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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Rocky Mountain Power for Authority to Increase Its Retail Electric Utility Service Rates in Utah and for Approval of Its Proposed Electric Service Schedules and Electric Service Regulations.	Docket No. 10-035-124 **UIEC'S COMMENTS ON THE DIVISION OF PUBLIC UTILITIES' REPORT TO THE UTAH PUBLIC SERVICE COMMISSION ON THE COLLABORATIVE PROCESS TO DISCUSS APPROPRIATE CHANGES TO PACIFICORP'S HEDGING PRACTICES**

Pursuant to the Utah Public Service Commission's ("PSC" or "Commission") Order Granting Extension, issued March 1, 2012, the Utah Industrial Energy Users intervention group ("UIEC") submits these comments on the Report to the Utah Public Service Commission ("Report") on the collaborative process which was established to discuss appropriate changes to PacifiCorp's hedging practices.

The UIEC commend the Division of Public Utilities ("Division" or "DPU") for its effort in organizing and conducting the collaborative proceedings and for producing its Report to the Commission. The data presented to the group during the workshops, as well as the discussions

facilitated by the Division, contributed greatly to the parties' understanding of the Company's risk management policies and practices and the positions and points of view of the other participating parties. While the UIEC believes that certain aspects of the Report are misguided, the process as a whole was instructive and worthwhile.

COMMENTS

1. Over the past several years, Rocky Mountain Power ("RMP" or the "Company") has passed on to Utah ratepayers hundreds of millions of dollars in losses arising from years of rigid adherence to a practice of acquiring financial derivatives in the form of fixed for variable price swaps to cover virtually all of the Company's forecasted natural gas needs. At times, when RMP's consumption of natural gas did not rise to the forecasted need, the Company's position in swaps actually exceeded its consumption of natural gas.

2. In the last several rate cases, the UIEC and others called to the Commission's attention the staggering losses caused by the Company's unwavering adherence, despite changes in business risk conditions, to a practice of acquiring swaps to cover its gas requirements. In the last general rate case, Docket No. 10-035-124, adjustments were suggested by nearly all of the parties when they each took the position that at least some part of the Company's natural gas acquisition should be exposed to market. That was especially appropriate in light of the trend since 2008, showing that natural gas costs were declining.

3. Because PacifiCorp is a multijurisdictional utility, it is impractical for one regulatory jurisdiction to prescribe portfolio standards or specific practices for the Company to follow when acquiring its natural gas supply if other jurisdictions do not impose the same requirements. The only effective tool available to the Utah Commission to remedy the

consequences of PacifiCorp's unwise practices is a prudence disallowance. Prudence disallowances were advocated in the last general rate case for up to a third of the market losses occasioned by the Company's purchase of financial swaps to cover virtually its entire forecasted gas burn. Due to the imprudent concentration of risk mitigation measures into a single vehicle, *i.e.*, swaps, and the imprudent timing horizon for acquiring swaps, as well as the unwavering adherence to its practice of acquiring swaps in face of consistently falling natural gas prices, the Company was incapable of responding to the dynamic nature of the natural gas market. Ultimately, the parties in that rate case reached a Settlement Stipulation by which they agreed that PacifiCorp would recover only a portion of its swap losses. But, the problem of financial losses from swaps persists. With the implementation of the EBA, it has become even more important that the Company's hedging practices, including the practice of purchasing fixed for variable swaps, are responsive to market conditions and are subject to close Commission scrutiny for prudence.

4. In the collaborative process convened to discuss the Company's hedging practice, the Company understandably tried to steer the process toward assuring some preapproval of its hedging practices, and to expand the scope beyond the focus on natural gas swaps. Also, understandably, the regulators, whose tendency is to plan and manage affairs for the utility, may have given too much heed to the Company's desires, possibly in part because of the conflict of interest the regulators face in trying to protect the financial integrity of the Company while also ensuring that the public interest, including that of the ratepayers, is served.

