STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

NEW ENGLAND GAS COMPANY	:	
GAS COST RECOVERY FILING	:	DOCKET NO. 3436

REPORT AND ORDER

I. NEGAS' JUNE 3, 2002 GCR FILING

On June 3, 2002, the New England Division of the Southern Union Company d/b/a New England Gas Company ("NEGas") filed with the Rhode Island Public Utilities Commission ("Commission") new Gas Cost Recovery ("GCR") factors for effect July 1, 2002.[1] The proposed GCR factors on a per therm basis were as follows: $0.6251 for residential and small commercial and industrial ("C&I") customers, $0.6110 for medium (C&I) customers, $0.6192 for large low load factor customers, $0.5641 for large high load factor customers, $0.6081 for extra large low loads factor customers, and $0.5331 for extra large high load factor customers. The proposed GCR factors would reduce the bill for the typical residential heating customer of the former Providence Gas Company ("ProvGas") by approximately 3 percent and would result in no change for the typical residential heating customer of the former Valley Gas and Bristol & Warren Gas Companies ("Valley"). In addition, NEGas proposed Gas Marketer Transportation Factors for effect September 1, 2002, as follows: FT-2 Firm Transportation Marketer Gas Charge of $0.0439 per therm, Pool Balancing Charge of $0.00147 per percent of balancing elected per therm, and weighted average upstream pipeline transportation cost of $0.0885 per therm of capacity.

[1] ProvGas and Valley merged with Southern Union on September 28 and September 20, 2000, respectively. The new GCR filing of June 3, 2002 represents the first such filing by NEGas following the merger.

In support of its filing, NEGas submitted the pre-filed testimonies of Peter Czekanski and Gary Beland. Mr. Czekanski is the Director of Pricing for NEGas. Mr. Czekanski explained that NEGas' proposed GCR charge is consistent with the Settlement Agreement approved in Docket No. 3401 and differs from the former ProvGas' GCC and Valley's PGPA charges. He noted that the proposed GCR introduces different gas cost factors for each rate class and that the GCR contains all gas-related costs including those formerly included in base rates. He noted that the GCR factors are calculated based upon estimated costs for the 16-month period July 1, 2002 through October 31, 2003 and were based on the NYMEX strip as of May 24, 2002. In addition, he pointed out that the $35 million gas costs undercollection by of April 2001 had declined to an estimated $2.7 million undercollection at the end of June 2002. Also, Mr. Czekanski stated that the GCR charges are composed of four components: supply fixed costs, storage fixed costs, supply variable costs and storage variable costs.[2] In addition, Mr. Czekanski updated the gas marketer charges for transportation service in conformance with the Settlement Agreement in approved Docket No. 3401.[3]

Mr. Beland is the Director of Gas Supply for NEGas. Mr. Beland stated that as a result of the merger there are potential dispatch savings of $1.8 million to $2.5 million from 2003 to 2005. He noted that NEGas is prepared to fully manage its own gas supply during the brief period from July to September 2002 following the expiration of the ProvGas' asset management agreement with Duke Energy. Also, he stated that NEGas is in the process of evaluating the features it would incorporate in a Request for Proposal

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[2] NEGas Ex. 02-1 (Czekanski's 6/3/02 testimony), pp. 4-9.
[3] Id., pp. 9-17.

for a new asset management contract.[4] Mr. Beland emphasized the need to continue with small hedges and the dollar cost averaging approach.[5]

II. JUNE 21, 2002 HEARING

After duly published public notice, the Commission conducted a public hearing on June 21, 2002 at its offices at 89 Jefferson Boulevard in Warwick, Rhode Island. The following appearances were entered:

FOR NEGAS:	Craig Eaton, Esq.
FOR DIVISION:	Paul Roberti, Esq. Assistant Attorney General
FOR COMMISSION:	Steven Frias, Esq. Executive Counsel

At the June 21, 2002 hearing, counsel for NEGas asked for adoption, on an interim basis, of the proposed GCR factors for effect July 1, 2002. Counsel for the Division of Public Utilities and Carriers ("Division") concurred with NEGas' request, in part, because it constitutes a slight rate decrease.[6] Mr. Bruce Oliver, a consultant, testified on behalf of the Division. He expressed a concern that NEGas has deviated from the non-discretionary requirements of the current gas purchasing program, and suggested the possibility of assessing penalties on NEGas for non-compliance with the current gas purchasing program. He also discussed the need to set a new benchmark for the current gas purchasing plan.[7] Mr. Oliver advocated the adoption of a benchmark based on the NYMEX prices by month from July 2002 through June 2003 as listed in the Wall Street Journal of June 21, 2002.

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[4] NEGas Ex. 02-2 (Beland's 6/3/02 testimony), pp. 2-7.
[5] Id., pp. 7-10.
[6] Tr. 6/21/02, pp. 8-10.
[7] Id., pp. 16-17, 32-34.

Mr. Beland testified on behalf of NEGas. He stated that NEGas deviations from the non-discretionary requirements of the current gas purchasing program were either unintentional or due to operational concerns. Mr. Beland also stated that he concurred with Mr. Oliver's benchmark proposal.[8] At the close of the hearing, the Commission rendered a unanimous bench decision approving the adoption of NEGas' proposed GCR factors on an interim basis for effect July 1, 2002. The Commission also approved the gas marketer transportation factors for effect September 1, 2002 as final rates. Finally, the Commission approved the adoption of the new benchmark as proposed by Mr. Oliver. Chairman Germani indicated an interest in the development of a gas procurement plan that would include rewards and penalties.[9]

III. DIVISION'S TESTIMONY OF JULY 26, 2002

On July 26, 2002, the Division submitted the pre-filed testimony of Mr. Oliver. Mr. Oliver stated that with minor exceptions, NEGas has complied with the Gas Purchasing Program that had been in effect since March 2001.[10] In regards to NEGas' discretionary gas purchases, Mr. Oliver stated that the Gas Purchasing Program may need further development or refinement because NEGas "has not taken advantage of opportunities for comparatively low cost purchases of gas as the Division had hoped when the plan was adopted." Mr. Oliver emphasized that "uniform discretionary purchases over a series of months have tended to mimic the dollar cost averaging strategy being pursued through monthly non-discretionary purchases." In particular, Mr. Oliver noted that for the period July 2002 through June 2003, "NEGas' discretionary purchases

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[8] Id., pp. 41, 55-56.
[9] Id., pp. 64-66.
[10] Div. Ex. 02-3 (Oliver's 7/26/02 testimony), pp. 5-6.

were, on average, slightly *more* costly than the non-discretionary purchases it has made for the same months"(emphasis added).[11]

Mr. Oliver attributed the following factors to the "mixed results" of the current Gas Purchasing Program: changes in gas market conditions, establishment of too broad a bandwidth around the benchmark prices, and "insufficient incentive for the Company to deviate from a simple dollar cost averaging strategy." Accordingly, Mr. Oliver recommended changing the benchmark structure and/or the bandwidth or "*create an incentive structure that evaluates the Company's discretionary purchases of gas for a given gas supply month based on the average cost of the Company's non-discretionary gas purchases for the same month*."[12] Mr. Oliver noted that the current plan demonstrates that dollar cost averaging is an acceptable and low risk approach for NEGas to apply to gas procurement. As a result, however, NEGas has demonstrated that it will not depart from the dollar cost averaging strategy and utilize purchasing discretion because there is "added risk for which no additional compensation is offered." Mr. Oliver expressed particular interest in developing a plan that would permit NEGas "*to retain a portion of savings achieved through discretionary purchases that are made at a lower average price than its non-discretionary purchases for the same gas supply period.*"[13]

IV. PROPOSED GAS PROCUREMENT AND ASSEST MANAGEMENT INCENTIVE PLAN

On October 8, 2002, NEGas filed a proposed Gas Procurement and Asset Management Incentive Plan ("Proposed Incentive Plan"). NEGas indicated that the

[11] Id., pp. 7-9.
[12] Id., pp. 10-12. (emphasis added).
[13] Id. pp. 13-16. (emphasis added).

Division supported the Proposed Incentive Plan. The Proposed Incentive Plan has two components: a Gas Procurement Incentive Program and an Asset Management Incentive Program. The Gas Procurement Incentive will apply to discretionary purchases of gas supply starting on or after January 2003 and the Asset Management Incentive will apply to fixed gas supply expenditures for the 12 months ending June 30 of each year. For each fiscal year, NEGas' maximum Gas Procurement incentive will be $600,000 and the maximum Gas Procurement penalty will be $250,000. For each fiscal year, NEGas' maximum incentive under the Asset Management Incentive Program will be $400,000.[14]

Under the Gas Procurement Incentive Program, NEGas will make two types of gas purchases: non-discretionary purchases and discretionary purchases. Non-discretionary purchases are mandatory monthly purchases of gas volumes made in uniform monthly increments that will equal 50 percent of the forecasted gas supply requirements for a normal weather month. NEGas will make these uniform non-discretionary monthly purchases starting 18 months prior to the delivery month but ending 2 months prior to the start of the delivery month. Also, NEGas' first purchases made each month will be deemed to constitute a non-discretionary purchase up to the amount of NEGas' uniform monthly purchase requirement. Discretionary purchases are either forecasted discretionary purchases or other discretionary purchases. Forecasted discretionary purchases are either physical volumes of gas purchased for delivery to the system in a given supply month or storage volumes purchased in excess of uniform non-discretionary purchase requirements for a given supply month. Forecasted discretionary purchases cannot exceed 45 percent of forecasted normal weather gas supply

[14] Joint Ex. 02-1, pp. 1-2. The Proposed Incentive Plan is attached as Appendix A hereto and is incorporated by reference herein.

requirements in a given gas supply month. Other discretionary purchases are gas volumes purchased less than 6 business days prior to the delivery month, including LNG and LPG purchases.[15]

Also, with the exception of LPG, LNG and purchases made less than 6 business days prior to the first day of the delivery month, any purchases made in excess of the uniform monthly non-discretionary purchase requirement for the month will be deemed forecasted discretionary purchases. In addition, the timing of discretionary purchases will be left solely to the discretion of NEGas with the condition that, by October 20th of each year, 70 percent of NEGas' total gas supply requirements for a normal winter will have been acquired at fixed or capped prices.[16]

Under the Proposed Incentive Plan, the Gas Procurement Incentive will be determined on the basis of comparisons of the volume-weighted average cost of forecasted discretionary purchases (in dollars per dekatherm) for the specified gas supply month to two benchmarks. One benchmark is the volume of weighted average cost of non-discretionary gas purchases for the same gas supply month. The other benchmark is the NYMEX price for the gas supply month at the close of trading for the 19th month *prior* to the start of the specified gas supply month.[17]

After all purchases for a given supply month are completed, the volume-weighted average cost of forecasted discretionary purchases for the month will be computed and compared to each of the benchmarks. If the weighted average cost of the forecasted discretionary purchases for the month is less than that of the non-discretionary purchases for the month, NEGas will earn a positive incentive equal to 10 percent of the difference

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[15] Id., pp. 2-3.
[16] Id.
[17] Id., p. 3.

