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 OPENING BRIEF

I. Introduction.

This docket concerns Portland General Electric Company (PGE)'s annual power cost update (APCU) in which PGE adjusts retail rates for the following calendar year to take into account updated gas- and electric-price forecasts and other information relating to its net variable power costs (NVPC). The Citizens' Utility Board of Oregon (CUB), the Industrial Customers of Northwest Utilities (ICNU), Staff of the Public Utility Commission of Oregon, and PGE have entered into a stipulation resolving all issues arising from PGE's APCU filing with the exception of issues related to cost recovery of PGE's purchase of a non-working interest in a natural gas well drilling, development and ownership venture (hereinafter referred to as the "Proposed Investment"). PGE's proposal raises a myriad of issues.

Staff opposes cost recovery for the Proposed Investment in PGE's retail rates. The Proposed Investment introduces new risk into PGE's operations and its cost-effectiveness is speculative. Accordingly, the link between the Proposed Investment and the purported benefit—stable retail rates—is tenuous. Given the significant risk associated with the Proposed Investment, the uncertainty regarding its cost effectiveness, and the absence of a nexus between the Proposed Investment and the purported benefit of rate stability, Staff recommends the Commission reject PGE's request to recover costs of the Proposed Investment in retail rates.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

II. PGE's proposal.

PGE's proposal relating to the investment in natural gas wells has three major components. The first component is the Proposed Investment itself, which is the purchase of a working non-operating interest in the drilling, development, and operation of multiple natural gas wells. PGE's counter party is a natural gas exploration and drilling (E&P) company (Production Partner). PGE intends to make the purchase through a subsidiary formed for this purpose, Portland General Gas Supply (PGGS).

The Second Component of PGE's proposal is a gas purchase contract between PGGS and PGE under which PGE will purchase gas (or the financial equivalent) that PGGS obtains through the Proposed Investment at PGGS's cost of service, including its return on and of the Proposed Investment. In order to make this gas purchase agreement work as PGE intends, PGE seeks a waiver of the Commission's lower than cost-or-market rule that applies to transactions between utilities and affiliated interests. Otherwise, PGE would not be able to recover the costs of the Proposed Investment when PGE's gas production costs exceed natural gas market prices.

The Third Component has two parts: (1) PGE's request for Commission approval of four long-term hedging guidelines to govern essentially identical drilling programs for additional wells in each of the next four years, and (2) PGE's proposal that a subsequent purchase of natural gas wells that is within the parameters of PGE's four hedging guidelines is presumptively prudent for purposes of cost recovery in future AUT proceedings.

a. The Proposed Investment.

[redacted]

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

[redacted]

c. **Hedging guidelines and presumption of prudence.**

PGE characterizes the Proposed Investment as a long-term hedge. PGE seeks approval of the following four hedging guidelines, proposing that these guidelines serve as parameters for the

---

[1] PGE Long-Form Agreement 1.

[2] Capital Program Agreement 17.

[3] Staff/504a, Kaufman/1, PGE Response to OPUC Data Request No. 031.

[4] PGE seeks review of three affiliated interest transactions; an Updated Master Service Agreement that was previously approved for other affiliates by Order No. 06-250, an Operating Service for PGE to provide PGGS technical services related to oil and gas properties; and a Purchase Gas Agreement. (PGE/100, Tinker-Sims/19.) PGE's requests for review of affiliated interest transactions and waiver of the lower of cost or market rule are docketed as UI 376. Staff plans to address the contracts and waiver request at the October 23, 2016 public meeting.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

four additional investment opportunities in well-drilling and operation ventures over the next four years.

1. The projected leveled cost of gas acquired in a hedge must be at or below the levelized forecast of gas used in PGE's IRP.

2. Long-term gas purchase commitments must not exceed an established limit (PGE proposes that an "appropriate range" for this limit would fall within "15 to 30 percent of projected annual average gas burn.")

3. Purchases of gas reserves must be only for reserves that are "proved or provable."

4. The unit cost of gas from purchases of gas reserves is included in power cost updates only up to a 10 percent deviation from forecast costs and volumes. [5]

PGE proposes that if the subsequent investments are consistent with the guidelines, the investments would have a presumption of prudence for purposes of cost recovery in future AUT proceedings.

III. The Commission should not allow PGE to recover costs associated with the Proposed Investment in retail rates.

a. The cost-effectiveness of the Proposed Investment is uncertain.

