State of Florida

Public Service Commission

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-M-E-M-O-R-A-N-D-U-M-

DATE: March 14, 2017

TO: Carlotta S. Stauffer, Commission Clerk, Office of Commission Clerk

FROM: Suzanne S. Brownless, Senior Attorney, Office of the General Counsel

RE: Docket No. 170057-EI - Analysis of IOU's hedging practices

Please file the attached Policy and Interpretive Statement on Local Distribution Companies' Natural Gas Hedging Practices order in this docket. Should you have any questions or need any additional information regarding this matter, please contact me at 413-6218.

Service Date: March 13, 2017

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Commission Inquiry into Local Distribution Companies' Natural Gas Hedging Practices	DOCKET UG-132019 POLICY AND INTERPRETIVE STATEMENT ON LOCAL DISTRIBUTION COMPANIES' NATURAL GAS HEDGING PRACTICES

I. BACKGROUND

A. Risk Management and Hedging

1 Natural gas local distribution companies (LDCs or Utilities) are responsible for procuring and delivering natural gas to end users.[1] Typically, the process of supplying customer demand for natural gas involves purchasing natural gas from a supplier and contracting capacity on regional pipelines to transport the natural gas from areas of supply to the LDC's distribution system. The rate customers pay for natural gas is directly related to the price a utility pays for natural gas from a supplier. Thus, the volatility of natural gas prices presents substantial risk to the utility and its ratepayers; a sharp increase in the price of natural gas supply can result in a sharp increase to a customer's utility bill.[2]

2 To mitigate the impact of market volatility on consumers, LDCs routinely engage in risk management programs. Risk management generally refers to coordinated activities aimed at controlling the impact of adverse events.[3] Because consumers view price increases as adverse events, LDCs managing risk are concerned with controlling the impact of possible price spikes on consumers' bills. Hedging is one risk management tool available to LDCs.

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[1] *See* RCW 80.28.010 and WAC 480-90-001.

[2] The natural gas commodity cost accounts for approximately 50 percent of a customer's bill.

[3] International Organization for Standardization, available at https://www.iso.org/obp/ui/#iso:std:iso:guide:73:ed-1:v1:en.

3 Generally, a hedge refers to a financial transaction that aims to mitigate exposure to market price volatility. Within the context of natural gas markets, a hedge refers to a financial position that offsets potential losses (or gains) incurred by fluctuations in the natural gas commodity price. Although LDCs sometimes contract for gas delivery at a fixed price, more commonly they contract for natural gas at set volumes with the price contingent on the market price at the time of delivery. Therefore, until delivery the price the utility will eventually pay for the contracted gas is uncertain, which fully exposes ratepayers to potential changes in price. Hedging can mitigate market price increases, but exposes ratepayers to hedge losses when prices decrease. From a utility perspective, a hedge is essentially an insurance policy against unexpected price increases.

B. Natural Gas Market

i. Periods of Volatility

4 Over the last 20 years, the natural gas market has experienced several major price spike events, often with dramatic increases in price occurring over a relatively short time. Since 1995, monthly closing New York Mercantile Exchange (NYMEX)[4] prices have exceeded $10 per million British Thermal Units (MMBtu) during five separate events, only to return to below $2MMBtu after three of those price spike events.[5] Beginning in 2000, the natural gas market began experiencing sustained upward pressure on market prices, ultimately culminating in NYMEX prices closing at over $15MMBtu in January 2006.

5 Several national supply disruptions contributed to price volatility between 1995 and 2006. A combination of low gas storage levels and high demand due to cold weather created price spikes in the winter of 2000/2001 and February 2003.[6] In January 2006, gas prices spiked following the aftermath of Hurricane Katrina. Supply disruptions, coupled with increasing use of natural gas as fuel for the electricity industry and decreasing

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[4] The NYMEX is a commodity futures exchange owned and operated by CME Group of Chicago. Prices quoted for transactions on the exchange are the basis for prices paid for various commodities (includes natural gas) throughout the world.

