Before the Washington Utilities and Transportation Commission

Report on Natural Gas Procurement Practices of Northwest Natural Gas Company

Docket UG-121434

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 Northwest Natural Gas 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 of Northwest Natural Gas 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 NWN 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 NWN 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.
- Analysis on the cost and effectiveness of the hedge program.

[1] *WUTC v. Northwest Natural Gas Company*, Docket UG-121434, Order 01 (October 31, 2012).

- 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 $8.2 million applicable to Washington customers.
3. We estimate that over the 10 year period from 2003 to 2012 the Company's hedging program has resulted in a cumulative higher cost of gas to Washington retail gas customers of approximately $29 million.
4. NWN's hedging strategy of locking in gas prices up to **[Begin Confidential**] XXX XXXX **[End Confidential**]before the gas is actually needed has not significantly reduced PGA rate volatility.

5. The 51% of total gas supply that the Company has recently hedged has declined from prior years but may still be relatively high. A high percent of hedging of the gas supply portfolio has not proven to have been beneficial to customers during the most recent 6 years.
6. The Company has continued generally on the same path of locking in fixed prices 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 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 at least **[Begin Confidential**] XXXXX **[End Confidential]** from recovery of 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 **[Begin Confidential]** XXXXXXXXXXXXXXXXX **[End Confidential**] the start of the 2011-2012 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 Account Balance and the 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 participation 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 a more robust and transparent regulatory oversight process 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 Northwest Natural Gas Company

Northwest Natural Gas Company is a natural gas local distribution and storage company headquartered in Portland, Oregon. At the end of 2012, NWN served about 686,000 customers in Oregon and southwest Washington, including the Portland-Vancouver metropolitan area, the Willamette Valley, the Oregon coast and the Columbia River Gorge. Approximately 90 percent of the company's customers are in Oregon, with the balance in southwest Washington.

In 2012, NWN had retail gas sales of 1.1 billion therms and utility revenue of $700 million. On an annual basis, residential and commercial customers typically account for about 50% to 60% of the utility's total volumes delivered and about 80% to 90% of its margin, while industrial customers account for the remaining 40% to 50% of volumes and about 5% to 15% of the utility margin. The remaining 10% or less of utility margin is derived from miscellaneous services, gains or losses from an incentive gas cost sharing mechanism and other service fees.

NWN purchases natural gas for its core market from a variety of suppliers in the western United States and Canada. Supply points include the NOVA Inventory Transfer (NIT) point in Alberta, Canada (also referred to as AECO), Huntingdon/Sumas and Station 2 in British Columbia, Canada, and multiple receipt points in the U.S. Rocky Mountains. Currently, about 71% of the gas supply comes from Canada, with the balance coming primarily from the U.S. Rocky Mountain region.

The Company has pipeline agreements with Northwest Pipeline for firm transportation capacity providing access to natural gas supplies in British Columbia and the U.S. Rocky Mountains through pipeline connections with Northwest Pipeline and GTN systems in Oregon.

The Company operates gas storage facilities in its service territory, contracts for additional gas storage outside its service territory, and provides gas storage services to other energy companies in the Northwest. In addition, the Company operates an underground gas storage facility in central California, near Fresno.

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

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 three primary supply sources: the AECO Hub, the Station 2/Sumas Hub, and the Rockies area basin.[2] The AECO Hub accounted for 40% of the total purchases with the Rockies basin and Station 2/Sumas Hub supplies at 37% and 22%, respectively. The remaining 1% is from miscellaneous sources. The AECO and SUMAS supplies are imported from Canada. These two sources make up 77% of the total supply. Information provided by the Company for prior years shows that the mix of supply has remained relatively constant.

The Company reported that for spot market purchases it uses mainly monthly 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 generally buys all its gas supplies at index/spot market prices and then uses financial price hedging tools to lock a fixed price. The use of fixed price hedging will be described below.

Price Hedging Policies and Strategies – The Company has employed price hedging strategies since 1995 with the objective of locking in a fixed price for a percentage of its gas purchases. Under its current [**Begin Confidential**] XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.[4] XXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

[2] NWN Response to Staff Informal Data Request No. 3.
[3] NWN Response to Public Counsel Informal Data Request No. 15.
[4] NWN Response to Staff Informal Data Request No. 6 (confidential).

