BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UG 344

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

LIBERTY REPORT OPENING TESTIMONY

OF THE

CITIZENS' UTILITY BOARD

May 4th, 2018

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I. INTRODUCTION

Q. Please state your name and qualifications.

A. My Name is Bob Jenks. I am the Executive Director of the Oregon Citizens' Utility Board (CUB). My business address is 610 SW Broadway, Ste. 400 Portland, Oregon 97205.

Q. Please describe your education background and work experience.

A. My witness qualification statements are found in CUB Exhibit 101.

Q. What is the purpose of your testimony?

A. I will provide CUB's testimony regarding the Liberty Report, Mist Storage, and optimization. The allocation of benefits resulting from storage at Mist and optimization of natural gas assets has been an open issue at the Commission for approximately 6 years. While there once was a commitment to resolving this by the end of 2013, the review of Mist and optimization has taken years. The review has resulted in the Liberty Report, an independent analysis of MIST and optimization that was ordered by the Commission. The primary conclusion of the Liberty Report is NW Natural's share of optimization revenues should be reduced substantially "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."[1] This is consistent with the recommendations CUB has been making since 2012.

II. MIST AND OPTIMIZATION

Q. What is Mist?

A. Mist is an area of northwest Oregon where natural gas was once extracted by NW Natural and other entities. Today, NW Natural has redeveloped it as a natural gas storage facility. There are three operational components of the facility: core customer storage, interstate/intrastate commercial storage (we will refer to this as interstate storage), and a new storage reservoir utilized by Portland General Electric for its Port Westward gas plants.

Q. Please describe the core customer storage?

A. Since 1989, NW Natural has developed reservoirs to store gas for use by its customers. NW Natural's customers primarily use natural gas for heating in the winter. Since the Company is able to store natural gas, the Company reduces costs and reduce price volatility for customers. Costs are reduced in two ways.

First, core customer storage relieves the Company from having to contract for firm pipeline capacity sized to meet its highest winter peak. NW Natural Natural's system is designed to provide gas to heat homes and businesses on the coldest day of the year. This means if the Company did not have storage available, it would

[1] Final Report on The Liberty Consulting Group's Evaluation of NW Natural's Optimization Activities, November 21, 2017, page 10

have to have the contracts in place for enough pipeline capacity to guarantee it could move enough gas into its system to serve that coldest day. This means, with the exception of the coldest days, the Company would always have excess capacity it did not need. Because gas can be pulled out of storage on those cold days, having storage allows the Company to maintain less firm pipeline capacity.

Second, having storage allows the Company to buy the gas it needs to serve winter customers throughout the year and store it for the winter. The quantity demanded of natural gas increases in the winter, which drives higher prices in the winter versus the summer. Since 1997, natural gas spot prices at Henry Hub have been 5.4% lower in July than prices the previous January.[2]

The storage system also reduces volatility, which benefits customers and shareholders. Cold weather events cause price hikes in the wholesale market. The stored natural gas serves a physical hedge against natural gas commodity price spikes, which stabilizes costs. Under the Purchased Gas Adjustment, the variation in actual gas costs, as compared to forecasted, is shared by the Company and customers.

The capital investments necessary to develop Mist Storage for core customers have been included in rate base. The O&M costs of operating Mist are also included in rates. CUB is generally supportive of NW Natural's use of Mist for core customers. However, CUB is concerned with how Mist Core Customer Storage is used for optimization and how the benefits from that are allocated.

[2] Averaged data from January and July. www.eia.gov/dnav/ng/hist/rngwhhdm.htm

Q. Please describe Intrastate Interstate Storage.

A. Interstate storage is a storage service offered to wholesale customers. This program began in 2001. When NW Natural proposed this development, it did so with the expectation that offering Interstate storage would be subsidized by ratepayers, because it allowed NW Natural to utilize staff and equipment already in customer rates. New costs associated with Interstate storage would be allocated to Interstate storage, but there would not be any attempt to identify the shared costs. To offset this subsidy, the Company proposed sharing 20% of the net revenues with customers:

> [T]he sharing for NW Natural's Mist Storage Services – which is set at 20% customers/80% Company - is intended to recognize the fact that the incremental investment to provide these services was provided by shareholders, while providing customers with benefits to reflect the shared use of certain rate-based investments.[3]
>
> By taking the incremental investment approach, NW Natural was able to leverage sunk costs and avoid construction of unnecessarily duplicative facilities. The Company's view was that the new potential non utility revenues could be used to not only cover its incremental investment and operating costs, but also could be partially shared with core utility customers to help offset some of the sunk costs already imbedded in their rates.[4]

Q. Please describe the recall of Interstate Storage.

A. Interstate storage at Mist can be recalled by core customers for core customer usage. This benefits core customers by reducing the cost of storage, and was an important part of limiting the risk of NW Natural in entering this commercial business.

