McDowell & Rackner PC

WENDY L. MCINDOO
Direct (503) 595-3922
wendy@mcd-law.com

January 28, 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 – Reply Comments

Enclosed for filing in the above-referenced docket are an original and five copies of NW Natural's Reply Comments. A copy of this filing has been served on all parties to this proceeding as indicated on the attached certificate of service.

Very truly yours,

Wendy 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:

DAVID J MEYER
VICE PRESIDENT & CHIEF COUNSEL
AVISTA CORPORATION
PO BOX 3727
SPOKANE WA 99220-3727
david.meyer@avistacorp.com

EDWARD A FINKLEA
CABLE HUSTON BENEDICT
HAAGENSEN & LLOYD LLP
efinklea@chbh.com

LOWREY R BROWN
CITIZENS' UTILITY BOARD OF OREGON
lowrey@oregoncub.org

ROBERT JENKS
CITIZENS' UTILITY BOARD OF OREGON
bob@oregoncub.org

PAULA E PYRON
EXECUTIVE DIRECTOR
NORTHWEST INDUSTRIAL GAS USERS
ppyron@nwigu.org

KEN ZIMMERMAN
PUBLIC UTILITY COMMISSION OF OREGON
550 CAPITOL ST NE, STE 215
SALEM OR 97301
ken.zimmerman@state.or.us

DAVID HATTON
ASSISTANT ATTORNEY GENERAL
DEPARTMENT OF JUSTICE
1162 COURT ST NE
SALEM OR 97301-4096
david.hatton@state.or.us

JON T STOLTZ
SR VICE PRES.—REGULATORY & GAS
CASCADE NATURAL GAS
jstoltz@cngc.com

KATHERINE BARNARD
DIRECTOR - REGULATORY AFFAIRS
CASCADE NATURAL GAS
kbarnard@cngc.com

JASON EISDORFER
CITIZENS' UTILITY BOARD OF OREGON
jason@oregoncub.org

CHAD M STOKES
CABLE HUSTON BENEDICT
HAAGENSEN & LLOYD LLP
cstokes@chbh.com

LAWRENCE REICHMAN
PERKINS COIE LLP
1120 NW COUCH ST, 10TH FLOOR
PORTLAND OR 97209-4128
lreichman@perkinscoie.com

Dated January 28, 2008

MCDOWELL & RACKNER PC

Wendy McIndoo

Wendy L. McIndoo
Legal Assistant

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	**NORTHWEST NATURAL'S REPLY COMMENTS**

I. INTRODUCTION

For the last twenty years the Commission has sought to align the interests of LDCs and their customers through the application of a gas purchase incentive mechanism ("GPIM"). In 1989, when the Commission first added a sharing component to what had previously been a 100% pass-through PGA, the Commission was clear as to its rationale; given that the LDCs had an opportunity to influence their gas expenses by implementing purchasing strategies, it made sense that they be granted a financial incentive to do so, to achieve the lowest reasonable cost on behalf of their customers.[1]

The threshold central question presented by the parties is this: Under current market conditions, do the LDCs continue to possess the ability to influence their gas purchase expense? If they no longer have any control over their gas purchase expense, then the concept of an incentive is obsolete. However, if the LDCs retain the ability to do so, then the LDCs and their customers will be best served by a continuation of the Commission's current policy.

In NW Natural's view, the answer to the question is clearly yes: LDCs still have the ability, through development and implementation of gas purchasing strategies, to pursue and achieve cost savings on behalf of their customers. It is true that today's gas markets present extraordinary challenges for the nation's LDCs. Prices are both high and volatile,

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[1] *See* UG 173, Order No. 89-1046, 105 P.U.R. 4th 365, 372-373 (1989).

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and it is more complex than ever for the LDCs to pursue their purchasing goals. As a result, under the current PGA sharing levels, the LDCs are exposed to an unacceptable level of financial risk. However, NW Natural believes that by employing their purchasing expertise – and in NW Natural's case, through the use of its storage resources – the LDCs are still able to influence their overall gas purchasing expense and achieve beneficial results for shareholders and customers. Accordingly, the Commission's policy of providing incentives to the LDCs to pursue lowest cost purchasing is sound and should not be abandoned.

Staff and the Citizens' Utility Board ("CUB") agree with the basic premise that the LDCs have *some* ability to influence their gas purchase expense. However, they differ – both with NW Natural and with each other – as to the degree and type of influence and therefore offer sharply contrasting solutions. Both Staff's and CUB's proposals will require fundamental changes to the current mechanism, and neither will achieve their intended purpose.

