BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UE 308

In the Matter of PORTLAND GENERAL ELECTRIC COMPANY, 2017 Annual Power Cost Update Tariff (Schedule 125).	STAFF REPLY BRIEF **[REDACTED]**

I. Introduction.

The only remaining issues regarding Portland General Electric Company (PGE)'s Automatic Power Cost Update (APCU) concern PGE's proposed [redacted] investment in natural gas well exploration, drilling, development and operation ("Proposed Investment"). The following is a brief description of the components of PGE's Proposed Investment and its requests to the Commission in this docket and in Docket No. UI 371 opened for PGE's application under ORS 757.495 related to an affiliated interest transaction.

a. Components of Proposed Investment

[redacted]

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[redacted]

Long-term hedging guidelines. PGE proposes a set of four guidelines to govern PGE's investments in subsequent drilling programs under the CPA in 2017 through 2020.

b. PGE's requests to the Commission.

PGE seeks to recover its 2017 costs for the Proposed Investment through its annual update to variable power costs for 2017 under PGE's Automatic Update Tariff (AUT) (Schedule 125). Specifically, PGE proposes that the 2017 NVPC forecast include PGE's costs to purchase natural gas at PGGS's cost of service under the Gas Purchase Agreement with PGGS.

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[1] PGE/800, Sims-Faist-Tooman/28.

[2] PGE Capital Program Agreement, paragraph 13.21.

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PGE also seeks approval in this docket of its proposed long-term hedging guidelines and its proposal that these guidelines govern PGE's investment in four additional exploring, drilling, development, and operation ventures between 2017-2020. PGE proposes that subsequent investments that fit within the guidelines would have a presumption of prudence.[3] PGE has stated that it does not need the Commission to approve the guidelines in this docket, but has not withdrawn its request that the Commission do so.

In Docket No. UI 371, PGE seeks Commission findings under ORS 757.495 regarding the Purchase Gas Agreement between PGE and Portland General Gas Supply (PGGS). PGE also seeks approval of a Guarantee of Indebtedness and a waiver of the requirement that services and goods purchased from an affiliate must be recorded in the utility's books at the lower of cost or market.

c. Questions presented to the Commission.

One of the two contested issues remaining in this AUT proceeding is whether PGE should be allowed to include costs of the Proposed Investment in its forecast of net variable power costs (NVPC) under PGE's Schedule 125. PGE asserts that the Proposed Investment should be included because it is cost-effective and provides a benefit as a long-term hedge of "limit[ing] electric price variability for customers by reducing gas cost volatility."[4] PGE's request raises sub-issues, including whether the AUT proceeding is the appropriate proceeding to determine the ratemaking treatment of this significant and long-term capital investment in gas reserves and whether the Proposed Investment is appropriately characterized as a hedge.

Staff does not think the Commission's decision regarding rate recovery of the Proposed Investment turns on resolution of either of these sub-issues. Although the AUT proceeding is abbreviated, Staff and the intervenors have had sufficient time to formulate recommendations regarding rate recovery of the Proposed Investment. And, whether the Proposed Investment is a

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[3] PGE/800, Sims-Faist-Tooman/50.

[4] PGE/800, Sims-Faist-Tooman/15.

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characterized as a hedge or not is not material. The Proposed Investment suffers from the same infirmities as a hedge as it does a fuel supply agreement – it is speculative and the purported benefits to ratepayers are easily outweighed by the risk associated with expansion into natural gas exploration, drilling, and production.

The second contested issue is whether to approve PGE's four long-term hedging guidelines and proposal that future investments that adhere to these guidelines should have a presumption of prudence. Although PGE has stated that it does not require that the Commission address the guidelines in this docket, PGE has not withdrawn its request that the Commission do so.[5] Staff recommends that the Commission deny PGE's request for approval of the guidelines and its proposal regarding future investments.

II. Staff recommends that the Commission not allow PGE to recover costs of the Proposed Investment in retail rates.

a. PGE did not show that the Proposed Investment benefits customers.

1. The Proposed Investment is speculative.

As discussed in Staff's testimony and opening brief, PGE determined the net present value (NPV) of the Proposed Investment by comparing a projection of the net costs of the Proposed Investment against a forecast of natural gas prices over 30 years. This base case comparison yielded a NPV of [redacted] This base comparison is not sufficient to support cost recovery of the Proposed Investment.

The [redacted] NPV is not stress tested. PGE agrees that forecasts are "inevitably wrong."[6] However, PGE does not offer analysis showing the NPV of the Proposed Investment under alternate scenarios. Staff's analysis reflects that changing decreasing the commodity prices assumed in the base case by 10 percent but making no other changes to the inputs assumed in PGE's analysis reduces the NPV [redacted].[7] Similarly, including a ten

[5] Opening Brief of Portland General Electric

[6] Confidential Hearing Transcript 31.

