ORDER NO. 08-504
ENTERED 10/21/08

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.	)))))))))	ORDER

DISPOSITION: CITIZENS' UTILITY BOARD OF OREGON'S PROPOSAL ADOPTED AS MODIFIED

I. INTRODUCTION

On November 21, 2006, the Public Utility Commission of Oregon (Commission) opened this investigation to review and modify, as appropriate, the Purchased Gas Adjustment (PGA) mechanism used by Oregon's three Local Distribution Companies (LDCs) – Northwest Natural Gas Company (NW Natural), Avista Corporation, dba Avista Utilities (Avista) and Cascade Natural Gas Corporation (Cascade).

The parties agreed to split this docket into two phases. In this first phase, the parties addressed mechanisms for the recovery of gas costs, including any proposed incentive arrangements. During the second phase, parties will address guidelines for implementing the mechanisms, portfolio purchasing of natural gas, and related documentation.

A workshop was held on February 4, 2008, with all Commissioners present. Following the workshop, and after conferring with the Commissioners, the Administrative Law Judge (ALJ) presented the parties with the broad guidelines for potential changes to the PGA mechanism, to be discussed at the parties' next workshop.

On May 2, 2008, Avista, Cascade, the Northwest Industrial Gas Users (NWIGU), NW Natural and Commission Staff (Staff) (Joint Parties) submitted a stipulation intended "to resolve all issues addressed in Phase I of this investigative docket." A copy of the Stipulation is attached as Appendix A. On May 14, 2008, the Citizens' Utility Board of Oregon (CUB) filed an objection to the Joint Parties' Stipulation and requested a prehearing conference.

A prehearing conference was convened on May 30, 2008, and a schedule set for the filing of testimony, a hearing, and submission of the case on concurrent briefs. Prior to the hearing, the parties agreed that no hearing was necessary. The hearing was canceled and the testimony received by motions to admit the prefiled testimony by the respective parties.

Briefs were filed by the Joint Parties and by CUB.

II. CURRENT MECHANISM

The PGA is a tariff that allows a utility to recover the changes in its wholesale gas costs on a periodic basis, without the need for a formal rate review. The PGA provides for pass through to customers of actual, prudently-incurred costs of natural gas purchases. The Commission determines the amount of gas costs that are passed through to customers in rates. Because actual gas costs incurred during any particular time period are not known in advance, deferred accounting is associated with the PGA mechanism.

The current PGA mechanism was established in 1989, with some modifications. As set out in Staff's comments, the dynamics and operation of natural gas markets have changed dramatically in the intervening years. The supply/demand equation has resulted in much higher prices, while gas trading practices have become much more sophisticated, with the trading of derivatives and hedges, combining the physical and financial sides of natural gas purchasing into a single transaction. According to Staff, "the rules for current U.S. and Northwest natural gas markets are not fixed and not likely to be fixed for some time to come." In this market, it has become "exceedingly difficult for any LDC to protect either its customers or its shareholders from the large risks." State regulatory commissions "are under great pressure to design natural gas recovery mechanisms for their LDCs that fit the circumstances of the changed natural gas market."[1]

Currently, a percentage (33 percent for Cascade and NW Natural and 10 percent for Avista) of any variance between an LDC's weighted average cost of gas (WACOG) included in its rates and its actual WACOG is absorbed or retained by the LDC. At the time this practice was adopted, prices were generally stable and relatively low. In such circumstances, the differences between costs incurred and costs recovered were relatively inconsequential.

Higher, more volatile gas prices have increased the risks for customers and shareholders. To mitigate that risk – particularly for shareholders – the LDCs have chosen to enter into financial and physical fixed-price hedges for nearly all of their supply needs. These practices have reduced the variation between the utilities' forecast and actual WACOGs to zero for these hedged volumes.

[1] Staff Opening Comments, 3-4 (Dec 4, 2007).

III. INITIAL COMMENTS

A. Introduction

Following a series of workshops, the parties filed opening and reply comments. Parties filing comments were Staff, NW Natural, Cascade, Avista, CUB and NWIGU.

B. Staff

Staff argued that the LDCs should focus on selecting portfolios based on their overall "risk-reward" characteristics, instead of merely compiling portfolios of purchases that individually have attractive risk-reward characteristics. "The greater the risks of price change or supply availability, the greater the need to follow the diversity, flexibility and balance requirements of portfolio theory."[2]

Staff stated that Oregon's PGA mechanism violates several of the Gas Purchasing Incentive Mechanism (GPIM) design principles, as promulgated by the National Regulatory Research Institute (NRRI). Staff describes the Oregon mechanism as creating an incentive for LDCs to move away from the requirements of portfolio purchasing.

Regarding a revised mechanism, Staff states that the tariff should be as simple as possible. The tariff should be clear and precise about what costs are eligible for pass through and how the prudence of the costs will be assessed.

Staff recommends that the tariff include only "direct gas costs:" commodity costs, transportation fees, costs for storage, and other costs directly related to gas supply. Staff proposes that an LDC recover 100 percent of its prudently incurred direct gas costs. To enhance review of an LDC's gas purchasing practices, Staff recommends more frequent PGA filings.

Regarding incentives, Staff states that any performance based mechanism should work with the PGA. To that end Staff proposes that the Commission adopt a GPIM that would provide an incentive for an LDC to keep its overall gas costs as low as reasonably possible.

C. NW Natural

NW Natural states that the PGA works to align customer and shareholder interests, is easy to administer, and lessens the Commission's reliance on prudence reviews as a means of protecting customer interests. However, given the changes in the

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[2] Staff Opening Comments, 5.

gas market, NW Natural believes that the current 67/33 balancing ratio is no longer sustainable. NW Natural proposes that it be allowed to modify its sharing level to 80/20.

According to NW Natural, the current PGA furthers the Commission's goals, adheres to the Commission's principles, and comports with NRRI's design principles. The PGA acts as a true incentive, encouraging the LDC to keep its gas costs as low as possible for its customers and rewarding the LDC when it is successful.

