Before the Washington Utilities and Transportation Commission

Report on Natural Gas Procurement Practices
of
Puget Sound Energy

Docket UG-121569

On Behalf of Public Counsel

March 8, 2013

REDACTED

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I. Introduction

A. Commission Concerns and Objectives

The Commission issued a complaint and order suspending the Purchased Gas Adjustment (PGA) filing of Puget Sound Energy (PSE or Company) on October 31, 2012.[1] The Commission allowed the proposed rate decrease to go into effect on a temporary basis, subject to revision. The Commission's Order stated that an investigation is warranted to determine whether the natural gas procurement and hedging practices Puget Sound Energy results in fair, just, reasonable, and sufficient rates.

The Commission further stated that it would hold hearings and conduct workshops as may be required, and required Staff to file a report on the status of the investigation no later than March 1, 2013, including a recommendation on the disposition of the tariff filing by PSE or the need for further process to make the appropriate determination.

B. Public Counsel Objectives

The issues and concerns raised by Staff and the Commission are also of great concern to Public Counsel. Retail customers have paid higher rates as a result of the gas procurement policies and practices of PSE during the past decade.

In this report, we will outline our initial findings and preliminary recommendations for continuation of this proceeding and improvements to the PGA mechanism. Our approach in this review was not solely to assess past performance and examine any potential failings of the Company's gas procurement practices, but also to propose ways to make future PGA proceedings more robust and transparent.

We issued in excess of 30 data requests inquiring on a variety of issues related to the PGA and the underlying gas procurement policies and practices of the Company, and particularly its price hedging program. Data requests covered the period 2003 to 2013 for the following areas:

- The information filed in the annual PGA and Deferred Gas Cost Account regulatory proceedings and support information.
- Gas supply sources and related purchase pricing arrangements.
- The cost of gas passed on to customers during each year.
- Interstate transportation and gas storage capacity.
- Price hedging policies and procedures.
- Specific price hedging transactions.
- Hedging gains, losses and costs of fixed price gas purchase contracts.
- The percent of the gas portfolio hedged and how early price hedges were placed before actual gas delivery.
- Hedging tools and methods employed.

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[1] *WUTC v. PSE,* Docket UG-121569, Order 01 (October 31, 2012).

- Analysis on the cost and effectiveness of the hedge program.
- Corrective steps taken to minimize price hedging costs to customers.

In our analysis, we also reviewed and made extensive use of the responses and data requested by Staff and other information publicly available.

The cost of gas passed on to customers through the PGA mechanism represents from 75% to 80% of the customer's gas bill. Yet, the amount of regulatory scrutiny that it receives pales in comparison to the level of scrutiny for a general rate case that impacts about 20-25% of the customer gas bill. The Commission must have a deeper understanding of how the Company's gas procurement policies and practices, and particularly price hedging strategies, will impact customer bills before those policies and strategies are implemented.

C. Report Author

To analyze the gas procurement and hedging strategies of the Company and to prepare this report of findings and recommendations, the Public Counsel employed the services of Mr. Sebastian Coppola, President of Corporate Analytics, Inc. Mr. Coppola is a gas industry expert intricately familiar with regulated natural gas utilities, gas price hedging programs and gas cost recovery mechanisms similar to the PGA.

He has more than thirty years of experience in public utility and related energy work, both as a consultant and utility company executive. He has testified in several regulatory proceedings before State Public Service Commissions. He has prepared and filed testimony in gas cost recovery mechanisms, gas general rate case proceedings, revenue and cost tracking mechanisms and riders, and other regulatory proceedings.

During his tenure at SEMCO Energy, a natural gas utility with 260,000 customers, he held the position of Chief Financial Officer and also had responsibility for certain storage and pipeline operations as President and COO of SEMCO Energy Ventures, Inc. Prior to SEMCO, Mr. Coppola was Senior Vice President of Finance for MCN Energy Group, Inc., the parent company of Michigan Consolidated Gas Company (MichCon). MichCon is a gas utility with more than a million customers and $1.4 billion in revenue.

In his role as Treasurer and Chairman of the MCN/MichCon Risk Committee from 1996 through 1998, Mr. Coppola was involved in reviewing and deciding on the appropriate gas purchase price hedging strategies, including the use of gas future contracts, over the counter swaps, fixed price purchases and index price purchases.

In March 2001, Mr. Coppola testified before the Michigan House Energy and Technology Subcommittee on Natural Gas Fixed Pricing Mechanisms. Mr. Coppola participates in natural gas issue forums sponsored by the American Gas Association and stays current on various energy supply issues through review of industry reports and other publications issued by various trade groups.