[7] Staff/500, Kaufman/6.

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percent adder to costs for contingencies, but keeping all other inputs the same, reduces the NPV [redacted] Staff also showed that increasing PGE's authorized ROR from the current 7.51 to PGE's 2006 AROR of 9.084 and keeping all other inputs the same would reduce the NPV to [redacted]

PGE dismisses Staff's analysis regarding alternate NPVs, asserting in its opening brief that "Staff assumes, without support, a very unlikely cost increase, coupled with a significant decrease in production a combination very unlikely occur together. * * * It is not surprising that such assumptions produce negative results. It is also not helpful to the analysis of this transaction."[8] PGE's critique is predicated, at least in part, on a misunderstanding of Staff's analysis. Staff's analysis does not rely on unlikely combinations of circumstances. As noted above, Staff found that decreasing commodity prices by ten percent, *or* including a ten percent adder to costs for contingencies, *or* increasing PGE's AROR, [redacted]

None of these scenarios can be characterized as "unlikely." Staff testifies that the commodity prices PGE uses for oil and natural gas liquids are optimistic, observing that PGE forecasts [redacted] It is not unreasonable to assume that PGE's actual costs will turn out to be higher than forecasted. And, PGEs AROR is currently at a historic low. It is not unreasonable to assume that PGE's AROR my increase more rapidly than other inputs.

Contrary to PGE's assertion, Staff's sensitivity analysis is helpful to determine the prudence of the Proposed Investment. And, the absence of Company analysis showing the cost-effectiveness of the Proposed Investment in a variety of different scenarios leads to the conclusion that PGE's projection that the Proposed Investment has a NPV of [redacted] is only speculation. As Dr. Kaufman testified at the August 21, 2016 hearing:

[8] Opening Brief of Portland General Electric 14.

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[redacted]

[redacted]

2. The evidence does not show the Proposed Investment has value as a hedge.

Contrary to PGE's assertion, any link between the Proposed Investment and retail rate stability for PGE customers is too tenuous to tip the scales toward cost recovery. First, the value of the Proposed Investment as a hedge on natural gas price variability is unclear. For example, a market wide increase in variable production costs would presumably affect both cost of service gas and market prices. If the cost of service gas increase is equal to market increase, the Proposed Investment provides no reduction in volatility. Similarly, the Proposed Investment provides little hedging benefit if the price for the cost of service gas sold to PGE from its subsidiary independently from market gas prices. For example, Staff has shown that an increase

[9] Confidential Hearing Transcript 92-93.

[10] Confidential Hearing Transcript 34.

[11] Staff/504b Kaufman/2.

[12] Staff/504b, Kaufman/4.

[13] Staff/504b, Kaufman/4.

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to PGE's AROR will increase the Proposed Investment's gas cost. If market gas prices remain stable while the Proposed Investment's gas cost increases, the Proposed Investment will result in greater price volatility than market based purchases.

Simply put, the Proposed Investment could be a hedge on PGE's cost to acquire gas in some circumstances, but not all. Because it is impossible to predict what factors may lead to variability in PGGS's cost of service, the value of the Proposed Investment as a hedge on natural gas price variability is uncertain.

Second, even assuming the Proposed Investment is a hedge against variability in PGE's cost to acquire natural gas, there is little if any evidence to show that this will translate to retail rate stability.

3. The Proposed Investment could create an intergenerational subsidy.

Staff also questions the benefit of the Proposed Investment to customers because cost recovery of the Proposed Investment could lead to a subsidy from one generation of customers to a subsequent generation. [redacted][14] Specifically, customers in initial years would experience higher than average cost and customers in the later years potentially experiencing lower than average costs.[15]

b. The Proposed Investment benefits PGE's shareholders.

Although it is not clear that the Proposed Investment in natural gas wells will benefit customers, it is clear that the Proposed Investment would benefit PGE's shareholders. Under PGE's proposal, the cost of gas obtained from the investment would include a return of and on the capital investment. PGE does not recover a return on its natural gas supply when PGE purchases natural gas from the producer. PGE's proposal to buy an ownership interest in gas wells rather than enter into a market-based purchase agreement for natural gas raises the build vs.

[14] Confidential Hearing Transcript 101 ([Bob Jenks:] [redacted]

[15] Confidential Hearing Transcript 92.

