *minus* Benchmark Unhedged Costs (*i.e.*, the 1st factor minus the 2nd factor).

1 price in the daily spot market and what the utility actually paid that day in the spot market
2 for the volume purchased that day. Since the daily index price represents the actual
3 purchases that happened that day, it represents prices that were available to the gas utility
4 for buying gas, and so this Variance should be small. An analogy would be if one were
5 to compare a store's cost of eggs in the ads in today's paper, to the actual cost of eggs
6 that one bought at that same store today. There is no reason for there to be a significant
7 difference.

8 It is important to remember that three of the parties behind this proposal are Staff,
9 Cascade, and Avista, all of whom have been advocating 100% pass-through of actual gas
10 costs.⁴ If you cannot get 100% pass-through of actual gas costs, the next best alternative
11 is to push the bulk of sharing to 95-5, and then create a second sharing mechanism with
12 wider sharing percentages, which would then share an insignificant amount. We discuss
13 this more later.

14 ***ii. The NW Natural Unhedged Variance***

15 NW Natural opposed the use of a daily benchmark index, as in the Cascade-
16 Avista Unhedged Variance, in its Reply Comments after Staff proposed such a
17 benchmark earlier this year. The reason for NW Natural's opposition was that the
18 mechanism would be based more on "luck than skill," and that "it would not reward the
19 Company's successful use of its storage to obtain lower cost gas."⁵

20 Thus, the NW Natural Unhedged Variance should be viewed as an attempt by
21 NW Natural to earn a reward on its use of storage. As we will discuss later, depending

⁴ Staff Draft Proposed Agreements Relating to the Oregon PGA Mechanism at 2, 4/7/2006; and UM 1286 Opening Comments at 9. UM 1286 Cascade Opening Comments at 1. UM 1286 Avista Opening Comments at 5.

⁵ UM 1286 NW Natural Reply Comments at 11.

1 on whether storage gas is considered unhedged, this reward could be significant, or it
2 could be really, really significant. In either case, the Parties' proposal would share the
3 WACOG Variance 95-5, and would then allow NW Natural to earn a reward on its
4 storage. This would offset some of NW Natural's 5% when costs were higher than
5 forecast and would add to its 5% when costs were lower than forecast.

6 Earlier, we noted that customers are concerned with the price that they pay during
7 the course of the gas year, and the surcharge or credit through which they share the
8 difference between forecast and actual costs. If the NW Natural mechanism
9 systematically rewards a utility for its use of storage, then the sharing between customers
10 and the utility would not be the 95-5 that is used in the calculation of the WACOG
11 Variance. Instead it would be more generous to the utility.

12 **III. The WACOG Variance**

13 Having briefly discussed the components of the Joint Parties' proposed PGA we
14 now will attempt to provide some analysis of how the mechanism would work. After all,
15 the adoption of a new methodology should be based on how the thing works and what
16 incentives it creates, yet determining how the proposed mechanism would work is
17 difficult because some of the responses we have gotten back from Staff and the utilities
18 are either not clear, are potentially incorrect, or are useless. However, based on these
19 answers, we do our best to analyze the proposed mechanism.

20 **A. The Current PGA Vs The Proposed WACOG Variance**

21 According to the Stipulation the "difference between the Annual Embedded
22 WACOG and the Monthly Benchmark WACOG would be calculated each month and
23 multiplied by total actual volumes" and 95% would be deferred for later collection or

1 refund.⁶ This calculation, which compares the Annual Embedded WACOG to the
2 Monthly Benchmark WACOG would be done on a monthly basis. We asked the utilities
3 to provide us with this calculation for the last three years. We were aware that the
4 Benchmark Price that Cascade and Avista intend to use would be the Daily Benchmark
5 Price, so, in order to reduce the amount of work caused by our data request, we limited
6 our request to the winter months.

7 NW Natural complied with our data request. Avista told us that the information
8 we requested would not be useful, and instead gave us a comparison between the
9 Monthly Embedded WACOG and the Monthly Benchmark WACOG. However, we note
10 that, as we read the Stipulation, the Monthly Embedded WACOG is not involved in this
11 calculation, the Annual Embedded WACOG is.⁷ Cascade provided us with a
12 comparison, but compared the Annual Embedded WACOG to the Monthly Embedded
13 WACOG calculated using a FOM Benchmark Price, not the Daily Benchmark Price
14 (which is what we know the Company intends to use). Cascade's answer obscures what
15 we might have learned about the proposed mechanism's effect on Cascade and its
16 customers.

17 We would have liked to have compared the results of the WACOG Variance,
18 calculated using the proposed market-based Benchmark Prices, with the difference
19 between actual costs and forecasted costs, as we do today. This would involve
20 substituting the actual cost of unhedged gas, rather than pricing that gas at the Benchmark
21 Price, but we are unable to do so. NW Natural did not include the actual cost of
22 unhedged gas in their spreadsheet, Avista gave us the wrong Embedded WACOG

⁶ UM 1286 Stipulation at 5.

⁷ *Ibid.*

1 (Monthly instead of Annual, though we do use Avista's data later, presuming that it
2 suffices for purposes of our analysis), and Cascade gave us the wrong Benchmark Price
3 (FOM instead of Daily).

4 **B. The WACOG Variance Carries The Bulk Of The Financial Risk**

5 CUB Exhibit 102 shows what Avista's WACOG Variance and Unhedged
6 Variance would have been for the last three winters, as well as the total amount that
7 would be deferred under the proposed mechanism, assuming that Avista chose the 90-10
8 sharing for the Unhedged Variance.⁸ Avista decided to change our data request and
9 instead provided us with the Monthly Embedded WACOG rather than the Annual
10 Embedded WACOG, which is what would be used in the mechanism. We decided to use
11 this data, anyway, with an assumption that the results would be close enough to what they
12 would have been if Avista had given us the Annual Embedded WACOG as described in
13 the proposed mechanism.

14 Avista's data demonstrates that the Unhedged Variance would have been much,
15 much smaller than the WACOG Variance. In the 2005-06 winter, the Unhedged
16 Variance would have been less than 1/20th the magnitude of the WACOG Variance and
17 would have been positive while the WACOG Variance would have been negative. In
18 2006-07, the Unhedged Variance would have been less than 1/10th the size of the
19 WACOG Variance, and again, opposite in sign. In 2007-08, the Unhedged Variance
20 would have been less than a quarter of the WACOG Variance, and both would have been
21 negative.

⁸ In the data response this is based upon, Avista mislabeled the arithmetic it performed, saying it was the "Actual Unhedged Volumes x Actual Unhedged Price Less Actual Unhedged Volumes x Unhedged Benchmark Price" when the formula embedded in the spreadsheet was the opposite, unhedged benchmark less actual. Finding and correcting that error was necessary in order to make sense out of the data Avista sent us.

1 Over the course of three winters, the sum of the WACOG Variances would have
2 been negative, producing an almost \$4 million refund to customers, and the sum of the
3 Unhedged Variances would also have been negative, producing a \$526 thousand refund
4 to customers. The net effect would have been a \$4.5 million refund to customers over
5 those three winters, with the WACOG Variance representing 88% of that amount.

6 **C. What Is The Benefit Of The Benchmark In The WACOG Variance?**

7 Putting all of this aside, the current PGA mechanism compares actual gas costs to
8 those that were forecast. The proposed WACOG Variance compares a benchmark gas
9 cost with what was forecast. We have spent two weeks analyzing this mechanism and we
10 do not see the value of the Benchmark Price. Removing it and comparing forecasted
11 costs to actual costs produces more-intuitive results, while retaining an incentive linked
12 to sharing. Without some analysis showing that using the proposed FOM or Daily
13 Benchmark Price in the WACOG Variance calculation 1) does not distort the comparison
14 or otherwise do harm, and 2) actually provides a meaningful incentive to reduce gas
15 costs, we see no reason to replace actual costs with benchmarked ones.

16 **IV. The NW Natural Unhedged Variance**

17 In its Reply Comments, NW Natural opposed setting a benchmark that was based
18 on daily spot market prices and comparing actual spot market purchases to that
19 benchmark (the Daily Benchmark Price to be used by Cascade and Avista), because it is
20 “not well-designed to reward least cost purchasing decisions.”⁹ The specific concern that
21 NW Natural cites is that the mechanism would not reward the Company for its use of
22 storage:

⁹ UM 1286 NW Natural Reply Comments at 9.

1 ... the LDCs have significantly greater ability to influence their overall
 2 spot market purchase expense by employing sound longer-term strategies
 3 as to how and when to purchase gas. As mentioned above, NW Natural’s
 4 strategic use of its storage capacity represents its primary tool in pursuing
 5 lowest cost gas and in managing volatility. And the Company’s skill in
 6 managing that capacity has been judged by an independent evaluator to be
 7 “truly impressive.” Yet, paradoxically, (and as illustrated above), Staff’s
 8 proposed GPIM would not reward the Company’s successful use of its
 9 storage to obtain lower cost gas for its customers.

10 UM 1286 NW Natural Reply Comments at 11.

11 NW Natural has a significant level of storage, accounting for about 15% of its
 12 annual gas supply,¹⁰ and wanted a benchmark that would “reward” it for its use of
 13 storage. How strongly the mechanism would reward NW Natural depends on whether
 14 storage gas is considered unhedged or not, though it would reward the Company in either
 15 case.

16 **A. Is Storage Gas Considered Unhedged In The Unhedged Variance?**

17 As mentioned earlier, it is unclear whether or not storage gas is considered
 18 unhedged in the calculation of the Unhedged Variance.

19 Variables

20 V: Volume (therms)

21 P: Spot Market Price (\$/therm)

22 S: Embedded Storage Price (\$/therm)

23 The formula we presented earlier for the Unhedged Variance is:

24
$$= (V_{actual-unhedged})(P_{actual}) - (V_{actual-unhedged})(P_{benchmark})$$

25 If “Unhedged Gas,” in calculating the Unhedged Variance, contains storage gas,

26 the above formula would be:

27
$$= ((V_{actual-spot})(P_{actual}) + (V_{actual-storage})(S_{embedded})) - ((V_{actual-spot} + V_{actual-storage})(P_{benchmark}))$$

¹⁰ UG 177 OPUC Order No. 07-480 Appendix A at 8.

