

# Davison Van Cleve PC

Attorneys at Law

TEL (503) 241-7242 • FAX (503) 241-8160 • mail@dvclaw.com  
Suite 400  
333 SW Taylor  
Portland, OR 97204

September 26, 2011

***Via Electronic Mail and FedEx***

Public Utility Commission  
Attn: Filing Center  
550 Capitol St. NE #215  
P.O. Box 2148  
Salem OR 97308-2148

Re: In the Matter of PORTLAND GENERAL ELECTRIC COMPANY  
2012 Annual Power Cost Update Tariff (Schedule 125)  
**Docket No. UE 228**

Dear Filing Center:

Enclosed please find the original and five (5) copies of the Reply Brief on behalf of the Industrial Customers of Northwest Utilities in the above-referenced docket. Confidential copies are being provided to parties who have signed the protective order in this docket. Thank you for your attention to this matter.

Sincerely yours,

/s/ Sarah A. Kohler  
Sarah A. Kohler

Enclosures

cc: Service List

## CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the foregoing Reply Brief on behalf of the Industrial Customers of Northwest Utilities upon the parties, on the service list, by causing the same to be deposited in the U.S. Mail, postage-prepaid, and via electronic mail where paper service has been waived.

Dated at Portland, Oregon, this 26th day of September, 2011.

/s/ Sarah A. Kohler  
Sarah A. Kohler

**(W) CITIZENS' UTILITY BOARD OF OREGON**

GORDON FEIGHNER (C)  
ROBERT JENKS (C)  
G. CATRIONA MCCRACKEN (C)  
610 SW BROADWAY, SUITE 308  
PORTLAND OR 97205  
gordon@oregoncub.org  
bob@oregoncub.org  
catriona@oregoncub.org

**(W) DEPARTMENT OF JUSTICE**

STEPHANIE S ANDRUS (C)  
1162 COURT ST NE  
SALEM OR 97301-4096  
stephanie.andrus@state.or.us

**(W) OREGON PUBLIC UTILITY COMMISSION**

ED DURRENBERGER (C)  
PO BOX 2148  
SALEM OR 97308-2148  
ed.durrenberger@state.or.us

**(W) DONALD SCHOENBECK**

Regulatory & Cogenerations Services, Inc.  
900 WASHINGTON ST STE 780  
VANCOUVER WA 98660-3455  
dws@r-c-s-inc.com

**(W) ENERGY STRATEGIES LLC**

KEVIN HIGGINS  
214 STATE ST - STE 200  
SALT LAKE UT 84111-2322  
khiggins@energystrat.com

**PORTLAND GENERAL ELECTRIC**

RANDY DAHLGREN (C) -1WTC0702  
DOUGLAS C TINGEY (C) - 1WTC13  
121 SW SALMON ST  
PORTLAND OR 97204  
pge.opuc.filings@pgn.com  
doug.tingey@pgn.com

**(W) NOBLE AMERICAS ENERGY SOLUTIONS**

GREG BASS  
401 WEST A ST., STE. 500  
SAN DIEGO CA 92101  
gbass@noblesolutions.com

**(W) RICHARDSON & O'LEARY**

GREG ADAMS  
PO BOX 7218  
BOISE ID 83702  
greg@richardsonandoleary.com

**BEFORE THE PUBLIC UTILITY COMMISSION  
OF OREGON**

**UE 228**

In the Matter of )  
 )  
PORTLAND GENERAL ELECTRIC )  
COMPANY )  
 )  
2012 Annual Power Cost Update Tariff )  
(Schedule 125) )  
\_\_\_\_\_ )

**REPLY BRIEF OF THE  
INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES**

**CONFIDENTIAL  
SUBJECT TO GENERAL PROTECTIVE ORDER**

**REDACTED VERSION**

**September 26, 2011**

## TABLE OF CONTENTS

	<u>Page</u>
TABLE OF CONTENTS.....	i
TABLE OF AUTHORITIES .....	ii
I. INTRODUCTION .....	1
II. ARGUMENT .....	2
A. ICNU Does Not Bear the Burden of Proof .....	2
B. PGE Has a History of Making Imprudent Purchases in Illiquid Markets .....	3
1. Making 48-60 Month Hedges Was a Novel and Unusual Practice.....	4
2. PGE Made These Purchases in an Illiquid Market .....	5
a. PGE Has Not Demonstrated that Any of Its 48-60 Month Hedges Were Made in a Liquid Market .....	5
b. PGE’s Data Responses Affirmatively Demonstrate that Many of Its Transactions Were Made in an Illiquid Market.....	8
3. PGE Failed to Meet its Burden to Document the Reasonableness of Each Trade or Analyze Market Liquidity.....	10
C. PGE Wishes the Commission to Judge the MTS on Whether it Was “Successful,” Not Whether it Was Prudent .....	13
D. ICNU Has Not Suggested a New Hedging Plan for PGE.....	16
E. ICNU Has Not Changed Its Position .....	17
F. PGE’s <i>ad hominem</i> Attacks Do Not Demonstrate that The Company Acted Prudently .....	20
G. Staff’s Arguments Are Unconvincing .....	20
1. Staff Has Not Actually Analyzed the Issue .....	20

