



ATTORNEY GENERAL OF WASHINGTON

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January 13, 2014

VIA ELECTRONIC FILING

Steven V. King
Executive Director and Secretary
Washington Utilities and Transportation Commission
1300 S. Evergreen Pk. Dr. S.W.
P. O. Box 47250
Olympia, WA 98504-7250

Re: Inquiry into Local Distribution Companies' Natural Gas Hedging Practices and
Transaction Reporting
Docket UG-132019

Dear Mr. King:

Pursuant to the Commission's December 18, 2013 Notice of Opportunity to File Written Comments (Notice), Public Counsel appreciates the opportunity to submit the following comments and attachments for consideration. We look forward to a healthy discussion with the Commission and stakeholders regarding hedging practices on January 23, 2014.

We are extremely pleased that the Commission has initiated this inquiry to revisit the issue of the hedging practices by the natural gas companies. Ken Costello has encouraged regulators to periodically review utility hedging activities, and further, "[w]hen these activities produce substantially higher prices over a consecutive number of years, they should raise a red flag for regulators."¹ Over the last several years, hedging losses have exceeded gains by staggering amounts, and those costs have been fully borne by Washington ratepayers. Public Counsel is highly supportive of this effort to better understand utility hedging practices and whether they are achieving the intended purpose. We also believe further Commission action is necessary to provide guidance and establish requirements that will benefit both ratepayers and the companies.

Public Counsel has engaged Michael A. Gettings of RiskCentrix as a subject-matter expert. Mr. Gettings has prepared comments and analysis addressing many of the inquiries contained in the Commission's Notice. Mr. Gettings has more than 30 years of experience in the energy field, including natural gas risk management beginning with the advent of the NYMEX contract, and

¹ *Gas Hedging: Should Utilities Do Less and Do It Differently?*, Ken Costello, Principal, National Regulatory Research Institute, May 2011, p. iv.

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has designed or redesigned numerous risk-mitigation (hedging) programs for large utilities, electric generation firms, and energy-intensive industrial firms. He has served as an ex officio member of risk oversight committees, helping to guide programs for years after development. He also presented a paper to NARUC's winter meeting in 2010 on prudence standards for utility hedging and has consulted with public power providers. For more detailed information about Mr. Gettings' experience, please refer to his *curriculum vitae*, attached hereto as Attachment A. Mr. Gettings comments and analysis is attached hereto as Attachment B.

Focus and Key Components of a Robust Hedging Program

A key concept that Mr. Gettings brings to the discussion is the distinction between having a *risk view* versus a *market view* in hedging. As Mr. Gettings observes, the market cannot be predicted. Hedging based on what a company thinks the market will do (rise or fall in price) is destined to produce bad results for the very reason that the trader cannot predict the market. However, risk can be measured. Focusing on risk acknowledges that the "direction and magnitude of future price changes is unknown, but the current futures prices (market consensus) is known, and the uncertainty of that consensus can be observed through daily futures price fluctuations."² A hedging program designed based on risk analysis, rather than market prediction, is more robust and likely to produce acceptable results. Additionally, regulatory response to hedging based on risk analysis is more likely to be fair to all stakeholders.

Mr. Gettings also describes the tolerances companies should develop in designing their hedging plans. Companies should develop two-directional tolerances to reflect the two directions of commodity price risk in relation to unhedged as well as hedged positions. If the market rises, costs could increase, but if costs fall, hedge losses occur. Tolerances define the high-confidence maximum commodity cost and high-confidence maximum hedge loss that is acceptable under the company's hedging plan.

During the 2012 PGA cycle, we learned that none of the LDCs in Washington define tolerance levels. At minimum, the Commission must require that the LDCs establish tolerance levels and develop the ability to measure risk on a routine basis. Risk should be measured daily or weekly. This would encompass the measurement of volatility for each of the forward 24 months' futures contracts and computing the risk of that volatility with respect to 2-sigma cost potential and the 2-sigma hedge-loss potential, as Mr. Gettings explains in his comments.

A robust hedging plan will include four different types of hedging decisions: programmatic, defensive, contingent, and discretionary. Mr. Gettings outlines the components of a robust hedging program and describes these four different types of hedging decisions. Hedging programs that are based on policy decisions set at one point in time, executed as specified, and left in place for the full term ("lock and leave" programs) tend to be less robust, less nimble, and more likely to produce undesirable results. It is critical for companies to closely monitor and evaluate hedging performance and make decisions to protect specified tolerance levels.