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[3] UM 1654 - NW Natural/100/White/2-3.
[4] UM 1654 - NWN/100/White/4-5.

First, it is important to recognize NW Natural's Integrate Resource Plans have been examining Mist storage as a capacity resource since the 1990s. When NW Natural proposed developing commercial opportunities, it was taking a resource identified as a future resource for customers as its winter demand grew. Taking a least cost resource proposed to benefit customers and using it for shareholder benefit could have generated opposition. However, allowing that storage to be recalled when needed for customers alleviated that concern and allowed its use for shareholders. Because it would come into rates partially depreciated, it reduced costs to ratepayers.

Second, allowing it to be recalled limited NW Natural's risk. NW Natural's IRP provided an expected schedule when storage would be economic for core customers. The Company's Interstate storage risk was limited to the period of time before it was recalled, rather than the entire life of the reservoir. It is not clear NW Natural would have been willing to take the risk and develop Interstate storage without recall. After gaining experience with Interstate storage at Mist, NW Natural decided Interstate storage services risks could be managed, and the Company invested in the Gill Ranch storage project in California. However, there was an "unconventional gas boom that blossomed about the same time" Gill Ranch opened, and this has reduced the value of Interstate storage.[5] NW Natural is now considering withdrawing from the California Interstate storage marketplace and divesting itself of Gill Ranch.

Q. Please Describe the North Mist Expansion.

[5] http://www.naturalgasintel.com/articles/113493-nw-natural-considering-all-options-for-gill-ranch-gas-storage

A. NW Natural has been working to add an addition reservoir and a new 13 mile pipeline, to be completed in October and used by Portland General Electric under a 30-year contract. Under the terms of this contract, NW Natural is investing $128 million in the expansion.[6] The cost of this expansion, including NW Natural's cost of capital, will be paid by Portland General Electric over the 30 year life.

However, because some of the personnel working on this project are employees of NW Natural's regulated business and paid for by all ratepayers, the contract requires a credit to be provided to NW Natural's core customers, to reimburse them for the costs they are contributing.

Q. Please Describe Optimization.

A. Optimization of assets is a common practice among utilities. Utility ratemaking has long held it is a good business practice for utilities to look to ways to add additional revenues by utilizing utility assets. There are many examples of this:

- Poll attachments, where a utility rents out space on a poll to other services such as phone or cable.
- Market arbitrage, where unused electric transmission capacity or pipeline capacity is utilized by moving electricity or natural gas from one market to another with higher prices.
- Off system sales of either electricity or natural gas.
- The Energy Imbalance Market (EIM) is an asset management program that gives one central contractor (CAISO) the ability to optimize generating plants

[6] http://www.naturalgasintel.com/articles/109567-nw-natural-begins-building-custom-natgas-storage-for-portland-general

throughout the West, to more efficiently balance the system in the sub-hourly market.

Asset management programs are not unusual. Most utilities attempt to optimize their assets. Because captive customers pay for these assets, the benefits normally flow to customers. Because the gas stored at Mist is one of the assets NW Natural optimizes, optimization is tied to Mist. NW Natural also uses it pipeline capacity as an optimization opportunity and optimizes its gas through liquid extraction.

With regards to the optimization activities at Mist, the Company allocates the optimization revenues between core storage and interstate storage, based on the gas stored. Optimization revenues allocated to interstate storage are shared on a 20/80 basis (customer/shareholder), while optimization revenues allocated to core storage, pipelines or liquid extraction are shared on a 67%/33% basis.

What separates NW Natural's optimization programs from nearly all other programs is the large benefit shareholders receive. The investments in Mist serving core customers are ratebased assets, where the Company earns its rate of return. However, unlike most utilities, NW Natural retains an additional 33% of optimization revenues.

