STATE OF NEW HAMPSHIRE
PUBLIC UTILITIES COMMISSION

DG 09-141

NORTHERN UTILITIES, INC.

Petition for Approval of Proposed Redesign of Financial Hedging Program

Order Approving Revised Hedging Plan

O R D E R N O. 25,087

March 30, 2010

APPEARANCES: Susan S. Geiger, Esq., of Orr & Reno, P.A. on behalf of Northern Utilities, Inc.; Kenneth Traum of the Office of Consumer Advocate on behalf of residential ratepayers; and Matthew J. Fossum, Esq., for the Staff of the New Hampshire Public Utilities Commission.

I. BACKGROUND

On August 7, 2009, Northern Utilities, Inc. (Northern or Company), a public utility supplying natural gas service to approximately 26,000 customers in the seacoast region of New Hampshire, filed a petition to revise its hedging program relative to natural gas futures. As part of its program redesign, Northern proposed three primary changes: (1) introduction of a price ceiling above which purchases of futures contracts would be suspended; (2) elimination of the price-based component of the existing hedging program; and (3) introduction of a process for selling futures contracts that have appreciated in value. *See* Exhibit 1 (Ex. 1) to March 9, 2010 hearing. This proposal was made in conjunction with a nearly identical proposal in Maine covering Northern's operations in that state. *See generally*, Maine Public Utilities Commision, Docket No. 2008-93. On October 1, 2009, the Office of Consumer Advocate (OCA), notified the Commission of its participation in this docket on behalf of residential ratepayers pursuant to

RSA 363:28. On December 8, 2009, the Commission adopted a procedural schedule setting a hearing on the Company's proposal for March 9, 2010.

Extensive discovery was conducted by the Staff in this proceeding, and also in the Maine proceeding by Maine Commission Staff. As a result, on February 17, 2010, the Company submitted a revised version of its hedging proposal, which altered some of its initially recommended changes. *See* Exhibit 2 (Ex. 2) to March 9, 2010 hearing. On February 23, 2010, Staff submitted the pre-filed testimony of Stephen Frink, Assistant Director of the Commission's Gas and Water Division, in support of the Company's revised proposal. *See* Exhibit 3 (Ex. 3) to March 9, 2010 hearing. A hearing on the proposal was held as scheduled on March 9, 2010.

II. CURRENT PROGRAM AND PROPOSED REVISIONS

A. Current Program

Under the current hedging program, Northern purchases futures contracts according to time-based and price-based criteria. Under the price-based criterion the Company defines a seasonal price distribution scale based upon five years of historical data. It then makes purchases any time the futures prices fall within certain ranges on this defined price distribution scale for deliveries in the peak season (November to April) or part of the off-peak season (May and October). Specifically, there are three defined price levels at which purchases are to be made. Over the last two years, each of the price levels has been met and, therefore, all proposed price-based transactions have been executed. Transcript of March 9, 2010 Hearing (Tr.) at 12.

Regarding the time-based criterion, the Company makes purchases each month without regard to the actual price. The contracts purchased under either criterion are then held until settlement without regard to any change in value. In scheduling its purchases, Northern generally begins hedging twelve months prior to filing for its semi-annual cost of gas (COG) rate adjustment.

Northern bases its targets for hedged volumes on its planned pipeline deliveries, which vary by month, as opposed to its total supply needs. Tr. at 11. Generally, these targets are a combination of a fixed target volume, which it meets through time-based purchases, and a variable target volume, which it covers by the price-based purchases. Historically, Northern has hedged an average of more than 75 percent of its peak season supplies under this program. Also, Northern has not had a fixed budget for its hedging program and notes that in order to cover its margin requirements, its hedging account balance has, at times, exceeded $10,000,000.

B. Initial Program Proposal

Northern submitted a proposal to redesign its hedging program on August 7, 2009. *See* Ex. 1. Under the initial proposal, the price-based criterion would be discontinued. More specifically, the criterion would not be a separate basis for purchases, but would be tied into the time-based criterion. Under the initial proposal, the Company would make time-based purchases subject to ceiling prices. That is, so long as prices remain below a defined price ceiling, the Company would make regular purchases each month. To the extent any purchases are not made because prices are above the ceiling price, the delayed purchases would be made at a time when the price falls below the ceiling.

Northern proposed to establish its price ceiling at one standard deviation above the mean price of contracts in a series of years. In particular, the calculation would be based upon the average daily closing price for the last two years of trading for each of the most recent five settled contracts for a given month, and for the next two contracts for that month that are still trading. For example, when establishing the ceiling for purchases in January 2009, the Company would review the settled contracts for January, 2005 through 2009, and the next two contracts for January, 2010 and 2011. It would then calculate the ceiling based upon the mean of these contracts and one standard deviation from the mean. Northern contends that setting such a price ceiling in this way “implies” that 84 percent of the time prices will be below the ceiling, and 16 percent of the time prices will be above it. *See* Ex. 1 at 11 of 21.