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX[5] [**End Confidential**]

The Company's recent gas hedging strategy has been to hedge only in the range of 50% to 60% of the contracted physical supplies for the upcoming year.[6] Prior to the 2006-2007 PGA year, the Company hedged as high as 88% of its gas purchases.[7]

The typical means for hedging until recent years has been through the use of financial swaps and option contracts. The Company prefers these financial tools instead of physical fixed price gas purchase contracts because it sees an increased risk with physical contracts. In case the supplier cannot deliver the fixed price gas, the Company would be exposed both on the fixed price and the need to buy gas in the spot market. NWN prefers to separate the physical delivery from the price hedging into two transactions with the use of financial hedges.[8]

Since 2007, the Company has also used more complex and sophisticated hedging techniques, such as 3-way costless collars, synthetic puts, swap/calls and extendible swap options.[9] It appears the objective of these additional hedging tools is to limit large gains and losses during periods of high volatility in natural gas prices. From the information provided, it is not clear if these additional hedging tools have been beneficial in reducing hedging losses.

Oversight of the Company's gas supply strategy is the responsibility of the Gas Acquisition Strategy and Policies Committee, which is headed by the Company's president and has representatives from supply procurement, regulatory and financial areas.

For the 2011-2012 PGA year, the Company fixed the price on approximately 51% of its gas purchases using almost entirely financial swap price hedges. A review of the fixed price hedges entered into for the 2011-2012 PGA year shows that financial swaps were entered into as early as [**Begin Confidential**] XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXX [**End Confidential**] per Dth. Those transactions for [**Begin Confidential**] XXXXXXX XXX [**End Confidential**] settled at a price of between [**Begin Confidential**] XXXXXXXX [**End Confidential**] or nearly 50% below the fixed price.[10] Overall, for the 2011-2012 PGA year, fixed price hedges were locked in at an average price of [**Begin Confidential**] XXX [**End Confidential**]per Dth.[11] In comparison, spot market prices for the period averaged $2.26 per Dth.

Results of Price 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 $299 million system-wide. Washington customers absorbed about $29 million of this amount. Table 1 shows the gains and losses from financial hedges over the time period.[12]

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[5] *Id*.
[6] NWN Response to Staff Informal Data Request No. 12.
[7] *Id.*
[8] NWN Response to Public Counsel Informal Data Request No. 18.
[9] NWN Response to Public Counsel Informal Data Request No. 21.
[10] NWN Response to Public Counsel Informal Data Request No. 22, Confidential Support Detail.
[11] *Id.*
[12] NWN Response to Staff Informal Data Request No. 18.

Although prior to the 2006-2007 PGA year, the Company reported consistent hedging gains, it is instructive to note that the Company incurred financial hedging losses in five of the most recent six years.

Table 1

NWN System-Wide Financial Gains & Losses[13]

Period	Financial Hedges Net Gains & (Losses) ($millions)
11/1/02 - 10/31/03	$ 37
11/1/03 - 10/31/04	25
11/1/04 - 10/31/05	63
11/1/05 - 10/31/06	24
11/1/06 - 10/31/07	(36)
11/1/07 - 10/31/08	4
11/1/08 - 10/31/09	(219)
11/1/09 - 10/31/10	(51)
11/1/10 - 10/31/11	(61)
11/1/11 - 10/31/12	(85)
Total	$ (299)

Off-System Gas Sales – In balancing natural gas retail load requirements with resources, the Company likely engages in off-system sales of natural gas (gas marketed outside NWN's service territory). Generally, these sales occur when actual customer loads fall below forecasted levels and excess gas supply must be disposed of. It is not clear from the information provided to what degree the Company engages in off-system sales transactions.

Also, it is not known 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 more than 50% 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 filing requirements and Deferred Gas Cost tracking process do not allow an opportunity to scrutinize these transactions to ensure they are reasonable, prudent and necessary.

Pipeline Transportation and Storage Capacity – The Company plans for sufficient pipeline and storage 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

[13] NWN Response to Staff Informal Data Request No. 18. Applying NWN's allocation factor of 9.64% results in losses of about $29 million for Washington.

economic value and partially offset natural gas costs, most gas utilities will release pipeline capacity in the open market and earn fees.