III. UG 221 AND UM 1654: CONSIDERATION OF MIST AND OPTIMIZATION

Q. What is the recent regulatory treatment of Mist and Optimization?

A. The issue of whether the sharing percentages associated with Mist and Optimization should be changed has been an unresolved issue since NW Natural filed its general rate case (UG 221) in December, 2011. Staff and CUB first raised the issue in UE

221. This led to an investigation (UM 1654) beginning in May, 2013. The first phase of that docket ended with the Commission ordering an “independent” cost study in March of 2015 “to determine with greater clarity how costs are generated and shared. Now, three years later, that independent cost study is completed, and it is the basis for CUB to again recommend changes to the sharing percentage related to optimization.

Q. What was proposed in UG 221?

A. Staff and CUB both proposed changes to how Mist and Optimization are handled in UG 221. Staff proposed having an independent study, and while that study was being conducted the sharing percentages should change:

- First, Staff called for an independent review:

> I recommend the Commission order NW Natural to conduct an independent review of the operation and financing of the Mist storage facility since its construction through an outside third party chosen by the Commission. This review should be conducted over the six-nine months following the final order in UG 221, with a report detailing the results and recommendations of the reviewers delivered to staff and UG 221 Parties no later than December 31, 2013. Using the report as its foundation, staff and UG 221 Parties can make recommendations to the Commission regarding changes needed to the future operations and financing of the Mist storage facility.[7]

- Second, Staff proposed to change the sharing percentage for Interstate storage from 20(customer)/80(shareholder) to 50/50:

> Until such time as new cost and sharing studies for the Mist off-system (both interstate and intrastate) sales services can be completed, reviewed, and approved by the Commission I have set the sharing percentage in Schedule 185 [Interstate storage] at 50/50, with both NW Natural and core utility customers each receiving 50 percent of net revenues as defined in the Schedule.

[7] UG 221/Staff/1000/Zimmerman/12.

> This should ensure fairness in sharing for both core customers and NW Natural.[8]

- Third, Staff proposed changing the sharing percentage for core storage from 67/33 (customer/shareholder) to 90/10:

> I have altered the sharing percentage in Schedule 186 from 67/33 to 90/10 with core utility customers receiving 90 percent of the revenues from NWN's optimization of core storage and pipeline assets. In all instances, as a public utility NW Natural is obligated to optimize the use of core utility storage and pipeline capacity, particularly that owned by NWNNW Natural, and to credit all of the benefits in terms of revenue from such optimization activities to its core utility customers. However, recognizing that a revenue incentive may prompt NW Natural to greater diligence in core storage and pipeline optimization I recommend here that NW Natural retain 10 percent of the revenues from such optimization.[9]

- Fourth, Staff proposed placing all optimization activities in Schedule 186 (core storage) and eliminating it from Schedule 185.[10] This had the effect of changing the sharing percentage on all optimization to 90/10.

CUB did not propose any changes to Interstate storage and instead focused on core customer storage and optimization. CUB argued core storage is a ratebased asset, and the Company is obligated to "maximize its value to the system."[11] CUB also proposed changing the sharing ratio to 90/10.

Q. How was this issue resolved in UG 221?

A. UG 221 was a difficult case, because many of the traditional revenue requirement issues were unsettled, leaving a large number of issues for the Commission to decide. The parties to the case agreed to settle Mist and Optimization by leaving the current sharing percentages in place, while opening a new contested case to

[8] UG 221/Staff/Zimmerman/1000/18.
[9] UG 221/Staff/Zimmerman/1000/19.
[10] UG 221/Staff/Zimmerman/1000/19.
[11] UG 221/CUB/200 Jenks - Feighner /47.

"evaluate these sharing mechanisms."[12] The stipulation is clear parties will request a decision be reached by December 31, 2013. CUB supported settling this issue, in order to reduce the number of contested issues being taken to the Commission in UG 221. However, it was important there was a deadline to obtain a decision, because CUB believed the current sharing mechanism was not reasonable.

Q. What happened in UM 1654?

A. UM 1654 began in May 2013, with a scheduled designed to be completed by December 31, 2013. According to the Prehearing Conference Memo:[13]

The parties agreed to the following procedural schedule, which was adopted:

EVENT	DATE
NW Natural Opening Testimony	July 15, 2013
Staff and Intervenor Reply Testimony	August 13, 2013
NW Natural Rebuttal Testimony	September 10, 2013
Pre-Hearing Briefs	September 17, 2013
Hearing	September 27, 2013
Post-Hearing Briefs	November 7, 2013
Commission Decision (Target Date)	December 31, 2013

However, this schedule was not maintained. CUB asked for an additional week for testimony in order to incorporate a data response.[14] NW Natural asked for a week delay in submitting rebuttal testimony.[15] Staff asked for an additional round of testimony.[16] The hearing was delayed until February 2014. After the hearing, there were multiple bench requests from the Commission and ultimately a second hearing in July 2014. Briefing was completed in August, and an order was issued in March 2015, approximately fifteen months after the target date.