[redacted]

---

[5] PGE/200, Sims-Outama/5.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

[redacted]

6 PGE/800, Sims-Faist-Tooman/30.

7 Staff/500, Kaufman/4.

8 Staff/500, Kaufman/5.

9 PGE/800, Sims-Faist-Tooman/21-27.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

[redacted]

Staff recommends that the Commission decline to allow rate recovery of the costs of the Proposed Investment primarily because the risk to ratepayers outweighs the potential benefit. This transaction will result in net benefits to customers over the term of the contract if commodity prices are in line with PGE's predictions, PGE's costs are limited to those included in its analysis (e.g., no regulatory compliance or unanticipated environmental costs), and PGE's rate of return remains where it is (relative to other inputs) for the duration of the contract. While it is possible that all these conditions will occur, it is possible they will not.

b. PGE's assertions the Proposed Investment will provide customers rate stability and PGE's assertion that customers are willing to pay for rate stability are both unsupported.

1. PGE has not established a link between the Proposed Investment and retail rate stability.

The link between retail rate stability and PGE's investment in natural gas supply through development and ownership of wells is tenuous. The cost of service gas prices that PGGS will

[10] Staff/500, Kaufman/6. [redacted]

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

charge PGE are not fixed, and may deviate from the forecasted costs in this case. Staff has shown that the NPV, and therefore the cost of service price for gas, is sensitive to the 30-year forecast of production volumes, production costs, and cost of capital. Actual commodity prices, production costs and PGE's cost of capital will vary from what PGE has forecasted. And, PGE does not provide evidence to that shows the value of its Proposed Investment under circumstances that differ from what it has forecast. Accordingly, it is not possible to tell what impact the Proposed Investment may have on PGE's gas costs.

Even putting aside the uncertainty regarding production volume and cost volatility, the Proposed Investment has an ambiguous impact on natural gas price risk. While there is likely some positive correlation between the value of the proposed investment and natural gas prices, (meaning when PGE's gas costs increase, the value of the Proposed Investment also increases), the correlation is limited.[11] The correlation is limited because approximately half the production value of the Proposed Investment is tied to oil prices.[12] And, as acknowledged by PGE, natural gas prices and oil prices do not always move in tandem.[13] Accordingly, it is not possible to tell how effective the Proposed Investment will be as a hedge against natural gas price volatility.[14]

Finally, even assuming the Proposed Investment limits natural gas price risk, there is little evidence to support the leap from a hedge on natural gas price risk to the "stable" rates PGE says are desired by its customers.

2. The Proposed Investment is too risky to be an effective hedge.

Staff believes that the Proposed Investment increases PGE's short-term and long-term business risk.[15] This means that any stabilizing effect that the Proposed Investment may have on

---

[11] Staff/500, Kaufman/12 .

[12] Staff/500, Kaufman/12 .

[13] Staff/504a, Kaufman/3.

[14] Staff/500, Kaufman/12.

[15] Staff/500, Kaufman/3.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

retail rates related to gas production costs could be offset by costs associated with risks of the Proposed Investment.

With respect to short-term risk, Staff expects that the added risk of the Proposed Investment will likely increase PGE's cost of capital (compared to what it would be absent the Proposed Investment), and consequently, increase PGE's rates. Testimony that PGE filed in its 2015 rate case stated PGE was seeking an upgrade to its credit ratings from S&P, which PGE stated would "help lower financing costs for customers through lower pricing on revolving lines of credit and new debt."[16] Staff believes, however, that rating agencies will be less likely to upgrade PGE's credit ratings if PGE proceeds with the Proposed Investment and would likely review PGE for a downgrade.[17]

The long-term risks from the Proposed Investment are found in the exposure to new types of environmental liability, potential regulatory compliance costs associated with well drilling and operation, and exposure to costs associated with bankruptcy of Production Partner.

CUB describes the potential risks associated with entering into a joint partnership for the drilling, developing and operating natural gas wells. The risks listed by CUB included:

[redacted]

[16] Staff/500, Kaufman/14, quoting UE 294 PGE/1000, Hager-Greene/5, lines 8 to 10.

[17] Staff/500, Kaufman/15.

[18] CUB/200, Jenks/14.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

[redacted]

Staff recognizes the value in hedging a portion of PGE's natural gas supply. However, to the extent that PGE suggests that the Proposed Investment is warranted by the extrinsic value ratepayers place on rate stability, Staff disagrees that this extrinsic value is provided by the Proposed Investment.

