McDowell & Rackner PC

Wendy L. McIndoo
Direct (503) 595-3922
wendy@mcd-law.com

August 29, 2008

VIA ELECTRONIC FILING AND FIRST CLASS MAIL

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

Re: Docket UM 1286 – Joint Parties' Brief

Enclosed for filing in the above-referenced docket are the original and five copies of the Joint Parties' Brief for PUC Staff, Avista Corporation, Cascade Natural Gas Company, Northwest Industrial Gas Users and Northwest Natural Gas submitted by Lisa Rackner.

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 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

David Hatton
Assistant Attorney General
Department Of Justice
1162 Court St NE
Salem OR 97301-4096
david.hatton@state.or.us

Ken Zimmerman
Public Utility Commission Of Oregon
550 Capitol St NE, Ste 215
Salem OR 97301
ken.zimmerman@state.or.us

Lawrence Reichman
Perkins Coie LLP
1120 NW Couch St, 10th Floor
Portland OR 97209-4128
lreichman@perkinscoie.com

Tommy Brooks
Cable Huston Benedict
Haagensen & Lloyd LLP
efinklea@chbh.com

Chad M Stokes
Cable Huston Benedict
Haagensen & Lloyd LLP
cstokes@chbh.com

Katherine Barnard
Director - Regulatory Affairs
Cascade Natural Gas
kbarnard@cngc.com

Jon T Stoltz
Sr Vice Pres.—Regulatory & Gas
Cascade Natural Gas
jstoltz@cngc.com

CUB – OPUC Dockets
Citizens' Utility Board Of Oregon
Dockets@oregoncub.org

Paula E Pyron
Executive Director
Northwest Industrial Gas Users
ppyron@nwigu.org

Robert Jenks
Citizens' Utility Board Of Oregon
bob@oregoncub.org

Dated August 29, 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	**JOINT PARTIES' BRIEF**

INTRODUCTION

On May 2, 2008, Staff of the Public Utility Commission of Oregon ("Staff"), Avista Corporation ("Avista"), Cascade Natural Gas Corporation ("Cascade"), Northwest Natural Gas Company ("Northwest Natural") and Northwest Industrial Gas Users ("NWIGU") (hereinafter, the "Parties") entered into a Stipulation in which they agreed upon a purchased gas adjustment mechanism ("PGA") to be recommended for adoption to the Public Utility Commission of Oregon ("Commission"). The Citizens' Utility Board of Oregon ("CUB") opposes the Stipulation. In support of the Stipulation, the Parties rely on their Joint Direct Testimony and Joint Reply Testimony[1], on the Reply Testimony of Alex Miller[2] and on the following brief.

DISCUSSION

In November of 2006, Commission Staff recommended that the Commission review the current PGA stating: "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."[3] Accordingly, Staff concluded that the Commission should consider a new PGA, specifically tailored to new market conditions.[4] Nearly two years have

---

[1] Filed on May 2, 2008, and August 8, 2008, respectively.

[2] Filed on August 8, 2008.

[3] Staff Report, November 21, 2006, Request to Open PGA Investigation, p. 2.

[4] *Id.*

McDowell & Rackner PC
520 SW Sixth Avenue, Suite 830
Portland, OR 97204

passed since then, and the passage of time has served to further validate Staff's view. Markets have remained unstable, with a marked upturn in volatility of late involving frequent, sharp, and unpredictable changes.[5] The PGA adopted by the Commission in this docket must be designed to respond to these conditions.

At the outset of this docket, the Parties offered various and often conflicting views as to the optimal PGA design. However, all of the Parties agreed on several basic principles:

1. The high prices and volatility that characterize the current gas markets together with the current PGA have left the LDCs increasingly and disproportionately exposed to market risk.
2. This increased and disproportionate amount of risk encourages the LDCs to engage in unduly conservative gas purchasing practices that may not result in the "least reasonable cost" for LDC customers.
3. The risks and costs posed by today's markets need to be realigned so that they are more fairly allocated between customers and LDCs.
4. This realignment will encourage the LDCs to pursue gas purchasing strategies that better balance risks and benefits for their customers.
5. An independent, market-based benchmark should be set against which actual gas costs would be measured.

Reliance on these basic principles allowed the Parties to find common ground and agree upon a new mechanism that will better respond over time to changing market conditions. The resulting Stipulated PGA is superior to the current mechanism in several respects.

First and foremost, the incentive mechanism contained in the Stipulated PGA is superior to the *current PGA because it is designed to function effectively in current natural gas market conditions and can effectively adjust to changes in those conditions as they occur.* As described in detail in the testimony, the Stipulated PGA introduces a new market-based benchmark-- the Unhedged Benchmark Price-- that is tied to more current market prices (either First of Month ("FOM") or the weighted monthly average of Gas Daily third

---

[5] The substantial market movement over the course of 2008 was the subject of both Staff and LDC presentations at the Commission's July 15, 2008 "Gas Outlook" Public Meeting.