[12] OPUC Order No 12-408, Appendix B.
[13] UM 1654 Prehearing Conference Memo.
[14] http://edocs.puc.state.or.us/efdocs/HAO/um1654hao8514.pdf
[15] http://edocs.puc.state.or.us/efdocs/HAO/um1654hao11572.pdf
[16] http://edocs.puc.state.or.us/efdocs/HAO/um1654hao12391.pdf

Q. Were the issue in UM 1654 the same as they were in UG 221?

A. A lot of the same issues were discussed, but parties had different positions. CUB's position was largely evolved from our position in UM 1654, as we gained a better understanding of NW Natural's optimization activities. In UM 1654, CUB took the following positions:

- The sharing percentage for optimizing customer assets should ultimately move from 67/33 to 90/10, but CUB was willing to accept a phased-in approach, where it was reset to 80/20 before the next rate case and moved to 90/10 in the next rate case.
- All optimization would be considered core customer optimization. CUB rejected the idea the Company was optimizing Mist storage. Instead, NW Natural was using stored gas as collateral for optimization activities, including some financial transactions. Since NW Natural has no legal right to use non-core gas for optimization activities, CUB believed all optimization activities were based on ratepayer assets.
- The Commission should order an independent cost of service study of Mist and optimization.

Staff's position in UM 1654 did not just evolve from UG 221. Instead, the new Staff witness rejected Staff's position in UG 221, and Staff recommended no changes in how Mist and optimization were treated. NWIGUs testimony supported CUB's position.

Q. What was the result of UM 1654?

A. Ultimately, after issuing multiple bench requests and conducting two hearings, the Commission decided it did not have enough information and ordered a cost study:

> We determine that a neutral third party should conduct an evaluation and cost allocation study of NW Natural's optimization activities. The study will more robustly examine the risks, costs, and benefits of NW Natural's optimization activities, the assets being utilized for those activities, the allocation between regulated and unregulated services, and the various components of NW Natural's system that drive the costs and revenues associated with interstate storage services. We agree with NWIGU that the sharing mechanisms should be fact-based and reflect the true value of customers' and shareholders' contributions.
>
> We direct the parties to this docket 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…
>
> IT IS ORDERED that Northwest Natural Gas Company, dba NW Natural, will form a steering committee comprised of representatives from Commission Staff and all other parties to this docket to identify, retain, and supervise a neutral third party to conduct an evaluation and cost allocation study, as described in this order. [17]

At this point, this case had already lasted fifteen months later than originally requested, and it did not resolve the issue. Instead the Commission recommended an independent third-party examine Mist and Optimization. The Commission also recommended the study be used to resolve the issues raised in UG 221 and UM 1654.

This order was issued more than three years ago, and the completed cost study is now in front of the Commission in this docket.

Q. What has taken so long?

A. From CUB's viewpoint, the Company has been the one to coordinate most of this, and it has not had a sense of urgency. This is not surprising, since the completed

[17] OPUC Order No 15-066.

study was expected to show NW Natural's sharing percentages for optimization are overly generous. Approximately nine months after this order, CUB had not heard anything from NW Natural about setting up the steering committee and moving forward with hiring a consultant and conducting a study. CUB contacted Jason Eisdorfer at the PUC to request Staff assistance in getting this part of the order fulfilled.[18] After Staff contacted NW Natural, it began working to implement the order, but each step of the way took about as long as possible. However, in November 2017, Liberty Consulting Group finished their independent review of NW Natural's Mist and Optimization activities – the study that Staff requested be conducted in 2012.

III. LIBERTY REPORT

Q. What did the Liberty Report examine?

A. The Liberty Report looked at the history of Mist and optimization, and it examined: how the costs of were allocated, how the risks were distributed to shareholders and customers, how the benefits were distributed, and how this compared to other natural gas utilities.