5. On March 30, 2012, the Division filed the Report with the Commission. The Report discusses the activities of the collaborative and proposes a set of "Principles and

Guidelines" (attached to the Report as Exh. A at 14-16) ("Guidelines") that recommend certain changes to the Company's hedging practices, which the Report states will "allow the Company to implement a hedging program that better reflect[s] customer risk tolerance." Report at 2. The UIEC believes that the collaborative process was useful in helping the participants understand the Company's approach to managing its natural gas purchasing practices. The Division's Report may also be useful as an expression of the "risk tolerance" of some of the participants in the collaborative group. However, the UIEC does not believe that the creation or use of the Guidelines is well advised, or that a group of collaborative participants are in any position to make sound recommendations about the complicated task the Company faces in managing it natural gas supply risks. For reasons discussed below, the measures proposed in the Guidelines are likely to be ineffective in mitigating imprudent hedging conduct. Moreover, to the extent the parties or the Company believe that Guidelines "allow the Company to implement" changes to its hedging program, they represent an unwise departure from the standards of prudence that this Commission has applied in the past and must apply going forward to determine whether hedging losses should be recoverable from ratepayers. For the reasons discussed below, the UIEC recommends that the Commission take no action to approve, accept or implement the Guidelines.

6. The Report states:

> While the majority of the participants have reached agreement on many of the issues, representatives from the "Utah Industrial Energy Consumers" (UIEC) expressed reservation and concerns and do not want the results of this process to be binding.

Report at 2. The statement is incorrect only insofar as it understates how vigorously the UIEC opposes the adoption or implementation of the Guidelines. To be sure, the UIEC has led the charge against allowing cost recovery of the Company's imprudently incurred swap losses. But,

it has been the UIEC's position throughout this docket and in prior dockets that "PacifiCorp should have reduced its 100% reliance on fixed for variable financial natural gas swaps and *have some portion of its program exposed to the market* in order to capture the benefits of increased supply of natural gas and associated price decline." Direct Testimony of J. Robert Malko ("Malko Direct"), Docket No. 10-035-124, (May 26, 2011), at 18:375-78 (emphasis added). Beyond that requirement, the UIEC has advocated, and continues to advocate, that the Company's hedging strategy should be left to the Company to determine, and that its natural gas hedging decisions should remain subject to a rigorous prudence review by the Commission.

7. The creation of the Guidelines through a collaborative process is, in the UIEC's view, both ineffective and dangerous. The Guidelines do not minimize the likelihood that the Company's hedging practices will be imprudent and they do not alleviate the risk that ratepayers will continue to pay for losses attributable to those imprudent hedging practices.

8. The Guidelines are the product of the participants in a collaborative group that, apart from the Company, have no expertise in natural gas purchasing, market analysis, or investment in derivative financial products. They do not have ready access to adequate information; they are not in a position to say how a prudent gas manager should respond to that information or to market conditions; and they lack the training and experience necessary to develop or execute an effective strategy for the acquisition of natural gas.

9. While all participants agreed that the Company's practice of hedging virtually all of its natural gas supply "does not allow [the Company] enough flexibility to adapt to changing requirements and changing market conditions," they also acknowledged that "the Company and not outside parties should determine the specific price, physical delivery, processes and

procedures, necessary for fuel procurement." Report at 2. Yet, the participants presumed to establish a set of detailed Guidelines that purport to advise the Company about how to analyze and manage its risk.

10. The use of the Guidelines or other tools to create a standard for acceptable conduct by the Company is likely to simply create a paradigm shift from PacifiCorp's rigid, failed strategy of acquiring swaps to a second rigid strategy of following the Guidelines, which in today's natural gas market, could be equally unsuccessful. The Guidelines simply serve to distract the Company from executing a well-considered hedging strategy that is responsive to market conditions by creating a false sense of security that the Company's conduct will be deemed prudent as long as it follows the Guidelines, and that it will therefore enjoy full cost recovery funded by the ratepayers.