The Company has an arrangement with an independent energy marketing company to provide asset management services for optimization of its storage and transportation capacity.[14] NWN credits a portion of fees generated by the asset management company to Washington customers through the annual PGA filing each November.

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 Account Balance 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

NWN Hedging Policy Objectives – In response to a question posed by Public Counsel, the Company answered that it follows a gas procurement strategy to (1) minimize the cost of gas to customers over time and (2) provide gas price stability in order to maximize customer satisfaction.[15]

The losses from financial hedging over the past 10 years clearly indicate that these objectives have not been met. The Company has not minimized gas costs for NWN customers. To the contrary, my analysis shows that the Company has incurred large losses in the past four years 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 2 below shows that PGA rates, including the annual deferred account cost adjustments, have varied significantly. The accompanying line graph in Table 3 shows clearly the year over year volatility in the combined PGA rate.

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[14] NWN 2012 annual report on Form 10-K.

[15] NWN response to Public Counsel Informal Data Request No. 17(e).

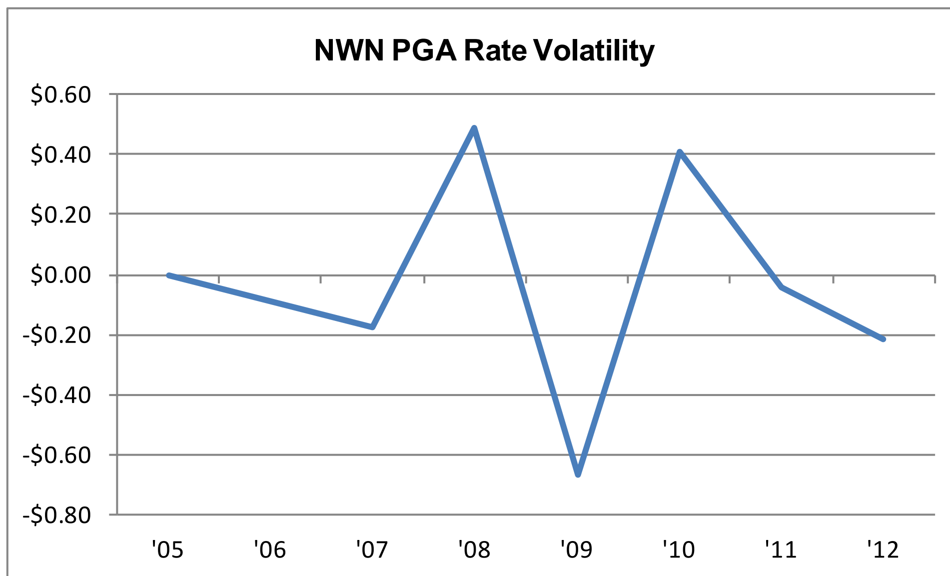
Table 2

NWN PGA Rates in ¢ Per Therm (Residential Service)

Date	PGA WACOG*	PGA Adjustment*	Total PGA Rate	Percent Inc. (Decr.)
10/1/2005	74.371	15.809	90.180	-
10/1/2006	77.060	5.210	82.270	-9%
11/1/2007	71.915	(4.292)	67.623	-18%
11/1/2008	86.464	14.254	100.718	49%
11/1/2009	59.654	(26.164)	33.490	-67%
11/1/2010	53.365	(6.100)	47.265	41%
11/1/2011	49.539	(4.321)	45.218	-4%
11/1/2012	38.659	(3.236)	35.423	-22%

* NWN Response to Public Counsel Informal Data Request No. 28.

Table 3



If we consider the combination of high hedging losses and PGA 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.[16]