Q. What were Liberty Consulting Group's Conclusions?

A. Generally, Liberty examined the agreement to allow the Company to develop Interstate storage at Mist, optimization of Mist assets, and optimization of non-Mist assets. It found: shareholders and customers of NW Natural have benefited from these activities, NW Natural's optimization programs are not unique, and Oregon allows NW Natural to retain a much greater share of optimization revenues than

[18] CUB Exhibit 201.

most utilities receive. Liberty Consulting did not find a problem with NW Natural using gas belonging to Interstate storage customers as collateral for optimization activities.

Q. What benefits did Liberty find with regards to Interstate storage?

A. Liberty found both customers and shareholders have benefited from the arrangement. Core customers have provided "substantial support" for Interstate storage, in terms of providing demand and usage to justify development of Mist. Core customers have also provided ratebased pipeline and other facilities required to connect Interstate storage to market, and they have provided personnel to provide for planning, development and market experience[19]. With respect to the 20/80 sharing (customers/shareholders), this has produced benefits for both shareholders and customers, but the returns to shareholders are not overly rich.[20] Liberty evaluated alternative for storage sharing but concluded:

> Overall, the data shows that continuation of the status quo will continue benefits for customers and ownership of the nature and at levels that have produced roughly balanced results to date. A large increase in the market value of storage would be required to alter these relationships significantly, and warrant a material change from the status quo.[21]

Q. How does CUB respond to Liberty's findings with regards to Interstate storage?

A. As we have examined Mist since 2012 through UG 221 and UM 1654, CUB has not advocated changes in how Interstate storage is treated. The Liberty report supports this position. CUB is not proposing any changes to the regulatory treatment of Interstate storage.

[19] UG 344/NWN/1301/Friedman/18.
[20] UG 344/NWN/1301/Friedman/19.
[21] UG 344/NWNl/1301/Friedman/35.

Q. What was Liberty's Consulting Groups conclusion relating to optimization of Interstate storage at Mist?

A. Liberty helped clarify what was happening with optimization at Mist. One of the issues contested over the last few years relates to what is being optimized. Is it storage, deliverability, or gas located in storage? Liberty helped clarify this:

> Mist Storage Optimization: Using some of the ability to inject into and withdraw from storage to buy from and sell to customers outside the utility's system, when those abilities exceed requirements for serving core customers. Storage optimization also frequently includes the purchase and sale of financial instruments backed by the parts of the storage system that TMV uses for optimization.[22]

This makes clear it is the gas itself that is the asset being optimized. It is what is being injected and withdrawn to buy and sell; the gas is what is used to back up financial instruments. CUB was surprised Liberty did not also conclude these are activities only conducted with core gas customers, and therefore all Mist optimization should be allocated to core customer functions.

Q. How does CUB respond to Liberty's conclusion relating to optimization of interstate storage?

A. CUB was an advocate for a third party independent analyst to examine Mist and optimization. While CUB was surprised with this result of their analysis, CUB is willing to accept their analysis. CUB is no longer proposing the Commission reallocate all Mist Optimization revenues to core customer storage.

Q. What was Liberty's conclusion relating to optimization of core customer assets?

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[22] UG 344/NW Natural/1301/Friedman/42.

A. Liberty concluded the current sharing mechanism allows NW Natural to retain much more of this revenue than is generally allowed by other regulated gas companies, and there was nothing unusual in terms of activities or risks justifying this:

> Our examination of the nature of optimization activities performed by TMV for NW Natural found them to be of a nature and extent similar to what others would be expected to do given the portfolio of assets assembled for serving core customers, and given the circumstances in which that portfolio operates. The arrangements with TMV give reasonably typical roles to management and to TMV. Where experience at NW Natural differs is in the comparatively low percentage share of margins produced from optimization available to offset costs that core customers bear in rates for service. The gap between what customers have available here is very large in magnitude and in the percentile into which that percentage falls.[23]

Liberty examined the regulatory treatment of optimization activities by other natural gas utilities and put them into quartiles:[24]

- 25% of companies provide customers 100% of optimization net revenues
- 25% provide customers at least 90% but less than 100%
- 25% provide customers more than 75% but less than 90%
- 25% provide customers 75% or less.

Liberty's conclusion was the "percentage that NW Natural ownership receives as a clear outlier among the population for which we have been able to secure information."[25]

NW Natural is in the bottom quartile. But NW Natural is also at the bottom end of the bottom quartile. Eleven utilities are within this bottom quartile but share more

[23] UG 344/NW Natural/1301/Friedman/65.
[24] UG 344/NW Natural/1301/Friedman/52.
[25] UG 344/NW Natural/1301/Friedman/54.

revenues with customers than NW Natural. Less than 6% of gas utilities provide share less optimization revenue than NW Natural. The fact that 25% of gas companies share 100% of optimization revenues with customers is not surprising, because utilities are expected to maximize the value of ratepayer financed assets. This is a traditional function of a utility.