D. Cascade

Cascade states that the existing PGA mechanism is "appropriate," but believes it should be modified to allow the LDCs to recover 100 percent of their gas costs, by eliminating the sharing provision. According to Cascade, the sharing provision "does not work in today's highly volatile natural gas market and does not provide a true incentive to lower gas costs; rather it is simply a mechanism to share the risk of fluctuating prices, which are outside the control of the LDCs."[3] The Commission should focus its efforts on monitoring the LDCs' purchasing practices.

E. Avista

Regarding the current gas cost sharing mechanism, Avista states "it makes no sense when applied to the current natural gas market."[4] Avista describes changes in the gas market that leave the LDC with no control over prices and not able to predict prices with certainty. "Sharing or incentive mechanisms should only be employed where the LDC can affect the outcome through the application of its knowledge, experience and tools available."

Avista states that the GPIM proposed by Staff is "a preferable incentive alternative as compared to the present gas cost sharing mechanism."[5] However, Avista opposes any gas procurement incentive mechanism. Avista disputes the underlying premise of a GPIM: that an LDC has some control over gas prices.

F. CUB

CUB states that the current mechanisms are working "reasonably well." CUB proposes to modify the current mechanisms "by adjusting the distribution of risk within the mechanisms to better reflect which entity, shareholders or customers, is better able to manage the risk in question."[6]

CUB proposes a risk sharing mechanism with an earnings deadband, gas cost deadband and gas cost sharing. The earnings deadband proposed is + or -100 basis points, return-on-equity (ROE). The gas cost deadband is -75 to +150 basis points ROE

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[3] Cascade Opening Comments, 1 (Dec 4, 2007).
[4] Avista Opening Comments, 2 (Dec 5, 2007).
[5] Avista Opening Comments, 4.
[6] CUB Opening Comments, 1-2 (Dec 4, 2007).

for gas utilities not subject to Senate Bill (SB) 408, and -45 to +90 basis points for gas utilities subject to SB 408. The gas cost sharing is 90-10 (customer-utility).

G. NWIGU

NWIGU states that any gas cost recovery structure that allows for 100 percent pass through of gas costs must also provide for heightened scrutiny of prudence. Otherwise, a utility can rely on market purchases, rather than management of its gas costs, using all available tools.

NWIGU states that the Commission need not endorse a singular mechanism, provided that all mechanisms provide for robust portfolio management strategies and provide for the lowest reasonable price. NWIGU believes that each of the utilities should be required to proactively manage its natural gas supply portfolios and acquire a balanced and diverse portfolio of physical and financial contracts with stable and reasonable prices, without regard to any incentive mechanism.

IV. COMMISSION WORKSHOP

As noted above, a workshop was held on February 4, 2008, with all Commissioners present. Following the workshop, and after conferring with the Commissioners, the ALJ offered the parties broad guidelines for changes to the PGA mechanism, to be discussed at their next pending workshop. The ALJ advised the parties as follows:

> I met with the Commissioners on Tuesday, to discuss the direction for this proceeding. They are inclined to retain the current mechanism, with some modifications. They are considering modifying the sharing provision from 67/33 to 80/20 or 90/10, at the utilities' option, with the earnings test set at 150 basis points for the 80/20 sharing, and 100 basis points for the 90/10 sharing.
>
> They propose to modify the filing requirement to semi-annual, with the rates fixed for the year, except that they may consider changing the industrial commodity rate semi-annually, based on the PGA filings. They would like data regarding industrial volumes of sales and transportation by month.
>
> They do expect the parties to continue to meet quarterly and they consider prudency reviews to be part of the process, as necessary.
>
> They expect that you will address the mechanism for setting the benchmark. You also should formulate any questions that you believe the Commission should answer in its decision, and provide whatever answers each of you believes are appropriate.

> I ask Staff to report to the Commission the results of this meeting, subject to the rights of all parties to comment on Staff's report. That report also should provide for the opportunity for parties to submit their answers to whatever questions may be forthcoming.

After additional meetings the settling parties submitted their joint Stipulation.

V. THE STIPULATION

A. Introduction

On May 2, 2008, some of the parties submitted a stipulation intended "to resolve all issues addressed in Phase I of this investigative docket." Signatories to the Stipulation are Avista, Cascade, NWIGU, NW Natural and Commission Staff (the Joint Parties). In support of their Stipulation the settling parties offered the joint direct testimony of Ken Zimmerman (Staff), Brian Hirschkorn (Avista), Katherine Barnard (Cascade), Alex Miller (NW Natural) and Paula E. Pyron (NWIGU).

B. Elements of the Proposed Mechanism

The parties state that they agreed upon a PGA mechanism that incorporates an incentive mechanism and an earnings review. Their proposed mechanism is comprised of five basic elements:

1. The annual setting of the embedded commodity WACOG in customer rates for the following PGA year;

2. The selection and application of sharing levels and corresponding earning threshold levels;

3. The selection and calculation of a monthly benchmark against which both Embedded WACOG (Embedded WACOG) and actual monthly gas costs will be compared;

4. The calculation of variance between the monthly benchmark and annual Embedded WACOG and between the monthly benchmark and actual monthly Unhedged Gas costs; and

5. The application of a spring earnings review.

C. Derivation of the Embedded WACOG

The Embedded WACOG is set as follows:

In the fall of each year, each LDC will file its Embedded WACOG that will serve as the basis for customer rates for the PGA year, beginning the following November 1 and ending October 31.

1. The initial PGA filing will be made on or before August 31; and

2. A mandatory update of the PGA filing will be made no later than two weeks prior to the Commission's scheduled Public Meeting addressing the PGAs.

