



## Energy Services Department

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State of Washington  
Utilities and Transportation Commission  
1300 S Evergreen Dr SW  
PO Box 47250  
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Re: Docket UG-132019

Dear Commission,

This is the City of Ellensburg's (Ellensburg) response to your inquiry regarding natural gas hedging practices and transaction reporting dated December 18, 2013. While Ellensburg does not fall under the UTC's jurisdiction related to retail rates we felt it was important for the UTC to hear from the largest municipally owned natural gas utility in Washington State.

### 1) Hedging Activities

- a) **What is the purpose of Hedging?** Reducing risk of price volatility. For Ellensburg hedging provides rate stability for our end user customers. We target 50% of our winter purchases to be under firm contracts or hedged, leaving the balance of our purchases on the spot market. This methodology is a good balance between a fixed price supply and the spot market.
  - i. **Reduction in price volatility allowing greater cash-flow certainty?** That is true to the utility. With firm contracted gas you know exactly what it costs unlike spot market gas with its large swings in price.
  - ii. **Protection against the substantial rate hikes?** This past December is a classic example of substantial price hikes. The first six days of the month spot market prices at the Sumas receipt point were averaging \$4.46 per MMBTU. A cold front dropped temperatures and increased region wide natural gas demand on the 4<sup>th</sup>. Temperatures dropped further on the 7<sup>th</sup>, which combined with a few days of high demands spiked the spot market at Sumas to \$11.00 per MMBTU for 3 days. The balance of December prices averaged \$4.68 per MMBTU. In December Ellensburg's supply portfolio was 47% hedged, 39% spot market and 13% pre-purchased storage gas. Average weighted cost of gas in December was \$5.82 per MMBTU delivered to our 'City Gate'.

If we did not have hedging as a purchasing option at our utility the average weighted cost of gas would have been \$6.57 per MMBTU and would have required a 5% retail rate increase.

- iii. **Stabilization of customer rates, especially during the winter months?** The ability to hedge natural gas supply (if properly executed) provides rate stability in the winter months for end users.
  - iv. **Other reasons?** It provides budgeting information to Ellensburg's large customers such as Central Washington University, and they have an idea of what to expect for their natural gas costs in advance.
- b) Who should be the beneficiaries of hedging?** Without question, the end users. At Ellensburg our retail rates reflect the actual cost of purchased natural gas each month. Ellensburg rates change slightly each month following variations in the cost of gas but end users directly benefit from hedging activities.
- c) Hedges are commonly negotiated for a fixed period of time; the time period can span from months to years.**
- i. **Is there a sound reason to limit the time horizon that companies contract for a hedge?** There are multiple parties involved in any commodity transaction. The further out in time a purchase is made the more the selling and financial parties are going to cover their risk. For example at the end of December spot market prices at Sumas were \$4.43 per MMBTU, January to March delivery contract gas was \$4.62 per MMBTU. There is still some risk of another cold front driving demand and prices up before the end of March so counterparties are covering that risk with a \$0.19 per MMBTU premium. It is not fiscally responsible to pay a premium to lock in a price for much beyond 3 to 5 years in our opinion.
  - ii. **If so, what should be the maximum time horizon?** Each utility will have a slightly different purchasing strategy, so a one size fits all approach would be difficult to apply across the board. In some parts of the country gas utilities will sell bonds and make 20 year gas purchases just so they have it done and out of the way. Most Washington investor owned utilities natural gas utilities do not hedge as they have no incentive to do so. Natural gas fired power generation utilities will make hedges to stabilize power rates with a typical approach of 1 to 3 years out with some going as far as 5 years.
  - iii. **What are the advantages, if any, of hedging over a multiple year period?** Purchasing an energy commodity with a goal to reduce price risk is difficult at best. It is a volatile market with outside forces influencing pricing beyond the control of any utility. A multiyear hedging strategy allows a utility to make multiple purchases and avoid the risk of buying at the top of a price curve. Even at Ellensburg, a very small utility, we make multiple hedges for each years' delivery and average the cost of those purchases into our retail rates.
- 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.**

