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September 26, 2011

Attention: Filing Center
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Re: *In the Matter of PORTLAND GENERAL ELECTRIC COMPANY 2012 Annual Power Cost Update Tariff*
PUC Docket No.: UE 228
DOJ File No.: 860115-GB0313-11

Enclosed are an original and five copies of Staff's Reply Brief in the above-captioned matter for filing with the PUC for today. Confidential copies are being provided to parties who have signed the protective order in this docket.

Sincerely,

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SSA:mme/#3016640
c: UE 228 Service List

BEFORE THE PUBLIC UTILITY COMMISSION OF OREGON

UE 228

In the Matter of Portland General Electric Company 2012 Annual Power Cost update Tariff (Schedule 125)	REPLY BRIEF OF THE STAFF OF THE PUBLIC UTILITY COMMISSION OF OREGON

I. Response to ICNU's arguments.

The Industrial Customers of Northwest Utilities ("ICNU") asks the Commission to disallow certain costs associated with hedging transactions that Portland General Electric Company ("PGE") executed in 2007 and 2008.[1] While the mechanics of ICNU's proposed adjustment are clear, the underlying rationale is less so because it appears to have changed between the submission of testimony and submission of the opening briefs.

a. ICNU's recommended disallowance.

In direct testimony, ICNU recommended that the Commission disallow 100% of costs of hedging transactions for 2012 that were executed more than 48 months prior to 2012. ICNU predicated this recommendation on its assertion that transactions executed more than 48 months in advance of the prompt year are "imprudent in the industry" because of potential fluctuation in gas generation production levels brought on by load forecast error, economic conditions or changes in generation from lower cost resources can have a dramatic affect on the amount of gas fuel needed in any one month.[2]

With respect to transactions PGE executed less than 48 months prior to the prompt year, ICNU based its recommended disallowance on its expert witness's assertions that PGE hedged

[1] The transactions are listed at ICNU/102, Schoenbeck/1 (Confidential exhibit).
[2] Confidential ICNU/100, Schoenbeck/8.

virtually all of its gas requirements for 2012 by the end of the third quarter of 2008, thereby hedging too much too fast by engaging in a "'front end' loaded methodology [to acquire] hedges for 2012."[3] ICNU asserted that a more prudent hedging strategy would be "programmatic," and would result in the acquisition of somewhere between 15% and 25% of the gas PGE needed to operate its two baseload natural gas plants in 2012.[4] ICNU also asserted that a reasonable utility would have purchased monthly, seasonal or quarterly hedging products, rather than the calendar-year products purchased by PGE, so as to avoid an oversupply during the second quarter of 2012.

ICNU's proposed disallowance was based on a comparison between what PGE's 2012 mark-to-market hedging costs would have been had PGE, by the end of 2008, hedged no more than 20% of PGE's gas requirements for PGE's two baseload gas plants for Q1, Q3, and Q4 and no more than 12.5% for Q2, and the 2012 costs associated with the hedges PGE actually acquired in 2007 and 2008.

Table 1. ICNU Recommended Gas Hedging Strategy

[CONFIDENTIAL]

	[redacted]	
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]

[END CONFIDENTIAL]

[3] Confidential ICNU/100, Schoenbeck/8.
[4] Confidential ICNU/100, Schoenbeck/8.

Staff created the following summary table to show how ICNU derived the dollar amount of its recommended adjustment.

Table 2. Staff's Summary of ICNU's Recommended Adjustment

[CONFIDENTIAL]

[redacted]

[END CONFIDENTIAL]

b. The record shows the market was sufficiently liquid in 2007 and 2008 for PGE to implement its MTS.

As noted above, ICNU recommends disallowing all 2012 costs for 2007 hedging transactions on the ground hedges executed more than 48 months prior to the prompt year are imprudent because the utility's gas needs may change prior to the prompt year. Now, ICNU asserts that the Commission should disallow these costs because PGE did not establish it executed the transactions in a liquid market and because PGE did not sufficiently document the analysis underlying each transaction. [5]

ICNU's assertions that PGE failed to show the market in 2007 and 2008 was sufficiently liquid are puzzling given the arguments ICNU made in testimony. The rationale underlying ICNU's proposed disallowance of costs associated with 2008 hedging transactions is that PGE did not take advantage of the liquid markets for alternate hedging products (e.g., monthly or quarterly) to better shape its hedges to its need. ICNU's witness testified, repeatedly, that there was a liquid market in both 2007 and 2008 for hedging products for 2012. ICNU's expert witness made the following statements in pre-filed testimony or his deposition:

