

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 14, 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 Opening 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 Opening 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 14th 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))
_____)

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

**CONFIDENTIAL
SUBJECT TO GENERAL PROTECTIVE ORDER**

REDACTED VERSION

September 14, 2011

TABLE OF CONTENTS

	<u>Page</u>
TABLE OF CONTENTS.....	i
TABLE OF AUTHORITIES	iii
I. INTRODUCTION	1
II. STANDARD OF REVIEW	2
III. ARGUMENT	3
A. PGE was Required to Document the Prudence of its Decision to Buy the Gas Hedges	3
1. Execution of the Purchases Was Contrary to the Direction of the OPUC Staff and PGE Was Aware of the Risk of Disallowance.....	4
B. PGE Provided No Contemporaneous Documentary Support for Its Decision to Enter into the Gas Hedges.....	6
C. The Market Was Not Liquid When PGE Purchased the 2012 Gas Hedges	10
D. PGE Should Have Considered Other Products, Instead of 12 Month Strips Exclusively.....	14
E. The Commission Should Adopt Mr. Schoenbeck’s Proposed Disallowance.....	15
F. PGE’s Arguments Are Unconvincing.....	17
1. A Single-Question Customer Survey Does Not Justify the Imprudent Bets Entered Into by the Company Under the MTS.....	17
2. PGE Has Not Demonstrated that a Disallowance for Imprudence Would Create any Adverse Effects beyond those Engineered by the Company Itself	18

3. The Commission Has Not Previously Approved the Hedging Contracts at Issue in this Case.....	20
4. PGE’s Insistence that Its Total Net Open Position Should Be Considered Is Irrelevant to The Question of Prudence.....	22
IV. CONCLUSION.....	24

TABLE OF AUTHORITIES

<u>Cases and Orders</u>	<u>Page</u>
<u>Barackman v. Anderson</u> , 338 Or 365, 109 P3d 370 (2005).....	20
<u>Nelson v. Emerald People's Utility Dist.</u> , 318 Or 99, 862 P2d 1293 (1993)	20
<u>OPUC v. Crooked River Ranch Water Co., et al.</u> , OPUC Docket Nos. UM 1381 and UW 120, Order No. 08-409 (Aug. 7, 2008)	20
<u>Re Avista Corp.</u> , OPUC Docket Nos. UG 176/UM 1279, Order No. 06-610 (Oct. 30, 2006).....	2
<u>Re Avista Corp.</u> , OPUC Docket No. UG 186, Order No. 09-422 (Oct. 26, 2009).....	21
<u>Re Northwest Natural Gas Co.</u> , Docket No. UG 132, Order No 99-697 (Nov. 12, 1999)	2, 19
<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 196, Order No. 10-051 (Feb. 11, 2010).....	19
<u>Re PGE</u> , OPUC Docket No. UE 208, Order No. 09-433 (Oct. 30, 2009)	21
<u>Re PGE</u> , OPUC Docket No. UE 215, Order No. 10-410 (Oct. 20, 2010)	21
<u>Re U.S. West Communications, Inc.</u> , Docket No. UT 125/UT 80, Order No. 00-191 (April 14, 2000).....	2
<u>Wah Chang v. PacifiCorp</u> , OPUC Docket No. UM 1002, Order No. 04-305 (May 27, 2004)	22
 <u>Statutes</u>	
ORS § 757.210.....	2, 19

I. INTRODUCTION

ICNU submits the following Opening Brief regarding PGE's 2012 Annual Update Tariff ("AUT") filing. The Industrial Customers of Northwest Utilities ("ICNU") respectfully requests that the Public Utility Commission of Oregon ("OPUC" or the "Commission") disallow [Confidential] [REDACTED] [Confidential] in costs from the net variable power costs included in the AUT as a result of imprudent gas hedges that Portland General Electric Company ("PGE" or the "Company") entered into for the 2012 rate year. These gas hedges were entered into as part of PGE's Mid-Term Strategy ("MTS"). PGE has failed to satisfy its burden of proof that the implementation of the MTS for 2012 was prudent.

In 2006, PGE embarked on a strategy to hedge its power supply risk by purchasing gas financial hedges in the 3-5 year market. PGE now claims the strategy was based on the desire of its customers to avoid rate volatility as allegedly expressed in a single question on a customer survey. PGE made a short presentation at one OPUC meeting in July 2006 to discuss the proposed strategy, and the MTS was adopted by PGE's Risk Management Committee in September 2006. OPUC Staff was supportive of the MTS, but only on the conditions that purchases must be made in a liquid market and that PGE must provide specific analyses supporting each of the transactions.