McDowell & Rackner PC
520 SW Sixth Avenue, Suite 830
Portland, OR 97204

party indices).[6] The benchmark contained in the current PGA is set once at the beginning of the PGA year, based on market forecasts. As the year progresses, the forecast may become less and less accurate, increasing the risk for the LDCs while at the same time providing a less effective incentive for the LDC to seek reasonable and stable prices through the construction of a balanced, flexible and diversified portfolio of supply resources.[7] On the other hand, by tying the benchmark to more current market prices, the Stipulated PGA provides a better measure of the LDC's purchasing decisions, while it also mitigates some of the increased financial risk presented by today's higher prices and greater market volatility. Mitigating this risk allows the LDC to financially hedge less of its portfolio, which has been a significant concern of Staff in recent years, and encourages the LDC to construct a more balanced and diverse portfolio which is in the best interests of customers and shareholders alike.

Second, the incentive mechanism contained in the Stipulated PGA is superior to the *current PGA because it includes two levels of incentive that work together to encourage the most effective purchasing practices.* The first level of incentive is calculated monthly by the comparison between the Embedded WACOG and the Monthly Benchmark WACOG. This incentive rewards or penalizes the LDC based upon the results of its longer-term decision making processes—in particular with respect to its decisions as to how much and when to hedge (primarily financially).[8] The second level of incentive is provided by the monthly comparison of the LDC's actual spot market purchases with the Unhedged Benchmark Price. This second level creates an incentive for the LDCs to manage shorter term purchasing to the benefit of customers.

---

[6] Joint Parties/100, Joint Parties/7-3.

[7] This risk can result in either an additional expense or reward to the utility, depending on the direction of the market price movement.

[8] Joint Parties/100, Joint Parties/15.

McDowell & Rackner PC
520 SW Sixth Avenue, Suite 830
Portland, OR 97204

Third, the Stipulated PGA is more flexible than the current PGA. As illustrated in the testimony supporting the Stipulation, differing levels of volatility and prices can alter the allocation of risk between the LDCs and their customers. Accordingly, sharing levels that are reasonable under more stable market conditions may prove unreasonable as market volatility increases. Thus, by allowing LDCs to elect an appropriate sharing percentage among designated options (and corresponding earnings threshold) each year, the Stipulated PGA will prove more durable under changing market conditions.[9]

The Stipulated PGA offers additional flexibility in allowing the LDCs to choose between two separate methods for calculating the Unhedged Benchmark Price, thus providing an incentive mechanism tailored to each particular company and its gas purchasing situation.[10]

Fourth, the linking of the sharing percentage and earnings threshold provides for a fair, reasonable and sustainable balance of risk and reward for both the LDCs and their customers. As discussed above, the Stipulated PGA allows the LDCs to choose amoung three levels of risk that they are willing to accept. However, this risk/reward choice is balanced by the corresponding earnings threshold that is applicable to each level of sharing.[11]

Fifth, the Stipulated PGA's process for determining the cost of unhedged volumes included in the Embedded WACOG is superior to that under the current PGA's method. In the current PGA, the LDCs have had the opportunity and the burden of selecting a method for calculating the cost of unhedged volumes in the Embedded WACOG each and every year. That process has proved to be extremely controversial, requiring all parties to expend substantial resources in resolving their differences. In the Stipulated PGA, the Parties have

---

[9] Joint Parties/100, Joint Parties/15-16; NW Natural/100, Miller/2-4.

[10] Joint Parties/100, Joint Parties/16.

[11] Joint Parties/100, Joint Parties/16.

McDowell & Rackner PC
520 SW Sixth Avenue, Suite 830
Portland, OR 97204

agreed to a reasonable method for setting Embedded WACOG, which will ensure smoother and more efficient PGA filings each fall. In addition, this method will be in place for three years and then be examined to determine whether it should continue with or without modification or be replaced.[12]

Sixth, the use of forecasted volumes in the Embedded WACOG produces a more accurate WACOG. The current method is to use recorded volumes adjusted for weather effects. This method excludes the effect of customer growth on expected sales. The use of forecasted volumes contained in the Stipulated PGA allows the LDCs to capture the effects of load change, thus providing a more accurate and reasonable charge to customers.

