March 29, 2005

Luly Massaro
Clerk
Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

Re: New England Gas Company Docket 3436

Dear Luly:

On March 10, 2005, the New England Gas Company filed a letter from its Manager of Regulatory Relations, Kevin Penders, recommending a modification to its Gas Purchasing Incentive Plan (GPIP). The Company's letter was responsive to a Commission's directive asking the Company, as well as the Division, to review the GPIP to see whether any modifications might be warranted, especially in the area of the penalty provisions.

Attached is a March 23, 2005 memo from Bruce Oliver, on behalf of the Division, summarizing his response to the Company's proposal. He concludes that the Company's proposal to increase the level of mandatory purchases to 70% (compared to the present 50%) for the period November to March is a reasonable one. Additionally, Mr. Oliver offers, for the Commission's consideration, a modification to the Company's proposal that would increase the mandatory procurement percentage to 70% for all months, not just the winter months, for the reasons so stated in his memo.

The Division finds Mr. Olivers' response to the Company is reasonable and submits it to the Commission for its consideration.

Sincerely,

Stephen Scialabba
Chief Accountant

Attachment
cc: service list

MEMORANDUM

TO: Steve Scialabba

FROM: Bruce Oliver

DATE: March 23, 2005

SUBJECT: NEG Proposed Amendment to its Gas Purchase Incentive Plan

Per your request, I have reviewed the March 10, 2005 letter from Kevin Penders of the New England Gas Company (hereinafter "NEG" or the "Company") to Luly Massaro of the Rhode Island Public Utilities Commission (the "Commission") regarding its Gas Purchase Incentive Plan ("GPIP"). That letter addresses two topics: (1) potential modifications to the current incentive/penalty structure under the GPIP and (2) metrics for the measurement of performance under that plan. This memorandum discusses the content of the Company's March 10 letter to the Commission and conveys my assessment of the Company's proposed amendment to the provisions of that plan.

In general the Company's letter provides a reasonable assessment of alternatives to the current incentive/penalty structure under the GPIP. Although I might quibble with some of the details of NEG's assessment of the identified alternatives in that letter, overall I do not have major problems with the Company's characterization of those alternatives or its recommendation for modification of the GPIP. However, for completeness and clarity, some facets of the Company's presentation regarding those alternatives warrant further development. Also, I would suggest that the Commission consider one minor refinement to the Company's proposed amendment for the GPIP.

First, the Company's discussion of the policy factors influencing the assessment of alternative incentive structures omits a concern that has been discussed by the Commission on several occasions over the past few years. That concern deals with the use of incentive structures to gain greater alignment of the interests of ratepayers and shareholders in the gas procurement process. Prior to the adoption of the current incentive structure, all of the Company's gas procurement costs were passed dollar-for-dollar to its firm gas sales customers regardless of the prices at which supply was obtained unless there was a finding of imprudence. Under that structure the Company's shareholders had no direct stake in the results of its own gas purchasing activities, and after-the-fact efforts to assess the prudence of the Company's gas procurement activities were found to be highly problematic. Thus, part of the rationale for adopting the current incentive structure was to achieve greater alignment of the interests of ratepayers and shareholders in the gas procurement process as an alternative to technically complex and highly litigious prudence proceedings. The current GPIP addresses the prudence of NEG's gas procurement activities in two parts. On one

hand, the specification of mandatory purchase requirements essentially relieves the Company of the threat of after-the-fact prudence reviews for a substantial portion of its gas procurement costs. On the other hand, the approved incentive structure imposes a form of self-policing prudence review for discretionary purchases, thereby holding the Company accountable for the results of its discretionary gas procurement decisions while reducing the potential for claims that any resulting penalties are the result of regulation through the application of hindsight.

Second, the Company's assessment of incentive structure alternatives makes multiple references to "rising" and upward trending gas prices, but it only seems to recognize those trends in hindsight. On a going forward basis, the Company (who consumers rely upon for expertise in gas procurement) appears wary of assuming responsibility for assessments of future price trends. This may be affecting its gas procurement decisions, particularly where such procurement actions may result in penalties. Although the Company's desire to avoid potential penalties is understandable, the procurement actions that result from such risk aversion may not effectively protect consumers from cost increases. Unfortunately, in recent periods, deferral of substantial discretionary purchases until late in the procurement cycle has led to higher overall gas costs for firm gas sales service customers.

In the context of the foregoing considerations, as well as those presented in NEG's discussion of alternative incentive structures, I find that the Company's proposal to increase the percentage of gas purchases that are made on a scheduled, dollar cost averaging basis, appears to provide a reasonable compromise. It does not take full advantage of a rising cost market by locking-in pricing for as much gas as possible early in the process, but it does reduce ratepayers exposure to higher costs for discretionary purchase that are deferred to late in the procurement cycle. It also substantially reduces the Company's exposure to potential gas procurement penalties without totally scrapping the existing incentive structure.

Therefore, I recommend that the Division support the Company's proposed GPIP amendment, but I offer one modification to the Company's proposal for the Commission's consideration. The modification that might be considered would be to expand the mandatory procurement percentage for <u>all months</u> to 70%. Given the growing influence of natural gas-fired electric generation on late spring and summer gas prices, procurement of a greater percentage of summer month gas supply requirements through scheduled mandatory purchases may be well-advised.

Finally, with respect to additional metrics for assessing the reasonableness of NEG's gas procurement activities, I suggest that the best metrics are the results of a well-devised, self-policing, incentive structure. Unfortunately, the development of an incentive structure that works well under all potential market conditions is a highly problematic task. If the Company's proposed GPIP amendment is approved, the role of the current incentive structure is reduced, but the importance of having other metrics to aid assessments of the results of NEG's gas procurement activities may increase. Finding meaningful metrics, however, can be as difficult as that of developing incentive

structures that can be relied upon to function reasonably under changing market conditions.

Gas procurement metrics for NEG may be divided into three categories:

- Measure of performance relative to the market
- Measures of performance relative to actual NEG experience in prior years
- Measure of performance relative to other utilities

Unfortunately, due to differences in customer composition, ratemaking practices, other regulatory policies, and available gas supply resources, comparisons of NEG gas costs with those of utilities in other jurisdictions are often of, at best, limited value.

From a long-term perspective, two metrics of performance relative to the market that may be of some value are:

(a) The relative magnitude of fluctuations in the Company's average gas commodity purchase costs versus the magnitude of price fluctuations in the NYMEX market. (Over 5 to 10-year periods, fluctuations in NEG prices should be less than that for NYMEX one-year strip prices.)

(b) The average annual change in the Company's gas commodity costs versus that for NYMEX one-year strip prices.

The Commission could also monitor the percentage of gas supply for a month that is purchased on a daily basis during the month of supply and the average costs of such purchases versus the average costs of gas purchased prior to the start of deliveries for that month. Where increases in the percentage purchases of daily gas supplies during a month and/or the costs of such purchases cannot be explained directly by extreme weather or major supply disruptions, the Commission may need to re-examine the effectiveness of the Company's GPIP.