Attachment

Northwest Gas Company Natural 2018 Hedging Plan
Docket UG-180781

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.

[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 NW Natural'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

NW Natural has not yet developed a comprehensive risk management strategy that incorporates risk-responsive hedging protocols. Because NW Natural 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.

The Commission recognizes the challenges multi-jurisdictional utilities face when developing new policies and procedures to comply with direction provided by regulators in one jurisdiction, and for that reason, the Commission remains flexible insofar as the company is making good-faith efforts to develop a risk-responsive hedging program. Therefore, we acknowledge receipt of the company's 2018 hedging plan and the company's concrete plan to develop a risk-responsive hedging program. We expect the company to begin developing and implementing risk-responsive hedging protocols over the next year and, consistent with the policy statement, we

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

expect NW Natural's 2019 hedging plan to reflect the company's intention to implement fully a risk-responsive hedging strategy during the 2019-2020 PGA year.

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

As NW Natural has not yet developed risk-responsive hedging capabilities, the company was not able to discuss the basic elements of a hedging plan as they relate to risk-responsive hedging. Year-to-year rate stability is not a useful goal in and of itself when considering hedging strategies; such a goal could be largely achieved with a hedging strategy that hedges 100 percent of expected demand multiple years out. Rather, the goal of a hedging program should be oriented toward managing risk – both upside price risk and hedge loss risk.

Regarding oversight and control of NW Natural's risk management activities, including development of risk-responsive hedging strategies, NW Natural appears to have a viable structure in place. The company's Gas Acquisition Strategy and Policies (GASP) committee is comprised of senior management and acts as the governing body for hedge strategy approval, execution and policy setting. The Gas Supply department analyzes and executes the hedging strategy and provides recommendations to the GASP committee. The Middle office provides daily oversight of compliance with policy and procedures, and calculates risk exposures. It is not clear, however, what group specifically is responsible for developing and managing the tool or model that will allow the company to measure and respond to market risk.

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. As NW Natural has yet to begin executing risk-responsive hedging protocols, there are no risk-responsive hedging activities for the Commission to consider here.

Regarding NW Natural's overall hedging activities, the company continues to hedge in a programmatic manner. When determining *when* to hedge, the company uses what it calls a "prompt year cost avoidance" strategy which uses weather forecasts and historical volatility to assess when prices are likely to be the lowest. The company does not describe how it determines *how much* to hedge, though that decision appears related to the goal of "year-to-year rate stability" and appears unrelated to the measurement of market risk.

In its hedging plan, NW Natural states that its goal is to develop a risk-responsive hedging program that it will implement during the 2019-2020 PGA year (i.e., after October 2019). In preparation for this shift, the company added a hedging and portfolio supply analyst to its gas supply team and launched an Energy Trading Risk Management system that integrates multiple office procurement functions on a single platform. It is evident that the company intends to develop the capacity to implement risk-responsive hedging protocols.

NW Natural also states that it intends to take a portfolio approach to its overall hedging strategy, which will include dynamic (risk-responsive) hedging, storage, and programmatic hedges. The Commission supports a portfolio approach as it allows companies to manage multiple categories of risks.

NW Natural reports that it is necessary to bifurcate the company's system-wide hedge portfolio into separate Washington and Oregon portfolios. It appears the basis for this conclusion is that the company has not received guidance from the Oregon commission regarding risk-responsive hedging. However, active management of both upside price risk and hedge loss risk is likely to provide downward (rather than upward) pressure on rates. Given the lengthy list of internal processes the company reports it would have to incur to effect the separation of Washington and Oregon hedging portfolios, it would seem more efficient for the company to communicate to the Oregon commission the intended enhancements to the company's risk management activities.

We understand that Washington represents only 10 percent of NW Natural's service territory, but risk-responsive hedging strategies are geared toward managing risk that is measurable and attempts to balance upside price risk with hedge loss risk while programmatic hedging strategies are more suitable for managing the risk of unforeseeable events. Given that these two approaches to hedging attempt to manage different categories of risk, progamamtic hedging is not a valid substitute for risk-responsive hedging. If the company disagrees (and it appears it does), the Commission would like to better understand the company's rationale.

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.

NW Natural did not produce a retrospective hedging report consistent with the expectations outlined in the Policy Statement. The company did provide a brief summary of its retrospective hedging activities which is helpful in understanding the company's general approach to hedging. Over the past year, NW Natural maintained a status quo approach to its hedging program, which is focused on programmatic hedges. The company reports that approximately 24 percent of its demand is hedged more then two years out, though it has recently updated its internal hedging policy resulting in a reduction to multi-year hedges (down to approximately 19 percent). The company does not report the proportion of its demand that is ultimately hedged after executing hedges in the two years leading up to delivery.

In next year's hedging plan, the Commission expects NW Natural to produce a much more 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.

C. Commission Guidance for NWN's Hedging Plans

Northwest Natural has not yet begun executing risk-responsive hedging protocols, and appears to have made little progress in developing the capacity to do so. However, we acknowledge here that NW Natural has filed a hedging plan wherein the company commits to develop a risk-responsive hedging program over the next year.

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

Future Heding Plans

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

1. Include demonstration that the company has developed the 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 and their capacities;
4. Provide a comprehensive list of the individual positions 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; and
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. 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).