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VIA ELECTRONIC FILING

Steven V. King
Executive Director and Secretary
State of Washington Utilities and Transportation Commission
1300 S. Evergreen Park Drive SW
P.O. Box 47250
Olympia, Washington 98504-7250

RE: Docket UG-132019: NW Natural's Comments - Inquiry into Local Distribution Companies' Natural Gas Hedging Practices and Transaction Reporting

Introduction

Northwest Natural Gas Company ("NW Natural" or the "Company") submits these comments in response to the notice issued April 11, 2016, inviting written comments on the topic of natural gas hedging and hedging practices, and the questions provided in that notice as they relate to the risk management approach proposed by Michael Gettings, Senior Partner, RiskCentrix, LLC in his July 2015 White Paper "*Natural Gas Utility Hedging Practices and Regulatory Oversight*" (the "White Paper"). We appreciate this additional opportunity to provide information and our views for the Commission's consideration of this complex and important topic. The Washington Utility and Transportation Commission's ("Commission") investigation into these issues has been a welcome process, and the Company values and appreciates the insights from Mr. Gettings and all of the parties in this docket.

NW Natural is committed to developing a comprehensive hedging program that complies with the Commission's resolutions of the issues in this docket. The Company views the White Paper as a high-level guide for aspects of a utility hedging program, but we do have concerns and continuing questions regarding how the White Paper would be distilled into a regulatory framework that allows each utility to tailor its hedging program to the specific dynamics of its unique market presence. NW Natural would urge the Commission not to develop overly prescriptive rules for hedging, and instead allow the utilities to develop and adopt programs that align with a Commission policy statement or guidelines for hedging. Striking the right balance on these issues should also be an iterative process that all parties are engaged in. For this reason, NW Natural encourages the Commission to continue the collaborative process in this docket as the Commission approaches a resolution. One possibility could be for the Commission to issue a proposed policy statement or proposed guidelines for hedging and invite comments and reply comments to that regulatory proposal, so that the parties have an opportunity to address a specific regulatory proposal rather than a more conceptual document like the White Paper.

NW Natural also has some concerns regarding the eventual implementation of the type of hedging program described in the White Paper. As described in these comments, the Company will likely need to add software capabilities and increase staffing to develop a sufficient program. In the event that our regulators in Oregon do not approve of the program for our Oregon customers, the entirety of the costs of these resources would be borne by our approximately 80,000 Washington ratepayers. While NW Natural believes that our current hedging strategies provide sufficient protection to our Washington customers, if the Commission believes that the White Paper program is a significant improvement on existing practices to justify the increased costs, NW Natural will expand its gas purchasing and hedging capabilities to accomplish this policy.

<u>Responses to Questions Provided in the April 11, 2016 Notice</u>

Question 1: Do you see benefits in a risk-management approach to hedging such as that presented in the White Paper as opposed to current hedging strategies used by utilities? Would the use of this methodology ultimately result in savings over traditional programmatic hedging to customers?

<u>Response</u>:

NW Natural sees benefits in a risk-management approach to hedging presented in the White Paper; however, NW Natural believes that a risk-management program should be focused on the overall impact to ratepayers. A balanced regulatory program should not solely focus on gas <u>costs</u>, but rather it should consider gas <u>rates</u> paid by customers to fully understand its impact. That is, the program proposed by Mr. Gettings allows gas costs to fluctuate during the PGA year in a way that will likely increase customer deferrals (which could be a surcharge or credit), and so the system actually could destabilize customer rates as compared to the traditional hedging strategies performed by NW Natural.

For example, as NW Natural understands the program, utilities could start with a certain amount of hedging in place (the "programmatic" strategy) and carve out another portion of the portfolio (the "defensive" strategy) as volumes to be hedged only if prices rise and cross the pre-established "action boundaries." Those action boundaries appear to extend no more than 24 months into the future from the current month because they depend on statistical calculations for which the data gets less certain the further out in time it is projected. Based on the 24 month action boundaries, a significant portion of the defensive strategy covers the current and next PGA year. Accordingly, these defensive volumes would need to be built into the PGA filing based on projected prices. In effect, the Company would be adding to the unhedged portion of the filed PGA. There are then three possible outcomes:

1. If actual prices exactly equal the projected prices, then no deferrals are created. Of course this is extremely unlikely.

