Attachment

Avista Corporation 2018 Hedging Plan
Docket UG-180734

A. Policy Statement and Intersection with Purchased Gas Adjustments (PGAs)

On March 13, 2017, the Commission issued its Policy and Interpretive Statement on Local Distribution Companies' Natural Gas Hedging Practices (Policy Statement).[1] The Policy Statement established the expectation that local distribution companies (LDCs) develop risk-responsive hedging strategies and limit programmatic hedging approaches that fail to balance upside price risk with hedge loss risk.

While the Commission made clear it would not provide prescriptive methodological guidance, the Commission stated its expectation that LDCs develop a framework for risk mitigation informed by quantitative metrics. Such a framework would enable utilities to measure and monitor market risk conditions, and identify meaningful hedging responses to those risk conditions.

The Policy Statement outlined a general process and timeline for regulatory review of utility hedging plans. In 2017, utilities began filing "preliminary" hedging plans coincident with the annual PGA filings. The Commission's expectation was that the 2018 hedging plans would be the first "comprehensive" hedging plans subject to formal acknowledgment. In these comprehensive hedging plans, the Commission expected utilities to demonstrate they had begun integrating risk responsive strategies into their overall hedging framework.

The Policy Statement also provided guidance on the topics the Commission expected utilities to address in the hedging plans and, thus, the focus of regulatory review. These topics are:

1. Communication of the utility's approach to the basic elements of its overall hedging plan: (a) objectives and goals, (b) exposure quantification, (c) strategic initiatives, and (d) oversight and control;
2. Demonstration that the utility incorporated risk responsive hedging protocols and that these are informed by quantitative metrics; and
3. A retrospective report of the prior year's hedging activities, including (a) a narrative on execution of the strategy, (b) commentary on metrics and tolerances, and (c) discussion of what the utility learned and how this relates to modifications going forward.

The Commission's review of utility hedging plans focuses primarily on these broad topics.

[1] Washington Utilities and Transportation Commission, Docket UG-132019, Policy and Interpretive Statement on Local Distribution Companies' Natural Gas Hedging Practices (Policy Statement) (March 13, 2017).

Natural gas commodity costs are directly passed through to customers via the PGA mechanism. Each year, companies submit a PGA filing where a price is set for the cost of gas that will be embedded in customers' rates for the coming year. At the end of the PGA year,[2] companies file an update to synchronize the differences between the actual costs of gas and the costs collected through rates. The *actual* cost of gas includes hedging gains and losses. Therefore, the effect of a company's settled hedges is included in the annual PGA filing and subject to Commission review and approval. In accordance with the Policy Statement, the Commission expects utilities to include clear identification of hedging losses and gains in the retrospective report so it can review strategies identified in the hedging plan to determine the appropriateness of hedging losses or gains for recovery through the PGA mechanism.

B. Commission Comments on Avista's 2018 Hedging Plan

The Commission reviews and acknowledges hedging plans to encourage each utility to develop the expertise necessary to integrate risk responsive hedging into its overall hedging framework and to execute risk responsive hedges according to the quantitative metrics and protocols it develops. The Commission does not expect utilities to abandon programmatic hedging altogether, and encourages each utility to diversify its hedging portfolio in a manner that helps mitigate the diversity of risks it faces, some of which the utility can measure and respond to, some of which it cannot. The Commission will look at the following three components of a utility's hedging plan:

1. Basic elements of a hedging plan;
2. Risk responsive hedging; and
3. Retrospective report

Avista has presented a comprehensive strategy that encompasses all its available resources and market position as an opportunity to mitigate risks. Because the company developed a risk responsive hedging tool and began executing risk responsive hedging protocols, the Commission considers Avista's 2018 Hedging Plan to be consistent with the fundamental direction provided in the Policy Statement.

Below are additional comments on the three general components of Avista's hedging plan.

1. Basic Elements of a Hedging Plan

In its Policy Statement, the Commission identified basic elements that it expected would be discussed in each utility's hedging plan, including (a) Objectives and goals, (b) exposure quantification in the risk responsive portion of the plan, (c) strategic initiatives, and (d) oversight and control.

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[2] The "PGA year" runs from November 1 through the following October 31.

