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### VIA ELECTRONIC FILING

January 13, 2014

Steven V. King

Executive Director and Secretary

State of Washington Utilities and Transportation Commission

1300 S. Evergreen Park Drive SW

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Olympia, Washington 98504-7250

RE: Docket UG-132019. NW Natural’s Comments - Inquiry into Local Distribution Companies’ Natural Gas Hedging Practices and Transaction Reporting

**Introduction**

NW Natural submits these comments in response to the notice of December 18, 2013, inviting comments on the topic of natural gas hedging, and the questions provided in that notice. We appreciate this opportunity to provide information and our views for the Commission’s consideration of this very important topic.

NW Natural assumes that the Commission’s references to “hedging” in the questions provided in the notice are broad enough to encompass not just the use of financial derivatives, but all other hedging tools as well, such as physical gas in storage, fixed price contracts with physical gas suppliers, and the production of natural gas reserves. Unless otherwise indicated, NW Natural’s comments intend this broad definition when referring to hedging.

**Response to Questions Provided in December 18th Notice**

Question 1: Hedging Activities

* 1. *What is the purpose of hedging?*
		1. *Reduction in price volatility allowing greater cash-flow certainty?*
		2. *Protection against the substantial rate hikes?*
		3. *Stabilization of customer rates, especially during the winter months?*
		4. *Other reasons?*

Response:

The purpose of hedging is to help ensure the Company’s objectives are met within risk tolerance levels for both customers and the Company. NW Natural views each of the three purposes for hedging described in the Commission’s above question as appropriate purposes for hedging. NW Natural tends to think of these purposes more specifically as providing for cost management, risk mitigation and rate stability. NW Natural does not enter into hedges for purposes of speculating on the market, by trying to “beat” future gas prices through hedges. Instead, hedges serve the purposes described above by limiting price volatility and allowing greater certainty of gas prices that will be passed on to our customers.

* 1. *Who should be the beneficiaries of hedging?*

Response:

Hedging is done on behalf of and for the benefit of the company’s customers. Hedging helps reduce price volatility for customers, and provides the benefits described above. The Company does not benefit from its hedging practices directly. Hedging does reduce the volatility of natural gas supply costs, which can benefit the Company and customers through guarding against significant additional financing costs that could be associated with price changes that occur after rates are set.

* 1. *Hedges are commonly negotiated for a fixed period of time; the time period can span from months to years.*
		1. *Is there a sound reason to limit the time horizon that companies can contract for a hedge?*
		2. *If so, what should be the maximum time horizon?*
		3. *What are the advantages, if any, of hedging over a multi-year period?*

Response:

There is no reason for the Commission to formally limit the time horizon. As a practical matter, the credit requirements for hedging will tend to establish a reasonable time horizon. For example, NW Natural’s policies allow it engage in financial derivatives up to five years into the future, but due to credit requirements, no authorized counterparties currently exist to do anything beyond a three-year horizon. To go beyond that period would require an alternate method for assuring credit, such as achieved by NW Natural through the acquisition of natural gas reserves. In other words, as long as the credit requirements are clearly established, an appropriate time horizon will be in place. Additionally, as explained below, there are advantages to allowing for flexibility with respect the time horizon that may be achievable under various hedging strategies.

Multi-year hedging can be beneficial, even over a long-term horizon where possible. By way of a rough analogy, hedging is in some ways similar to financing decisions regarding a home purchase. Like gas costs to an LDC, a house represents a considerable expenditure for the typical buyer. And, the question arises whether it is better to lock in the costs of a mortgage over the long-term in a fixed-rate mortgage, or over a shorter term as in a floating rate mortgage. Although there may be no single correct answer, if mortgage rates are perceived as relatively low, then in general, locking them in for a long term is viewed as advantageous. One reason for this is the natural “skew” in most financial markets. That is, mortgage rates (like natural gas prices) can drop, but do not go below zero, while their upward trend can be virtually unlimited. So if current gas prices look relatively low, then locking them in for a multi-year period, and even the long-term, could be beneficial.

* 1. *Companies normally hedge to a set “target” percentage of their expected load allowing the remainder of the unhedged load to be acquired on the spot market.*
		1. *Is there a need for the Commission to limit the percent of load hedged and, if so, what should be the maximum percent hedged?*
		2. *What are some of the factors affecting the amount of hedging that a utility should do?*
		3. *When discussing target percentages, should the Commission distinguish between physical and financial hedging?*

Response:

As stated above, NW Natural does not believe that it is appropriate to enter into hedging transactions for purposes of speculating on the market. Instead, hedging should be directly related to the company’s gas purchases for its utility sales customers. In light of this, volume limits on hedging should be no greater than the expected purchases by the LDC, with a proper accounting for weather variations and the utility’s standards for what constitutes an effective hedge.

