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PUGET SOUND ENERGY
The Energy To Do Great Things

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Mr. Steven V. King
Executive Director and Secretary
Washington Utilities and Transportation Commission
P.O. Box 47250
Olympia, WA 98504-7250

Re: Docket No. UG-132019; Inquiry into Local Distribution Companies' Natural Gas Hedging Practices and Transaction Reporting

Dear Mr. King:

In response to the Commission seeking written comments on issues related to local distribution company's natural gas hedging practices and transaction reporting in Docket UG-132019, Puget Sound Energy, Inc. ("PSE" or the "Company") offers the following comments regarding the questions the Commission posed in its opportunity to file written comments on December 18, 2013.

1.a. What is the purpose of hedging?

The goal of hedging is to lower volatility of customer supply costs by reducing exposure to higher natural gas prices. An important element in a utility hedge program is balancing price protection with potential hedging costs. The annual PGA provides stability within a one year period, and PSE's multi-year hedging program provides stability across PGA periods.

1.a.i. Reduction in price volatility allowing greater cash-flow certainty?

While hedging gas commodity price volatility theoretically provides greater cash flow certainty, it is not the primary motivation behind PSE's gas hedging program. Rather, PSE considers this to be more of a byproduct of its program. From a cash flow perspective, PSE gas hedging program helps the Company more accurately forecast its daily cash needs in the short term, since it will essentially be locking in its gas energy payments in advance. This then allows PSE to better manage its cash borrowing needs and reduce exposure to interest rate risk. In the absence of a gas hedging program, PSE would be exposed to both increased gas commodity price volatility and interest rate volatility. Being able to better anticipate cash needs in advance, PSE can better manage which cash resources to draw from, be it commercial paper, credit facilities or some other form of financing. This helps to reduce PSE's cost of capital and, by extension, customers' rates as well.

1.a.ii. Protection against substantial rate hikes?

Utility hedging strategies can protect against unpredictable price changes. PSE has the tools to analyze the probability and simulate the portfolio impact of these events. A combination of financial and physical hedge strategies help mitigate this risk.

1.a.iii. Stabilization of customer rates, especially during the winter months?

Unfavorable price events can happen in any season. Predicting volatility is not easy so the principles of a balanced hedge program should increase price stability in all months. Analysis of expected costs and risk mitigation is equally important in both summer and winter seasons.

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

Customers. As noted above, the goal of hedging is to lower volatility by reducing exposure to higher natural gas prices for the benefit of customers.

1.c. Hedges are commonly negotiated for a fixed period of time; the time period can span from months to years.

1.c.i. Is there a sound reason to limit the time horizon that companies can contract for a hedge?

Time horizons should be determined by each utility as part of its procurement program rather than being established by the Commission. A hedging strategy should have a specific time horizon with defined goals. PSE's multi-year program aligns with typical market liquidity, increasing price diversification, decreasing the probability of unfavorable hedge concentration in any one year.

1.c.ii. If so, what should be the maximum time horizon?

Maximum time horizon is a subjective measure that is difficult to define. Factors such as market liquidity, hedging costs, and risk mitigation are key considerations for a hedging strategy.

1.c.iii. What are the advantages, if any, of hedging over a multi-year period?

Hedging over a multi-year period provides increased price diversification. Price diversification limits the potential for high priced hedge concentration resulting from short term volatility. Multi-year hedging also increases a portfolio's flexibility to be responsive to short term market moves.

1.d. 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.d.i. Is there a need for the Commission to limit the percent of load hedged and, if so, what should be the maximum percent hedged?

Hedge percentages should be determined by utility management as part of their risk management policies and procedures rather than being prescribed by the Commission. A diversified utility hedging strategy should balance price stability with exposure to monthly base-load and spot gas pricing, but allow for customers to benefit from potential lower short term spot prices.

1.d.ii. What are some of the factors affecting the amount of hedging that a utility should do?

Balancing price stability benefits with potential hedging costs are important considerations in portfolio hedging volume. Additional key components include supply basin diversity, resource mix, market liquidity and market price.

1.d.iii. When discussing target percentages, should the Commission distinguish between physical and financial hedging?

There should be no distinction, as physical and financial hedge instruments can have very similar costs and risk mitigation characteristics. Physical hedges should be included in the calculation of target hedge percentages.

1.e. Should the Commission consider providing an incentive mechanism allowing for sharing of gains as well as losses associated with a company's hedging practices?

The Commission should not consider an incentive mechanism that allows for sharing of gains or losses specifically related to a utility's hedging practices. Doing so would convert the cost management and price risk-avoidance purpose of hedging for the benefit of

customers into a profit-driven trading function for the utility, with a high potential for unintended consequences.

1.f. Is it 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?

In theory, developing a financial model that would provide a benchmark and safe harbor for each utility may be an attractive concept for both the utilities and the Commission. In practice, the complexity involved with developing consensus around model architecture, inputs, and maintenance seems onerous and impractical. Additionally, there would need to be complex adjustments of model outputs to reflect the unique mix of assets of each utility.