The Embedded WACOG will be set as a function of the LDC's expenses for (a) fixed price hedges; (b) storage, and (c) unhedged volumes. These components of the Embedded WACOG will be calculated as follows:

1. Total PGA volumes will be set on a forecasted basis;

2. Fixed price hedges and storage fill (completed by July 31 for the Initial Filing and by September 30 for the Update Filing) will be included in Embedded WACOG at 100 percent of cost. Additional storage refills taking place by October 31 of each year will be separately accounted for and passed through to customers at 100 percent of cost.

3. Amounts for gas supplies that are unhedged as of the date of filing will be calculated using the following inputs:

   a. Prices will be set using the basis-adjusted 60-day NYMEX strips for the PGA year. This methodology will be used for three years, after which the Commission will review its effectiveness.

      i. The initial filing will use the basis-adjusted NYMEX daily information from the previous 60 calendar days through July 31.

      ii. The update filing will use the basis-adjusted NYMEX daily information from the previous 60 calendar days through September 30.

   b. Volumes will be priced using the expected percentage mix of supply basins for "Unhedged Gas" supply for each of the 12 months of the PGA year. The expected percentage mix will be based on the LDC's three-year historical weighted average volumes adjusted for known and measurable changes.

D. Selection of Unhedged Benchmark Price

By August 31 of each year, the LDC will select an independent benchmark. Each year the LDC may select one of two methods for setting its Benchmark:

1. First of Month index, which will be weighted by the actual purchases at each basin during the month, plus/minus an appropriate amount applicable for each basin for physical supplies, adjusted for each month; or

2. The average of the *Gas Daily* indices, which will be weighted by the actual purchases at each basin during the month, plus/minus an appropriate amount applicable for each basin for physical supplies adjusted for each day.

E. Calculation of Variances and Sharing for Deferrals

The Monthly Benchmark WACOG is the actual unhedged volume at the Unhedged Benchmark Price, plus the costs of fixed price hedges and storage withdrawals, divided by total actual volumes. The difference between the Annual Embedded WACOG and the Monthly Benchmark WACOG will be calculated each month and multiplied by total actual volumes and deferred for later collection or refund. Any variance will be shared at 95/5, meaning that 95 percent of any variance will be collected from or refunded to customers.

The actual costs for the Unhedged Gas will be calculated each month. Differences between actual costs for the Unhedged Gas and the product of the Unhedged Benchmark Price multiplied by actual unhedged volumes will be deferred for later collection or refund. The Unhedged Benchmark Variance will be shared with customers at the percentage selected by the LDC each year by August 15, at one of the following levels: 67/33, 80/20 or 90/10 (meaning that 67, 80 or 90 percent of any variance will be collected from or refunded to customers).

F. Earnings Review

An earnings review will be performed each spring. The 2009 earnings review will use 2008 Fiscal Year results and the earnings thresholds currently allowed by the Commission for each LDC. For subsequent years, the earnings threshold applied to each fiscal year's results will correspond to the sharing election made by the LDC the previous August, for the following PGA Year, as described below, e.g., the August 2008 election will apply to the 2009 Fiscal Year results which are the subject of the 2010 earnings review.

1. For LDCs choosing to share at 67/33 (with the exception of Cascade), the earnings threshold will be set at 175 basis

points (bp) of return-on-equity (ROE) (as determined in the LDC's last rate case), further modified by 20 percent of any change in the risk free rate for the 12 month calendar year preceding the annual earnings review.

2. For LDCs choosing to share at 80/20, the earnings threshold will be set at 150 bp of ROE, further modified by 20 percent of any change in the risk free rate for the 12 month calendar year preceding the annual earnings review.

3. For LDCs choosing to share at 90/10, the earnings threshold will be set at 100 bp of ROE, further modified by 20 percent of any change in the risk free rate for the 12 month calendar year preceding the annual earnings review.

4. By August 31, 2008, Cascade may select 67/33 commodity sharing with an earning threshold of 215 bp of ROE, further modified by 20 percent of any change in the risk free rate for the 12 month calendar year preceding the annual earnings review, through 2012, providing Cascade continues to meet its merger conditions. If by August 31 of any year before 2012, Cascade elects either 89/20 or 90/10 commodity sharing, and following 2012, Cascade will choose from the options listed above and cannot return to the 67/33 commodity sharing with an earnings threshold of 215 bp of ROE.

Sharing percentages for earnings above the threshold will be adjusted to account for the impact of SB 408. Based on current federal and state tax rates, the customers of LDCs subject to SB 408 will receive 20 percent of earnings above the threshold.

There will be no fall earnings review. The sunset provision for earnings reviews will be removed through a subsequent rulemaking.

The adoption of the PGA shall not alter the Commission's review of the prudency of the LDCs' actions in gas procurement.

VI. FURTHER PROCEEDINGS

On May 14, 2008, CUB filed an objection to the Stipulation and requested a prehearing conference. A prehearing conference was convened on May 30, 2008, and a schedule set for the filing of testimony, a hearing, and submission of the case on concurrent briefs.

CUB submitted the testimony of Bob Jenks, in opposition to the Joint Parties' Stipulation. In reply to CUB's testimony, the settling parties offered the joint

testimony of Ken Zimmerman, Brian Hirschkorn, Katherine Barnard, Alex Miller and Paula E. Pyron. NW Natural also submitted reply testimony of Mr. Miller.

Prior to the hearing, the parties agreed that no hearing was necessary. The hearing was canceled and the testimony received by motions to admit filed by the respective parties.

VII. POSITIONS OF THE PARTIES

A. The Joint Parties

The Joint Parties state that all parties agreed on these 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 imposed by today's markets need to be realigned so that they are more fairly allocated between customers and LDCs.

4. The 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 principles enabled the parties to agree on the new mechanism proposed in their Stipulation.

According to the Joint Parties, the proposed mechanism is superior to the current PGA mechanism because it is designed to function in current gas market conditions, as well as able to adjust effectively to market changes. They explain how the proposal incorporates a new market based benchmark – the "Unhedged Benchmark Price" – that is tied to current market prices.

