BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1654

In the Matter of NORTHWEST NATURAL GAS COMPANY, dba NW NATURAL Investigation of Interstate Storage and Optimization Sharing	STAFF OPENING POST HEARING BRIEF

I. INTRODUCTION

In the last Northwest Natural Gas Company (NW Natural) general rate case proceeding, Docket No. UG 221, the Public Utility Commission of Oregon (Commission) approved a stipulation that reserved these issues and moved them from the rate case to this new proceeding, Docket No. UM 1654. The purpose of this proceeding is to consider NW Natural's Interstate Storage and Optimization Revenue sharing mechanisms, which are located in NW Natural's schedule 185 and 186. On January 27, 2014, the parties filed prehearing briefs. Since the filing of those prehearing briefs, the Commission issued bench and supplemental bench requests and NW Natural has filed responses to those bench requests, as well as several supplemental responses.

NW Natural argues that the current sharing percentages should remain unchanged, that the cost of service study recommended by CUB is inappropriate, and that the income derived from optimization activities should be exempt from income reported on its regulated results of operation report (ROO report). The Citizens' Utility Board (CUB) and the Northwest Industrial Gas Users (NWIGU) argue that the sharing percentages should be changed to allocate more of the income to ratepayers, that a cost of service study related to interstate storage is appropriate, and that income derived from optimization income should be reported on the ROO report. The Public Utility Commission of Oregon Staff (Staff) proposes that the sharing percentages for Interstate Storage and Optimization Revenue in Schedules 185 and 186 remain the same, that a cost of service study

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is inappropriate to support changing the sharing percentages[1], but that NW Natural be required to report income derived from these activities on its ROO report.

NW Natural's argument would maintain the status quo and maintain the existing sharing percentages (and require no future cost of service study) and exempt the income derived from these activities from reporting on its ROO report. Staff's recommendation would result in a change to the ultimate sharing of revenues that would be more beneficial to customers and less generous to shareholders because of the requirement that NW Natural report the income on its ROO report, which could impact the amount of income that NW Natural shareholders are allowed to retain depending on NW Natural's overall earnings. If the Commission were to adopt CUB and NWIGU's arguments, the change in the ultimate sharing of revenues for these services would be more beneficial to customers and less generous to shareholders than Staff's recommendation.

Staff's recommendations should be adopted because it reasonably balances the interests of the customers and shareholders and strikes a reasonable balance between the utility and consumer advocate positions. Staff's recommendation recognizes that NW Natural is going beyond the requirements of a typical gas local distribution (LDC) utility in these optimizing activities and should be given an incentive to do so, but also recognizes that the income derived from activities that are only made possible by customer-funded assets should be considered regulated income. The combination of Staff's recommendations would result in an ultimate sharing of revenues that is more beneficial to customers than the status quo, but that also continues to provide an incentive to NW Natural to continue its optimization activities.

II DISCUSSSION

1. <u>Income derived from use of customer-funded assets should be reported as regulated income on NW Natural's regulated ROO report.</u>

When income is derived or made possible by the use of customer-funded assets (what Staff refers to as "AMA Optimization"), it should be included in NW Natural's ROO report. Both CUB

[1] *See* Staff/200; Colville/7.

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and NWIGU agree that this income should be reported on NWN Natural's ROO report, making NW Natural the only party to this case that believes that AMA Optimization income should be exempt from ROO reporting.

NW Natural does not offer a direct rationale for not including income derived or made possible by the use of customer-funded assets, but makes three arguments against inclusion of AMA Optimization income in its ROO report. First, NW Natural argues that inclusion of this income would result in a de facto reduction of the current sharing percentages, which would operate to dilute its incentive to participate in these activities.[2] Staff agrees that inclusion of this income may result in a de facto reduction in current sharing percentages depending on earnings in a particular year, but the combination of the sharing percentages and reporting the income on NW Natural's ROO still provides an incentive for continuation of the optimization activities.[3]