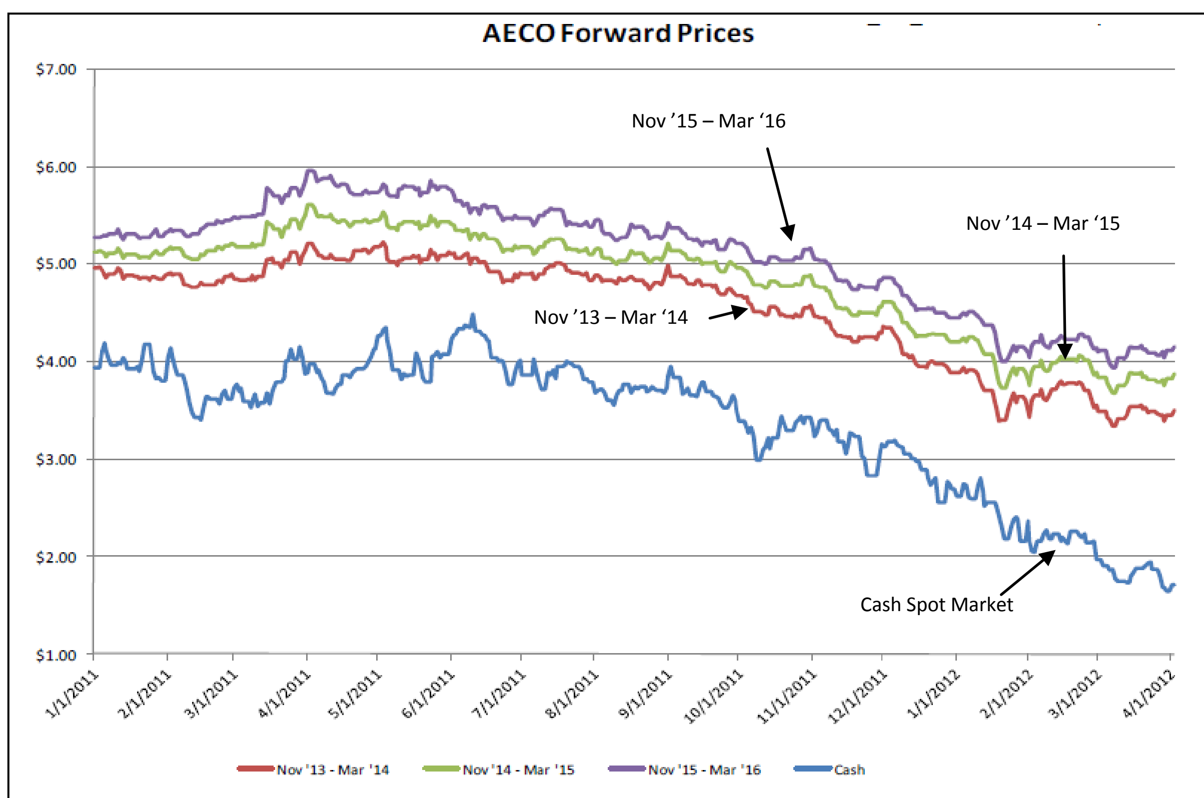
[16] NWN Response to Public Counsel Informal Data Request No. 25

The response focused on technical and administrative improvements. While these improvements were worthwhile, the response did not address the core issue of why, with larger losses beginning to pile on from the 2008-2009 PGA year, did the Company not take 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 its gas purchases by locking in fixed prices at generally the same level for the upcoming years. In my opinion, this was a very imprudent decision.

The following graph in Table 4 clearly shows the large gap between the AECO forward prices and the cash spot market price during 2011 and early 2012. This information was certainly available to the Company and should have given management a reason to pause on any further hedging for the upcoming years.

Table 4



Nevertheless, the Company continued to hedge for the coming year (prompt year). In response to a data request, the Company provided information that it had placed fixed price hedges as recent as three months before the start of the 2011-2012 PGA year. [17]

[17] NWN Response to Staff Informal Data Request No. 13.

Appendix B (Confidential) shows the price hedges on **[Begin Confidential]** XXXXXXXXX **[End Confidential]** of gas purchases that the Company put in place from **[Begin Confidential]** XXXXXXXXXXXXXXXX **[End Confidential]** for the 2011-2012 PGA year. The appendix also shows the unrealized hedge losses each month from **[Begin Confidential]** XXXXXXXXX XXXXX **[End Confidential]** on these purchases. The unrealized losses are depicted graphically in Table 5 below. As shown, the Company would have been aware that unrealized hedge losses were in a range of **[Begin Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXX.