For the past several years, Staff has expressed concern about the ability of the LDCs to influence their gas expense through purchasing strategies. In Staff's opinion, the LDCs' only reliable tool for blunting volatility and limiting cost is to maintain a diverse portfolio.[2] It is unsurprising, then, that Staff proposes that the Commission discard the current incentive mechanism, which is designed to reward successful purchasing strategies. Staff *does* propose two alternative GPIMs that it suggests the Commission adopt on a trial basis. However, these mechanisms are focused on those results over which the LDCs have the least control, and will not result in least cost purchasing. As a result, Staff is essentially

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[2] *See, e.g.*, UG 180/UM 1346, Order 07-477, Appendix A, p.7; UG 179/UM 1342, Order 07-478, Appendix A. On occasion Staff has also opined that the LDCs need to actively manage their purchasing activities, *see, e.g.*, UG 179, Order No. 07-478 (portfolio approach requires "attention and effort"). However, its predominant message is that there is little in the way of purchasing strategy that can be successful.

advocating that the Commission eliminate purchasing incentives and abandon its traditional policy of seeking to align customer and shareholder interests.

In place of an effective incentive mechanism (and consistent with its views on the limits of the LDCs' ability to implement effective purchasing strategies), Staff proposes that the Commission adopt a system of prescriptive portfolio purchasing guidelines, and more rigorous Staff monitoring and prudence review of gas purchasing activities.[3] While NW Natural appreciates Staff's role in ensuring that the LDCs purchase prudently, Staff's proposed regime will not and cannot incent the LDCs to seek lowest cost resources on behalf of their customers. First, prudence is a different standard than lowest cost. Instead of encouraging the LDCs to accept an increased risk to provide lower cost gas to their customers, Staff's proposed prudence regime will motivate the LDCs to act more conservatively in order to ensure that no purchases are judged imprudent. Moreover, even if Staff *could* appropriately dictate lowest cost purchasing for the LDCs, there is no evidence to support Staff's suggestion that its judgment as to appropriate purchasing strategies is superior to that of the LDCs, and thus, no reason to conclude that a regime governed by Staff dictates will achieve superior results to those achieved by the LDCs under the current incentive policy.

CUB apparently takes the opposite view; in arguing that the LDCs should absorb 100% of first dollar variance through an electric utility-style Power Cost Adjustment Mechanism ("PCAM"), CUB suggests that the LDCs' control over their commodity costs is analogous to that of the electrics. In so doing, CUB misunderstands the critical differences between the electric utilities' and LDCs' influence over and relation to commodity costs. In fact, the PGA proposed by CUB would expose the LDCs to too much financial risk and as a

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[3] Staff's Opening Comments, pp. 8-9.

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result would discourage the LDCs from exercising their best judgment – including, where appropriate, taking reasonable risks – in order to obtain cost savings for customers.

All of the GPIM proposals offered by the parties possess the same fundamental structure: a benchmark is selected for setting a baseline gas purchase expense; actual gas purchase expense is compared to the benchmark; and the variance between the benchmark and actual expenses is shared by the LDC and its customers. However, those GPIMs proposed by NW Natural, Staff, and CUB reflect substantially differing views of the degree to which the LDCs can influence their gas purchase expense, the respective roles of the Commission and the LDCs, the amount of risk to which LDCs should be subject, and the proper way to incent the LDCs to achieve low costs. In the end, the Commission should be guided by the degree to which each of the proposals will provide an incentive to the LDCs to meet their gas purchasing goals. In this respect, the evidence is clear: the Commission's current PGA has served Oregon gas customers well for over 20 years. In particular, NW Natural has received high praise from a Commission Staff report[4] and independent analysts[5] for its efforts in lowest reasonable cost purchasing. In good years NW Natural's customers have received the lion's share of the benefits of lower cost gas, and in challenging years the Company has absorbed a substantial portion of higher cost gas.

Under these circumstances, there is no reason for the Commission to embark on a wholesale restructuring of the Oregon PGA. NW Natural urges the Commission to deny Staff's and CUB's invitation to do so.

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[4] *See* Public Utility Commission of Oregon Natural Gas Procurement Study, performed by Steve W. Chriss, pp. 4-5.

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

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II. DISCUSSION

A. The Commission's Longstanding Policy of Aligning Shareholder and Customer Interests through the PGA Has Been Successful and Should be Retained.

1. The Current PGA Provides Benefits to LDC Customers and Shareholders

In 1989, the Commission first adopted a PGA with a robust sharing component to align shareholder and customer interests by providing the LDCs with a financial incentive to seek lowest reasonable cost purchasing. The basic structure of the PGA is quite simple: at the beginning of each "gas year" each LDC calculates its benchmark for the weighted average cost of gas ("WACOG") for its unhedged purchases for the coming year. At the end of the year, that number is compared with the LDC's actual cost of gas for those same purchases; and the variance between projected WACOG and actual costs are shared between the LDC and customers at preset sharing percentages, with no tolerance bands or deadbands. This basic structure has been flexible enough to accommodate different sharing percentages and updated methods of setting the benchmark.