Between [Confidential] [REDACTED]

[REDACTED] [Confidential] PGE purchased gas financial hedges for [Confidential] [REDACTED]

[REDACTED] [Confidential]

The Company provided no contemporaneous analysis or documentation to support its

purchases other than one-page preapproval memos. Further, for the second quarter (“Q2”) of 2012, [Confidential] [REDACTED] [Confidential] PGE’s failure to provide analytical support for its purchases or evidence that the market was liquid was imprudent.

II. STANDARD OF REVIEW

The purpose of this proceeding is to determine whether PGE’s 2012 net variable power costs were prudently incurred and should be included in rates. PGE has the burden of demonstrating that its proposed rates are just and reasonable. ORS § 757.210(1)(a). The burden of demonstrating that rates are just and reasonable is borne 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). PGE must demonstrate that an expense was reasonable and prudent before the Commission will allow it to be included in rates. Re US WEST Communications, Inc., Docket Nos. UT 125/UT 80, Order No. 00-191 at 15 (April 14, 2000). Prudence is determined by the circumstances that existed at the time the expense was incurred and is based on what the company knew or should have known at the time it made the decision. Re Northwest Natural Gas Co., Docket No. UG 132, Order No 99-697 at 53 (Nov. 12, 1999).

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). Consequently, ICNU’s role in this proceeding is responsive, and ICNU is not required to show that PGE was *imprudent* to prevail.

III. ARGUMENT

When PGE implemented the MTS to hedge its gas needs for 2012, it made a huge bet on the price of natural gas. Unfortunately for customers, PGE bought at the top of the market. Between [Confidential] [REDACTED] [Confidential] PGE entered into [Confidential] [REDACTED] [Confidential] fixed-for-floating gas financial hedges [Confidential] [REDACTED] [REDACTED] [Confidential] ^{1/} ICNU/100, Schoenbeck/2. As a result of the decline in the price of gas since that time, PGE will be required to pay out approximately [Confidential] [REDACTED] [Confidential] for the gas financial hedges included in the AUT. PGE now seeks to recover the cost of these hedges in rates. PGE's big bet on gas was imprudent because PGE failed to adequately document its reasons for implementing a front-end loaded gas strategy or the analysis supporting each transaction. Likewise, PGE failed to show that it bought the gas hedges in a liquid market. In fact, the lack of reported transaction data, combined with the limited number of available counterparties demonstrates that the market was not liquid at the time PGE entered into the transactions. In sum, PGE provides little justification for taking such a big gamble.

A. PGE Was Required to Document the Prudence of its Decision to Buy the Gas Hedges

ICNU and CUB are challenging PGE's gas hedges because they were imprudent at the time they were made, not because the market price of gas dropped. In 2007 and 2008, PGE implemented the MTS, which was an untested strategy and

^{1/} Each transaction is listed in lines [Confidential] [REDACTED] [Confidential] of ICNU/103, Schoenbeck/1.

approach, but PGE failed to exercise oversight and control of traders, who went on a [Confidential] [REDACTED] [Confidential] spending spree buying gas hedges four and five years into the future (ironically, at the height of the market), without showing that the markets were liquid or providing adequate documentation. While PGE continues to insist that these purchases were prudently made, by the Company's own admission, it now allows its traders to buy hedges only 48 months in the future. PGE/400, Lobdell-Outama/16. If this more prudent 48 month limitation had been in place in 2007 and 2008, customers would not now be asked to foot such a large bill associated with PGE's failed hedging strategy.

1. Execution of the Purchases Was Contrary to the Direction of the OPUC Staff and PGE Was Aware of the Risk of Disallowance

PGE tries to portray an extensive regulatory process related to adoption of the MTS; however, the MTS was only briefly discussed at one Commission meeting. In July 2006, at the only public meeting at which the MTS was discussed before implementation, PGE gave the Commission an approximately ten-minute presentation describing the new strategy. PGE/403. At that time, the OPUC Staff made it clear that its support of the MTS was contingent on two requirements: 1) there must be liquidity in the 3-5 year market that the MTS targeted; and 2) PGE must document the analysis underlying each transaction. ICNU Cr. Ex. 703 at 10-11.

The concerns that prompted Staff to establish conditions for its support of the MTS were well founded. At the time of the OPUC meeting, PGE admitted that there was not sufficient liquidity in the market for the kinds of purchases they wanted to make,

and the MTS was based on their hope that a liquid market would emerge. Id. at 7. The purpose of PGE's plan was "to be able to be at the front end of" the market. Id. Staff's conditions were meant to ensure that PGE would not enter into risky transactions by requiring PGE to document the analysis which supported *each* transaction or risk a prudence disallowance.