They note that the benchmark in the current PGA mechanism is set once – at the beginning of the PGA year. That forecast may become less accurate over the year, increasing the risk for LDCs and reducing their incentive to build a balanced, flexible and diversified portfolio of supply resources. By tying the benchmark to more current market

prices, the Joint Parties argue that their proposed PGA mechanism provides a better measure of an LDC's purchasing practices, while mitigating the financial risks associated with the higher prices and increased volatility. Mitigating these risks allows an LDC to hedge less of its portfolio – enabling an LDC to build a more balanced and diverse portfolio, to the benefit of customers and shareholders.

The Joint Parties further argue that their proposed mechanism also is superior to the current PGA because it includes two levels of incentive that work together to promote the most effective purchasing practices. The first level of incentive is calculated monthly and is based on the difference between the "Embedded WACOG" and the "Monthly Benchmark WACOG." According to the Joint Parties, this level of incentive rewards (or penalizes) an LDC, based on the results of its longer-term decision making processes. The second level of incentive is provided by the monthly comparison of the LDC's actual spot market purchases with the "Unhedged Benchmark Price." The Joint Parties believe that this creates an incentive for the LDCs to manage their shorter term purchases for the benefit of their customers.

Joint Parties state that their proposed mechanism is more flexible than the current mechanism. They cite their testimony to support their claim that changing levels of volatility and prices can alter the allocation of risk between LDCs and their customers. They argue that, by allowing an LDC to elect an "appropriate sharing percentage" each year, their proposed mechanism will prove more durable under changing market conditions.

Joint Parties state that their proposed linking of the sharing percentage and the earnings threshold provides for a "fair, reasonable and sustainable" balance of risk and reward.

According to the Joint Parties, their proposed method for determining the cost of unhedged volumes that are included in the Embedded WACOG is superior to the method in the current PGA mechanism. They note that, in the current mechanism, the LDCs have the opportunity and the burden of selecting a method for calculating the cost of the unhedged volumes in the Embedded WACOG every year. The Joint Parties state that they have agreed to a reasonable method for setting the Embedded WACOG, which will avoid the controversy that has been associated with the current practice.

Joint Parties further argue that their proposed use of forecasted volumes in the Embedded WACOG will produce a more accurate WACOG. They note that the current method uses recorded volumes, adjusted for weather effects. Their proposed use of forecasted volumes allows the LDC to capture the effects of load change.

The Joint Parties state that CUB's testimony opposing the Stipulation contains several errors. They argue that the Stipulation and their testimony are "quite clear as to what components are included in the two variance calculations." They dispute CUB's claim that the LDCs are paid a rate of return to secure the lowest cost gas supply. They state that CUB ignores the continuing oversight of LDC gas purchasing by the

Commission. They dispute CUB's claim that their proposed mechanism "disproportionately" shifts risks to customers. The Joint Parties state that their proposed mechanism can result in savings for customers – as compared to the current mechanism.

The Joint Parties criticize CUB's proposal. They state that CUB's proposal assumes that the current mechanism "isn't broken." The Joint Parties dispute that position. They argue that CUB's proposal fails to address the realities and risks of today's gas markets. The result, they claim, is that CUB's proposal would shift an inappropriate level of risk to the LDCs.

The Joint Parties state that CUB's preference for "mechanical consistency" would result in a rigid mechanism. The Joint Parties believe that their proposed mechanism provides for flexibility and is more likely to be sustainable.

The Joint Parties challenge CUB's opposition to their proposed treatment of Cascade. They argue that Cascade is unique among the LDCs and should be allowed to continue to use the earnings threshold adopted by the Commission in Cascade's recent rate case, so long as Cascade continues to elect the sharing percentage of 67/33.

The Joint Parties oppose CUB's proposed changes to the earnings sharing mechanism. They claim that their own proposal accounts for the impact of SB 408 on some LDCs, and that sharing the excess earnings on an equal percentage of margin basis is "more fair and just."

B. CUB

CUB disputes any suggestion that it has not acknowledged increased volatility in the natural gas markets. CUB's proposed mechanism shifts more of the risks of gas cost variations onto the core customers than does either the current mechanism or CUB's original proposal in this case. CUB notes that its proposed mechanism includes the sharing percentage originally proposed by NW Natural.

CUB credits itself as the only party to have offered evidence to show that the current mechanism works "reasonably well." CUB also claims that it is the only party to offer evidence "based on actual data" regarding how the Joint Parties' proposed mechanism would work.

CUB observes that a stipulation between the utilities, supported by Staff and a customer advocate group, might seem likely to have considerable merit. However, CUB argues that their proposed mechanism is a "mess of group accommodation," reflecting the LDCs desire to shift risk and shift Staff away from its previous approach. The result is a proposal that is untested, complicated, confusing, and causes a significant shift of risk to core customers.

CUB argues that the Joint Parties have the burden of proving that their proposed change to the PGA mechanism will be beneficial to customers. CUB states that

they have failed to prove either that the incentive in their proposal is "better" than the current incentive, or that their proposal provides for a reasonable balance of risk and reward.

CUB states the proposed mechanism would significantly reduce the risk for the LDCs. According to CUB, most of the gas costs would be subject to a 95/5 sharing – a material change from the current PGA sharing percentage, to the advantage of the LDCs. The Joint Parties' testimony offers little support for shifting this risk to customers.

CUB questions whether the proposed "Benchmark" price provides real value to customers. The Benchmark may be a good way to minimize the variance between rates and costs, but CUB foresees that it is likely that "the benchmark may determine the purchasing pattern of the utility."[7]

CUB compares the current PGA mechanism with the mechanism proposed by the Joint Parties, in terms of the relative ease of explaining their operation to customers. CUB warns that explaining the results of the proposed mechanism "will not be an easy task."[8]

CUB argues that the options allowed under the proposed mechanism are one-sided: "since the optionality involves shifting risk from the LDC to the customer and is at the LDC's discretion, it is hard to see how this reduces risk to the customer."[9] When the market looks risky, CUB anticipates that the LDCs will select the option that puts the greatest risk on customers.