The Oregon PGA has been remarkably successful in encouraging the LDCs to use their discretion when building a gas supply portfolio to achieve savings on behalf of their customers, and incentives on behalf of their shareholders. NW Natural's experience in the 2006/2007 gas year provides an excellent example of these "win/win" results.[6]

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[6] In the spring and summer of 2006, the Company chose to hedge at levels that were significantly lower than those of recent years. At the time of the original filing, less than 50% of the Company's coming gas year supplies had been hedged (financial and storage combined). In September of 2006 the Company layered in an additional 10% of financial hedges and voluntarily included these in a revised PGA filing. These hedging levels were significantly below the approximately 85% level at which the Company had hedged in recent years and below the maximum 75% advocated by Staff. While NW Natural was concerned about the level of risk to which its shareholders were exposed by such low hedging levels, this concern was overridden by the Company's judgment that, given the specific market condition, it was in customers' best interest to hold back on hedging levels to see if the market would eventually settle down. In the end, the Company's strategy paid off. In accordance with the current sharing mechanism, the Company achieved substantial savings, in which the customers shared at over three times the rate.

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2. Staff's Criticisms of the Current PGA are Unfounded

Despite the PGA's past success, Staff has leveled numerous criticisms against the current PGA. Staff's objections can be distilled down to three fundamental concerns, each of which is unfounded.

First, Staff argues that the sharing component of the Oregon PGA either prevents the LDCs from fully recovering all of their gas costs, or leads the LDCs to over-recover their gas costs.[7] This is true. However, far from indicating a failure of the mechanism, this "over recovery" or "under recovery" is the intended result of the incentive portion of the PGA. Indeed, any incentive mechanism will lead to "over recovery" or "under recovery" in this fashion.[8] That is the point of the mechanism—to ensure that the LDC has "skin in the game."

Moreover, this criticism makes no sense coming from Staff, which itself has proposed an incentive mechanism. Although Staff labels its PGA "100% pass through," the GPIM portion of its mechanism works to impose "penalties" for underperformance and "rewards" for positive performance, with precisely the same result. If Staff wished to avoid "under-recovery" or "over-recovery," it would be unable to propose any GPIM at all.[9]

Second, Staff argues that the current PGA's benchmark is not exogenous, and suggests it may be "too easy to beat."[10] Here, Staff defines "exogenous" to mean that the

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[7] Staff's Opening Comments, p. 6.

[8] *See* A HARD LOOK AT INCENTIVE MECHANISMS FOR NATURAL GAS PROCUREMENT, The National Regulatory Research Institute, November 2006 ("NRRI Report"), p. 3.

[9] Staff also incorrectly asserts that Oregon law does not allow LDCs to make a profit on natural gas purchases. There is no such requirement in the statutes, rules or Commission policy. As Staff points out, the current PGA does allow shareholders to share in gains and losses in natural gas purchases and has done so since 1989. The Commission has never cast any doubt on the legality of this arrangement.

[10] Staff's Opening Comments, p. 6.

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values for price are outside the control or influence of the LDC.[11] Staff appears to believe that any benchmark selected by the LDC is *per se* not exogenous. NW Natural disagrees with Staff's conclusion. Beginning in 2005, NW Natural first employed a NYMEX forward price curve to set its benchmark and has used that method for the last three gas years. The NYMEX is a market curve and as such NW Natural has no ability to affect it. The fact that it was proposed by NW Natural does not mean that it fails the "exogenous test."

NW Natural does agree with Staff that the Commission should approve a method for setting the benchmark for each LDC, and that that method should not be varied from year to year unless there is good cause to do so. Adopting a consistent method will assure the Commission that the LDCs will be unable to "game the system" by proposing a different benchmark each year to attempt to achieve a different result. In particular, NW Natural proposes that the Commission adopt the NYMEX price curve methodology accepted by the Commission in NW Natural's most recent PGA.

Third, Staff argues that the sharing component of the PGA creates an incentive for the LDCs to move away from the requirements of portfolio purchasing "if and when natural gas markets change in directions that threaten the LDCs."[12] This is Staff's primary objection to the current PGA—that it encourages LDCs to hedge a greater percentage of their gas purchases than would be dictated by "best practices" guidelines. However, this is just another way of saying that under the current mechanism, the LDCs are subject to too much

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[11] Staff's Opening Comments, p. 6, fn.7.

[12] Staff's Opening Comments, p. 5. Staff also points out that most states allow the LDCs to pass through 100% of their gas expense to customers, However, this fact alone does not demonstrate that such mechanisms provide the best results for LDCs or their customers. Oregon's incentive mechanisms recognize that LDCs do have a role to play in implementing and carrying out strategy; as NW Natural demonstrates, Oregon's regulatory paradigm has resulted in strong benefits to LDC customers.