Appendix A provides more details on Mr. Coppola's experience and regulatory credentials.

D. Key Definitions

Financial hedging – The use of financial tools, such as price swap agreements, futures contracts, option contracts, etc., where a financial counterparty agrees to a fixed price for a set volume of gas to be delivered at a specified location for a specified period of time. The Company will buy gas in the spot market and the gas utility will make a payment to the financial counterparty if the spot market price is lower than the fixed price. If the spot market price is higher than the fixed price, the financial counterparty will make a payment to the gas utility to get its cost of gas down to the fixed price.

Hedging losses – The difference between an agreed to fixed price and the spot market price in the month of delivery of the gas, where the fixed price is higher than the spot market price.

Hedging gains – The difference between an agreed to fixed price and the spot market price in the month of delivery of the gas, where the fixed price is lower than the spot market price.

Physical hedging – An arrangement between the utility and a gas supplier to deliver an agreed volume of gas at a specified location at a fixed price for a specified period of time.

Physical hedging cost and benefits – Hedging losses and gains generally relate only to financial hedging. With regard to physical hedging there are not losses or gains per se. Since the utility does not settle with a financial counterparty. In a physical hedge, the utility agrees to buy a quantity of gas at a fixed price with a gas supplier and pays that price when the gas is delivered. In these transactions, there is a cost premium or a benefit that is calculated against the spot market price. Therefore, a physical hedging cost premium occurs when the fixed price exceeds the spot market price in the month the gas is delivered. A physical hedging benefit occurs when the fixed price is below the spot market price in the month the gas is delivered.

II. Executive Summary

A. Summary of Findings

The initial findings from our preliminary review of the Company's gas procurement and hedging program has shown the following:

1. The Company's gas price hedging program has resulted in large losses and higher cost of gas for retail customers.
2. For the 2011-2012 PGA year, the Company reported hedging losses of approximately $169 million applicable to Washington customers.
3. We estimate the cumulative higher cost to retail customers over the 10 year period from 2003 to 2012 has been approximately $714 million.
4. The hedging strategy of locking in gas prices up to **[Begin confidential]** XXXXXX **[End confidential]** before the gas is actually needed has not significantly reduced PGA rate volatility.

5. The 67% of total gas supply that the Company has recently hedged is relatively high and has not proven to have been beneficial to customers over the past 10 years.
6. The Company has continued generally on the same path of locking in fixed prices for 51% to 67% of its gas supply even in the face of mounting hedging losses and significantly above market fixed price hedges.
7. As a result of price hedges put in place in prior years, significantly higher gas costs and hedge losses will continue into 2013 and future years.
8. We find that the Company did not act prudently to limit hedge losses and higher gas costs during the 2011-2012 PGA year.
9. The Company also has had large volumes of off-system gas sales which may have resulted in index and fixed price gas purchases being sold at a loss because of excess supplies during the year.
10. Additionally, the Company has released a significant amount of pipeline capacity. This indicates that the Company has excess pipeline capacity for which it is likely getting capacity release credits below what it paid for the capacity initially. This would result in added costs being passed on to customers through the PGA rate.
11. The current PGA and Deferred Gas Cost Adjustment procedures do not provide sufficient scrutiny of gas procurement practices and do not provide an early warning of potentially costly strategies, such as price hedging, that may harm customers.

B. Recommendations

Based on our initial findings and analysis, we make the following preliminary recommendations:

1. The Commission should consider disallowing recovery of at least **[Begin confidential]** XXXXX **[End confidential]** from gas costs included in the current Deferred Gas Cost Account. As explained in greater detail later in this report, we base this conclusion on the fact that the Company entered into fixed price financial hedges from **[Begin confidential]** XXXXXXXXXXX **[End confidential]** the start of the 2011-2012 PGA year to as late as **[Begin confidential]** XXXXXXXXXXX **[End confidential]** the end PGA year, when clear evidence existed from prior months that cash spot market prices were much more advantageous than forward hedge prices.
2. The Commission should order the Company to reduce the Deferred Gas Cost Adjustment tariff rate to reflect the disallowance.
3. The Commission should order the Company to suspend entering into any new hedging transactions until it has received recommendations from Staff, Public Counsel and other parties on an appropriate hedging program in collaboration with the Company.
4. The Commission should order Staff to organize and lead a Technical Collaborative with the Company and Public Counsel. The purpose of the Collaborative is to develop recommendations to the Commission on appropriate price hedging guidelines, policies and technical aspects of an effective hedging program, including

percentages of the gas supply to be hedged, the length or window in which to hedge and acceptable hedging tools to minimize hedging costs.