CUB asks whether the unhedged sharing variance choice is about spot purchases, "or is it about how much the utility expects to earn?"[10] Given the few dollars that are at stake here, CUB argues that the percentage of sharing is immaterial. What matters are the earnings thresholds associated with the variances.

CUB challenges the Joint Parties' claim that CUB's testimony includes errors. CUB observes that customers already bear much of the risk of increases in gas costs. CUB states that the proposed mechanism would shift much of the remaining risk to customers.

CUB argues that the language of the Stipulation is not always clear. CUB states that it asked straightforward questions to the Joint Parties about how their mechanism would operate, and "they could not accurately and clearly answer the questions."

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[7] CUB Opening Brief, 8 (Aug 29, 2008) ("CUB Brief").
[8] CUB Brief, 9.
[9] *Id.*
[10] *Id* at 10.

Regarding rate of return, CUB cites NW Natural's risk profile. As NW Natural's credit rating is strong, CUB infers that Oregon regulation, including the current PGA mechanism, "is not viewed by credit rating agencies as out of line with the current (rate of return)."[11]

CUB also disputes the Joint Parties' statement to the effect that CUB claimed that the proposed mechanism would not provide a "real incentive." CUB states that it wasn't concerned with whether the incentive was "real," it was concerned with the behavior that might result from the application of the new mechanism, compared to the incentive in the current PGA mechanism.

CUB argues that, the better the mechanism aligns parties' interests, the less oversight that is required. The designers of the mechanism should acknowledge the inherent limitations of oversight.

CUB states that the incentive under the current PGA mechanism is to minimize gas costs. According to CUB, under the proposed mechanism the incentive is to minimize the WACOG and the Unhedged Variances, a result that does not always result in lower gas costs.

According to CUB, the proposed mechanism trades off the shifting of risks to customers for a lower earnings threshold for an earnings review. CUB states that there are several issues raised by the proposed earnings sharing.

CUB states that Staff and NW Natural do not agree whether earnings related to gas costs are counted in an earnings review. Staff proposes to include the earnings; NW Natural proposes to exclude them. CUB agrees with Staff.

CUB cites testimony, from a NW Natural witness, to the effect that NW Natural and Staff agree that the Commission need not resolve this issue in this proceeding. CUB disagrees. CUB argues that the issue must be addressed to evaluate the trade-off between the increased risk for customers and the reduced earnings sharing.

CUB notes that the Joint Parties propose that 33 percent of earnings above the threshold will be shared by customers of Cascade, but only 20 percent will be shared by customers of NW Natural and Avista. SB 408 does not apply to Cascade. This treatment is intended to recognize the effect of the statute.

CUB states that the Joint Parties attempt to address the SB 408 effect on the share of earnings that flows back to customers, but ignore the effect on the earnings retained by the LDCs. Pursuant to SB 408, customers will pay a tax surcharge for the over-earning between the company's authorized rate of return and the earnings threshold, and a tax surcharge of 80 percent of the over-earning retained by the LDC. CUB argues

[11] CUB Brief, 14.

that an appropriate adjustment would require an additional sharing to customers to compensate them for the additional amount of taxes they will be charged.

CUB notes that the Joint Parties propose that over-earnings be allocated to all customers on an equal percentage of margin basis. CUB argues that core customers would be assigned a greater risk and should receive a corresponding greater reward.

According to CUB, earnings can be attributed to specific sources of revenue. CUB states that, in this year's earnings review, the amount of over-earning attributed to gas purchases and sales to core customers was 270 basis points. CUB argues that over-earnings paid by core customers on gas purchases should not be used to reduce the rates of non-core customers.

CUB notes the change in position by NW Natural, from its earlier support for the current mechanism. CUB posits that NW Natural's "change of heart" may be on account of the opportunity to use its storage to "beat" the First of the Month Benchmark price and increase its earnings.

CUB notes that an independent study of NW Natural's use of its storage had found that the Company had performed very well under the current mechanism. CUB argues that it would make "little sense" to trade an incentive that works, for a new mechanism that depends on prudence reviews to protect customers.

CUB offered its own proposal. CUB proposes to change the current PGA mechanism to provide for either 90/10 sharing (customer-LDC), with the earnings sharing threshold set at 100 basis points, return-on-equity, or 80/20 sharing, with the earnings sharing threshold set at 150 basis points, return-on-equity, Each LDC would make a one-time election between the two options. A utility may apply for an exception, based on a change of circumstances.

CUB states that it shares Staff's view that commodity cost differences, positive or negative, retained by the company, are properly accounted for in the company's earnings for purposes of the earnings review. CUB proposes that, of earnings above the threshold, 33 percent would be allocated to customers – half to be allocated to core customers on the basis of equal cents per therm, and half to all customers on the basis of an equal percent of margin.

CUB states that its proposal accounts for the increased volatility in the gas markets, responds to the Commission's feedback by adjusting an already working mechanism, is straightforward, and would result in a consistent application of the PGA mechanism to all three LDCs.

VIII. DISCUSSION

As noted earlier, following a workshop with all parties, the Commission met and decided to retain the current mechanism, with minor modifications. Those

modifications were intended to better align the risks inherent in the operation of the mechanism with current market conditions.

Following the workshop the ALJ informed the parties of the Commission's determination and provided instructions for their successful resolution of outstanding issues.

The Stipulation submitted by the Joint Parties does not meet the Commission's specifications. The terms of the Stipulation were not proposed at the time of the all party workshop held with the Commissioners. The Joint Parties or Staff did not report to the Commission as instructed by the ALJ. Instead, the Joint Parties presented their Stipulation, believing their PGA mechanism was "superior" to the Commission's "inclinations."[12]

CUB is correct that the current mechanism provides a simple, direct incentive for the LDCs to minimize their gas costs. The price is set at the beginning of the gas year. To the extent the LDC "beats" the price, it shares in the savings. To the extent it pays higher prices, shareholders pay their share of the higher costs.