Within Oregon, Avista Utilities also has an asset optimization program. In Washington, Avista shares 100% of net revenues with customers. In Oregon, 100% of Avista's net revenues flow to customers through the PGA, but these revenues can be impacted by the 90/10 PGA sharing mechanism.

Q. Did Liberty find a reason for the company to retain such a high level of revenues?

A. No. Liberty looked at three possible explanations:

1. Exceptional market uncertainties or dynamics (risks)
2. Unusual optimization scope or activities (benefits)
3. Asset or operating expense contributions by ownership (costs).

Liberty conclusion was none of these offered a justification.

- With regards to risk:

  We did not find any risk exposure that, in our judgment, would justify an unusually large share of optimization margins. [26]

- With regards to scope or activities:

  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.[27]

- With regards to asset or expense contributions:

[26] UG 344/NWN/1301/Friedman/54.
[27] UG 344/NWN/1301/Friedman/54.

With respect to costs, the assets at issue here all fall into rate base. Ownership contributes no assets whose costs rate base fails to include.[28]

Q. Does Liberty Recommend a Change in the Sharing Percentages?

A. Yes. Liberty clearly states it believes "it is appropriate for stakeholders to look at changes that will retain a strong performance incentive, but lower cost to customers."[29] Liberty, however, does not make a specific recommendation. Instead, Liberty models several alternatives, including increasing the sharing percentage to customers, allocating the cost of the asset manager in a fairer manner, and using a declining block for the customer share. In effect, Liberty tells us customers should receive a greater share of the revenues, and they provide a menu of options without choosing which menu item.

Q. What does CUB recommend?

A. CUB has been recommending a change since 2012. Liberty's analysis shows such a change is reasonable, but customers have lost millions of dollars over the last 6 years, as this issue has been left unresolved. It is time to resolve it by increasing the customer share. CUB continues to believe asset optimization is a fundamental obligation of a utility, and sharing is not necessary. A utility who does not engage in asset management is not operating prudently. At the same time, CUB is open to incentive regulation, allowing for some incentive to utilities to maximize customer benefits. In this case, we continue to believe a 90/10 split is a reasonable recognition of this.

[28] UG 344/NWN/1301/Friedman/54.
[29] UG 344/NWN/1301/Friedman/65.

The Company already recovers it rate of return on the ratebased investments used for optimization, so the Company is being compensated for the underlying assets. Allowing the utility to keep 10% of the net revenues, without placing any additional capital at risk, is reasonable.

According to Liberty's quartiles, 50% of all natural gas utilities share 90% ***or more*** of their net optimization revenues with customers. This puts Oregon smack dab in the middle of how regulation treats these programs nationally.

In addition, CUB recommends NW Natural's optimization Asset Manager costs be allocated to all sources of optimization revenues. Currently, NW Natural pays its Asset Manager to manage the optimization activities, but it allocates the Asset Manager's share to the non-Mist optimization revenues. This has the effect of ensuring the asset manager comes out of the pot of revenue that is shared 67-33, rather than 20-80. This makes no reasonable sense, other than to increase NW Natural's income from optimization. The asset manager is managing optimization of both the Mist portion and the non-Mist portion. Within Mist, the asset manager is optimizing both the core and the interstate storage assets (or gas within the storage).

Liberty models two approaches to this. First, they propose splitting the cost between customers and shareholders on a 50/50 basis. Second, they propose to split it proportionally based on the optimization revenue. The first approach seems as arbitrary as the current methodology, and it would have NW Natural paying more of the asset manager's cost than it receives in benefit. Proper cost allocation requires the asset management costs to be allocated across all functions, before applying any sharing. The net income after paying the asset manager is what is then subject to sharing. This means customers and shareholder both contribute based on their share of revenues.

IV. RESULTS OF OPERATIONS REPORTING

Q. What is the concern with Results of Operations (ROO) Reporting?

A. During UM 1654, CUB and other parties discovered the Company had not been reporting earnings related to Optimization activities as part of its Results of Operations Report. Instead, the Company booked its share of optimization revenue as non-utility storage revenue. While CUB believes this is a reasonable approach to the share of optimization revenue derived from interstate storage, this is not proper with regards to optimization from core customer storage, pipeline capacity, or other assets related to core customer service. In its order in UM 1654, the Commission said it would address this issue after the cost study was completed.

