ITEM NO. 4

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: November 21, 2006

REGULAR X **CONSENT** ____ **EFFECTIVE DATE** N/A

DATE: November 14, 2006

TO: Public Utility Commission

FROM: Ken Zimmerman

THROUGH: Lee Sparling, Ed Busch, and Bonnie Tatom

SUBJECT: OREGON PUBLIC UTILITY COMMISSION STAFF: Request to open an investigation into the Purchased Gas Adjustment (PGA) mechanism used by Oregon's three local distribution companies.

STAFF RECOMMENDATION:

Staff recommends that the Commission open an investigation into the PGA mechanism pursuant to ORS 756.515.

DISCUSSION:

The PGA mechanism (mechanism) currently used by Oregon's three local distribution companies (LDCs) was established by the Commission in 1989,[1] and certain provisions have since been modified.[2] The purpose of the Oregon PGA mechanism has been two-fold: (1) to allow the LDCs to recover the costs associated with the purchase and transportation of natural gas to their systems without the need for a general rate review and (2) to provide an incentive to the LDCs to minimize the cost of natural gas purchases. The mechanism included a sharing component allowing the LDC to share in savings if the actual monthly cost of gas per therm was less than the current embedded cost of natural gas (determined in the annual PGA filing and approved by the Commission). The component was symmetrical—the LDC also shares in any additional cost incurred if the actual monthly cost of natural gas was greater than the current embedded cost of natural gas.

Since 1989, the dynamics and operation of the US and Northwest natural gas markets have changed dramatically. During the 1970s, the wellhead price of natural gas was

[1] *See* Order No. 89-1046, entered August 4, 1989 (Docket UG 73).
[2] *See* Order No. 99-272 (Docket No. UM 903) and Order No. 05-852 (Docket UG 73).

deregulated by the Federal Power Commission (now the Federal Energy Regulatory Commission or FERC). After that deregulation, the so called "gas bubble" developed in which an oversupply of natural gas suppressed the price of natural gas for all US end-users. However, by the late 1990s, this bubble was evaporating and prices for natural gas began to rise. During this time, NYMEX opened futures trading for natural gas financial contracts and middlemen (e.g., marketers, aggregators) began to enter the physical market for sales of natural gas. By the end of the 1990s, these changes were firmly established, as was a system of regional purchasing points or hubs across the US, with the Henry Hub in Louisiana established as the central hub to which the price at the other regional hubs was compared. The NYMEX futures contracts were priced at the Henry Hub. Also by then, a financial derivatives market for natural gas had been established and gradually the common practice of fixing the price of natural gas purchases over time by entering into a physical priced contract with a producer or marketer was replaced by financial derivatives, generally purchased through NYMEX.

After 1999, changes in the natural gas sector moved very rapidly. Independent "energy marketing" companies emerged (e.g., Enron, Dynegy) who combined the physical and financial side of natural gas purchasing, often merging the two into a single transaction. The number of counterparties for natural gas financial instruments expanded geometrically, until finally today, banks and stock brokerage houses are heavily involved in the financial and even physical side of the business.

These changes in the natural gas sector have placed great pressure on state commissions as well as the LDCs. The state regulatory commissions that oversee the operations, particularly the gas purchasing of these LDCs are under great pressure to design natural gas cost recovery mechanisms for their LDCs that fit the circumstances of the changed natural gas market. The Oregon PGA mechanism in place today was designed to meet LDC needs in a stable, lower priced, and more predictable natural gas market. That market no longer exists. The mechanism designed for that now-extinct market no longer serves well either LDCs or Oregon gas customers. During the workshops leading up to this formal investigation all participants recognized this fact and discussed how the current PGA mechanism needed to be modified in order to better meet the needs of LDCs and customers in today's natural gas market. It is time to review that PGA mechanism and consider how it might be redesigned. Among the areas this investigation will look into are:

1. Guidelines for implementing portfolio purchasing of natural gas that meets all the goals of such purchasing – diversity, balance, and flexibility,

2. The sharing of gas cost differences between the LDC and its customers and the percentages for such sharing,

3. Guidelines for the level and type of financial hedging of natural gas prices,

4. Guidelines for documentation of financial hedging decisions,

5. Guidelines for the sources and methodology for the forecasts of spot (cash) natural gas prices included in the PGA,

6. Guidelines for the use of storage as part of the LDC portfolio of natural gas,

7. A common format for PGA filings with the Commission,

8. A common format for the PGA workpapers that support the PGA filing with the Commission, and

9. Guidelines for documentation of natural gas market intelligence reviewed by LDCs in making purchasing decisions.

Staff expects to hold workshops beginning soon on these topics and anticipates completion of the investigation and proposed guidelines for Commission review by late 2007. This timeframe will not entirely mesh with the LDCs' natural gas purchasing timeframes, but Staff believes that our continuing quarterly meetings with each LDC will permit us to discuss interim strategies for the 2007 PGA filings.

PROPOSED COMMISSION MOTION:

An investigation be opened to review and modify, as appropriate, the PGA mechanism used by Oregon's three LDCs.