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risk, and are therefore incented to hedge a larger share of their portfolio than Staff believes that they should.[13]

NW Natural disagrees with Staff's frequently-voiced premise that hedging a significant percent of its gas purchase portfolio is always contrary to best practices portfolio purchasing.[14] Hedging is one of many tools the LDCs uses to manage risk and is central to the company's ability to control volatility—which is one of the LDCs' most important purchasing goals. As such, the LDCs must retain discretion to determine how much hedging is required under changing market conditions.

That said, Staff is correct that the current sharing percentages leave NW Natural (and possibly the other LDCs) exposed to an undue degree of risk that is out of alignment with that facing its customers; in some cases this undue risk could incent NW Natural to unduly conservative purchasing. However, the answer to this problem is to reduce the degree of risk facing NW Natural in order to bring the risks facing customers and shareholders into alignment-- not to eliminate the risk altogether. Yet this is precisely what would be achieved by Staff's proposal.

Staff proposes that the Commission abandon its longstanding PGA and instead adopt 100% pass-through of gas cost combined with an incentive mechanism. Unfortunately, the incentive portion of Staff's proposal is improperly designed and thus fails to provide the LDCs with an effective incentive to engage in lowest reasonable cost purchasing.

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[13] This point is reinforced by NW Natural's 2006-07 purchasing strategy (discussed in footnote 6), where in the face of a highly challenging market, the Company held off on hedging, to the benefit of customers and shareholders.

[14] *See, e.g.*, Staff's Opening Comments, p. 5; Staff Report re NWN Advice No. 07-6, November 1, 2007, pp. 2-3; Staff Report for Public Meeting Date October 25, 2006, UM 1286, p. 8.

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B. Staff's Proposal is Flawed and Should be Rejected

In place of the current PGA mechanism, Staff offers two separate GPIMs which it proposes the Commission adopt on a trial basis. In Staff's first GPIM proposal ("Proposal 1"),[15] the LDCs' actual expense for spot purchases during a month is compared to the benchmark calculated by averaging the daily published market prices for that month. In other words, the LDC earns a reward or penalty based upon whether it, on average, beat the daily market prices that month. Staff's second GPIM proposal ("Proposal 2")[16] attempts to evaluate LDC hedging decisions in the same way. As in the first, the difference between the LDC's actual expense and the benchmark is computed. But in this alternative, the benchmark WACOG is based on both spot purchase *and* firm gas purchases of more than a month in duration, both priced at index and hedged either physically or financially.

The fundamental problem with Staff's GPIMs is that, by concentrating on the LDCs' ability to beat daily (or a monthly average of daily prices in the case of hedges) market prices, they are focused on the wrong metric for success. As a result, the GPIMs suffer from two significant and related flaws: (1) they are not well-designed to reward least cost purchasing decisions; and (2) they concentrate on results over which the LDCs have the least control while overlooking the results over which they have the most control.

Staff's GPIMs are not well-designed to reward least cost purchasing. Under both Proposal 1 and Proposal 2, the LDC earns a reward or penalty based upon its ability to beat *daily*[17] market prices. Accordingly, the proposals focus on day–to–day performance, and the LDC is rewarded or penalized each month based upon how it performs in one-day increments. On the other hand, longer-term LDC decisions as to the timing of purchases do

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[15] Staff's Opening Comments, Attachment B.

[16] Staff's Opening Comments, Attachment C.

[17] It is not clear exactly how the benchmark for Proposal 2 would be calculated, however it appears that it would involve the averaging of daily values.

not figure into the mechanism at all. Thus, in one month when prices are high an LDC may decide to withdraw gas from storage in the belief that prices will go down the next month. If the LDC is correct and prices do go down the next month, the LDC's expertise will have saved its customers money. However, if on the day that the LDC chooses to purchase it does so right at market (the number calculated and published at the end of the day), it will earn no reward. Conversely, the LDC's judgment may turn out to be incorrect and market prices may rise even higher the following month. However, if on the day the LDC does choose to purchase, it is able to beat the market price, that purchase may earn it a reward, even if overall the customers lose as a result of its decision to withdraw from storage the previous month.

Thus, Staff's mechanism completely ignores the performance of the LDCs' portfolio over time, and gives out rewards based upon their daily ability to beat the market—regardless of the end result for customers.

Staff's GPIMs focus on those aspects of purchasing over which the LDCs have the least control. Staff's short-term approach provides incentives that are exclusively focused on those aspects of gas purchasing over which the LDCs have the least control, and they ignore entirely those aspects over which they have the most control, and where their skill can benefit customers. LDCs, like any purchasers on an open market, have very little ability to beat the market on any given day.[18] This is true whether they are making a spot purchase, or negotiating a hedge. Indeed, the Commission has noted in the past that an incentive is only effective if it is viewed as an incentive by the utility.[19] In this case, while NW

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[18] This is why stock brokers are not judged by their ability to beat daily market prices on individual trades. They are judged on the performance of their clients' portfolio over time—typically in annual increments.

