PUGET SOUND ENERGY
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March 19, 2013

VIA WEB PORTAL AND OVERNIGHT MAIL

Mr. Steven V. King, Acting Executive Director and Secretary
Washington Utilities and Transportation Commission
P.O. Box 47250
Olympia, Washington 98504-7250

Re: Docket UG-121569 2012 Purchased Gas Adjustment

Dear Mr. King:

On September 26, 2012 Puget Sound Energy ("PSE") filed its annual Purchased Gas Adjustment ("PGA"), which included proposed rates for projected gas costs and deferred gas costs, with the Utilities and Transportation Commission ("Commission"). At its October 25, 2012 open meeting, in response to the Commission Staff's ("UTC Staff") recommendation, the Commission allowed the proposed rates to go into effect on a temporary basis subject to revision, and ordered the UTC Staff to begin an investigation of PSE's books accounts, practices and activities related to purchased gas costs. The Commission took similar actions with respect to three other natural gas utilities in Washington State. On March 1, 2013 UTC Staff filed its report related to the investigation. On March 1, 2013 and March 8, 2013, Public Counsel filed letters related to this proceeding.

PSE offers the following comments in response to UTC Staff's report and Public Counsel's recommendations.

UTC Staff Recommendations and Schedule Concerns
PSE supports UTC Staff's recommendation that the tariff suspension be lifted and the rates in effect November 1, 2012 be made permanent. PSE also supports the development of guidelines related to gas procurement practices and will participate in workshops and other proceedings established by the Commission.

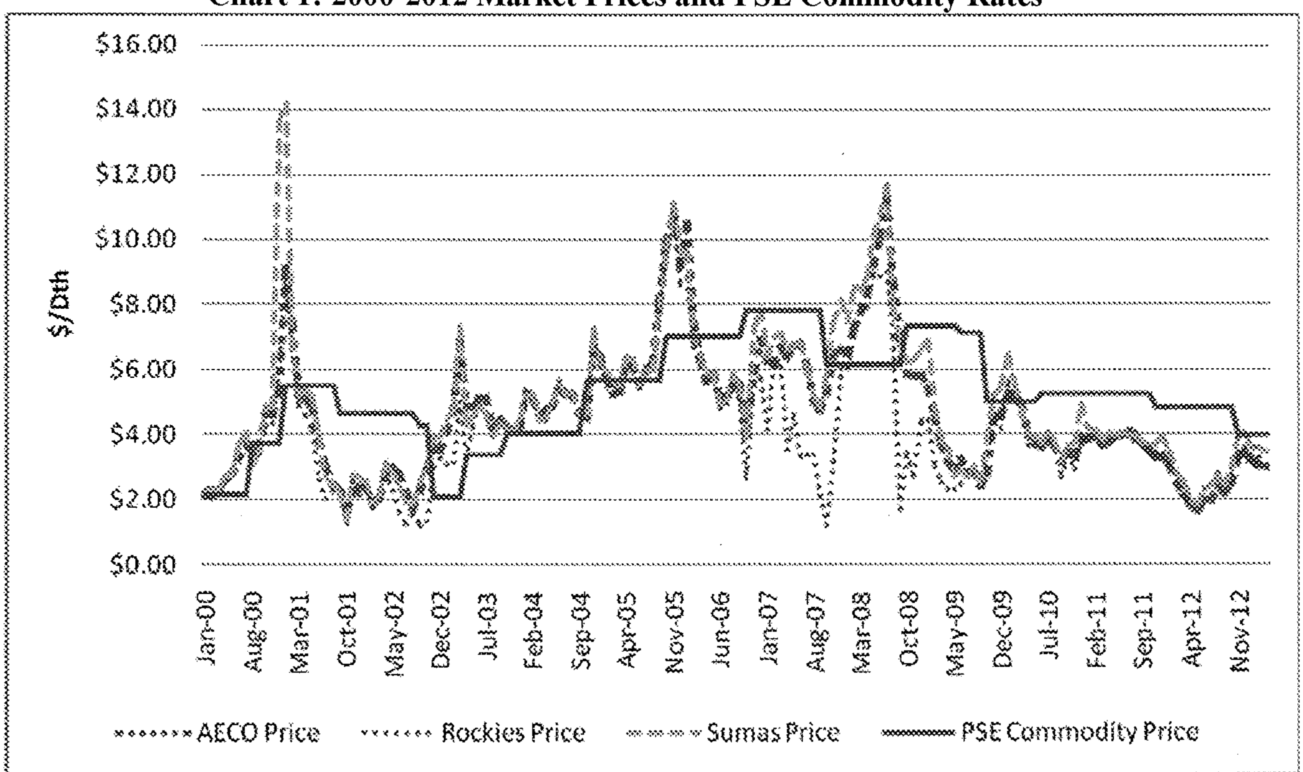
All four Washington natural gas utilities typically propose PGA rate changes effective November 1. This requires that the analysis be completed in September and filed by October 1. Guidelines that are developed in workshops or a rulemaking should apply to transactions entered into after those guidelines are established. Gas purchase transactions that are made prior to establishment of permanent guidelines should be judged in accord with each utility's existing policies related to gas purchases, unless the Commission issues specific guidance applicable to hedging activities during this interim period.