1 If “Unhedged Gas” does not include storage gas, then the Unhedged Variance
2 formula would be:

$$3 = (V_{actual-spot})(P_{actual}) - (V_{actual-spot})(P_{benchmark})$$

4 At first blush, it appeared that the Unhedged Variance only includes spot market
5 purchases. According to the Stipulation:

6 The actual costs for the Unhedged Gas will be calculated each month.
7 Differences between actual costs for the Unhedged Gas and the product of
8 the Unhedged Benchmark Price multiplied by the actual unhedged
9 volumes (Unhedged Benchmark Variance) will be deferred for later
10 collection or refund.

11 UM 1286 Stipulation at 5.

12 The Stipulation is clear that unhedged gas and storage are separate items in the
13 WACOG Variance. For the purposes of setting the embedded WACOG (forecasted cost
14 of gas), a utility’s expenses consist of: “(a) fixed price hedges; (b) storage, and
15 (c) unhedged volumes.”¹¹ For setting the embedded WACOG, the Stipulation goes on to
16 say that “supplies that are unhedged (‘Unhedged Gas’) as of the date of the filing . . . ,”¹²
17 clearly referring to the amount of gas supply that is not covered by fixed price hedges or
18 storage gas. However, the Stipulation is not so clear about the Unhedged Variance.

19 First, it is clear from the record that NW Natural felt that an incentive mechanism
20 should reward it for using its storage capabilities well. Second, the inclusion of a
21 FOM Benchmark Price was clearly for NW Natural. With this in mind, we asked data
22 requests of Staff and NW Natural to clarify how the Unhedged Variance treated storage.

¹¹ UM 1286 Stipulation at 3.

¹² *Id.* at 4.

1 ***i. Data Responses Point To Inclusion Of Storage Gas***

2 NW Natural's formula for computing the Unhedged Variance follows the
3 language of the Stipulation:

4 = *Actual cost paid for Unhedged Gas - (Actual Unhedged Volumes * FOM Index)*¹³

5 The confusion arises over whether unhedged gas includes storage gas or not. We
6 asked Staff and NW Natural "how a utility's use of storage could impact the results of the
7 calculation." The answers we received suggest that, in the calculation of the Unhedged
8 Variance, "unhedged" refers to *both* storage gas and spot market purchases. Interpreting
9 the proposed Unhedged Variance this way would provide NW Natural with a windfall
10 from its use of storage. This would mean that we would compare the actual cost of
11 unhedged gas (spot purchases and storage gas) with the Benchmark Price (which, for
12 NW Natural, would be established using a First of Month index) multiplied by the
13 unhedged volumes, and this amount would be subject to the sharing percentage. As
14 storage gas is largely bought off-season and is generally less expensive than gas
15 purchased at on-season prices, this means that the difference between the off-season
16 *actual* cost of storage and the on-season *value* of storage is one of the components subject
17 to sharing.

18 Staff answered that storage gas is considered "un-hedged, and would flow into the
19 monthly un-hedged cost total."¹⁴ While "monthly un-hedged cost total" is not a term
20 used in the Stipulation, we assume Staff is referring to the monthly actual cost of
21 unhedged gas, which is then compared to actual unhedged volumes priced at the
22 FOM Benchmark Price to determine the sharing. This would result in the utility sharing

¹³ CUB Exhibit 103 at 1. NW Natural response to CUB data request 6.

¹⁴ CUB Exhibit 106 at 4. Staff response to CUB data request 8.

1 the difference between the actual cost of storage gas and the cost of storage gas priced at
2 the FOM Benchmark Price, and would provide a windfall to NW Natural.

3 NW Natural's data request was clear in its support of this interpretation:

4 In NW Natural's case, the Unhedged Benchmark Price will be set to the
5 first of the month (FOM) index. Thus, if the cost of gas in storage is less
6 than the FOM index, and NW Natural withdraws gas from storage to meet
7 customer requirements, it will share in the savings with customers.

8 CUB Exhibit 103 at 1. NW Natural response to CUB data request 6.¹⁵

9 NW Natural goes on to argue that this is similar to the current mechanism where
10 the cost of storage gas is compared to the embedded WACOG:

11 This is similar to the way the current PGA mechanism works, except that
12 in the case of the current mechanism, the utility and its customers share in
13 the savings when the actual cost of gas in storage is less than the
14 embedded WACOG, rather than the FOM index.

15 CUB Exhibit 103 at 1. NW Natural response to CUB data request 6.

16 While these provisions may be similar mechanically, the result is very different.
17 Under the existing mechanism, the actual cost of storage gas is compared to the
18 embedded WACOG, which includes storage gas priced at its actual cost. Both sides of
19 the comparison include the actual price of storage gas purchased off-season. Under the
20 proposed mechanism, the cost of storage gas purchased off-season would be compared to
21 on-season market prices when the gas was used.

22 Finally, NW Natural notes that this mechanism could go in reverse:

23 Both mechanisms obviously work in reverse as well; if the cost of gas in
24 storage is more than the benchmark (either the FOM index, in the case of
25 the new mechanism, or the embedded WACOG price, in the case of the

¹⁵ In a phone call on 7-17-08, NW Natural suggested that this data response might be "wrong" in its interpretation of the mechanism. This Stipulation was developed in February. The parties that supported the Stipulation worked through May 2 to come up with the written description and testimony to support it. We asked our data requests in May and received answers on May 29th. It is now late July, and we are still not entirely sure the parties to the Stipulation understand it. In addition, the May 29th answers still represent the data responses we received from NW Natural.

1 current mechanism) and the utility withdraws gas from storage to serve
2 load, the utility and its customers share in the loss.

3 CUB Exhibit 103 at 1. NW Natural response to CUB data request 6.

4 NW Natural is, of course, correct. If the cost of storage gas that the utility
5 withdraws were greater than actual storage volumes priced at the FOM Benchmark Price,
6 then the utility and the customers would share in the loss, but the Company fails to
7 discuss how likely this might be. Also, we note that, at the first of each month, if the
8 FOM Benchmark Price were below the actual price of storage gas, NW Natural could
9 respond by purchasing more gas at the FOM index price and reducing its volume of
10 storage withdrawals. While the Company's ability to use its storage this way is not
11 without reliability and capacity limitations, it is a tool the Company can use when spot
12 market prices are below the embedded cost of storage gas.

13 More importantly, in addition to reliability and capacity benefits, storage allows a
14 utility to purchase gas off-season when gas tends to be less expensive. According to a
15 recent study by Altos Management Partners, NW Natural has been very effective at using
16 storage to reduce its gas costs. Staff described the study in its Public Meeting Memo of
17 October 30, 2007.

18 With regard to storage, last year Staff raised concerns about NW Natural's
19 recovery of 100% of its commodity storage costs. Staff was not certain
20 NW Natural was operating its storage in the most effective ways to secure
21 both reliable service and reasonable price arbitrage between off-peak and
22 on-peak natural gas prices. Staff suggested and NW Natural agreed to
23 have an independent, outside qualified party perform a study to answer
24 these questions. That study was performed by Altos Management
25 Partners, Inc. (Altos), an experienced and knowledgeable analyst
26 of natural gas questions and issues. Altos' report of its analysis of
27 NW Natural's storage operations concluded that:

- 28 • ...
- 29 • Finally, NW Natural's storage operations during the past few years
30 realized through price arbitrage a net savings of over \$40 million.

1 Storage was efficiently dispatched to capitalize on price arbitrage
2 opportunities, as well as meet load. NW Natural's strategy to
3 capitalize on arbitrage opportunities, provided that there are adequate
4 storage inventories, has paid off for its ratepayers. The amount
5 saved represents almost half of the theoretical maximum savings
6 with perfect foreknowledge of future prices and loads which we find
7 is truly impressive

8 Altos' report answers the operational questions about storage Staff raised
9 during its review of the Company's 2006 PGA portfolio.

10 UG 177 OPUC Order No. 07-480 Appendix A at 9.

11 In 2006, Staff was concerned with NW Natural storage operations, and was
12 considering whether storage gas should be passed through at less than 100% of cost in
13 order to encourage the Company to manage its storage better.¹⁶ NW Natural has also
14 called for an incentive mechanism that rewards it for its use of storage gas.¹⁷

15 According to the interpretation from NW Natural's and Staff's data responses,
16 while the WACOG Variance would pass through storage gas at its actual cost, the
17 Unhedged Variance would track the difference between the actual cost of storage gas and
18 actual storage withdrawals priced at the market price of gas, and return to NW Natural
19 33% of this difference (at the 67-33 sharing percentages). This means that, under the
20 Parties' proposed mechanism, the \$40 million in net savings identified in the Altos report
21 would have been shared between the Company and its customers. The Company would
22 have retained \$13.3 million, and customers would, therefore, have paid an additional
23 \$13.3 million.

¹⁶ We note that, around the same time, Staff was proposing 100% pass-through of all other components of gas supply. Staff Draft Proposed Agreements relating to the Oregon PGA Mechanism at 2, 4/7/2006. We simply don't understand a regulatory approach that would pass through financial hedges at 100% and spot market purchases at 100%, but would not pass through storage gas at 100%, since storage gas is likely to be the lower-cost of the three, and is the one that is associated with an asset in rate base that a utility earns a rate of return on.

¹⁷ UM 1286 NW Natural Reply Comments at 9.

1 We do not know of any incentive mechanism in the history of the Oregon
2 Commission that allowed a utility to keep 33% of the economic benefits associated with a
3 rate base asset. Customers pay the fixed costs associated with storage plus a rate of
4 return on the asset, and the regulatory tradition has been that the benefits resulting from
5 the use of that asset flow to customers. The Altos report suggests that NW Natural, under
6 the current regulatory approach, has done an excellent job of managing its storage
7 facilities to reduce gas costs.