---

[19] Staff/500, Kaufman/ .

[20] Staff/500, Kaufman/10.

[21] Staff/500, Kaufman/11.

[22] Staff/500, Kaufman/8.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

3. PGE has not established that customers are willing to take on additional risk for rate stability.

PGE's assertion that customers are willing to pay a premium for rate stability is not sufficiently supported. PGE acknowledges that a premium exists to hedge price certainty into the future and this premium increases as the length of the transaction grows, but that "this type of premium also represents the implicit value of price stability and was exactly what PGE's business customers said they were willing to pay during a period when natural gas prices were inflated."[23]

However, PGE's evidence that PGE's customers are willing to pay such a premium is not compelling. PGE relies on information reported in its 2007 IRP for its assertion regarding customer preferences for price stability. Its 2007 IRP includes the following summary regarding 2005 interviews by a third-party contractor, KEMA, with ten of PGE's 163 "key customers" and with four customer "focus groups," two residential and two commercial, made up of ten or eleven customers each:

> Business focus group participants expressed a strong preference for cost predictability and indicated that they would be willing to pay more for a particular resource or mix of resources if they could be assured long-term price predictability. Residential group participants were more resistant to price increases, even if those increases were for resources they later said they preferred (such as wind). Key customers had mixed responses about the relative importance of price predictability and higher costs.[24]

KEMA's findings showing a strong preference by approximately 20 customers from PGE's business customers for price predictability, a resistance to price stability in favor of lower costs by the residential customers and a mixed reaction by its key customers is not sufficient to support PGE's assertion that the Proposed Investment is appropriate given the extrinsic value customers place on rate stability.

---

[23] PGE/800, Sims-Faist-Tooman/48.

[24] PGE 2007 Integrated Resource Plan 138.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

The 2007 IRP also discusses customer research performed in December 2005 January 2006 by Momentum Market Intelligence regarding customers' preferences regarding the types of resources PGE used to supply electricity.[25] PGE includes with its testimony a slide from a PGE presentation made to the Commission in February 2006 indicating a majority of customers surveyed by Momentum preferred electric supply resources with long-term arrangements that would mean locking in small, predictable, annual price increases rather than increases that might be lower on average, but less predictable.[26] However, the rate effect of the Proposed Investment is not predictable, but will depend on a number of different variables, including commodity prices for oil and NGLs.

c. PGE can obtain equivalent value from financial hedges.

[redacted]

As PGE notes, "premium exists to hedge price certainty into the future and that this premium increases as the length of the transaction grows."[29] PGE has provided little evidence to justify ratepayers' absorbing the premium associated with the Proposed Investment given that shorter-term hedges can provide very similar value.

---

[25] PGE 2007 Integrated Resource Plan, pages 138-144.
[26] PGE/800, Sims-Faist-Tooman/802.
[27] Staff/500, Kaufman/12.
[28] Staff/500, Kaufman/12.
[29] PGE/800, Sims-Faist-Tooman/46.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

d. Staff's position is supported by independent research.

Staff recommends that the Commission decline to allow rate recovery of the costs of the transaction primarily because the risk to ratepayers outweighs the potential benefit. This transaction will result in net benefits to customers over the term of the contract if commodity prices are in line with PGE's predictions, PGE's costs are limited to those included in its analysis (e.g., no regulatory compliance costs), and PGE's rate of return remains where it is (relative to other inputs) for the duration of the contract. While it is possible that all these conditions will occur, it is possible they will not.

Staff's recommendation against rate recovery is supported by the National Regulatory Research Institute (NRRI). The NRRI published a report in which it finds that the benefits of reserve ownership to the utility and its affiliates are much more definitive than any (potential) benefits to the utility's customers. While the utility can rate base the gas-reserve 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, NRRI finds that "no good reason exists to believe that long-term hedging benefits to customers warrant the substantial efforts that utilities have made to consummate joint agreements" for reserve ownership.[30]

Staff is persuaded by NRRI's assessment that because "utilities are betting that future natural gas prices will increase based on highly imperfect information, and then structur[ing] a long term plan to achieve gas-cost savings," the "vertical arrangements proposed by utilities resemble more of a speculative than hedging activity."[31]

---

[30] Staff/400, Fitch-Fleischmann/7, quoting NRRI Report No. 16-04, page 41. (The NRRI Report is included in ICNU's testimony as ICNU/202.)