11. The Guidelines have already proved to be inadequate to allow the Company to respond to changing market conditions. The Report acknowledges the deficiency when, at the same time it proposes Guidelines that set expectations for hedging, it states in the body of the Report that "the Company should follow prudent management strategies and *may act outside the percentage and time horizon limits* when market conditions warrant" – such as now when "the Company should be looking at the possibility of securing long-term purchase fixed price contracts." Report at 7 (emphasis added). The participants to the collaborative undoubtedly have not identified the only instance where prudence might require a departure from the Guidelines. Far more likely, the Guidelines, by providing the illusion of a "safe harbor" for the Company, will increase the chances that by following them, the Company's actions will be imprudent and costly.

12. The Guidelines are also ineffective because they fail to encourage the Company to exercise continued vigilance in managing hedges once they have been acquired. While the DPU's Report sets out in some detail the principles and guidelines the Company should follow in acquiring swaps to meet its forecasted natural gas supply, there are no principles or guidelines on managing the acquired swaps. That is a significant omission. While it may not be imprudent to acquire a fixed for variable swap at the time it is acquired, it may be imprudent to fail to liquidate the swap when market conditions begin to change. How long should the Company hold a swap acquired at $7.00 when the market price of gas begins to fall? At what point does prudence require that it try to minimize its losses? The Guidelines do not address these issues, nor should they. The Company should simply be required to act prudently in both acquiring and managing its hedges, with or without guidelines.

13. The Guidelines are not only unlikely to discourage imprudent decisions, they have completely missed the mark by failing to recognize the importance of hedging as a means of cost minimization. Hedging natural gas purchase serves a dual purpose of providing price stability and minimizing gas costs. *See* Malko Direct, at 2:28-30. UIEC witness, Robert Malko, testified in this docket as follows:

> The fundamentals of economic regulation require that cost minimization be one of the primary goals used by energy utility management in the development and implementation of its hedging program for natural gas in order to address the interests of captive ratepayers. It must be a joint goal with price stability. By failing to address and balance cost minimization and price stability as joint primary goals, PacifiCorp has incurred significant losses for its ratepayers in its natural gas hedging program.

Id. at 21:436-43. The Company has been successful in achieving price stability by hedging most of its gas supply. By buying swaps, it has fixed the price of a large portion of its future gas

supply and hedged against a fly-up in prices. But price stability has come at a very high cost – hundreds of millions of dollars – as the Company, nearly fully hedged, has been unable to respond to falling gas prices.[1] The Company apparently has made no effort to consider the second objective of a prudent hedging strategy – to minimize gas costs. Indeed, despite the call from nearly every party to also consider cost minimization, the Company steadfastly maintains that its sole purpose of its hedging strategy is to ensure price stability. *See*, *e.g*., Transcript of Hearing Proceedings, Docket No. 09-035-15 (Aug. 17, 2010) at 58:18-23.[2] Now that the EBA removes the risk of swap loss cost recovery from the Company, the only stability ensured by the Company's hedging strategy is the stability of its own earnings. The customers get an interim rate increase.

14. The collaborative was established in this docket in response to the parties' complaints about RMP's cost recovery for the astonishing losses due to its imprudent hedging practices. Yet, the Report offers no principles or guidelines to require or encourage the Company to take measures to minimize hedging losses, or to protect ratepayers from having to pay for hedging losses due to the Company's imprudent practices. Nor should they. Even if the Company were to follow the Guidelines to the letter, there is nothing to protect ratepayers against swap losses due to imprudence. If the Company, for example, were to ignore the suggestion in the DPU's Report to consider long term fixed price contracts in the current market, and if it were to purchase hedges instead, the Company conceivably could comply with the hedging Guidelines and still incur swap losses due to imprudent conduct. This is a failure of the

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[1] As of the date of these Comments, the weekly settlement price on front-month natural gas was below $2 per decatherm. Wall St. Journal, April 12, 2012, at C4.

[2] During the hearings in the first EBA case (Docket No. 09-035-15), Company witness Greg Duvall testified, "The hedging is not intended to reduce cost or increase cost, it's intended to reduce volatility."