2. If actual prices fall from the projections, then deferrals are created that would be in the right direction for customers, i.e., future refunds. However, being deferrals, they also increase customer rate volatility.

3. If actual prices exceed the projections in the PGA, the defensive hedges eventually kick in and mitigate the increase, but some amount of deferrals is created that is in the wrong direction for customers, i.e., future surcharges. And as above, since we are creating deferrals, we are similarly increasing customer rate volatility.

NW Natural noted this concern about increased deferrals during the March 28th workshop, and recognizes that Mr. Gettings suggested that the White Paper approach could be adapted to focus on customer rate effects, including deferrals. NW Natural believes this would be an important modification that should be explored.

Regarding the second question, NW Natural is not certain whether or not the use of Mr. Gettings' methodology will ultimately result in savings over traditional utility hedging strategies. Based on the Company's current understanding regarding the potential costs to customers from utilizing this particular risk-management approach, it is likely that the program would function appropriately in flat and declining markets. But in a rising market, since hedges would be implemented at a slower rate than the programmatic approach, customers would not be as effectively shielded from higher costs. Accordingly, given the current state of gas market prices, i.e. on the low end relative to the last ten years, the Company is concerned that this could be the wrong time to implement the Gettings' approach.

Another concern is the potential for an unintended and adverse effect on natural gas prices if all utilities in Washington adopt the same hedging approach. For instance, if "buy signals" (to transact more hedges) are being communicated to multiple utilities at approximately the same time, it is possible that the LDCs could move gas prices higher due to the surge in buying interest, thereby causing a sort of feedback loop that requires more and more hedging in response to rapidly increasing prices. Mr. Gettings has presented results that relate back to NYMEX pricing, where this concern would be modest since the Pacific Northwest constitutes such a small portion of national gas usage and NYMEX hedging. However, the LDCs in Washington would be using this program to hedge at our regional trading hubs in western Canada and the U.S. Rockies, and there our collective influence could be much stronger. Of special concern would be British Columbia supplies at Sumas and Station 2, which have the least liquidity coupled with a high concentration of activity from the Pacific Northwest LDCs. This includes FortisBC, which as mentioned at the March 28th workshop and in regulatory submittals is also working with Mr. Gettings on a similar program[1].

Question 2: If so, what are your current in-house capabilities to implement risk-management hedging practices of the kind proposed in the White Paper?

Response:

Currently, the Company's "in-house capabilities" are fully utilized. The Company estimates a need to hire one or two full-time employees to take on the additional work created by the analytical complexities and transactional requirements of the program outlined in the White Paper as well as the additional reporting envisioned by the Capacity Blueprint concept introduced at the March 28th workshop. An interim step might be to contract the work to an outside consultant, but the aim would be to in-source as soon as practical, both to save money and to build this as a core competency. NW Natural also would need to invest in additional software to automate as much of the new process as might be possible. At this time, NW Natural does not have a cost estimate for the additional software.

It should be noted that NW Natural operates in both Washington and Oregon, and the above presumes that the Company would have one hedging system for our entire system. However, if the White Paper approach is not implemented in Oregon, then the Company would be faced with implementing the hedging system for only about 10% of our system (less than 80,000 customers). This would further increase the complexity of the program and the cost to our Washington ratepayers of developing such a program. Developing and implementing a program of this magnitude for a small number of utility customers may not provide optimal value for our customers.

Question 3: What are the potential costs associated with adopting such a hedging program?

Response:

See Comment 2 regarding potential internal company costs.

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[1] https://www.fortisbc.com/About/RegulatoryAffairs/GasUtility/NatGasBCUCSubmissions/Documents/160308_FEI_2015_PRM_-_BCUC_Scope_B_IR1_Response_FF.pdf

Question 4: What transition period would be required to adopt such a program?

<u>Response</u>:

The Company believes that the transition period to fully implement the program will likely require at least three and as many as five years in order to:

1. Fully develop the details of the new program, starting with its objective function, e.g., how to best balance customer rate stability with WACOG minimization.
2. Develop appropriate job descriptions and hire new staff.
3. Evaluate and implement new software systems.
4. Determine the role for the remaining programmatic hedges, which the White Paper (page 21) suggests could be up to 30% of hedging.

