DG 02-137

NORTHERN UTILITIES, INC.

Petition to Terminate Fixed Price Option Program and Modify Hedging Activities

Order Nisi Approving the Proposed Hedging Policy and Termination of the Fixed Price Option Program

O R D E R N O. 24,037

August 16, 2002

I. Background

On July 19, 2002, Northern Utilities, Inc. (Northern), a public utility primarily engaged in distributing natural gas in the seacoast area, filed with the New Hampshire Public Utilities Commission (Commission) a proposal to terminate its Fixed Price Option (FPO) Program and modify its hedging activities.

The Commission approved Northern's FPO program and hedging plan in Order No. 23,740 (July 12, 2001) as a pilot program effective for the 2001/2002 winter period. Northern was ordered to hedge a minimum of 50 percent of its winter gas supply portfolio, including 50 percent of its winter upstream pipeline capacity through the use of financial instruments. The order also stated:

> …the FPO should be treated as a pilot program for the 2001/2002 winter period. The program should be closely monitored and the results reviewed and evaluated to serve as a basis for continuing and improving the plan going forward. We believe that the terms of the Settlement addressing monitoring and evaluation of the FPO program will provide Northern, the OCA [Office of the Consumer Advocate] and Staff [Commission Staff] sufficient information to discuss whether the program should be offered in subsequent years and whether any program modifications are necessary.

On March 15, 2002, Northern submitted to the Commission and parties a preliminary evaluation of the FPO program, reporting that approximately 10% of eligible customers participated in the FPO and that feedback from those customers had been mixed. The evaluation also noted that due to low participation in the FPO program the percentage of hedged supplies included in the Cost of Gas (COG) rate calculation increased dramatically and resulted in actual costs being significantly different from forecasted costs, thereby contributing to an undercollection.

Due to limited participation in the pilot program and a desire to provide a high level of price stability for all of its firm sales customers, Northern has proposed to terminate the FPO program but continue its hedging strategy. Northern proposes to hedge its winter supply portfolio as ordered for the pilot, with one exception: winter upstream pipeline supplies will be hedged at a minimum of 40 percent and a maximum of 70 percent for the 2002/2003 winter period, rather than a fixed 50 percent.

Approximately 53% of Northern's normal winter requirements are hedged physically through underground storage supply, which is injected into storage on a ratable basis throughout the summer period, and an additional 10% of normal winter requirements is comprised of Liquid Natural Gas and Liquid Propane supplies that are locked into a price with a supplier prior to the winter season. The remaining 37% will be satisfied via pipeline supplies.

Northern will hedge 40% of the pipeline supplies through the use of futures contracts that will be layered-in over twelve months, such that the price of those supplies will be tied to market prices prevailing over that time. Combined with the physical hedges and fixed price supplemental supplies, hedging 40% of the winter pipeline supplies will insure approximately 78% of the winter gas costs will be known when setting the winter COG rates.

Northern would hedge up to 30% more of its normal pipeline supply at any time if certain price targets are achieved, bringing known costs up to a maximum of 89% of normal winter requirements prior to setting rates. There will be three distinct target prices based on a four-year historical average of winter futures strip prices with targets based on a weighted average (i.e. the most recent year will be weighted at 40% and each of the remaining 3 years will be weighted at 20%). When a target price is reached, Northern would hedge an additional 10% at that time. While the primary goal of the proposed hedging policy is to reduce price volatility, the objective of hedging when target prices are achieved is to procure supplies when prices are historically low, resulting in COG rates that are likely to be lower than those experienced in recent years. The percentiles have been set based on Northern's consultations with an independent broker and may be reset from time-to-time, as market conditions warrant. Northern would seek Commission approval of any changes in the target prices.

The actual hedging transactions will be made by the Energy Supply Services group of NiSource based on the parameters of hedging requirements as set by Northern, including timing and volumes. The transactions will be entered into in accordance with NiSource's risk management policy, a copy of which was included in the filing and has been approved by the NiSource Board of Directors.

As stated in a response to a Staff data request regarding potential savings as a result of discontinuing the FPO program, Northern anticipates a reduction in administrative expenses of approximately $80,000 per year. Included in the 2001/2002 Winter COG were costs to administer the FPO program, charges related to direct mailing, enrollment and ongoing Information Technology support.

