BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UG 344

In the Matter of NORTHWEST NATURAL GAS COMPANY, dba NW NATURAL Request for a General Rate Revision.	STAFF BRIEF

Department of Justice
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I. Introduction.

This docket concerns the request for a general rate increase filed by Northwest Natural Gas Company (NW Natural) on December 29, 2018. Most of the issues identified by Staff and the two intervenors to this docket, Oregon Citizens' Utility Board (CUB) and Association of Western Energy Customers (AWEC), have been resolved by an all-party stipulation filed with the Commission on August 6, 2018. The issues not resolved in the stipulation filed on August 6, 2018, are issues related to the corporate tax rate decrease under Tax Cuts and Jobs Act (TCJA), NW Natural's Pension Balancing Account, and the appropriate allocation of revenues from NW Natural's Mist storage service and the optimization of both Mist and non-Mist facilities.

Staff has entered into an agreement in principle with NW Natural and CUB to resolve the issues related to the corporate tax rate decrease and NW Natural's Pension Balancing Account.[1] The settlement in principle is not yet reduced to a written stipulation. Because the stipulating parties are still in the process of reducing the agreement to writing and the stipulation has not yet been executed, Staff will not address these two issues in this brief. Accordingly, the only issue addressed in Staff's brief is the allocation of storage service and system optimization net revenues between shareholders and customers.

Staff recommends that the Commission retain the current shareholder/ratepayer sharing for net revenues from interstate and intrastate storage service and optimization activities using NW Natural's Mist underground storage facility, but increase the percentage of net revenues passed through to ratepayers for system optimization activities using non-Mist assets.[2] Currently, ratepayers receive 67 percent of the "net margin" produced by these optimization activities and the Company retains 33 percent.[3] For reasons discussed below, Staff recommends

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[1] AWEC is not part of the settlement in principle.

[2] See Staff/1300, Glosser/2.

[3] *In the Matter of Northwest Natural Gas Company dba NW Natural Investigation of Interstate Storage and Optimization Sharing* (UM 1654), Order No. 15-066, pp. 2-3.

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that the Commission increase the percentage provided to ratepayers to 90 percent and decrease the percentage retained by the Company to 10 percent.

A. Background.

1. Mist-related storage service and optimization activities.

NW Natural's Mist storage facility utilizes depleted gas reservoirs located near Mist, Oregon.[4] The original utility storage and related pipeline development went into service in 1989, with subsequent expansions for utility customers in 1991, 1997, and 1999. These early expansions were intended to serve core customers, and the capital costs were included in NW Natural's rate base.[5]

Since 2000, NW Natural shareholders have developed additional capacity at Mist that is subject to "recall" when NW Natural determines the capacity is needed for its core customers.[6] The shareholder-owned facilities remain outside NW Natural's rate base until NW Natural "recalls" them to serve core customers. After they are recalled, they are placed into rate base at their depreciated value.[7]

NW Natural uses excess capacity at the Mist Storage facility to provide interstate storage service. Net revenues from storage service using the shareholder-owned assets at Mist are shared between shareholders and ratepayers with an 80/20 split, with shareholders keeping the larger share.[8] Net revenues from storage service using customer-owned facilities are also shared 80/20, but with customers keeping the larger share.[9]

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[4] *Id.*, p. 1.

[5] *Id.*, pp. 1-2.

[6] NW Natural/1301, Friedman/5, Final Report on The Liberty Consulting Group's Evaluation of NW Natural' Optimization Activities (Liberty Report).

[7] NW Natural/1301, Friedman/5 (Liberty Report).

[8] *In the Matter of Northwest Natural Gas Company dba NW Natural Investigation of Interstate Storage and Optimization Sharing* (UM 1654), Order No. 15-066, pp. 2-3.

[9] *In the Matter of Northwest Natural Gas Company dba Northwest Natural Investigation of Interstate Storage and Optimization Sharing* (UM 1654), Order No. 15-066, pp. 2-3.