8 Finally, we note that the storage gas we are discussing represents more than 40%
9 of the gas that would be subject to the Unhedged Variance. For the 2007-08 gas year,
10 NW Natural's target for financial hedging was 65%.¹⁸ Storage was projected to be 15%,
11 and spot purchases would then make up the final 20%, thus making storage gas 43% of
12 an unhedged supply that includes both spot purchases and storage.¹⁹ This is not a small
13 issue.

14 ***ii. If Storage Gas Is Not Considered Unhedged***

15 Even if there were clear consensus that the calculation of the Unhedged Variance
16 does not include storage volumes, NW Natural still stands to benefit from its storage
17 capability through the Unhedged Variance, because the volume of spot market purchases
18 included in the Unhedged Variance would reflect how much storage gas NW Natural
19 chose to use. As NW Natural plans to use the First of Month Benchmark Price, its
20 knowledge of the FOM Benchmark Price would allow it to adjust its volume of spot
21 market purchases throughout the month by adjusting its use of storage withdrawals. This
22 volume of spot market purchases would then go into the Unhedged Variance, giving the

¹⁸ UG 177 OPUC Order No. 07-480, Appendix A at 8.

¹⁹ $15\% \div (15\% + 20\%) = 0.429$.

1 Company another tool to benefit shareholders. While the Company must manage its
2 storage in order to ensure reliability, the Company also has a great deal of discretion and
3 is able to adjust its use of storage in reaction to market prices and regulatory incentives.

4 The Altos report makes clear that NW Natural has done a great job of using its
5 storage to keep costs down. The current PGA mechanism creates an incentive to produce
6 lower costs, because it compares actual costs to forecasted costs and shares the
7 difference. Period. The proposed mechanism would create an incentive for NW Natural
8 to use its storage gas in reaction to the FOM Benchmark Price in order to reduce the
9 Unhedged Variance on a month-to-month basis, which might not be in the best interests
10 of customers over the course of the year, as the Unhedged Variance is only one
11 component of the overall mechanism.

12 During the month, if spot market prices were higher than the FOM Benchmark
13 Price, NW Natural could draw on its storage, thereby reducing its spot purchases at a
14 market price that would be above the FOM Benchmark Price. If spot market prices were
15 lower than the FOM Benchmark Price, NW Natural could use less of its storage, and
16 purchase more gas on the spot market. Consider the incentive NW Natural would have
17 when an outside event caused the price of gas to rise during a month. In the middle of the
18 month, when the price of spot market gas is greater than the FOM Benchmark Price, and,
19 due to the aforementioned event, likely to stay high or continue rising, NW Natural
20 would have an incentive to lean on its storage and avoid buying on the spot market. This
21 is because the Company would know that its FOM Benchmark Price would be updated to
22 what would likely be a higher price the following month.

1 NW Natural could then purchase more from the spot market the next month, when
2 its FOM Benchmark Price was higher. Even if the Company had to purchase more
3 expensive spot market gas the next month, the Unhedged Variance would be less
4 because the difference between the price of that spot gas and the following month's
5 FOM Benchmark Price would be smaller. Under the current PGA mechanism, the
6 Company has an incentive to manage its storage gas to protect both itself and its
7 customers from higher gas costs as spot prices rise. Under the Parties' proposed
8 mechanism, however, instead of managing its gas supply to achieve the lowest overall
9 gas cost, the Company would now have an incentive to manage its gas supply on a
10 monthly basis to beat the FOM Benchmark Price, even if doing so could lead to higher
11 costs over the course of the year.

12 Consider another example. If the price of spot market gas were below the
13 FOM Benchmark Price, but greater than the cost of storage gas, using storage gas would
14 produce the lowest cost overall. If storage gas is not considered unhedged in the
15 Unhedged Variance, however, storage gas would not impact that portion of the sharing.
16 Nevertheless, the Company would receive a benefit by using spot gas, because the
17 Unhedged Variance would allocate 33% of the difference between the spot market and
18 the FOM Benchmark Price to the Company.

19 By sharing the difference between actual costs and forecasted costs, the current
20 mechanism creates an incentive for NW Natural to keep costs as low as possible. The
21 proposed mechanism would create an incentive to beat a benchmark each month, which
22 may or may not lead to the lowest cost over 12 months. Staff had NW Natural
23 commission an independent analysis which demonstrated that NW Natural has done an

1 “impressive” job of using its storage capability to reduce costs under the existing PGA
2 structure. The Parties have given us no reason to move to a different incentive structure
3 for NW Natural’s use of storage, and the Altos study suggests that there isn’t much room
4 for NW Natural’s storage management to get better (which leaves plenty of room for it to
5 get worse).

6 **V. The Cascade-Avista Unhedged Variance**

7 The previous discussion of the Unhedged Variance, and whether or not it includes
8 storage, applies primarily to NW Natural, as it has a significant amount of storage and
9 intends to use the FOM Benchmark Price. The question of whether or not storage gas is
10 considered unhedged for purposes of calculating the Unhedged Variance is also relevant
11 for Avista, but we will not revisit that here. The question pertinent to the Cascade-Avista
12 Unhedged Variance is whether beating the Daily Benchmark Price with daily purchases
13 requires more luck than skill.

14 In 8 of the 15 months we examined, Avista’s actual spot purchase costs would
15 have been less than its spot purchases priced at the Daily Benchmark Price, *i.e.*, the utility
16 would have beaten the benchmark. In 7 of those months, the opposite would have been
17 the case. In 2 of the 3 winters overall, however, Avista would not have beaten the spot-
18 purchase benchmark represented by the Unhedged Variance. In addition, this variance is
19 small. It would have been less than \$100,000 in 11 of the 15 months and was less than
20 \$10,000 in 3 of those months. In its Reply Comments, NW Natural suggests that beating
21 a benchmark for daily spot purchases that is based on a daily price index would be more a
22 matter of luck than skill. The data provided by Avista suggest that the results might,
23 indeed, be more random than systematic.

1 **VI. The Combination Of The WACOG Variance & Unhedged Variance**

2 In terms of what customers would pay, the sum of the WACOG Variance and the
3 Unhedged Variance is where the rubber meets the road. In answering our data request,
4 Cascade did not provide any information relating to the Daily Benchmark Price, that is
5 based on an average of daily indices. As the Daily Benchmark Price is what Cascade
6 intends to use, we have little data with which to use to analyze how this mechanism
7 would affect Cascade, so in this section we refer only to data from NW Natural and
8 Avista (for Avista, we assume that the Monthly Embedded WACOG is a reasonable
9 substitute for the Annual Embedded WACOG).

10 In examining the data provided by Avista, we found that that the impact of the
11 Unhedged Variance is small, and, from a policy standpoint, can lead to results where
12 customers would pay more than the actual difference between forecasted and actual costs,
13 or receive a refund greater than the actual difference.

14 **A. Actual Cost Differences Vs. Proposed Mechanism – NW Natural**

15 CUB Exhibit 104 shows how the proposed mechanism would have compared to
16 the current PGA mechanism for NW Natural over the past 2 years. This Exhibit contains
17 two charts, one represents the 2006-07 PGA year, and the other represents the 2007-08
18 PGA year through April. These charts were prepared by NW Natural, so they represent
19 that Company's interpretation of the mechanism. We can see how the proposed
20 mechanism systematically shifts risk from shareholders to customers.

21 In 2006-07, \$52.2 million was shared between shareholders and customers (not
22 including Washington). Under the existing mechanism, this was split 67% to customers
23 (\$34.8 million), and 33% to shareholders (\$17.4 million). Under the proposed

1 mechanism, with its two Variance calculations, customers would have received
2 \$50.0 million, or 96%, and shareholders would have taken just \$2.1 million, or 4%.

3 The partial results for 2007-08 would have been just plain bizarre. The actual
4 costs were below what was forecast in the PGA. Under the existing mechanism,
5 customers would be allocated \$1.9 million, 70 %, and shareholders would be
6 allocated \$0.8 million, 30%. Under the proposed mechanism, however, customers
7 would be allocated \$4.6 million, 170%, while shareholders would be allocated
8 negative \$1.9 million, -70%.

9 While in theory, it might be nice for customers to receive a refund that is greater
10 than the actual variation, it is nonsensical. We note that this calculation applies the
11 proposed mechanism retrospectively, and NW Natural was not purchasing its spot gas or
12 withdrawing its storage gas with the proposed mechanism in mind. Regardless, this
13 simply shows that, as a mechanism to share the variation between actual costs (or a
14 benchmark version thereof), and forecasted costs, this mechanism is not well developed.

15 **B. Actual Cost Differences Vs. Proposed Mechanism – Avista**

16 One of the potential pitfalls in combining two different sharing calculations, with
17 different sharing percentages in the same mechanism, is that the two calculations can
18 interact in unexpected ways. This seems to be the case with the proposed mechanism,
19 where, using the data provided by Avista, it appears that, when actual costs are less than
20 what was forecast, customers could receive a refund that would be greater than the
21 difference between actual and forecasted costs, and vice versa.

22 CUB Exhibit 102 looks at the forecasted gas costs, using the Monthly Embedded
23 WACOG, and compares this to the actual gas costs the utility incurred. This represents

1 the real, hands-on difference between forecasted and actual gas costs. We then compared
2 this actual cost difference to what would have resulted from the combination of the
3 WACOG Variance and the Unhedged Variance that make up the proposed mechanism.
4 We found that, in all three winters, the actual gas cost was less than what was forecast, so
5 the actual gas cost difference was negative. Under the proposed mechanism, with its two
6 Variance calculations, for the winter of 2005-06, 95% of the actual cost difference would
7 have been shared with customers. For the winter of 2007-08, 94% of the actual cost
8 difference would have been shared with customers under the proposed mechanism.
9 Strikingly, for the winter of 2006-07, 103% of the actual cost difference would have been
10 shared. This means that, for that winter, under the proposed mechanism, customers
11 would have received a refund that would have been greater than the difference between
12 forecasted costs and actual costs.

