STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: PROVIDENCE GAS COMPANY ANNUAL GAS CHARGE CLAUSE FILING, VALLEY GAS COMPANY ANNUAL PURCHASED GAS PRICE ADJUSTMENT CLAUSE FILING, AND PROVIDENCE GAS COMPANY'S TRANSPORTATION TARIFF REVISION	:	DOCKET NOS. 1673, 1736 & 3347

REPORT AND ORDER

I. Background

On an annual basis, Providence Gas Company ("ProvGas") files with the Public Utilities Commission ("Commission") its Gas Charge Clause ("GCC") filing. ProvGas has made this filing in Docket No. 1673 since 1982. Also, on an annual basis, Valley Gas Company ("Valley") files with the Commission its Purchased Gas Price Adjustment Clause ("PGPA") factor. Valley has made this filing in Docket No. 1736 since 1984. The GCC and the PGPA are both purchased gas adjustment ("PGA") clauses. PGA clauses are designed to "recover the costs of gas supplies" purchased by local gas distribution companies ("LDCs") such as ProvGas and Valley.[1] These PGA clauses are not automatically passed through to the ratepayers, and instead "only reasonable, prudent" gas supply costs incurred by a LDC "will be passed on to ratepayers."[2]

II. Valley's August 1, 2000 Filing

[1] See RIPUC Tariff PGC No. 100, Schedule A, Sheet 1; See also R.I. PUC Tariff VGC No. 100, p. 1.
[2] Order No. 10711, Tariff Filing Made by the Providence Gas Company, Docket No. 1612, (issued 6/23/82) p. 87.

On August 1, 2000, Valley proposed to increase the PGPA factor from $0.435 per Mcf to $1.758 per Mcf effective September 1, 2000. In support of this request, Valley submitted pre-filed testimony from Thomas E. Philbin, Controller of Valley, and Alan N. Roy, Assistant Vice-President of Gas Supply for Valley. Mr. Philbin provided a summary of the information needed to calculate the PGPA factor. He noted that the proposed increase would increase the average residential heating customer's bill by $125 annually, an annual bill increase of 16%.[3]

Mr. Roy explained that the request for a higher PGPA factor was caused by "much higher wellhead gas prices".[4] Since February 2000, Mr. Roy noted that wholesale natural gas prices "began an upward spiral" and at its peak on June 27, 2000, had a NYMEX twelve-month average of $4.3125 per deckatherm.[5] Nonetheless, Mr. Roy stated that Valley had been able to maintain its deferred account balance to a "modest" $912,627.[6] However, Mr. Roy was troubled that due to high NYMEX prices, it was "prohibitively costly to inject gas into underground storage" and that it prevented Valley from locking in gas prices.[7]

Mr. Roy discussed Valley's price management strategy. He stated his view that the "high-priced current NYMEX strip is in the long run, unsustainable," and therefore it was decided only to fill 19.4% of Valley's

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[3] Valley's Ex. 00-5 (Philbin's pre-filed testimony), p. 3.
[4] Valley's Ex. 00-6 (Roy's pre-filed testimony), p. 1.
[5] Id., p. 2.
[6] Id.
[7] Id.

underground storage instead of following its traditional approach of filling "virtually 100% of its storage space."[8] Instead, Valley pursued a "storage replication service" in which the marketer delivers "firm gas to the utilities' city gates in quantities approximately equal to what the LDCs would be able to withdraw from their contracted underground storage providers."[9] By following this approach, Mr. Roy noted that Valley's ratepayers could save $125,935.[10] Mr. Roy indicated his belief that wholesale natural gas prices "will fall further", and therefore the storage replication service would provide Valley "the flexibility of locking in gas at any point forward through the upcoming winter at a cost which is less than the current NYMEX winter strip".[11] In conclusion, Mr. Roy re-emphasized that Valley would "retain the flexibility to secure a fixed price" for gas on behalf of the ratepayers "if gas prices fall", which "should happen" at some point "in the September through October 2000 period."[12]

III. Valley's August 31, 2000 Hearing

Following notice, a public hearing was conducted at the offices of the Commission, 100 Orange Street, Providence, Rhode Island on August 31, 2000. The following appearances were entered:

FOR VALLEY: Deming Sherman, Esq.