PGE understood the conditions of Staff's support. In September 2006, when the MTS was approved by the PGE Risk Management Committee, proponents of the strategy told the Committee that the Company would [Confidential] [REDACTED] [REDACTED] [Confidential] ICNU Cr. Ex. 704 at 6. Thus, while the MTS created a framework for entering 3-5 year transactions, actually implementing the transactions was contingent on market analysis and a demonstration of liquidity. ICNU/110 includes transaction preapprovals for each of the [Confidential] [REDACTED] [Confidential] gas hedges. Preapproval was required for each of the transactions under PGE's Risk Management Policy due to their tenor. ICNU/100, Schoenbeck/6; ICNU/102, Schoenbeck/3-5.

PGE also understood that the MTS was a risky strategy. When presenting it to the Commission, PGE acknowledged that the MTS would negatively affect its credit ratings, potentially consume resources to meet margin calls, and limit its short-term liquidity. ICNU Cr. Ex. 703 at 6-7. PGE admitted that more collateral would be needed. As markets declined, more financial pressure was placed on the Company, and increases in collateral were required from counter parties. PGE/400, Lobdell-Outama/40. As the evidence discussed below demonstrates, despite understanding the tremendous risks

PAGE 5 – REDACTED OPENING BRIEF OF ICNU

involved, PGE hedged more than its needed gas supplies and failed to document or justify its long-term purchases. The Company allowed its traders to work in illiquid markets, ultimately incurring huge losses, which it now asks the Commission to shift to its customers.

B. PGE Provided No Contemporaneous Documentary Support for Its Decision to Enter into the Gas Hedges

When PGE began to implement the MTS, it failed to meet the prudence conditions required by Commission Staff and explained to the PGE Risk Management Committee. PGE failed to document the analysis supporting each specific transaction, and the evidence in the record does not show that a liquid market existed for calendar year gas strips for 2012 during the [Confidential] [REDACTED] [Confidential] that PGE executed transactions.

As justification for its purchases, PGE produced documents in response to ICNU Data Request No. 90, which are included at ICNU/110, Schoenbeck/36. These documents do not provide a record of reasoned analysis supporting each hedging transaction. ICNU/110 demonstrates that PGE began cautiously authorizing purchases of small fixed-for-floating swaps, and it limited the time in which the traders could execute the transactions and the prices at which the transactions could be executed. For example, on [Confidential] [REDACTED] [REDACTED] [Confidential]^{2/} ICNU/110, Schoenbeck/37.

At this early date, the company appeared to be exercising some oversight, stipulating a

^{2/} While the nominal value does not necessarily reflect the net value of a hedge at the time of payout, it does provide a useful metric for comparing the relative size of transactions.

[Confidential] [Confidential]
and allowing a [Confidential] [Confidential] window to execute the transactions before expiration of the approval. Id. These approval terms are typical for the transactions that took place during the [Confidential]
[Confidential] See, e.g. ICNU/110, Schoenbeck/38-41. However, as gas prices rose and PGE continued on its financial hedging spree, this oversight vanished. By the [Confidential] [Confidential] PGE traders were being given carte blanche to enter into long-term financial hedging deals with total nominal values as large as [Confidential] [Confidential] Id. at Schoenbeck/66. Traders were given as long as [Confidential] [Confidential] to execute these deals before further oversight was required, and they were given price ranges of [Confidential] [Confidential] [Confidential] or more in which to make transactions. Id. at Schoenbeck/67 [Confidential] Schoenbeck/130 [Confidential]

Despite the extraordinary and expanding latitude that was given to PGE's traders, there was no concurrent increase in oversight by management or in reporting by the traders. In fact, contrary to the Commission Staff's precondition that each long-term trade should be accompanied by written justification and evidence of market liquidity, PGE made no effort to document either the appropriateness of each transaction or the liquidity of the market. Indeed, PGE's forays into this new and untested strategy were generally supported only by single-page memoranda that did not provide any analysis of market conditions or liquidity. See, e.g., ICNU/110, Schoenbeck/37-39. On

[Confidential] [REDACTED], [Confidential] PGE pre-approved trades worth up to [Confidential] [REDACTED] [Confidential] for which PGE has been unable to supply one single page of supporting analysis. Id. at Schoenbeck 66.

PGE provided [Confidential] [REDACTED] [Confidential] financial hedges entered into in 2007 and 2008. [Confidential] [REDACTED] [REDACTED] [Confidential] See ICNU/110, Schoenbeck/37-141. Even in the few cases that PGE has provided what it claims to be documentation supporting the approval of a transaction, the company appears to have neither created nor relied upon any analysis for the 4-5 year hedges made under the MTS. For example, for the preapproval memo dated April 28, 2008, PGE supplied 60 pages of e-mails and trade journal printouts, which allegedly provide support for one of the transaction approvals executed under the MTS; however, a careful review of these documents demonstrates that nearly all of the materials are analyses of short term, 1-24 month markets, and none of them provide any support for 4-5 year hedges, or analyses of the 2012 and 2013 markets which were being hedged under the MTS. Id. at Schoenbeck/69-129.