Other factors that the Commission may want to consider would include:

1. Ensuring that hedging reflects the basins in which an LDC purchases its gas supplies, and that the transactions occur where there is liquidity (i.e. workably competitive markets);
2. What the predictability of load is;
3. The volatility of cash and future gas prices; and
4. The level of gas prices

Physical hedging can have different risks than financial hedging, so the Commission should distinguish between the two when considering appropriate hedging strategies. And, any targets that are determined should be flexible enough to allow for the ability to take advantage of any benefits that may be gained through movement between the different forms of hedging.

* 1. *Should the Commission consider providing an incentive mechanism allowing for sharing of gains as well as losses associated with a company’s hedging practices?*
		1. *What should be the benchmark?*
		2. *What are the challenges in developing an incentive mechanism?*

Response:

No. NW Natural believes that such an incentive mechanism related to hedging would send the signal that the LDCs should try to be “market timers” rather than prudent managers of their gas costs. In other words, it would introduce the element of speculation into hedging strategies, which NW Natural believes in inappropriate. NW Natural notes that in Oregon, where there is a sharing mechanism related to WACOG gains and losses, hedges are treated differently, with the full costs of hedges entered into prior to the annual PGA filing being deferred and passed through without sharing.

* 1. *It is feasible to develop a financial model that would provide a benchmark the Commission could use as a “safe harbor” when evaluating a company’s hedging performance?*
		1. *Assuming the Commission decides to establish requirements or set limitations on hedging, as discussed above, by what means should the Commission act?*
			1. *Rule,*
			2. *Order applicable to all companies following a hearing,*
			3. *Company-specific orders after individual hearings,*
			4. *Non-binding policy statement,*
			5. *Other*

Response*:*

NW Natural believes that it would be difficult to develop a “safe harbor” that would be the same for each LDC and the same from year to year. However, NW Natural is certainly willing to explore this concept further.

Regarding the establishment of any requirements or limitations, we believe flexibility is important in order to avoid missing any opportunities that may not be fully contemplated at this time. Accordingly, any direction should provide for enough flexibility to allow appropriate deviations that may provide benefits. In this regard, something along the lines of a non-binding policy statement, as referred to above, may be appropriate if the Commission were to take this approach.

**Question 2: Purchased Gas Adjustment Mechanism (PGA) – WAC 480-90-233**

*Although purchased gas costs include costs beyond hedging costs, hedging gains and losses can make up a material portion of the associated rate adjustment. The Commission believes it is important as part of this inquiry to examine certain aspects of the PGA filing requirements as they relate to hedging.*

* 1. *Washington companies file adjustments to their PGA mechanisms annually. However, some stakeholders have suggested that annual filings fail to provide proper economic signals to consumers and may actually contribute to large swings in rates due to the accumulation of under-recovered or over-recovered amounts.*
		1. *Should the Commission require more frequent PGA filings, such as semi-annually, quarterly or even monthly?*
		2. *If companies make more frequent, to what extent should the companies provide additional supporting data and narrative above those already provided in its annual filing? (Please address the additional resources that the Commission may require to process the additional filings.)*

Response:

NW Natural believes that it is clear that additional filings would require additional time and resources on the part of the LDCs, the Commission, its Staff and any intervenors. Accordingly, given these additional costs, there should be demonstrable benefits to customers before changing the current approach of an annual filing. Some relevant questions may include: Is short-term price elasticity observed in all customers groups such that monthly or quarterly rate changes would be expected to affect behaviors? If price elasticity is really a long-run phenomenon, then would multiple rate changes have a significant impact on consumption? Could these multiple rate changes have the reverse effect of creating a misperception that natural gas prices are more volatile than they actually are? Would multiple rate changes actually have the effect of masking changes in gas prices year to year, such that the price signal to customers would be even less clear?

NW Natural believes that these issues should be more fully explored before any decision to move toward more frequent gas rate changes. NW Natural also notes that in instances where the deferred variances between actual gas costs and forecast gas costs become large during a PGA year, NW Natural and other utilities have been willing to make refunds to customers as appropriate to provide rate relief sooner than would have otherwise been the case under an annual PGA. Thus, to the extent the Commission’s question relates to concerns about variances in gas costs during the PGA year, we note that this problem can be addressed on a case specific basis.

* 1. *Should the Commission consider a uniform PGA reporting standard allowing for:*
		1. *Comparability of data?*
		2. *Staff effectiveness and efficiency?*

Response:

NW Natural believes it is appropriate to streamline processes and improve efficiencies, and is willing to explore these possibilities further.

Thank you for the opportunity to provide comment in this proceeding. We look forward to discussing these issues further at the January 23, 2014 workshop.

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Sincerely,

*/s/ Mark R. Thompson*

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