Hedging Program

The UTC Staff report focused on the gains or losses from financial hedges. A discussion of the costs and benefits of hedging should include consideration of physical as well as financial hedges. Focusing only on financial transactions is limited and does not present the full picture of hedging practices. The benefits of hedging should not be viewed as a calculation of profit or loss on hedge transactions. It is more appropriate to view the benefits of hedging as a narrowing of the distribution of potential price outcomes through time. By definition, hedging eliminates the lower probability extreme events (high and low price outcomes) and increases the price certainty of the portfolio.

Public Counsel argues that PSE's PGA rates are volatile, and presents percentage changes to PGA rates as evidence in Table 4 of its March 8 letter. PSE's rates are not as volatile as Public Counsel indicates when compared with market prices. Chart1 presents first-of-month index prices from three basins, AECO, Rockies and Sumas, and the commodity rate charged to PSE customers including deferred commodity costs. Chart 1 illustrates that PSE rates increased in steps between 2000 and 2009, then steadily declined. It also illustrates that because of PSE's procurement practices, customers have not paid the market high prices of $12-14 / Dth, nor have they paid the lowest market prices. PSE's procurement practices have achieved both relative price stability for customers when compared with market prices, and declining prices over time. The stability seen in PSE's rates in Chart 1 is not simply a function of the current annual PGA process where prices change only once per year and rates are stable in between rate changes, as observed by UTC Staff. It is also a function of PSE's procurement practice of hedging a portion of the portfolio and leaving an open position.

Chart 1: 2000-2012 Market Prices and PSE Commodity Rates



PSE's hedging program recognizes that market prices can be volatile and takes a dollar-cost averaging approach to gas purchases to help insulate customers from price volatility. This means that customers do not experience either the high extremes or low extremes of market prices. When hedges are used in declining price markets, average costs are above the latest market prices, and in increasing price markets, average costs are below the latest market prices. The decline in market prices in recent years due to unprecedented events such as the financial crisis and its effect on the economy, as well as the prolific development of shale gas, has resulted in market prices below the average costs obtained through PSE's portfolio approach to gas purchases. This does not mean that the price stability provided by hedging should be disposed of entirely and abruptly. A good example of the volatility and uncertainty in natural gas prices is contained the WUTC's consultant's report where it states that the natural gas market "term structure stayed largely contango other than for seasonal conditions." In other words, the natural gas market over the November 2009 – November 2011 period displayed higher commodity prices in the forward price curve as compared to the current spot price. During this period it wasn't until roughly three months prior to delivery that the market price declined relative to the previously hedged price.

PSE customers have expressed risk aversion related to market prices and a preference for price stability over capturing the lowest market prices. PSE's approach to gas purchases was developed with customers' preferences in mind. It combines programmatic hedging for a portion of the portfolio with an open position that allows PSE to take advantage of declining market prices. The program has been modified over time to respond in a disciplined fashion to changing market realities.

To halt hedging altogether would be speculative, taking a position based on the assumption that gas prices will remain low. This action would leave customers more exposed to market prices and could easily backfire should market conditions change and prices rise. Therefore Public Counsel's recommendation that hedging activity be immediately halted should be rejected.

Should the Commission order PSE to immediately cease hedging activities as recommended by Public Counsel, such order needs to include a clause to hold PSE harmless for the increased exposure to market prices that would result from suspension of hedging activities.