- i. **Is there a need for the Commission to limit the percentage of load hedged and, if so, what should be the maximum percentage?** This should be up to the individual utilities governing body not the UTC.
  - ii. **What are some of the factors affecting the amount of hedging that a utility should do?** Natural gas that is contracted for future delivery will almost always cost more than natural gas in a stable spot market. The purpose of hedging is to reduce exposure to the volatility of the spot market. Each utility must determine how much exposure to that volatility they are willing to accept and therefore how much hedging they will do to mitigate that risk.
  - iii. **When discussing target percentages, should the Commission distinguish between physical and financial hedging?** Yes. The Commission needs to do its background on the Dodd-Frank Act. The U.S. Commodity Futures Trading Commission has very robust oversight and comprehensive regulations that governs the commodity marketplace to lower risk, promote transparency and protect the American public. This is new for commodity traders and utilities and has added complexity to the Base Agreements needed to purchase energy. The U.S. Commodity Futures Trading Commission will take precedence over the State UTC in these matters so do your homework. In general utilities should only use physical hedging because they need to take delivery of the product for their end users. Financial hedging relies more on banks and has more risk associated with it. Physical hedging is done to provide rate stability to end users not make a profit, or loss, in the financial market place.
  
- 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?** Yes. Utilities should be allowed to pass the gains as well as the differences (losses) associated with a company's hedging practices on to their end users.
  - i. **What should be the benchmark?** The purchasing plan of least risk is for a utility's supply would be 100% on the spot market or monthly index. Most utilities have several pricing points but they could be averaged for a benchmark to use as a comparison to hedging activities.
  - ii. **What are the challenges in developing an incentive mechanism?** For the UTC it would be an administrative effort to monitor pricing to verify what the utility's accomplish with their hedging practices. Prices change hourly and there are several points to monitor so looking at a utilities purchases against a daily midpoint price index of the spot market would require a tremendous effort on the UTC's part. You're looking at a field where a lot of money is made every day by those who are good at it, so you will need to be just as good at monitoring it to control it.
  
- f) **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 performance?** Anything is feasible provided enough money is spent to properly design and implement it.
  - i. **Assuming the Commission decides to establish requirements or set limitations on hedging, as discussed above, by what means should the**

**Commission act?** Ellensburg is not experienced with how the Commission establishes process. In this case, however, we would hope there would be input from the utilities' affected in an equitable process.

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

**Although purchased gas cost 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 the inquiry to examine certain aspects of the PGA filing requirements as they relate to hedging.**

**a) Washington companies file adjustments to their PGA mechanism 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.**

- i. Should the Commission require more frequent PGA filings, such as semi-annually, quarterly or even monthly?** Ellensburg is a municipal utility whose rates are not governed by the UTC. Our rate structure is set by our elected City Council and consists of three components; monthly purchased gas cost, a fixed distribution charge, and a fixed monthly customer charge. So Ellensburg essentially does a monthly PGA for our rates. This is not a burden and accurately reflects the cost of gas each month. We do this to avoid being in the position of playing catch up with purchased gas costs as our fellow investor owned utilities are. If the Commission is truly wanting to pass the value of hedging thru to the end users, a monthly PGA would more accurately accomplish that goal.
- ii. If companies make more frequent, to what extent should the companies provide addition supporting data and narrative above those already provided in its annual filing?** Ellensburg rates are not regulated by UTC so we are not familiar with annual filings or what data is included in them. Therefore we have no comments.

**b) Should the Commission consider a uniform PGA reporting standard allowing for:**

- i. Comparability of data?** Yes, it would be important to have the same format in reports and data.
- ii. Staff effectiveness and efficiency?** Hedging is not a science and does not have a right or wrong way to accomplish the goal of reducing risk. It is more an art with a projected optimal solution that requires some experience, understanding of the energy commodity market, what drives it and historic market trends. There is not a perfect way to purchase the least expensive natural gas only one that is acceptable to each entities governing body. Certainly some organizations will be better than others at hedging but what would the Commission do about that? Without hedging rate payers will suffer the volatility of market conditions.

In summary the U.S. Commodity Futures Trading Commission has new regulatory authority as a result of the Dodd-Frank Act affecting natural gas utilities gas purchases. Today Washington (and Oregon) State investor owned utilities have no incentive to hedge natural gas purchases and simply pass the cost of gas purchased on to their consumers. It is the least risk for utilities, however it exposes the consumers to all the market volatility. It would be nice to offer some incentives for properly executed hedging of natural gas purchases to help reduce and stabilize rates to the end users.

Respectively submitted,

A handwritten signature in blue ink that reads "Shan Rowbotham". The signature is written in a cursive, slightly slanted style.

Shan Rowbotham  
Power and Gas Manager  
City of Ellensburg

Cc: Larry Dunbar  
Darren Larsen