

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))

REDACTED

OPENING TESTIMONY OF THE
CITIZENS' UTILITY BOARD OF OREGON

June 30, 2011



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OF OREGON**

UE 228

In the Matter of)	
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PORTLAND GENERAL ELECTRIC)	OPENING TESTIMONY OF THE
COMPANY)	CITIZENS' UTILITY BOARD OF
)	OREGON
2012 Annual Power Cost Update Tariff)	
(Schedule 125))	

1 Our names are Bob Jenks and Gordon Feighner, and our qualifications are listed
2 in CUB Exhibit 101.

3 **I. Introduction**

4 CUB has reviewed Portland General Electric Company (also, "PGE" or "the
5 Company")'s filing in this docket and is encouraged by the overall reduction in Net
6 Power Costs (NPC) that the Company has calculated from its initial forecast. CUB
7 proposes two adjustments in this docket, both concerning PGE's natural gas hedging
8 and trading policies.

9 **II. CUB Adjustments**

10 **A. Excessive Natural Gas Hedging**

11 CUB is concerned by PGE's level of natural gas hedging, especially the amount
12 of longer-term (greater than 36 months) hedges. CUB focused a great deal of resources

1 on NW Natural's gas hedging recently in the UM 1520 docket, and has concerns about
2 a utility hedging a significant portion of its gas supply through conventional hedges that
3 are greater than 3 years (36 months). There are real questions about the liquidity of the
4 market in a timeframe greater than 36 months, and the price risk associated with 5-year
5 hedges is significant.

6 BEGIN CONFIDENTIAL [REDACTED]

7 [REDACTED]¹ XXXXXXXXXXXXXXXX

8 [REDACTED]
9 [REDACTED]
10 [REDACTED]
11 [REDACTED]² END CONFIDENTIAL

12 It is unusual for a utility to hedge the majority of its need for a commodity so
13 early. As a natural gas-only utility, NW Natural must manage the risks of the gas
14 market. Because natural gas is its only commodity, it would be imprudent for NW
15 Natural to not manage that price risk. Until NW Natural's recent deal with Encana,
16 which is a physical purchase of a 30-year gas supply, NW Natural committed to
17 financial hedges with terms of "up to three years."³ While NW Natural would have
18 been willing to enter into longer hedges, the gas utility could not find reliable
19 counterparties with acceptable credit ratings.⁴ The alternative to the 30-year supply that
20 consultant KPMG was asked to analyze in that docket was a running series of 3-year

¹ CUB CONFIDENTIAL Exhibit 102, page 1.

² CUB CONFIDENTIAL Exhibit 102, page 2.

³ UM 1520 / NWN / 400 / Friedman / 2.

⁴ UM 1520 / NWN / 200 / Cronise / 10.

1 hedges because this was seen as the prudent default strategy.⁵ In addition, while PGE
2 does have a power cost adjustment mechanism that shares the difference between
3 forecasted gas costs and actual gas costs, this mechanism has a double deadband (costs
4 and earnings) and is intended for significant variation from forecast and does require
5 surcharges or refunds in most years. This means that much of the risk that is being
6 hedged is shareholder risk. As hedging shifts the risk of commodity price fluctuations
7 from shareholders to ratepayers, a commodity purchase strategy that is chiefly reliant
8 upon hedging removes incentives for a utility to prudently manage commodity costs.
9 CUB believes that buying nearly all of the gas volume needed in long-term hedges is
10 not a prudent hedging strategy.

11 *i. Order from UM 1282*

12 In its Order No. 07-200 adopting the Stipulation filed by the participating Parties in
13 UM 1282, the Oregon Commission indicated that Avista Corp. was engaging in a
14 natural gas purchasing strategy that was imprudent because it was too reliant upon
15 hedging. At the time Avista was hedging 91% of its natural gas load in Oregon. Avista
16 agreed in the Stipulation to cap its hedging at 70% of its Oregon load, which the
17 Commission agreed would provide an incentive for Avista to prudently manage its
18 natural gas costs.

19 PGE's high level of hedging frequently leaves it long on gas supply in certain
20 months. Any long position places the Company's hedging at a greater level than
21 Avista's was when Staff filed a complaint challenging the prudence of that company's
22 hedging strategy. The Staff challenge ultimately led to an agreement for Avista to
23 significantly reduce its hedging positions. CUB recommends that the Commission

⁵ UM 1520 / CUB / 100 / Jenks / 51.