The current mechanism is simple to describe and simple to apply. The proposal by the Joint Parties is neither.

In their Stipulation the Joint Parties propose to allocate to customers 95 percent of the changes in gas costs. While not going quite as far as Staff's original proposed 100 percent allocation, their proposed 95 percent allocation to customers is excessive. The Commission already stated it would consider 80/20 or 90/10.

By proposing to use market prices, the Joint Parties are reducing the link for customers between their rates and their utility's actual gas costs. The prospect of a nominal gain is not enough for the customers to give up the comfort of having their rates tied to their LDC's actual costs.

Like CUB, we are concerned with how NW Natural's storage inventory is accounted for by the proposed Stipulation. NW Natural has been commended for its effective use of its storage asset. The proposed mechanism is not likely to cause NW Natural to do "better" on behalf of its customers. The mechanism is likely to cause NW Natural to do "better" on behalf of its shareholders. There is no corresponding trade-off for the customers.

As directed by the Commission, the ALJ instructed the parties the Commissioners "expect that you will address the mechanism for setting the benchmark." In their Stipulation the Joint Parties propose a method for setting the "Embedded WACOG" that is responsive to the Commission's directive. In its testimony, CUB

[12] *See* CUB/106, Jenks/1 (Jul 25, 2008); Joint Parties/100 (May 5, 2008).

stated that the Joint Parties' proposal is an "improvement" over the current mechanism. The Commission agrees. Those provisions of the Stipulation (part III, sections 2 and 3) are adopted.

CUB proposes that an LDC make a one-time election whether to choose the 90/10 sharing (100 basis points ROE earnings threshold) or 80/20 sharing (150 basis points ROE). CUB suggests the Commission allow any utility to apply to the Commission for an exception "should its circumstances change."[13]

The Commission is not persuaded that a one-time election is necessary. An annual election, not later than August 1st, is reasonable and is adopted for future gas years. For the gas year beginning November 1, 2008, each utility shall make its election at the time it files its tariffs as ordered in this decision.

In their Stipulation the Joint Parties address the earnings review procedure that is performed pursuant to OAR 860-022-0070. While the details of their proposal are moot, we do adopt their provision for the elimination of the fall earnings review as well as for the removal of the sunset provision for the spring earnings review. We will convene a rulemaking proceeding to make the necessary changes to the rule.

The spring 2009 earnings review will be conducted under the ground rules applicable under the now current mechanism, in recognition that ten months of the year 2008 will have been conducted under the current rules.

CUB's rate design proposal is not adopted.

The adopted mechanism applies to NW Natural, Avista and Cascade. In all other respects, the provisions of stipulations and orders relating to Cascade in other proceedings are unchanged and remain in force and effect.

IX. CONCLUSION

The Commission reiterates its view that the current mechanism works well enough to fairly balance the risks and opportunities for all of the participants in Oregon's retail gas market. CUB largely conformed its proposal to the Commission's directive. CUB's proposal, as modified herein, should be adopted.

FINDINGS OF FACT

1. The current PGA mechanism provides LDCs a meaningful incentive to minimize their gas costs.

2. Changes in gas markets have increased gas supply risks for shareholders.

[13] CUB Brief, 25.

3. That increased risk should be recognized in modifications to the PGA mechanism.

4. CUB's proposed modifications to the PGA mechanism are consistent with the Commission's instructions to the parties.

5. CUB's proposed modifications to the PGA mechanism provide for a fair allocation of risk between ratepayers and shareholders.

6. The calculation of the benchmark price should be modified.

7. The terms of the Joint Parties' Stipulation provide a reasonable method for calculating the benchmark price.

8. LDCs should be allowed to make an annual election whether to choose 90/10 sharing, or 80/20 sharing, with the corresponding earnings review thresholds.

9. The fall earnings review is unnecessary.

10. The sunset provision for the spring earnings review should be eliminated.

CONCLUSIONS OF LAW

1. CUB's proposal, as modified above, should be adopted.

2. A rulemaking proceeding should be instituted to modify OAR 860-022-0070.

3. Part III, sections 2 and 3 of the Joint Parties' Stipulation, should be adopted.

ORDER

IT IS ORDERED that:

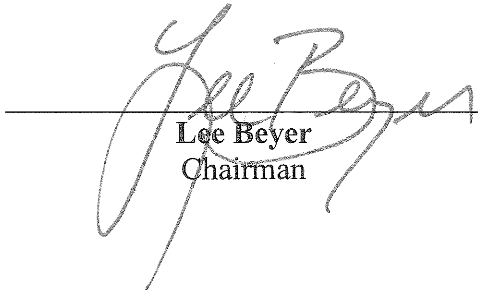
1. The Citizens' Utility Board of Oregon's proposed modifications to the current PGA mechanism, as modified herein, are adopted.

2. The Joint Parties' (Avista, Cascade Natural Gas, the Northwest Industrial Gas Users, Northwest Natural Gas and Commission

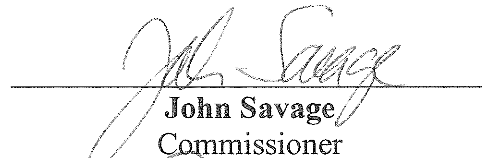
Staff's) proposal for setting the "Embedded WACOG" as described in their Stipulation, attached as Appendix A is adopted.

3. Within five days, Northwest Natural Gas Company, Avista Corporation, dba Avista Utilities, and Cascade Natural Gas Corporation shall file tariff modifications to conform their PGA mechanisms to comply with this order, to be effective November 1, 2008.

Made, entered, and effective OCT 21 2008.