(in dollars per dekatherm) between the weighted average cost of the forecasted discretionary purchases and the weighted average cost of non-discretionary purchases for the month, multiplied by the actual volume of forecasted discretionary purchases for the month. Also, if the weighted average cost of forecasted discretionary purchases is less than the NYMEX price for the gas supply month at the close of trading for the 19th month prior to the start of the specified gas supply month, NEGas will earn a positive incentive equal to 10 percent of the difference (in dollars per dekatherm) between the weighted average cost of the forecasted discretionary purchases for the month and the referenced NYMEX closing price, multiplied by the actual volume of forecasted discretionary purchases for the month. Furthermore, NEGas will earn both incentives if both benchmarks are met for the month.[18]

If neither of the benchmarks is met for a specified gas supply month, NEGas will be assessed a penalty (negative incentive) equal to 10 percent of the actual volume of forecasted discretionary purchases for the month multiplied by the difference (in dollars per dekatherm) between the weighted average cost of forecasted discretionary purchases for the month and the higher of: the weighted average cost of non-discretionary purchases for the same gas supply month or the NYMEX price for the gas supply month at the close of trading for the 19th month prior to the start of the specified gas supply month. Furthermore, if the weighted average cost of forecasted discretionary purchases is more than $0.50 below the lower of the two benchmarks, then NEGas will receive an additional Meritorious Performance Bonus equal to 10 percent of the difference (in dollars per dekatherm) between the weighed average cost of forecasted discretionary

[18] Id., pp., 3-4.

purchases for the month and the lower of the two benchmarks, multiplied by the actual volume of forecasted discretionary purchases for the month.[19]

As for the Asset Management Incentive, NEGas will earn a dollar incentive based on reductions achieved in fixed gas supply and fixed storage costs from the amounts projected, as accepted by the Commission, for each gas supply year. The net effect of fixed costs recovered from marketers under the capacity assignment feature will not be counted in the calculation of the incentive. The calculation will include all fixed costs associated with gas supply, asset management fees or credits, capacity release credits and off-system sales margins. To discourage achievement of fixed cost savings through the manipulation of gas commodity purchases, the amount of the Asset Management Incentive shall be dependent upon NEGas' success in its gas procurement activities. If NEGas' actual gas procurement costs for the gas supply year are below its projected gas procurement costs on a dollars per dekatherm basis, then NEGas shall be provided an Asset Management incentive equal to 20 percent of the amount by which the sum of NEGas' actual fixed gas supply costs and fixed storage costs are below the projected fixed gas supply and storage costs, accepted by the Commission, for the gas supply year. If NEGas' actual gas procurement costs for the gas supply year are above its projected gas procurement costs on a dollars per dekatherm basis, then NEGas will be provided an Asset Management incentive equal to 10 percent of the amount by which the sum of NEGas' actual fixed gas supply costs and fixed storage costs are below the projected fixed gas supply and fixed storage costs accepted by the Commission for the gas supply

[19] Id., p. 4.

year.[20] Lastly, the monetary results of the Gas Procurement and Asset Management Incentive Plan will not be included in NEGas' earning calculations.[21]

V. NOVEMBER 7, 2002 HEARING

On November 7, 2002, a public hearing was conducted by the Commission on the Proposed Incentive Plan. NEGas presented Mr. Beland and the Division presented Mr. Oliver to testify regarding the Proposed Incentive Plan. Mr. Oliver explained that NEGas needs an incentive plan for gas procurement in order to depart from the dollar cost averaging technique for discretionary purchases. Without an incentive, Mr. Oliver stated that NEGas will take a very "risk-adverse" approach to gas procurement. However, Mr. Oliver noted that NEGas' "risk-adverse" approach is not a strategy that produces the best results for ratepayers.[22]

Mr. Oliver discussed various aspects of the Proposed Incentive Plan. Mr. Oliver stated that the 19 month NYMEX (fixed) benchmark is "established before" NEGas "starts purchasing for any given future month," that NEGas "can purchase below that level," and that NEGas will "have an incentive."[23] He explained that the non-discretionary benchmark is a dynamic benchmark that reflects the dollar cost averaging approach. Mr. Oliver admitted that "when you have these two benchmarks, and frankly, they're designed such that the likelihood that the company is ever going to incur a penalty in this from my perspective is fairly small."[24]

Under cross-examination, Mr. Beland agreed that if the Commission mandated NEGas to purchase 60 percent of its discretionary purchases when gas reached a certain

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[20] Id., pp. 4-5.
[21] Cover letter of Proposed Incentive Plan.
[22] Tr. 11/7/02, pp. 25-26, 29-30.
[23] Id., pp. 41-42.
[24] Id., p. 43.

low price, NEGas would purchase the gas. He indicated that he has "seen exactly the type" of "process used elsewhere." Both Mr. Beland and Mr. Oliver agreed that such a Commission mandate would not be difficult to execute.[25] Mr. Oliver admitted that a Commission directive to NEGas to purchase gas at a low price is "doable" but expressed concern as to how a Commission directive would interact with the incentive program. Regarding a Commission mandate for NEGas to purchase gas when it reaches a certain low price, Mr. Oliver stated, "certainly if that's what the Commission desires…I think you can work in that kind of lower benchmark for mandated additional purchases. I just would hope that we'd have the opportunity not to destroy the other incentives that we built into this".[26]

Mr. Oliver testified that the reward and penalty amounts in the Proposed Incentive Plan are asymmetrical because an equal amount of incentives and penalties would cause NEGas to be risk-adverse. Mr. Oliver stated that the penalty is large enough to cause NEGas to change its gas purchasing behavior.[27] Mr. Oliver stated it would be difficult for NEGas to manipulate the non-discretionary benchmark. Mr. Oliver admitted that the Proposed Incentive Plan is also asymmetrical in that NEGas will receive a reward if it beats either of the benchmarks, but would only incur a penalty if it failed both benchmarks. Also, Mr. Oliver acknowledged that gas procurement incentive plans vary from state to state, and that some plans have symmetrical reward/penalty attributes.[28] Mr. Oliver stated that the Proposed Incentive Plan should be adopted as soon as possible. He also indicated that the reward and penalty level in the proposal would be in place at least

[25] Id., pp. 53, 61-62.
[26] Id., pp. 70, 94.
[27] Id., pp. 99-101.
[28] Id., pp. 144-147, 150-151, 159-160.

through June 30, 2004, at which time it could be revisited. In addition, he stated that the Proposed Incentive Plan is not required to remain in effect through June 30, 2004.[29]

Mr. Oliver expressed concern that a Commission mandate for NEGas to make non-discretionary gas purchases at certain prices would detrimentally affect the non-discretionary benchmark and could cause NEGas to incur a penalty if NEGas did not purchase all its discretionary gas purchases at the same time. However, Mr. Oliver reiterated that a Commission mandate to purchase gas at certain prices could be included in the program.[30] In response to a question as to whether the proposed reward amount of $600,000 and the proposed penalty amount of $250,000 could be increased, Mr. Oliver stated, "I don't think those are hard and fast numbers. I think there's room for discretion there" because NEGas and the Division "went back forth."[31] At the conclusion of the hearing, counsel for NEGas made an oral motion for the Commission to approve the interim GCR factors as final rates. There was no objection from the Division. NEGas was directed to file a written motion.[32]

On November 12, 2002, NEGas filed a motion requesting that the Commission approve the interim GCR factors as final rates, effective through October 31, 2003. At an open meeting on December 4, 2002, the Commission approved the motion.

VI. POST-HEARING DEVELOPMENTS REGARDING PROPOSED INCENTIVE PLAN

After the conclusion of the November 7, 2002 hearing, the Commission staff issued data requests to NEGas and the Division regarding the Proposed Incentive Plan.

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[29] Id., pp. 163, 172-173.
[30] Id., pp. 180-181, 183-184, 187.
[31] Id., pp. 199-200.
[32] Id., pp. 222-223.

