

ITEM NO. 1

**PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: October 23, 2007**

REGULAR X CONSENT EFFECTIVE DATE November 1, 2007

DATE: October 15, 2007

TO: Public Utility Commission

FROM: Ken Zimmerman

THROUGH: Lee Sparling, Ed Busch and Bonnie Tatom

SUBJECT: NORTHWEST NATURAL: (Advice No. 07-6) Requests approval of Interim 2007-08 Purchased Gas Cost Adjustment Mechanism in Schedule P, Purchased Gas Cost Adjustments.

STAFF RECOMMENDATION:

I recommend the Commission suspend Northwest Natural Gas Company's (NW Natural or Company) request that the proposed amendment to the Purchased Gas Adjustment (PGA) mechanism become effective as of November 1, 2007.

DISCUSSION:

NW Natural filed Advice No. 07-6 on August 24, 2007. In its filing, NW Natural requests the Commission approve its proposed amendment to the Company's Schedule P, "Purchased Gas Cost Adjustments." That adjustment would add a collar to the current PGA for gains or losses above \$15 million. The change would apply only to the 2007-2008 PGA year, November 1, 2007, to October 31, 2008.

NW Natural's proposal would alter the current PGA mechanism in place for the Company by changing the sharing component of that mechanism. Currently 33% of any variance between the Company's weighted average cost of gas (WACOG) included in rates and the actual cost of gas is absorbed (if greater than the WACOG embedded in rates) or retained (if less than the WACOG embedded in rates) by NW Natural. NW Natural's proposal would retain that sharing arrangement up to a variance of \$15 million. Above the \$15 million level, the sharing arrangement would change to 90%/10%. That is, for any variance above \$15 million, NW Natural would absorb or retain only 10% of that difference.

According to the Company's testimony, ". . . NW Natural's current Purchased Gas Adjustment ("PGA") mechanism places a disproportionate and inappropriate level of risk on the Company's shareholders . . ." (NWN/100/Miller/1/14-16). According to NW Natural, the change proposed by the Company is intended to mitigate that risk, bringing shareholder and customer risks more into alignment. NW Natural's testimony in support of its application also claims that "shareholders' exposure to disproportionate risk will negatively affect the Company by increasing its borrowing costs and decreasing the Company's risk rating" and "As a result . . . the long-term consequences will harm shareholders and customers alike." (NWN/100/Miller/6) The validity of the Company's assertion is uncertain, but what is certain is that this argument is not relevant to NW Natural's current proposal, which is for an interim, one-year change.

The term risk, as used by Staff in this memo, refers to the failure to apply appropriate portfolio natural gas purchasing methodology. This failure leaves both shareholders and customers of NW Natural with an increased chance of experiencing natural gas prices that are more volatile and/or higher than would otherwise be the case. In its testimony, NW Natural appears to use the term risk to refer to the maximum tolerable level of sharing that its shareholders should be required to absorb.

Staff does not find NW Natural's arguments for the requested change persuasive. NW Natural's premise that reduced financial hedging of gas volumes increases the risk for both shareholders and customers, but particularly for shareholders is fatally flawed. Thus, the solution NW Natural offers of a collar on hedging above \$15 million is also flawed. According to NW Natural's testimony,

In 2006, with the support of Commission Staff, the Company reduced its hedging levels from approximately 90% to 75% because forward prices appeared to have a significant "hurricane premium" built into them, keeping prices artificially high. In addition, NW Natural judged the market to have ended its steady upward movement and moved into a period of high volatility. Under these circumstances, the Company believed there was an opportunity to experience lower gas costs by hedging less. In so doing, we exposed both customers and the Company to increased risk, but this increased risk fell disproportionately on shareholders, as explained above. However, we believed that if this risk could be fairly allocated, decreased hedging under the prevailing market conditions could result in significant benefits for both customers and shareholders. (NWN/100/Miller/4/2-13) [Emphasis added]

NW Natural's description of the changes in the US natural gas market over the last 10 years or so, and the current character of that market are accurate. However, financially

hedging nearly all the expected annual sales volumes is not the appropriate means to address the increases in price and price volatility in that market. Financial hedging of natural gas volumes is only one resource among many for meeting customers' gas supply needs reliably, at the lowest reasonable price, while managing price volatility. Other resources include storage; firm multi-month index purchases of natural gas; spot purchases (daily and monthly) of natural gas; city gate purchases; gas exchanges; and purchases at multiple hubs over varying time periods of varying volume packages across the entire PGA year. The strategy generally accepted as the best option for purchasing under current natural gas market conditions is portfolio purchasing— purchasing a portfolio of supply resources rather than any one type, over a limited time period, at a limited number of trading hubs, or from a single or limited number of counterparties. This strategy is also generally accepted in the industry as providing the greatest level of risk mitigation for both shareholders and customers over the long-term in terms of price and price volatility while not impeding the goal of reliable gas supply for core customers.