Lee Beyer
Chairman



John Savage
Commissioner

Ray Baum
Commissioner

A party may request rehearing or reconsideration of this order pursuant to ORS 756.561. A request for rehearing or reconsideration must be filed with the Commission within 60 days of the date of service of this order. The request must comply with the requirements in OAR 860-014-0095. A copy of any such request must also be served on each party to the proceeding as provided by OAR 860-013-0070(2). A party may appeal this order by filing a petition for review with the Court of Appeals in compliance with ORS 183.480-183.484.

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	**STIPULATION**

I. INTRODUCTION

The parties to this Stipulation are Avista Corporation ("Avista"), Cascade Natural Gas Corporation ("Cascade"), Northwest Industrial Gas Users ("NWIGU"), Northwest Natural Gas Company ("NW Natural"), and Commission Staff ("Staff") (collectively, the "Parties").

By entering into this Stipulation, the Parties intend to resolve all issues addressed in Phase I of this investigative docket, as more particularly described below.

II. BACKGROUND

On November 14, 2006 , Staff issued a memorandum in which it requested that the Oregon Public Utility Commission (the "Commission") open an investigation into the Purchased Gas Adjustment mechanism ("PGA") used by Oregon's three local distribution companies ("LDCs") (hereinafter, "the Staff Memorandum" or "Memorandum"). In that Memorandum, Staff proposed a list of 9 general issues to be addressed in the investigation, including: guidelines for implementing portfolio purchasing; guidelines for hedging practices; the sharing of cost differences between the LDCs and their customers; and guidelines for documentation of purchasing decisions and practices.

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The Parties to this Stipulation intervened in the docket, as did Citizens' Utility Board of Oregon ("CUB").

A prehearing conference was held on January 11, 2007, and the Parties agreed to a proposed schedule of 8 workshops which were held between January 22 and August 23 of 2007. After the workshops concluded, the Assistant Attorney General David Hatton wrote to the ALJ on behalf of all parties to describe the parties' agreement to bifurcate the docket into two phases as follows: Phase I of the docket would address PGA mechanisms, including any proposed "incentive" arrangements. Phase II would address guidelines for implementing PGA and incentive mechanisms, and portfolio purchases of natural gas and related documentation.[1] The parties proposed that they file two rounds of comments in Phase I which were in fact filed on December 4, 2007 and January 28, 2008.

After the Comments had been filed, the Commission held a workshop which was attended by all parties to the docket. Subsequently, the parties held a settlement conference on February 7, 2008. That settlement conference was continued on February 13, 2008, this second session being held via teleconference.

As a result of these settlement negotiations, the Parties agreed to enter into this Stipulation:

III. STIPULATION

1. The Parties agreed upon a PGA mechanism that incorporates an incentive mechanism and an earnings review. The PGA is comprised of five basic components:

   (1) The annual setting of the embedded commodity WACOG in customer rates for the following PGA year;

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[1] The parties may recommend that additional issues be addressed.

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(2) The selection and application of sharing levels and corresponding earnings threshold levels;

(3) The selection and calculation of a monthly benchmark against which both embedded WACOG ("Embedded WACOG") and actual monthly gas costs will be compared;

(4) The calculation of variance between the monthly benchmark and annual Embedded WACOG and between the monthly benchmark and actual monthly unhedged gas costs; and

(5) The application of a spring earnings review.

Setting Embedded WACOG

2. In the fall of each year, the LDC will file its embedded WACOG ("Embedded WACOG") that will serve as the basis for customer rates for the PGA year beginning the following November 1 and ending October 31 (the "PGA Year").

(A) The initial PGA filing ("Initial Filing") will be made on or before August 31.

(B) A mandatory update of the PGA filing ("Update Filing") will then be made no later than two weeks prior to the scheduled Public Meeting addressing the PGAs.

3. The Embedded WACOG will be set as a function of the LDC's expenses for (a) fixed price hedges; (b) storage, and (c) unhedged volumes. These components of the Embedded WACOG will be calculated as follows:

(A) Total PGA volumes will be set on a forecasted basis.

(B) Fixed price hedges and storage fill (completed by July 31 for the Initial Filing and by September 30 for the Update Filing) will be included in Embedded WACOG at 100% of cost. Additional storage refills taking place by October 31 of each year will be separately accounted for and passed through to customers at 100% of cost.

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(C) Amounts for gas supplies that are unhedged ("Unhedged Gas") as of the date of filing, as discussed in a. below, will be calculated using the following inputs:

a. Prices will be set using the basis-adjusted 60-day NYMEX strips for the PGA Year. This methodology will be used for three years (through the 2010/2011 PGA Year), after which the Commission will review its effectiveness.

(i) The Initial Filing will use the basis-adjusted NYMEX daily information from the previous 60 calendar days through July 31.

(ii) The Update Filing will use the basis-adjusted NYMEX daily information from the previous 60 calendar days through September 30.

b. Volumes will be priced using the expected percentage mix of supply basins for Unhedged Gas supply for each of the twelve months of the PGA Year. The expected percentage mix will be based on the LDC's three-year historical weighted average volumes adjusted for known and measurable changes.

Selection of Unhedged Benchmark Price

4. By August 31 of each year, the LDC will select an independent benchmark (the "Unhedged Benchmark Price"). Each year the LDC may select one of two methods for setting its Benchmark:

(A) First of Month (FOM) index, which will be weighted by the actual purchases at each basin during the month plus/minus an appropriate amount applicable for each basin for physical supplies, adjusted for each month; or

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(B) The average of the Gas Daily indices, which will be weighted by the actual purchases at each basin during the month, plus/minus an appropriate amount applicable for each basin for physical supplies adjusted for each day.

Calculation of Variances and Sharing for Deferrals

5. The Monthly Benchmark WACOG is the actual unhedged volumes at the Unhedged Benchmark Price plus the costs of fixed price hedges and storage withdrawals divided by total actual volumes.