Rather than making hedging purchases twelve months prior to the filing for a COG adjustment, the initial proposal called for Northern to make purchases eighteen months prior to the filing. This change was meant, in part, to allow suspension of purchases in months when prices exceed the established ceiling. In addition, rather than basing its volume targets on planned pipeline deliveries, the Company would use a new target equal to thirty-four percent of peak season load. Half of this target volume would go towards storage injection and the other half towards peak month delivery. Moreover, the new hedges would only apply to natural gas supplies to be utilized during the peak season (November to April) and would no longer apply to natural gas supplies to be utilized in May and October.

In addition to changing the manner of hedging purchases, the Company also proposed to change how it handles contracts following purchase. Under the initial proposal, the Company would liquidate any contract that appreciates by forty percent or more, with the proceeds credited to the COG rate. This rule would apply at any time prior to the final settlement of a futures contract. The Company would not replace any contract liquidated due to appreciation. Northern stated that it determined an appreciation of forty percent to be appropriate based upon its identification of a threshold that was attainable, but rare, and which would not easily be surpassed following the liquidation of a contract. According to Northern's calculation, over the last five years of peak months, on average, thirteen percent of contracts appreciated by at least forty percent prior to the time they closed.

Finally, Northern's initial proposal contained new budgetary limits on the hedging program. Specifically, the Company would suspend additional hedging purchases if the margin requirements exceed $4,000,000. According to Northern, the other proposed changes to its hedging program would serve to mitigate margin requirements and decrease the likelihood of exceeding the $4,000,000 budget.

C. Revised Program Proposal

Based upon its discussions with Staff and other parties, Northern further refined its proposal. *See* Ex. 2. Under the revised proposal, Northern would adopt a "portfolio" approach for its hedging. Northern would count both its physically and financially hedged supplies toward achieving a goal of having seventy percent of its total projected winter supplies subject to fixed prices. Northern would include as physical hedges its underground storage and fixed-price contracts. Through physical hedges Northern currently covers about sixty to sixty-five percent of its forecasted winter supplies. For the remainder, Northern would use financial hedges – specifically, NYMEX futures contracts. Tr. at 17-18.

The previously discussed changes to the time- and price-based criteria for purchases of futures contracts would still be implemented, including the use of the price ceiling above which purchases would be suspended. In addition, the Company would maintain its proposals to begin hedging eighteen months prior to a particular peak season, and to sell futures contracts that appreciate by at least forty percent. One difference between the initial proposal and the revised proposal is in the manner in which the Company defines the price ceiling. Under the initial proposal, the price ceiling was defined by using the average daily closing price for the last two years of trading for each of the most recent five settled contracts for a given month, and for the next two contracts for that month. Under the revised proposal, the Company would use the average daily closing prices for the last two years of trading for the two most recent settled contracts, and the two contracts now trading in their final two years. For example, to determine the ceiling for January 2010, the Company would use the two most recently expired contracts for January, *i.e.*, January 2009 and January 2010, along with the two January contracts trading in their final two years before expiration, *i.e.*, January 2011 and January 2012. *See* Ex. 2 at 4 of 15 and fn. 1. Also, the revised proposal does not contain a budget cap for margin requirements or a provision calling for the hedging of gas intended for storage, as proposed initially.

In addition to the above, Northern would submit, with each summer COG filing, a hedging plan for the eighteen months after the start of that summer period. Finally, Northern's proposal notes that because it has already achieved the seventy percent goal for the 2010-2011 winter period, it will suspend any further purchases for that period.

III. POSITIONS OF THE PARTIES

A. Northern

In filing its revised proposal, Northern contended that the proposed changes to its hedging program will result in significant benefits to ratepayers. It contends that the new program will reduce the Company's and ratepayers' exposure to market volatility. Moreover, the new program would enable the Company to obtain greater financial benefits from its hedging contracts. Finally, the Company contends that the proposed changes will offer greater predictability for itself, its ratepayers, and for the Commission.

At the March 9, 2010 hearing, Rob Furino, Director of Energy Contracts for Unitil Service Corporation, which provides certain administrative services to Northern, testified on behalf of the Company's revised proposal. He stated that the desire to revise the Company's hedging program originated with a request from the Maine Commission to review the benefits of the Company's hedging. Tr. at 9. During that review, participants identified improvements to the program that were then incorporated into the Company's proposal.

Mr. Furino clarified that under the Company's current program, it uses time-based purchases to cover about forty percent of its pipeline supplies, and price-based ones to cover about thirty percent of its pipeline supplies. Tr. at 11-12. Under its new "portfolio" approach, the Company would use physical and financial hedges to cover approximately seventy percent of its total supplies. Tr. at 12-13. He stated that, while a portion of the Company's hedging portfolio was under a fixed-price contract that is due to expire on October 31, 2011, it had not yet determined how to replace that supply upon the contract's expiration. Tr. at 17.