Guidelines to take into account the importance of cost minimization in the Company's hedging strategy, while at the same time creating a misperceived safe harbor for the Company's inflexible hedging practices and cost recovery of its hedging losses.

15. Prudence requires a balance between price stability and cost minimization. Given the Company's history of losses from its hedging strategy, it is clear that the Company is far more concerned with cost recovery than cost minimization. And, given the magnitude of its hedging losses, the Commission and parties should continue to inquire whether it is prudent to achieve price stability at any cost, especially, when the ratepayers are now at risk for all of the losses.

16. The Guidelines do not increase the probability that the Company will act prudently in its hedging practices to minimize the cost of natural gas, or that it will achieve a proper balance between price stability and cost minimization. The magnitude of its hedging losses (although historically astronomical) is simply immaterial under the Guidelines. It is ironic the very issue that impelled the creation of the collaborative in the first place – the avoidance of cost recovery of substantial, imprudently incurred hedging losses – was not a topic of meaningful discussion, and is not reflected in the Report or the Guidelines.

17. The Guidelines are not only ineffective, they are dangerous. To the extent they purport to recommend acceptable hedging practices, they compromise the only protection that ratepayers have against imprudent utility conduct. The Report states that the principles and guidelines "do not relieve PacifiCorp's burden to demonstrate the prudence of all Energy Planning and Procurement activities." Report at 13. Yet, the Report also states: "The principles and guidelines … should be used as a general starting point for prudency analysis." It seems

axiomatic that if the Guidelines are used as a "starting point for a prudency analysis," a showing that the Company's conduct was in conformity with the guidelines will, in some measure, create an inference that the Company's conduct was prudent. This raises a significant concern about preserving the burden of proof in cases coming before the Commission related to PacifiCorp's hedging practices.

18. A utility seeking a rate increase has the burden of proof to demonstrate that the increase is just and reasonable. *Utah Dep't of Bus. Regulation v. Public Serv. Comm'n*, 614 P.2d 1242 (Utah 1980). Rates are not just and reasonable if they include an amount for the recovery of imprudently incurred costs, regardless of the impact on the financial health of the utility. The EBA statute specifically allows only for the recovery of "*prudently incurred* actual costs [of fuel and purchased power] in excess of revenues collected." Utah Cod Ann. § 54-7-13.5(2)(h) (emphasis added).

19. In conducting a prudence review, the Commission must apply the standards set out at Utah Code Ann. §54-4-4(4)(a).[3] The standards require that the Commission consider,

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[3] Section 54-4-4(4)(a) of the Commission's statutes sets forth the standards for the Commission to conduct a prudence review:

> (4)(a) If, in the commission's determination of just, reasonable, or sufficient rates, the commission considers the prudence of an action taken by a public utility or an expense incurred by a public utility, the commission shall apply the following standards in making its prudence determination:
>
> (i) ensure just and reasonable rates for the retail ratepayers of the public utility in this state;
>
> (ii) focus on the reasonableness of the expense resulting from the action of the public utility judged as of the time the action was taken;
>
> (iii) determine whether a reasonable utility, knowing what the utility knew or reasonably should have known at the time of the action, would reasonably have incurred all or some portion of the expense, in taking the same or some other prudent action; and
>
> (iv) apply other factors determined by the commission to be relevant, consistent with the standards specified in this section.

among other things, "whether a reasonable utility, knowing what the utility knew or reasonably should have known at the time of the action, would reasonably have incurred all or some portion of the expense, in taking the same or some other prudent action." To apply the standard, the Commission must look at what a "reasonable utility" would have done. In the case of determining the prudence of a hedging decision, that requires information about the hedging practices that may be prevalent in the industry generally, among other similarly situated utilities in particular, and among other large purveyors and consumers of natural gas. Prudence cannot be determined by inquiring whether the utility measured up to a list of principles and guidelines formulated by regulators and customer groups.[4] While the Guidelines may to some extent express the risk tolerance of the Division and some of the utility's customers, they cannot serve as a standard by which to measure the prudence of the Company's conduct in hedging.