On December 2 and 3, 2002, NEGas and the Division, respectively, filed responses indicating that the Proposed Incentive Plan could be modified to incorporate a Commission-mandated requirement that NEGas purchase a specified amount of gas when gas reaches a certain price.[33] Neither party offered a recommendation as to the appropriate "trigger" price or the appropriate amount of gas that the Commission should mandate NEGas to purchase.[34] After the issuance of further data requests from the Commission staff regarding potential modifications to the Proposed Incentive Plan, on January 3, 2003, NEGas filed a letter with the Commission indicating that NEG was withdrawing its proposal and requesting that an informal process be established with the Commission to address the development of the incentive mechanism for gas procurement. On January 8, 2003, the Division stated that it wanted to participate in the informal process to have the Proposed Incentive Plan be structured to accommodate the Commission's policy objectives.[35]

The Commission staff engaged in an informal discussion with the parties regarding the Proposed Incentive Plan on January 21, 2003. A follow-up meeting was not scheduled. Specifically noting that NEGas never received express permission from the Commission to withdraw the Proposed Incentive Plan pursuant to Rule 1.11(c) of the Commission's Rules of Practice and Procedure ("Commission Rules"), the Commission staff issued additional data requests regarding potential modifications to the Proposed Incentive Plan on February 24, 2003. On March 10 and 13, 2003, NEGas and the Division, respectively, filed responses indicating their opposition to: eliminating the 19

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[33] A Commission mandate that NEGas purchase gas at a certain price and in a certain volume was referred to at times during the proceeding as "an overriding benchmark."
[34] PUC Ex. 02-1 (Data Responses dated 12/02/02 and 12/03/02).
[35] Correspondence of NEGas on 1/3/03 and of the Division on 1/8/03.

month NYMEX benchmark, increasing the rewards and penalty limits, and the Commission giving express permission to NEGas to purchase a certain volume of gas at a certain price. Specifically, the Division indicated that eliminating the 19th month NYMEX benchmark "will result in a less effective gas procurement program." The Division also stated that increasing the reward and penalty limits "would not necessarily be a benefit to ratepayers." In addition, the Division stated that the purchasing parameters proposed by the Commission raised questions as to how the incentives will be calculated and how these parameters will be monitored.[36]

VII. NEGAS' FEBRUARY 14, 2003 GCR FILING

On February 14, 2003, NEGas filed a proposal to increase the GCR factors for effect with March 1, 2003 billing cycles. The proposed GCR factors on a per therm basis were as follows: $0.7169 for residential and small C&I customers, $0.7034 for medium C&I customers, $0.7117 for large low-load factor C&I customers, $0.6639 for large high-load factor customers, $0.6993 for extra large low load factor customers and $0.6265 for extra large high load factor customers.[37] If approved, these proposed GCR factors would cause the bill of a typical residential heating customer over an eight month period to increase by approximately eight percent, or $47.

In support of this filing, NEGas submitted pre-filed testimonies by Mr. Czekanski and Mr. Beland. In his pre-filed testimony, Mr. Czekanski stated that NEGas projects that there will be an undercollection of approximately $11 million in the deferred gas cost account by the end of October 2003, which will be equivalent to approximately 4 percent

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[36] PUC Ex. 02-1 (Data Responses dated 3/10/03 and 3/13/03).

[37] Revisions to the GCR factors were filed by NEGas on March 20, 2003, on a per therm basis, as follows: $0.7119 for residential and small C&I customers, $0.6988 for medium C&I customers, $0.7068 for large low-load factor C&I customers, $0.6603 for large high-load factor customers, $0.6948 for extra large low load factor customers and $0.6238 for extra large high load factor customers. (NEGas Ex. 02-7).

of NEGas' annual gas revenues. He discussed the GCR's components: supply and storage fixed costs, as well as supply and storage variable costs. Also, he noted that the BTU conversion factor will be 1.026 Dekatherms for the period May 2003 through October 2003.[38]

In his pre-filed testimony, Mr. Beland explained that future gas prices as of February 6, 2003 had increased substantially from the NYMEX future prices underlying he gas cost estimates in the June 3, 2002 GCR filing. He noted that actual prices in January and February 2003 are $0.84 and $1.56 per Dth higher than the NYMEX strip used in the June filing. Also, NYMEX future prices for March through October 2003 are an average of $1.39 per Dth higher than the NYMEX strip used in June filing.[39]

Mr. Beland explained that the increase in gas prices are the result of extremely hot summer weather that raised the demand for gas for electric generation, two hurricanes, a significant increase in oil prices due to the crisis in Iraq and the strike in Venezuela, and severely colder than normal weather this winter. Mr. Beland argued that the impact of the higher gas prices has been limited because 75 percent of the gas supply for NEGas' normal forecasted send-out was purchased at fixed prices. However, due to colder than normal winter weather, NEGas had to secure 35 percent of January's requirements at monthly or daily market prices. Lastly, Mr. Beland recommended that the benchmark for the current Gas Purchasing Program be updated to be the NYMEX closing strip for February 6, 2003.[40]

On February 26, 2003, the Division and the Attorney General filed an objection to NEGas' proposed GCR rates going into effect for consumption prior to March 16, 2003,

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[38] NEGas Ex. 02-5 (Czekanski's 2/14/03 testimony), pp. 3-7.
[39] NEGas Ex. 02-6 (Beland's 2/14/03 testimony), pp. 2-3.
[40] Id., pp. 4-6.

or thirty days after NEGas' February 14, 2003 GCR filing. The Division stated that pursuant to R.I.G.L. Section 39-3-11, NEGas cannot make any change in rates without at least thirty days prior notice. Also, the Division argued that the effective date of rate change must be applied prospectively to consumption on or after the effective date of the rate change. At an open on February 27, 2003, the Commission voted to suspend NEGas' proposed GCR factors filed on February 14, 2003 for effect March 1, 2003 and that, as stated by the Division, there could be no increase in GCR rates for consumption prior to March 16, 2003.

VIII. DIVISION'S TESTIMONY OF MARCH 19, 2003

On March 19, 2003, the Division submitted pre-filed testimony by it consultant, Bruce Oliver. Mr. Oliver stated that the increase in the deferred gas cost balance has been caused by colder than normal weather, sharp increases in gas costs, and significant migration of throughput volumes from transportation service to firm sales service.[41] Mr. Oliver indicated that, according to Mr. Beland, the current winter heating season has been 15 percent colder than normal. Mr. Oliver noted there was a 12.3 percent increase in NEGas' firm gas sales volumes for the period July 2002 through January 2003. Also, he pointed out that this 12.3 percent increase is comprised of a 9.1 percent increase in sales to residential and small commercial customers, and a 26.2 percent increase in firm sales to other C&I rate classes. Mr. Oliver stated that the significant increase in customer migration from transportation to firm sales service caused programmed purchases of gas under the current Gas Purchasing Program to under-achieve the percentage of normal weather supply requirements in the plan so that to supply even normal weather requirements required the use of storage gas, LNG and daily purchases. Also, the

[41] Division Ex. 02-4 (Oliver's 3/19/03 direct testimony), p. 3.

increase in customer migration to firm sales service, coupled with colder than normal winter weather, undermined NEGas efforts to optimize its gas supply portfolio to serve its forecasted supply requirements for firm sales customers. In addition, Mr. Oliver noted that the supply variable costs were 20.6 percent above NEGas' June 2002 forecast, while NEGas' supply fixed costs were nearly $1 million below forecasted levels, and storage fixed costs were roughly in line with earlier projections.[42]

Mr. Oliver explained that the GCR factors are differentiated by class and the Division presumed that NEGas would reconcile actual gas costs and gas cost recoveries separately for each of six rate classes established under the Settlement approved in Docket 3401. Mr. Oliver noted that prior to July 1, 2002, GCR factors were not differentiated by rate class, but now NEGas does differentiate its GCR factors by rate class so reconciliation of gas costs and gas cost recoveries by rate class may be an appropriate, if not necessary, requirement.[43]

In conclusion, Mr. Oliver recommended that the GCR factors as computed in NEGas' corrected exhibits should be implemented. Also, he recommended that NEGas should be required to perform a class-specific reconciliations of the deferred gas cost balances for the entire July 2002 through October 2003 period in its next GCR filing. He transfer of customers between firm sales and transportation service without reasonable advance notice; and establishing a separate gas cost rate for transportation customers who transfer to firm sales service either for short periods of time or without advance notice or just prior to the winter heating season. Lastly, Mr. Oliver stated that the proposed increase in GCR charges will prevent further growth of NEGas' deferred gas cost balance. He also noted that attempting to recover the entire deferred gas cost balance over the remainder of the current GCR period would result in a rate shock.[44]

IX. MARCH 25, 2003 HEARING

After duly published public notice, the Commission conducted a public hearing on March 25, 2003 at its offices at 89 Jefferson Boulevard in Warwick, Rhode Island. The following appearances were entered:

FOR NEGAS:	Craig Eaton, Esq.
FOR DIVISION:	Paul Roberti, Esq. Assistant Attorney General
FOR GEORGE WILEY CENTER:[45]	Hugo Ricci, Esq.
FOR COMMISSION:	Steve Frias, Esq. Executive Counsel

At the hearing, NEGas presented Mr. Czekanski and Mr. Beland as witnesses. Mr. Czekanski stated that the deferred gas cost balance as of April 1, 2003 will be $17.6 million and that, absent any change in rates, it would increase to $25.7 million by November 1, 2003. If the proposed GCR factors are implemented then the deferred gas cost balance would be approximately $18 million as of October 31, 2003.[46] Mr. Czekanski estimated that NEGas' annual gas costs are $170 million, and if the $18

[44] Id., pp. 11-14.
[45] The George Wiley Center filed a motion to intervene. No objection was made.
[46] Tr. 3/25/03, p. 27.

million undercollection were collected over a year starting on November 1, 2003, it would increase ratepayers' bills an additional 5 percent. However, he noted that this increase could be offset by a potential $3.8 million weather normalization revenue reduction starting November 1, 2003.[47]

Mr. Beland admitted that the migration of transportation customers to firm sales service required NEGas to purchase additional gas supplies that were expensive this winter. Mr. Beland admitted that NEGas did not exercise its discretion under the tariff to charge a higher incremental cost of gas for transportation customers who migrated to firm sales in the middle of winter.[48] Mr. Czekanski stated it would be possible to offer NEGas ratepayers a fixed price option. Mr. Beland admitted that gas prices since May 2000 have commonly been above $4 for a winter month and $3 for a non-winter month. Mr. Beland expressed concern over further increasing the hedging percentage above 70 percent, as currently required, because in a warm winter NEGas would likely have to sell the excess gas at a loss. Also, Mr. Beland admitted that, because NEGas had incorrectly forecasted (overestimated) the number of transportation customers that were projected to migrate from firm sales to transportation service, NEGas had also underestimated its forecasted supply needs for its firm sales customers. He also noted that November is the most common month when this migration to transportation would occur.[49]