6. The difference between the Annual Embedded WACOG and the Monthly Benchmark WACOG will be calculated each month and multiplied by total actual volumes (Monthly WACOG Variance) and deferred for later collection or refund. The Monthly WACOG Variance will be shared at 95/5, meaning that 95% of any variance will be collected from or refunded to customers.

7. The actual costs for the Unhedged Gas will be calculated each month. Differences between actual costs for the Unhedged Gas and the product of the Unhedged Benchmark Price multiplied by actual unhedged volumes (Unhedged Benchmark Variance) will be deferred for later collection or refund. The Unhedged Benchmark Variance will be shared with customers at the percentage selected by the LDC each year by August 15 at one of the following levels: 67/33, 80/20 or 90/10 (meaning that 67, 80 or 90% of any variance will be collected from or refunded to customers).

Earnings Review

8. An earnings review will be performed each spring (pursuant to OAR 860-022-0070). The 2009 earnings review will use 2008 Fiscal Year results and the earnings thresholds currently allowed by the Commission for each LDC. For subsequent years, the earnings threshold applied to each fiscal year's results will correspond to the sharing election made by the LDC the previous August, for the following PGA

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Year, as described below, e.g. the August 2008 election will apply to the 2009 Fiscal Year results which are the subject of the 2010 earnings review.

(A) For LDCs choosing to share at 67/33 (with the exception of Cascade, as provided below), the earnings threshold will be set at 175 basis points (bp) of ROE (as determined in the LDC's last rate case), further modified by 20% of any change in the risk free rate for the 12-month calendar year preceding the annual earnings review (pursuant to Commission Order No. 04-203, as modified by Order 07-019);

(B) For LDCs choosing to share at 80/20, the earnings threshold will be set at 150 bp of ROE (as determined in the LDC's last rate case) further modified by 20% of any change in the risk free rate for the 12-month calendar year preceding the annual earnings review (pursuant to Commission Order No. 04-203, as modified by Order 07-019);

(C) For LDCs choosing to share at 90/10, the earnings threshold will be set at 100 bp of ROE (as determined in the LDC's last rate case) further modified by 20% of any change in the risk free rate for the 12-month calendar year preceding the annual earnings review (pursuant to Commission Order No. 04-203, as modified by Order 07-019).

(D) By August 31, 2008, Cascade may elect 67/33 commodity sharing with an earnings threshold of 215 bp of ROE (as determined in Cascade's last rate case), further modified by 20% of any change in the risk free rate for the 12-month calendar year preceding the annual earnings review, through 2012, providing Cascade continues to meet its merger conditions. If by August 31 of any year before 2012, Cascade elects either 80/20 or 90/10 commodity sharing, and following 2012, Cascade will choose from the options listed

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above, and cannot return to the 67/33 commodity sharing with an earnings threshold of 215 bp of ROE.

9. Sharing percentages for earnings above the threshold will be adjusted to account for the impact of SB 408. Customers of LDCs not subject to SB 408 will receive 33% of earnings above the threshold. Based upon current federal and state tax rates, customers of LDCs subject to SB 408 will receive 20% of earnings above the threshold. This percentage is subject to change as federal and/or state tax rates change.

10. There will be no fall earnings review.

11. The sunset provision for the earnings reviews will be removed through a subsequent rulemaking.

12. The application of this agreed-upon PGA shall not alter the Commission's review of the prudency of the LDCs' actions in procuring gas supplies for their customers.

Audit Provision

13. All deferrals pursuant to this Stipulation are subject to audit and modification for a period of up to three years.

Terms of Agreement

14. The Stipulation is offered into the record of this docket pursuant to OAR 860-014-0085. The Parties agree to support the Stipulation throughout this proceeding and any appeal, to provide witnesses to sponsor the Stipulation at any hearing held in this docket and recommend that the Commission issue an order adopting the settlement contained herein.

15. The Parties have negotiated the Stipulation as an integrated document. If the Commission rejects any material portion of the Stipulation or conditions its approval upon the imposition of additional material conditions, any party disadvantaged by such action shall have the right, upon written notice to the Commission and all

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Parties within 15 business days of the Commission's order to withdraw from this Stipulation, pursue its rights under OAR 860-014-0085 and shall be entitled to seek reconsideration of the Commission's order. However, prior to withdrawal, the Party shall engage in good faith negotiation with the other Parties. No Party withdrawing from this Stipulation shall be bound to any position, commitment, or condition of this Stipulation.

16. By entering into this Stipulation, no Party shall be deemed to have approved, admitted to, or consented to the facts, principles, methods or theories employed by any other Party in arriving at the terms of the Stipulation.
17. This Stipulation may be executed in counterparts and each signed counterpart shall constitute an original document.
18. Each Party enters into the Stipulation on the date below.

OPUC STAFF	NW NATURAL GAS COMPANY
By: Bonnie B. Tatom	By:____________________
AVISTA CORPORATION	CASCADE NATURAL GAS CORP.
By:____________________	By:____________________

NORTHWEST INDUSTRIAL GAS USERS

By:____________________

Dated: May 2, 2008

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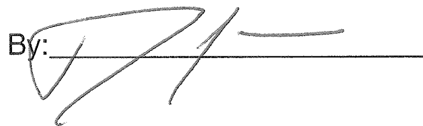
By: 

CASCADE NATURAL GAS CORP.

By:________________________

NORTHWEST INDUSTRIAL GAS USERS

By:________________________

Dated: May 2, 2008

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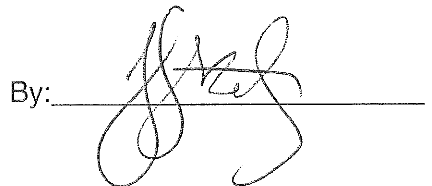
By: 

NORTHWEST INDUSTRIAL GAS USERS

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By:______________________	By:______________________
AVISTA CORPORATION	CASCADE NATURAL GAS CORP.
By:______________________	By:______________________

NORTHWEST INDUSTRIAL GAS USERS

By: Paula E. Pyron

Dated: May 2, 2008

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