[5] Gettings, Michael, *"Natural Gas Utility Hedging Practices and Regulatory Oversight,"* (Washington Utilities and Transportation Commission Whitepaper, 2015), Figure 1.

[6] "Report on the Natural Gas Spike of February 2003," Federal Energy Regulatory Commission Staff Investigating Team (July 2003).

national production, created ripe conditions for market volatility and sustained upward price pressure.[7]

ii. The Shale Revolution and Continued Market Uncertainty

6 Beginning in 2007, advances in horizontal drilling and hydraulic fracturing (fracking) substantially improved the cost effectiveness of shale gas extraction. Vast deposits of shale, once cost prohibitive to mine, became economically accessible, leading to a dramatic increase in domestic natural gas production. Shale gas production increased from less than 5 percent of US production in 2006 to 47 percent in 2013.[8] Importantly, shale production also allowed for geographic diversification of natural gas supply. Shale plays in the Northeast and Midwest of the US shifted production away from the South. In contrast to previous decades, a wider distribution of supply basins reduced the influence of disruptions at any one supply source on natural gas prices. As a result, a general expectation developed that US shale gas production would have a stabilizing effect on natural gas prices.[9]

7 This effect was realized following the Great Recession in 2008. With a steady and abundant supply of natural gas, prices began to fall. Since 2009, prices have averaged less than $4MMBtu and have not exceeded $8.15MMBtu. In 2015 and 2016, Henry Hub[10] prices averaged just over $2.50MMBtu.[11] Notably, natural gas prices have become less volatile in the current market.

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[7] EIA, *An Analysis of Price Volatility in Natural Gas Markets*, available at https://www.eia.gov/naturalgas/archive/ngprivolatility.pdf.

[8] Wiggins, S., Etienne, X., "US Natural Gas Price Determination: Fundamental and the Development of Shale", (2015).

[9] The Energy and Commerce Committee, *More American Energy = Lower Prices,* available at https://energycommerce.house.gov/news-center/press-releases/more-american-energy-lower-prices (Oct. 7, 2014).

[10] Henry Hub is a distribution hub on the natural gas pipeline system, owned by Sabine Pipe Line LLC. It interconnects with nine interstate and four intrastate pipelines. Spot and future natural gas prices set at Henry Hub are generally seen to be the primary price set for the North American natural gas market.

[11] EIA Henry Hub Natural Gas Spot Price, available at https://www.eia.gov/dnav/ng/hist/rngwhhdm.htm.

8 Despite natural gas prices remaining relatively low and stable, future regulation and economic forces may create price and supply uncertainty. A handful of cities and states have implemented bans or moratoria on hydraulic fracturing, and, in a recent study, the Environmental Protection Agency concluded that hydraulic fracturing can impact drinking water sources.[12] Concurrently, numerous liquid natural gas (LNG) export facilities have been proposed across North America to export natural gas to overseas markets.[13] Other risk factors may include an increase in natural gas demand due to closures of nuclear and coal plants, rise in operating costs, and an expanding electric vehicle industry. Conversely, new technologies such as Distributed Energy Resources (DER), renewables, and storage capabilities may reduce demand. Ultimately, history has shown that commodity market conditions are never stagnant and utilities cannot predict the future with certainty. Accordingly, they must be prepared for future unknown market shifts.

C. Purchased Gas Adjustment Mechanism

i. Brief history

9 In 1985, the Federal Energy Regulatory Commission (FERC) issued Order 436, which enabled utilities to purchase gas directly from pipelines or upstream suppliers. In 1992, FERC issued Order 636 designating pipelines as common carriers, effectively separating the gas supply business from pipeline subsidiaries. This placed a greater responsibility on LDCs to plan, procure, and transport natural gas supply to meet customer demand.