5. In conjunction with or separately from the investigation in the current docket, the Commission should undertake a rule making process to modify and strengthen the PGA initial filing requirements and the subsequent gas cost reconciliation. The Commission should include the following objectives in initiating a new rule making for the PGA in order to achieve more uniformity:
    a. The annual PGA filing should include testimony that describes the entire gas procurement plan in detail and with exhibits identifying sources of supply, short and long term gas purchase arrangements, forecasted pricing, price hedging strategies, pipeline transportation arrangements and cost, gas storage utilization plans, gas sales forecast including peak day demand and plans on how to meet that peak demand.
    b. The PGA filing should also include a forecast of gas costs, sources and strategies for the subsequent four years. This longer term forecast would provide an early warning of events that could significantly affect gas prices.
    c. At the end of the PGA year, the Company would file a gas recovery reconciliation case presenting testimony to explain its actual gas supply procurement decisions and costs with detailed cost schedules and exhibits.
    d. Both the PGA filing and Cost Gas Recovery reconciliation proceedings should be contested cases similar to a rate case, but on a more expedited schedule, to ensure transparency and a full assessment of the prudency and reasonableness of the utility gas supply purchase decisions.
    e. The PGA rate could be adjusted at least quarterly, if needed, to reflect changes in actual versus forecasted gas costs. This would insure customers get charged for gas costs in the year incurred and not in subsequent years as currently done with the deferred gas cost account.

These recommendations will result in more robust and transparent regulatory oversight to ensure gas costs have been appropriately reviewed by the Commission and found to be reasonable and prudently incurred. A more robust and transparent process also will give customers renewed confidence that the largest cost component of their gas bills is receiving sufficient scrutiny and appropriate oversight by the Commission.

It is also worth noting that a significant number of Regulatory Commissions in States such as Michigan, Maryland, New Jersey, Ohio and Pennsylvania have moved from a simplified PGA filing procedure to a more robust regulatory process similar to the one outlined above.

III. Profile of Puget Sound Energy

PSE is the largest electric and natural gas utility in the state of Washington, primarily engaged in the business of electric transmission, distribution and generation and natural gas distribution. PSE serves approximately 1.1 million electric and 761,000 natural gas customers principally in the Puget Sound region. For 2011, the Company reported $1.1 billion in revenues for gas sales of 954 million therms to retail customers. At December 31, 2011, PSE had approximately 2,800 full-time employees.

PSE purchases a portfolio of natural gas supplies from a diverse group of major and independent natural gas producers and marketers in the United States and Canada. PSE also enters into physical and financial fixed-price derivative instruments to hedge the cost of natural gas for its customers. All of PSE's natural gas supply is ultimately transported through the facilities of Northwest Pipeline GP (NWP), the sole interstate pipeline delivering directly into PSE's service territory. Accordingly, delivery of natural gas supply to PSE's natural gas system is dependent upon the reliable operations of NWP.

During 2011, approximately 49.5% of natural gas supplies purchased by PSE for its gas customers originated in British Columbia, while 14.8% originated in Alberta and 35.7% originated in the United States. PSE's firm natural gas supply portfolio has adequate flexibility in its transportation arrangements to enable it to achieve savings when there are regional price differentials between natural gas supply basins. The geographic mix of suppliers and daily, monthly and annual take requirements permit some degree of flexibility in managing natural gas supplies during off-peak periods to minimize costs.

For base load, peak demand and supply reliability purposes, PSE supplements its firm natural gas supply portfolio by purchasing natural gas in off-peak periods, injecting it into underground storage facilities and withdrawing it during the peak winter heating season. Underground storage facilities at Jackson Prairie in western Washington and at Clay Basin in Utah are used for this purpose.

PSE has a Purchased Gas Adjustment (PGA) mechanism in retail natural gas rates to recover variations in natural gas supply and transportation costs.

Natural gas is marketed outside PSE's service territory (off-system sales) whenever on-system customer demand is below normal. The resulting cost or benefits flow through the PGA mechanism.

IV. Major Findings

A. Gas Procurement Policies and Practices

Gas Supply Purchases, Sources and Pricing Methods – The Company has disclosed that for the period November 2011 to 2012 it obtained natural gas supplies from four supplies sources: the

AECO Hub, the Sumas Hub, Station 2 and the Rockies area basin.[2] The Rockies basin accounted for 34% of the total purchases with Station 2, the AECO Hub and Sumas Hub supplies at 34%, 16% and 16%, respectively. The AECO, Station 2 and SUMAS supplies are imported from Canada. These sources combined make up 66% of the total supply. The Company did not provide information for prior years, so it is not possible to assess how its supply strategy may have changed over time.