Objectives and Goals. Although Avista's hedging plan contains a section titled "Objectives and Goals," that section does not discuss specific objectives and goals other than Avista's high-level strategy for managing price and load uncertainty. Avista describes its primary mission in very general terms – "having a diversified portfolio of reliable supply with a level of price certainty in volatile markets."[3] In future hedging plans, the Commission expects that Avista will identify specific goals of its hedging activites and measurable objectives in pursuit of that goal.

Exposure quantification. In its hedging plan, Avista has demonstrated that it quantifies its exposure daily on a system-wide basis. The company calculates its exposure by valuing its volumetric positions using the associated forward prices. Avista also calculates the portfolio-level value-at-risk (VaR) to measure risk beyond the quantified exposure.

Strategic Initiatives. Avista did not report on its strategic initiatives. However, as utilities are in the developmental stages of building a risk responsive hedging framework and updating their overall approach to risk management, the Commission expects Avista to provide information and analysis of strategic initiatives after risk responsive strategies are fully implemented.

Oversight and Control. Avista has demonstrated that it has a robust oversight and control framework in place. Avista's maintains a Risk Management Committee (Committee) that is responsible for the oversight of the company's Energy Resources Risk Policy (Risk Policy) and associated Natural Gas Plan (which includes hedging). The Committee, composed of corporate officers and senior-level managers, establishes the directives in the Risk Policy and monitors compliance through regular meetings that include discussion of hedge activity, market conditions, and other natural gas-related matters.[4] The Gas Supply Department is responsible for the management of the overall Gas Plan and associated hedge transactions. Avista also maintains a Strategic Oversight Group (SOG) that provides the Gas Supply Department with input and advice and serves as a sounding board for strategic decisions. SOG members include representatives from across a range of company departments. However, details on the input the SOG gives to the Committee are not specified in the plan, and it is not clear how the Committee assesses input from the SOG. It also does not appear that Committee meetings are documented.

The Risk Policy provides guidance for several processes including load and obligations estimation, natural gas resources, management of associated surplus or deficit, responsibility and approvals for transactions, and reporting.[5] The Risk Policy also governs financial contracts and derivatives. Although it is clear that Avista has an established Risk Policy that includes guidance on hedging, it is unclear how the Risk Policy governs the day-to-day hedging activities or is used in making the ultimate decision of whether or not to execute a hedge. In the next hedging plan, in addition to discussing oversight and control of the Company's overall Risk Policy, Avista should include discussion of the oversight and control of individual hedging decisions and how the Risk Policy guides the decision-making process. Finally, neither the Risk Policy nor the Natural Gas Plan clearly identify who is ultimately responsible for making hedging decisions.

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[3] UG-180734 Avista Utilities Natural Gas Procurement Plan and Hedging framework. Page 2.
[4] *Id*. Page 3.
[5] *Id.*

2. *Risk Responsive Hedging*

In the Policy Statement, the Commission noted its expectation that each utility would demonstrate in its 2018 hedging plan that it has begun to incorporate risk responsive hedging protocols into its overall hedging framework, and that these protocols are informed by quantitative metrics.

Avista's procurement strategy consists of three different approaches: dynamic window hedges (i.e., programmatic hedges), Strategic Optimization, and defensive (i.e., risk responsive) hedges.

The programmatic, dynamic window hedging (DWH) portion establishes temporal hedge windows in which the company will execute a hedge if statistically derived upper or lower control limits (UCL and LCL) are breached. If the UCL or LCL is not breached, the utility nevertheless will execute a hedge at the expiration date of the window. Strategic Optimization refers to the monetization of market opportunities that arise in the Company's service territory on a daily basis. By using its pipeline access, transportation and storage capabilities, the Company is able to materialize advantageous market positions. The Company has multiple ways to accomplish this goal. It can buy commodity at lower prices, transport it, and sell it at higher prices; release unused transportation capacity to third parties, or manage injections and withdrawals from the storage facilities.