In addition, there is absolutely no discussion of how these apparently random printouts of trade press information support individual transactions. Also missing is any explanation of why PGE granted its traders increasing latitude as to the price and timing of purchases to implement the MTS. When questioned about the fact that PGE's supporting materials did not discuss long term markets, Company witness

Outama only noted that one bullet point in one e-mail from an outside consultant updated construction progress on a pipeline. Tr. at 133: 13-18, (Lobdell-Outama). While third-party construction projects might have some unquantifiable effect on some undetermined future markets, it is difficult to understand how mentioning the construction schedule for one pipeline project constitutes analysis supporting the transaction and the market liquidity surrounding the transaction to which the e-mail was attached.

In fact, the Company essentially admits that it did not document whatever analysis might have gone into each trade, saying, “[t]hat document we take as a whole that the organization is looking at when we were making those trades in that open position” Id. at 138: 4-6. Though confusing, the Company appears to be claiming that because they had a mid-term strategy, and because they used the mid-term strategy to make the trades in question, their obligation to provide documentation justifying each trade was somehow met. Apparently, PGE believes that the fact that it made the trades is, in itself, all the justification that the Commission should need to show the trade was prudent.

PGE understood that implementation of the MTS involved risk. PGE’s witnesses acknowledged that they had a duty to support their trades with documentation.

[Confidential] [REDACTED]

[REDACTED] **[Confidential]** Further, PGE acknowledged at the 2006 OPUC meeting that the 3-5 year market was not yet liquid. Nevertheless, PGE however, failed to document how market conditions had changed when it began purchasing 2012 gas hedges in 2007. The Commission should decline to

put in rates transactions with nominal values well in excess of [Confidential] [REDACTED] [Confidential] dollars based on *no* supporting documentation whatsoever, or in the best cases, on a stack of seemingly irrelevant e-mails with a few words about pipelines or information about short term markets.

C. The Market Was Not Liquid When PGE Purchased the 2012 Gas Hedges

Though PGE admitted that there was not yet a functioning market for the products it wished to purchase in mid-2006, [Confidential] [REDACTED] [Confidential] ICNU/102, Schoenbeck/1. PGE has not demonstrated that the market for financial hedges 48-60 months out suddenly became liquid. In fact, the evidence in the record demonstrates that the market for these products was not liquid.

Liquidity depends upon the “number of parties participating in . . . transactions and the number of products they are willing to offer.” ICNU/108, Schoenbeck/7. As Mr. Schoenbeck explains, liquidity disappears “[a]s the tenor of the sought after transaction increases [because] the number of offered products will drop off due to the risk, uncertainty and cost arising from the length of the transaction.” ICNU/108, Schoenbeck/7. This means that liquidity depends, for each individual entity, on the transactions it has access to; thus, a utility with better credit might find greater liquidity for products than a utility with poorer credit, and based on this fact, it should be expected that PGE, with a BBB rating from Standard & Poor’s, will face a less liquid market than a utility with, as an example, an A- rating. ICNU Cr. Ex. 700 at 2.

Nonetheless, whether a certain type of product is generally liquid can be determined based on objective market measures, primarily, the number of available counterparties and the volume of transactions. PGE states that a market is liquid if “it gets traded fairly frequently.” Tr. at 110: 12-13, (Lobdell-Outama). Mr. Stoddard, PGE’s outside expert, states that liquidity for long-term hedges is indicated by data from the Intercontinental Exchange (“ICE”). PGE/500, Stoddard/19. He explains that higher volumes of natural gas traded among numerous market participants on ICE signals a liquid market for the products, and conversely, low volumes indicate that the products were not liquid. Id. Mr. Stoddard’s position on using ICE to determine liquidity was stated during the hearing:

Q: Is the ICE data, in your opinion, a valid data point for determining liquidity in 2007 and 2008?

A: Yes. I think that it’s indicative, if not dispositive.

Tr. at 63: 15-19, (Stoddard). Applying this standard, the evidence indicates that PGE was making its purchases of 2012 calendar strips in an illiquid market. Mr. Stoddard’s work papers show that for [Confidential] [REDACTED] [REDACTED] [Confidential] ICNU Cr. Ex. 705. This means that the trading volume was [Confidential] [REDACTED] [REDACTED] [Confidential] in which PGE was making purchases. The Company’s data responses to ICNU data requests 82 and 84 indicate that the Company’s contemporary analyses of liquidity were primarily based upon the ICE data used by Mr. Stoddard.