The Company reported that for spot market purchases it uses mainly the First of Month (FOM) and Daily Price indices tied to the delivery hubs and gas basins in which it purchases natural gas supplies.[3] The use of these index prices allows the Company to cover also the basis (location price) differential risk. The Company's use of fixed price purchases will be described below.

In its annual PGA filings, the Company did not specify its supply sources, pricing or strategy in any great detail. Therefore, it is difficult to conclude whether or not its basic gas procurement practices are prudent and reasonable at this time

Price Hedging Policies and Strategies – The Company has employed price hedging strategies since 2003 with the objective of locking in a fixed price for a percentage of its gas purchases. **[Begin confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXX **[End confidential].**[4]

The policy leaves setting the appropriate percent of gas supply to be hedged to the discretion of the Company's Energy Management Committee, which consist of representatives from supply procurement and financial areas. For the 2011-2012 PGA year, the Company fixed the price on 67% of its gas purchases. This percentage was the highest since the Company began hedging in 2003. In the prior five years the percentage has ranged from 51% to 61%.[5]

[Begin confidential] XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXX **[End confidential]**.[6]

The Company has established different hedging windows to spread the purchase of fixed price supply and financial instruments over multiple years. The Risk Policy allows locking in fixed prices up to **[Begin confidential]** XXXXXX **[End confidential]** before the gas is delivered to the Company's facilities. However, it does not specify what percent should be hedged in each year before delivery. This task seems to be left to the discretion of the Energy Management Committee. From internal reports, presentations, and responses to data requests, the Company has disclosed that its hedging strategy consists primarily of **[Begin confidential]** XXXXXX.[7] In

[2] PSE Response to Staff Informal Data Request No. 34.
[3] PSE Response to Staff Informal Data Request No. 35.
[4] PSE Response to Staff Informal Data Request No. 5 (Confidential).
[5] PSE Response to Staff Informal Data Request No. 11.
[6] PSE Response to Staff Informal Data Request No. 16.
[7] PSE Responses to Staff Informal Data Request No. 5 (Confidential).

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XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXX.[End confidential] Unfortunately, those gas prices continued to decline significantly into 2012, resulting in substantial losses.

A review of the fixed price hedges entered into for the 2011-2012 PGA year shows **[Begin confidential]** XXXXXXXX **[End confidential]** were made as early as **[Begin confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX[8]. XXXXXXXXXXXXX, **XXXXXXXXXXXXXXX,[End confidential]** or at about a 50% loss. The Company did not provide requested information prior to the 2011-2012 PGA period. Therefore, it is not possible to determine if hedging in prior years spanned the three-year period stated in the risk policy.

Results of Financial Hedging – The Company was asked to report the results of its price hedging strategies during the past ten years. For the 10-year period, the Company reported financial hedging losses of $695 million.[9] It is instructive to note that the Company incurred losses in each of the last seven years and even in those years in 2007-2008 when gas prices were rising rapidly. The Company only reported relatively small gains in the first three years of its hedging program. Table 1 below, which was provided by the Company, shows the gains and losses from financial hedges over the ten-year time period.

Table 1

PSE Financial Gains & Losses[10]

Period	Financial Hedges Net Gains & (Losses)
11/1/02-10/31/03	$ 7,568,322
11/1/03-10/31/04	4,131,299
11/1/04-10/31/05	7,012,608
11/1/05-10/31/06	(12,204,785)
11/1/06-10/31/07	(81,607,244)
11/1/07-10/31/08	(6,414,037)
11/1/08-10/31/09	(204,319,517)
11/1/09-10/31/10	(119,221,178)
11/1/10-10/31/11	(133,038,603)
11/1/11-10/31/12	(156,834,589)
Total	$ (694,927,723)

[8] PSE Response to Staff Informal Data Request No. 12, Attachment B (Confidential).
[9] PSE Response to Staff Informal Data Request No. 16.
[10] PSE response to Staff Informal Data Request No. 16. PSE retail gas business only serves customers in the State of Washington so the entire loss is applicable to Washington retail gas customers.

Physical Contract Hedging – In addition to price hedging using financial contracts, the Company uses fixed price gas purchase contracts with gas suppliers. Table 2 shows the cost premium to customers of locking in fixed prices on these contracts.