10 Prior to FERC Orders 436 and 636, LDCs bought gas from pipelines at rates approved by FERC. LDCs had a single supplier, and gas prices were outside of LDC control. Further, changes in price were known several months ahead of time during pending FERC proceedings. Under these circumstances, purchased gas adjustments (PGAs) were established in order to automatically pass through changes in supply costs, effectively reducing regulatory lag.[14]

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[12] "Hydraulic Fracturing for Oil and Gas: Impacts from the Hydraulic Fracturing Water Cycle on Drinking Water Resources in the United States (Final Report)," U.S. Environmental Protection Agency, Washington, DC, EPA/600/R-16/236F, (2016).

[13] Energy Information Administration, *Today in Energy*, March 4, 2016, available at http://www.eia.gov/todayinenergy/detail.php?id=25232.

[14] Regulatory lag refers to the length of time between a utility's request for new rates and the date the new rates go into effect. It can also refer to the length of time between rate cases.

11 Subsequent to FERC Orders 436 and 636, natural gas planning, procurement and transportation became much more complicated. LDCs now purchase gas supply from a number of producers across multiple basins and transport that supply across regional pipelines. As a result, administration of the PGAs has become more complex and time-consuming. Nevertheless, gas production and transportation costs are still largely outside the LDCs' control. Although an LDC can attempt to minimize price by choosing to contract at basins with a favorable price outlook, actual production costs and supply constraints are subject to the market.

ii. Mechanics

12 The PGA mechanism is a regulatory tool used to adjust rates to reflect the changing cost of gas in the wholesale market. The PGA passes through the utility's actual cost of natural gas to customers on a periodic basis. PGA mechanisms contain two general components: a forecasted cost component and an annual true-up component.

13 Under existing PGA methodology, companies project demand and then develop estimated supply costs to meet that demand. First, companies use published forward gas prices to calculate the estimated cost of the unhedged gas supply. Second, any known costs associated with hedges that will be transacted in, and for, the PGA year are included.

14 As the PGA year unfolds, the Company incurs actual costs, both for the unhedged gas purchased at spot/index prices, and for previously hedged gas purchased at negotiated prices. The Company defers the difference between the projected cost from the PGA filing and the actual cost incurred for the PGA period (12 months). As part of the annual true-up component of the PGA mechanism, these deferrals are ultimately amortized back to customers with interest as a refund or a surcharge.

II. PROCEDURAL HISTORY

A. Review of 2012 PGAs

15 During the months of August, September, and October of 2012, Northwest Natural Gas Company (Northwest Natural), Avista Corporation (Avista), Puget Sound Energy, Inc. (PSE) and Cascade Natural Gas Corporation (Cascade) (collectively, the Companies)

filed revisions to their PGA tariffs (2012 PGA Filings) with an effective date of November 1, 2012.[15]

16 Commission staff (Staff) reviewed the filings and identified concerns with the hedging strategies employed by the Companies. Specifically, Staff noted the large financial hedging losses reported in the PGA period of November 1, 2011, through October 31, 2012, and the recurring financial hedging losses recorded and passed onto ratepayers in previous years.[16]

17 At the Commission's regularly scheduled open meeting on October 25, 2012, Staff recommended the Commission suspend the tariff revisions in each docket, citing the need for additional time to investigate hedging transactions, potential implications of the procurement practices, hedging guidelines, and uniformity of PGA reporting. The Commission agreed with Staff that an investigation into the natural gas hedging and procurement practices for LDCs regulated by the Commission was warranted.

18 On October 31, 2012, the Commission issued complaints and orders suspending each Company's tariff revisions in Order 01 of the respective 2012 PGA Filing dockets. The Commission also ordered Staff to report back to the Commission on the status of its investigation no later than March 1, 2013.

19 On March 1, 2013, Staff filed with the Commission its report regarding the natural gas hedging policies and practices of the investor-owned LDCs operating in Washington. Staff also presented the results of its investigation during the Commission's recessed open meeting on March 22, 2013.