ICNU/110, Schoenbeck/27, 29. This means, using the Company's own standards, that for these four quarters at least, PGE was trading in an illiquid market.

As Mr. Schoenbeck notes, a bilateral liquid market could exist, even if the transactions were not reported on ICE; however, the Company has not rebutted the presumption of illiquidity created by the ICE data. Pursuant to its duty to document, PGE should have kept records demonstrating that there was a liquid bilateral market.

Lack of market liquidity also is demonstrated by the number of counterparties that PGE was authorized to buy from in the 3-5 year market. Mr. Stoddard agrees that the existence of numerous market participants is another indication of market liquidity. PGE/500, Stoddard/19. [Confidential] [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] [Confidential] this large number of available counterparties clearly indicates a liquid market for these products, which is consistent with the

[Confidential] [REDACTED]

[REDACTED]

[REDACTED] [Confidential] On the other hand,

[Confidential] [REDACTED]

[REDACTED]

[REDACTED] [Confidential] Rather than rebut the indication of illiquidity offered by

ICE, examination of the Company's available counterparties in the bilateral market reinforces this presumption. While transaction data and available counterparties increased over time, PGE documented no contemporaneous analysis to demonstrate that the market had become liquid.

During the course of this proceeding, PGE has substantially changed its position regarding the data that should be relied on to determine market liquidity. At the hearing, PGE backed away from its data responses, which indicated it primarily relied upon ICE data for liquidity analyses. Instead, PGE stated that it now believes liquidity was determined by comparing what the Company believed a product was worth to the price at which the product was offered to the Company. Tr. at 107: 13-20 (Lobdell-Outama). This means that rather than using any objective marker to determine liquidity, such as volume of trades or counterparties, PGE simply made a guess as to the value of natural gas 48-60 months in the future, and then looked to see whether any of the limited available counterparties would offer the product at that price. PGE relied upon the judgment of its traders, in effect bidding against itself, to procure **[Confidential]** [REDACTED] **[Confidential]** 48-60 months into the future. In other words, the Company decided that if it liked the price that counterparties were offering, then the market must be liquid. Accepting this tail-wags-the-dog logic would allow the Company to buy any item at any price and claim that its purchase was prudent. Perhaps it was just this kind of behavior that the Commission Staff had in mind when it set the condition that PGE justify each purchase with a documented analysis. At best, PGE's purchases were speculation.

PAGE 13 – REDACTED OPENING BRIEF OF ICNU

Even ignoring PGE's failure to adequately document its transactions, the evidence shows that by objective measures, namely transaction volumes and available counterparties, there was not a liquid market for 2012 gas hedges, [Confidential] [REDACTED] [Confidential] The evidence shows that PGE's actions were imprudent.

D. PGE Should Have Considered Other Products, Instead of 12 Month Strips Exclusively

ICNU does not believe that PGE could have prudently purchased [Confidential] [REDACTED] [REDACTED] [Confidential] ICNU/100, Schoenbeck/8. Further, PGE does not need gas during the second quarter of each year, because its gas generation is not needed due to abundant hydro power. ICNU/100, Schoenbeck/11. Nevertheless, PGE bought 12 month gas hedges, creating a surplus during the second quarter, when market prices are lower. PGE provided no documentation or analysis to support this strategy. If the Commission were to determine that PGE has demonstrated a liquid market for gas hedges 60 months in advance, then the markets for monthly or seasonal strips were no less liquid than for calendar strips. ICNU/108, Schoenbeck/7-8.

PGE claims that it was implementing a strategy of buying calendar strips and selling off the surplus during Q2. PGE/400, Lobdell-Outama/31. This appears to be an after the fact rationalization because there is no contemporaneous support for this claim. Likewise, PGE claims that monthly and quarterly products were available, but subject to a premium. PGE/400, Lobdell-Outama/29. Yet, PGE provides no evidence of

what the premium would be, nor any evidence that PGE even stopped to consider the alternatives. Finally, there is no evidence that supports PGE's claim that it was cheaper to buy 12-month strips and sell the Q2 surplus, compared to buying monthly or quarterly hedges.

PGE appears to believe that a prudent investment strategy focuses all risk on a single commodity purchased in 12 month strips in a short period of time. Risk is actually reduced by diversifying hedges over time. Not only did PGE dogmatically refuse to consider quarterly or monthly strips that were no more illiquid than the hedges it purchased, the Company also failed to reduce risk by diversifying with both gas and electric hedges. As Mr. Schoenbeck has pointed out, many of the same market participants that deal in long-term gas hedges also deal in power hedges, particularly up to 48 months. ICNU/108, Schoenbeck/6. This means that by the end of PGE's hedging spree in an illiquid gas market, the market for power swaps would have been becoming liquid – a fact that PGE ignored. The prudent strategy would have been a diversified approach that varied the timing, tenor, and products being purchased.