2. Staff Makes Many Assertions that Are Factually Incorrect.....	21
III. CONCLUSION.....	22

**TABLE OF AUTHORITIES**

<b><u>Cases and Orders</u></b>	<b><u>Page</u></b>
<u>Re Avista Corp.</u> , OPUC Docket Nos. UG 176/UM 1279, Order No. 06-610 (Oct. 30, 2006).....	2
<u>Re PacifiCorp</u> , OPUC Docket No. UE 116, Order No. 01-787 (Sept. 7, 2001).....	2
<u>Re PGE</u> , OPUC Docket No. UE 139, Order 02-772 (Oct. 30, 2002) .....	3, 4, 5, 10, 11, 13, 16
<u>Re PGE</u> , OPUC Docket No. UE 196, Order No. 10-051 (Feb. 11, 2010).....	16, 17, 22
<u>Re U.S. West Communications, Inc.</u> , Docket No. UT 125/UT 80, Order No. 00-191 (April 14, 2000).....	16

## I. INTRODUCTION

The Industrial Customers of Northwest Utilities (“ICNU”) has shown that Portland General Electric (“PGE” or the “Company”) made a large bet on 2012 gas prices by buying fixed for floating financial hedges during a 15-month period that began in May 2007. PGE made these purchases at a time when the market for 2012 gas was illiquid, and PGE provided no contemporaneous market analysis or justification for its actions. PGE relies primarily on customers’ alleged desire for rate stability, regardless of the cost, and the fact that PGE’s combined net open position (“NOP”) for gas and electricity was not completely filled by PGE’s gas hedging. These arguments miss the point, because even if true, they do not render PGE’s gas purchases in an illiquid market prudent.

In order to show that the transactions at issue in this case were prudent, PGE must show contemporaneous documentation of both market analysis and market liquidity. While this standard was identified in the only Public Utility Commission of Oregon (“OPUC” or the “Commission”) meeting where the Mid-Term Strategy (“MTS”) was considered, it is also based on directly applicable precedent from PGE’s 2003 RVM case, UE 139. In UE 139, the Commission disallowed \$14.65 million in imprudently incurred power costs for many of the same reasons that ICNU is seeking a disallowance in this case, namely that PGE failed to provide adequate documentation to justify its purchases or show market liquidity.

Evidence produced late in this case demonstrates that the market for 2012 gas was illiquid when PGE began implementing the MTS, because there were few counterparties available to PGE and few if any reported transactions. The combination of

the lack of liquidity combined with PGE's failure to document the reasonableness of each transaction demonstrates that PGE was imprudent. At the very least, PGE has failed to meet its burden of proof of demonstrating prudence.

Based on PGE's imprudence, ICNU requests that the Commission disallow [Confidential] [REDACTED] [Confidential] in costs from the 2012 AUT. The amount of the disallowance is based on a more prudent approach of hedging evenly over the four years in advance of the rate year. However, as described in more detail below, there is a subset of transactions which provide a more compelling justification for disallowance, because even PGE admits that there were no reported offers or cleared transactions at the time PGE entered into to these transactions. Alternatively, ICNU requests that the Commission disallow [Confidential] [REDACTED] [Confidential] specific transactions for a total disallowance of [Confidential] [REDACTED] [Confidential].

## II. ARGUMENT

### A. ICNU Does Not Bear the Burden of Proof

PGE mischaracterizes the legal standard in this case, alleging that "ICNU has failed to establish that PGE's hedging strategy was imprudent." PGE Opening Brief at 15. This statement is both factually untrue and legally incorrect. The burden of demonstrating that rates are just and reasonable is borne exclusively by the utility throughout the proceeding and "does not shift to any other party." Re PacifiCorp, Docket No. UE 116, Order No. 01-787 at 6 (Sept. 7, 2001). A utility "is *solely* responsible for justifying whether its strategy was prudent." Re Avista Corp., Docket Nos. UG 176/UM 1279, Order No. 06-610 at App. A at 15 (Oct. 30, 2006) (emphasis added). PGE's

PAGE 2 – REDACTED REPLY BRIEF OF ICNU

arguments about calendar strips, commentary on the success or failure of the MTS, *ad hominem* attacks on Mr. Schoenbeck, and other assertions are fatally flawed in that they do not address the singular issue in this proceeding: whether PGE's long-term gas hedges under the MTS were reasonable, and therefore, prudent.

**B. PGE Has a History of Making Imprudent Purchases in Illiquid Markets**

PGE claims that it would be a novel and disruptive event for the Commission to disallow a portion of its requested 2012 power costs based on the imprudence of the company in entering into long-term hedging contracts. Tr. 21:16 – 22:24 (Pope-Valach). PGE was on notice, however, that it was subject to a prudence disallowance for illiquid hedges because the Commission disallowed nearly \$15 million for imprudent hedges in PGE's 2003 RVM. Re PGE, OPUC Docket No. UE 139, Order No. 02-772.