[19] *See* Re Electric Utility Incentives for Acquisition of Conservation Resources, UM 409, Order No. 92-1673 (noting that "a mechanism can only be an incentive if the entity sought to be encouraged views it as an incentive").

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Natural has confidence that it possesses the experience and judgment to achieve gas savings over the course of the year by employing a longer term purchasing strategy, it has no such confidence in its ability to beat a daily price, which in its view would involve more luck than skill.

On the other hand, the LDCs have significantly greater ability to influence their overall spot market purchase expense by employing sound longer-term strategies as to how and when to purchase gas. As mentioned above, NW Natural's strategic use of its storage capacity represents its primary tool in pursuing lowest cost gas and in managing volatility. And the Company's skill in managing that capacity has been judged by an independent evaluator to be "truly impressive."[20] Yet, paradoxically (and as illustrated above), Staff's proposed GPIM would not reward the Company's successful use of its storage to obtain lower cost gas for its customers. In fact, under Staff's proposal, the only reference to the LDCs' use of storage is punitive. That is, the LDCs can be deprived of the opportunity to earn incentives if their storage ratchets are not met.[21] Thus, in order to earn an incentive under Staff's proposals, the LDCs will need to focus on discrete purchasing decisions—at the cost of employing those strategies that count for customers over time.

This result is not inconsistent with Staff's view that natural gas markets are far too complex and volatile for LDCs to navigate without close supervision and strict purchasing guidelines. Indeed, for several years now Staff has been promoting the idea that the *only* thing LDCs can do to control their gas expense is to diversify their portfolios in hopes of avoiding extreme losses (or gains).[22]

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[20] *See* Final Report: Assessment of the Effectiveness and Efficiency of Northwest Natural Storage Operations, Altos Management Partners Inc., September 4, 2007, pp. 4-5.

[21] *See* Staff's Opening Comments, pp. 10-11. NW Natural has violated these inflexible storage ratchets consistently in the past two years—the same years in which it has achieved significant savings for its customers.

[22] *See, e.g.* Orders 07-477, 07-478, *supra* note 3.

Although Staff claims to endorse the use of incentive mechanisms, it appears actually to be advocating a return to old-fashioned prudence reviews—and more prescriptive Commission purchasing guidelines and more intense Staff oversight of LDC purchasing decisions—to motivate LDC gas purchasing. Underlying this view is Staff's unspoken assumption that its own expertise in gas purchasing is superior to that possessed by the LDC. After noting that "the current market is intimidating even to seasoned market traders," Staff concludes: "The LDCs need to work closely with their regulators to effectively procure natural gas in the current complex and hard-to-analyze natural gas markets."[23]

Thus, Staff suggests that it is the regulator's supervision – and rigid portfolio purchasing – that offers the solution to today's complex gas markets. Consistent with this view, Staff proposes that the Commission adopt more detailed portfolio and PGA guidelines that will govern the LDCs' purchases.[24] Prudence reviews will ensure that purchases are carried out in accordance with the requirements of "best practices" portfolio purchasing, while Staff closely monitors the LDCs' purchases with "*at least* semi-annual" audits of gas costs and quarterly meetings between the LDCs and Staff.[25] Taken together, Staff's proposal of a "mis-focused" incentive mechanism together with increased Staff and Commission oversight, would suggest that LDCs do not need a real incentive to encourage them to purchase gas at low cost when they can simply follow Staff's guidance to achieve the same result.

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[23] Staff's Opening Comments, p. 4.

[24] Staff's Opening Comments, p.14. NW Natural does not believe that purchasing guidelines, in and of themselves, are harmful. However, NW Natural opposes the adoption of highly detailed and prescriptive guidelines that may deprive the LDCs of the ability to react appropriately under all market (and Company-specific load requirement) conditions. Of course the worst of all possible worlds for the LDCs would be the combination of highly detailed and prescriptive guidelines coupled with a PGA modeled on CUB's proposal which requires the LDCs to absorb significant first dollar variability on a 100% basis.

[25] Staff's Opening Comments, p. 14 (emphasis added).

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NW Natural appreciates the role of the Commission and Staff in ensuring that customers are protected. However, that role cannot supplant the function of an incentive mechanism. The Commission's role is to ensure that the LDC acts prudently given the information available to it at the time. In the case of gas purchases, this standard requires that customers should not pay the consequences when and if the LDC acts unreasonably in making its gas purchases. The prudence standard can encompass a range of decisions and in particular does not require the LDC to make the best possible decision, or one that results in savings for customers. An incentive mechanism, on the other hand, is designed to motivate the LDC to go beyond prudence and exercise their expertise, including taking reasonable risks, to seek additional savings for customers.