CUB's testimony opposing the Stipulation contains several errors. First, contrary to CUB's assertions, the Stipulation and testimony are quite clear as to what components are included in the two variance calculations for the incentive mechanism.[13] Second, CUB incorrectly argues that LDCs are already being paid a rate of return ("ROR") to secure the lowest possible cost for gas supply, so the LDCs should bear a greater portion of the risk of difficult to predict and volatile gas prices. In fact, LDCs are gas *distribution* companies, and their ROR does not include consideration of the multiple risks involved with purchasing gas in today's market.[14] Third, CUB's concerns over LDC abuse of the PGA mechanism ignore the fact that LDC purchasing decisions are subject to continual oversight by the Commission.[15] Finally, CUB's argument that the Stipulated PGA disproportionately shifts risk and costs to customers is unsubstantiated by any evidence and refuted by the detailed examples the Parties provide in their reply testimony.[16] Moreover, depending on the

---

[12] Joint Parties/100, Joint Parties/14.

[13] Joint Parties/200, Joint Parties/3.

[14] Joint Parties/200, Joint Parties/4.

[15] Joint Parties/200, Joint Parties/4-5.

[16] Joint Parties/200, Joint Parties/7-11; Joint Parties/201.

McDowell & Rackner PC
520 SW Sixth Avenue, Suite 830
Portland, OR 97204

direction of the market, the Stipulated PGA can result in savings for customers as compared to the current mechanism.[17]

CUB proposes that the Commission retain the current mechanism essentially as is, but add the linking of sharing percentages to narrower earnings thresholds.[18] The Joint Parties appreciate the fact that CUB has moved away from its initial proposal, which included the imposition of deadbands on calculated variances.[19] However, CUB's proposal is based on its position that the current PGA mechanism "isn't broken."[20] This position is incorrect. CUB's proposal fails to address the realities and risks of today's gas markets and would shift an inappropriate level of risk and potential cost onto the LDCs. CUB also opposes the various aspects of optionality built into the Stipulated PGA, which allow LDCs to make certain elections on an annual basis to better respond to market conditions, thereby providing benefits for customers. CUB's preference for "mechanistic consistency"[21] would result in an overly rigid mechanism. The Stipulated PGA, on the other hand, provides for flexibility over time and across LDCs and, for that reason, is likely to be a more enduring and effective mechanism. *All* of the Parties agree that the Stipulated PGA is superior to the existing mechanism, for all of the reasons discussed above and in the Parties' testimony.

CUB also opposes the portion of the Stipulation that would allow Cascade to continue to use the earnings threshold the Commission ordered in Cascade's recent rate case (UG 173) for a few additional years (through 2012) so long as Cascade continues to elect the sharing percentage of 67/33.[22] The Parties agree, however, that Cascade's situation is sufficiently unique among the LDCs so that this treatment is appropriate for a

---

[17] *Id.*

[18] CUB/100, Jenks/38-41.

[19] See CUB's Opening Comments, filed January 28, 2008.

[20] CUB/100, Jenks/42.

[21] CUB/100, Jenks/42.

[22] CUB/100, Jenks/36-37.

McDowell & Rackner PC
520 SW Sixth Avenue, Suite 830
Portland, OR 97204

period of time. Cascade's earnings threshold was recently adjusted in the Commission orders approving the settlements in Cascade's recent rate case (UG 173, Order No. 07-220) and its merger approval docket with MDU Resources (Docket UM 1283, Order No. 07-221). These settlements and Commission orders tie Cascade's new earnings threshold to other terms and conditions, including Cascade's current sharing percentage, its new ROE, a cap on A&G expenses, and guaranteed rate credits, which extend through 2012. For these reasons, the Parties agreed that Cascade should be allowed to retain its recently ordered earnings threshold, but *only* so long as it continues to share at 67/33.[23]

Finally, CUB proposes modifications to the earnings sharing mechanism. The Commission should adopt the Parties' proposal for earnings sharing because it accounts for the impact of SB 408 on some LDCs and because sharing excess earnings on an equal percentage of margin basis is more fair and just.[24]

CONCLUSION

For all of the reasons set forth in the Parties' testimony and in this brief, the Parties urge that Commission approve the Stipulated PGA.

DATED: August 29, 2008

McDOWELL & RACKNER PC

Lisa F. Rackner

Of Attorneys for NW Natural

---

[23] Joint Parties/100, Joint Parties/11-12.

[24] Joint Parties/100, Joint Parties/15-18.

McDowell & Rackner PC
520 SW Sixth Avenue, Suite 830
Portland, OR 97204

NORTHWEST NATURAL GAS COMPANY

Alex Miller
Inara K. Scott
Manager, Regulatory Affairs

PUBLIC UTILITY COMMISSION STAFF

David B. Hatton
Department of Justice
Counsel for the Public Utility Commission

AVISTA CORPORATION

David J. Meyer
Vice President &
Chief Counsel forAvista Corporation

CASCADE NATURAL GAS

Lawrence Reichman
Perkins Coie LLP
Counsel for Cascade Natural Gas Corp.

NORTHWEST INDUSTRIAL GAS USERS

Chad M. Stokes
Cable Huston Benedict et al
Counsel for Northwest Industrial Gas Users