Avista has begun incorporating risk responsive hedging protocols into its risk management activities, and has made substantial progress in meeting the fundamental objective of the Commission's Policy Statement. The Commission commends Avista for its ability to develop a risk responsive hedging tool and its demonstration of successful implementation of risk responsive hedging protocols. The Commission also commends Avista for its overall strategic approach to gas procurement that optimizes the use of the company's available resources and includes a balance of risk responsive hedging, programmatic hedging, storage, and index purchases.

In its hedging plan, Avista demonstrates that it has developed what it calls its risk responsive hedging tool (RRHT). The RRHT monitors the market and calls for additional hedging if risk tolerance limits are triggered. It includes all utility purchase and sales transactions, forecasted customer load, and storage injections and withdrawals, to derive open positions (by basin) that are marked to forward market prices. The company's program uses the open positions along with market volatility to calculate the VaR by basin, which is used to evaluate defensive hedging. Due to the high levels of volatility in the market for the PGA year, Avista continues to view hedging as a type of risk insurance from upside prices.

Because of successfully rolling out the RRHT, Avista scaled down its programmatic hedging portfolio from 46 percent to 40 percent of total costumer load. The company currently hedges up to 60 percent of its total natural gas portfolio on a total company basis.

3. Retrospective Report

In its Policy Statement, the Commission requested that each utility include a retrospective report of the prior year's hedging activities, including (a) a narrative on execution of strategy, (b) commentary on metrics and tolerances, and (c) discussion of learnings and how they relate to modifications going forward.

Avista did not produce a retrospective report consistent with the expectations laid out in the Policy Statement. Rather, Avista provided only a summary of the hedges settled in the 2018 PGA year. While this provides some insight into the costs of individual hedges, it does not show how the company is making decisions to execute hedges or whether the company is adaptively managing its hedging activities. For future hedging plans, Avista should provide a more thorough assessment of its retrospective hedging activities, including the development and evolution of metrics and strategic approach. Avista should also provide information related to the data used for the hedge execution and indicate whether the hedge was executed pursuant to a dynamic window protocol or a defensive protocol.

A well-developed retrospective report also can help the Commission and interested parties understand how the company is managing its hedging activities and how those activities relate to the PGA results.

C. **Commission Guidance for Avista's 2019 and Future Hedging Plans**

The Commission encourages Avista to continue improving its risk responsive strategies while maintaining an approach that is consistent with the Commission's policy guidance, and offers the following additional guidance below concerning hedging plan content and hedging documentation as it relates to the PGA.

<u>*Future Hedging Plans*</u>

The Commission requests that Avista take the following additional actions when preparing its hedging plans in future years:

1. Include a clear definition of the goal of its hedging activities as well as measurable objectives in pursuit of that goal.
2. Include a more detailed description of how its Risk Policy governs the company's hedging activities and how the Gas Supply Department operationalizes the Risk Policy directives.
3. Ensure that to the extent Risk Management Committee meetings relate to the company's hedging activities, they should be discussed in the hedging plan. The company should also demonstrate how the committee incorporates the Strategic Oversight Group collaboration in its decision making process.
4. Provide a comprehensive list of the individuals involved in the hedging decision-making process including individual responsibilities of each member, decision-making hierarchy, and other relevant details to understand how hedging decisions are made.
5. Provide a list of source documents that were used or that influenced the ongoing design or assessment of the company's hedging program.

6. Produce a retrospective report, consistent with the guidelines provided in the Policy Statement.

PGAs and Hedging Documentation

The company should provide the following in future PGA filings and, where appropriate, in the retrospective report:

1. Detail of all financial instruments that aim to reduce exposure in the natural gas markets;
2. Hedging program results, including costs associated with transactions (i.e., broker's fees or other necessary expenses) and how those costs are allocated;
3. Descriptions of the relationship, if any, between natural gas hedging gains or losses that are flowed through electric power costs versus the hedges that are part of the natural gas operations;
4. A description of multijurisdictional cost allocations for hedging transactions; and
5. A list of individual hedging transactions with identification of:
   a. Gains and losses;
   b. Hedged price;
   c. Commodity price at settlement date;
   d. Type of hedge executed (e.g., fixed-price physical, financial derivative);
   e. Hedge strategy (e.g., programmatic, defensive); and
   f. Reason for execution (e.g., tolerance exceedance, upper or lower control limit breach, time window expiration).