Moreover, as a practical matter, there is no support for Staff's implication that its regime of heightened monitoring and review will yield results superior to those achieved by the LDCs pursuit of their own purchasing strategies. As noted in NW Natural's Opening Comments, a 2007 study by Altos Management Partners found the Company's use of storage for price arbitrage to be "truly impressive," while in its study of LDC gas purchasing strategies, Commission Staff found that for the years studied, NW Natural outperformed the market.[26] While NW Natural welcomes Staff's involvement in ensuring that the Company act prudently, it does not believe it can or should delegate its own responsibility for seeking lowest cost gas purchases on behalf of its customers.

Finally, despite Staff's claim to the contrary, its GPIM mechanisms would be exceedingly complex to administer. It would involve daily tracking and monthly averaging of

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[26] *See* Public Utility Commission of Oregon Natural Gas Procurement Study, performed by Steve W. Chriss, pp. 4-5.

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market prices to produce benchmarks. Moreover, some of the information Staff proposed be used for Proposal 2 is not even publicly available.[27]

C. CUB's Proposal for a PGA based on an Electric Utility PCAM is Misguided and Should Be Rejected

NW Natural agrees with CUB that this Commission should adopt a robust incentive mechanism that seeks to align customer interests with those of the LDCs. However, in proposing that the Commission adopt for the LDCs an electric utility-style power cost adjustment mechanism ("PCAM") based on the one the Commission adopted for PGE in UE 180, CUB suggests a complete shift in the regulatory paradigm applicable to LDC gas purchasing. In particular, through its recommendation for a cost deadband, in which the LDCs would be required to absorb all gas purchase variance, CUB inappropriately seeks to redefine the basic regulatory assumption for LDCs from the traditional 100% pass-through, to a "100% absorption" model.

CUB's proposal is misguided for two reasons. First, CUB's proposal is based on the false premise that the degree of control held by the LDCs over their commodity costs is analogous to that of the electric utilities. And second, CUB's proposal is based on the false premise that the purpose of a PGA incentive mechanism is analogous to the purpose of a PCAM.

1. The LDCs' Ability to Control and Relationship to their Commodity Costs is Not Analogous to that of the Electric Utilities.

Through the imposition of its cost deadband, CUB's model will require that the LDCs absorb on a 100% basis substantial first dollar variance. In so doing, CUB is seeking to completely redefine the regulatory paradigm applicable to the LDCs. As discussed in NW Natural's Opening Comments, the traditional regulatory assumption for LDCs is that of a

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[27] *See* Staff's Opening Comments, Attachment C (benchmark includes fixed-price hedging prices "averaged by NWP hub for all counterparties *for which information is available*") (emphasis added).

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100% pass through of gas costs. That assumption has been varied only to the extent that the incentive mechanism has been adopted in many jurisdictions that allow for the sharing of a defined percentage of variance. CUB now seeks to turn the paradigm on its head.

CUB argues that its cost deadband is appropriate because the LDCs, like the electric utilities, should absorb a certain amount of variance as a part of their "normal business risk." However, the LDCs and electric utilities are not similarly situated with respect to commodity costs and risks, and it therefore makes no sense to structure their incentive mechanisms similarly.

First, LDCs have significantly less ability to manage their commodity costs than do the electrics. Electric utilities own and operate the means to generate the lion's share of their commodity. For instance, both PacifiCorp and Idaho Power generate the power to supply approximately seventy-five percent of their loads.[28] As such, the electrics have significant control over the cost of their commodity. Thus, not only can the electrics actively plan for and manage their costs of generation, they can also control their market purchasing expenses through decisions as to how and when to operate their plants. Conversely, while LDCs use their skill to minimize commodity costs, they must purchase 100% of their load and have control over their purchase expenses only to the extent that they can time their purchases when the prices are lower.[29]

Second, the regulatory paradigm applicable to electric commodity purchasing is fundamentally different from that applied to the LDCs' gas purchases. CUB erroneously asserts that the "current PGA mechanisms fail to recognize the inherent business risk that

[28] *See* LC 39, Order No. 06-029, p. 2; Idaho Power 2006 Integrated Resource Plan, p. 13.

[29] CUB seeks to analogize the situation of the LDCs and electrics in this respect by pointing to the fact that electrics are subject to hydro variability. However, while hydro variability is outside the control of the electrics, it is a stochastic risk that can and should be built into the electrics' base rates. No party has suggested that gas market variability can be modeled or so incorporated into rates.

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utilities are expected to, and paid a rate of return to, manage."[30] However, while electric utilities are indeed paid a rate of return to build and manage their "product," the LDCs are not.

For the electrics, the generation of electricity is central to their business. The electric utilities earn a return on their investment in generation, and that return represents a significant percentage of their rate base. On the other hand, gas purchasing is not critical to an LDC's business, and LDCs earn no return on their gas purchases. In fact, up until 1989, when the sharing component was added to the Oregon PGA, LDCs recovered exactly 100% of their purchased gas expense, and that has changed only to the extent that the LDCs can earn an incentive or suffer a penalty. Thus, if the purchasing function was removed from an LDC, there would be virtually no change in the LDC's business. The fact is that CUB's proposal represents a fundamental departure from the regulatory paradigm that has traditionally, and appropriately, applied to LDCs.