II. Commission Analysis

We do not believe the limited participation in the 2001/2002 Winter FPO program to be indicative of customers' sentiments regarding rate volatility, as identical programs offered by New Hampshire's two other gas utilities have grown in each of the years their FPO programs have been in existence. The lack of participation is more likely a reflection of publicity during the summer and fall of 2001 forecasting lower energy costs for the 2001/2002 winter period compared to the prior winter period and that the FPO program was a new offering. We believe that participation in the FPO program would increase if it were continued, as market conditions are likely to change and customers become more familiar with it. But given that the proposed hedging policy will lead to stable prices for all firm sales customers and save approximately $80,000 in annual administrative costs, we will approve termination of the FPO program. We continue to believe that an important component of any energy supply portfolio is hedging risks related to a sharp run-up in prices. Northern's proposed hedging program appears to address that concern and the amounts to be hedged will provide for a fairly stable winter COG rate based on average prices over a long period of time, providing price stability for all of its winter firm sales customers. The policy reduces speculation by requiring that set amounts be hedged over a long period of time, so that even during a period of rising prices, Northern will have secured a significant portion of its supply prior to setting rates. Therefore, we approve the proposed hedging policy.

We believe requiring additional hedging when certain price targets are achieved will allow Northern the opportunity to take advantage of favorable prices should the opportunity arise.

Locking in historically low prices may preclude capturing additional savings should prices continue to fall, but it increases the likelihood that COG rates will be lower relative to recent rates and insures that such an opportunity is not missed. We understand the need to adjust price targets based on changes in the market, as a change in market fundamentals may make target prices set on historical averages unattainable in the foreseeable future or reduce the opportunity of greater savings in the event of a sustained depressed market. We encourage Northern to monitor its target prices and provide testimony in the semiannual COG proceedings as to why the current targets are appropriate, or if not, recommend new target prices. Northern may also petition for a change in target rates at any time, if it feels more immediate action is required.

Given that we view Northern's proposed hedging policy favorably, believing it reduces the speculative nature of commodity buying and will contribute to more stable COG rates, we believe the policy should be extended to cover a portion of the summer period as well. Northern's summer supply portfolio is made up almost exclusively of pipeline supplies and approximately half those purchases are made in May and October. Normal October pipeline purchases are only matched by pipeline volumes purchased in January, and May purchases are only exceeded by those in the months of October and January. Clearly, price spikes in either

May or October natural gas prices may well have a profound impact on the summer rates if those supplies are not hedged. Therefore, we direct Northern to implement its hedging policy to cover both May and October, with May 2003 to be the first summer month to be hedged.

The results of the hedging policy should be monitored and evaluated to serve as a basis for continuing and improving the policy going forward. Northern currently files a monthly COG report and going forward that report should include the status of Northern's hedged positions. Northern should also provide a summary of hedging results when filing the summer and winter cost of gas reconciliation reports.

Lastly, Northern should work with the Commission's Consumers Affairs Division in determining how best to inform customers, particularly those who participated in last winter's FPO program, that the program will no longer be offered.

Based upon the foregoing, it is hereby

ORDERED NISI, that Northern Utilities, Inc. Winter Fixed Price Option Program is hereby terminated; and it is

FURTHER ORDERED, that the proposed Northern Utilities, Inc. hedging policy, modified to include the months of May and October, is hereby APPROVED; and it is

FURTHER ORDERED, that Northern Utilities, Inc. will include in its monthly cost of gas reports the position of its hedged gas contracts; and it is

FURTHER ORDERED, that Northern Utilities, Inc. shall cause a copy of this Order Nisi to be published once in a statewide newspaper of general circulation or of circulation in those portions of the state where operations are conducted, such publication to be no later than August 22, 2002 and to be documented by affidavit filed with this office on or before September 14, 2002; and it is

FURTHER ORDERED, that all persons interested in responding to this petition be notified that they may submit their comments or file a written request for a hearing on this matter before the Commission no later than September 11, 2002; and it is

FURTHER ORDERED, that any party interested in responding to such comments or request for hearing shall do so no later than September 14, 2002; and it is

FURTHER ORDERED, that this Order Nisi shall be effective September 16, 2002, unless Northern fails to satisfy the publication obligation set forth above or the Commission provides otherwise in a supplemental order issued prior to the effective date; and it is

FURTHER ORDERED, that Northern shall file a compliance tariff with the Commission on or before October 1, 2002, in accordance with N.H. Admin. Rules Puc 1603.02(b).

By order of the Public Utilities Commission of New Hampshire this sixteenth day of August, 2002.

Thomas B. Getz	Susan S. Geiger	Nancy Brockway
Chairman	Commissioner	Commissioner

Attested by:

Michelle A. Caraway
Assistant Executive Director