Table 2

PSE Physical Fixed Contracts[11]

Period	Physical Hedges Benefits & (Costs) ($millions)
11/1/02 - 10/31/03	$ -
11/1/03 - 10/31/04	-
11/1/04 - 10/31/05	(883,072)
11/1/05 - 10/31/06	1,950,323
11/1/06 - 10/31/07	-
11/1/07 - 10/31/08	(142,399)
11/1/08 - 10/31/09	(11,686,688)
11/1/09 - 10/31/10	(5,699,823)
11/1/10 - 10/31/11	-
11/1/11 - 10/31/12	(2,983,766)
Total	$ (19,445,424)

The cost premium was calculated as the difference between the price that the Company locked in for each gas purchase contract and the monthly FERC index spot price in the month the gas was delivered. In other words, the cost premium or benefit reflects how much more or less the Company paid for buying fixed price supply instead of buying that gas at the typical spot market index price.

As shown in Table 2, the Company reported that it paid a net cost premium of approximately $19 million during the 2002 to 2012 period. Only in the 2005-2006 PGA year did customers benefit from a lower fixed price than the spot market price. In each of remaining years, the Company paid a premium over the spot market FERC index price.

Therefore, when we combine the financial hedging losses with the cost premium paid for physical hedges, the total cost to PSE gas customers from the price hedging program was $714 million over the past 10 years. Since the Company has entered into fixed price arrangements for the next three year, in many cases at above market rates, additional losses likely will continued to accumulate into 2013 and future years.

Off-System Gas Sales – In balancing natural gas retail load requirements with resources, the Company engages in off-system sales of natural gas (gas marketed outside PSE's service territory). Generally, these sales occur when actual customer loads fall below forecasted levels and excess gas supply must be disposed of. In addition, the Company can purchase and resale

[11] *Id.*

natural gas to optimize use of pipeline capacity and capture economic benefit from arbitrage opportunities.

During the 2011-2012 PGA year, the Company reported arbitrage gas purchases and sales of approximately 29 million Dth.[12] Arbitrage and off-system sales represent about 20% of total gas purchases for the period. It is not clear from the information provided how much of these sales represent sales of gas that had to be sold due to lower retail customer demand.

Also, it is not clear from the information provided by the Company at what prices the off-system sales are occurring. If a portion of the off-system sales is occurring as a result of surplus natural gas supplies, it is likely that these volumes are being sold at spot market prices. With the Company purchasing 67% of its gas supplies at fixed prices significantly above spot/index prices, it is possible that off-system sales in certain months are resulting in a financial loss and an incremental cost to retail customers.

Unfortunately, the current PGA and Deferred Gas Cost Account process does not allow an opportunity to scrutinize these transactions to ensure they are reasonable, prudent and necessary.

Pipeline Transportation Capacity – The Company uses an interstate pipeline to transport natural gas to its distribution system and gas storage facilities. The Company plans for sufficient natural gas delivery capacity to serve its retail customers on a theoretical peak day. During non-peak day periods, it generally has more pipeline and storage capacity than needed. To generate economic value and partially offsets net natural gas costs, the Company will release pipeline capacity in the open market and earn fees.

The level of pipeline capacity, which is reflected in the PGA tariff, and the capacity release transactions do not appear to be sufficiently scrutinized in the current annual PGA/Deferred Gas Cost Account process. Thus, there is not an opportunity to ensure the Company has contracted for the appropriate level of capacity and that gas costs have been reasonably and prudently incurred.

B. Assessment of Gas Procurement Practices

PSE Hedging Policy Objectives – In its Risk Policy the Company has stated the following risk management philosophy and primary objectives: [**Begin confidential**]

- XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.
- XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
- XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.[13]

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

[12] PSE Response to Staff Informal Data Request No. 19.
[13] PSE Response to Staff Informal Data Request No. 32, Attachment A (Confidential).

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX[14]
[End confidential]

The losses from financial hedging and cost premiums paid for fixed price purchases over the past 10 years clearly indicate that the Risk Policy objectives have not been met. They have not achieved an [**Begin confidential**]XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXX. [**End confidential**]To the contrary, the analysis above shows that the Company has incurred large losses and cost premiums year after year which have harmed gas customers.

PGA Rate Volatility – With regard to reducing volatility, a review of the PGA rates charged to customers from 2005 to 2012 shows that the hedging program has not provided as much rate stability as claimed or intended. Table 3 below shows that PGA rates, including the annual deferred account cost adjustments, have varied significantly. The accompanying line graph in Table 4 shows clearly the volatility in the combined PGA rate.