13 The proposed mechanism has the potential to yield results whereby, when actual
14 costs are less than what was forecast, customers could receive a refund that would be
15 greater than the difference between actual and forecasted costs. Likewise, when actual
16 costs are higher, customers might see a surcharge that is greater than the difference
17 between the forecasted and actual costs. This can happen when the WACOG Variance
18 and the Unhedged Variance go in opposite directions.

19 **VII. Policy Flaws In The Parties' Variance Proposals**

20 The proposed mechanism would be something of a regulatory quagmire in its
21 complexity, and contains a number of policy flaws that render it inappropriate.

1 **A. Proposed Mechanism Takes A Simple Concept And Obscures It Brilliantly**

2 The basic premise of the current PGA mechanism is to charge customers based on
3 a forecast of gas costs and then share between customers and shareholders the difference
4 between the actual cost of gas and that which was forecast. This risk-reward sharing
5 serves as an incentive to keep the utility actively managing its gas portfolio by balancing
6 the goals of low cost and low risk. Though customers are responsible for the bulk of
7 commodity costs, the current mechanism keeps a utility's skin in the game, as its
8 shareholders share some of the risk of high gas costs and reap some of the reward of low
9 gas costs with customers.

10 The current PGA mechanism charges customers for forecasted gas costs plus
11 much-but-not-all of the difference between actual costs and forecasted costs. Thus,
12 customers pay most of their commodity cost, but shareholders are in the boat with
13 customers, and share in the results of the utility's gas procurement strategy. It's simple,
14 it's clean (ignoring the patchwork of things that have been tacked onto the PGA filings),
15 it's understandable, it has been working reasonably well, and there is little room for
16 unexpected regulatory outcomes.

17 As for the proposed mechanism ... where to begin? We have been pouring over
18 the written responses and the spreadsheets provided in response to our data requests for
19 two weeks, we have talked extensively with NW Natural about their calculations, and it is
20 still not entirely clear what is going on. It's also not entirely clear that the Parties know
21 exactly what's going on either. The Parties did not perform any back-casts of their
22 proposal prior to recommending it. Only in response to our data requests did we get any
23 data to demonstrate how the mechanism might work.

1 For all of the convolutions proposed, the FOM and Daily Benchmark Prices, the
2 WACOG Variance, the Unhedged Variance, and the less-than-meaningful Unhedged
3 Variance sharing percentages, the Parties provide little reason and no evidence to support
4 their proposal. The Parties point out that their proposal includes a process for
5 determining the cost of unhedged volumes in the embedded WACOG and for
6 establishing forecasted volumes.²⁰ Fine, these tweaks seems reasonable and we support
7 them, but they are not germane to the larger, fundamental risk shift that is being
8 proposed. The Parties fail to demonstrate that the incentive in their proposal is better
9 than what we currently have (and we think that it is worse), point out that their proposal
10 is more flexible (which, as manifested in the proposal is not an improvement), and fail to
11 demonstrate that the combination of the WACOG Variance, the Unhedged Variance, and
12 the Earnings Test might provide any reasonable balance of risk and reward.

13 **B. Proposal Would Shift Risk To Customers & Reduce Risk-Reward Incentive**

14 The Parties' proposal would be a significant shift in risk from the current PGA
15 mechanism without any counterbalancing offset in reduced return on equity or reasonable
16 demonstration that this risk shift might lower gas costs or otherwise benefit core
17 customers. The proposed mechanism would reduce the risk-reward sharing for the bulk
18 of the Variance amounts, the WACOG Variance, to 95-5. While this may not seem to be
19 too far from CUB's proposed sharing percentages, 90-10 and 80-20, remember that
20 NW Natural and Cascade share commodity cost differences at 67-33 and Avista shares at

²⁰ UM 1286 Joint Parties/100/Joint Parties/14-15.

1 90-10, though this high sharing percentage was intended to be temporary.²¹

2 It should also be noted that this is simply the latest shifting of risk onto core
3 customers. In recent years, we have seen decoupling shift the risk of load reductions due
4 to energy efficiency, recessions, and higher prices onto customers. We have seen
5 WARM shift most of the weather risk onto core customers. This proposed PGA is
6 simply the latest proposal to shift the business risk of a natural gas utility onto its core
7 customers.

8 **C. Proposed “Incentive Levels” Are Smoke And Mirrors**

9 The first level of incentive (provided by the application of the Embedded
10 WACOG) is similar to the current PGA incentive and rewards (or
11 penalizes) the results of the LDC’s longer-term decision making
12 processes, in particular with respect to longer term contracts and hedging.

13 The second level of incentive provided by the application of the Unhedged
14 Benchmark Price tied to current market prices (either First of Month or
15 Gas Daily third party indices) creates an incentive for the LDCs to manage
16 shorter term purchasing to the benefit of customers. Thus where the
17 current PGA has one incentive level (provided by the application of the
18 benchmark WACOG) the Stipulated PGA has two.

19 UM 1286 Joint Parties/100/Joint Parties/15.

20 Other than the obvious conclusion that 2 must be better than 1, it is unclear how
21 the provided incentives are an improvement over the current mechanism. First, there
22 aren’t two different incentives, there are two different Variances that both measure
23 differences between actual, benchmarked, and forecasted commodity costs on a monthly
24 basis and defer them over a single year. Yes, this may involve multi-year contracts or
25 storage gas that carries over from one year to the next, but this is no different than the

²¹ Staff Public Meeting Reports. June 24, 2008. NW Natural at 2, Cascade at 2, and Avista at 2. With regard to Avista’s 90-10 sharing, from the Staff Report for the October 25, 2006 Public Meeting at 15, footnote 4: “Avista’s sharing percentage is higher than the other two LDCs. This is a result of a negotiated settlement with the company after the company discontinued its experimental Gas Benchmark Mechanism. It was meant to be a temporary sharing percentage, subject to change when the informal and/or formal PGA mechanism review was completed.”

1 current mechanism. Under the current mechanism, the utility benefits from good hedging
2 practices and effective use of storage. Under the current mechanism, the utility benefits
3 from good spot market purchasing practices. The Parties seem to be arguing that the
4 proposed mechanism would be an improvement, because it would do this too.

5 As to the specific incentive to manage short-term spot purchases, that incentive
6 exists today and does not require a benchmark. Whether the comparison is between
7 actual costs and either a benchmark or a forecast, a utility that is sharing the costs or
8 savings of its spot purchases has an incentive to minimize the price of those purchases.
9 The difference is that the current mechanism provides that incentive as part of an
10 incentive to minimize overall costs, whereas the proposed Unhedged Variance is simply
11 focused on the price of short-term unhedged gas, regardless of the overall cost of the
12 entire portfolio.

13 In its data response to us, Cascade objected to producing a back-cast because the
14 Company was not operating under the incentive in the proposed mechanism.

15 Cascade objects that any response to the data request may not be
16 completely accurate since the proposed PGA mechanism was not, in fact,
17 in place for the historical periods that are the subject of the request.
18 Therefore the underlying Annual Embedded WACOG, upon which the
19 Monthly WACOG Variance is based, was not developed in the manner
20 consistent with that proposed in the Stipulation nor did the company
21 speculate as to how its hedging or gas purchasing strategies may have
22 been different had the mechanism been in place in the past.

23 CUB Exhibit 105 at 1. Cascade response to CUB data request 1.

24 While the current mechanism is an attempt to create an incentive to keep costs as
25 low as possible, Cascade seems to imply that the proposed mechanism would create a
26 different incentive, the utility would act differently, and the results would be different.
27 We certainly acknowledge that utilities will react to the incentives provided in regulatory

1 mechanisms; this does not, however, relieve them of their responsibility to prudently
2 procure a gas supply for customers. If Cascade believes that it would have acted
3 differently over the last three years, had this mechanism been in place, shouldn't we
4 require a showing of what this different behavior would have been, and that it would have
5 been beneficial to customers?

6 **D. The Touted "Flexibility" Is A Downgrade Not An Improvement**

7 The Parties point out that their proposed mechanism is "more flexible than the
8 current PGA."²² The proposed mechanism would allow the utilities to choose between a
9 FOM Benchmark Price or a Daily Benchmark Price each year, as well as between 3
10 levels of sharing in the Unhedged Variance.

11 The Stipulated PGA allows the LDCs to select their sharing percentage ...
12 on an annual basis ... The Stipulated PGA will allow the LDCs to more
13 easily adapt to changing market and financial conditions ... The Stipulated
14 PGA provides for additional flexibility by allowing the LDCs to choose
15 between two separate methods for calculating the Unhedged Benchmark
16 Price ...

17 UM 1286 Joint Parties/100/Joint Parties/15-16.

18 When considering the long-term stability and functioning of the proposed PGA
19 mechanism, having the utilities changing the way that customers are charged on an
20 annual basis, based on changing market conditions, is a recipe for controversy and risk-
21 shifting, as it would be the utility in the position to judge market conditions and which
22 combination of Benchmark Price and sharing percentage would benefit shareholders.
23 Every year, customers could be charged on a different basis, selected by the utility, and
24 based upon the utility's interpretation of market conditions and what the utility
25 anticipates would best serve its shareholders. Ironically, though this is touted as an

²² UM 1286 Joint Parties/100/Joint Parties/15.

1 improvement, Staff doesn't seem to think that utilizing this flexibility would be a good
2 idea. We asked Staff:

3 Under the proposed mechanism, when a utility perceives the market to be
4 relatively risky on an annual basis, it could shift risk, through its sharing
5 selection, to customers, while, when a utility perceives the market to be
6 relatively stable on an annual basis it can take more risk itself, through its
7 sharing selection. Does Staff agree with this statement, and if so, please
8 explain how this benefits customers? If Staff does not agree with the
9 statement, please explain why.