Mr. Oliver testified on behalf of the Division. Mr. Oliver stated that the migration of transportation customers to firm sales required NEGas to purchase additional gas supplies at higher prices. He discussed various approaches to dealing with the issues including having a different type of a gas procurement plan for customers who are not

[47] Id., pp. 36-37, 46-47, 94.
[48] Id., p. 99-100, 105-106.
[49] Id., pp. 112, 116-118, 136-137, 159-161.

residential or small commercial and industrial. [50] Also, Mr. Oliver noted that gas procurement incentive plans vary regarding rewards and penalties. He indicated that the monetary limits on incentives can be based on the amount of non-mandatory gas purchases made by the company. In regards to the penalty limit, Mr. Oliver said it is important that "the company and its management are comfortable" with "large penalties".[51] Mr. Oliver was not adverse to increasing the reward limit. However, he also stated that, at a later date, there can be adjustments to the reward and penalty limits.[52] He acknowledged that the current Gas Purchasing Program has one benchmark and that the proposed two benchmark proposal is "somewhat unique". Also, he disagreed with the view that a gas procurement plan with one benchmark could not be effective. He acknowledged that gas prices since May 2000 have for the most part been above $3.50 for a winter month and $3.00 for a non-winter month.[53]

COMMISSION FINDINGS

I. THE JULY 1, 2002 GCR DECREASE

The Commission was pleased with the decrease in the GCR factors filed on June 3, 2002. These proposed GCR factors lowered the ProvGas average residential heating customer's bill to $1,116 annually. The combination of falling wholesale gas prices, extensive hedging under the Gas Purchasing Program, and merger savings passed on to ratepayers in Docket No. 3401 had lowered a typical annual residential heating customer's bill to below the level that existed on October 1, 2000.[54] Accordingly, on June

[50] Id., pp. 173-179, 183.
[51] Id., pp. 186-189.
[52] Id., pp. 190-194.
[53] Id., pp. 201-202.
[54] From October 1, 1997 to September 30, 2000, a typical residential heating customer of the former ProvGas paid $983 annually. On October 1, 2000, this amount was increased to $1,125 annually.

21, 2002 the Commission approved these GCR factors for effect July 1, 2002 through October 31, 2003.[55]

II. THE APRIL 1, 2003 GCR INCREASE

The Commission was disappointed with NEGas' GCR filing of February 14, 2003. A GCR factor increase is always unfortunate, but in addition, NEGas sought the increase to go into effect for billings on and after March 1, 2003. NEGas' proposal was not in conformance with the 30-day notice requirement of R.I.G.L. Section 39-3-11 and NEGas did not seek relief from the Commission from this statutory requirement. Consequently, the Commission suspended the effective date of NEGas' proposed GCR factors beyond March 1, 2003.[56] In addition, the Commission will henceforth interpret R.I.G.L. Section 39-3-11 to require that a rate increase will be applied prospectively to consumption on or after the effective date of the rate increase so as to comply with the 30-day notice requirement, unless good cause is shown pursuant to R.I.G.L. Section 39-3-12 or an emergency under R.I.G.L. Section 39-1-32 is demonstrated.

After addressing this procedural issue, the Commission determined that NEGas' proposed increase in the GCR factors filed on February 14, 2003, as corrected on March 20, 2003, was appropriate and ordered that they go into effect for consumption on and after April 1, 2003 through October 31, 2003. The Commission recognizes the

[55] These GCR factors constituted a 3 percent decrease for typical residential customers of the former ProvGas. In keeping with the Commission's general practice, the Commission exercised its discretion under R.I.G.L. Section 39-3-12 and, for good cause shown, approved this rate *reduction* on less than the 30-day notice requirement of R.I.G.L. Section 39-3-11 in Order No. 16909 (issued 2/5/02) p. 4, fn. 10.

[56] In general, since September 1, 2000, the Commission has not put rate *increases*, specifically GCR factors, into effect on less than 30 days notice. The one clear exception was the GCC and PGPA factors filed on November 29, 2000 and approved for effect on December 15, 2000. In that instance, ProvGas and Valley had provided 30 days notice but the Commission put the rate increase into effect earlier in order to begin reducing an approximately $40 million undercollection. A dire financial situation was emerging. Order No. 16745 (issued 10/17/01), p. 33, and fn. 153. In this instance, NEGas has only an $11 million undercollection.

importance of limiting the growth of an undercollection.[57] However, unlike the fall and winter of 2000, current short-term interest rates are at historical lows. Southern Union's short-term debt rates and the tariffed interest rate for deferred gas costs are in the low two percent range, which is far below the short-term rates in the winter of 2000-2001. Also, in its February 14, 2003 filing, NEGas indicated it had only an $11 million undercollection, which is far below the $40 million undercollection that necessitated the dramatic increase in GCC and PGPA factors for the winter of 2000-2001. An undercollection of $11 million is not an unreasonable deferred gas cost balance for NEGas to maintain. A prior NEGas witness testified in a January 23, 2001 hearing that prior to the merger, ProvGas had carried a short-term debt balance of $11 million since September 1999 and the Valley had carried a short-term debt balance in excess of $3 million since January 1999.[58] Certainly, Southern Union, with its presumed superior access to capital markets, should be able to maintain as large an undercollection as the combined undercollection maintained by the ProvGas and Valley prior to the merger. Furthermore, NEGas' original proposal to recoup the entire $11 million undercollection by October 31, 2003 is unfair. It would have caused non-heating customers to pay more in their gas bills because of an undercollection attributable to heating customers during the winter heating season. The Commission will not approve such an inequitable impact on ratepayers.

At the hearing on March 25, 2003, NEGas testified that without approval of the proposed increase in the GCR factors, the undercollection would grow to $25.7 million by October 31, 2003. Also, NEGas stated that if the proposed GCR increase was

[57] Id., p. 63.
[58] Id., p. 45.

approved, then the undercollection would be $18 million by October 31, 2003, which is very close to the $17.6 million undercollection projected at April 1, 2003. The Commission has approved the proposed increase in the GCR factors in order to limit the growth of the undercollection. The result is a relatively small increase in the bills of the typical residential heating customer, totaling approximately $30 over the 7-month period of April 1 through October 31, 2003. This amount is not significant enough to cause rate shock. Moreover, on an annualized basis, from November 1, 2003 through October 31, 2004, the result for a typical residential heating customer would be an annual bill increase from $1116 to $1206. The latter amount is almost five percent below $1264, which was the amount of an annual bill for a typical residential heating customer after the dramatic GCC rate increase of December 15, 2000. The Commission is very leery of further increasing rates because of the possibility of rate shock.

To avoid this problem in the future, the Commission reviewed the evidence to determine the origin of the recent GCR factors increase and deferred gas cost undercollection. The Commission determined that this increase and undercollection were the result of a number of factors: (1) higher wholesale gas prices caused by a colder than normal winter and a foreign policy crisis in Iraq; (2) the migration of transportation customers to firm sales service; and (3) the failure of NEGas to depart from utilizing the dollar cost averaging approach for its discretionary gas purchases so as to take advantage of lower gas prices. The first factor is beyond this Commission's scope of authority, but the other two factors are certainly within this Commission's jurisdiction. These two last issues will be discussed in detail.

III. MIGRATION TO FIRM SALES

In a prior order, the Commission addressed the problem of commercial and industrial gas customers migrating from firm sales service to transportation service without paying their appropriate share of an undercollection.[59] In this proceeding, the Commission must address the problem of firm sales gas costs increasing and resulting in an undercollection due to the migration of transportation customers to firm sales service. Also, the Commission may need to address NEGas' failure to properly forecast migration between firm sales and transportation service and the appropriateness of its reaction when customers failed to migrate from firm sales to transportation service as NEGas had forecasted. The Division raised the issue that the migration of transportation customers to below-market-priced firm sales service required NEGas to purchase additional gas at higher prices. NEGas' incorrect forecast of migration from firm sales to transportation also required NEGas to purchase additional gas at higher prices. Therefore, the Commission directs NEGas to perform and file a class-specific reconciliation of the deferred gas cost balance for the period July 1, 2002 through October 31, 2003 in its next GCR filing. A class-specific reconciliation will help insure that the migrating customer who, in part, caused the increase in gas costs for firm sales service customers, will pay for an appropriate portion of this increase. A class-specific reconciliation may also reduce the percentage of the undercollection directly attributable to the residential and small C&I customer classes, which do not have the option of entering the competitive gas supply market through transportation service.

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[59] Id., pp. 66-67.

Also, the Division suggested various approaches for dealing with the problems of customer migration from transportation to firm sales service. The Commission directs NEGas and the Division to present jointly or separately to the Commission in May 2003 a proposal to address the problem of customer migration from transportation service to firm sales service. If necessary, the Commission will consider excluding potential transportation customers from receiving the gas prices produced by the Gas Purchasing Program. Instead, these customers could receive gas based on the spot market price unless they waive the option of migrating to transportation service and commit to stay on firm sales service for a specific long-term period. Furthermore, the Commission may investigate the reasonableness of NEGas' charging migrating transportation customers below-market-priced rates for firm sales service. Also, the Commission may review NEGas' failure to properly forecast the migration of customers from firm sales to transportation service and the appropriateness of its reaction when its forecast proved to be inaccurate.

IV. GAS PROCUREMENT AND ASSET MANAGEMENT INCENTIVE PLAN

A. BACKGROUND

For the typical NEGas residential heating customer, wholesale gas costs constitute slightly more than half a customer's annual bill. This Commission has noted that NEGas has little incentive to minimize wholesale gas costs because these costs are simply passed-through to ratepayers via the GCR charge.[60] NEGas' gas purchases are subject to a prudence review, but such a review is inherently litigious and occurs by necessity only after the harm has been caused. Therefore, the Commission and the Division have indicated the need to mitigate gas cost increases by aligning the interests of shareholders

[60] Id., pp. 73, 79.

and ratepayers.[61] As a result, the Commission has determined there is a need to alter or replace the existing Gas Purchasing Program with a gas procurement plan that includes rewards and penalties.