- "I believe the electricity and gas bilateral markets are reasonably liquid 48 months from the prompt month. It is prudent to execute hedges in both markets within this time period."[6]

- "In [his] view, there was a liquid market for quarterly or monthly gas hedges in 2007 for the 2012 rate year."[7]

- Monthly quarterly and seasonal financial hedge products were readily available in the market from May 2007 through August 2008.[8]

- PGE could have filled its hedging requirements 37 to 48 months prior to 2012 with a combination of hedging products, including calendar strips, seasonal strips and quarterly and monthly products, that there may be fewer counterparties for monthly and quarterly strips than annual strips "very far out," and that he is "absolutely sure" that monthly and seasonal strips were available in "the 2007 to 2009 time frame . . .looking forward three to four years."[9]

In other words, ICNU has asserted that there was a liquid market in 2007 and 2008 for hedging products for 2012. Its argument that the Commission should disallow costs of

[5] *See* Confidential Opening Brief 2 and 24-25.
[6] ICNU/108, Schoenbeck/12, lines 3-5.
[7] ICNU/108, Schoenbeck/9, lines 3-5.
[8] ICNU/100, Schoenbeck/7.
[9] ICNU/109; (Schoenbeck Deposition 72-73 and 77).

hedging transactions that PGE executed in 2007 and 2008 on the ground PGE did not create contemporaneous documentation showing market liquidity and did not establish in this proceeding that there was a liquid market in 2007 and 2008 for long-term hedges is simply not persuasive.

In any event, the evidence discussed in Staff's opening brief is sufficient to establish the market in 2007 and 2008 was sufficiently liquid to allow PGE to implement its mid-term strategy ("MTS").

b. PGE established that it did not hedge "too much too soon."

As discussed above, ICNU recommends disallowing a large portion of costs of 2008 hedging transactions on the ground that PGE hedged too much too soon. A significant infirmity in ICNU's argument is that ICNU does not adequately address the fact that while PGE may have hedged a large amount of its *gas* net open position ("NOP") by end of 2008, it hedged less than one-third of its NOP for gas and power (based on PGE's load forecasts for 2012 that PGE relied on at the time of the hedging activity).

ICNU's expert witness testified that starting with the fourth year prior to the prompt year a prudent utility might annually hedge between 15% and 25% of its NOP for the prompt year. PGE essentially implemented this strategy, but started in the fifth year prior to the prompt year rather than the fourth. Based on PGE's revised load forecast for 2012 (which PGE revised in 2009), PGE hedged approximately 19% of its total NOP by the end of 2007, and hedged an additional 23% by the end of 2008. [10]

Furthemore, PGE's cumulative hedges at the end of 2008 were a relatively small increment above ICNU's 2008 ceiling for Q1, Q3, and Q4 of 2012 (no more than 25% of

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[10] PGE/400, Lobdell-Outama/37.

need).[11] The difference between what a prudent utility would have done, (in ICNU's opinion) and what PGE actually did does not support ICNU's proposed disallowance.

c. PGE's rationale underlying its hedging strategy for Q2 of 2012 is reasonable.

ICNU argued that PGE overhedged for Q2 of 2012 because it failed to scale back its hedges to accommodate the reduced need for gas in that quarter. In response, PGE explains that it hedges on an annual basis and planned to use hedges acquired for Q2 as hedges in other Quarters as the market for monthly hedging products became more liquid. In its opening brief, ICNU asserts that PGE's explanation of its strategy appears to be an after-the-fact justification.

ICNU's assertion is not supported by any evidence in the record. Notably, the list of hedging transactions submitted by ICNU reflects that PGE did in fact execute hedging transactions between 2009 and 2011 in which it sold Q2 gas.[12] Meaning, the record shows that years before this proceeding, PGE in fact executed the strategy it has described for its Q2 hedges.

d. ICNU's assertions regarding PGE's lack of documentation are not persuasive.

ICNU asserts that "PGE's failure to provide analytical support for its purchases . . . was imprudent."[13] Whether PGE's hedging strategy was prudent does not turn on whether PGE adequately documented its analysis supporting its hedging transactions. Whether PGE's strategy was prudent turns on questions such as whether PGE reasonably concluded that it needed a MTS, whether PGE sufficiently defined the parameters of the MTS, and whether PGE executed the MTS within those parameters. For the reasons discussed in Staff's opening brief, Staff believes PGE established the 2012 costs associated with PGE's implementation of its MTS were prudently incurred.