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In 2002, NW Natural began realizing significant net revenue from the optimization of Mist capacity by a third-party asset manager, Tenaska Marketing Ventures (TMV).[10] In 2003, the Commission authorized NW Natural to share revenues realized from shareholder-owned assets using the same 80/20 split used for sharing of revenues for storage service using assets owned by NW Natural. However, the Commission authorized NW Natural's proposal that net revenues from optimization using customer-owned facilities at Mist are shared 67/33, with customers keeping the larger share. [11]

The Mist-related sharing arrangements are reflected in Schedule 185, "Special Annual Interstate and Intrastate Storage and Transportation Credit," which applies to core customers receiving firm sales service whose rates include costs related to the Mist storage facility. Schedule 185 credits these core customers for the Oregon share of net margins received by the company for (1) interstate storage and related transportation services provided under FERC jurisdiction, (2) intrastate storage activities and related transportation services under Schedule 80, and (3) optimization of total Mist storage capacity.[12]

2. Non-Mist system optimization.

TMV, the third-party asset manager that performs the optimization activities at Mist, also performs optimization activities for NW Natural's non-Mist customer-owned resources. Optimization activities include sale and trading of excess gas and excess capacity on upstream pipeline contracts on the Northwest Pipeline, wholesale trading activities such as the exchange of gas commodity contract purchases at different trading locations (portfolio optimization), the use of off-system, underground storage contracts at Jackson Prairie and in Alberta, and the extraction of natural gas liquids (NGLs, or liquids).

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[10] NW Natural/1301, Friedman/28 (Liberty Report).

[11] NW Natural/1301, Friedman/26 (Liberty Report).

[12] *In the Matter of Northwest Natural Gas Company dba Northwest Natural Investigation of Interstate Storage and Optimization Sharing* (UM 1654), Order No. 15-066, pp. 2-3.

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Under Schedule 186, "Special Annual Core Pipeline Capacity Optimization Credit," eligible customers are credited with the Oregon share of net margins received by NW Natural for the optimization of core customer pipeline, gas processing, commodity supply, and non-Mist storage capacity. Schedule 186 provides that NW Natural will share with eligible customers the net margin attributable to third-party optimization for the entire portfolio of upstream capacity contracts. The company shares revenues with its firm and interruptible sales customers on a two-thirds basis, with 67 percent credited to customers.

3. The Commission investigation of NW Natural storage and optimization revenue sharing.

In NW Natural's last general rate case, which was in 2012, Staff and CUB recommended that the Commission modify the revenue sharing arrangement between NW Natural and shareholders under Schedules 185 and 186. The parties reached a settlement in the rate case under which the sharing arrangement originally authorized by the Commission remained in place and parties would ask the Commission to open an investigation to evaluate Mist storage and optimization sharing.[13] The Commission approved the parties' agreement and opened Docket No. UM 1654 to investigate the allocation of storage and optimization net revenues.

Ultimately, the Commission made no decision on the merits in Docket No. UM 1654. Instead, the Commission ordered a cost study "to determine with greater clarity how costs are generated and shared."[14] The Commission directed "the parties to [Docket No. UM 1654] to form a steering committee that will develop the third-party contract, develop and articulate the elements of the study, interview and hire the third party who will conduct the study, and oversee the contractor's work."[15]

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13 *In the Matter of Northwest Natural Gas Company dba NW Natural Investigation of Interstate Storage and Optimization Sharing* (UM 1654), Order No. 15-066, *supra,* p. 1.

14 *Id.*, p. 1.

15 *Id.*, p. 1.

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4. The Liberty Report.

The Docket No. UM 1654 parties complied with the Commission's order and formed a steering committee that hired the Liberty Consulting Group. The steering committee worked with Liberty Group during Liberty Group's evaluation. Among other interactions, the Liberty Group held weekly status calls with the steering committee to keep the committee updated on project status and give an opportunity for the steering committee and Liberty Group to "discuss issues, observations, key assumptions, data needs, next study steps, and other matters[.]"[16]

NW Natural filed Liberty Group's Final Report on March 27, 2018. With respect to the sharing of net revenues from interstate and intrastate storage service and optimization using Mist assets, Liberty concluded:

> The original design, the historical results, the expected results, the continuation of similar risks and opportunities, and the comparatively smaller dollar amounts at stake provide significant support for continuing the current sharing arrangements for interstate and intrastate Mist storage.[17]

With respect to the sharing of net revenues from optimization activities using non-Mist assets, Liberty concluded:

> Substantial room exists to reduce ownership's share of optimization margins to bring them closer into line with those established in other jurisdictions, while still leaving management with a sufficiently strong incentive to perform optimization in complex and dynamic markets.[18]

B. The Commission should maintain the revenue sharing for storage service and optimization using Mist assets.

Staff does not recommend changing how Mist-related net revenues are shared under Schedule 185, even the 67/33 sharing for net revenues from optimization using customer-owned Mist facilities. The circumstances at Mist are unique because of the benefits to customers from the subject-to-recall assets owned by shareholders. As noted in the Liberty Report, the subject to

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[16] NW Natural/1301, Friedman/7 (Liberty Report).