PGE claims that the Commission has not required the Company to provide documentary justification for unusual, long-term purchases, nor evidence of contemporaneous analyses of market liquidity. PGE Opening Brief at 10. This claim appears to be a response to Mr. Galbraith's comments at the July 27, 2006 public meeting when a brief presentation was made regarding the MTS. *Id.* It is true that Mr. Galbraith identified liquidity and documentation as conditions to Staff's support of the MTS. ICNU Cr. Ex. 703 at 10-11. However, Mr. Galbraith did not simply make up these conditions on the spot. Rather, they are a concise restatement of the test that the Commission has previously developed and implemented for prudence reviews of unusual long-term purchases. The Commission based its disallowance on the following criteria: 1)

the decision to purchase long-term power was unusual; 2) PGE made the purchases before the market was liquid; and 3) the fact of market volatility did not “relieve PGE of its burden to establish that it acted reasonably. . . .” Docket No. UE 139, Order 02-772 at 11-12, 14. Elaborating on the final factor, the Commission stated: “[w]e also emphasize that PGE provides little if any supporting evidence . . . or internal company analysis of that advanced market to justify its decision.” Id. at 13. ICNU finds it remarkable that in 2006, only three years after being denied recovery of nearly \$15 million on precisely the same grounds, PGE found Mr. Galbraith’s restatement of the Commission’s requirements to be no more than advisory. In this case, PGE has failed the Commission’s three part test in nearly an identical manner as it did in UE 139.

**1. Making 48-60 Month Hedges Was a Novel and Unusual Practice**

PGE has claimed that the MTS is not a new strategy. PGE/400, Lobdell-Outama/22. The question in this case is what PGE should have known at the time it entered into the hedging contracts. Docket No. UE 139, Order No. 02-772 at 11. There is no question that, at the time the 48-60 month hedges were executed, the MTS was a new strategy, and 48-60 month hedges were new and unprecedented purchases. PGE/400, Lobdell-Outama/9 (stating that the MTS, including both 48-60 month and 36-48 month hedges, could not have been instituted prior to 2006). Therefore, it is uncontradicted that, in 2007 and 2008, five-year gas hedges were unusual purchases.

## **2. PGE Made These Purchases in an Illiquid Market**

### **a. PGE Has Not Demonstrated that Any of Its 48-60 Month Hedges Were Made in a Liquid Market**

In an effort to justify its long-term commodity bets, PGE has relied on shifting, unorthodox, and inventive definitions of liquidity that are directly at odds with the definitions given by Mr. Stoddard and Mr. Schoenbeck in this case, as well as Commission Staff in previous cases. PGE's definition also contradicts the standard for liquidity previously articulated by this Commission. This Commission has defined liquidity as "a function of the number of like transactions conducted during a relevant time period." UE 139, Order 02-772 at 11. Mr. Schoenbeck and Mr. Stoddard agree that liquidity is a function of a large volume of trades and trading parties. ICNU/108, Schoenbeck/7; PGE/500, Stoddard/19. In UE 139, Commission Staff provided the most detailed and useful definition of a liquid market, which is: "a market where *many* buyers and sellers are conducting a *large number* of transactions." UE 139, Order 02-772 at 8 (emphasis added). Staff went on to demonstrate why liquidity matters, stating that that liquidity is "necessary for markets to produce competitive prices." Id. Thus, purchases made outside of demonstrably liquid markets are assumed to be unreasonable and imprudent because it is impossible to know the actual value of the item purchased.

In UE 139 and UE 149, OPUC Staff criticized PGE for basing its price curve on a "limited number of transactions." Re PGE, OPUC Docket No. UE 149, Testimony of Maury Galbraith at 18-19. As it did in those cases, PGE now attempts to justify its costs by creating its own arbitrary definition of liquidity that is based entirely

on its traders deciding that someone would sell at the price they were willing to pay. Tr. 144: 25–145:1-4, (Lobdell-Outama). Mr. Outama, the “main architect” of the MTS, now claims that liquidity is a “comparison between value that you have established versus the market price that other offers have offered to you.” Tr. 144: 20-22 (Outama). This unusual definition of liquidity originates, not in markets, but with PGE’s own forward price curve, or “what the traders have valued that strip for . . . .” Id. at 143: 5-6.

Essentially, the Company claims that if one of PGE’s very few available counterparties

[Confidential] [REDACTED]

[REDACTED] [Confidential] responds with a quote that is close to the forward price projections of PGE’s traders, there must be market liquidity.