E. The Commission Should Adopt Mr. Schoenbeck's Proposed Disallowance

Though aware of the importance of comprehensive documentation and the risk of a prudence disallowance without it, the Company chose to implement the MTS without the kind of documentation that would have allowed the Risk Management Committee and the executive leadership to exercise proper oversight.

Without proper oversight or documentation, PGE traders made enormous purchases in a tremendously thin market as much as 5-years in advance. As Mr.

Schoenbeck explains, in his over 35-years of experience in the industry, he has seen that utilities in Washington, Oregon, and California simply do not hedge that far out.

ICNU/108, Schoenbeck/13. PGE has presented no evidence that these markets were liquid, or that its purchases were arguably prudent. The Company's own expert has testified to a method of analysis that indicates the markets were illiquid. PGE itself has provided no evidence supporting market liquidity, saying only that the market for fixed-for-floating swaps, executed for a commodity usually traded thousands of times every day between dozens or hundreds of parties, was liquid when there were only [Confidential] [Confidential] participants, including PGE.

The Commission should adopt Mr. Schoenbeck's recommendation and disallow recovery of [Confidential] [REDACTED]

[REDACTED] [Confidential] for over procurement of second quarter gas needs and

[Confidential] [REDACTED] [Confidential] for hedges over 48 months in tenor.

ICNU/108, Schoenbeck/3. The proposed disallowance recalculates the mark-to-market value of the hedges based on a more appropriate programmatic hedging approach.

ICNU/102, Schoenbeck/118. This disallowance is equal to the sum of the [Confidential]

[REDACTED]

[REDACTED] [Confidential]

ICNU/109, Schoenbeck/100.

F. PGE's Arguments Are Unconvincing

1. A Single Customer Survey Question Does Not Justify the Imprudent Bets Entered Into by the Company Under the MTS

PGE claims that it instituted the MTS because of customer demand; however, it goes without saying that customers don't want *high* stable rates. Primarily, PGE appears to have relied upon anecdotal evidence. With no supporting data or records, the Company merely claims to have "heard from numerous customers . . . that they value retail price stability." PGE/400, Lobdell-Outama/6. This assertion is so vague and ambiguous as to be meaningless in this proceeding.

PGE's second rationale is based on a single question on a customer survey, which asked whether customers preferred "'small, predictable, annual price increases' or resources that would result in smaller, but less predictable, price increases.'" Id. at 6-7. It is hard to take seriously PGE's claim that this vague, open-ended, and undefined question could justify the entire MTS strategy and the risks the Company entered into under it. This single question did not provide any indication of what the difference between "small" and "smaller" would actually be. It does not address the fact that prices can also go down. PGE made no effort to inform the customers of the kinds of risks or price increases it contemplated.

The Company also compares hedging to the purchase of an insurance policy. PGE/500, Stoddard/6-7. PGE's reliance on one vague survey question is akin to asking a customer if he or she would like more coverage or less coverage under an insurance policy, without revealing how much the premium will increase, let alone

informing the customer that the premium will be tied to risky, imprudent bets in the commodities market.

2. PGE Has Not Demonstrated that a Disallowance for Imprudence Would Create any Adverse Effects Beyond those Engineered by the Company Itself

PGE argues that the Commission cannot disallow recovery of any part of PGE's [Confidential] [REDACTED] [Confidential] in losses on gas financial hedges because disallowance would ruin predictability and stability, shock investors and ratings agencies, and damage the Company's credit rating and stock price. PGE/300, Pope-Valach/8. This argument is flawed in two ways: first, the Company has not demonstrated that any such adverse effects would follow, and second, the Commission sets rates based on reasonable and prudent investment, not on a utility's concern that it might suffer adverse impacts if imprudent investments are not allowed.

While disallowance of *prudently* incurred costs could theoretically have a negative effect upon a utility's ability to attract capital, there is no evidence that a disallowance of *imprudently* incurred costs in this case would do so. Also, the evidence related to a previous prudence disallowance suggests otherwise. On February 11, 2010, the Commission disallowed \$13.2 million, plus accrued interest, related to the 2005 outage at the Boardman power plant. Re PGE, OPUC Docket No. UE 196, Order No. 10-051 (Feb. 11, 2010). ICNU has been unable to find a single reference to this substantial disallowance in any ratings agency materials review related to PGE. When questioned repeatedly, PGE's CFO was also unable to show that the disallowance affected the Company's ratings. Tr. at 93-99 (Pope-Valach).