In addition, given NW Natural's relatively small customer base in Washington, it would be reasonable to pursue this program with Oregon regulators in order to integrate these activities as much as possible across NW Natural's system. This could be done in parallel with the items listed above, but any undue delays arising from the pursuit of this program in Oregon would stretch out the transition period.

Question 5: Given that several LDCs have operations in states that do not use a risk management approach to hedging, rather instead expect the use of programmatic hedging, what challenges does this Commission face in considering this situation in implementing a risk management approach to hedging?

<u>Response</u>:

NW Natural believes that there may be various different hedging strategies that provide benefits to customers, and would be deemed prudent approaches. In light of this, it is possible that different states in which a utility operates may adopt different hedging strategies and guidelines for their utilities. Under those circumstances, implementing the approach outlined in the White Paper could result in costs unique to the Washington hedging program, but not shared by other states. This would mean that the costs of implementing the Gettings' approach in Washington could likely be appropriately borne by Washington customers. As stated above, NW Natural is concerned that this result could harm its Washington customers by adding significant costs to their rates, given NW Natural's relatively small number of Washington customers.

Question 6: How should companies assess the tolerance of customers for bill increases, due to commodity price volatility?

<u>Response</u>:

We have done research in this area and have reviewed several surveys and studies associated with customer preferences in regards to bill stability (i.e. rate volatility), lowest commodity cost and customer usage response.

Although we believe that many of these surveys and studies are subjective, generally speaking, the results we have found conclude the following:

- For customers who are concerned with higher gas costs, the most frequent response in regards to why they are concerned are associated with the difficulty of budgeting for natural gas expense, particularly for those on fixed income[2]
- The majority of survey responders thought it more important to maintain a steady price than to obtain the lowest price[3]
- Customers showed elastic price sensitivity and willingness to adjust loads (i.e. usage) when given signals on upcoming price spikes[4]
- Ratepayers generally show a delayed, and inefficient, response to high energy commodity prices by responding to prices from past months' bills[5]
    - Long-term hedging is one method for removing inefficiencies by setting ratepayer price expectations on forward prices where consumption decisions are based on known forward price curves, rather than lagged averages of wholesale prices

Even in light of the above general findings, the precise balance that should be struck is not clear. Thus, we believe that the Commission and the companies must continue to apply their judgment about the appropriate balance, with recognition that there is no single right answer.

Question 7: At his workshop presentation March 28, Mr. Gettings proposed that the Commission create a "rebuttable presumption" that hedging expenses were prudently incurred if a company adopted and faithfully executed a risk management hedging strategy. Can the Commission legally create such a presumption? If not, what sort of standard can the Commission offer to the gas LDCs that would mitigate against any future?

<u>Response</u>:

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[2] NRRI Hedging Teleconference; June 23, 2011
[3] NRRI Hedging Teleconference; June 23, 2011
[4] Real-Time Pricing Is the Real Deal: An Analysis of the Energy Impacts of Residential Real-Time Pricing; Proceedings of the ACEEE; 2006
[5] The Value of Using Coal Gasification as a Long-Term Natural Gas Hedge for Ratepayers; Carnegie Mellon Electricity Industry Center Work Paper; 2006

NW Natural is not aware of a reason that would prevent the Commission from creating a rebuttable presumption that hedging expenses were prudently incurred if a company adopted and faithfully executed a risk management hedging strategy. The Company believes that creating such a standard would be within the broad authority granted to the Commission, and would be limited only by a court determination that the Commission's specific determinations regarding implementation were, for some reason, arbitrary and capricious.

Question 8: At the workshop, Mr. Gettings also proposed that utilities would file with the Commission a "Capability Blueprint" or similar hedging plan. By what standard would the Commission review such a filing? Could it acknowledge such a plan similar to how it reviews integrated resource plans? Should a "Capability Blueprint" be separate from a PGA filing or concurrent with it?