10 To which Staff replied:

11 No. Perceptions of the market's future prices are very risky due to the
12 instability of the market. So the LDC's perceptions of the market price
13 may not shift risks as anticipated. The Stipulated PGA removes the
14 incentive for the LDC to rely on such perceptions. Instead it encourages
15 the LDC to rely on a balanced, flexible, and diverse portfolio of supply
16 types and options. This addresses the inherent instability in the market
17 and cushions the LDC and its customers from changes in price, whichever
18 direction they go.

19 CUB Exhibit 106 at 2. Staff response to CUB data request 3.

20 So, the proposed mechanism is superior to the current mechanism because it
21 allows "the LDCs to more easily adapt to changing market and financial conditions," but
22 "[p]erceptions of the market's future prices are very risky due to the instability of the
23 market," and "the LDC's perceptions of the market price may not shift risks as
24 anticipated." In other words, the proposed mechanism lets the utilities change their
25 mechanism every year based on market and financial conditions, but Staff thinks that this
26 would be very risky, that the utilities would be better-off relying on balanced portfolio
27 design, and that, somehow, the "Stipulated PGA removes the incentive for the LDC to
28 rely on such perceptions." Staff's position in Testimony and in its data response appear
29 inherently contradictory.

1 In addition, we disagree with the Parties over the benefit of this flexibility. We
2 think sharing mechanisms should be established as long-term regulatory tools. In some
3 years, they will benefit customers. In some years they will benefit utilities. On balance,
4 the ideal is for the results to flow equally in both directions. Allowing a utility to change
5 its sharing percentages based on its expectations of whether it is likely to be sharing a
6 cost or a savings, is a way to play the mechanism to ensure that, over time, higher costs
7 flow more heavily to core customers than do lower costs.

8 **VIII. Earnings Review**

9 So far, we have discussed the elements of the Stipulation that shift risk from gas
10 utilities to their core customers. This shift is supposed to be, at least in some measure,
11 offset by the changes in the earnings thresholds. The earnings threshold is determined by
12 which sharing percentage the utility chooses within the Unhedged Variance. A utility
13 that chose to share its Unhedged Variance at 67-33 would have an earning threshold of
14 175 basis points of ROE. A utility that chose to share at 80-20 would have an earnings
15 threshold of 150 basis points of ROE, and a utility that chose to share at 90-10 would
16 have an earnings threshold of 100 basis points of ROE. Unless the utility is Cascade, in
17 which case it can maintain an earnings threshold of 215 basis points through 2012, if the
18 Company chose 67-33 sharing for its Unhedged Variance.

19 As we have shown, the Cascade-Avista Unhedged Variance is designed to be
20 small, so the sharing percentage will not have much of an effect on customer rates – rates
21 that would instead primarily be affected by the WACOG Variance. The 75 basis point
22 difference between the ROE earnings thresholds could take on greater financial
23 significance than the amounts that would be captured by the different sharing options for

1 the Unhedged Variance. For a utility that is over-earning, more money could be at stake
2 in sharing the utility's over-earnings than would be at stake from the Unhedged Variance.
3 What the sharing percentage is, and therefore what the earnings threshold would be for
4 Cascade and Avista, may tell us more about whether they expect to over-earn than it does
5 about the risks they perceive in the spot gas market.

6 NW Natural expects to be able to use its storage to beat its Unhedged Variance, so
7 it would not be unreasonable to expect that NW Natural would choose the 67-33 percent
8 sharing. This has two benefits for the Company. It would allow the Company to keep a
9 greater share of the savings from beating the Unhedged Variance, and it would also
10 reduce the over-earnings that it would have to share with customers. If NW Natural can
11 systematically beat the Unhedged Variance (and we think the Company's use of storage
12 would allow it to do so), then this arrangement makes little sense. Under such a
13 circumstance, customers would benefit more from sharing the Unhedged Variance at
14 90-10, so that sharing level should have the highest ROE earnings threshold, while
15 customers would benefit least from sharing the Unhedged Variance at 67-33, so that
16 sharing level should have the lowest ROE earnings threshold.

17 **A. Staff And NW Natural Do Not Agree On The Earning Review**

18 While Staff and NW Natural are both signatories to the Stipulation, they do not
19 agree on how it would be carried out with regard to the Earnings Review. We asked Staff
20 the following question to explain how the Earnings Review would work under the
21 proposed mechanism:

1 With regard to the proposed Earnings Review:

2 a. Please explain how a utility's gas costs themselves would impact a
3 utility's earnings test.

4 b. If a utility's actual cost of unhedged gas is lower than its embedded
5 WACOG, will this improve the utility's return on equity?

6 c. If the answer to (b) is "yes," will this be captured by the proposed
7 Earnings Sharing?

8 CUB Exhibit 106 at 3. CUB data request 5 for Staff.

9 Staff's response is as follows:

10 a. The level of the LDC's gas costs may affect the utility's rate of return
11 that is considered within the annual spring earnings review.

12 b. Under the stipulated mechanism, the actual cost of unhedged gas is
13 compared to the Unhedged Benchmark Price, not to the embedded
14 WACOG. If actual cost is lower, the sharing percentage retained by
15 the LDC should increase its earned return on equity.

16 c. To the extent the LDC's earnings are above the benchmark ROE, a
17 portion of this amount (33% for Cascade, 20% for Avista and
18 NW Natural) would be shared with customers.²³

19 CUB Exhibit 106 at 3. Staff response to CUB data request 5.

20 While we did not ask this same question of NW Natural, we met with them on
21 June 6, 2008 to review the mechanism and data responses. From that conversation, it was
22 clear that NW Natural and Staff did not agree on this part of the mechanism. NW Natural
23 believes that, once the PGA mechanism determines the sharing of gas costs, gas costs
24 must be removed from the calculation of the Company's earnings. From Staff's data
25 response, Staff clearly does not agree.

26 The disagreement between Staff and NW Natural is highlighted in Staff's June
27 Memo to the Commission, where Staff discusses the NW Natural Earnings Review. The

²³ According to Staff's Public Meeting Reports for the July 8, 2008 Public Meeting, all three utilities share earnings above their earnings thresholds at 33%. Avista Staff Report at 2. Cascade Staff Report at 2. NW Natural Staff Report at 2. This is the percentage used in CUB's proposal.

1 difference between Staff's view of NW Natural's earnings calculations and NW Natural's
2 view was whether excess earnings caused by the PGA mechanism should be included in
3 the Earnings Review.

4 The portion of savings retained by shareholders was approximately
5 \$14.1 million. The Company removed the impact of the shareholders'
6 portion of savings as a Type 1 adjustment. Staff and the Company
7 disagree as to whether this is an appropriate Type 1 adjustment.

8 Staff Report. NW Natural 2008 Spring Earnings Review. June 24, 2008.

9 This is not a small adjustment and, Staff's Report goes on to point out that
10 NW Natural's calculation of its adjusted ROE was 10.15%, while Staff's was 12.84 %.

11 **B. CUB Shares Staff View Of Including Gas-Cost Sharing In Earnings Sharing**

12 Most of the traditional risk of providing utility service has been shifted to core
13 customers. This proposed mechanism shifts most of the remaining risk of the variability
14 of commodity prices to core customers. As mentioned earlier, decoupling shifted most of
15 the risk of energy efficiency, recessions, and reduced load due to higher prices onto core
16 customers. WARM shifts most of the weather risk onto core customers. As core
17 customers are taking so much of what used to be the utility's risk, they should be
18 compensated. This can happen through a significant reduction to each utility's ROE, but
19 that is not a subject in this docket, or that can happen by sharing over-earnings with
20 customers. As core customers are taking most of the risk of gas commodity variations, if
21 gas commodity costs contribute to a utility's over-earning, then it is core customers who
22 should share in that over-earning.

23 **C. Allocation Of Over-Earning**

24 The disagreement between Staff and NW Natural also raises an additional issue of
25 how the excess earnings should be allocated to customer classes, which is not addressed

1 in the Stipulation. Excess earnings under the current Earnings Review are shared
2 between customer classes based on an equal percent of margin. However, if some of the
3 earnings come from gas commodity costs, which industrial transport customers do not
4 pay, this means that some of what core customers pay in commodity costs is being used
5 to reduce the bills of large industrial transportation customers through the Earnings
6 Review, and this is inappropriate.

7 While the rate spread of excess earnings is not addressed by the Stipulation, we
8 feel it needs to be addressed. The proposed mechanism has an explicit trade-off. More
9 risk is being assigned to core customers, in exchange for lower earnings thresholds in the
10 Earnings Review. The problem with this trade-off is that 100% of the additional risk is
11 being placed on core customers, while much of the new benefit would flow to non-core
12 customers who are not taking additional risk.

13 Again, this is not new. As we have mentioned, other recently-adopted
14 mechanisms, notably decoupling and WARM, have shifted additional risk onto core
15 customers. Now this proposed mechanism (and even CUB's proposed mechanism),
16 would shift additional risk to core customers, while requiring core customers to share the
17 benefit of lower earnings thresholds that would help offset the additional risk.

18 The obvious solution to this would be to recognize that all the risk that is shifted
19 in this mechanism is being shifted onto core customers. Therefore, the offsetting benefit
20 of the lower earnings threshold should also flow to core customers. Under this solution,
21 the current earnings threshold would still apply to transportation customers, but excess
22 earnings between the new threshold and the old threshold would not be shared with non-
23 core customers.

1 We doubt that such a solution, while fair, would be met with much enthusiasm
2 from the large industrial customers. As an alternative, we suggest splitting customers'
3 share of the over-earnings in half. Half would be allocated to core customers on an equal
4 ϵ /therm basis and the other half would be allocated to all customers on an equal
5 percentage of margin. This solution would be simple to enact. Most importantly, it
6 would provide a benefit to all customers. Industrial transport customers, while receiving
7 a smaller share of the over-earnings, would begin receiving a share of over-earnings at a
8 much lower earnings threshold. The lower level of the earnings threshold should make
9 over-earning rate credits more frequent, providing a benefit to all customers. Core
10 customers would benefit, because they would be compensated for the additional risk that
11 gas regulation in Oregon has placed upon them.