As was the case in UE 196, any shock that the current disallowance might create would happen not at the disallowance, but when the investment community became aware of the risk of disallowance due to a prudence review. The investment community well understands the concept of a prudence review. Id. at 101:2-7. In fact, PGE testified that investors and analysts from ratings agencies carefully follow PGE's regulatory proceedings. PGE. Id. at 100: 1-17. This means that any shock caused by a disallowance of imprudent costs would stem not from the Commission's proper oversight, but would be caused by PGE's inexplicable failure to discuss any details of this case with its investors. Id. at 100: 23-25. PGE has not demonstrated that disallowance of imprudently incurred costs would adversely affect the regulatory environment or investment community.

Ultimately, the financial impacts of a disallowance are irrelevant to the Commission's determination in this case. The Commission only has authority to allow fair, just and reasonable rates. ORS § 757.210(1)(a). To this end, PGE must demonstrate the prudence of its decisions. Re Northwest Natural Gas Co., Order No. 99-697 at 53. Conversely, the OPUC has never recognized an exception whereby imprudently incurred costs may be allowed in rates due to the alleged adverse financial implications of a disallowance. The Commission should decline to add a financial impact test to the well established prudence equation, because disallowance of imprudent costs will always have negative financial impacts for a utility.

3. The Commission Has Not Previously Approved the Hedging Contracts at Issue in this Case

PGE contends the hedges at issue in this case cannot be challenged because some of the agreements were included in power costs approved in previous AUT cases. This argument essentially amounts to an unfounded assertion of collateral estoppel or issue preclusion. See, e.g., PGE/300, Pope-Valach/8, PGE/400, Lobdell-Outama/25. There are “five requirements essential to the application of issue preclusion.” Barackman v. Anderson, 338 Or 365, 368, 109 P3d 370 (2005). Those five requirements are:

1. The issue in the two proceedings is identical. . . . ;
2. The issue was actually litigated and was essential to a final decision on the merits in the prior proceeding. . . . ;
3. The party sought to be precluded has had a full and fair opportunity to be heard on that issue. . . . ;
4. The party sought to be precluded was a party or was in privity with a party to the prior proceeding. . . . ; and
5. The prior proceeding was the type of proceeding to which this court will give preclusive effect. . . .

Nelson v. Emerald People's Utility Dist., 318 Or 99, 104, 862 P2d 1293 (1993).^{3/}

As an initial matter, the first Nelson requirement of issue identity is not present here. The instant case concerns whether the hedging transactions affecting 2012 power costs are just and reasonable. The Commission must consider market liquidity issues which are not identical to those which could have been raised in prior AUT cases—that is, even though the same hedging transactions may have been included in previous AUT cases, a five year hedging strip implicates different liquidity

^{3/} The Commission both recognizes and has applied Oregon’s five-factor issue preclusion test in its own determinations. OPUC v. Crooked River Ranch Water Co., et al., OPUC Docket No. UM 1381, Order No. 08-409 at 8 (Aug. 7, 2008).

considerations in, for example, the fourth or fifth years. A decision to hedge three years out may be prudent while a decision to hedge five years out may be imprudent, based on differences in market liquidity between those years. Accordingly, hedging prudence issues are not identical, year-in and year-out, even for a single multi-year hedge.

Further, the second, third and fifth Nelson requirements also are not present. The OPUC adopted both the 2010 and 2011 AUT settlement stipulations (in UE 208 and UE 215, respectively) by adopting each stipulation “in its entirety.” Re PGE, OPUC Docket No. UE 208, Order No. 09-433 at 12 (Oct. 30, 2009); Re PGE, OPUC Docket No. UE 215, Order No. 10-410 at 5 (Oct. 20, 2010). In each of those stipulations (both of which ICNU signed), PGE agreed that no party would be “deemed to have . . . consented to the . . . methods . . . employed by any other [Stipulating] Party in arriving at the terms of this Stipulation,” and that no stipulation provision would be “appropriate for resolving issues in *any other proceeding*.” Re PGE, Order No. 09-433 at Appendix A, p. 5, ¶ 14; Re PGE, Order No. 10-410 at Appendix A, pp. 5–6, ¶ XVII (emphases added).

The Commission has recognized and honored similar non-preclusive provisions in other adopted settlement stipulations. For instance, the OPUC has stated that “all settlements are understood to be limited to their specific circumstances.” Re Avista Corp., OPUC Docket No. UG 186, Order No. 09-422 at 9 (Oct. 26, 2009). In Re Avista Corp., in adopting the parties’ settlement stipulation, the Commission recognized that the stipulation was a negotiated compromise “and that the terms incorporated in the Stipulation should not be viewed as precedent setting in subsequent proceedings.” Id. at 7. To apply preclusive effects to settlement stipulations would be anything but fair and

just—creating an incentive for utilities to bury imprudent transactions within workpapers and claim that prudence was “decided” by the adoption of an unspecific stipulation.