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buy issue that the Commission investigated with respect to acquisition of generation in Docket No. UM 1286. The Commission described the issue as follows:

> Most of the parties in this proceeding accept the premise that a bias exists [in] the utility resource procurement process that favors utility owned resources over PPAs. While the magnitude of the bias is difficult, if not impossible, to quantify parties identified two primary sources for the bias. First, owned resources offer a utility an opportunity to earn a return, while PPAs do not. If a utility is faced with the choice of building a generating plant or entering into a PPA—and there is no difference in cost between the two options—the utility will likely choose to build the plant because of the opportunity to earn a return on its investment. Second, rating agencies may consider PPAs as long-term commitments that have debt-like obligations. As a result, the rating agencies may impute debt equivalency amounts to a utility's balance sheet, which could negatively impact the credit ratios of a company.[16]

In its testimony, Staff noted that, the National Regulatory Research Institute (NRRI) released a report in April of this year finding that the benefits to the utility and its affiliates of owning natural gas reserves ownership are much more definitive than any (potential) benefits to the utility's customers. The NRRI Report finds that while the utility can rate-base the gas-reserves assets, and their affiliates get a reliable cash flow and the chance of higher profits from selling to the utility rather than on the open market, "no good reason exists to believe that the long-term hedging benefits to customers warrant the substantial efforts that utilities have made to consummate joint agreements" for reserve ownership.[17]

As Staff witness Fitch-Fleischmann noted in his pre-filed testimony and at the hearing, there is no particular advantage that PGE's ownership of natural gas reserves would provide customers as compared to purchasing natural gas on the market. Natural gas markets are liquid.[18] Contracts to purchase natural gas are straightforward for those in the utility industry and the

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[16] *In the Matter of THE PUBLIC Utility COMMISSION OF OREGON An investigation regarding performance-based ratemaking mechanisms to address potential build vs. buy bias* (UM 1276), Order No. 11-001.

[17] Staff/400, Fitch-Fleischmann/7, *quoting* NRRI Report No. 16-04, page 41.

[18] Confidential Hearing Transcript 69. See also TR 101 ([Bob Jenks:] "By all accounts the competitive market for natural gas is well functioning. Customers are well served. There's little evidence to suggest that that market will not continue to function effectively to deliver natural gas.")

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transaction costs to purchase natural gas using the marketplace are not burdensome.[19] Mr. Fitch-Fleischmann concludes that in these circumstances, PGE's proposal to enter the natural gas exploration and development business that introduces new types of risk into PGE's operations is not supported by economic theory.[20] Mr. Fitch-Fleischmann stated at the hearing:

[redacted]

Staff does not oppose hedging against natural gas price variability.

PGE asserts that "Staff and CUB have posited that customers do not want hedging without providing evidence to support their claim."[22] This is incorrect. Staff questions PGE's reliance on customer preference for stable rates without some indication of what premium customers are willing to pay for stable rates. Here, PGE's assertions that customers want stable rates does not inform whether they are willing to pay the premium for a 30-year investment in natural gas reserves of willing to take on the risk associated with the drilling, development, and ownership of natural gas reserves.

Furthermore, as Staff points out in its testimony, financial hedges would provide greater gas price certainty than the Proposed Investment, (for as long as the financial hedge lasted). And, financial hedges have less risk than the Proposed Investment. Accordingly, PGE's reliance on customer preference for stable rates is also undercut by the lack of evidence in the record about other less expensive and less risky hedging options that PGE may pursue to hedge natural gas price volatility.

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[19] Confidential Hearing Transcript 69

[20] Confidential Hearing Transcript 69-70.

[21] Confidential Hearing Transcript 83.

[22] Opening Brief of Portland General Electric 9.

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III. The AUT proceeding is not the appropriate proceeding to address cost recovery of the Proposed Investment.

Chair Hardie asked parties to address whether the AUT proceeding is the appropriate proceeding to address the ratemaking treatment of capital investments such as PGE's Proposed Investment. PGE argues that it is appropriate. PGE notes that it is allowed to update the AUT forecast for contracts for purchase or sale of power and fuel and changes in hedges, options, and other financial instruments to serve retail load and the gas purchase agreement between PGE and PGGS fits within these parameters.[23]

Staff agrees that an update to PGE's forecasted NPC to account for PGE's costs to purchase gas from PGGS is technically permissible under Schedule 125. However, this observation does not resolve whether it is appropriate to address the proper ratemaking for PGE's [redacted] capital investment in gas reserves. Staff does not think the process that has been used to review the Proposed Investment is appropriate. As CUB stresses in its testimony, [redacted]

[redacted]

[redacted]

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[23] Opening Brief of Portland General Electric 6.

[24] Confidential Hearing Transcript 115.

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IV. Staff recommends that the Commission not approve PGE's hedging guidelines.

Staff's opposition to the hedging guidelines is set forth in testimony and its opening brief and Staff will not repeat its arguments here. For the reasons previously argued, Staff recommends that the Commission not approve PGE's proposed long-term hedging guidelines.

V. Conclusion.

Staff recommends that the Commission deny PGE's request to include costs associated with the Proposed Investment in its forecast of NVPC and PGE's request for approval of its long-term hedging guidelines.

DATED this 17th day of October 2016.

Respectfully submitted,

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