² Attachment B, Comments of Michael Gettings, RiskCentrix, at p. 6.

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Potential Commission Action Regarding Hedging

The Commission's Notice asked which procedural vehicle the Commission should use in the event it is determined that requirements or limitations on hedging should be established. In Public Counsel's view, a few different actions are likely appropriate and necessary. As discussed below, some rule changes are very likely appropriate to update PGA reporting requirements. With respect to hedging, the Commission should consider establishing certain requirements or guidelines as to components of utility hedging programs to be filed with the Commission. These guidelines or expectations, as well as reporting requirements, could be established by rule, policy statement, or potentially in Commission orders for each utility. Subsequent to this generic proceeding it may be most appropriate to have separate hedging proceedings with each of the four LDCs, given their different size and approach to hedging, to establish procedures and expectations for filing its hedging plan with the UTC, as well as subsequent reporting requirements to demonstrate the company followed its hedging plan.

To ensure that each of the companies meet minimum requirements, it may also be necessary to establish general, industry-wide guidelines. Mr. Gettings encourages the Commission to develop prudence standards that result in a process-oriented prudence review and that would encourage Companies to develop more sophisticated and robust hedging plans. These prudence standards might begin with the establishment of minimum requirements, and would ultimately involve agreement on the framework for measuring risk and responding to those metrics. Specific tolerances would be determined by each company as set forth in its hedging plan.

Incentives

The Commission's Notice asked whether an incentive mechanism should be considered, whereby the company's shareholders may share in the gains or losses resulting from hedging. We are certainly mindful that currently hedging costs (or potential gains) are fully passed on to ratepayers, and that over the past several years hedging losses have been substantial. On the electric side, the Power Cost Adjustment mechanisms of Avista and PSE provide for some potential sharing of costs or gains between ratepayers and shareholders. However, gas companies are distribution companies, and do not earn any return on the commodity portion of the business. We also recognize that designing an effective, fair incentive mechanism may be highly complicated. At this time, Public Counsel is not taking a position as to whether an incentive mechanism should be considered for gas procurement, and we look forward to continuing to examine this issue in the context of this Commission inquiry.

Percentage of Load to Hedge

The Notice also raised the issues of whether the Commission should establish limits as to the percentage of load that a utility should hedge. At this time, Public Counsel does not believe there is a specific "magic number" that is appropriate for all companies under all market conditions. Mr. Gettings identifies an 85 percent maximum (including both physical and financial hedges), but that is not to say that a program that includes 85 percent of the company's

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load to be programmatically hedged would be appropriate, or that 85 percent would be appropriate in all circumstances. Nor should any company necessarily hedge up to its ceiling. Any such limitation would likely depend on the structure and sophistication of the company's hedging program, and would therefore be best addressed in the context of company-specific proceedings regarding hedging.

Purchased Gas Adjustment Mechanism

Washington appears unique with our current structure of adjusting natural gas commodity rates annually through the PGA filing. The typical practice in other states is to adjust rates more frequently, such as monthly or quarterly. Public Counsel is open to considering more frequent rate adjustments. Such an approach would minimize the likelihood of large deferrals (or credits) that can result from annual true-ups. Yet, the current annual PGA mechanism has provided a certain level of price stability to customers. If the structure is modified for more frequent rate changes, we are interested as to whether that would affect utility hedging plans in any way. Also, if natural gas commodity rates are adjusted more frequently, such as quarterly, there would remain a need for a more comprehensive review of gas procurement, including hedging. That more comprehensive review would necessarily require more than the 30 or 45 day timeline for PGA filings, and might be conducted on an annual basis. In addition, Public Counsel is very supportive of establishing common reporting requirements, to facilitate Commission Staff and stakeholder review of PGA and natural gas procurement filings. All of these potential modifications to the PGA mechanism would likely best be accomplished by rule.

Thank you again for the opportunity to file these comments. Public Counsel believes the inquiry the Commission has undertaken in this docket is an important one. We look forward to reviewing comments filed by other stakeholders and participating in the stakeholder workshop on January 23, 2014. Mr. Gettings will also be in attendance.

Sincerely,



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