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[8] Id., p. 3.
[9] Id.
[10] Id., p. 4.
[11] Id., pp. 5-6.
[12] Id., p. 6, fn. 13.

FOR DIVISION:	Paul J. Roberti, Esq. Assistant Attorney General
FOR OSRAM SYLVANIA:	Stephen Izzi, Esq.
FOR COMMISSION:	Steven Frias, Esq. Senior Legal Counsel

At the hearing, Mr. Philbin and Mr. Roy testified on behalf of Valley. Mr. Roy estimated that as of August 31, 2000, Valley would have an under-collection of approximately $912,000 in its PGPA account.[13] He estimated that if the Commission did not increase the PGPA factor, Valley would have an additional under-collection of approximately $345,000 for the month of September.[14] The hearing was abbreviated due to the fact that Mr. Gregory Benik, counsel for Osram Sylvania, was unavailable for the hearing. Therefore, the Commission determined that an additional hearing would be conducted in the matter.[15] The Division's position was that Valley's proposed PGPA factor be adopted on an interim factor and go into effect September 1, 2000, subject to further review by the parties and the Commission at a subsequent hearing.[16] It was the Division's position that delay in the implementation of the increase would magnify the need for an increase in October 2000 due to the loss of the September billing month.[17] On September 1, 2000, at an open meeting

[13] Tr. 8/31/00, p. 30.
[14] Id., p. 36
[15] Id., pp. 11-13.
[16] Div. Ex. 00-1, Division's Memorandum 8/30/00.
[17] Id.

the Commission adopted the PGPA factor of $1.758 per Mcf on an interim basis subject to refund and further investigation.

IV. Division's September 2000 Rebuttal To Valley's August 1, 2000 PGPA Filling

In response to Valley's August 1, 2000 filing, the Division submitted pre-filed testimony by Bruce R. Oliver, its outside consultant from Revilo Hill Associates. At the outset, Mr. Oliver explained that recent increases in natural gas prices were primarily due to "sharp increases in our dependence upon natural gas as a fuel for electric generation" and "continued growth in U.S. reliance on foreign sources of crude oil and refined petroleum products."[18] Mr. Oliver noted that U.S. production of crude petroleum had declined while U.S. demand for petroleum products has increased more than 20%, resulting in approximately two-thirds of U.S. demand for petroleum products coming from foreign sources.[19] Also, Mr. Oliver explained that virtually all new electric generating plants are fueled by natural gas so that natural gas-fired generation plants will increase from 10% of total electric generation in 1990 to 30% by 2020.[20] He further noted that gas-fired generation plants are now being utilized for base load generation instead of for peaking generation, thereby increasing the annual volume of natural gas

[18] Div. Ex. 00-3, (Oliver's pre-filed testimony), p. 6.
[19] Id., pp. 6-7.
[20] Id., p. 7.

for electric generation.[21] Due to the increased use of natural gas for electric generation, the U.S. does not have "sufficient natural gas supply elasticity to counter oil price increases" or "sufficient oil price competition to serve as a check on increases in natural gas prices."[22] Furthermore, Mr. Oliver noted that drilling activity has increased in the U.S. due to higher natural gas and oil prices but that "a time lag of 6 to 18 months" can be anticipated "between the completion of a productive new well and the initial delivery of output from that well to the market."[23] Mr. Oliver also emphasized that recent increases in natural gas prices will not be short-lived, and that the natural gas price levels of the 1998-1999 period were the "lowest levels in more than 20 years."[24]

