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August 8, 2008

VIA ELECTRONIC FILING AND FIRST CLASS MAIL

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

Re: Docket UM 1286 – Joint Testimony

Enclosed for filing in the above-referenced docket are the original and five copies of the Reply Testimony of Alex Miller.

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

Very truly yours,

Wendy McIndoo

Wendy L. McIndoo
Legal Assistant

Enclosure

CERTIFICATE OF SERVICE

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

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Dated August 8, 2008

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BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

UM 1286

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

REPLY TESTIMONY

OF

ALEX MILLER

AUGUST 8, 2008

Q. Please state your name, occupation and business address.

A. My name is Alex Miller. I am employed by Northwest Natural Gas Company ("NW Natural") as Managing Director Regulatory Affairs and Assistant Treasurer. My business address is 220 NW Second Ave, Portland, Oregon, 97209.

Q. Have you previously filed Testimony in the docket?

A. Yes. I previously offered testimony in this docket through the Joint Direct Testimony filed on behalf of Staff, Avista, Cascade, NW Natural and NWIGU (the "Parties") on May 22, 2008. My qualifications are appended to that testimony as Joint Parties Exhibit 104.

Q. What is the purpose of your testimony?

This testimony is intended to supplement the Joint Reply Testimony filed by the Parties – which I have also joined -- by providing NW Natural's specific perspective on some of the issues raised by Citizen's Utility Board of Oregon ("CUB") in its testimony filed on July 25, 2008.

Q. Please comment generally on CUB's position in this case.

A. It is impossible to dispute that the scale of prices and volatility in gas markets today is dramatic and unprecedented. Indeed, as Jason Eisdorfer of CUB stated at the Commission's recent Gas Outlook meeting: "We are in a whole new world."[1] In this light, Mr. Jenks' testimony suggesting that there is no need to change the existing PGA strikes me as disingenuous. The fact is that the high prices and volatility that characterize today's gas markets have thrown customer and shareholder risks and interests out of alignment; the PGA mechanism ultimately adopted by this Commission must rebalance these elements.

[1] An audio file of Mr. Eisdorfer's comments at the July 15, 2008 Public Meeting can be accessed on the Commission's website at http://apps.puc.state.or.us/audio/071508/default.htm.

Q. What do you mean when you say that customer and shareholder risks and interests are out of alignment?

A. I say that customer and shareholder *risks* are out of alignment because, given current volatility and high prices, the Company's shareholders are shouldering an unfair and disproportionate share of the risk associated with gas purchasing. Customer and shareholder *interests* are out of alignment because the unfair risk borne by shareholders can encourage conservative gas purchasing that is not necessarily in the best interest of customers.

Q. Can you provide an example showing this effect?

A. Yes. In the Company's Opening Comments we provided the following simplified example to assist the Commission in understanding this imbalance:

First we asked the Commission to make the following assumptions which are based upon NW Natural's actual experience in 2006:

- NW Natural's pretax earnings are approximately $100 million;
- Customer bills are approximately $1,000 million;
- Gas requirements are approximately 80,000,000 bcf, 25% of which is unhedged and as a result, 20,000,000 bcf is exposed to the market.

Given these circumstances, we asked the Commission to assume that the price of gas increased by $2.00—which, we pointed out, is a reasonable assumption under today's volatile gas markets. In this case, the potential gas variance would be $40,000,000. Under the Company's existing PGA sharing percentages of 67/33, this variance would result in a 13% loss of earnings to shareholders and an increase in customer bills of 2.7%.[2] These risks remain out of alignment even at a lower sharing percentage. At 80/20, this variance would result in an 8% loss of earnings to

[2] Opening Comments at p. 20.

shareholders and an increase in customer bills of 3.2%. (In this simplified example, the risk levels come into alignment only at 90/10 sharing, with a 4% earnings impact and a 3.6% bill impact.) So, clearly the risks are currently out of balance.

Q. How does this imbalance in risk throw customer and shareholder interests out of alignment?

A. As can be seen from the example above, most of the financial risk we are discussing is associated with unhedged gas supplies. An LDC such as NW Natural carries unhedged supplies as part of its portfolio for two reasons. First, to meet the demand volatility resulting from weather variations in the most cost-effective manner, the LDC will typically hedge supplies only to the level that would cover a warmer than average winter. Second, in general, a well-diversified gas portfolio will include unhedged supplies to provide the opportunity to capture favorable market opportunities.

Put another way, an LDC will hedge portions of its portfolio to capture certainty in prices and mitigate price volatility. It will leave other portions of its portfolio unhedged in order to capture favorable market movements and address demand volatility.

When customer and shareholder interests are out of alignment with shareholders bearing excessive risk, the Company may tend toward more conservative purchasing strategies. It may hedge a greater percentage of its purchases to reduce its risk. Over time, the reduced flexibility and optionality may result in higher gas costs.

Q. CUB repeats throughout its testimony that the Stipulated PGA inappropriately shifts risk from the LDCs onto the customers' shoulders. Do you agree?