2. The PCAMs and the Oregon PGA are Intended to Serve Entirely Different Purposes.

By using the PCAM adopted for PGE as the basis of its proposal, CUB implies that the PCAM was intended to achieve the same purpose as a PGA. CUB is incorrect. The purpose of a PCAM is to *mitigate the effects of unusual variability* – especially for electrics that depend heavily on hydro generation – for electric utilities that would otherwise *absorb* 100% of their generation expense.[31] PGA's on the other hand are intended to *create incentives* for lower cost purchasing on the part of LDCs that would otherwise *recover* 100% of their gas expenses. Put another way, PCAMs do not need to provide incentives for the electric utilities to achieve cost savings. That incentive is built into the regulatory paradigm

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[30] CUB Opening Comments, p. 13.

[31] *See* UE 165/UM 1187, Order No. 05-1261, at 9-11.

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applicable to the electrics. On the other hand, Oregon's PGA is intended to provide LDCs with incentives that would otherwise be absent. CUB's deadbands run directly counter to this purpose.

First, by requiring the LDC to absorb first dollar variance on a 100% basis, the CUB cost deadband will layer additional risk on the LDCs who are already overexposed.

This docket was originally opened, in part, because Staff recognized that under current market conditions the LDCs are subject to an unacceptable degree of risk.[32] CUB's proposal would increase, not decrease, that risk. As a result, if it were to be adopted, the LDCs would be discouraged from taking the reasonable risks necessary to achieve savings for their customers. In fact, given the degree of risk proposed by CUB, the LDCs would be incented to hedge virtually all of their purchases—the precise result Staff is attempting to avoid.

CUB suggests that its proposal does not really alter the overall risk to the LDCs because the imposition of the cost deadband is "counterbalanced by shifting more of the risk of significant commodity cost variations to customers."[33] NW Natural is unconvinced. First, under most market conditions the Company can expect a certain amount of variation over which it has little control—and that is the variation that it expects to occur within the deadband. Requiring the LDC to absorb 100% of this normal variation does not appear a fair trade off for the protection at the extreme. Second, NW Natural is presently exposed to too much risk as a result of the current PGA mechanism, and therefore CUB's argument that its proposal holds risk levels constant is cold comfort.

Second, the earnings deadband functions much like the cost deadband, exposing the LDCs to too much risk, and failing to achieve the purpose of the current earnings test.

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[32] *See* Staff Report, November 21, 2006, UM 1286, p. 2.

[33] CUB Opening Comments, p. 18.

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In 1999 the Commission adopted the current PGA earnings test, the purpose of which is to ensure that deferred amounts under the PGA do not result in earnings for the LDCs that are excessive.[34] Accordingly, the Commission selected a benchmark for each of the LDCs and ordered that, in the event that the LDCs earnings exceeded the benchmark, amounts set for deferral under the PGA would be shared with customers on a 67/33 basis.

CUB's proposal operates in an entirely different manner. CUB's PGA sets an earnings deadband of +/- 100 basis points in which there would be no sharing of amounts to be deferred. In the event the LDC's earnings are outside of the earnings deadband, after application of a 90/10 sharing mechanism, the mechanism calculates the amount required to get the LDC back to the edge of the deadband, and that amount is shared between the customers and LDC.[35] Thus, the CUB earnings deadband not only ensures against "excessive" earnings, but it also works with the cost deadband to ensure that the LDC absorbs first dollar variability—which should not be the function of an earnings test.

3. If the Commission is inclined to adopt an electric utility style PCAM for the LDCs, it should be modified in recognition of the critical differences between the LDCs and electrics.

Notwithstanding NW Natural's concerns about CUB's proposal, the Company does appreciate CUB's efforts to retain a robust incentive mechanism that aligns customer and shareholder interests. And although NW Natural disagrees that an electric utility-style PCAM should be applied to the LDCs, the Company also appreciates the extent to which CUB has adjusted the PCAM model to accommodate recognized differences between the LDCs and the electrics. However, in this respect CUB's proposal does not go far enough. Accordingly, if the Commission is inclined to accept CUB's general approach, the following adjustments to its proposal should be made:

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[34] UM 903, Order No. 99-272, 193 P.U.R. 373, 380 (1999).

[35] CUB's Opening Comments, pp. 10-12.