Q. Did the Liberty Report deal with this issue?

A. Not directly. But it did include some helpful information for understanding this issue. First, it shows that Mist is a small portion of optimization revenues. In 2016 - 2017, Mist optimization Revenues were [redacted], while total optimization revenue was [redacted] In addition, Liberty reports interstate storage represents [redacted] of Mist Optimization revenues.[31] Therefore, we can calculate the optimization revenues associated with interstate storage to be [redacted] of Optimization Revenues. Second, the Liberty report makes clear that beyond the

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[30] UG 344/NWN/1301/Friedman/45.
[31] UG344/NWN/1301/Friedman/27.

interstate storage optimization, all assets being optimized are ratebased or otherwise paid for by customers[32].

Q. What does this mean with regards to ROO?

A. It means NW Natural has been reporting income related to optimization as non-utility storage income, when only a [redacted] of it is non-utility storage income. This makes the ROO inaccurate, reduces transparency, makes comparisons between utilities and state regulators difficult, and establishes a terrible precedent for incentive regulation.

Q. Please explain how this is inaccurate and reduces transparency?

A. Results of Operations are supposed to show the Company's earnings from its regulated system. Oregon regulation allows the Company to earn income from regulated investment, and that income should show up in the ROO. This is regardless of whether the income comes from return on equity, reducing costs between rate cases, or an incentive program for optimizing assets. Currently, NW Natural ROO reports do not accurately reflect the earning shareholders receive from Oregon regulated utility system, because some of the earnings allowed under Oregon regulation are not reported there. Someone using the ROO reports would not be able to determine the earnings the utility makes off of its regulated system.

Q. Please explain how this makes comparisons between utilities and state regulators difficult?

A. If Oregon allows NW Natural to underreport its Oregon earnings, then anyone who uses the ROO to identify NW Natural's Oregon earnings is receiving a false

[32] UG 344/NWN/1301/Friedman/54.

impression. If this is used to evaluate the approach of Oregon regulators, it will suggest the regulatory structure in Oregon limits NW Natural's earnings beyond what is actually true.

Q. Please explain how this sets a terrible precedent for incentive regulation?

A. Oregon, like a number of other states, is beginning to consider alternative regulatory approaches, such as incentive regulation, or sometimes called performance based ratemaking. SB 978 directed the Commission to investigate whether:

> developing industry trends, technologies and policy drivers in the electricity sector might impact the existing regulatory system and incentives currently employed by the commission. If warranted, the commission may consider changes to the existing regulatory system and incentives[33].

The regulatory approach to NW Natural optimization activities is an example of incentive regulation. NW Natural receives bonus earnings above its regulated rate of return on ratebased assets, if it can optimize and gain revenues from those assets. This is not different than some of the suggests for incentive regulation on the electric side: allowing an electric company to earn an extra return for keeping rates low, reducing carbon emissions or meeting reliability target.

The Oregon PUC is allowing addition earnings as an incentive for the utility to do something valued by the regulatory system. If Oregon is going to go down this path, there must be transparency. There will be no way to evaluate the effectiveness of incentive regulation, if incentives are not included in ROO reporting.

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[33] http://www.puc.state.or.us/Renewable%20Energy/SB%20978 Bill.pdf

Q. Why does NW Natural oppose including optimization earnings in its ROO?

A. CUB's understanding is NW Natural is concerned such earnings will then be included in earnings tests associated with deferrals or other mechanism where earnings are examined. If the company has a deferral which includes an earnings test, NW Natural is concerned optimization earnings would then be used to offset the deferral, and this would effectively reduce the value of the optimization incentive.

Q. Does NW Natural's concern have merit?

A. No. Being transparent and having accurate ROO reporting is a separate issue from how various regulatory mechanisms interact. In the case of a deferral, the application of an earnings test is normally done in order to ensure the Company does not get an outcome greater than what it would through traditional regulation in a rate case.

Let's say NW Natural has a tax hike of $50 million, and $50 million is deferred and subject to an earnings test while the Company is overearning by $10 million. The regulatory theory is if this was handled in a rate case, rates would be set at a level $40 million higher than current rates ($50 million higher cost – 10 million overearnings), because the overearning would be removed to get the company back to its regulated ROE. But this theory changes if the overearning comes from an incentive mechanism not adjusted in a rate case. NW Natural would have a good argument to make in a rate case, this $10 million would not be affected, and rates would increase by $50 million. Therefore, the earnings test should not include this $10 million.