In the past, the Commission and Staff have definitively rejected this analysis. In UE 149, PGE made the same argument they do here, claiming that illiquid market purchases were prudent because the contract prices lined up with forward price curves of PGE’s traders. Docket No. UE 149, Testimony of Maury Galbraith at 18. Mr. Galbraith concluded that, “[t]his type of justification seems to reduce to the contract prices being reasonable simply because the traders who set the forward price curve said so.” Id. at 18, 19. In this case, PGE repeatedly relies on precisely the same definition and faulty logic that was discredited in UE 149.

PGE’s unsupported analysis ignores the fact that true liquidity does not appear until numerous parties enter a market. PGE’s definition also contradicts the very purpose of waiting for market liquidity, which is to let the market, *not* PGE’s traders, set a product’s price. In a truly liquid market, bid-offer spread is tight because of the

function of market information – parties in a liquid market bid and offer in a tight range because like transactions guide them, not because traders guessed. In this case, as well as in UE 139 and UE 149, PGE made decisions based not on market information, but simply because “the traders who set the forward price curve said so.” Further, PGE provides no analysis or documentation of the bid-offer spread between their forward price curve and counterparty offers other than Messrs. Lobdell’s and Outama’s unsupported and unquantifiable assertions that they were “tight.” Therefore, even if PGE’s novel price-based method for determining liquidity was valid, there is no contemporaneous analysis or quantitative evidence demonstrating that bid-ask spreads were in fact tight.

In a prudence review, PGE bears the burden of establishing the reasonableness of its actions, and in the case of long-term hedges, this specifically means demonstrating market liquidity. This means establishing that many parties were actively trading high volumes of gas hedges. PGE has produced no such evidence; rather, the Company’s ICE data, analyzed by its own expert, shows that [Confidential] [REDACTED] [REDACTED] [Confidential] was reported for 48-60 month hedges during Q2 and Q3 of 2007, nor in Q1 of 2008, and the volume for 48-60 month products during the rest of the period that PGE was hedging was very thin. ICNU Cr. Ex. 705. This means that the only actual evidence PGE has produced is in Mr. Stoddard’s words, “indicative, if not dispositive” of an illiquid market. ICNU Cr. Ex. 705; Tr. 63: 18-19 (Stoddard).



The Rockies gas market was even slower to develop liquidity than AECO. PGE claims, again without support, [Confidential] [REDACTED] [REDACTED] [Confidential] ICNU/110, Schoenbeck/12. PGE thus establishes that prior to this time, no Rockies products were even quoted in its markets. Yet, by the time the first quotes for these products were made, PGE had executed a total of [Confidential] [REDACTED] [Confidential] transactions for these products, producing cumulative mark-to-market losses of [Confidential] [REDACTED] [Confidential] ICNU/102, Schoenbeck/1 at ll. 1, 3-4, 10.

Without providing analysis or documentation, [Confidential] [REDACTED] [REDACTED] [Confidential] As was the case with Rockies products, this means that no one was quoting, let alone trading, SUMAS calendar strips prior to 2008 in its markets. By February 2008, when this liquid market allegedly began to form, PGE had already entered into [Confidential] [REDACTED] [REDACTED] [Confidential]. ICNU/102, Schoenbeck/1 at ll. 7, 11.

For each of the above transactions, PGE has provided data establishing that it made its purchases without any comparable trades taking place in the relevant markets. Given that the Commission has firmly stated that PGE may not consider the volume of its own trades when determining liquidity, PGE's data shows that it made these [Confidential] [REDACTED] [REDACTED]

[REDACTED] [Confidential] Docket No. UE 139, Order No. 02-772 at 12.

While PGE has not met its burden to demonstrate that any of its 48-60 month purchases were made in liquid markets, if the Commission were to find that some market conditions were liquid, these six trades, as affirmatively demonstrated by PGE's data responses, were imprudently executed in illiquid markets.

### **3. PGE Failed to Meet its Burden to Document the Reasonableness of Each Trade or Analyze Market Liquidity**

PGE has the "burden to establish that it acted reasonably in responding to those [market] conditions." UE 139, Order No. 02-772 at 12. In disallowing recovery of \$14.65 million for imprudent long-term purchases, the Commission emphasized that PGE provided "little if any supporting evidence relating to [future price trends] or internal company analysis of that advanced market to justify its decision." Id. at 13. The Commission stated that:

[I]n the absence of more complete information and analysis of the market conditions for 2003 power, we have no basis to evaluate the reasonableness of PGE's business decision to buy high-cost power during 10 months in 2003 in which there was no indication of power reliability problems. Accordingly, we agree . . . to disallow the disputed contracts.

Id. at 14. Thus, before allowing recovery for unusual transactions, the Commission's practice has been to evaluate each transaction, based on the Company's contemporary documentation. As ICNU has pointed out, for [Confidential] [REDACTED]

[REDACTED] [Confidential] PGE has not provided a single page of analysis documenting future price trends or "internal company analysis of [the] advanced market to justify its decision." Especially troubling are the memoranda that

appear on pages [Confidential] [REDACTED]

[REDACTED] [Confidential] ICNU/110, Schoenbeck/37-40, 66; see also id. at 41.