Current Outlook

PSE's current PGA rate outlook looks stable. There are hedges in place at prices very close to the commodity costs in rates today. For the November 2013 – October 2014 rate year, the average hedge price is \$4.41/Dth and the weighted average forward market price is \$3.94[1]. For the November 2014 – October 2015 rate year, the average hedge price is \$3.91/Dth and the weighted average forward market price is \$4.04. This will protect customers should market prices rise, and the open position will allow PSE to take advantage of lower costs should prices again decline.

PGA Process

Adequate information for review can be provided through the current PGA process. WAC 480-90-233 requires that utilities include PGA procedures in their tariffs, and the PSE tariff describes

[1] Based on official price marks on March 15, 2013, weighted by volumes hedged by PSE by basin.

the costs that are allowed for inclusion in the PGA. Workpapers that detail the cost components included in PSE's PGA along with assumed forward market prices are provided to UTC Staff every year when UTC Staff review the PGA. If UTC Staff wish to see more detail on transactions than they have reviewed in the past, PSE will certainly provide requested data. PSE also provides deferral account balances to the Commission every month as required by WAC 480-90-233. In addition, the establishment of guidelines as envisioned by UTC Staff will create greater transparency around hedging. The changes to the PGA filing requirements proposed by Public Counsel are unnecessary, unduly burdensome and should be rejected by the Commission.

Public Counsel's Recommended Disallowance

Public Counsel's recommendation that the Commission disallow certain costs should be rejected. As pointed out by UTC Staff, there are no guidelines or policy statements for utilities to reference when developing procurement plans, and the Commission has approved rates that included hedging-related costs and benefits in the past, at the recommendation of UTC Staff. PSE has a programmatic approach to hedging and has consistently adhered to that approach. To adhere to a policy only when it appears to be in the money, and deviate from the policy when it appears to be out of the money would be speculative, would negate the value of defining policies, and is against PSE's company policy. PSE provided updates on its hedging program to UTC Staff in 2002, 2004, 2007, 2008, 2009 and 2012. PSE has also fully cooperated with UTC Staff reviews of PSE's annual PGA filings, and provided copies of its annual filings to Public Counsel. Given these opportunities for Commission involvement over the years, to abruptly disallow costs based on Public Counsel's recommendation would be punitive and inappropriate.

Public Counsel argues that the net losses from hedges entered into between August 2011 and August 2012 for settlement in the February – November 2012 period should be disallowed.[2] Following is some information available to PSE staff at the time the transactions were executed.

1. The average spot market price for the parallel months in 2010 (February – November) had been $3.81 per Dekatherm (Dth)
2. The average spot market price for the parallel months in 2011 (February – November) had been $3.80/Dth
3. The commodity rate charged to customers was $5.62/Dth in August 2011 and changed to $5.08/Dth in November 2011.
4. The weather forecast indicated a cold winter was expected.
5. The forward price curve indicated that forward prices were higher than spot market prices.

The fixed prices of the transactions executed between August 2011 and mid-January 2012, part way through the winter, ranged from $2.69/Dth to $4.37/Dth with an average of $3.57. Nationally the winter turned out to be the warmest in over 100 years, which drove market prices below the fixed prices of the transactions in question. The net settlement of this first group of transactions was a loss.

Market factors changed as the winter progressed and expectations for a cold winter diminished. The winter had turned out to be warm, and market prices reflected the lack of weather-related demand and burgeoning amounts of gas in storage. The fixed prices of the transactions executed

[2] Even though Public Counsel indicates that its recommended disallowance includes only costs for the 2011 PGA year, November 2011-October 2012, the transactions listed in the calculated disallowance in Appendix B include transactions settled in November 2012, the first month of the current, 2012, PGA period.

between late January and August 2012 ranged from $1.72/Dth to $2.82/Dth with an average of $2.43/Dth. Due to fluctuations in market prices, some of these transactions ended up in the money, and some were out of the money. The net settlement of this second group of transactions was a gain.

It is easy to look back and point to hedge losses. However, when one examines the decisions made by PSE staff at the time, they were reasonable given the information available in the context of PSE's policies. PSE should not be penalized for purchasing gas at prices ranging from $1.72/Dth to $4.37/Dth given the information available at the time.

Please contact me at (425) 456-2110 if you have questions or I can be of assistance.

Sincerely,

Ken Johnson
Director, State Regulatory Affairs