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[11] ICNU's ceiling for Q2 was 12.5%.
[12] ICNU's proposed adjustment includes an offset for the gain realized by these sales.
[13] Opening Brief of ICNU 2.

II. Reply to CUB's arguments.

Like ICNU, CUB asserts that PGE's explanation of its strategy for Q2 hedging appears to be after-the-fact justifications, arguing "[i]f PGE was indeed using a Stack and Roll strategy, why did it not disclose that long ago, when it was making all those other arguments, instead of waiting until the hearing to provide this evidence of its 'correct' use of a known financial theory?"[14] Contrary to CUB's assertion, PGE explained its Q2 strategy in reply testimony submitted immediately after the ICNU and CUB rebuttal testimony proposing adjustments to PGE's hedging strategy (*i.e.*, when it was "making all those other arguments"). And, prior to that, PGE actually executed the strategy by selling some of its Q2 gas as 2012 approached.

In any event, CUB places too much emphasis on PGE's expert witness's introduction of the description "Stack and Roll" strategy at the hearing in this matter. After PGE filed its reply testimony, (which included testimony regarding its Q2 hedging strategy), PGE hired an expert witness, Robert Stoddard, who testified in pre-filed written testimony that PGE reasonably hedges forward as much gas as its expected annual requirement, notwithstanding the lessened need for gas in Q2. His pre-filed testimony is as follows:

> As part of its MTS, PGE only hedges forward as much gas as its expected annual requirement. Even if it needs less gas in Q2 than the annual average, the net long *gas* position in Q2 is simultaneously a hedge against its net short gas position in the other three quarters of the year (a gas-on-gas hedge) and against it net short power position in Q2 (a gas-on-power hedge). The risk of power purchases can be hedged using gas because the prices are correlated. Consequently, Q2 purchases of gas not only hedge the risk of gas needed to run power plants (in Q2 and in other quarters), but can be used alternatively to hedge power purchase risks.[15]

At the hearing, Mr. Stoddard testified that the strategy employed by PGE was like the "Stack and Roll" strategy described in one of the two books on hedging on which Mr.

[14] CUB Opening Brief 10.
[15] PGE/500, Stoddard/16-17.

Schoenbeck had stated he relied. In other words, it appears that at least in part, the point of Mr. Stoddard's testimony identifying PGE's strategy as the commonly-practiced "Stock and Roll" Strategy was to note that the strategy was discussed in one of the primary reference volumes *used by ICNU's expert witness.*

CUB also criticizes PGE for arguing that CUB and ICNU are precluded from challenging hedges for 2012 because CUB and ICNU have not previously challenged hedges executed pursuant to PGE's MTS. Staff believes that CUB has taken PGE's testimony on this topic out of context.

PGE's pre-filed testimony describing its MTS presentation to the Commission in 2006 and describing PGE's subsequent updates in its Quarterly Power Suppy Update meetings and other regulatory processes responded to CUB's testimony that the hedging strategy in this docket "appears to be a new strategy."[16] Staff has not found any assertion, or even any suggestion, in PGE's testimony that CUB or ICNU are precluded from challenging 2012 costs associated with the MTS because they did not challenge the inclusion of MTS hedging costs in previous years.

In any event, while it is clear that PGE's 2006 presentation to the Commission in no way precludes a challenge to the prudence of the strategy for purposes of excluding the costs from rates, Staff does find that testimony regarding the 2006 presentation is probative of the merit of ICNU's assertion that hedging more than 48 months before the "prompt year" is imprudent in the industry. More plainly, PGE told the Commission, in the presence of representatives of CUB and ICNU, that it intended to embark on a strategy that included executing hedging transactions 36 to 60 months in advance of the need. The fact that this presentation did not excite a protest from either CUB or ICNU

[16] PGE/400, Lobdell-Outama/22.

contravenes ICNU's unqualified assertion that hedges executed 48 months prior to the prompt year are "imprudent in the industry."

III. Conclusion.

For the reasons discussed in the Staff's Opening Brief and the foregoing reasons, the Commission should reject the disallowance to PGE's Net Variable Power Costs proposed by CUB and ICNU.

DATED this 26th day of September 2011.

Respectfully submitted,

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Of Attorneys for Staff of the Public
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CERTIFICATE OF SERVICE

I hereby certify that on the 26th day of September, 2011, I served the foregoing Staff's Reply Brief upon the persons named on the service list, by mailing a full, true and correct copy thereof and to such persons waiving such service by mail who were served at their e-mail address as listed on the service list.

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