Table 5

TABLE: CONFIDENTIAL

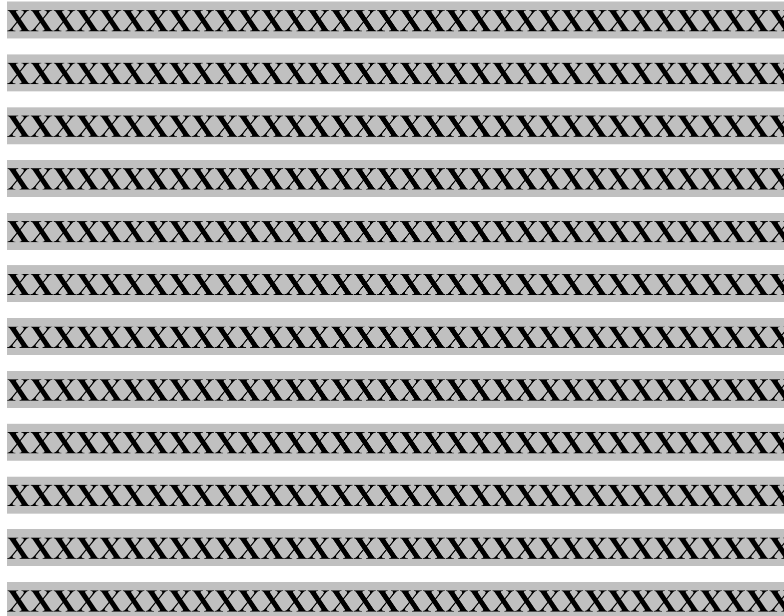


TABLE: CONFIDENTIAL

[End Confidential]

Disallowance of Gas Costs – Despite clear evidence that spot market prices were significantly below forward hedge prices as depicted in Table 4, the Company decided to hedge an additional **[Begin Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[End Confidential]** for future periods spanning **[Begin Confidential]** XXXXXXXXXXXXXXXX XXXXXXXXXXXXX **[End Confidential]** per Dth.[18] In comparison, the index/spot market price for those months in the **[Begin Confidential]** XXXXXXXXXXXXXXXXXXX **[End Confidential]** per Dth lower. The result of entering into these hedges was an additional cost to customers of approximately **[Begin Confidential]** XXXXXXXXXXXXXXXXXXXXXXXX XXXX **[End Confidential]** is applicable to Washington customers. Appendix B (Confidential) shows this calculation.

[18] NWN Response to Public Counsel Informal Data Request No. 22, Confidential Support Detail.

In my opinion, the Company was imprudent in proceeding with fixing the price on **[Begin Confidential]** XXXXXX **[End Confidential]** of gas purchases **[Begin Confidential]** XXX XXXXXX **[End Confidential]** the beginning of the 2011-2012 PGA year. Although the Company also reported losses from hedges put in place in prior months and 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 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]** XXXXX **[End Confidential]** from recovery of gas costs from the Company's deferred gas cost account, 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 it is not necessarily advantageous to hedge a large percent of the supply portfolio or begin hedging multiple years before the gas is needed.

NWN can reduce the percent of gas supply hedged and also shorten the hedging window from **[Begin Confidential]** XXXX **[End Confidential]** to less than one year and 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 important questions with regard to pipeline transportation and storage 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 date of the 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 Gas Cost Account 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 the 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. Frequently, the Company will defer millions of dollars of unrecovered or over-recovered gas costs into the following year.

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. 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.

V. Recommendations

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

1. The Company's gas price hedging program has resulted in large losses and higher cost of gas for retail customers.
2. The hedging strategy of locking in gas prices up to three years or more before the gas is actually needed has not significantly reduced PGA rate volatility.
3. The percent of gas supply hedged is high and has not proven to have been beneficial to customers over the past 10 years.
4. The Company has continued generally on the same path of locking in fixed prices even in the face of mounting hedging losses and significantly above market fixed price hedges.
5. The Commission should consider disallowing at least **[Begin Confidential]** XXXXX **[End Confidential]** from recovery of gas costs included in the current deferred account balance and order the Company to reduce the Deferred Gas Cost Adjustment tariff accordingly.
6. 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.
7. The current PGA and Deferred Gas Cost Adjustment filing requirements do not provide sufficient scrutiny of gas procurement practices and early warning of potentially costly strategies, such as price hedging, which may harm customers.
8. The Commission should order Staff to organize and lead a Technical Collaborative with the participation of the Company and Public Counsel. The purpose of the Technical Collaborative is to develop recommendations to the Commission on 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.
9. The Commission should undertake a rule making process to modify and strengthen the PGA initial filing requirements and 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 in PGA filings for all gas utilities:
    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.

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 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.

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