A. No I do not. As demonstrated above, and as explained by NW Natural since the beginning of this case: (1) given today's unstable gas market conditions, the current PGA and current sharing percentages place an unfair and unsustainable level of risk on the Company, and (2) this risk must be realigned so that it is fairly borne by the customers and shareholders. So, I will agree that the Stipulated PGA rebalances the risk faced by the Company and its customers, but I would point out that this rebalancing of risk is appropriate and necessary.

Q. How do you respond to CUB's statement on p. 3 of its Testimony that "most of the traditional risk of providing utility service has already been shifted to core customer," and that "the proposed mechanism shifts most of the remaining risk of the variability of commodity prices to core customers."

A. This statement is both inflammatory and untrue. On the contrary, as demonstrated above, under the current mechanism, NW Natural shareholders bear a disproportionate share of commodity price risk. And to CUB's complaint that WARM shifts risk to core customers, as CUB is aware, the WARM mechanism does not shift risk from one group to another, but rather normalizes costs so that customers do not pay disproportionately high amounts during cold weather, or disproportionately low amounts during warm weather. For example, as a result of this year's significantly colder-than-average winter, the WARM mechanism reduced customers' bills by $4.8 million from January through June of 2008. In the context of NW Natural's 2003 rate case, UG 152, CUB agreed to the implementation of WARM and agreed to the Return on Equity in the case. NW Natural's decoupling mechanism was already in place. Further, in 2007, CUB, along with the NW Energy Coalition, the Department of Energy, and OPUC Staff, signed a stipulation extending WARM until 2012. So while CUB's accusation may make for a good "sound byte," the evidence suggests that CUB believes these mechanisms are, in fact, good for customers and have been considered in light of NW Natural's allowed ROE.

Q. CUB questions how NW Natural's storage will be treated in calculating the Unhedged Benchmark Variance. Can you clarify the matter?

A. Yes. The calculation of the Unhedged Benchmark Variance does not include storage volumes. Accordingly, the formula for calculating the Unhedged Benchmark Variance is:

((Actual Unhedged Volumes) x (Actual Spot Market Price per therm)) – (Actual Unhedged Volumes) x (Unhedged Benchmark Price (FOM for NW Natural)).

Q. CUB points out NW Natural's response to CUB data request 6 suggests that NW Natural does assume that storage volumes are included in the Unhedged Benchmark Variance. Can you explain this discrepancy?

A. This was an error on our part. Storage fill completed prior to November 1 is not included in the Unhedged Benchmark Variance. However, please note that this error did not carry over to our calculation of the backcasting results; we did not include storage volumes in Unhedged Volumes in our analysis of our data for CUB for their Data Request Number 7.

Q. CUB argues that even if storage volumes are not included in the Unhedged Benchmark Variance, the Stipulated PGA still allows NW Natural "to benefit from its storage capability through the Unhedged [Benchmark] Variance, because the volume of spot market purchases included in the Unhedged [Benchmark] Variance would reflect how much storage gas NW Natural chose to use." What is your response?

A. My first response is that the Stipulated PGA *does* allow NW Natural to benefit from its storage capability and intentionally so. The entire purpose of the incentive mechanism is to create a situation where both the LDC's shareholders and its customers benefit when the LDC uses its skills and assets to procure the lowest reasonable cost gas on behalf of its customers. To that end, the Stipulated PGA allows NW Natural to benefit by making strategic decisions as to when and how much storage gas to use. Far from being a detriment, this feature is precisely what we want from an incentive mechanism, creating the "win/win" alignment we always talk about.

However, I disagree with CUB's argument that the Stipulated PGA will encourage the Company to use its storage gas to the detriment of customers. The Company's discretion in using its storage assets is limited by its responsibility to act prudently on behalf of its customers to maintain reliability and serve its load; as such, the Company's use of its storage is subject to extensive oversight and guidance by the Commission and its Staff. Moreover, CUB appears to greatly overestimate the amount of discretion we have in utilizing our storage. Each year, we forecast the volumes of storage gas that will be withdrawn on a monthly basis and include those forecast volumes in the PGA. If we withdraw more storage than planned in a given month, we simply won't have those volumes to withdraw in a later month. Given perfect foresight, we could withdraw additional storage gas when market prices were high in the hopes of purchasing on the spot market when prices were lower, but unfortunately, we don't have that perfect foresight.

Q. **CUB points out the disagreement between Staff and NW Natural on the treatment of WACOG savings and costs in the earnings review, and argues that Staff is correct. What is your response?**

A. CUB is correct that Staff and NW Natural disagree on this issue. However, this disagreement is not specific to the Stipulated PGA—it exists regardless of the PGA adopted by the Commission. Staff and NW Natural agree that the Commission need not resolve this issue in this proceeding and instead should allow the parties an opportunity to resolve the disagreement outside of this docket.

Q. **Does this conclude your testimony?**

A. Yes.