In addition, the Commission has noted flaws in the existing Gas Purchasing Program. Specifically, the Commission has previously indicated that the existing Gas Purchasing Program placed more emphasis on the objective of price stability than the objective of affordability (low cost gas). The Commission stated that the "ideal gas procurement approach balances the objective of price stability with the objective of affordability".[62] Consequently, the Commission has determined there is a need to alter or replace the existing Gas Purchasing Program with a gas procurement plan that properly balances the objectives of price stability and affordability.

In these proceedings, the Commission's focus in reviewing a proposed gas procurement plan is to determine whether the proposed plan: (1) includes enough rewards and penalties to align the interests of ratepayers and shareholders; and (2) properly balances the objectives of price stability and affordability for customers. On October 8, 2002, NEGas filed a Proposed Incentive Plan in an attempt to address these two primary policy objectives of the Commission. Through hearings and discovery, the Commission determined there was a need to make modifications to this proposal in order to accomplish these two objectives and therefore serve the public interest as well as the best interest of the ratepayers.

[61] Id., pp. 8, 16, 84.
[62] Id., pp. 69-72.

B. BALANCING STABILITY AND AFFORABILITY

The Proposed Incentive Plan allows for a proper balance between the objective of price stability and the objective of affordability. The objective of price stability is achieved by requiring 50 percent of a month's gas supply under normal weather conditions to be purchased in uniform monthly increments starting 18 months prior to delivery and ending 2 months prior to the start of deliveries. These purchases are referred to in the Proposed Incentive Plan as non-discretionary purchases and will give ratepayers price stability because the price of these purchases will be dollar-cost averaged. The objective of affordability can be achieved by allowing up to 45 percent of a month's gas supply under normal weather conditions to be purchased at a time, amount and price of NEGas' choosing. These purchases are referred to in the Proposed Incentive Plan as discretionary purchases and, if appropriately handled by NEGas, will produce lower gas prices for ratepayers.

C. NON-DISCRETIONARY BENCHMARK

The Proposed Incentive Plan attempts to incent NEGas to utilize its discretionary purchases in a manner that will lower gas prices for ratepayers because Southern Union will be subject to a reward and a penalty on NEGas' discretionary purchases. Southern Union will receive a reward if, for a given month, the volume-weighted cost of NEGas' discretionary purchases is below the volume-weighted average cost of its non-discretionary purchases.[63] In other words, Southern Union will receive a reward if

[63] The Commission is concerned that NEGas could inflate the price of this benchmark. The Division stated that it would be difficult for NEGas to manipulate the benchmark. Paragraph III.A(d) provides some assurance in this area, however, the Commission and, presumably, the Division will closely monitor this benchmark to ensure that NEGas is not attempting to inflate the price of its non-discretionary purchases.

NEGas' discretionary purchases beat the price produced by its dollar cost averaging approach. Under these circumstances, it is reasonable for Southern Union to receive a reward. Under the current Gas Purchasing Program, however, NEGas utilizes the dollar cost averaging strategy for both its non-discretionary and discretionary purchases. This is not appropriate. The purpose of including discretionary purchases in the Proposed Incentive Plan is to allow NEGas to reduce the amount of gas purchased at higher prices while increasing the amount of gas purchased when gas prices are lower.[64] Hopefully, a reward will incent NEGas to exercise its discretion to depart from utilizing dollar cost averaging for discretionary purchases in order to obtain lower priced gas.

Human nature being what it is, however, a carrot alone may not be sufficient; therefore, a stick is needed as well. Unfortunately, under the Proposed Incentive Plan, Southern Union will not incur a penalty if the volume-weighted average cost of NEGas' discretionary purchases for a given supply month is above the volume-weighted average cost of its non-discretionary purchases for the same month. Instead, Southern Union would only incur a penalty if NEGas has also failed an additional benchmark, the NYMEX price for the gas supply month established 19 months *prior* to the start of that gas supply month. Moreover, the Proposed Incentive Plan would allow Southern Union to receive an additional reward if NEGas beats this benchmark. It is at this point the Commission finds it necessary to modify the proposal in several respects, as more fully described below.

D. <u>19-MONTH NYMEX BENCHMARK</u>

The Commission rejects the proposed 19-month NYMEX benchmark. First, if NEGas were to make discretionary purchases below this benchmark, it would not

[64] Div. Ex.02- 3 (Oliver's 7/26/02 testimony), p. 8, fn. 4.

necessarily lead to lower prices for ratepayers. If the 19-month NYMEX benchmark price is below the non-discretionary benchmark price, Southern Union will receive an additional reward for beating the non-discretionary benchmark. It is unnecessary to add an additional reward to incent NEGas to exercise its discretion to purchase gas under those circumstances. However, if the 19-month NYMEX benchmark price is *above* the non-discretionary benchmark price, Southern Union would still receive a reward if NEGas makes a discretionary purchase below the 19-month NYMEX benchmark. This result is not in the best interest of the ratepayers. In essence, Southern Union would receive a reward for gas purchased at a price above NEGas' non-discretionary dollar cost average price. This result does not benefit the ratepayers because lower gas prices for ratepayers are not produced. Indeed, the only benefit produced in these circumstances is an unjustified reward for Southern Union's shareholders.

Second, the 19-month NYMEX benchmark could be too easy for NEGas to beat. For Southern Union to receive a reward, NEGas would have to beat a price that it knew of 19 months ahead of time. Although in the early phase of implementation this will not be the case, in the long-run it would be nearly impossible for NEGas not to beat this benchmark. As a result, under the NEGas' proposal, Southern Union would always receive a reward and never be penalized, even though gas prices for ratepayers would not necessarily be lower, because NEGas would not be required to beat the non-discretionary dollar cost averaging benchmark. Moreover, under NEGas' proposal, NEGas must only beat one benchmark to receive a reward but, in order to be penalized, NEGas must fail both benchmarks. This asymmetrical triggering mechanism is not in the public interest because it nearly assures that Southern Union will receive a reward without necessarily lowering gas costs for ratepayers. The Division's witness admitted that this asymmetrical trigger for rewards and penalties based on these two benchmarks was "frankly…designed such that" the likelihood "the company is ever going to incur a penalty" would be "fairly small".[65]

Frankly, the Commission is not interested in creating a penalty that is a mere paper tiger. If Southern Union is to enjoy the real possibility of obtaining a reward for NEGas' gas procurement, it should face the equally real threat of incurring a penalty for gas procurement. Anything less is not in the public interest. Consequently, the Commission finds that an incentive gas procurement plan based on a single, non-discretionary dollar-cost-averaging benchmark is in the public interest. It is also consistent with the Division's original pre-filed testimony.[66] Although the Division's witness currently views the proposed two-benchmark approach as more effective, he essentially acknowledged that an incentive plan based on one benchmark could also be effective.[67]

It is well-settled that the Commission can reject the expert opinion of witnesses presented to the Commission and utilize its own expertise or pick from among conflicting positions of the expert witnesses.[68] Accordingly, the Commission modifies the Proposed

[65] Tr. 11/7/02, p. 43.
[66] Div. Ex. 02-3 (Oliver's 7/26/02 testimony), pp. 10-16.
[67] Tr. 3/25/03, p. 196.
[68] See e.g. Wakefield Water Co. vs. PUC 457 A.2d 251, 253 (R.I. 1983); Valley Gas Co. vs. Burke 446 A.2d 1024, 1033 (R.I. 1982); R.I. Consumers Council vs. Smith 111 R.I. 271, 295-296 (1973). A rate making agency "is not intended to be passive arbiter but the guardian of the public interest", and consequently, is "not a prisoner of the parties' submission" but must "make full use of the expert knowledge of commissioners and staff". Baltimore Ohio R. Co. v. United States 386 U.S. 359, 427-430 (1967) (J. Brennan, concurring). In the Valley Gas case cited in this footnote, the Rhode Island Supreme Court recognized that this Commission can base a decision upon evidence neither party offered into the record. In said case, the Commission rejected Valley's depreciation methodology even though the Division accepted it with a few adjustments, and instead adopted the methodology the Commission, itself, required Valley to perform in response to a Commission data request. 446 A.2d at 1027-1028, 1030, 1033. The

Incentive Plan by eliminating the 19-month NYMEX benchmark from the Plan.[69] This modification assures ratepayers and shareholders that Southern Union has an equal opportunity to receive a reward or a penalty for NEGas' gas purchasing activities. It also assures ratepayers that Southern Union will only receive a reward if NEGas can lower its gas costs. This, in turn, requires a determination of the appropriate reward and penalty for Southern Union with respect to NEGas' gas procurement activities.

E. REWARDS AND PENALTIES

The Proposed Incentive Plan indicates that Southern Union will receive a reward or penalty equal to 10 percent of the difference between the volume-weighted average cost of NEGas' forecasted discretionary purchases and the volume-weighted average cost of its non-discretionary purchases for a given gas supply month. If the discretionary purchases are priced above the non-discretionary purchases, Southern Union will incur a penalty but if the discretionary purchases are priced below the non-discretionary purchases, Southern Union would receive a reward. The Commission could have increased the percentage difference between the discretionary purchases and non-discretionary purchases that would be used for a reward or penalty. At this time, however, the Commission finds that 10 percent is a sufficient incentive (reward or penalty). The Commission is interested in determining how this plan operates prior to determining if any alteration in the percentage is necessary. If this plan results in savings to ratepayers and rewards to Southern Union, then no alteration in the percentage may be

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Rhode Island Supreme Court upheld the Commission on this issue and rejected the gas utility's contention that the Commission had "assumed the role of advocate". Id. at 1033.