Further, the first two of these memoranda were signed before any 2012 calendar strips were executed in the markets to which PGE has access. Compare ICNU/110, Schoenbeck/37-38 (trade authorizations prior to June 29, 2007) with ICNU/110, Schoenbeck/12 (PGE states that there were no trades in PGE's markets prior to June 29, 2007).

This means that for all trades executed under these memoranda, PGE gave blanket trading authorizations without any indications of market liquidity because ICE showed no cleared transactions and PGE has not documented any trades of the products in any of its own bilateral markets. There is simply no basis for the Commission to evaluate the reasonableness of these 13 decisions. ICNU recommends that the Commission disallow recovery of all trades made under these authorizations because, in the Commission's words, there is simply "no basis to evaluate the reasonableness of PGE's business decision to buy high-cost" long-term hedges. UE 139, Order No. 02-772 at 14.

PGE has provided an assortment of e-mails and reproductions of trade journal articles, which were contemporaneous with the authorization dates for the remaining 13 authorizations, however, none of these documents provide specific support for these transactions. Also, PGE claims that traders must first establish market liquidity

PAGE 11 – REDACTED REPLY BRIEF OF ICNU

before they are even permitted to seek approval for trades, and that PGE's Risk Management Committee, "after receiving the results of a thorough analysis" sets risk limits. PGE Opening Brief at 5, 9. However, when ICNU asked for all PGE market assessments done in 2007 and 2008, PGE referred ICNU to the responses to data requests 66 and 88, which provide only broadly worded, unsupported descriptions of the market written *last month*. ICNU/110, Schoenbeck/18; and see id. at 11, 33. In other words, PGE has produced no contemporary market analyses of the type that it claims are required before trades are authorized. Further, given that PGE claims that its traders were required to provide a "thorough analysis" of liquidity before seeking authorization for a trade, it is inexplicable that no mention of liquidity exists in any approval memoranda, or in any of the "supporting" documents.

PGE says that no party has challenged the propriety of its hedges, yet PGE supports this claim by citing to statements Mr. Schoenbeck made prior to the data responses that demonstrate PGE's failure to properly document the transactions at issue here. Compare PGE Opening Brief at 10 with, e.g., ICNU/110, Schoenbeck/17, 36 (data responses received on August 23, subsequent to Mr. Schoenbeck's deposition and testimony). It is irrelevant that Mr. Schoenbeck did not testify regarding PGE's lack of documentation, because the evidence is contained in PGE's own data responses, and it is also unsurprising, given that the PGE did not produce the requested evidence regarding documentation and liquidity until the night before Mr. Schoenbeck's Surrebuttal Testimony was due. Regardless, it is not the responsibility of ICNU, or any party other than PGE, to demonstrate the prudence of its hedges.

PAGE 12 – REDACTED REPLY BRIEF OF ICNU

**C. PGE Asks the Commission to Judge the MTS on Whether it Was “Successful,” Not Whether it Was Prudent**

PGE’s expert claims that the MTS should be “judged based on of the goal it set out to achieve: reduction in price volatility.” PGE Opening Brief at 6. The Commission has stated that, “we do not focus on the outcome of the utility’s decision . . . we review the reasonableness of the actions.” UE 139, Order No. 02-772 at 11. PGE wishes the Commission to decide this case based on the *post hoc* outcome of reduced price volatility – an impermissible consideration that has never been at issue. In the absence of the 48-60 month trades, PGE’s prices would still be stable, but much lower – an outcome that customers would likely endorse in a survey question. PGE refers repeatedly to its single survey question as though it established definitively that PGE’s customers wanted reduced volatility regardless of the cost. The Company ignores the fact that in 2007 and 2008 its customers were focused on PGE’s high rates. In its brief in PGE’s 2008 general rate case, ICNU wrote, “PGE currently has the highest rates in the Pacific Northwest. The rate increase proposed in this case will only exacerbate the problem.” Re PGE, Docket No. UE-197, Opening Brief of Industrial Customers of Northwest Utilities at 3 (Oct. 24, 2008) (citation omitted). Thus, PGE’s claim that its MTS was successful both misses the point of a prudence review and is also factually suspect.