NW Natural's high level of fixed-price hedging (financial and physical) prior to 2005 certainly has many explanations. NW Natural's view of these explanations tells part of the story. But to complete the picture Staff feels it important to point out that at least one of these explanations is to protect its shareholders from the risks transferred to them by Oregon's PGA sharing arrangement. NW Natural is correct that the current PGA sharing arrangement in conjunction with the changes in the natural gas market over the last 8-10 years shifts significant risk to shareholders. As a rational participant in the natural gas market, NW Natural and the other local distribution companies (LDCs) sought ways to mitigate this shift of risk to shareholders. Since NW Natural could not alter or avoid the changes occurring in the gas market in terms of higher prices and price volatility, the means it settled on was to enter fixed-price financial and physical hedges for approximately 90% of annual expected sales volumes before the PGA was filed each year. As physical hedging opportunities rapidly declined in the early 2000s NW Natural continued this same strategy by replacing physical hedges with financial hedges. This strategy effectively reduced the variation between the Company's WACOG included in rates and the actual cost of gas to zero. This approach is not consistent with portfolio purchasing and thus always shifts risk to customers. Customers experience more risk because they do not have the protections afforded by the application of appropriate portfolio natural gas purchasing. Barring virtually certain knowledge of future natural gas prices, which is never available, portfolio purchasing is the best option for protecting customers from changes in the price of natural gas. Beginning with the 2005 PGA, Staff sought to move NW Natural and the other two Oregon LDCs toward proper portfolio purchasing and thus away from the very high levels of fixed-price financial hedging in which the Company had engaged over the several years prior to 2005. However, in making this Staff requested change NW

Natural also removed the strategy it had utilized to mitigate the shift of risk to shareholders inherent in the Oregon PGA sharing arrangement.

One of the purposes of UM 1286 is to investigate and propose implementation of practices and guidelines for long-term minimization of gas costs risks for both shareholders and customers; and for long-term mitigation for both groups of what risks remain. These are long-term problems, requiring long-term solutions. No short-term change in the PGA sharing arrangement, as proposed by NW Natural, can effectively address these problems. In fact, short-term solutions, no matter their form, only aggravate the problems associated with such risks. Since the price of natural gas and the volatility of natural gas prices are unpredictable in the long-term, short-term changes in such things as sharing percentages or levels merely randomly benefit or harm one or both groups, depending on the direction and level of natural gas price and price volatility from year to year. UM 1286 provides NW Natural the appropriate forum for seeking ways to mitigate the gas cost risks shifted to its shareholders by Oregon's PGA sharing arrangements and the changes in the natural gas market over the last 8-10 years, and for aligning the interests of shareholders and customers. The Company's current filing cannot achieve either of these objectives.

In summary, Staff's recommends the Commission suspend NW Natural's proposed change to its PGA mechanism because:

1. The PGA change proposed by NW Natural, even if it were a reasonable long-term modification, is a one-year change that does not achieve the long-term mitigation of the shift of gas cost risks to shareholders or encourage proper natural gas supply portfolio purchasing by the Company. Both those objectives are the focus of the investigation in UM 1286.
2. Despite NW Natural's claims to the contrary, customers receive no benefit from the change proposed by the Company and, in fact, are actually harmed by it. Applying proper portfolio purchasing practices remains impeded, meaning that a greater portion of the risk associated with gas purchasing is shifted to customers, because shareholders have other options available to mitigate such risks, up to and including selling the utility's stock. Outside the argument for proper portfolio purchasing practices, NW Natural's interim proposal also transfers more responsibility for commodity cost differences during the 2007-08 PGA year from shareholders to customers.

Absent further direction from the Commission, suspending the filing is not likely to change the positions of the parties or result in new information. Staff believes that its time and that of NW Natural is better spent offering the Commission timely and well-

thought out comments in Docket UM 1286. As a practical matter, the Company has already financially hedged nearly 50% of its planned gas supply for the coming year and has injected storage gas to cover approximately an additional 15% of that supply need. As Staff indicated in its public meeting memo last year, entering financial hedges of an additional 10% of this supply (bringing the total hedged amount to approximately 75%) would be appropriate for an LDC with the physical characteristics, demand and purchasing options of NW Natural. Simply said, it is not necessary to approve the Company's proposal—the Company has already executed hedges for the 2007-08 PGA year at a prudent percentage level and should not hedge additional natural gas volumes to mitigate the risk it perceives from the sharing mechanism.

PROPOSED COMMISSION MOTION:

NW Natural's proposal to revise Schedule P, modifying the treatment of accounting for differences between embedded costs and actual costs for the 2007-08 PGA year, be suspended.