Response:

NW Natural believes that it would be appropriate for the Commission to review the Capability Blueprint to determine if it met the Commission's expectations in terms of detail and content, and to assess whether it was satisfied that the utility is making acceptable progress towards implementing any appropriate changes to its hedging strategies, in light of guidance provided by the Commission through this proceeding. The Commission could acknowledge a utility's Capability Blueprint similarly to how it reviews integrated resource plans, and could clarify through its orders the effect of that acknowledgment. NW Natural believes that this approach is well within the Commission's regulatory authorities, and would be a reasonable implementation of its decision-making powers, with a view to providing utilities guidance on whether the Commission views utilities' progress and plans on hedging as adequate.

NW Natural recommends that the effect of the Commission's acknowledgment should be that in future proceedings where a utility's hedging practices are reviewed (likely the Purchased Gas Adjustment process), the utility's actions would be presumed to be prudent to the extent its actions were consistent with the utility's implementation of its Capability Blueprint.

For example, the Capability Blueprint may identify that the utility does not at that particular time have in place certain analytical capabilities that would allow a full implementation of some particular hedging strategy. If that Capability Blueprint is acknowledged as appropriate at that time, that acknowledgement would generally prevent a Commission finding that the utility acted imprudently because it did not have the analytical capability that it identified as lacking. Conversely, if a utility's Capability Blueprint indicated that it had certain controls in place, and yet the utility failed to implement those controls, the Commission would be uninhibited in conducting a review to determine whether the failure to implement those controls was imprudent.

NW Natural understands Mr. Gettings' proposal to be that the Capability Blueprint would be submitted annually. The Commission's question asks whether this should be separate from the annual PGA filing, or concurrent with it. While NW Natural is open to either approach, we note that it would be helpful for companies to have the Commission's acknowledgement of the Capability Blueprint ahead of entering into hedging transactions consistent with it. In other words, it would be helpful to have an acknowledged Capability Blueprint before the time that transactions are reviewed in the PGA for purposes of ensuring if those transactions are in compliance with the blueprint. For this reason, the filing could either be done well ahead of the annual PGA, or the Commission should recognize that it may not be appropriate to hold utilities to a Capability Blueprint for transactions that may have predated the development of the blueprint.

Question 9: What kind of communication with or reporting to the Commission on hedging strategies is appropriate?

Response:

NW Natural believes that the level of reporting and communication should be tailored so that it is meaningful and not overly burdensome for either the Commission Staff or the Companies. To be meaningful, NW Natural believes that it should be of a nature and frequency that it can be reviewed and processed within a reasonable amount of time. Additionally, it should provide information that is useful in understanding the situations to which a utility is responding, and what decisions it is making. NW Natural does not currently know what specifically would be reported in order to demonstrate compliance with a new hedging strategy that may be adopted by the Commission, but is open to exploring the specific details of that, and in trying to make sure that such reports align with the principles above.

With respect to frequency, NW Natural believes that reporting should not be done more frequently than on a quarterly basis, and perhaps on an annual basis. NW Natural's experience is that reporting more frequently than this would be burdensome for the utilities, as it requires significant staffing time to prepare and review. Additionally, we anticipate that it could be burdensome on Staff and other stakeholders to be expected to review reports from every company on a more frequent basis. As stated above, because the details of such reporting are not currently clear, we look forward to further discussions to ensure that the reporting meets the objectives of Staff, the utilities, and other stakeholders.

Question 10: If the Commission determines that the proposals in the White Paper set out a template for hedging best practices, should the Commission proceed with a non-binding policy statement on hedging, issue a CR-101 with intent to adopt a rule, or consider other possible procedures?

Response:

NW Natural believes that either a non-binding policy statement on hedging or a rulemaking are workable processes for the proposals set out in the White Paper. Given that the new proposals in the White Paper are complex, and that the utilities development of the hedging programs may be an iterative process, a non-binding policy statement may provide an appropriate degree of flexibility in the event that the proposals in the White Paper need to be adaptive as the utilities and interested stakeholders continue to understand and implement the new, untested proposal.

NW Natural appreciates the opportunity to comment in this proceeding. Please address correspondence in this matter to me with copies to:

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Sincerely,

/s/ Mark Thompson

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