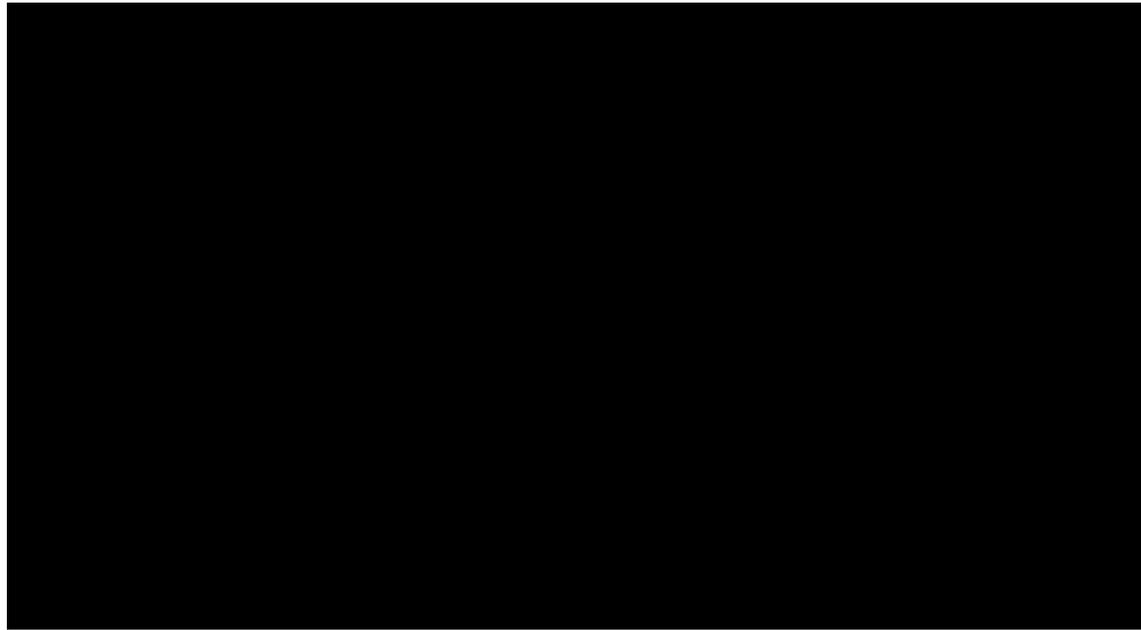
Further, the Company attempts to justify its hedges with the *post hoc* rationale that it acquired only half of its net open position through these bets, and so, regardless of cost or risk, it must have been a success. PGE Opening Brief at 4. PGE

claims prudence by stating that “at no time did PGE buy more gas than its generation portfolio required.” Id. The fact is, regardless of total NOP, as illustrated in ICNU/102, Schoenbeck/12, PGE purchased essentially [Confidential] [REDACTED]

[REDACTED] [Confidential]

The following chart illustrates PGE’s front end loaded approach:

[Confidential]



[REDACTED]

[REDACTED]

[Confidential]. ICNU Cr. Ex. 702 at 25. The fact that PGE’s 2012 NOP was not filled does not make otherwise imprudent actions prudent.

PGE disingenuously claims that it cannot find an example of a utility hedging in the manner described in Mr. Schoenbeck’s testimony. PGE Opening Brief at 14. Yet, at his deposition, Mr. Schoenbeck referred the company to its *own* example,

pointing out that “for 2009 [PGE’s hedging] is what I consider much more programmatic. They’re in the market every quarter, as contrasted to their hedging for the year 2012, where it’s basically all front-end loaded.” ICNU/109, Schoenbeck/27. This more consistent averaging approach is illustrated by the following graph:

**[Confidential]**



**[Confidential]**. ICNU/102, Schoenbeck/10. This far more prudent strategy represents a method that both reduces volatility risk, yet also reduces exposure to market risk. Mr. Schoenbeck stated early in this proceeding that one of the foundations of a prudent hedging strategy is the application of the portfolio diversification principle. ICNU/100, Schoenbeck/5. Purchasing one commodity exclusively over a short period of time is a highly risky strategy and runs directly counter to the portfolio diversification principle of buying diverse products gradually over time to ameliorate market risk. Mr. Schoenbeck

went on to state that “[o]ne of the few ways to limit this risk exposure is to limit the gas hedges transacted long before the prompt month. . . .” ICNU/100, Schoenbeck/8.

**D. ICNU Has Not Suggested a New Hedging Plan for PGE**

PGE claims that ICNU wishes to dictate how the utility should hedge its net open position, and that ICNU asks the Commission to retroactively apply a new hedging policy to the Company. PGE Opening Brief at 14. This is simply untrue. The evidence demonstrates that the flexible, programmatic policy described by Mr. Schoenbeck is a moderate and prudent baseline that reflects prudent regional utility practices. In addition, by spreading purchases over time, in a dollar cost averaging type approach, the utility avoids the risk of locking in all of its supply at the top of the market, as PGE did here.

The Commission has stated that in a prudence review, it is appropriate to use a proxy price “based on what PGE would have actually paid if it had prudently waited for the market to become liquid.” UE 139, Order No. 02-772 at 14. The purpose of a prudence review is not to impose a policy upon a utility, but rather to determine whether costs were prudently incurred. Only if the costs were prudently incurred will the Commission include them in rates. Re US WEST Communications, Inc., Docket Nos. UT 125/UT 80, Order No. 00-191 at 15 (April 14, 2000). For example, in UE 196, ICNU did not suggest, and the Commission did not impose, a new way of installing turbines. Rather, ICNU claimed, and the Commission confirmed, that a prudent company, knowing what PGE did at the time of the installation, would not have acted as PGE did, and therefore, the Commission imposed an imprudence disallowance. Re PGE OPUC

Docket No. UE 196, Order No. 10-051 at 14 (Feb. 11, 2010). In this case, ICNU has demonstrated that faced with market uncertainty, prudent utilities do not hedge in illiquid conditions more than 48 months out from the prompt year. ICNU's proposed programmatic hedging method is merely a methodology for estimating what the prudent costs would have been.