[69] Paragraphs III. B.1(b), III. E. 2, 3, 4(b) are deleted from the Proposed Incentive Plan. Paragraph III E. 4 is modified so as to indicate that NEGas' failure to beat the non-discretionary benchmark will, by itself, result in a penalty. Paragraph III. E. 5 is modified to delete any reference to the 19 month NYMEX benchmark.

necessary. However, if NEGas refuses to embrace this plan by continuing to treat discretionary and non-discretionary purchases in the same manner, and thereby incur a small penalty, then it may be necessary to increase the percentage so as to cause Southern Union to absorb larger penalties to incent NEGas to change its behavior. At this juncture, the assumption must be that NEGas will be proactive in obtaining a reward for Southern Union; therefore, ratepayers should enjoy 90 percent of gas cost savings while Southern Union's shareholders will receive 10 percent of gas cost savings.

To incent NEGas, the reward and the penalty must be large enough to cause it to change its gas procurement behavior. The parties recommended a reward limit of $600,000 and a penalty limit of $250,000. These amounts appear inadequate to incent NEGas to change its gas procurement behavior. The Commission is interested in having NEGas be proactive in gas procurement to beat the non-discretionary benchmark. A $600,000 reward limit could mean approximately $5.4 million in gas cost savings for ratepayers. This amount of potential ratepayers savings is rather small in light of the amount of gas costs charged to ratepayers annually. NEGas testified that its annual wholesale gas costs are approximately $170 million annually, or $76.5 million in discretionary purchases under the proposal. Gas cost savings of $5.4 million would not amount to even a 10 percent reduction in NEGas' total discretionary purchases. Therefore, Commission has increased the reward limit to $1,000,000 not only to incent NEGas, but also to increase the potential gas cost savings for ratepayers. A $1,000,000 reward limit could mean approximately $9 million in gas cost savings for ratepayers, representing up to 10 percent reduction in gas costs for discretionary purchases and a 5 percent reduction in overall gas costs.

In reviewing the incentive limits, the Commission was concerned that if the penalty limit was not also appropriately increased, NEGas could become too aggressive and speculative with gas procurement because it would have a very large reward to pursue and only a very small penalty risk. The Commission weighed the option of making the reward and penalty limits symmetrical and increasing both to $1,000,000.[70] However, the Commission was concerned that equalizing and increasing the reward and penalty amounts could cause NEGas to engage in an overly cautious gas procurement policy in order to minimize any penalty. Accordingly, the Commission increased the penalty limit to $500,000.

This amount, in relation to the increased reward limit, should allow NEGas to be proactive in its gas procurement but discourage it from unconstrained speculation. Also, this increased penalty limit is quite reasonable in that it constitutes less than 1 percent of NEGas' discretionary purchases and is the penalty amount that NEGas has proposed in another Commission docket relating to the adoption of a service quality plan for NEGas. As acknowledged by the Division's witness, there is "room for discretion" in electing reward and penalty limits. [71] He noted that these amounts can vary from state to state.[72] The Division's witness expressed the concern that a larger penalty could make NEGas' management "uncomfortable".[73] Once again, the Commission is not interested in setting a penalty limit that will make NEGas management feel comfortable. Rather, our purpose in setting a higher penalty limit is to make NEGas feel uncomfortable enough to modify its behavior regarding discretionary gas purchases in order to lower gas costs for the

[70] This amount is not inclusive of the additional $400,000 maximum reward included in the proposed Asset Management Incentive Plan.
[71] Tr. 11/7/02, pp. 199-200.
[72] Tr. 3/25/03, pp. 186-189.
[73] Id., p. 189.

ratepayers. Accordingly, the Commission modifies the Proposed Incentive Plan to increase the annual reward limit to $1,000,000 and the annual penalty limit to $500,000. [74]

If the Commission was confident that NEGas would embrace this plan and change its behavior regarding discretionary gas purchases, there would be no need for further substantive modifications to the plan. However, NEGas may refuse to change its behavior and take advantage of low cost gas through its discretionary purchases. As a result, the Commission reviewed the need to establish directives for NEGas to follow regarding gas procurement.

F. RECOMMENDED PURCHASE GUIDELINES

The Proposed Incentive Plan as modified above by the Commission should be sufficient to incent NEGas to utilize its discretionary purchases to lower gas costs. However, there is the possibility that NEGas may still prefer to incur a penalty rather than deviate from utilizing the dollar cost averaging method for discretionary purchases. Accordingly, as a necessary safeguard for the ratepayers, the Commission adopts Recommended Purchase Guidelines ("RPGs") to give express permission for NEGas to purchase a certain percentage of its discretionary purchases at or below a certain price and still be entitled to a reward. Specifically, NEGas may: (1) purchase up to 60 percent of its forecasted discretionary gas purchases for a winter month (November through March) when the NYMEX price is at or below $3.50; (2) purchase up to 80 percent of its forecasted discretionary gas purchases for a winter month when the NYMEX price is at or below $3.00; (3) purchase up to 60 percent of its forecasted discretionary gas

[74] In Paragraph II.C.1(a), the amount $600,000 is replaced with the amount $1,000,000. In paragraph II.C. 1(b), the amount $250,000 is replaced with the amount $500,000.

purchases for a non-winter month (April through October) when the NYMEX price is at or below $3.00; and (4) purchase up to 80 percent of its forecasted discretionary gas purchases for a non-winter month when the NYMEX price is at or below $2.80.[75]

The Commission considered making these purchase guidelines mandatory. If the guidelines were mandatory, however, there would be no need to incent NEGas financially for making these purchases. This would not be in keeping with the overall concept of an incentive plan. Also, if there was no financial reward for NEGas to purchase gas at or below the "guideline" prices indicated by the Commission, NEGas would attempt to purchase gas priced just above the Commission's "guideline" prices, so as to receive a reward under other provisions of the plan. Thus, mandatory purchase guidelines may not be workable in the context of the incentive plan at this time. At this stage, the Commission prefers not to direct NEGas in when or how to procure gas, nor is the Commission comfortable with giving NEGas total purchasing discretion because of its failure to mitigate gas costs during the months leading up to the winter of 2000-2001. Instead, the Commission has chosen to give NEGas express guidance in the form of RPGs as to an appropriate price and appropriate percentage of gas to purchase under certain circumstances.

The Commission next considered what type of reward Southern Union should receive if NEGas follows the RPGs. The simplest approach is to allow Southern Union to obtain a reward if NEGas' purchases under the RPGs would otherwise qualify for a reward under the Proposed Incentive Plan.[76] Thus, if the price of a discretionary gas

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[75] Of course, if NEGas has purchased 60 percent of its forecasted discretionary purchases at the 60 percent guideline and the price were to reach the 80 percent guideline, then NEGas would be expected to purchase an additional 20 percent of its forecasted discretionary purchases at the lower price.
[76] These paragraphs are III.E.1, 5.

purchase made pursuant to the RPGs is below the non-discretionary benchmark price, Southern Union would receive a reward equal to 10 percent of the price difference. If the price of a discretionary gas purchase made pursuant to the RPGs is equal to or greater than 50 cents below the non-discretionary benchmark price, Southern Union would receive an additional reward, a "Meritorious Performance Bonus," that is 10 percent of the price difference. In other words, any gas purchase made by NEGas pursuant to the RPGs will be deemed the same as any other discretionary purchase under the plan for purposes of determining if a reward has been earned.

In regards to a penalty, the Commission has determined that if NEGas acts pursuant to the RPGs, NEGas should not incur a penalty if the price of the discretionary purchase turns out to be higher than the non-discretionary benchmark. Consequently, NEGas can claim an exemption from the penalty provision in the Proposed Incentive Plan for discretionary gas purchases made pursuant to the RPGs.[77] NEGas is directed to notify the Division and Commission on a monthly basis of any discretionary gas purchases made pursuant to the RPGs including the date, the volume and the price of each purchase.

NEGas will be entitled to a strong presumption of prudence if it acts in accordance with the RPGs because in that scenario, NEGas will have followed a Commission recommendation. Conversely, there will likely be a rebuttable presumption of imprudence if NEGas refuses to act in accordance with the RPGs because in that scenario, NEGas will have acted contrary to the express permission and guidance of the Commission. However, a satisfactory defense would be that NEGas had already purchased a percentage of forecasted discretionary gas for a given month that precluded it

[77] The penalty provision in question is Paragraph III.E.4 as modified by the Commission in this order.

from acting fully in compliance with the RPGs. For instance, NEGas could not be expected to purchase the entire 60 percent of its forecasted discretionary gas at $3.50 or $3.00 for a particular supply month if it had already purchased more than 40 percent of its forecasted discretionary gas for that month.

The Commission considered broadening the applicability of the RPGs to NEGas' non-discretionary gas purchases as well. However, if the Commission recommended or mandated the purchase of 60 to 80 percent of all gas purchases to be at a certain price, the non-discretionary benchmark could be skewed. Also, non-discretionary gas purchases are supposed to reflect the dollar cost averaging approach, which provides price stability to ratepayers.

The Commission is aware that the wholesale gas market is extremely volatile and that currently, the "guideline" prices listed in the RPGs are relatively low. As noted by the witnesses for the Division and NEGas, these prices are below what has been commonly available in the market for the last three years.[78] The Commission is cognizant that the "guideline" prices listed in the RPGs may cease to be appropriate if market prices were to decline dramatically. In that case, the Commission on its own initiative, or at the request of a party, could adopt new RPGs with revised "guideline" prices and percentages. Monitoring and updating the RPGs from time to time should be no more difficult than altering the NYMEX benchmark used in the current Gas Purchasing Program over the last two years. During that time, the benchmark was altered twice.

[78] Tr. 3/25/03, pp. 117-118, 201-202.