Next, Mr. Oliver discussed the reasonableness of Valley's proposed PGPA factor, its gas procurement strategy, and the options available to the Commission to mitigate the impact of gas cost increases. Mr. Oliver found Valley's actions "individually...reasonable" but "in total," he found these "actions fall well short of what was necessary or appropriate to mitigate the impact of gas cost increases."[25] Although in last fall's PGPA proceeding, Valley was encouraged to consider entering into long-term fixed-price gas supply arrangements, Mr. Oliver noted that Valley "has continued to purchase its gas supply requirements under pricing

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[21] Id., p. 8, Mr. Oliver also noted that there are no new coal-fired plants, or new nuclear generating facilities currently planned or under construction. Id., pp. 7-8.
[22] Id., pp. 9-10.
[23] Id., p. 10.
[24] Id., p. 12.
[25] Id., p. 14.

arrangements" that give ratepayers "little or no protection from market price fluctuation."[26] Furthermore, Mr. Oliver emphasized that "despite continued upward movements in gas prices over the course of the year, Valley has forgone numerous opportunities to lock-in gas prices."[27] Also, Mr. Oliver found that the gas cost incentive mechanism for Valley was "ineffective".[28] Mr. Oliver further expressed concern that Valley's filing of a PGPA factor of $1.758 will significantly understate its actual gas costs for the coming years because of "Valley's strategy of relying heavily on spot market purchases," and its "arrangement of storage replication services" which could "noticeably increase...Valley's overall gas costs."[29]

In conclusion, Mr. Oliver referred to the Commission's concern over the magnitude of the year-to-year fluctuations for Valley's PGPA factor.[30] He noted that Valley took "no substantial action to lock-in more favorable gas prices or hedge against upward spiraling as costs" and instead relied upon the "spot market procurement of gas supplies."[31] Also, Mr. Oliver explained that due to the "lack of alignment of shareholder and ratepayer interest," Valley was "inclined to pay rising spot market prices for natural gas than to take a risk that regulators might subsequently judge a locked-in or capped price for gas supplies to be too high" and therefore

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[26] Id., p. 15.
[27] Id.
[28] Id., pp. 15-16.
[29] Id., pp. 17-18.
[30] Id., p. 19.
[31] Id.

"disallow recovery" of all or the some of costs for gas procurement.[32] Lastly, Mr. Oliver explained that due to recent increases in natural gas prices, it would not be reasonable for Valley to enter into a "multi-year fixed-price gas supply" contract. He "recommended that the Commission take no action with respect" to Valley's gas procurement strategy for the winter and rather focus on "the creation of a more carefully devised long-term strategy including...the creation of a more tightly structured multi-year incentive mechanism to ensure that ratepayer and shareholder interests are more clearly aligned in future gas procurement decision making."[33]

V. Valley's September 26, 2000 Hearing

The hearing on Valley's August 1, 2000 filing was resumed on September 26, 2000. Valley presented Mr. Roy and Mr. Philbin as witnesses at the hearing. Mr. Roy noted that in the previous thirty days there had been a daily escalation of wholesale natural gas prices with no sign of down-turning and therefore Valley would need to refile an increased PGPA factor shortly.[34] Mr. Roy testified that "it's become clear to the Company at this time that there is serious upward rise for our customers", and thus Valley intends "to lock in some spot gas" for this winter in the range of 25 to 50 percent of its load.[35]

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[32] Id., pp. 19-20.
[33] Id., pp. 20-21.
[34] Tr. 9/26/00, pp. 15-16.
[35] Id., pp. 16-17.