20 The analysis completed by Staff and its consultant[17] indicated that, on a system basis, the Companies collectively experienced net hedging losses of over $1.1 billion between November 1, 2002, and October 31, 2012.[18] Washington's share of these net losses were

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[15] Avista, Docket UG-121501; Cascade, Dockets UG-121592 and UG-121623: Northwest Natural, Docket UG-121434, and PSE, Docket UG-121569 (2012 PGA Filings).

[16] Washington Utilities and Transportation Commission, *Report of Commission Staff Regarding the Natural Gas Hedging Policies and Practices of Avista Corporation, Docket UG-121501, Puget Sound Energy, Inc., Docket UG-121569, Cascade Natural Gas, Dockets UG-121592 and UG-121623, and Northwest Natural Gas Company, Docket UG-121434* (March 1, 2013).

[17] Staff retained Schneider Electric to work with Staff to analyze the policies, procurement strategies and execution of each Company's hedging program.

[18] *Id.* at Attachment B.

passed on to ratepayers. Nevertheless, Staff concluded that the hedging practices employed by the Companies conformed to their internal procurement policies. Consequently, the recovery of hedging costs presented in the November 2012 Filings were consistent with annual filings previously accepted by the Commission. Staff therefore recommended that the Commission enter an Order Dismissing the Complaint and Order Suspending Tariff Revisions, and allow the tariff revisions in all dockets to become effective on a permanent basis. However, Staff also recommended that the Commission initiate separate proceedings to examine broadly, on a forward-looking basis, the natural gas hedging practices and policies of all natural gas companies the Commission regulates.

21 The Public Counsel Section of the Office of the Washington Attorney General (Public Counsel), an active participant throughout this process, agreed that the Commission should initiate a forward-looking examination of hedging practices, but objected to Staff's recommendation to dismiss the complaints. Instead, Public Counsel recommended the Commission impose a moratorium on hedging pending the outcome of a formal adjudicative proceeding to determine whether the Commission should disallow a portion of each Company's purchased gas costs during the 2012 PGA cycle.

22 Following further discussion with Staff, Public Counsel, and representatives from the utility companies during the Commission's regularly scheduled open meeting on March 22, 2012, the Commission deferred its decision and requested the parties review additional information that would help determine whether an adjudicative proceeding was required.

23 At the Commission's recessed open meeting on April 5, 2013, Staff presented the results of its additional investigation. Based on its review of voluminous documents, Staff continued to recommend that the Commission dismiss the complaints and initiate a generic proceeding to address hedging practices. Public Counsel retreated from its proposed moratorium on hedging but maintained its preference for the Commission to consider disallowances for all four natural gas companies.[19] The Northwest Industrial Gas Users (NWIGU) supported Public Counsel's recommendation.

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[19] Public Counsel withdrew its proposed disallowance for Avista, but requested the Commission proceed with an adjudicative proceeding to make formal discovery under the Administrative Procedure Act (RCW 34.05) and the Commission's procedural rules (WAC 480-07-400 – 425) available .

24 The Commission accepted the results of Staff's investigation and agreed that a forward-looking examination of hedging policies and practices would be more productive than continuing to investigate past Company practices. Accordingly, on May 1, 2013, the Commission issued Order 02 in each of the 2012 PGA Filing dockets, dismissing the complaints and stating its intention to initiate a generic proceeding on gas utility hedging practices.