PGE's argument that it will "curtail much, if not all" future hedging if a disallowance is imposed does not ring true. PGE/300, Pope-Valach/11. As noted above, in 2002, the Commission disallowed PGE recovery of \$14.65 million for imprudent hedges made in illiquid markets. Only a few years later, PGE instituted the MTS, a far more ambitious hedging program than that which caused the disallowances in 2002.

**E. ICNU Has Not Changed Its Position.**

At the beginning of this proceeding, ICNU asserted that PGE's purchases of gas 48-60 months ahead of the prompt date were imprudent. In addition, PGE was well aware that it needed to establish that its hedges were prudent by providing documentation of liquidity, because these requirements were imposed in PGE's own prior prudence reviews. Further, despite not receiving the data responses that illuminate PGE's lack of documentation for its purchases until one week before the hearing, ICNU raised the issue in mid-August, requesting production of all PGE marketplace assessments done during 2007 and 2008. ICNU/110, Schoenbeck/18.

Even before PGE produced its data responses, Mr. Schoenbeck explained that one of the factors driving his recommended disallowance was that "the further out you go, your credit and collateral risk costs become greater. Your counterparties become

less. The market becomes less liquid.” ICNU/109, Schoenbeck/38. He went on to note that because counterparties are fewer and risk increases the farther out a utility hedges, an electric utility should not go out more than 48 months. Id. at 55. The position of ICNU has been, and continues to be, “you should not put all your eggs in an illiquid basket.” Id. at 59. Any claim by PGE that ICNU has not been, from the beginning of this proceeding, challenging the prudence of its 48-60 month transactions is simply untrue.

PGE also mischaracterizes the alleged change in position, stating: “Mr. Schoenbeck admits he did *not* use his recommended targets to quantify his suggested adjustment;” however, the line to which PGE cites to support this accusation very plainly reads “to quantify a recommended disallowance, I *did* use the recommended targets as precise values.” Compare PGE Opening Brief at 21 (emphasis added) with ICNU/108, Schoenbeck/12 (emphasis added). The Company’s assertion—that Mr. Schoenbeck changed his position simply because, when asked to clarify whether his 20% targets for yearly hedging were hard and fast, he readily answered that a 5% variance either way would be prudent—is similarly overreaching, as is Company’s insistence that 15-25% is somehow inconsistent with 20% plus or minus 5%. Compare ICNU/109, Schoenbeck/108-110 with PGE Opening Brief at 20-21. It is also disingenuous for PGE to claim that the MTS produced hedges of approximately 20% per year during 2007 and 2008, and that this fits within Mr. Schoenbeck’s recommended targets, when even a cursory review of Mr. Schoenbeck’s exhibits would reveal that his suggested target for five years out (i.e., 2007) was 0.0%. Compare PGE Opening Brief at 21 with ICNU/102, Schoenbeck/18.

PAGE 18 – REDACTED REPLY BRIEF OF ICNU

Admittedly, ICNU's position in this case has evolved as PGE produced information late in this proceeding. As noted, the very important documents contained in ICNU/110 were provided to ICNU the day before ICNU's surrebuttal testimony was due, and only one week before the hearing. Mr. Schoenbeck has stated that a liquid market existed for 2012 monthly or seasonal products; however, this was not a blanket assertion of market liquidity. As Mr. Schoenbeck stated during his deposition, liquidity is unique to each specific market, and it may well be that some utilities have access to fewer liquid markets than do others. See, e.g., ICNU/109, Schoenbeck/54-55. PGE, in fact, has agreed with this analysis, saying that individual companies "experience different levels of liquidity" depending on factors such as quality of credit, balance sheet size, or risk management procedures. PGE/400, Lobdell-Outama/46.

During the course of these proceedings, ICNU has become aware that, while liquid markets existed in some places for long-term products, PGE did not have access to these markets. See, e.g., Tr. 113-114 (Lobdell-Outama). The data responses and workpapers produced by PGE late in these proceedings has made it clear that PGE did not have access to liquid markets for either calendar strips or the seasonal products that Mr. Schoenbeck identified, based both on its geographical position and other factors.

As a result, discovery and cross examination during this proceeding has reinforced ICNU's original position that it was imprudent for PGE to hedge gas more than 48 months from the prompt year.