But incentive regulation could have a larger impact. The Commission might be asked to consider incentive regulation that decreases ROE to deemphasize the incentive to invest, with more earnings coming from incentives. Instead of incentives being bonuses; the incentives are a core part of utility compensation examined in every rate case. Ultimately, how various regulatory mechanisms utilizing earnings interact should be considered on a case-by-case basis, based on the facts at hand. That is a separate issue from accurately reporting earnings from the regulated system.

Q. Please summarize your recommendations?

A. CUB makes the following recommendations:

Interstate Storage: CUB recommends no change to the current sharing of income from interstate storage (20/80 ratio -- customers/company).

Interstate Storage Optimization: Based on the Liberty Report, CUB no longer recommends eliminating an allocation of optimization revenues to interstate storage. Instead CUB recommends no change to Interstate Storage Optimization.

Core Customer Optimization: CUB recommends the Commission direct 90% of the revenues from core customer optimization to customers. This puts Oregon in the mid-point of utility regulation nationally.

Asset Manager Costs: The cost of the optimization asset manager should be allocated to all optimization activities based on revenue share of each activity, before any sharing between customers and shareholders.

Results of Operations Reporting: The PUC should require NW Natural to include optimization revenues associated with ratebased, regulated activities in its ROO reporting and exclude optimization revenues associated with interstate storage.

V. CONCLUSION

This has been a long process. Staff first called for an independent study in 2012. Now one has been completed, and the finding of the independent study is clear:

> Given the lack of large risk involved in optimization and given the lack of factors that make optimization materially more complex or challenging at NW Natural, we can postulate no reason justifying a large gap between NW Natural and the rest of the industry. If the goal in Oregon remains to provide a sufficient incentive for management to commit fully to asset optimization, then the experience of our large sample group compels a conclusion that the prevailing view is that a lower share for ownership will nevertheless provide strong incentives to maximize performance without incurring undue risk.[34]

It seems like some issues in Oregon are never resolved, but we have been looking at this for six years. We now have the results from independent analysis. It is time to make a change to how Oregon allocates optimization revenues, so we can put an end to this issue.

[34] UG344/NWN/1301/Friedman/65.

Bob Jenks <bob@oregoncub.org>

UM 1654

2 messages

Bob Jenks <bob@oregoncub.org> Wed, Nov 4, 2015 at 4:03 PM
To: EISDORFER Jason <jason.eisdorfer@state.or.us>
Cc: Sommer Templet <sommer@oregoncub.org>

It was exactly 8 months ago tomorrow that the Commission issued the following order and the Company has yet to form the steering committee:

D. Resolution We determine that a neutral third party should conduct an evaluation and cost allocation study of NW Natural's optimization activities. The study will more robustly examine the risks, costs, and benefits of NW Natural's optimization activities, the assets being utilized for those activities, the allocation between regulated and unregulated services, and the various components of NW Natural' s system that drive the costs and revenues associated with interstate storage services. We agree with NWIGU that the sharing mechanisms should be fact-based and reflect the true value of customers' and shareholders' contributions.

We direct the parties to this docket 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. NW Natural will receive cost recovery for the cost of the study.

While the study is being conducted and reviewed, we will retain the company's current sharing percentage, and do not require that revenues be reported in the company's ROO. We will decide these issues after the cost allocation study is complete.

IV. ORDER

IT IS ORDERED that Northwest Natural Gas Company, dba NW Natural, will form a steering committee comprised of representatives from Commission Staff and all other parties to this docket to identify, retain, and supervise a neutral third party to conduct an evaluation and cost allocation study, as described in this order. Made, entered, and effective

Bob Jenks

Executive Director

Citizens' Utility Board of Oregon

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EISDORFER Jason <jason.eisdorfer@state.or.us> Wed, Nov 4, 2015 at 4:06 PM
To: Bob Jenks <bob@oregoncub.org>
Cc: Sommer Templet <sommer@oregoncub.org>

UG 344 – CERTIFICATE OF SERVICE

I hereby certify that, on this 4th day of May, 2018, I served the foregoing **CUB Confidential Opening Testimony** in docket UG 344 upon the Commission and each party designated to receive confidential information pursuant to Order 18-002 by U.S. mail, postage prepaid.

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