Attachment

Cascade Natural Gas Corporation 2018 Hedging Plan
Docket UG-180825

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 or utilities) 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.

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[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 purchased gas adjustment (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 Cascade'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

Cascade has not yet developed a comprehensive risk management strategy that incorporates risk-responsive hedging protocols. Because Cascade has yet to develop the capacity to evaluate and execute hedges in a risk-responsive manner, the company has fallen short of meeting the timeline for implementation identified in the Commission's Policy Statement. However, the company has made significant efforts to develop the necessary skills to implement a risk-responsive hedging program, and has enlisted the services of a consultant to help them do so.

The Commission recognizes the challenges utilities face when developing new policies and procedures to comply with direction provided by regulators, and for that reason, the Commission remains flexible insofar as the company continues to develop risk-responsive hedging capabilities. Therefore, the Commission acknowledges receipt of Cascade's 2018 hedging plan as it includes concrete strategies to develop a risk-responsive hedging program. Consistent with

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

the Policy Statement, we expect Cascade's 2019 hedging plan to reflect implementation of a comprehensive risk-responsive hedging strategy during the 2019-2020 PGA year.

Below are additional comments on the three general components of Cascade'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.

Objectives and Goals. In its hedging plan, Cascade does not clearly identify the specific objectives and goals of its hedging activities. However, the plan does appear to suggest the primary goal of hedging is to create price stability. The Commission notes here that price stability is questionable as a standalone goal, as a goal of price stability could lead a utility simply to hedge 100 percent of demand. In future hedging plans, the Commission expects that Cascade will identify specific goals of its hedging activites and measurable objectives in pursuit of that goal.

Exposure quantification. In its current hedging plan, Cascade confirmed that it does not quantify its exposure but rather engages in fixed-priced physical contracts in a programmatic manner. As it begins developing a data-driven hedging program, Cascade reports it plans to use correlations between the supply basins and Henry Hub, NYMEX, or other relevant location basis transactions to calculate risk metrics such as value at risk. While calculation of VaR is consistent with methods discussed in the Gettings White Paper, it is unclear which risk metrics will be used and how decision makers will use them. The Commission expects the company to document in its next hedging plan a clear definition of the risk metrics the company is using for its exposure quantification, and how those metrics are being used.

Strategic Initiatives. Cascade 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 Cascade to provide information and analysis of strategic initiatives after risk responsive strategies are fully implemented.

Oversight and Control. The Gas Supply Oversight Committee ("Committee") oversees and approves the gas supply purchasing and hedging strategy each year. Members of the Committee are senior management from Gas Supply, Regulatory, Finance and Operations. The Manager of Supply Resource Planning functions as compliance manager regarding the Commission's policy statement. Primarily the Supervisor of Gas Supply under the leadership of the Manager of Gas Control & Supply executes the portfolio for Cascade's Western Region. Cascade appears to have adequate oversight and control in place. The Commission notes, however, that it does not appear that the Committee's ongoing activities are documented. In addition, Cascade reports the Director, Gas Supply-Utility Group, oversees the team, but it is not clear what "team" the company is referring to and what the Director's oversight role entails.

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 incorporating risk-responsive hedging protocols into its overall hedging framework, and that these protocols are informed by quantitative metrics. As Cascade has yet to begin executing risk-responsive hedging protocols, there are no risk-responsive hedging activities for the Commission to review here.

However, in its hedging plan, Cascade presented its ongoing activities aimed at developing the capacity to implement a risk-responsive hedging program and indicates that it expects to execute risk-responsive hedging protocols during the 2019-2020 PGA year (i.e., after October 2019). In preparation for this shift, the company hired a consultant to aid in the development of a program that reflects the policy statement guidance, and has begun outlining an approach to develop quantitative risk metrics. Cascade intends to calculate risk exposure using volume estimates established in the IRP in combination with measurement of market volatility, and plans to use correlations between the supply basins and Henry Hub, NYMEX, or other relevant location basis transactions to calculate risk metrics such as VaR. The company notes that it excludes daily gas and storage gas when measuring risk exposure, though it is not clear how it can perform an accurate assessment of risk without considering daily gas and storage. Cascade should discuss its rationale for excluding daily gas and storage gas from its risk assessment in its next hedging plan. The Commission also expects the company to document in its next hedging plan a clear definition of the specific risk metrics the company is using for its exposure quantification, and how those metrics are being used.