12 **D. CUB Opposes The Cascade Exception**

13 Under the proposed mechanism, Cascade would have a different earnings
14 threshold than the other utilities, based on the agreements that went into place in its last
15 rate case.²⁴ We do not think that this would be appropriate. The proposed Stipulation
16 would significantly shift the risk of gas cost variations from Cascade to its core
17 customers. This is a significant benefit to Cascade shareholders, and it requires an
18 adjustment to Cascade's earnings threshold.

19 Cascade has made clear that it wants a 100% pass-through mechanism, and so, if
20 Cascade were willing to accept 67-33 in the Unhedged Variance, it would only further
21 support our argument that the amount of money actually tracked by that Variance would
22 be negligible (otherwise, Cascade would not choose 67-33 sharing). If Cascade wants to

²⁴ UM 1286 Stipulation at 6.

1 maintain the earnings threshold that it currently has, then it should be required to
2 maintain the allocation of risk on commodity costs that is currently in place. If Cascade
3 wants to shift risk onto core customers, it should be required to offset that additional risk
4 by adjusting its earnings threshold.

5 **IX. No Indication That Current Mechanism Needs To Be Discarded**

6 At this point, we step away from the Parties' proposed mechanism to look at
7 Oregon's current PGA mechanism, and why there has been so much controversy over a
8 mechanism that appears to be working quite well.

9 **A. Staff Position On PGA Risk-Reward Incentive Has Changed**

10 This current discussion has been building since the spring of 2006, when Staff
11 changed its position supporting Oregon's risk-reward incentive structure, and decided
12 that a 100% pass-through of gas commodity costs would be a more appropriate
13 mechanism.²⁵ In Comments submitted to Staff in April 2006, both CUB and NWIGU
14 opposed Staff's proposed 100% pass-through of gas commodity costs, and agreed that
15 there was no apparent need to significantly change the current PGA mechanism.²⁶

16 After that informal process, this docket was opened in the fall of 2006 and,
17 after numerous workshops, the parties submitted Comments to the Commission in
18 December 2007 and January 2008. Staff continued to support a 100% pass-through PGA
19 mechanism, but offered some possible incentive mechanisms that could be layered on top

²⁵ Staff Draft Proposed Agreements Relating to the Oregon PGA Mechanism at 2, 4/7/2006. See also: Comments of Bob Jenks of The Citizens' Utility Board of Oregon to Oregon PUC Staff On Proposed Changes to the PGA Mechanism, 4/26/06; and NWIGU Letter to Ken Zimmerman Re: Proposed Agreements relating to the Oregon PGA Mechanism, 4/26/2006.

²⁶ CUB 2006 Comments to Staff at 1-4. NWIGU 2006 Comments to Staff at 2.

1 of that foundation.²⁷ Staff recommended that the Commission adopt two different
2 incentive mechanisms, and, presumably, the utility would choose between them. It is not
3 clear whether or not Staff considered the selection of an incentive mechanism to be
4 optional, *i.e.*, it is unclear whether Staff would have recommended that the Commission
5 allow a utility to decline any incentive mechanism at all, and use only Staff's 100% pass-
6 through PGA.

7 **B. No Evidence On The Record To Suggest That The Current PGA Is A Problem**

8 Despite claims of unacceptable risk exposure from the gas utilities, the utilities
9 have provided no tangible evidence that Oregon's current PGA mechanism is in need of
10 an overhaul. From the data we presented in our Opening Comments, there is no
11 indication that the current PGA mechanism, which has been in place for a number of
12 years, is having a negative impact on the utilities.²⁸ Indeed, in our Opening Comments
13 we present NW Natural's strong credit rating as evidence that Oregon's PGA mechanism
14 is not seen as an unreasonable mechanism for passing gas commodity costs to customers,
15 while maintaining a risk-reward incentive. NW Natural is a gas-only utility and operates
16 primarily in Oregon, and so would seem to be a good barometer of rating agency views
17 on Oregon's regulatory mechanisms.

18 In addition, in our Opening Comments we reviewed the gas costs of Oregon's
19 utilities and compared them to utilities in the surrounding states and we could not find
20 any evidence that the current mechanism is producing higher prices for gas customers. In
21 their Testimony, the Joint Parties offered no evidence that the current mechanism is not
22 working and needs to be changed.

²⁷ UM 1286 Staff Opening Comments at 9-12.

²⁸ UM 1286 CUB Opening Comments at 4-7.

1 We still do not understand the pressing need to radically reallocate risk. If our
 2 current mechanism does not adversely affect the credit rating of utilities and does not lead
 3 to higher costs, we are not sure that it is broken. While we recognize that, since Staff
 4 began supporting a 100% pass-through, the utilities have become interested in a
 5 wholesale redesign of the PGA, this self-interested enthusiasm for shifting risk to core
 6 customers should not be a substitute for evidence that such a shift is good policy.

7 **C. Commission Has Suggested Only Moderate Modification Of Current PGA**

8 CUB Exhibit 107 is CUB’s settlement proposal of February 11, 2008. This
 9 proposal is based on the feedback we received from the Commission, through Judge
 10 Power, after the UM 1286 workshop with the Commission. As CUB understood the
 11 Commission’s feedback, a reasonable modification to the current PGA structure would
 12 be:

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

13 The Commission’s sketched proposal represents a significant, but reasonable
 14 modification to the current PGA mechanism, as well as a simplification and unification of
 15 what have become three different PGA mechanisms, with a patchwork of customizations.
 16 We are in agreement with the Commission that Oregon’s current PGA structure, with its
 17 risk-reward incentive, has been serving both customers and utilities reasonably well.
 18 Without any evidence on the record to support either a wholesale change of Oregon’s
 19 PGA structure, or the probable outcome and benefit of the proposed alternative, we share

1 what appears to be the Commission’s approach: that modification, while not necessary,
2 may be appropriate.

3 We recognize that this proposal is a significant shift of risk onto customers.
4 Under the current PGA, the risk sharing begins at 67-33. Under this proposal, it begins at
5 80-20. That is a large change that would shift considerable risk of post-PGA gas cost
6 variations onto core customers, but this risk shift can be balanced, at least in part, by
7 reduced earnings thresholds and a rate spread for earnings sharing that reflects the shift in
8 risk.

9 We asked Staff about its reaction to the Commission’s feedback, and Staff replied
10 as follows:

11 Administrative Law Judge Patrick Power briefly summarized the
12 “inclinations” of the Commission following the February workshop in
13 which the Commissioners and Parties participated. The Commission did
14 not outline a mechanism. Staff considers the Stipulated PGA to be
15 superior in ways described in its testimony filed jointly with the other
16 stipulating parties:

17 The cost of the unhedged volumes in the Embedded WACOG is based on
18 company-specific data from a published source;

19 There are two levels of incentive that work together to encourage the most
20 effective purchasing practices by the LDCs;

21 The Stipulated PGA is more flexible;

22 The linking of the sharing percentage and earnings threshold provides for
23 a fair, reasonable and sustainable balance of risk and reward for both the
24 LDC and its customers;

25 The use of forecasted volumes in the Embedded WACOG produces a
26 more accurate WACOG; and

27 The Stipulated PGA should be less controversial.

28 CUB Exhibit 106 at 1. Staff response to CUB data request 2.

1 While we agree that using a consistent and externally-produced source to price
2 spot market purchases when forecasting the Embedded WACOG, and that using
3 forecasted volumes in the Embedded WACOG are improvements in the current
4 mechanism, these are small tweaks and were not issues that the Commission addressed in
5 its feedback. On the other issues, we disagree with the Staff. The two Variances, rather
6 than improving the mechanism, interact in ways that are counter-intuitive and lead to
7 results that provide incentives that are not yet completely understood. The increased
8 flexibility is gained by giving each gas utility 2 options for its Benchmark Price each year
9 (which appears in both the WACOG Variance and the Unhedged Variance), which,
10 combined with three sharing options of the Unhedged Variance (except for Cascade
11 which gets an additional option), gives the utilities 6 options to choose from each year so
12 that each utility can try to minimize the sharing of lower costs and maximize the sharing
13 of higher costs.

14 Finally, it is hard to swallow the idea that this mechanism would be less
15 controversial than the current PGA, especially given that it is so complicated that
16 NW Natural has expressed concerns that its own data response may describe it
17 incorrectly. While controversy may be reduced in that the mechanism shifts risk to core
18 customers so the gas utilities will not complain as much, its complicated and interactive
19 nature lays the groundwork for future disagreement, unexpected outcomes, and further
20 controversy as to how best to fix this flawed mechanism.

21 **X. CUB Proposal**

22 In our Reply Comments, CUB proposed a PGA mechanism with a gas cost
23 deadband, a single 90-10 sharing of gas costs beyond the deadband, and an earnings

1 deadband of 100 basis points of return on equity. Though we continue to think that
 2 proposal has merit, the feedback from the Commission suggested to us that this was more
 3 of a change from the current PGA mechanism than the Commission was looking for.
 4 With this in mind, our proposal adopts the framework proposed by the Commission, but
 5 adjusts the sharing of earnings to account for the fact that core customers would take on
 6 greater risk and cost than they have in the past.

7 We approach our PGA proposal with the following principles in mind:

- 8 1. Don't fix what isn't broken;
- 9 2. Simplicity and transparency allow customers to understand what they are being
 10 charged, and reduce the prospect of unexpected outcomes; and
- 11 3. Mechanistic consistency both for an individual utility and between utilities, serves
 12 to allow customers to understand how they are being charged, allows the
 13 Commission to compare the year-to-year performance of a mechanism without
 14 having to account for annual benchmark changes or sharing percentage elections,
 15 and helps to ensure that customers of the three utilities are being treated equitably.

16 Therefore, we recommend what we understood the Commission's proposal to be:

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

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

1 For Earnings above the threshold, 33% would go to customers. Of that 33%, half
2 would be shared with core customers on an equal ¢/therm basis, and the other half would
3 be shared with all customers on an equal percent of margin.