B. Current Investigation, Docket UG-132019

25 On October 30, 2013, the Commission opened a Staff Investigation in this docket regarding policy issues related to the Companies' natural gas hedging practices and transaction reporting. On December 18, 2013, the Commission issued a Notice of Opportunity to File Written Comments, which posed questions regarding the purpose and practice of hedging, and certain aspects of the PGA filing requirements related to hedging. On January 13, 2013, the Commission received written comments from eight parties.[20]

26 Commenters provided substantial insight about the purpose of hedging and proposed reasonable parameters for hedging programs. Commenters also provided useful strategies for choosing the percentage of load to hedge in addition to practical time horizons for individual hedges. The responses generally supported hedging as a means of gaining some protection from natural gas price volatility and upside price shock to ratepayers. Utility comments generally did not favor an overly prescriptive Commission approach to hedging. All respondents supported establishing a uniform PGA reporting standard to streamline processes and facilitate Staff and stakeholder review.[21]

27 On January 23, 2014, the Commission hosted a workshop to gather information regarding the development of a possible policy framework for utility hedging practices. Thirteen interested parties representing nine organizations provided oral comments at the workshop.[22] The meeting included presentations by two nationally respected experts on

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[20] The Commission received comments from Avista, PSE, Cascade, Northwest Natural Gas, Public Counsel, Northwest Energy Coalition, the City of Ellensburg, and Aether Advisors.

[21] PSE agreed a uniform (high level) PGA reporting standard could improve the comparability of data between utilities and facilitate efficient review but maintained the utilities need to retain the freedom to develop work papers as they see fit.

[22] Commenters were Mike Parvinen, Cascade Natural Gas; Onita King and Allen Geertz, Northwest Natural Gas Corporation; Ila Cupta, Chris Smith, and Colin Crowley, Puget Sound Energy; Mary Kimball, Public Counsel; Mike Gettings, RiskCentrix; Ken Costello, NRRI; Julia

hedging: Michael Gettings, Senior Partner at RiskCentrix, and Ken Costello, Principal Researcher with the National Regulatory Research Institute.

28 The workshop discussion revealed a need for a shared understanding of generally accepted hedging terms, methods, and policies, and a critical need to establish a foundation to develop a risk management framework to evaluate utility hedging strategies. Staff and Public Counsel agreed to co-sponsor a white paper on natural gas utility hedging practices and subsequently contracted with Michael Gettings of RiskCentrix, LLC. On July 25, 2015, Mr. Gettings published a white paper entitled, *"Natural Gas Utility Hedging Practices and Regulatory Oversight*" (White Paper).

29 On March 28, 2016, the Commission convened a second workshop to facilitate additional discussion in response to the White Paper. At the workshop, Mr. Gettings presented the concepts and principles detailed in his White Paper, providing an opportunity for stakeholders and commissioners to examine the finer points and participate in a broader discussion of the regulatory implications surrounding hedging strategies.[23]

30 On April 11, 2016, the Commission solicited an additional round of comments to provide an opportunity to stakeholders to clarify and expand upon the positions expressed during the March 28, 2016, workshop. The Notice posed ten questions regarding the risk management approaches proposed by Mr. Gettings, but did not limit respondents to those specific questions. Instead, the Commission welcomed stakeholder concerns, challenges, opportunities, and observations related to the recommended methods and a discussion of the inherent challenges of implementation. On May 23, 2016, the Commission received five comments.[24]

31 Generally, commenters anticipate additional benefits from a risk-management approach to hedging, such as those presented in the White Paper, compared to the Companies' current hedging strategies. Commenters were unable to confirm that savings would be

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Ryan, Aether Advisors; Steve Harper and Patrick Ehrbar, Avista Corporation and, Ed Finklea, Northwest Industrial Gas Users.

[23] Participants included representatives from Deloitte & Touche, LLP, Cascade, Avista, Pacific Power, NW Natural, NWIGU, Public Counsel, PSE, and Aether Advisors.

[24] Comments were received by Avista, NWIGU, Public Counsel, Northwest Natural, and Cascade.

realized, however, as Companies anticipate additional costs for program implementation and maintenance, and that market trends will impact plan effectiveness.