With respect to the changes between the initial proposal and the revised proposal, Mr. Furino stated that some were in response to issues raised by Staff in discovery. Tr. at 7. Regarding the budget cap on margin requirements, he noted that margin requirements tend to increase when prices are dropping. Tr. at 20. Therefore, suspending hedging at that time because a budget limit might be reached would run counter to the purpose of the program. Tr. at 20. Moreover, he stated that because the Company will be able to realize gains from its contracts, those gains would mitigate its margin requirements. Tr. at 20. Regarding the removal of the proposal to hedge gas intended for storage, Mr. Furino stated that this provision did not appear to add any stability to rates that was not already achieved by other means. Tr. at 20-21.

Regarding the price ceiling, Mr. Furino also clarified that to the extent any purchases are delayed because prices exceed the ceiling, those delayed purchases would be made at one time when the price fell back below the ceiling, rather than be made serially when prices decreased. Tr. at 26-27. He stated that the single-purchase method was preferable because the Company had not found a way to make a reliable model for timing multiple purchases in the face of continually falling prices. Tr. at 27. Mr. Furino also stated that the structure of the price ceiling would protect against price spikes of four to six months, or sometimes longer, but that eventually the ceiling would rise to reflect the lasting high prices. Tr. at 31-32. Mr. Furino stated that, because Northern is essentially a price-taker in the gas market, it can exercise only limited control over such pricing. Tr. at 32.

Mr. Furino also stated that the elimination of the price-based component of the program was necessary because although it was, perhaps, sound in principle, in practice it did not work. Tr. at 32-33. He stated that more value was generally obtained through the time-based than the price-based transactions over the eight years the Company reviewed. Tr. at 33. He noted that even though recent volatility had impacted the average value of those purchases, the decline in their value had been evident in prior periods as well. Tr. at 33. Also, he stated that the revised proposal allows for more structure to the Company's purchases than did inclusion of the previous version of the price-based purchases. Tr. at 32-33.

In addition to the changes to the program itself, the Company would change how it reports on the program to the Commission. Tr. at 34. Mr. Furino stated that Company will “enhance” its regular monthly COG reports to reveal more about the Company’s hedging. Tr. at 34. The enhanced reports would include portions showing whether purchases had been suspended, the Company’s hedging status on various dates, and other information. Tr. at 34. Moreover, the Company would solicit feedback from Commission Staff on ways to further improve its reporting. Tr. at 34.

Finally, Mr. Furino contended that the revised program will provide significant benefits to ratepayers. Specifically, ratepayers will benefit from decreased volatility and from the ability of the Company to realize gains on its appreciated contracts. Tr. at 14. He requested that the Company’s petition be approved quickly so that it could implement the revised program by mid-April 2010, to cover the coming peak period of 2011-2012, approximately eighteen months in advance as proposed. Tr. at 24. He confirmed that because Northern has already reached its targeted amount for the 2010-2011 peak period, it will not implement its revised plan for effect in that period. Tr. at 25.

B. OCA

OCA took no position relative to the Company’s request. Tr. at 45. OCA did question Staff to confirm that the portions of Staff’s pre-filed testimony which stated that those customers who migrate to transportation service must remain on such service for twelve months, was not a change from the current rules governing such customers. Tr. at 44. Staff confirmed that there was no change to such customers from this policy. Tr. at 44.

C. Staff

Stephen Frink testified on behalf of Commission Staff. Mr. Frink first commented on many of the items highlighted by Mr. Furino. Specifically, he agreed with Mr. Furino that because the Company has substantial storage capacity, which fixes a portion of its supply, and thereby its price, the Company would only lose a limited amount of price protection by eliminating the fixed-price contract. Tr. at 37. Also, regarding mitigation of rate volatility, Mr. Frink agreed that elimination of the price-based component was appropriate. Tr. at 37-38. He noted that when purchases were made at prices below those recently experienced, customers were assured of lower rates relative to what they had been paying. Tr. at 38. However, when the economy faltered, prices fell even below the favorable ones obtained by Northern, which customers found troubling. Tr. at 38. Therefore, having less of Northern's supply locked in by the price-based purchases will result in rates that more closely track market prices and customer expectations. Tr. at 38-39.

In addition, Mr. Frink noted that because the Company will be enhancing its reporting program, Staff will be aware of the Company's hedging status and be in a position to recommend changes to the program if appropriate. Tr. at 36. He made it clear that the redesigned program was not intended to be static, but that it would be open to review and revision in the future if necessary. Tr. at 36.