4 We support the Parties' proposals for establishing, when setting a utility's
5 embedded WACOG, consistent methods for establishing a utility's load (forecasted
6 basis) and for calculating the forward prices that will be used for spot market purchases
7 (basis-adjusted NYMEX strips).²⁹

²⁹ UM 1286 Stipulation at 3-4.

UM 1286 - CUB List of Exhibits

Exhibit

- | | |
|-----|---------------------------------|
| 101 | Bob Qualifications |
| 102 | Avista Actual Vs Proposed |
| 103 | NW Natural Data Response |
| 104 | NW Natural Charts |
| 105 | Cascade Data Response |
| 106 | Staff Data Responses |
| 107 | CUB Settlement Proposal 2-11-08 |

WITNESS QUALIFICATION STATEMENT

NAME: Bob Jenks

EMPLOYER: Citizens' Utility Board of Oregon

TITLE: Executive Director

ADDRESS: 610 SW Broadway, Suite 308
Portland, OR 97205

EDUCATION: Bachelor of Science, Economics
Willamette University, Salem, OR

EXPERIENCE: Provided testimony or comments in a variety of OPUC dockets, including UE 88, UE 92, UM 903, UM 918, UE 102, UP 168, UT 125, UT 141, UE 115, UE 116, UE 137, UE 139, UE 161, UE 165, UE 167, UE 170, UE 172, UE 173, UG 152, UM 995, UM 1050, UM 1071, UM 1147, UM 1121, UM 1206, and UM 1209. Participated in the development of a variety of Least Cost Plans and PUC Settlement Conferences. Provided testimony to Oregon Legislative Committees on consumer issues relating to energy and telecommunications. Lobbied the Oregon Congressional delegation on behalf of CUB and the National Association of State Utility Consumer Advocates.

Between 1982 and 1991, worked for the Oregon State Public Interest Research Group, the Massachusetts Public Interest Research Group, and the Fund for Public Interest Research on a variety of public policy issues.

MEMBERSHIP: National Association of State Utility Consumer Advocates
Board of Directors, Environment Oregon Research and Policy Center
Telecommunications Policy Committee, Consumer Federation of America
Electricity Policy Committee, Consumer Federation of America

Proposed Deferral Amount - Avista

	2005-06		2006-07		2007-08		3-Yr Total
	WACOG Variance	Unhedged Variance	WACOG Variance	Unhedged Variance	WACOG Variance	Unhedged Variance	
Nov	97,303	57,882	(224,167)	20,946	(706,127)	(529,489)	
Dec	298,600	(17,102)	(247,801)	(36,288)	(829,992)	116,801	
Jan	(148,317)	6,211	(763,875)	(17,617)	(763,812)	36,224	
Feb	(479,991)	(4,258)	(165,989)	30,919	(516,816)	(120,270)	
Mar	(507,239)	(4,621)	840,455	60,317	(48,725)	(184,501)	
Total Variance	(739,644)	38,111	(561,376)	58,276	(2,865,472)	(681,235)	
Defer 95% of WACOG Variance	(\$702,661)		(\$533,308)		(\$2,722,199)		(\$3,958,168)
Defer 90% of Unhedged Variance		\$34,300		\$52,448		(\$613,112)	(\$526,364)
Total Deferral	(\$668,362)		(\$480,859)		(\$3,335,311)		(\$4,484,532)

Note: Negative numbers indicate a credit to customers, positive numbers indicate a surcharge.

Actual Gas Cost Difference vs. Proposed Deferral Amount - Avista

	Monthly Embedded WACOG x Actual Volume	Actual WACOG x Actual Volume	Actual Cost Difference	Amount Deferred From WACOG & Unhedged Variances	Deferral as % of Actual Cost Difference
2005-06					
Nov	7,955,237	8,110,422	155,185		
Dec	10,350,510	10,632,007	281,498		
Jan	8,152,136	8,010,030	(142,107)		
Feb	8,905,003	8,420,754	(484,249)		
Mar	6,865,086	6,353,226	(511,860)		
Total	\$42,227,972	\$41,526,439	(\$701,533)	(\$668,362)	95%
2006-07					
Nov	9,477,397	9,274,174	(203,223)		
Dec	13,023,587	12,775,787	(247,801)		
Jan	14,087,736	13,306,244	(781,492)		
Feb	9,917,627	9,782,557	(135,070)		
Mar	6,598,278	7,499,049	900,772		
Total	\$53,104,625	\$52,637,811	(\$466,814)	(\$480,859)	103%
2007-08					
Nov	8,237,133	7,001,517	(1,235,616)		
Dec	10,569,689	9,856,498	(713,191)		
Jan	12,003,280	11,275,692	(727,588)		
Feb	9,542,274	8,905,188	(637,086)		
Mar	7,297,980	7,064,754	(233,226)		
Total	\$47,650,356	\$44,103,649	\$3,546,708	(\$3,335,311)	-94%

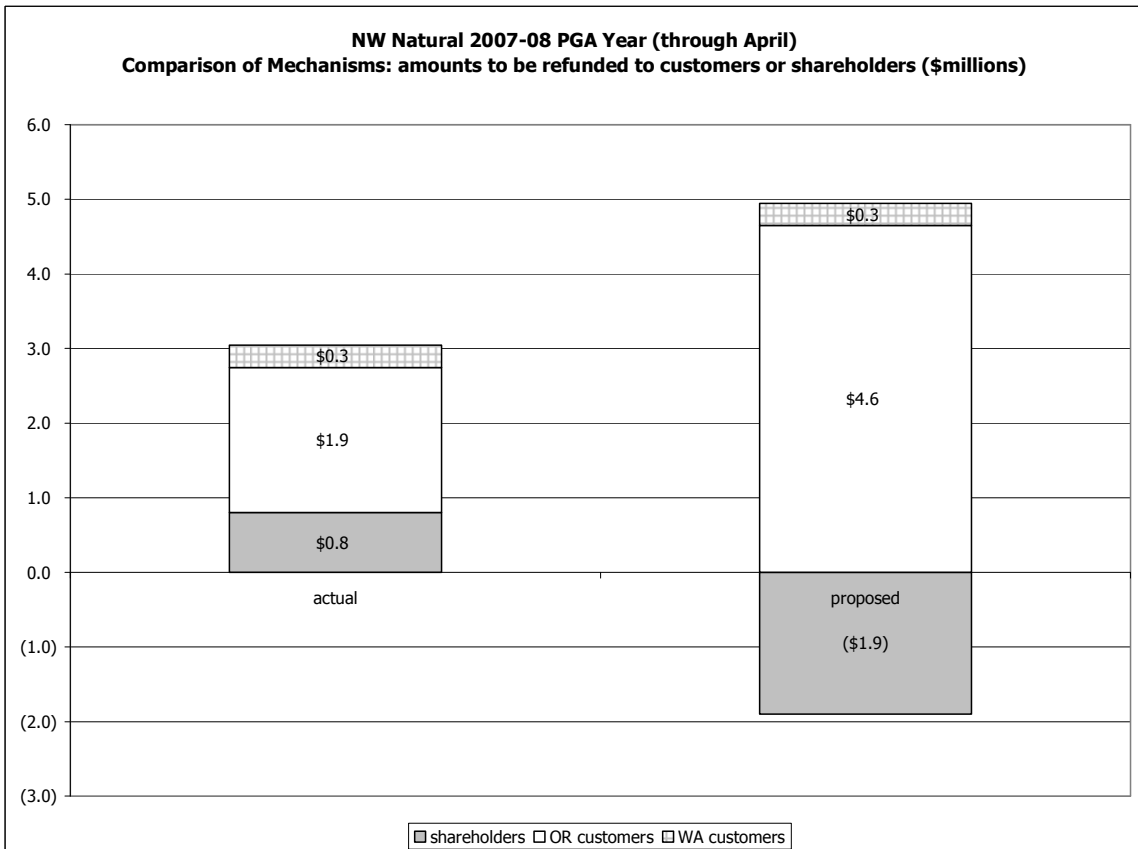
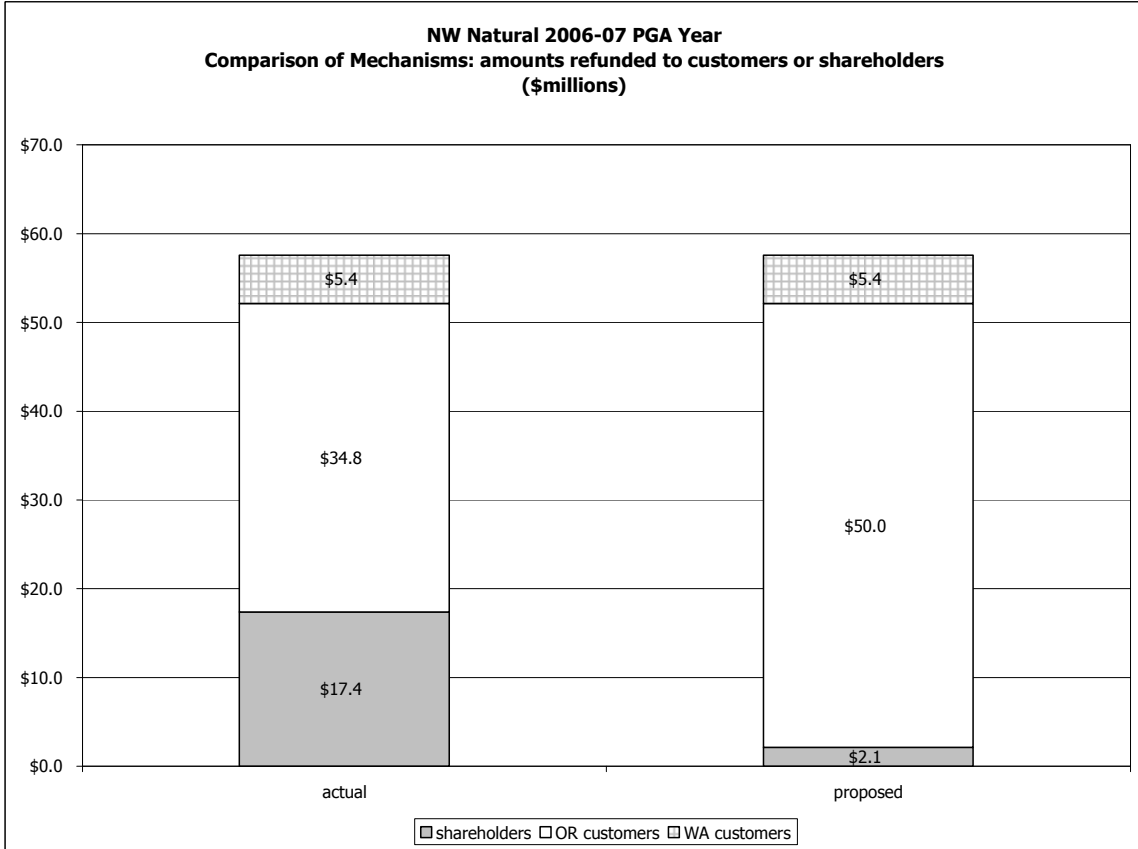
NW Natural Response To CUB Data Request

6. Please provide the mathematical formula for calculating the Unhedged Benchmark Variance, and explain how a utility's use of storage could impact the results of the calculation.