**F. PGE's *ad hominem* Attacks Do Not Demonstrate that The Company Acted Prudently**

ICNU finds it curious that, despite pages of *ad hominem* attacks on Mr. Schoenbeck's experience, the Company did not bother to cross examine ICNU's witness. It is further ironic that while attacking the credentials of one of the most experienced energy experts in the region, PGE relies extensively on a Boston based "expert," Mr. Stoddard, who, by PGE's admission, has never testified in a proceeding addressing gas or electric hedging policies. ICNU/110, Schoenbeck/10. Further, Mr. Stoddard has only reviewed Northwest Power Markets, with which he is generally unfamiliar, because of current, confidential work defending an undisclosed financial institution that is under investigation for its trading practices, and he did not review the hedging strategy of even one other utility while preparing his testimony. ICNU/110, Schoenbeck/14, 16; PGE/500, Stoddard/2.

**G. Staff's Arguments Are Unconvincing**

**1. Staff Has Not Actually Analyzed the Issue**

In its opening brief, Staff has painstakingly restated and reframed the positions of the other parties in this proceeding, but ICNU is unaware of any independent analyses or studies conducted by Staff. ICNU finds it disappointing that Staff has adopted PGE's unsupported assertions of prudence, without even considering the Company's failure to satisfy the conditions that it previously imposed on the MTS. Staff Opening Brief at 13. This is particularly disappointing because the guidance that Staff offered the Company in 2006 was sound and, had the Company followed it, customers

would not now be faced with the possibility of bearing PGE's large losses. Yet, nowhere in their brief does Staff even mention the conditions from the meeting in 2006, nor the standards for liquidity established in UE 139.

## **2. Staff Makes Many Assertions that Are Factually Incorrect**

Staff also makes a number of factually incorrect assertions that appear to indicate that their review of the record in this case has been cursory, at best. For example, Staff's Opening Brief states that Mr. Schoenbeck "does not offer a rationale for why [considering power hedges and "nonstandard" gas strips] is superior to PGE's reliance on gas hedges, or more importantly, why PGE's practice is imprudent." Staff Opening Brief at 14.

Mr. Schoenbeck's recommendation regarding hedging is prefaced with an explanation of the importance of reducing risk in a hedging strategy through the universally accepted diversification principle of portfolio theory and the alignment of cost and revenue risk. ICNU/100, Schoenbeck/5. Thus, Mr. Schoenbeck plainly stated that considering multiple products and purchasing them consistently over time is a prudent strategy because the most basic and widely accepted investment principles have demonstrated this to be so.

Second, and perhaps even more troubling, Staff's position is inconsistent with the very standard governing this proceeding. In critiquing Mr. Schoenbeck for not offering a rationale as to "why PGE's practice is imprudent" (which Mr. Schoenbeck has painstakingly done), Staff apparently fails to grasp the rudimentary principle that *PGE* must demonstrate prudence in order to recover its hedging losses; neither ICNU nor any

other party must establish *imprudence* in order for recovery to be disallowed. UE 196, Order No. 00-191 at 14-15.

Another example of Staff's misperceptions regarding the facts of this proceeding is demonstrated by its assertion that PGE "did not establish hard and fast volumetric targets for each year of the MTS." Staff Opening Brief at 18. This appears to be a criticism of Mr. Schoenbeck's recommendation of a programmatic approach that targets closure of approximately 20% of the utility's NOP each year for four years before the prompt month. See ICNU/109, Schoenbeck/71 (stating that 20% should not be a "hard and fast" target). Staff somehow characterizes this as "rigid," while parroting PGE's claim that the MTS is not.

The actual terms of PGE's original MTS require the Company to acquire [Confidential] [REDACTED] [REDACTED] [Confidential] PGE/Ex. 601: 182; and see PGE/406C, Lobdell-Outama/39 (establishing definitive volumetric targets for each year of the MTS). Not only did PGE set mechanistic, volumetric targets for acquisition, it set precise calendar *dates* by which these should be reached. In short, if anyone should be critiqued for "hard and fast" hedging targets, it is PGE and not ICNU.

### III. CONCLUSION

After instituting the MTS, PGE hedged all of its gas needed to run its generating plants in 2012. Despite acknowledging at the outset that markets were not liquid, PGE forged ahead and bought financial swaps without any proof of market liquidity. PGE now must pay out over [Confidential] [REDACTED] [Confidential] based

on the mark-to-market valuation of these financial instruments. Despite the lessons of UE139 and 149, and Staff's advice when the MTS was adopted, PGE failed to document the internal analyses of future markets that the Commission requires to show prudence. As a result, PGE has failed to meet its burden to demonstrate the reasonableness and prudence of these hedges. ICNU requests that the Commission disallow [Confidential] [redacted] [Confidential] in costs from the 2012 AUT. In the alternative, ICNU requests that the Commission disallow the [Confidential] [redacted] [redacted] [Confidential].

Dated this 26th day of September, 2011.

Respectfully submitted,

DAVISON VAN CLEVE, P.C.

/s/ S. Bradley Van Cleve

S. Bradley Van Cleve

333 S.W. Taylor, Suite 400

Portland, Oregon 97204

(503) 241-7242 phone

(503) 241-8160 facsimile

bvc@dvclaw.com

Of Attorneys for the Industrial Customers of  
Northwest Utilities