20. The Guidelines also create confusion about the applicability of the Settlement Stipulation (filed in this docket and others), leaving an opening for the Company to argue that its swap losses due to imprudent decisions may not be challenged as long as the Company does not depart from the guidelines. The Stipulation provided in relevant part:

> The Parties agree, based on … that hedging transactions entered into before July 28, 2011 will not be challenged for prudence on the grounds that they:
>
> a. Do not comply with the policy changes implemented through the Collaborative Process, Commission order or as a result of this Stipulation.

(b) The commission may find an expense fully or partially prudent, up to the level that a reasonable utility would reasonably have incurred.

[4] For a comprehensive discussion of the elements of prudent review, *see* J. R. Malko, V. M. Baldwin, *Prudence Reviews and Traditional Revenue Requirement Regulation: Some Thoughts*, The Electricity Journal, Vol. 24, Issue 8 (Oct. 2011) at 88-91.

Settlement Stipulation, at 13 (attached to Report and Order, Docket Nos. 10-035-124, 09-035-15, 10-035-14, 11-035-46, 11-035-47, (Sept. 13, 2011). The UIEC contend that the Guidelines do not and should not create any immunity under the Stipulation against the Company's imprudent management of its hedges. Many hedges entered into before July 28, 2011 are now held by the Company and are losing value every day that the market price for natural gas declines. Because the Guidelines do not address prudent management of hedges or standards to achieve cost minimization (nor should they), the parties to the Stipulation are not foreclosed from mounting a challenge to cost recovery for losses caused by imprudently holding those swaps in a declining market.

21. Moreover, while the Stipulation provides that hedging transactions entered into before July 28, 2011 will not be challenged for prudence on the grounds that they "do not comply with the policy changes implemented through the Collaborative Process," there is no immunization against an imprudence challenge for swaps entered into after that date, even if they comply with "the policy changes implemented through the Collaborative Process."

22. With the single exception stated in the Stipulation, the Guidelines should not be construed or applied to create any inference or presumption affecting the burden of proof in any proceeding before the Commission or to change or shift PacifiCorp's burden to demonstrate the prudence of its actions or inactions in undertaking fuel planning, acquisition and hedging activities.

23. Although the UIEC does not believe the Guidelines should be adopted or implemented, the collaborative yielded positive results in two areas. The consensus of all who participated was that the Company should not continue to hedge all of its natural gas supply, but

that "a portion should remain open to short-term market price exposure and for operational flexibility." Report at 6. The Report recommends a certain percentage range to allow for fluctuations in the Company's natural gas requirement. The UIEC agrees that maintaining an open position will reduce the possibility that the Company will find itself in an over-hedged position. Leaving a portion of the Company's requirements open to short-term market prices, while it does not guarantee prudence, is an important component of a prudent portfolio.

24. The UIEC also supports the Company's filing of a semi-annual hedging report including the information contained in Confidential Exhibit C to the Report. This same information is relevant to all matters in which cost recovery of swap costs is at issue. The Commission should require that same semi-annual report be made available in to the parties in the current EBA Docket and in the pending general rate case.

25. For the reasons discussed above, the Commission should decline to take any action approving, accepting or implementing the Guidelines.

26. In addition, before allowing cost recovery of hedging losses, the Commission should require that Company bear the burden of proof, regardless of whether it has adhered to the Guidelines, to demonstrate that it has prudently acquired and managed its hedges. As part of that prudence review the Commission should consider whether the Company's hedging strategy strikes an appropriate balance between price stability and cost minimization.

DATED this 13th day of April, 2012.

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CERTIFICATE OF SERVICE

(Docket No. 10-035-124)

I hereby certify that on this 13th day of April 2012, I caused to be e-mailed, a true and correct copy of the foregoing **UIEC'S COMMENTS ON THE DIVISION OF PUBLIC UTILITIES' REPORT TO THE UTAH PUBLIC SERVICE COMMISSION ON THE COLLABORATIVE PROCESS TO DISCUSS APPROPRIATE CHANGES TO PACIFICORP'S HEDGING PRACTICES** to the parties below:

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