INCENTIVE MECHANISMS

NARUC STAFF SUBCOMMITTEE ON ACCOUNTING AND FINANCE

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OVERVIEW

• Utility perspective on –
  • Goals of Incentive Mechanisms
  • How they work
• Examples from NW Natural
• Thoughts and questions
GOALS OF INCENTIVE MECHANISMS

• Create opportunities
  • Benefit both the customers and the company
  • Induce desirable behavior

• Address some of the shortcomings of traditional regulation
  • Avoids benefits all going to one side or the other
  • Allows utility to benefit from actions other than rate base increases
HOW THEY WORK

• Expressly decided upon
  • Stakeholder buy-in
  • Commission approval

• Applied prospectively
  • Incent future behavior
  • Create opportunity
  • Changes also applied prospectively

• Accounting and reporting
  • Transparency
  • Monitoring
EXAMPLES FROM NW NATURAL

- Gas Cost / Savings Sharing Mechanism
- Revenue sharing related to FERC-jurisdictional interstate storage operations
- Revenue Sharing related to optimization activities
- Annual earnings test, with revenue sharing above specified threshold
EXAMPLES FROM NW NATURAL

- **Purchased Gas Adjustment – Cost Savings Sharing**
  - Creation of benchmark = forecast cost of gas (WACOG)
    - Sets price of gas for upcoming year that goes into PGA
    - Unhedged volumes, priced at forecast market price
    - Costs of fixed price hedges
    - Storage withdrawals, using price of stored gas
  - **Actual costs calculated on monthly basis**
    - Difference between forecast and actual costs are deferred, for recovery / refund in the next PGA
EXAMPLES FROM NW NATURAL

• **Purchased Gas Adjustment – Cost Savings Sharing (cont’d)**
  • Utility bears, or retains a percentage of the deferred costs / credits
    • Utility can select either 10% or 20%; chosen ahead of gas year
    • Choice affects a “deadband” that is part of annual earnings test
  • Intended to ensure an incentive to keep gas costs low
    • Some dispute about how much utilities can control this
    • Some dispute about percentages that should be applied
EXAMPLES FROM NW NATURAL

• **Storage Operations**
  • NW Natural owns an underground storage facility in Northwestern Oregon (Mist)
  • Multiple reservoirs, depleted gas field
  • Initially developed in late 80’s
  • Allows avoidance of significant pipeline demand charges during winter
  • Allows opportunity to have an alternative to spot market prices for gas supply
EXAMPLES FROM NW NATURAL

- **Interstate Storage Operations Revenue Sharing**
  - Initial storage investment to meet “core customer” needs, costs included in rates
  - Opportunities for further development, at cost to shareholders, costs not included in rates
  - Revenue sharing arrangement adopted, with recall rights for customers
EXAMPLES FROM NW NATURAL

• Interstate Storage Operations Revenue Sharing (cont’d)
  • Benefits to Company: Opportunity to participate in interstate market, with associated risks and rewards
  • Benefits to Customers:
    • Revenue Sharing
    • Ability to “recall” storage on as-needed basis (avoid lumpy investments)
    • Recall occurs at depreciated amount
    • Customers do not bear risks of being “worse off”
EXAMPLES FROM NW NATURAL

• **Optimization Activities**
  • Assistance from third party
    • Larger footprint
    • Expertise not associated with typical gas utility operations
  • Speculative transactions not engaged in as gas utility function

• **Categories:**
  • Optimization of Mist storage as a whole
  • Liquids extraction
  • Portfolio optimization
  • Upstream pipeline optimization
EXAMPLES FROM NW NATURAL

- **Optimization Activities (cont’d)**
  - *Benefits to Company:* Opportunity to participate in different market, with associated risks and rewards
  - *Benefits to Customers:*
    - Revenue Sharing
    - Offsets costs of providing utility service, access to opportunities not typical for gas utility
  - Customers do not bear risks of being “worse off”
EXAMPLES FROM NW NATURAL

- **Earnings Test with Revenue Sharing**
  - Annual earnings test conducted on utility’s Results of Operations (regulated ROE)
  - Earnings over threshold shared with customers
  - Threshold depends on level of sharing selected for gas cost savings
THOUGHTS ABOUT INCENTIVES IN REGULATED UTILITY CONSTRUCT

- Effective way to expand opportunities for Customers and Company
- Require up front buy-in, and recognition of reliance on the construct
- Does represent a departure from normal rate of return regulation, for good reason