Table 3

PSE PGA Rates in ¢ Per Therm

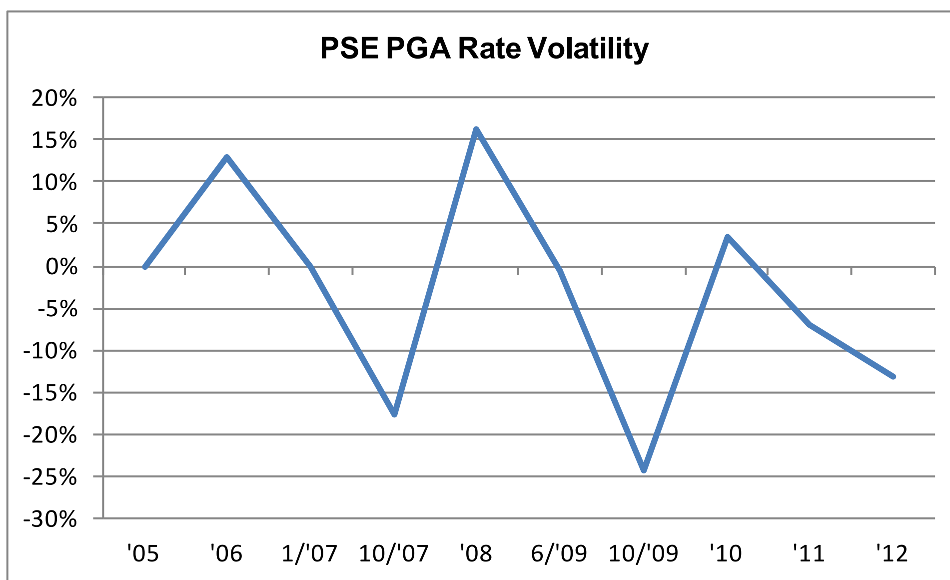
Date	PGA WACOG[1]	PGA Adjustment[2]	Total PGA Rate	Percent Inc. (Decr.)
10/1/2005	75.728	3.901	79.629	-
10/1/2006	85.536	4.299	89.835	13%
1/13/2007	85.529	4.271	89.800	0%
10/1/2007	80.491	(6.537)	73.954	-18%
10/1/2008	87.746	(1.848)	85.898	16%
6/1/2009	87.746	(2.285)	85.461	-1%
10/1/2009	72.032	(7.076)	64.956	-24%
11/1/2010	68.861	(1.718)	67.143	3%
11/1/2011	64.904	(2.529)	62.375	-7%
11/1/2012	57.996	(3.852)	54.144	-13%

[1] Schedule 101 for rate schedule 23 Residential.

[2] Deferred Account adjustment from Schedule 106.

[14] *Id.*

Table 4



If we consider the combination of high hedging costs and rate volatility, it is obvious that the fixed price hedging program has not served retail customers well.

Analysis of Hedging for 2011-2012 PGA Year – It is perplexing then why the Company would continue with the same hedging strategies year over year in the face of mounting losses and higher gas costs. In a data request, the Company was asked if it had evaluated its hedging program over the past years to assess its effectiveness and if it had taken steps to improve it. The response only provided a few technical changes that increased the percent to be hedged and the hedging window. [15] The Company is now considering using **[Begin confidential]** XXXX **[End Confidential]** as another financial tool to perhaps better manage price increases and take advantage of price declines. However, what the response did not address is why with larger losses beginning to pile on from the 2008-2009 PGA year, the Company did not take earlier corrective steps to minimize the damage.

Disregarding the negative impact of the hedging program on utility customers is inconsistent with the Company's duty to minimize gas costs. In the most recent two PGA years, it should have been quite obvious that spot market prices were significantly outperforming the forward market prices. Yet, the Company continued to hedge up to 67% of its gas purchases by locking in fixed prices in the upcoming prompt year. In my opinion, this was a very imprudent decision.

The following graph in Table 5 clearly shows the large gap between the AECO forward prices and the cash spot market price. This information was certainly available to the Company and should have given management a reason to pause on any further hedging for the upcoming year.

[15] PSE Response to Public Counsel Informal Data Request No. 26 (Confidential).

Table

AECO Forward Prices

$7.00
$6.00
$5.00
$4.00
$3.00
$2.00
$1.00

Nov '15 – Mar '16
Nov '14 – Mar '15
Nov '13 – Mar '14
Cash Spot Market

1/1/2011 2/1/2011 3/1/2011 4/1/2011 5/1/2011 6/1/2011 7/1/2011 8/1/2011 9/1/2011 10/1/2011 11/1/2011 12/1/2011 1/1/2012 2/1/2012 3/1/2012 4/1/2012

Nov '13 - Mar '14 Nov '14 - Mar '15 Nov '15 - Mar '16 Cash

5

Nevertheless, the Company continued to hedge for the coming year (prompt year). In response to a data request, the Company provided information that it entered into financial hedges for the 2011-2012 PGA year **[Begin confidential]** XXXXXXXXXXXXXXXXXXX.[16] XXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXX. **[End confidential]** Despite clear evidence that spot market prices were declining significantly, well below forward hedge prices, the Company decided to hedge **[Begin confidential]** XXXXXXXXXXXXXXXXXXXXXXXXX. **[End confidential]** The result of entering into these hedges was a loss of approximately **[Begin confidential]** XXXXXX. **[End confidential]** Appendix B (Confidential) shows the hedge transactions in question and the calculation of the hedge losses that I recommend the Commission should consider disallowing.