In its plan, Cascade presents a number of loosely defined goals of its revamped hedging activities, including being more "risk responsive," reducing hedge losses in a falling market, and protecting against price increases. Additionally, the company discusses how it will develop a "risk awareness," though it is unclear what "risk awareness" means and how it will help accomplish the goals of a risk-responsive program. In the next hedging plan, the Comisssion expects more clarity and consistency in definining the goals of Cascade's hedging activities and quantitative support for the establishment of measurable objectives.

Regarding Cascade's overall hedging activities, the company continues to hedge in a programmatic manner. Natural gas is considered "hedged" when a contract with a fixed-price and a specific scheduled delivery date in the physical market is established.[3] In this context, the decision to hedge is driven by the expected delivery date, allowing up to 40 percent of projected load the year prior to the final consumption of the gas. Cascade claims it uses up to 5 percent of structured products, such as caps, floors, and derivatives, to offset fixed priced physicals being “out of the money.” However, the logic behind this approach is unclear. In Cascade’s next hedging plan, the Commission expects the company to discuss how these transactions interact with the company’s gas hedging strategy and the value these transactions bring to the company’s risk management activities. Whether hedges are “out of the money” is not necessarily an issue, especially with risk-responsive hedges, as such hedges are meant to address the *risk* of high prices, not the certainty of high prices.

The company should continue working with its selected consultant to develop its hedging strategy. Once the company has developed and begun to manage its risk-responsive hedging program, it should consider obtaining an indepedent evaluation of its approach.

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.

Cascade did not provide a clearly delineated retrospective report in its hedging plan. However, although Cascade has yet to execute risk-responsive hedging protocols, the company did provide some narrative on the execution of its retrospective hedging strategy.

Over the past year, Cascade has maintained a status quo approach to its hedging program, which is focused on programmatic, fixed-price physical contracts. The company reports that approximately 40 percent of its supply is hedged in this manner. However, the company clearly intends to move beyond this strategy in the near future, and has provided substantial commentary on the progress it is making.

Cascade also reports that it will produce a monthly guidance document to memorialize the most important information about its hedging and risk assessment activities. Although the company provided a brief summary of the monthly guidance it has gathered to date, the commission asks that in future hedging plans the company discuss this guidance in more detail, particularly as it relates to modifications to the company’s hedging practices.

In next year’s hedging plan, the Commission expects Cascade to produce a detailed retrospective report consistent with the guidance provided in the Policy Statement. The retrospective report should provide information necessary to understand how well the program has performed in terms of meeting goals and objectives, with enough detail to understand the relationship between hedge settlements and PGA deferrals. The report should show how the company is making decisions to execute hedges or whether the company is adaptively managing its hedging activities. Cascade should also provide information related to the data used for the hedge execution and indicate whether the hedge was executed under a programmatic or a risk-responsive method.

A well-developed retrospective report 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 Cascade's Hedging Plans

Cascade has not yet begun executing risk-responsive hedging protocols, but it appears to have made significant progress in developing the framework and expertise to begin integrating risk-responsive hedging activities into its overall hedging program. We acknowledge that Cascade filed a hedging plan wherein the company commits to complete development of a risk-responsive hedging strategy over the next year, with the goal of implementation in the following PGA year.

The commission offers the following further guidance below concerning hedging plan content and hedging documentation, as it relates to the PGA:

Future Hedging Plans

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

1. Describe its newly developed capacity to execute risk-responsive hedging protocols;
2. Include a clear definition of the goal of its hedging activities as well as measurable objectives in pursuit of that goal;
3. Identify relevant oversight and control entities within the company and their capabilities / functions. Include a description of the team overseen by the Director of Gas Supply-Utility Group;
4. Document Gas Supply Oversight Committee meetings , as well as Committee decisions and guidance. To the extent committee meetings relate to the company's hedging activities, they should be discussed in the hedging plan;
5. Provide a comprehensive list of the individuals involved in the hedging decision-making process including the individual responsibilities of each member, decision-making hierarchy, and other relevant details to understand how hedging decisions are made;

6. Identify specific risk metrics and analysis the company will use for decision-making. This should include how the company will use metrics and analysis for decision making purposes, basins it will consider, and how the model will establish price tolerances for hedging decisions;
7. Identify policy guidance and metrics used to make decisions with respect to trading structured products, caps, floors, and derivatives that are used to offset hedging losses;
8. Perform independent third-party evaluations once the company develops the autonomy to manage its own hedging program;
9. Provide a list of source documents that were used or that influenced the ongoing design or assessment of the company's hedging program; and
10. Produce a retrospective report, consistent with the guidelines provided in the Policy Statement. In the retrospective report, discuss more thoroughly the information provided in the monthly guidance documents and how that information relates to ongoing program evolution.

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. A description of multijurisdictional cost allocations for hedging transactions; and
4. 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).