Second, NW Natural argues that Staff recommends inclusion of revenue from the optimization of non-utility Mist storage and that this would create a mismatch because the investment in non-utility Mist storage is not accounted for in customer rates. NW Natural argues that including the revenues from non-utility Mist storage in an earnings review, while the investment is excluded would artificially inflate NW Natural's earnings.[4] Staff disagrees because Mist Optimization does not include storage optimization, but rather the optimization of customer-owned gas. All revenues derived from the optimization of Mist storage are only made possible because of NW Natural's exclusive use of customer-owned gas to backstop the optimization contracts.[5] The utility/non-utility split that NW Natural references is only used to calculate the allocation of the net proceeds of the Mist Optimization activities in recognition of the non-utility investment in Mist storage related to deliverability.[6] Not only do customers own the gas that NW Natural uses to backstop these transactions, they also pay for all costs associated with the Mist

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[2] *See* NW Natural Prehearing Brief at 12, lines 5-17.
[3] *See* Staff Prehearing Brief at 3, lines 3-12.
[4] *See* NW Natural Prehearing Brief at 13, lines 11-18.
[5] *See* CUB Prehearing Brief at 12-14, NWIGU Prehearing Brief at 8.
[6] *See* NWN/100; White/15, lines 8-15; Staff Errata Staff/302; Garcia/1.

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Optimization activities because the allocated amounts are calculated only after all the costs are covered.[7] Although NW Natural may account for the proceeds of Mist Optimization that rely upon customer-owned gas under its non-utility umbrella, the manner in which the utility accounts for revenues is not controlling for regulation. For regulatory purposes, these earned revenues should be included in regulated utility revenues because no revenues for Mist Optimization are possibly using only non-utility Mist storage.

Third, NW Natural argues that if AMA Optimization revenues are included in the utility earnings for the purpose of the Site Remediation Recovery Mechanism (under consideration in Docket No. UM 1635), this could result in years where NW Natural's share of revenues could be reduced to zero, which would erode NW Natural's incentive to continue these activities.[8] As with NW Natural's first argument on the inclusion of AMA Optimization income in the ROO report, this argument is based upon the effect of the policy of including all income derived or made possible by the use of customer-funded assets, not on the rationale for why such income should be included. If the Commission was to agree with Staff, CUB and NWIGU that AMA Optimization income should be reported on NW Natural's ROO report, it can consider how it would use this reported income for purposes of an earnings test for environmental remediation costs in Docket No. UM 1635 rather than decide that issue in this proceeding.

2. NW Natural's Optimization activities go beyond the requirements of a typical regulated local gas distribution company and benefit both customers and shareholders. Because of these facts, regulatory policy should provide an incentive beyond that for typical LDC optimization for NW Natural to participate in these activities.

While Staff and CUB agree that income derived from AMA Optimization should be reported in NW Natural's ROO report, even though NW Natural would prefer to isolate its shareholder portion of the income, Staff and NW Natural agree that the sharing percentages

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[7] *See* NW Natural Tariff Nos. 185 and 186, Special Condition 1 (in both tariffs). Staff requests official notice of these tariffs pursuant to OAR 860-001-0460(1)(d).
[8] *See* NW Natural Prehearing Brief at 14, lines 4-9.

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currently in effect should remain the same. Even though the activities employ customer-funded assets, Staff demonstrates that the optimization activities go beyond the requirements of a typical regulated local distribution company.[9] In going above the requirements of a typical local distribution company, NW Natural is earning income that benefits both customers and shareholders. Because of the risk and type of atypical activities involved in NW Natural's AMA Optimization, Staff recommends that the current sharing percentages in Schedules 185 and 186 remain the same.[10]

In relation to what CUB calls interstate/intrastate storage (Schedule 185 less the third party optimization of Mist core storage included in Schedule 186, as shown in the figure on Staff/200 page 7), NW Natural and Staff agree that the sharing should remain 20 percent to customers and 80 percent to shareholders. CUB agrees to maintaining the sharing percentage for storage services, but only until such time as a cost of service study can be completed and it can be determined if the cost study supports the 20/80 sharing. In relation to what CUB calls storage optimization (Schedule 186 plus third party optimization of Mist core storage included in Schedule 185 as shown in the figure on Staff/200 page 9), NW Natural and Staff agree that the sharing should remain 67 percent to customers and 33 percent to shareholders for optimization of resources in customer rates and 20 percent customers and 80 percent shareholders for optimization of resources not in customer rates. CUB argues that the sharing structure should be changed to 90 percent to customers and 10 percent to NW Natural shareholders.