32 The commenters largely agreed that it would be appropriate to submit some form of hedging plan with the annual PGA filing that includes an acknowledgment response similar to the Commission's current Integrated Resource Plan (IRP) process. Utilities emphasized a focus on substance over formal structure and expressed concern that reporting should not be overly burdensome to Staff or the Companies. Commenters held differing opinions regarding the regulatory path to implement hedging best practices.[25]

C. Summary of Current Washington Utility Hedging Practices

33 Through its review of the 2012 PGA Filings and subsequent investigation, Staff found that the Companies generally employ hedging strategies classified as "programmatic." In programmatic hedging, hedges are accumulated systematically according to a calendar schedule.[26] Typically, company management determines the amount a utility hedges on an annual basis (annual fixed hedge ratio, or hedge ratio) during the development of the company's gas procurement plan, although specific prescriptive hedge ratios vary by month across a prospective year. As a general matter, the Companies prescribe hedge ratios up to a year in advance, and the execution of prescribed hedges are largely independent of market risk conditions at the time of execution.

34 A programmatic hedging strategy necessarily is disconnected from a critical assessment of market risk conditions; there is no need for a company to measure risk conditions if it has no intention to respond to changing risk. As noted in Staff's initial review of the 2012 PGA Filings, Companies regard the primary hedging objective to be "price stability."[27] Thus, most Companies established large hedge ratios and maintained those ratios in a declining and stabilizing natural gas market. Utilities explicitly seeking price stability will endeavor to maintain large hedge ratios, in effect exchanging exposure to market volatility for stable and potentially high prices.

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[25] Utilities generally preferred a non-binding policy statement. NWIGU recommended additional workshops to develop guidance or rules. Public Counsel favored rules over a non-binding policy statement.

[26] Gettings White Paper at 19.

[27] Commission Staff's Report at 4.

III. STATEMENT OF POLICY PROBLEM

35 The four LDCs regulated by the Commission experienced net hedging losses of over $1.1 billion between November 1, 2002, and October 31, 2012. While it is tempting to characterize the problem simply in terms of hedging losses, "mark-to-market" losses are a likely outcome of any hedging strategy.[28]

36 It is evident that, at any given moment, some level of hedging is justified, and the level of hedging is informed largely by an assessment of market volatility. Although management of upside price risk is the central function of hedging, deciding when *not* to hedge (or, perhaps more accurately, when to hedge *less*) is central to managing ratepayer exposure to hedge losses.

37 Using theoretically sound hedging practices, an objective hedge manager will measure market volatility and execute hedges that result in a reasonable balance between exposure to upside price risk and exposure to hedge loss risk. Thus, hedging objectives should seek to simultaneously minimize both "cost risk" and "loss risk".

38 The unstable, downward-trending market, coupled with a continued programmatic hedging strategy, brought about the large mark-to-market losses experienced by the Companies over the past 10 years. In blindly adhering to programmatic hedging strategies, the Companies failed to respond to changes in underlying market conditions and continued to protect against diminishing upside market risk, resulting in higher exposure to hedging losses.

IV. STATEMENT OF COMMISSION POLICY

A. Preliminary Remarks

39 Utility decisions attempting to mitigate regulatory risk to shareholders are currently in conflict with decisions attempting to mitigate price risk to ratepayers. Based on the voluminous information received during the course of these proceedings, we find that an articulated policy statement on discrete aspects of utility hedging practices is appropriate at this juncture. Policy guidance is a critical first step in leading the Companies toward risk-responsive hedging strategies.

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[28] Mark-to-market losses are the difference between the cost actually paid, set by hedging contracts, and the final market price at the time of settlement. Large losses are indicative of a fall in market prices after companies locked in future prices through contracts.

40 We recognize that each company may have somewhat differing hedging strategies based on company-specific operations. For this reason, we will not provide a prescriptive methodology. However, it is important to set several expectations.

41 First, hedging practices should not be speculative in nature. Hedging is an activity designed to reduce price uncertainty, not an attempt to realize profits based on predictions of anticipated market movements.