1 impose a limit to PGE's hedging volumes that is similar to the limit agreed upon by
2 Avista in UM 1282.

3 ***ii. Portfolio Approach***

4 In theory, both parties to a hedge have knowledge of the market, and a hedge
5 has a relatively even chance of being in the money or out of the money. Because of this
6 equivalency, it is important for a utility to "hedge" its hedges by spreading out hedges
7 over a period of time so that it is not overly dependent on a single transaction, or on the
8 state of the hedging market at a particular time. There is always a danger that traders
9 will begin to believe that their knowledge of the market is superior and that their insight
10 will allow them to "win" the hedge. There is also a danger that once a company
11 establishes a goal, traders will fill it quickly in order to meet that objective quickly. To
12 avoid these pitfalls, a portfolio approach should be used that layers hedges on top of
13 each other over a period of time.

14 If one were to assume that PGE's counterparty risk is different than NW
15 Natural's and that a five-year window of hedging is prudent, then a portfolio approach
16 would layer on those hedges over that 5-year window. Assuming that hedging almost
17 all gas purchases is prudent, then the appropriate portfolio approach would be to layer
18 the hedges approximately 20% of the hedges each year for 5 years. However, because
19 the price risk increases the further out a hedge is purchased (5 years in the future is
20 riskier than 3 years), it would be prudent to purchase hedges on an inclining block
21 portfolio (for example, 10% year 5, 15 % year 4, 20% year 3, 25% year 2 and 30% year
22 1). A strategy based on hedging nearly 100% of gas requirements in the first two years
23 contains too much risk.

1 ***iii. CUB's Recommendation***

2 PGE has failed to demonstrate that its strategy of heavily purchasing hedges at
3 the earliest time possible, when the market is not very liquid and the price risk is the
4 greatest, is prudent. PGE's hedging strategy hedges too much natural gas volume, and,
5 potentially even worse, hedges that natural gas volume too early, creating significant
6 financial risk to customers. Given the volatility of the long-term hedging market and
7 the substantial losses suffered by PGE and its customers associated with the Company's
8 activity in this market, CUB recommends that the Commission reject as imprudent
9 PGE's gas hedging strategy.

10 CUB believes that hedging should generally be limited to about 75% of gas
11 supply, unless a utility can demonstrate that more is prudent under current market
12 conditions. CUB also believes that most hedges should come from a hedging strategy
13 that is executed during the 3 years before the gas is purchased. While a limited amount
14 of hedging should be allowed in a 3 to 5 year window, a utility must demonstrate that
15 the market is liquid at the time and that this early hedging is consistent with a prudent
16 approach to hedging.

17 PGE has failed to demonstrate the prudence of its strategy. The Commission
18 should find that the Company's strategy is imprudent—that it over-hedges and hedges
19 too early. In order to protect customers from this flawed strategy, CUB recommends
20 disallowing all hedges in the current AUT which were entered into more than 36
21 months ahead of the gas delivery. Instead, this gas supply should be re-priced at the
22 forward price curve for gas at the time of the final update in November.

1 **B. Gas Arbitrage Adjustment**

2 BEGIN CONFIDENTIAL

3 [REDACTED]
4 [REDACTED]
5 [REDACTED]⁶ [REDACTED]
6 [REDACTED]
7 [REDACTED]
8 [REDACTED]
9 [REDACTED]
10 [REDACTED]
11 [REDACTED]
12 [REDACTED]
13 [REDACTED]
14 [REDACTED]

15 CUB Confidential Exhibit 103 shows that the Company actually buys gas from
16 the Rockies [REDACTED] months of the year. The final Monet runs for the last three years,
17 however, show that Monet only forecasts gas purchases (from the Rockies or any other
18 market) for [REDACTED] months each year.⁷ PGE does engage in arbitrage for these additional
19 two months each year, but the primary beneficiary each year is the Company's
20 shareholders.

21 END CONFIDENTIAL

⁶ CUB Confidential Exhibit 103.
⁷ CUB Confidential Exhibit 104.