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

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

IV. The Commission should not approve PGE's "hedging guidelines."

PGE proposes four "hedging guidelines" to "establish a framework around which prudence can be measured for the proposed long-term gas hedging strategy and specific transactions pursuant to that strategy." [32]

1. The projected leveled cost of gas acquired in a hedge must be at or below the levelized forecast of gas used in PGE's IRP.
2. Long-term gas purchase commitments must not exceed an established limit (PGE proposes that an "appropriate range" for this limit would fall within "15 to 30 percent of projected annual average gas burn.")
3. Purchases of gas reserves must be only for reserves that are "proved or provable."
4. The unit cost of gas from purchases of gas reserves is included in power cost updates only up to a 10 percent deviation from forecast costs and volumes. [33]

PGE proposes that if the four additional investments in well drilling programs contemplated under its agreement with Production Partner are within the proposed guidelines, "the presumption is that the transaction is prudent subject to Commission determination that new circumstances or evidence demonstrates otherwise."[34]

Staff recommends that the Commission decline to approve PGE's proposed hedging guidelines. The first "guideline" applies to ratemaking and does not restrict or guide hedging activities.[35] The first, third, and fourth "guidelines" apply specifically to the ownership of gas reserves rather than long-term hedging in general. The second guideline that prescribes a fixed percentage of PGE's gas needs subject to long-term hedges is not necessarily desirable in that it is not responsive to market conditions.

As explained in Staff testimony, hedging activities should be responsive to market conditions and hedging guidelines should reflect this. PGE's proposed guidelines are not

---

[32] PGE/200, Sims-Outama/2.

[33] PGE/200, Sims-Outama/5.

[34] PGE/200, Sims-Outama/2.

[35] Staff/400, Fitch-Fleischmann/10.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

responsive to market conditions, but are tailored specifically to facilitate the acquisition of gas reserves at this time, rather than a comprehensive approach to hedging.[36]

Finally, Staff opposes PGE's proposal to use these hedging guidelines to evaluate prudence of subsequent investments in natural gas wells. Since these guidelines are not adequate to guide hedging activities and should not be used to just the prudence of future long-term investments in natural gas wells, Staff recommends that the Commission reject them.

V. The AUT is not the appropriate proceeding to determine the ratemaking treatment of the Proposed Investment.

Staff agrees with the testimony of CUB on whether an AUT Proceeding is the appropriate proceeding to determine the ratemaking treatment of PGE's long-term investment in natural gas wells, particularly CUB's testimony that the AUT Proceeding cannot take the place of integrated resource planning and a general rate case.[37] Examining the Proposed Investment in an IRP would include looking at how it performs under various risk metrics, including various carbon and methane scenarios, and the value of the investment with different assumptions concerning future risks.[38] It would also include an examination of PGE's actual need for natural gas and whether investment in natural gas production is actually the least-cost, least-risk method to fill that need. As noted above, analysis such as this was missing from PGE's case. And, given the short time allowed for review of APCU filings, difficult for Staff and intervenors to do in the AUT Proceeding.

As CUB testified, determining the rate treatment for the Proposed Investment in a general rate case would allow the Commission to determine whether there should be offsetting adjustments to PGE's ratebase. In this docket, PGE proposes to essentially add its investment to rate base (by allowing PGE to pass through the cost of PGGS's return of investment through the

---

[36] Staff/400, Fitch-Fleischmann/10.

[37] CUB/200, Jenks/19-20.

[38] CUB/200, Jenks/17.

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784

Purchase Gas Agreement). This incremental increase to PGE's rate base would not occur in a general rate case without an examination of the need for offsetting decreases to rate base to account for depreciation and plant that is no longer in use.

VI. Conclusion.

Staff recommends that the Commission deny PGE's request recover costs associated with the Proposed Investment in its retail rates. Staff also recommends that the Commission deny PGE's request to approve four hedging guidelines.

DATED this 3rd day of October 2016.

Respectfully submitted,

ELLEN F. ROSENBLUM
Attorney General

Mike ... for

Stephanie S. Andrus, #92512
Sr. Assistant Attorney General
Of Attorneys for Staff of the Public Utility
Commission of Oregon

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 947-4520 / Fax: (503) 378-3784