Disallowance of Gas Costs – In my opinion, the Company was imprudent in proceeding with fixing the price on **[Begin confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. [End confidential]** Although the Company also reported losses from hedges put in place in prior years, one can understand there was not much that could have been done with those transactions by **[Begin confidential]** XXXXX **[End confidential]**. However, to compound the problem by entering into additional hedging transactions after multiple years of hedging losses is incomprehensible.

The historical losses and past experience should have given the Company reason to reduce the amount and percentage of gas volumes to be hedged. In other words, why continue on the same

[16] PSE Response to Staff Informal Data Requests No.12C and No.13C (Confidential).

strategy that had created losses and increased gas costs for customers year after year? The Company's decisions were neither reasonable nor prudent and ultimately hurt customers. Therefore, I recommend that the Commission consider disallowing at least **[Begin confidential]** XXXXXX **[End confidential]** from recovery of gas costs from the Company's deferred gas cost account balance and order the Company to file a revised tariff to reflect this disallowance.

Suspend Hedging Program – Also, the Commission should order the Company to suspend its current hedging strategy until Staff and the Public Counsel have had an opportunity to review that strategy in more detail and recommend appropriate modifications in collaboration with the Company. Experience with similar hedging programs at other utilities has shown that the hedging window can be shortened from**[Begin confidential]** XXXXXX **[End confidential]** to less than one year and the utility can still achieve significant reduction in gas price volatility. Most importantly, with a shorter window the price of the hedged volumes is more reflective of current spot market prices, therefore avoiding large losses and gains. Although gas prices may appear attractive today against historical levels and the temptation exists to try and lock in perceived attractive prices for future gains, such practice would be pure price speculation and not a sound strategy to reduce price volatility.

There are also significant issues with regard to off-system sales and pipeline transportation capacity that need to be addressed going forward. The Commission should consider undertaking additional rule making to revamp the PGA filing process to ensure adequate regulatory scrutiny of these costs take place in a more robust PGA review process. This topic will be discussed in more detail later in this report.

C. Assessment of PGA Regulatory Process

Under the current regulatory procedures outlined in WAC 480-90-233, the Company is required to:

1. Make a PGA filing within a maximum of fifteen months since the effective of last PGA or file supporting documents demonstrating why a rate change is not necessary.
2. Accrue the difference between actual gas costs and the amount billed to customers in a deferred account and accrue interest on the balance at the FERC rate.
3. File a monthly report showing the activity in the deferred account.

WAC 480-90-194 and other applicable rules require the Company to provide public notification to customers about any rate changes and also follow other filing procedures.

PGA Filings – A review of recent PGA filings shows that typically the Company will make a filing two to three months before the start of the next PGA year to update both the Weighted Average Cost of Gas (WACOG) rate and the Deferred Account Balance Adjustment rate. This Adjustment rate recovers or refunds the difference between billed and actual gas costs for the prior year.

The filings typically consist of a few schedules providing a summary of gas commodity purchases and pipeline transportation costs. Most of the exhibits show calculation of demand and commodity tariff rates for each customer rate schedule. The package is usually accompanied by a

cover letter summarizing this information and pointing out unusual events and compliance with the customer notification rules.

What is clearly lacking from the package is a comprehensive discussion of the Company's gas procurement plan for the coming year, including purchases it plans to make from each basin, the price assumptions, the annual and peak day demand it forecasts, the amount of pipeline capacity needed to meet peak demand, the utilization of gas storage versus winter purchases, the short term and long term price hedging strategies, the expected cost of hedging versus spot market prices and other gas procurement strategies to minimize the cost of gas to customers. This discussion should be supported by detailed volume and cost schedules. Without this information it is not possible for Staff, Public Counsel and other parties, who have an interest in these proceedings, to adequately assess that the proposed PGA rates and WACOG are reasonable and in the best interest of customers.

The current concern with the amount of hedging losses accumulated by Washington gas utilities has highlighted the fact that gas procurement issues have not had sufficient visibility and scrutiny. The hedging issue would not have been a surprise in recent months if a more rigorous regulatory oversight process would have been in place.