Response: The mathematical formula is as follows:

$$\text{Unhedged Benchmark Variance} = \text{Actual cost paid for Unhedged Gas} - (\text{Actual Unhedged Volumes} * \text{FOM Index})$$

If the actual cost of gas is less than the Unhedged Benchmark Price, creating a positive Unhedged Benchmark Variance, the utility shares that variance 33/67 with customers. In NW Natural's case, the Unhedged Benchmark Price will be set to the first of the month (FOM) index. Thus, if the cost of gas in storage is less than the FOM index, and NW Natural withdraws gas from storage to meet customer requirements, it will share in the savings with customers. This is similar to the way the current PGA mechanism works, except that in the case of the current mechanism, the utility and its customers share in the savings when the actual cost of gas in storage is less than the embedded WACOG, rather than the FOM index. Both mechanisms obviously work in reverse as well; if the cost of gas in storage is more than the benchmark (either the FOM index, in the case of the new mechanism, or the embedded WACOG price, in the case of the current mechanism) and the utility withdraws gas from storage to serve load, the utility and its customers share in the loss.



Cascade Response To CUB Data Request

CASCADE NATURAL GAS CORPORATION Oregon Public Utility Commission Docket UM 1286

CUB Data Request No. 1

Had the proposed PGA mechanism been in place for Cascade, for each of the last three heating seasons, November through March of '05-'06, '06-07, and '07-'08, please provide, by month:

- a. The Unhedged Benchmark Price from the Stipulation page 5, section 4(B);
- b. The Monthly Benchmark WACOG;
- c. The Monthly WACOG Variance;
- d. The Unhedged Benchmark Variance; and
- e. The difference between the cost of fixed price hedges as established in the Company's PGA and the cost of fixed price hedges as actually realized.

Response:

Cascade objects to this request to the extent it requires Cascade to perform a special study or analysis, on the grounds that it is unreasonable and would be unduly burdensome to respond. Additionally, Cascade objects that any response to the data request may not be completely accurate since the proposed PGA mechanism was not, in fact, in place for the historical periods that are the subject of the request. Therefore the underlying Annual Embedded WACOG, upon which the Monthly WACOG Variance is based, was not developed in the manner consistent with that proposed in the Stipulation nor did the company speculate as to how its hedging or gas purchasing strategies may have been different had the mechanism been in place in the past. The Annual WACOG utilized in the Company's response to the data request is based upon the Annual WACOG approved by the Commission in the annual PGA filing associated with the historical periods. Additionally, the data request seeks information for only certain months of the years and, given that the existing and proposed PGA mechanisms are based on an Annual WACOG, such limited data may provide a misleading picture of the overall impact of the proposed mechanism. Subject to and without waiving these objections, Cascade responds to the data request as follows.

- 1a. See attached spreadsheet
- 1b. See attached spreadsheet
- 1c. See attached spreadsheet
- 1d. See attached spreadsheet
- 1e. There is no difference between the cost of fixed price hedges established in the PGA and those actually realized by the Company.

Staff Response To CUB Data Request

CUB's Data Request 2

At the February 4th workshop, Judge Power provided an outline of a mechanism from the Commission to guide the parties in their discussions. A summary of the Commission's proposed mechanism is attached, as represented in CUB's settlement proposal of February 11, 2008. Please explain why Staff considers the Stipulation's proposed mechanism to be superior to the one outlined by the Commission.

Response to CUB Data Request 2

Administrative Law Judge Patrick Power briefly summarized the "inclinations" of the Commission following the February workshop in which the Commissioners and Parties participated. The Commission did not outline a mechanism. Staff considers the Stipulated PGA to be superior in ways described in its testimony filed jointly with the other stipulating parties:

- The cost of the unhedged volumes in the Embedded WACOG is based on company-specific data from a published source;
- There are two levels of incentive that work together to encourage the most effective purchasing practices by the LDCs;
- The Stipulated PGA is more flexible;
- The linking of the sharing percentage and earnings threshold provides for a fair, reasonable and sustainable balance of risk and reward for both the LDC and its customers;
- The use of forecasted volumes in the Embedded WACOG produces a more accurate WACOG; and
- The Stipulated PGA should be less controversial.

Staff Response To CUB Data Request

CUB's Data Request 3

The Joint Parties claim that the proposed mechanism is “superior” to the current mechanism in part due to the flexibility provided by allowing the utilities to annually select their sharing percentage.

- a. Does Staff believe this benefits customers? If so, please explain.
- b. Under the proposed mechanism, when a utility perceives the market to be relatively risky on an annual basis, it could shift risk, through its sharing selection, to customers, while, when a utility perceives the market to be relatively stable on an annual basis it can take more risk itself, through its sharing selection. Does Staff agree with this statement, and if so, please explain how this benefits customers? If Staff does not agree with the statement, please explain why.

Response to CUB Data Request 3

- a. Yes. The proposed mechanism aligns the gas price for the PGA filing benchmarks with actual gas purchasing and pricing of the LDCs. This encourages the LDCs to seek the lowest cost combination (portfolio) of gas supplies, short- and long-term, hedged and un-hedged, and storage.
- b. No. Perceptions of the market's future prices are very risky due to the instability of the market. So the LDC's perceptions of the market price may not shift risks as anticipated. The Stipulated PGA removes the incentive for the LDC to rely on such perceptions. Instead it encourages the LDC to rely on a balanced, flexible, and diverse portfolio of supply types and options. This addresses the inherent instability in the market and cushions the LDC and its customers from changes in price, whichever direction they go.

Staff Response To CUB Data Request

CUB's Data Request 5

With regard to the proposed Earnings Review:

- a. Please explain how a utility's gas costs themselves would impact a utility's earnings test.
- b. If a utility's actual cost of unhedged gas is lower than its embedded WACOG, will this improve the utility's return on equity?
- c. If the answer to (b) is "yes," will this be captured by the proposed Earnings Sharing?

Response to CUB Data Request 5

- a. The level of the LDC's gas costs may affect the utility's rate of return that is considered within the annual spring earnings review.
- b. Under the stipulated mechanism, the actual cost of unhedged gas is compared to the Unhedged Benchmark Price, not to the embedded WACOG. If actual cost is lower, the sharing percentage retained by the LDC should increase its earned return on equity.
- c. To the extent the LDC's earnings are above the benchmark ROE, a portion of this amount (33% for Cascade, 20% for Avista and NW Natural) would be shared with customers.

Staff Response To CUB Data Request

CUB's Data Request 8

Please provide the mathematical formula for calculating the Unhedged Benchmark Variance, and explain how a utility's use of storage could impact the results of the calculation.

Response to CUB Data Request 8

If storage injections and withdrawals are completed according to the schedule consistent with the LDC's acknowledged portfolio plan, there should be no impact. The prices for storage gas injected reflect off season short-term pricing. That's one of the purposes of storage; to capture this lower price differential during the peak time for customer demand. The prices for storage gas would reflect those market prices, would be un-hedged, and would flow into the monthly un-hedged cost total.

CUB Settlement Proposal

2-11-08

Adopt the Commission's proposal as presented by Judge Power, with clarification on establishing the forward price curve and load forecast.

Sharing

Utility makes a one-time election between:

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

Baseline

November 1 st – April 30 th	Rates established in autumn PGA filing
May 1 st – October 31 st	Forward price updated from autumn filing

Forward Price Curve

60-day average of NYMEX prices

We appreciate the discussion about the premium carried by NYMEX prices, especially during the hurricane season, and think that the possibilities of using a 30-day average and/or adjusting the NYMEX average for that premium should be explored.

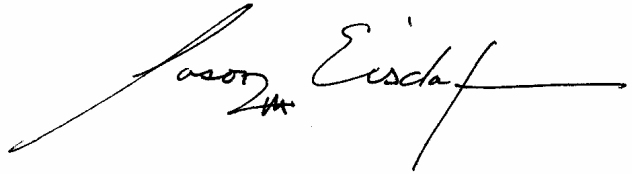
Load Forecast

The utility's forecast for the upcoming gas year

UM 1286 – CERTIFICATE OF SERVICE

I hereby certify that, on this 25th day of July 2008, I served the foregoing Testimony 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,

A handwritten signature in black ink, appearing to read "Jason Eisdorfer". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Jason Eisdorfer Attorney #92292
The Citizens' Utility Board of Oregon

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...

Filing Date: 11/21/2006

Case ZIMMERMAN, KEN (503) 373-1583

Law Judge(s): POWER, PATRICK

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Summary Report

UM 1286 INVESTIGATION INTO PURCHASED GAS ADJUSTMENT MECHANISM

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