[17] NW Natural/1301, Friedman/14 (Liberty Report).

[18] NW Natural/1301, Friedman/14 (Liberty Report).

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recall assets provide ratepayers two benefits generally absent when a utility invests in gas supply assets: (1) "just-in-time" capacity additions through the ability to recall just the amounts needed presently and from a pool of resources designed to exist in advance of core utility needs, and (2) reduced costs through the ability to bring the assets into rate base at their depreciated original costs at the time of recall.[19]

Staff believes it is appropriate to recognize this value in the sharing of net revenues from storage and optimization using the combined assets of shareholders and ratepayers at Mist. For this reason, Staff recommends no change to the sharing for net revenues for Mist storage and optimization under Schedule 185.

B. Non-Mist system optimization.

1. The sharing percentage for non-Mist optimization net revenues should be modified.

TMV, the third-party asset manager that performs the optimization activities at Mist, also performs optimization activities for non-Mist customer-owned resources. Optimization activities include sale and trading of excess gas and excess capacity on upstream pipeline contracts on the Northwest Pipeline, wholesale trading activities such as the exchange of gas commodity contract purchases at different trading locations (portfolio optimization), the use of off-system, underground storage contracts at Jackson Prairie and in Alberta, and the extraction of natural gas liquids (NGLs, or liquids).

The circumstances presented by optimization of the non-Mist assets are different than those presented by the Mist assets. The customer-owned and shareholder assets are co-mingled at Mist and these assets are optimized as a whole. The use of shareholder assets at Mist provides benefits to customers that are appropriately captured in the sharing of net revenues from optimization of the co-mingled assets. The same is not true for non-Mist assets. And, there are

[19] NW Natural/1301, Friedman/23-24 (Liberty Report).

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no unique circumstances related to NW Natural's optimization of non-Mist assets that warrants NW Natural keeping a one-third share of net revenues.

For non-Mist assets, customers bear all the investment risk associated with the optimized assets. Notably, Liberty states that it "did not find any risk exposure that, in our judgment, would justify an unusually large share of optimization margins."[20] The Liberty Report also reflects that NW Natural's efforts to optimize customer-owned assets are comparable to those performed by other utilities:

> With respect to the question of optimization scope and activities, management directly observed that it does not undertake activities that are unusual. Our review confirms this view. Management does, however, believe that it pursues a range of optimization activities that, while typical, it seeks out more vigorously. That belief is necessarily subjective. Without criticizing in any respect the aggressiveness (with accompanying care) of management's optimization efforts, we find it difficult to separate in a tangible way the quality or intensity of its efforts from what we have observed elsewhere.[21]

NW Natural is an outlier in only one respect; it is allowed to keep a larger share of optimization revenues than most of the comparable utilities considered by Liberty. Liberty states that it "conducted a very broad, nationwide survey of margin-sharing arrangements, against which we could perform robust comparisons of NW Natural's optimization sharing methods and proportions."[22] Liberty concludes "these comparisons demonstrated that the percentage share available to offset NW Natural core-customer rates falls at the lowest (least remunerative for customers) of the observed range for jurisdictions that provide for sharing."[23]

2. NW Natural's arguments that the sharing percentages should not be changes are not persuasive.

In its brief, NW Natural argues the sharing percentage should not be changed because:

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[20] NW Natural/1301, Friedman/54 (Liberty Report).

[21] NW Natural/1301, Friedman/54 (Liberty Report).

[22] NW Natural/1301, Friedman/38 (Liberty Report).

[23] NW Natural/1301, Friedman/38 (Liberty Report).

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(1) Modification is not supported by the Liberty Report because it does not contain sufficient information about the peer utilities Liberty examined to determine that the current 67/33 sharing is more remunerative to the utility than all but one of the sharing arrangements compared by Liberty.