The Commission adopts the RPGs and incorporates them into the Proposed Incentive Plan, as modified by the Commission in this order.[79] The RPGs will not interfere with any reward provision or any benchmark of the modified Incentive Plan. These RPGs are comparable to what other states have implemented. Both the Division and NEGas stated that mandatory purchase directives could be incorporated into the Proposed Incentive Plan.[80] While not mandatory in the nature, the RPGs should provide assurance to ratepayers that when gas prices fall below certain levels, NEGas has been given express permission to deviate from its dollar cost averaging approach for discretionary purchases and purchase a larger percentage of the low priced gas. While the RPGs may not always produce the lowest possible prices for these discretionary gas purchases, the Commission expects they should be lower, for the most part, than gas prices have been over the last three years. If prices should move in a clear downward trend, the prices listed in the RPGs can always be modified with input from the parties. Ultimately, the Commission expects that discretionary gas purchases pursuant to the RPGs will be a "win-win" for both Southern Union and NEGas ratepayers because these purchases should result in rewards for Southern Union and lower gas prices for ratepayers.

G. OTHER PROCUREMENT ISSUES

In order to closely monitor the effectiveness of the Incentive Plan, the Commission requires NEGas, in addition to all other reporting requirements, to file semi-

[79] The RPGs provision should be considered to be part of Section III of the Proposed Incentive Plan. A discretionary purchase made pursuant to the RPGs would be eligible for a reward under Section III but would not be eligible for a penalty if NEGas can demonstrate it made the discretionary purchase pursuant to RPGs. In addition, there would be a monthly reporting requirement for any purchases made pursuant to the RPGs. Also, there may be a need to exempt purchases made pursuant to the RPGs from Paragraph III. A(d).

[80] PUC Ex. 02-1 (Data Responses dated 12/12/02 and 12/3/02).

annual reports with the Commission as to all rewards and penalties incurred by Southern Union as well as savings to ratepayers. The first such report will be due no later than thirty days after the close of the first semi-annual reporting period, which is December 31, 2003.[81] The effective date of the modified Incentive Plan will be June 1, 2003 so as to give NEGas time to make the necessary adjustments to its operating procedures for gas procurement.[82]

The Commission finds the Meritorious Performance Bonus to be reasonable at this time because it provides an incentive for NEGas to achieve additional gas cost savings for ratepayers. Southern Union will receive an additional 10 percent reward if the volume-weighted average cost of NEGas' forecasted discretionary gas purchases is equal to or greater than 50 cents lower than the volume-weighted average cost of its non-discretionary purchases. Under this scenario, there is again a "win-win" situation in that ratepayers would receive 80 percent of the gas cost savings.

The Commission also finds the Asset Management Incentive to be reasonable at this time. Reduction in fixed costs could become permanent savings for ratepayers. Also, the safeguard of determining the amount of the incentive based on whether NEGas' actual gas procurement costs are above or below its projection for the year appears reasonable and should deter NEGas from manipulating gas commodity purchases.

Lastly, the Commission finds the requirement that 70 percent of all gas supply for a normal winter be acquired or "hedged" at a fixed or capped prices to be reasonable. The 70 percent requirement gives price stability to ratepayers for that part of the year when the most gas is consumed. The Commission considered increasing the percentage

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[81] This modifies Paragraph II.B of the Proposed Incentive Plan.
[82] This alters Paragraph II.B.1 from January 2003 to June 2003.

of this requirement, but was concerned that in a warmer than normal winter, NEGas would be required to sell the excess gas at a loss. Lastly, it is clear that any reward or penalties under the Incentive Plan will not be incorporated or affect the earning sharings mechanism adopted in Docket No. 3401.

H. PROCEDURAL ISSUES

At the outset, the Commission considered the Proposed Incentive Plan to be an application under Commission Rules 1.9 and 1.11 and not a settlement agreement under Commission Rule 1.24. In its cover letter of October 8, 2002 and letter to the Commission on January 3, 2003, NEGas does not refer to the Proposed Incentive Plan as a settlement agreement. Also, NEGas does not dispute the representation in the February 24, 2003 Commission data request that Commission Rule 1.11 applies to the Proposed Incentive Plan. In addition, the Proposed Incentive Plan does not conform to the form or substance of a typical settlement agreement. For instance, the attorneys for NEGas and the Division did not sign the Proposed Incentive Plan as they would a settlement agreement as required by Rule 1.24(b)(1). Also, the Proposed Incentive Plan does not contain a provision common in settlement agreements indicating that if the Commission makes modifications to the settlement agreement that are unacceptable to a party, the settlement is deemed withdrawn. The Proposed Incentive Plan thus differs in form and substance over prior settlement agreements between the Division and NEGas, or its predecessors.[83]

[83] See e.g. Appendixes to Order No. 17381 (issued 2/28/03), Order No. 16745 (issued 10/17/01), Order No. 16584 (issued 4/30/01). Other utilities such as Kent County Water Authority, Pawtucket Water Supply Board and Providence Water Supply Board have complied with the requirements of Rule 1.24 when submitting a document purporting to be a settlement agreement. See e.g. Appendixes to Order No. 17024 (issued 6/6/02), Order No. 16585 (issued 4/30/01); and Order No. 16073 (issued 3/10/00).

In fact, the Proposed Incentive Plan is similar in form to the Gas Purchasing Program filed on November 29, 2000. Although the Division supported the Gas Purchasing Program with modifications, the Division never was a settling party to that plan. Similarly, the Proposed Incentive Plan is an application of NEGas supported by the Division and not a settlement agreement between the two parties. Accordingly, the Commission can adopt and order into effect the Proposed Incentive Plan with any modifications the Commission deems reasonable, regardless of whether NEGas consents to the modifications.

The Commission gave adequate notice to the parties that the Commission could make modifications to the Proposed Incentive Plan. Data requests, that served as the basis of the modifications, were issued and both NEGas and the Division responded with their opinions. At both the November 7, 2002 hearing and the March 25, 2003 hearing, Commission staff engaged in cross-examination of the witnesses regarding modifications to the Proposed Incentive Plan. Neither NEGas nor the Division objected to this cross-examination. When the Commission duly posted its notice of an open meeting to be held on March 31, 2003 it indicated that the Proposed Incentive Plan would be a topic of discussion. Neither NEGas nor the Division requested an opportunity to submit further evidence or file briefs, or objected to the Commission considering the Proposed Incentive Plan. The parties had ample opportunity to present evidence and make arguments regarding the merits of the Proposed Incentive Plan and the problems of the proposed modifications. The Commission simply did not find the parties' arguments and evidence persuasive. Any further delay in Commission action would have only harmed the ratepayers. The Commission was interested in having a new gas procurement plan in effect for the bulk of gas purchases for the upcoming winter of 2003-2004 and for nearly all the gas purchases for the winter of 2004-2005.

I. COMMISSION AUTHORITY

The Rhode Island Public Utilities Commission, like other public utility commissions, operates "pursuant to a broad statutory authorization with a general mandate to establish just and reasonable rates without specific direction as to how that is to be accomplished."[84] Pursuant to R.I.G.L. Section 39-1-3, this Commission is a quasi-judicial body that engages in ratemaking for regulated public utilities in Rhode Island. The Commission's administrative proceedings, where the parties are heard and evidence is presented, constitute the quasi-judicial aspect of the ratemaking process.[85] The Commission notes that the "rate setting process is often referred to as a legislative function, reflecting the fact that it was originally exercised by legislatures before being delegated to its PUCs.[86]" Pursuant to R.I.G.L. Section 39-1-1, the General Assembly has delegated its ratemaking power to establish just and reasonable rates to the Commission.

The gas procurement incentive plan ordered by the Commission in this docket is a form of performance based ratemaking ("PBR"). It provides NEGas with an incentive, in the form of rewards and penalties, to procure gas in a manner that provides ratepayers with price stability and affordability. PBR is expressly allowed under Title 39. In R.I.G.L. Section 39-1-27.5, the General Assembly required PBR for electric distribution companies. The General Assembly indicted that PBR was needed "to hold overall rate increases to the level of inflation," and that the Commission must impose performance standards with "an annual penalty or reward" on these companies. The General

[84] In Re: Public Service Co. of New Hampshire, 114 B.R. 820, 834 (Bkrtcy, D.N.H. 1990).
[85] Id.
[86] Id.

Assembly imposed PBR along with penalties and rewards on electric distribution companies without some sort of consent agreement from the electric utilities.

The ratemaking power of this Commission is legislative in nature and is sufficient to impose PBR on gas utilities without their consent. Imposing PBR on NEGas with rewards and penalties to Southern Union is consistent with the ratemaking philosophy underlying R.I.G.L. Section 39-1-27.5. Currently NEGas is under a form of PBR for its non-wholesale gas costs.[87] The gas procurement incentive plan approved by the Commission in this order merely extends PBR principles to NEGas' wholesale gas costs.[88]

NEGas may be under the impression that the Commission needs the consent of NEGas to impose penalties on its gas procurement policies. This is a false impression. Under Title 39, the Commission has broad authority, as indicated by R.I.G.L. Section 39-1-38, to establish regulatory methodologies to produce just and reasonable rates as required by R.I.G.L. Section 39-1-1 and 39-2-1. Wholesale gas costs are included in NEGas' retail rates. NEGas has control over the timing of its wholesale gas purchases; the timing of these gas purchases determines the prices which, in turn, determine the costs or rates to be paid by NEGas' ratepayers. To ensure that these rates are just and reasonable, NEGas must have some incentive to be proactive in gas procurement. A penalty is necessary to incent NEGas to be more proactive and prudent. However, the

[87] See Order No. 17381 (issued 2/28/03).