Staff's recommendation to include AMA Optimization income in NW Natural's ROO report could operate to increase the optimization income credited to customers and decrease the optimization income to NW Natural shareholders. Because Staff also recommends that the current sharing percentages in Schedule 185 and 186 remain the same, Staff's position lands between the positions of NW Natural and CUB. Staff contends that its recommendation is reasonable because

[9] *See* Staff/100; Colville/14 and Staff/200 Colville/9.
[10] *See* Staff/100; Colville/9-18, Staff/200 Colville/7, and Staff/200 Colville/9.

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it meets its two primary objectives, which are that income derived from the use of customer-funded assets should be included as regulated income and that NW Natural should be provided a financial incentive beyond that for typical LDC optimization to continue its current optimization activities.

3. NW Natural's bench responses further support the conclusion that NW Natural's optimization activities go beyond the requirements of a typical regulated local gas distribution company and benefit both customers and shareholders, which provides additional justification for maintaining the existing sharing percentages.

The Commission issued bench request 1 for information related to liquid extraction and other Companies that may conduct similar activities. NW Natural identified the following natural gas LDCs that transport gas to the Alberta/B.C. border:

- Cascade Natural Gas
- FortisBC Energy Inc.
- Southern California Gas Company
- NW Natural

In relation to other utilities' liquid extraction activities, NW Natural stated that it has limited information about which LDCs employ companies to extract and sell natural gas liquids, and the details of those arrangements. In general, this information is not made public, and the details of such arrangements are confidential.

NW Natural stated that it believes that many LDCs take advantage of revenues that can be achieved from extracting and selling liquids associated with their gas purchases and deliveries as those purchases are moved through processing plants that are located along the path to the LDCs' service territories. With respect to purchases from Alberta, NW Natural generally understands that the other above-listed companies move gas through the Cochrane processing plant, located on the western leg of the TransCanada Alberta (NOVA) system, and that they likely obtain revenues related to liquids extraction.

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Staff reviewed NW Natural's response to bench request 1 and believes it supports Staff's understanding that NW Natural's liquid extraction activities are beyond basic LDC expectations.[11]

The Commission issued bench request 2 for information related to Mist Storage Optimization. While Staff notes that the bench request and resulting NW Natural responses are hypothetical, they do confirm that shareholder investment in Mist is a key driver to the ability to create revenue for customers and shareholders from underutilized or unutilized assets.[12] Additionally, NW Natural's responses identify that Mist Storage Optimization has evolved over time requiring subjective judgment, tempered with experience. The activities have proven to require sophisticated trading systems and a large trading staff to analyze and act quickly when transactional opportunities arise (as exemplified by the July 10, 2014, hearing discussion about setting the size of the backdraft in the summer preceding the March/April transactions).[13]

Staff notes that the February 21, 2014, bench request 2 and the June 3, 2014, bench requests 2-3 attempt to verify the reasonableness of the current 53 percent core customer and 47 percent inter/intrastate customer revenue split for sharing income derived from Mist Storage Optimization. The reasonableness of this revenue split was not directly questioned in the UG 221 case and was not analyzed by Staff in this proceeding.

Understanding that the revenue split is of interest to the Commission, Staff observes that the current revenue split is a function of Mist Storage deliverability. Currently, 53 percent of Mist Storage deliverability is allocated to core customers while 47 percent is allocated to inter/intrastate customers. Those percentages change as Mist Storage is recalled for use by core customers. Because these bench requests were hypothetical, NW Natural's responses were illustrative in showing that shareholder investment in Mist is a key driver to the ability to create revenue for customers and shareholders from underutilized or unutilized assets and that those optimization activities carry with them a level of risk beyond that of basic LDC activities.

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[11] *See* Staff/100; Colville/17-18.
[12] *See* Staff/200; Colville/5.
[13] *See* Staff/100; Colville/12.

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Staff further notes that splitting revenue from Mist Storage Optimization could alternately be a function of Mist Storage capacity, Mist Storage net book value, or Mist Storage asset balance. Each alternate approach would result in a different revenue split, but those splits are not part of the record in this proceeding. Choosing the right approach requires subjectivity, but Staff does state that the primary purpose of Mist Storage is as a peaking resource. Because the primary attribute of a peaking resource is its deliverability, basing the Mist Storage Optimization revenue split on the Mist Storage deliverability appears rational.