In summarizing his pre-filed testimony, Mr. Frink noted that the objective of a hedging policy is to protect customers from unanticipated spikes in price. Tr. at 40. Moreover, many customers had shown their interest in having some level of price protection by their substantial participation in fixed-price options offered by the State's other gas utilities. Tr. at 40, 42-43. Thus, he concluded, hedging in order to decrease rate volatility was in the public interest. Tr. at 40.

As to the amount of hedging, Mr. Frink noted that seventy percent was a reasonable amount in that it was in the range for the hedging done by other utilities throughout the country. Tr. at 40. Moreover, it was in line with the amount of hedging done by the State's other large gas utility. Tr. at 40. He stated that under the current policy Northern hedged far more than this amount, so it was appropriate to revise its policy. Tr. at 40.

Mr. Frink noted that the impact of financial hedging on the volatility of Northern's prices was only limited, but that a limited impact was not surprising given that only about twenty-three percent of Northern's total winter supply was fixed through financial hedges even with all price-based purchases having been made for this winter. Tr. at 40-41. This is compared to the approximately sixty percent fixed by other means such as storage and fixed-price contract. Tr. at 41. However, while the impact has been limited, Mr. Frink noted that the costs have also been limited, and that they amounted to only about one-third of one percent of the Company's total gas costs. Tr. at 41. He noted that these costs included utility personnel costs, which would be unlikely to change should hedging be eliminated. Tr. at 41. Moreover, Mr. Frink noted that the revised program will lower costs further as compared to the current program. Tr. at 41.

Mr. Frink observed, as he had in his pre-filed testimony, that gas prices are relatively low and, therefore, the risk of price increases was greater than that associated with price decreases. Tr. at 41-42. Accordingly, he recommended that the Commission approve the Company's revised hedging policy because it would provide additional rate protections to customers at relatively low cost. Tr. at 42.

IV. COMMISSION ANALYSIS

Having reviewed the Company's current hedging policy and the revised proposal to amend that policy, we agree that such revision is appropriate and we approve the Company's revised proposal. As noted by both Staff and the Company, the underlying purpose to the hedging program is not to ensure that prices remain low, but to ensure that the volatility in the natural gas markets is dampened to mitigate against monthly rate increases. We find that the Company's revised proposal is a reasonable means to achieve this goal.

With regard to specific provisions, we conclude that the adoption of a "portfolio" approach with a target of having seventy percent of the Company's total winter supply hedged is reasonable. As noted by Staff, seventy percent is in the range for the hedging done by other gas utilities throughout the country, and in line with that done by EnergyNorth. This is not to conclude that the amount reflects the ideal volumes, but only that is a reasonable practice in light of similar actions by other companies in the industry. Moreover, including the Company's physical hedges in the portfolio will help to give a more accurate picture of its exposure to the volatility in the marketplace.

Regarding the termination of the price-based component and the use of the price ceiling, we find these changes to be reasonable. These alterations give the Company defined goals around which to base its purchases, while at the same time allowing it flexibility should prices spike. We also agree with the Company's proposal to begin its hedging eighteen months prior to the peak season, in part to allow time to make purchases that were delayed due to prices rising above the ceiling.

As to the sale of contracts that have appreciated by forty percent, we also agree that such a change is reasonable. As noted by Mr. Furino, there have been times when contracts have appreciated significantly, but then decreased by a greater margin prior to closure. Tr. at 15. Thus, the Company had missed opportunities to capture those gains. Tr. at 15. While such occurrences do not appear common, the change in the hedging program will allow the Company to take advantage of the times where significant value has been gained. Moreover, Mr. Frink made clear that selling the contracts and using the profits from them to offset the COG rate guarantees that customers will realize a benefit. Tr. at 37. Although there is some risk that once the contracts are sold, prices will continue to rise, this risk does not appear to be substantial, and that provision of the hedging policy could be revisited if the circumstances warranted it.

Finally, we note that the Company will be improving and enhancing its reporting to the Commission with regard to hedging and that this proposal is subject to review and revision should those reports reveal the need to alter the hedging plan. We find both the increase in information and the willingness to revisit the program reasonable and appropriate. For the above reasons, we conclude that the revised proposed hedging plan is in the public interest and hereby approve it.

Based upon the foregoing, it is hereby

ORDERED, that the revised hedging plan as proposed by Northern Utilities, Inc. on February 17, 2010 is hereby approved for implementation beginning with 2011-2012 peak period purchases; and it is

FURTHER ORDERED, that the first annual hedging plan filing under the revised policy be included in the 2010 off-peak cost of gas filing from Northern Utilities, Inc.

By order of the Public Utilities Commission of New Hampshire this thirtieth day of March, 2010.

Thomas B. Getz	Clifton C. Below (KMS)	Amy L. Ignatius
Chairman	Commissioner	Commissioner

Attested by:

Debra A. Howland
Executive Director