Deferred Gas Cost Account Adjustment Filings – A similar concern must be voiced with regard to the gas cost deferred account reconciliation process. From what we have observed, the process is merely an accounting reconciliation. The actual costs included in the account do not undergo any significant regulatory oversight to ensure the amounts and the Company decisions that created those costs were reasonable, prudent and in the best interest of the gas utility customer. The Commission rules and regulatory process do not seem to contemplate a rigorous review. Unlike rate case filings where the Staff and intervenors perform considerable discovery and due diligence reviews, the PGA costs are not reviewed with the same rigor.

Additionally, there is not an easy mechanism for the Company to increase the PGA rate during the current year to recover higher gas costs or reduce the rate to pass through to customers lower gas costs in a timely fashion. For example, by September 2012, the Company had over collected gas costs and was deferring $37.5 million of refunds. In September 2011, the amount of over-recovery was $10.5 million. On the other hand, in September 2010, the Company had an accumulated under-recovery of $8.4 million to be amortized and billed to customers in the following year.[17]

The current procedure defers refunding or surcharging gas costs from the current year, when the costs were incurred, to the following year. This delay potentially shifts the responsibility of gas costs to customers who did not take service in the prior year and now either pay for costs they should not be paying or benefit from a refund of costs they never paid. According to the Company, during the 2011-2012 PGA year, 154,968 customers disconnected service and 158,710 customers initiated gas service. Each year, the Company has a significant number of customers who disconnect service and move out of the service area. Likewise, a number of customers relocate or begin service in the utility's service area. This turnover in customers reinforces the point that PGA costs and adjustments need to occur as much a possible during the same year.

[17] PSE Response to Public Counsel Informal Data Request No. 13.

V. Recommendations

Our initial findings and analysis supports the following preliminary conclusions and recommendations:

1. The Commission should consider disallowing recovery of **[Begin confidential]** XXXXXXX **[End confidential]** from gas costs included in the current Deferred Gas Cost Account. As explained in greater detail earlier in this report, we base this conclusion on the fact that the Company entered into fixed price financial hedges from **[Begin confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXX, **[End confidential]** when clear evidence existed from prior months that cash spot market prices were much more advantageous than forward hedge prices.
2. The Commission should order the Company to reduce the Deferred Gas Cost Adjustment tariff rate to reflect the disallowance.
3. The Commission should order the Company to suspend entering into any new hedging transactions until it has received recommendations from Staff, Public Counsel and other parties on an appropriate hedging program in collaboration with the Company.
4. The Commission should order Staff to organize and lead a Technical Collaborative with the Company and Public Counsel. The purpose of the Collaborative is to develop recommendations to the Commission on appropriate price hedging guidelines, policies and technical aspects of an effective hedging program, including percentages of the gas supply to be hedged, the length or window in which to hedge and acceptable hedging tools to minimize hedging costs.
5. In conjunction with or separately from the investigation in the current docket, the Commission should undertake a rule making process to modify and strengthen the PGA initial filing requirements and the subsequent gas cost reconciliation. The Commission should include the following objectives in initiating a new rule making for the PGA in order to achieve more uniformity:
    a. The annual PGA filing should include testimony that describes the entire gas procurement plan in detail and with exhibits identifying sources of supply, short and long term gas purchase arrangements, forecasted pricing, price hedging strategies, pipeline transportation arrangements and cost, gas storage utilization plans, gas sales forecast including peak day demand and plans on how to meet that peak demand.
    b. The PGA filing should also include a forecast of gas costs, sources and strategies for the subsequent four years. This longer term forecast would provide an early warning of events that could significantly affect gas prices.

c. At the end of the PGA year, the Company would file a gas recovery reconciliation case presenting testimony to explain its actual gas supply procurement decisions and costs with detailed cost schedules and exhibits.

d. Both the PGA filing and Cost Gas Recovery reconciliation proceedings should be contested cases similar to a rate case, but on a more expedited schedule, to ensure transparency and a full assessment of the prudency and reasonableness of the utility gas supply purchase decisions.

e. The PGA rate could be adjusted at least quarterly, if needed, to reflect changes in actual versus forecasted gas costs. This would insure customers get charged for gas costs in the year incurred and not in subsequent years as currently done with the deferred gas cost account.

These recommendations will result in more robust and transparent regulatory oversight to ensure gas costs have been appropriately reviewed by the Commission and found to be reasonable and prudently incurred. A more robust and transparent process also will give customers renewed confidence that the largest cost component of their gas bills is receiving sufficient scrutiny and appropriate oversight by the Commission.