42 Second, this policy statement does not distinguish between physical and financial hedges. As Avista notes, "all financial hedges should be associated with a physical index priced transaction, thus equalizing the physical and economic effects of both physical and financial hedges."[29] We expect the Companies to utilize an appropriate mix of hedging instruments supported by theoretically sound hedging practices.

43 Finally, continued communication between the Companies, Staff, and interested stakeholders is necessary for the successful implementation of risk-responsive hedging practices. We commend the parties for the collaborative process demonstrated in this proceeding, and encourage them to continue to work together.

B. Risk-responsive Hedging Strategy

44 The White Paper serves as a foundational document for the Commission's policy position on natural gas utility hedging practices. The White Paper provided the Commission with convincing evidence that strict programmatic hedging strategies disable utility capacity to adequately mitigate price risk to ratepayers. In describing the function of risk-responsive hedge strategies, which demonstrate the value of measuring and responding to changing market risk conditions, the White Paper provides guidance to lead the Companies toward more robust risk management programs.[30]

45 It is the Commission's explicit policy preference that the Companies employ risk-responsive hedge strategies. The singular programmatic hedging approach employed by many utilities fails to balance upside price risk with hedge loss risk in any meaningful way. An inflexible plan makes a utility's hedging less adaptable to changing conditions. Utilities must find a way to manage, simultaneously and continuously, upside price risk

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[29] Avista comments filed on January 10, 2014, at 3.

[30] Mr. Gettings describes strategies that work effectively across a broad range of market conditions as "more robust".

and downside hedging loss, and evaluate whether the "insurance" benefit justifies the cost.

46 The Companies should develop a framework for risk mitigation informed by quantitative metrics. Quantitative metrics allow utilities to measure, monitor market risk conditions, and facilitate identification of meaningful hedging responses. While we stop short of requiring use of the specific value-at-risk (VaR) methodology described in the White Paper, it is clear to us that each utility must develop robust analytical methods and incorporate these methods in their risk management frameworks.[31]

47 Finally, the Companies should document data-driven decisions either in response to changing conditions or staying the course in compliance with their hedging plan. This documentation is vital to demonstrate strategic adaptation, allow for evaluation of objectives and outcomes, and provide confirmation of prudent costs.

C. Regulatory Review

i. Preliminary Hedging Plan

48 Although we appreciate that it may take significant time for the Companies to develop and implement a comprehensive responsive risk management strategy, we expect each utility to begin the process of developing a more sophisticated risk management methodology as soon as possible. We therefore direct each company to submit, as part of its 2017 PGA filing, a preliminary hedging plan that outlines the company's intended path to incorporating risk-responsive hedging strategies for the coming year.[32] This plan should articulate the company's hedging objectives and communicate its approach to address the basic elements of risk-responsive hedging: objectives and goals, exposure quantification, strategic initiatives, and oversight and control.[33] Additionally, the Companies should provide a timeline for building expertise and acquiring management

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[31] We acknowledge Northwest Natural's comments filed on May 23, 2016, for flexibility in modifying the White Paper approach to consider both gas costs and customer rate effects, including deferrals, when establishing a more tailored approach to a comprehensive hedging program.

[32] The Annual Hedging Plan year will cover the November through October period in agreement with the PGA year.

[33] The Hedging Practices Review Reports filed under the 2012 PGA dockets for each Company provide a risk management best practice gap analysis. These reports may provide helpful guidance on the basic elements of risk responsive hedging practices for Companies to consider in developing their 2017 preliminary hedging plan for submission.

systems, as well as a plan for managing the interim risk (beyond 2017 but before the risk-responsive strategies are fully implemented).

49 The Commission will take a measured approach in implementing its policy preference. Insofar as the Companies are making good faith efforts to develop appropriate risk management strategies and otherwise executing hedges in a prudent manner, the Commission will be flexible in allowing sufficient time for full implementation.