[88] Narragansett Electric is currently not under PBR for its wholesale electric costs because it, and its predecessors, entered into 12-year Standard Offer Service ("SOS") contracts pursuant to R.I.G.L. 39-1-27.3. Over the long-term these SOS contracts have provided ratepayers with relatively stable and affordable wholesale electric costs. In contrast, ProvGas, NEGas' predecessor, failed to be proactive in developing a gas procurement policy in anticipation of the expiration of its three-year fixed price wholesale gas supply contract on October 1, 2000. Order No. 16745 (issued 10/17/01), pp.72, 75-82. Also, as noted in this order, the flaws in the current Gas Purchasing Program have, in part, led to a recent rate increase and an undercollection of purchased gas costs.

penalty is also appropriate because NEGas has an equally reasonable opportunity to avoid the penalty and obtain a reward for Southern Union. A guaranteed reward is not an appropriate incentive; it is merely corporate welfare. Other state Commissions have ordered gas procurement plans with penalties, including penalties larger than $500,000.[89]

Also, the June 21, 2002 hearing, Mr. Oliver discussed imposing penalties on NEGas for actions it took under the Gas Purchasing Program.[90] There was no indication from the Division or NEGas, either at the hearing or afterward, that in order to impose penalties on NEGas for gas procurement the Commission must have the consent of NEGas. Certainly, this Commission's broad statutory authority allows it to impose reasonable penalties on NEGas for gas procurement so as to incent it to be more proactive and prudent. Otherwise, NEGas will consider the recovery of these wholesale gas costs to be a mere "pass-through" to ratepayers that it is of little concern to NEGas, and this Commission could be deemed a rubber stamp for the resulting rates. When the legislature created the Commission and gave it the express authority to set just and reasonable rates, it surely did not envision the Commission being merely a passive rubber stamp.

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[89] See, e.g., Gas Purchasing Practices (Brooklyn Union Gas Company), 165 PUR 4th 147 (NY 1995); Wisconsin Power and Light Company, 158 PUR 4th 80 (WI 1994); Southern California Gas Company, 150 PUR 4th 271 (CA 1994). The New York Public Service Commission declared that gas utilities can "not assume purchased gas costs are uncontrollable and impervious to performance-related rewards and penalties". 165 PUR 4th at 147. The California Public Utilities Commission has set forth its "preference for regulatory mechanisms that impose some measure of market risk and opportunity" and indicated that an incentive plan for gas procurement "brings regulation of gas purchases more in line with our regulation of non-gas costs". 150 PUR 4th at 272, 274. Lastly, in adopting "staff recommended changes to the company's proposal" for a gas procurement incentive the Wisconsin Public Service Commission gave no indication that it needed the gas utility's consent to impose modifications to the incentive plan. 158 PUR 4th at 98.

[90] Tr. 6/21/02, pp. 16-17, 32.

J. CONCLUSION

In this proceeding, the Commission has attempted to take gas procurement to the next stage. The Commission's modifications to the parties' Proposed Incentive Plan takes a middle path to this next stage.

Rhode Island's gas utilities have treated the recovery of purchased gas costs as a mere "pass-through" to ratepayers. Consequently, prior to the winter of 2000-2001, Rhode Island's former gas utilities, ProvGas and Valley, tended to rely nearly exclusively on spot market purchases and claimed that this served the objective of affordability. A litigious and contentious prudence review by the Commission ensued, which resulted in savings to ratepayers. NEGas, the successor of ProvGas and Valley, learned the lessons of the winter of 2000-2001. NEGas hedged extensively and followed a dollar cost averaging approach to achieve price stability. Unfortunately, the winter of 2002-2003 demonstrates that dollar cost averaging is not enough to keep ratepayers' bills reasonable and affordable. As a result, NEGas must utilize its discretionary purchases to depart from a simple dollar cost averaging strategy and take advantage of low priced gas in order to achieve affordability.

The Proposed Incentive Plan as modified by the Commission achieves a marriage of price stability and affordability. Price stability is achieved by requiring 50 percent of NEGas' gas supply be purchased through a dollar cost averaging approach. Affordability is achieved if NEGas utilizes its discretionary purchases, covering up to 45 percent of the gas supply, to purchase gas below the price produced by its dollar cost averaging strategy for non-discretionary purchases. To incent Southern Union to utilize its discretionary purchases as envisioned, the Commission had to modify the reward and penalty structure proposed by NEGas. Under NEGas' proposal, Southern Union would be nearly assured of never incurring a penalty and always receiving a reward, even if NEGas' discretionary gas purchases did not lower gas costs by being lower than the price of its non-discretionary purchases. A true incentive system provides a realistic opportunity for Southern Union to receive a reward for lowering gawersnTrauyn(a)d for -5.8(out)-4.1((a -5.8(oue prts no of the experts presented, the Commission under its broad Title 39 authority has incorporated the RPGs into the approved Incentive Plan.

The Commission's approved Incentive Plan is an attempt to align and balance the interests of NEGas' ratepayers and Southern Union's shareholders. The Commission hopes this approach will be sufficient to incent NEGas' to be proactive in gas procurement so as to lower gas costs for its ratepayers. Wholesale gas costs account for more than 50 percent of the typical residential heating customer's annual bill. Also, NEGas' annual bill for a typical residential heating customer is clearly the most expensive utility bill for the average Rhode Islander.[91] The Commission will not merely rubber stamp the pass-through to ratepayers of NEGas' gas cost increases. The Commission has taken the proactive step of ordering the implementation of an Incentive Plan that is designed to incent NEGas to be more proactive in procuring lower cost gas. If NEGas is not interested in pursuing rewards for Southern Union, then it will face penalties. The penalties could grow with time if NEGas refuses to be proactive. At this time, however, the Commission has chosen a middle path that gives ample opportunity for Southern Union to receive rewards. Southern Union can either embrace the Incentive Plan and pursue rewards or stubbornly refuse to change its ways and face penalties. The choice is for Southern Union to make.

Accordingly, it is

(17444) ORDERED:

[91] According to NEGas, a typical residential heating customer utilizing 1000 ccf of gas will have an annual bill of $1206 if current rates remain in effect past October 31, 2003. A typical bill is based on the assumption of a normal winter. Also, it does not include taxes. In comparison, if Narragansett Electric's proposed rate increase is put into effect for June 1, 2003, the typical residential customer will pay $714 annually, including taxes. Also, Verizon-Rhode Island's typical residential customer pays approximately $567 annually, including taxes and surcharges. This typical phone bill would include local basic exchange service, discretionary services like call waiting, and an hour of toll calls.

1. The Gas Cost Recovery factors on a per therm basis filed by NEGas on June 3, 2002, set forth on a per therm basis, of: $0.6251 for residential and small commercial and industrial customers; $0.6110 for medium commercial and industrial customers; $0.6192 for large low load factor customers; $0.5641 for large high load factor customers; $0.6081 for extra large low load factor customers; and $0.5331 for extra large high load factor customers, are approved for effect July 1, 2002 through October 31, 2003.

2. The Gas Marketer Transportation factors filed by NEGas on June 3, 2002 of: $0.0439 per therm for FT-2 Firm Transportation Marketer Gas Charge; $0.00147 per percent of balancing elected per therm for Pool Balancing Charge; and weighted average upstream pipeline transportation cost of $0.0885 per therm of capacity, are approved for effect September 1, 2002 through October 31, 2003.

3. A new benchmark pricing strip for the Gas Purchasing Program based on the June 20, 2002 NYMEX monthly future price is hereby approved.

4. The Gas Cost Recovery factors on a per therm basis filed by NEGas on February 14, 2003, as revised on March 20, 2003, set forth on a per therm basis, of: $0.7119 for residential and small commercial and industrial customers; $0.6988 for medium commercial and industrial customers; $0.7068 for large low load factor commercial and industrial customers; $0.6603 for large high load factor customers; $0.6948 for

extra large low load factor customers; and $0.6238 for extra large high load factor customers, are approved effective for consumption on and after April 1, 2003 through October 31, 2003.

5. The Gas Procurement and Asset Management Incentive Plan filed by NEGas on October 8, 2002 is approved for effect June 1, 2003, with the following modifications:

   A. The Plan will contain of only one benchmark, which shall be the weighted average cost of non-discretionary gas purchases.

   B. The Plan's maximum annual gas procurement reward will be $1,000,000 and the maximum annual gas procurement penalty will be is $500,000.

   C. Recommended Purchase Guidelines that give NEGas express permission to make discretionary gas purchases, with the possibility of earning an incentive thereon, are incorporated into the Plan as follows: (1) NEGas may purchase up to 60 percent of its forecasted discretionary gas purchases for a winter month (November through March) when the NYMEX price is at or below $3.50; (2) NEGas may purchase up to 80 percent of its forecasted discretionary gas purchase for a winter month (November through March) when the NYMEX price is at or below $3.00; (3) NEGas may purchase up to 60 percent of its forecasted discretionary gas purchases for a non-winter month (April through October) when the NYMEX price is at or below $3.00; (4) NEGas may purchase up to 80 percent of its forecasted discretionary gas purchases for a non-winter (April through October) when the NYMEX price is at or below $2.80.

D. NEGas shall report to the Commission on a monthly basis regarding any gas purchases made pursuant to the Recommended Purchase Guidelines.

E. NEGas shall report semi-annually to the Commission regarding all rewards and penalties received under the Plan as well as savings to the ratepayers, with the first report for the initial six-month period ending December 31, 2003 due no later than January 31, 2004.

6. NEGas and the Division either jointly or separately shall make a filing in May 2003 addressing the issues raised in this docket relating to the migration of customers between transportation and firm sales service.

7. NEGas shall comply with the reporting requirements and all other findings and directives contained in this Report and Order.

EFFECTIVE IN WARWICK, RHODE ISLAND ON JULY 1, 2002, APRIL 1, 2003 AND JUNE 1, 2003 PURSUANT TO A BENCH DECISION ON JUNE 21, 2002 AND OPEN MEETING DECISIONS ON DECEMBER 4, 2002 AND MARCH 31, 2003. WRITTEN ORDER ISSUED MAY 1, 2003.

PUBLIC UTILITIES COMMISSION

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Elia Germani, Chairman

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Kate F. Racine, Commissioner

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Brenda K. Gaynor, Commissioner