In the past, the Commission has declined to extend the preclusion doctrine beyond judicial review to settlements. Addressing an issue related to a settlement reached in a Federal Energy Regulatory Commission (“FERC”) proceeding, the Commission stated that “[i]n any case, the FERC proceedings were resolved by settlement, *which is not the same as adjudicatory review.*” Wah Chang v. PacifiCorp, OPUC Docket No. UM 1002, Order No. 04-305 at 6 (May 27, 2004) (emphasis added). This implicitly recognizes the second element of Nelson that the issue must be actually litigated in the previous case. While the transactions at issue in this case may have been included in previous AUT cases for different time periods, the prudence of those transactions was not actually litigated. Thus, the elements of Nelson for issue preclusion have not been met, and the prudence of the hedging transactions is properly at issue in this case.

4. PGE’s Total Net Open Position Is Irrelevant to The Question of Prudence

While PGE has not presented any documentation showing its traders were purchasing long term fixed-for-float swaps in a liquid market, the Company relies heavily on its claim that it hedged gas as a way to hedge its overall power needs. Its argument appears to be that this made it *per se* prudent [Confidential] [REDACTED]
[REDACTED] [Confidential] PGE/400, Lobdell-Outama/8-9. PGE acknowledges that the Commission never approved the MTS, and it

certainly it did not require that the terms of the MTS be met, particularly if doing so would be imprudent. Tr. at 137: 4-10, (Lobdell-Outama). In fact, PGE acknowledged that the fact that the long term purchases would be particularly vulnerable to prudence reviews was one of the most serious downsides of the strategy. PGE/404C Lobdell-Outama/10.

While ICNU understands that there is a correlation between gas and electricity, the idea that it was prudent for the Company to rush to hedge [Confidential] [Redacted] [Confidential] that the traders were implementing the MTS ignores the fact that the company must still show a documented rationale for each transaction, and it must prove that the market for these purchases was liquid at the time it made the transaction. Mr. Schoenbeck pointed out that [Confidential] [Redacted] [Redacted] [Confidential] and most utilities spread their transactions over time to diversify risk, rather than trying to beat the market by trying to purchase [Confidential] [Redacted] [Confidential] in a short time frame. ICNU/108, Schoenbeck/11-12; ICNU/109, Schoenbeck/27. Any departure from this norm should require a reasoned contemporaneous justification.

Despite the fact that the MTS was instituted, in the Company's words, in order to "be able to be at the front end" of an allegedly emerging market, PGE still claims that it does not bet on the market. Yet a purchase of the Company's [Confidential] [Redacted] [Confidential] of time is a de facto bet by any investment standard. If the company had prudently waited for market liquidity rather

than trying “to be at the front end,” the company would not have bet the house at the peak of the market. By averaging purchases over time through a programmatic approach, the risk of high prices would have been averaged while still lowering volatility. Instead, PGE’s gas hedging binge lasted until [Confidential] ██████████, [Confidential] after which the purchases abruptly cease. ICNU Cr. Ex. 702 at 25. At the point that all parties would agree that the market for 2012 hedges became liquid, PGE quit trading and did not make another purchase for over a year. Id.

IV. CONCLUSION

In 2006, PGE developed a complex plan to begin purchasing risky financial products in an effort to be on the front of what it considered to be an emerging market. The Company gave the Commission a ten-minute presentation on the plan and then ignored the conditions that the Commission Staff set for their support of the strategy. PGE’s evidence shows that it executed this strategy without proper documentation or oversight, and as a result, its traders imprudently front-loaded the Company’s gas needs in an illiquid market. Given the opportunity meet its burden of proof, PGE has offered evolving and self-serving justifications for the manner in which market liquidity might have been determined, but in the end, the transactions in question were documented by no more than single-page memoranda void of any serious analysis of market conditions. The Company has not demonstrated that these unusually risky purchases were prudently entered into; therefore, the Commission should not allow the Company to pass the negative results off onto customers.

PGE has failed to show the hedges in question were prudent, and it offers no serious justification for its risky choices. As a result, the Commission should adopt the recommendation of Mr. Schoenbeck and disallow [Confidential] [REDACTED] [Confidential] for imprudent hedges for the 2012 rate year.

Dated this 14th day of September, 2011.

Respectfully submitted,

DAVISON VAN CLEVE, P.C.

/s/ S. Bradley Van Cleve

S. Bradley Van Cleve

Melinda J Davison

333 S.W. Taylor, Suite 400

Portland, Oregon 97204

(503) 241-7242 phone

(503) 241-8160 facsimile

bvc@dvclaw.com

mjd@dvclaw.com

Of Attorneys for the Industrial Customers of
Northwest Utilities