50 While we reiterate we are not mandating a specific hedging strategy, annual hedging plans will be required of each utility. The orders approving the 2017 PGAs will contain a provision requiring submission of comprehensive annual hedging plans as described in the following section.

ii. Comprehensive Annual Hedging Plan

51 When making their 2018 PGAs filings, we require the Companies to submit annual comprehensive hedging plans that demonstrate the integration of risk responsive strategies into the Companies' overall hedging framework. The Commission expects that full implementation will take no longer than 30 months. Therefore, by the deadline for submitting 2019 PGA filings, barring extraordinary circumstances, the Companies should file annual hedging plans that exhibit a full strategy implementation for 2020 and beyond.

52 As part of the comprehensive annual hedging plan, the Companies should incorporate a retrospective hedging report. This report should provide a narrative of the utility's perspective on the execution of its prior year hedging strategy. Additionally, the report should include a discussion providing insight about whether the metrics and tolerances identified in the previous year's plan continue to be appropriate, and how the Company's retrospective evaluation has informed modifications to the forthcoming year's hedging plan.[34]

iii. Confidentiality

53 The Commission recognizes the information requested in the annual hedging report, both preliminary and comprehensive, may constitute proprietary commercial information, and that broad dissemination of this material could jeopardize a company's ability to access

[34] Companies may find that the reporting template on page 34 of the White Paper will be useful in determining how to summarize hedge accumulation data and weekly metrics.

fair price quotes for prospective hedges. Therefore, the Companies may reasonably expect to submit information as confidential pursuant to WAC 480-07-160.

iv. Acknowledgement

54 The annual hedging plan, although submitted concurrently with the annual PGA filing, will be recognized as an independent document. The Commission will review the strategies identified in the plan to determine the appropriateness of hedging losses or gains for recovery through the PGA mechanism. However, the Commission declines to formally accept or reject Companies' hedging plans. Instead, we opt to employ the acknowledgement process similar to that used with IRP submissions.

v. Prudence Standards

55 Consistent with our intention not to be overly prescriptive about *how* the Companies develop more robust, risk-responsive hedge strategies, we decline here to be formulaic in suggesting how utilities ought to operate in a prudent manner. We adopt an affirmative policy that natural gas company hedging programs must adapt to constantly changing market risk conditions, and that utilities should seek to, "[implement the most economically superior strategy] that produces a cost-mitigation tolerance with the smallest hedge-loss exposure."[35] The Companies must determine how best to achieve these objectives.

56 Nevertheless, the Commission expects utilities to make reasonable progress in developing a more sophisticated risk management framework consistent with this policy statement. As we move forward, we are more likely to entertain arguments regarding the prudency of extraordinary hedging losses, particularly for companies that continue to rely upon a strict programmatic hedging approach. Therefore, continuing to maintain largely static hedge ratios without justification will become an increasingly risky proposition.

57 In light of expert recommendation and comments filed in this proceeding, we determine that the Commission's existing prudence standard remains sufficient to evaluate decisions and subsequent outcomes related to hedging losses.[36]

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[35] Gettings White Paper at 15.

[36] *WUTC v. Puget Sound Power & Light Company,* Cause No. U-83-54, Fourth Supplemental Order at 32 (Sept. 28, 1984).

D. Conclusion

58 The Commission provides this policy statement affirming its preference that Washington natural gas local distribution companies utilize risk responsive hedging practices. While no "right" mix of methods may be applied unilaterally due to utility specific operations, the Companies must reasonably plan for market volatility and appropriately react to balance ratepayer exposure to hedging losses with ratepayer exposure to price spikes. Annual hedging results must be reconciled with each Company's hedging policies and annual plan. Thus, the Commission adopts these policies supporting dual protection of upside price risk and downside hedging loss, along with annual validation of acceptable hedging outcomes.

DATED at Olympia, Washington, and effective March 13, 2017.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DAVID W. DANNER, Chairman

ANN E. RENDAHL, Commissioner