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First, the gas cost deadband proposed by CUB should be symmetric. CUB argues that the deadband should be asymmetric for the same reasons the Commission adopted an asymmetric deadband for PGE – in order to maintain "revenue neutrality."[36] However, the revenue neutrality principle is not appropriately applied to a PGA, which is adopted for a purpose entirely separate from that of a PCAM. As explained above, the PGE PCAM was intended to mitigate the effects of the unusual variability to which PGE is subject, largely because of its dependence on hydro generation. It makes sense that such a mechanism be revenue neutral. However, the Oregon PGA is intended to provide an incentive for lower cost purchasing. As an incentive, the LDCs earns a reward whenever its performance beats the benchmark. As long as the benchmark is fairly set, the more often the LDC beats the benchmark, the better result for both the customer and the LDC. As such, revenue neutrality is not a proper goal.

Second, the gas cost deadband should be smaller than that proposed by CUB. There are two reasons for this. As pointed out above, this docket was initiated in recognition of the fact that the current market imposes too much risk on the LDCs. Therefore, if the Commission is to adopt a mechanism that shifts a new risk to the LDCs (the risk of first dollar variability) the Commission should do so in a conservative manner, so as not to exacerbate a pre-existing problem. Similarly, as also pointed out above, the imposition on LDCs of first dollar variability represents a dramatic shift in the regulatory paradigm. If the Commission is inclined to embark on this path, it should do so conservatively, in order to avoid unintended and harmful consequences. For this reason NW Natural recommends that the gas cost deadband be +/- 25 basis points ROE.

Third, the earnings test currently applicable to the LDCs should be retained, with an earnings deadband of +/- 200 basis points ROE. As explained above, imposing a deadband

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[36] *See* UE 180, Order No. 07-015, pp. 26-27.

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around earnings is not the proper function of an earnings test for a PGA. For that reason, NW Natural recommends that the current PGA earnings test be retained. That said, in order to help reach a compromise, NW Natural is willing to agree that the current +/- 300 basis point test be reduced and that a +/- 200 basis point earnings test be adopted.

NW Natural believes that CUB's proposed PGA is ill-suited for LDCs, and should not be adopted. However, if the Commission chooses to move forward with CUB's proposal, at a minimum the impact of the proposal's possible effects on LDCs and their customers should be controlled by reducing the gas cost deadband, making the gas cost deadband symmetrical, not adopting an earnings deadband, and maintaining the current earnings test with a +/- 200 basis point deadband.

D. Reply to Cascade and Avista

Both Cascade and Avista agree with NW Natural that the degree of risk to which an LDC is exposed should reflect the degree to which it can control its gas costs. In other words, as explained by Avista, sharing or incentive mechanisms should be employed where the LDC can affect the outcome through the application of its knowledge, experience and tools available.[37] However, unlike NW Natural, Cascade and Avista believe that, because of the unpredictable nature of the gas market, gas expense is entirely outside the control of the LDCs. For this reason these LDCs advocate that they should be allowed to defer and recover 100% of their gas costs.

This position may well reflect the fact that Cascade and Avista do not own storage and for that reason have less ability than NW Natural to manage and control their gas expense. Accordingly, it makes sense that Cascade and Avista should have less exposure to risk than that imposed by NW Natural's requested 80/20 sharing. The precise split should be determined by the companies' individual circumstances.

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[37] Avista Opening Comments, p. 2.

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Portland, OR 97204

III. CONCLUSION

NW Natural recognizes the degree to which the world has changed and is fully aware of the challenges presented by purchasing gas in today's market. For this reason the Company has supported the Commission's efforts to evaluate the current PGA to determine whether changes needed to made. And, NW Natural appreciates the time and effort all parties have expended in evaluating the current PGA and exploring alternative mechanisms. In the end, NW Natural has concluded that the current mechanism is the best. Through its sharing component, the Oregon PGA successfully aligns customer and shareholder interests in motivating the LDCs to reasonable least cost purchasing. Moreover, its flexible sharing bands allow the PGA to be successfully adapted to markets presenting varying degrees of risk—as has occurred over the past twenty years. NW Natural does agree with those parties who note that the LDCs are currently exposed to an undue level of risk. However, that failing can be remedied by adjusting the PGA's sharing percentages, as proposed by NW Natural in its Opening Comments.

The fact is that no party has made a compelling argument as to why the Commission should adopt a brand new incentive mechanism; on the contrary, there are compelling reasons why it should not. Natural gas markets are complex today, and they are certain to become even more so. In a carbon-constrained world, demand for gas can only increase, as customers switch from electricity to gas, and as gas is depended upon to "firm up wind," and to fuel the newest turbines. This is not a time to discard a PGA that is working

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in favor of an untested "experiment" or complete paradigm shift, particularly in a docket intended to reduce, rather than create, uncertainty.

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McDOWELL & RACKNER PC

Lisa Rackner

Lisa F. Rackner

Of Attorneys for NW Natural

NW NATURAL

Inara K. Scott
Manager, Regulatory Affairs
Alex C. Miller
Assistant Treasurer
220 NW Second Ave
Portland, OR 97209