III. CONCLUSION

After considering the February 3, 2014 Commissioner Examination Hearing discussions, and after considering NW Natural's response to the Commission's February 21, 2014 bench requests 1 and 2, NW Natural's supplemental response to the February 21 bench request 1, Staff's March 10, 2014 data requests 5-9, NW Natural's response and supplemental response to the Commission's June 3, 2014 bench requests 1-3, and July 10, 2014 Commissioner Examination Hearing discussions, Staff reaches the following conclusions:

- The Tariff Schedule 185 and 186 optimization activities are beyond basic LDC expectations. Staff recommends 67/33 remain as the optimization sharing percentages for revenue derived from use of core utility customer assets in these optimization activities.[14] Staff finds no justification for changing the existing interstate/intrastate storage and storage optimization activities or sharing.[15]

- There was no evidence presented to support a conclusion that NW Natural's optimization activities are substantially similar to those of the other two Oregon LDCs. Without presentation of evidence to the contrary, Staff must rely upon its observation from regular engagement with all three Oregon LDCs that, while the other two LDC's optimization activities use some common methods and result in some degree of optimizing customer assets, NW Natural's optimization activities are more refined, require more expertise, and are higher in risk.

- Having noted that there are similarities between the various Oregon LDC optimization activities, there is justification to consider segregating those similar activities from NW Natural's other optimization activities so that benefits from those similar activities can be directed to customers through the annual Purchased Gas

[14] *See* Staff/100; Colville/17-18.
[15] *See* Staff/200; Colville/1.

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Adjustment (PGA), as it is done with the other two Oregon LDCs. Staff recommends that this segregation occur as a discreet activity in the next NW Natural rate case, with customers' benefits commencing in the next PGA following resolution of that rate case.

- In the next NW Natural rate case, Staff recommends that NW Natural staff cost allocations between basic LDC expectations and the optimization activities be reviewed and revised as necessary to accurately reflect NW Natural staff utilization.

- Staff recommends NW Natural revise the wording of Tariff Schedules 185 and 186 to more clearly state what optimization revenues each schedule captures. Staff also recommends NW Natural consider including in Tariff Schedules 185 and 186 a figure or table depicting how the sharing percentages are applied to each of the optimization revenue streams. Staff's suggested revisions to Tariff Schedules 185 and 186 were provided in Staff/102.

- Staff recommends that NW Natural hold a workshop prior to the next PGA filing to show Staff and parties that customers are protected from potential harm that could occur if the Company were to sell physical gas to cover a financial transaction resulting from its Optimization Activities. NW Natural has stated that because any exchanges of gas for optimization purposes are priced identically the result is a net zero gain or loss on such exchanges.[16] In the event that this workshop fails to show that customers are protected, Staff recommends that in the next PGA filing that NW Natural:

    1. Itemize (volume, cost, and parties) all physical gas sales from Mist and associated replacement gas purchases to identify sales made for covering financial transactions; and

    2. Exclude from rates any differential cost or revenue resulting from such sale or purchases from rates such that those costs or revenues are entirely the responsibility of NWN shareholders.[17]

In summary, Staff's recommendation is that NW Natural should be ordered to include AMA Optimization revenue in its ROO report because income earned using customer-funded assets is utility income and should be included in its ROO report. Staff, however, also recommends continuation of the current sharing percentages. The combination of these two recommendations will result in income earned from customer-funded assets to be correctly

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[16] *See* NWN/500; White/2.
[17] *See* Staff/200; Colville/1-2.

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reported as income in NW Natural's ROO report, while also providing an incentive to NW Natural to conduct these activities.

Staff's recommendations are reasonable because they balance the interests of the customers and shareholders and strike a balance between the utility and consumer advocate positions. Staff recognizes that NW Natural is going beyond the requirements of a typical gas local distribution company in these optimizing activities and should be given an incentive beyond that for typical LDC optimization to do so, but also recognizes that the income derived from activities that are only made possible by customer-funded assets should be considered regulated income. Staff's recommendations would result in an ultimate sharing of revenues that is more beneficial to customers than the status quo, but that also provides an incentive to NW Natural to continue its optimization activities. Staff's recommendations strike a reasonable balance and should be adopted.

For the foregoing reasons, Staff respectfully requests the Commission issue an order finding that Staff's recommendations are reasonable and should be implemented.

DATED this 25th day of July 2014.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that on July 25, 2014, I served the foregoing STAFF Opening Post Hearing Brief upon all parties of record in this proceeding by delivering a copy by electronic mail only as all parties waive paper service.

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