(2) The Company's level of participation in optimization activities goes above and beyond that of the Company's peer utilities.

(3) Any significant change to the Company's sharing percentage could impact the Company's incentive to optimize.[24]

None of NW Natural's arguments is persuasive.

a. The Liberty Report provides an adequate basis for modification.

The Liberty Report contains data points for its benchmarking studies for utilities in 17 states plus the District of Columbia. This information was available to the steering committee. The Liberty methodology comparisons sought to recognize factors complicating direct comparisons between cohort utilities. First, they removed any company with PGA-only mechanisms from the data. The local distribution companies reflected in the data points include those with optimization-only mechanisms, like NW Natural's. Liberty also included joint PGA savings and optimization margins that peg sharing percentages at the same level for both benefits. Second, the data presented shows the customer/company split of optimization revenues net of any asset-manager share. Thus, the comparisons come as close to comparing the same things as the available data allows.[25]

Furthermore, the topic of the benchmarking study methods and selection and analysis of the cohort peer utilities (and data) were features of the weekly meetings of the steering committee, and NWN had ample time to request more detailed information, or raise any issues they had with the study, at all points during the Liberty investigation. They did not do so.[26]

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[24] NW Natural's Opening Brief, pp. 13-15.

[25] NW Natural/1301, Friedman/51-52 (Liberty Report).

[26] Staff/1600, Glosser/15-16.

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b. The Liberty Report analyzed NW Natural's participation in the optimization activities.

NW Natural's assertion that their involvement in optimization goes above and beyond that of other utilities was addressed by the Liberty Report. Based on its survey of other utilities and jurisdictions, Liberty concluded that NW Natural's efforts in working with the third-party asset manager are not beyond those generally seen in the industry. Liberty's assessment of the Company's participation and its impact on the appropriate sharing is found in the "Summary of Key Conclusions in the Liberty Report":

- NW Natural management remains well engaged in overseeing the TMV relationship and the asset manager's activities, but again not to a degree outside our experience in the industry.
- NW Natural management does not bear unusual risk associated with the optimization activities that TMV undertakes and that management oversees.
- Optimization comprises a core responsibility of prudent management by gas distribution companies, who, like NW Natural, have significant supply and transportation portfolios.
- We have examined optimization sharing arrangements across the country – some from our direct experience and others through an extensive set of contacts with knowledgeable public service commission staff members.
- We conducted a very broad, nationwide survey of margin-sharing arrangements, against which we could perform robust comparisons of NW Natural's optimization sharing methods and proportions.
- Those comparisons demonstrated that the percentage share available to offset NW Natural core-customer rates falls at the lowest end (least remunerative for customers) of the observed range for jurisdictions that provide for sharing.[27]

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[27] NW Natural/1301, Friedman/37-38 (Liberty Report).

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c. Reducing NW Natural's share of the net revenues of system optimization should not reduce NW Natural's incentive to optimize.

NW Natural's assertion that making the margin sharing less favorable to NW Natural would diminish NW Natural's incentive to pursue optimization activities is concerning. NW Natural has an obligation to act in the interests of its customers. Staff would possibly understand NW Natural's position if the optimization activities posed significant risk to the Company, but they do not.

The optimization activities also do not require NW Natural to incur significant costs. NW Natural has hired an asset manager to perform the optimization activities. The asset manager is paid by the optimization revenues so NW Natural does not bear any extraordinary cost for the asset manager's service.

For the reasons stated above, Staff believes a one-third share of the net revenues overcompensates NW Natural and recommends the Commission allow NW Natural to retain 10 percent of the net revenues rather than 33 percent.

C. NW Natural should report the system optimization revenues in its annual Results of Operations (ROO).

NW Natural does not include system optimization revenues in its Results of Operation (ROO) report. Staff recommends the Commission require the Company to report this income on its ROO. It is appropriate that the Commission require the utility to be transparent about these revenues.

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II. Conclusion.

The Commission should modify the net revenue sharing between ratepayers and the Company under Schedule 186 and require the Company to pass along to ratepayers 90 percent of the net revenues rather than 67 percent. Staff recommends no other change to Schedules 185 and 186.

DATED this 29th day of August, 2018.

Respectfully submitted,

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