1.f.i. Assuming the Commission decides to establish requirements or set limitations on hedging, as discussed above, by what means should the Commission act?

1.f.i.1 Rule?

1.f.i.2 Order applicable to all companies following a hearing?

1.f.i.3 Company-specific orders after individual hearing?

1.f.i.4 Non-binding policy statement?

1.f.i.5 Other?

Assuming the Commission decides to establish requirements or set limitations on hedging, it should do so through utility-specific orders pertaining to the utility's hedging program.

2.a. 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.

2.a.i. Should the Commission require more frequent PGA filings, such as semi-annually, quarterly or even monthly?

PSE's customers are best served by the current practice of annual PGA filings. The annual PGA has the benefits of rate stability, simplicity, and fairness. Moving to more frequent filings might reduce the size of periodic rate changes and produce more precise price signals. However, there are also tradeoffs to consider, such as the complexity of rates, fairness between customer classes, customer confusion and rate stability.

Annual PGA rates are stable and easy to understand. By way of contrast, rates set more frequently may provide more timely price signals, but stability would be sacrificed as rates track market prices more closely. Under current market conditions, more close alignment with market prices would also mean that PGA commodity rates would be higher in the winter than they are in the summer, which has significant implications for customers and would be especially harsh on low income customers. Monthly rates also would be more complex, and customers could find frequent rate changes confusing.

Another advantage of the current system of annual PGA filings is that the deferral amortization cycle mirrors the cost recovery cycle. Different classes of customers have different load profiles, and using an annual cycle for charging/crediting deferrals preserves the relative contributions of customer classes to over or under recoveries. Putting the deferral amortization on a different frequency than the cost recovery cycle would interrupt the seasonal relationship between customer classes' contribution to deferrals and amortization of those deferrals, potentially resulting in significant cross-subsidization among customers.

A decision to change to more frequent rate changes needs to include a determination of which rates would actually be changed. For example, if monthly filings were required, which components would be changed, the commodity rate, the demand rate, or the deferral rate? The greatest concern regarding price signals and large deferrals seems to be related to the commodity cost, because those costs make up the largest share of PGA costs and market prices are volatile. Demand costs are relatively stable from month to month, but because these costs are recovered on a volumetric basis and volume is highly seasonal, demand costs also generate deferral balances. Use of an annual PGA for these costs allows cost recovery over a 12 month period with stable rates to customers over those 12 months.

It is also important to note that the Commission's existing PGA rules allow for out of cycle PGA filings. If the market changes drastically from when the PGA is initially filed or the deferrals start to get large, the utilities have the ability to file an update to the PGA during the year to mitigate large one-time annual changes in PGA rates.

The current natural gas market conditions, potential confusion for customers from the increased frequency in rate changes, potential customer impacts in the winter, and fairness concerns outweigh the positives and lead to PSE's recommendation that the Commission maintain the current practice of filing PGAs annually. Should conditions change in the future, PSE would be open to revisiting this topic.

2.a.ii. If companies make more frequent filings, to what extent should the companies provide additional supporting data and narrative above those already provided in its annual filing?

As stated previously, PSE does not support more frequent PGA filings. The amount of additional supporting data to be filed by a utility would be substantial. The depth and volume would depend on whether the PGA rate update is to the gas commodity rate, demand cost rate, the amortization rate, all of the above, or some combination of the above. Additionally, the amount of additional supporting data is also impacted by whether a utility would be required to update its load forecast with each filing.

Any marginal benefit to customers of more frequent PGA filings does not justify the additional resources required from Commission staff to process and review them. Nor would additional supporting data and/or narrative necessarily improve the chances of addressing the potential issues of fairness between customer classes, customer confusion or rate stability that were discussed above.

2.b. Should the Commission consider a uniform PGA reporting standard allowing for:

2.b.i. Comparability of data?

2.b.ii. Staff effectiveness and efficiency?

PSE recognizes the challenge Commission staff face in reviewing PGAs with different presentations and work papers. Development of a common summary filed by the utilities of important PGA costs and data used in the PGA filing could improve the comparability of data between utilities and allow for staff effectiveness and efficiency while reviewing. PSE would be open to working with Commission staff and the other utilities to develop this filing summary.

Any uniform PGA reporting standard should be at a relatively high level. The utilities in Washington use different models for forecasting PGA costs and the work papers are very different, even though they all forecast the same gas and delivery costs. Utilities need to retain the freedom to develop their work papers as they see fit, consistent with their gas supply portfolios, operations and rate structures. Building a common template that covers all the gas supply, storage, and transportation options the different utilities utilize to procure and deliver gas to customers, and the various tariff structures, may not be feasible.

PSE appreciates the opportunity to present these comments. Please direct any questions regarding these comments to the undersigned at (425) 456-2110.

Sincerely,

/s/ Ken S. Johnson

Ken S. Johnson
Director –State Regulatory Affairs