1 CUB is unsure of the cause of this modeling issue. It could reflect a flaw in the
2 Monet model, which doesn't forecast arbitrage when the plant is scheduled for
3 maintenance or held back due to economic dispatch. Or it could be that forward market
4 curves used in Monet do not show an opportunity for arbitrage during the spring. The
5 fact remains, though, that such an arbitrage opportunity exists every year.

6 CUB recommends an outboard adjustment in the final NPC update equal to the
7 average revenue earned from arbitrage on natural gas sales during the two month period
8 where arbitrage occurs but is not forecast.

9 **III. Conclusion**

10 In this brief testimony CUB has raised two issues related to PGE's natural gas
11 hedging and trading strategies. CUB encourages the Commission to adopt both
12 proposed adjustments:

13 1. *Disallow all hedges in the current AUT that were made more than 36*
14 *months in advance of the purchase date and reprice the gas supply at the current*
15 *price shown in the final November update.*

16 2. *Include an adjustment in the final NPC update equal to the average*
17 *revenue earned from arbitrage on natural gas sales during the two month period*
18 *where arbitrage occurs but is not forecast.*

WITNESS QUALIFICATION STATEMENT

NAME: Bob Jenks

EMPLOYER: Citizens' Utility Board of Oregon

TITLE: Executive Director

ADDRESS: 610 SW Broadway, Suite 400
Portland, OR 97205

EDUCATION: Bachelor of Science, Economics
Willamette University, Salem, OR

EXPERIENCE: Provided testimony or comments in a variety of OPUC dockets, including UE 88, UE 92, UM 903, UM 918, UE 102, UP 168, UT 125, UT 141, UE 115, UE 116, UE 137, UE 139, UE 161, UE 165, UE 167, UE 170, UE 172, UE 173, UE 207, UE 208, UE 210, UG 152, UM 995, UM 1050, UM 1071, UM 1147, UM 1121, UM 1206, UM 1209, and UM 1355. Participated in the development of a variety of Least Cost Plans and PUC Settlement Conferences. Provided testimony to Oregon Legislative Committees on consumer issues relating to energy and telecommunications. Lobbied the Oregon Congressional delegation on behalf of CUB and the National Association of State Utility Consumer Advocates.

Between 1982 and 1991, worked for the Oregon State Public Interest Research Group, the Massachusetts Public Interest Research Group, and the Fund for Public Interest Research on a variety of public policy issues.

MEMBERSHIP: National Association of State Utility Consumer Advocates
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WITNESS QUALIFICATION STATEMENT

NAME: Gordon Feighner

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WORK EXPERIENCE: I have previously provided testimony in dockets including UE 196, UE 204, UE 207, UE 208, UE 210, UE 213, UE 214, UE 216, UE 217, UE 219, UE 227, UM 1355, UM 1431, and UM 1484. I have also completed the Annual Regulatory Studies Program at the Institute of Public Utilities at Michigan State University in 2010.

Between 2004 and 2008, I worked for the US Environmental Protection Agency and the City of Portland Bureau of Environmental Services, conducting economic and environmental analyses on a number of projects. In November 2008 I joined the Citizens' Utility Board of Oregon as a Utility Analyst and began conducting research and analysis on behalf of CUB.

**CUB EXHIBIT 102 IS CONFIDENTIAL
SUBJECT TO PROTECTIVE ORDER NO. 11-102**

**CUB EXHIBIT 103 IS CONFIDENTIAL
SUBJECT TO PROTECTIVE ORDER NO. 11-102**

**CUB EXHIBIT 104 IS CONFIDENTIAL
SUBJECT TO PROTECTIVE ORDER NO. 11-102**

UE 228 – CERTIFICATE OF SERVICE

I hereby certify that, on this 30th day of June, 2011, I served the foregoing **RESPONSE TESTIMONY OF THE CITIZENS' UTILITY BOARD OF OREGON** in docket UE 228 upon each party listed in the UE 228 PUC Service List by email and, where paper service is not waived, by U.S. mail, postage prepaid, and upon the Commission by email and by sending an original and five copies by U.S. mail, postage prepaid, to the Commission's Salem offices.

(W denotes waiver of paper service)

(C denotes service of Confidential material authorized)

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Respectfully submitted,

A handwritten signature in black ink that reads "Sommer Templet". The signature is written in a cursive, flowing style.

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