Under cross-examination, Mr. Roy stated since February 2000 he and the upper management of Valley "have been looking at gas prices on a daily basis" and admitted that Valley knew that "the Commission would like us to give price stability."[36] He reiterated this point at other times in his testimony. For instance, Mr. Roy acknowledged that "the Commission in the last two or three years has pointed in the direction of price stability".[37] Mr. Roy emphasized that he "knew the Commission would like us to go for price stability, and that's what [Valley] tried to do this year starting in February" 2000.[38] Furthermore, Mr. Roy explained that in the past year Valley "felt as though there would be at some point a significant break in prices and at that point we [Valley] would be to lock in prices."[39]

Under cross-examination by Osram Sylvania, Mr. Roy admitted that Valley did not have a written risk management policy, which would include a hedging program. He also affirmed that Valley could have implemented such a policy without Division approval.[40] Furthermore, Mr. Roy acknowledged that for the previous three years Valley had purchased at least 50 percent and as much as 75 percent of its gas supply from the spot market, and at that time, had not entered into any long-term fixed contracts with a cap.[41] Mr. Roy admitted that in the past

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[36] Id., p. 26.
[37] Id., p. 36.
[38] Id., p. 29.
[39] Id., p. 38.
[40] Id., pp. 50-52, see Osram Ex. 99-7.
[41] Id., pp. 55, 59.

Valley had retained RMI, as a consultant for gas procurement, and in past years Valley had not followed RMI recommendations to lock in prices for its gas supply.[42] Furthermore, Mr. Roy acknowledged that Valley "did not enter into risk management hedging", had no in-house expertise on hedging, and instead focused on purchasing from the spot market.[43]

Under cross-examination by the Commission, Mr. Roy stated he found the spot market for natural gas to be generally volatile.[44] Mr. Roy concurred that the diversified approach to gas procurement would result in greater price stability.[45] Mr. Roy explained that Valley, as an LDC, needed parameters to be set for gas procurement.[46] Also, Mr. Roy admitted that the risk for not locking in gas supply is borne by the ratepayer.[47] Valley's goal for gas procurement, Mr. Roy explained, was to "get the lowest priced gas".[48] Under further cross-examination by Osram, Mr. Roy noted that gas prices had been low in 1998 and 1999, that Valley expected that gas prices "would probably go up" but the company did not lock in any long-term gas contracts at that time.[49]

Mr. Oliver testified on behalf of the Division. He discussed the establishment of an incentive structure for gas procurement by Valley.

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[42] Id., pp. 59, 64-65.
[43] Id., pp. 66, 160.
[44] Id., p. 73.
[45] Id., p. 81.
[46] Id., p. 91.
[47] Id., p.. 133.
[48] Id., p. 105.
[49] Id., pp. 177-178.

This structure would include a diversified approach to gas procurement based on the time and length of the gas purchase.[50] Mr. Oliver noted that there are many different types of hedging practices such as options, calls, and long-term contracts. It was his opinion that Valley had not used any of these hedging practices since 1997.[51]

VI. ProvGas' September 1, 2000 Filing

On September 1, 2000, ProvGas filed to increase its Gas Charge Clause ("GCC"), which is applicable to sales service customers, from $1.283 per Mcf to $3.436 per Mcf for residential and small C&I customers, from $5.624 per Mcf to $7.777 per Mcf for medium/large C&I customers, and from 5.361 per Mcf to $7.514 per Mcf for extra large C&I customers. This filing would increase the average residential heating customer bill from $1.060 annually to $1,296, an increase of $237 or 22.4%.

Mr. Lyons explained that the then current GCC rate was based on a commodity price of $2.568 per MMBtu for natural gas as a result of ProvGas' long term contract with Duke Energy.[52] Mr. Lyons estimated the commodity price of wholesale natural gas in the GCC rate to increase from $2.568 per MMBtu to $4.694 per MMBtu.[53]

ProvGas also filed transportation related GCC factors, which relate to the provision of firm transportation services. These charges are

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[50] Id., pp. 214, 217-218.
[51] Id., pp. 225, 227.
[52] Prov. Ex. 00-1 (Lyon's pre-filed testimony) p. 3-4.

primarily billed to Gas Marketers. The company makes available up to 20,000 MMBtu per day of capacity on six different pipeline paths to provide for transportation of gas by marketers to customers of ProvGas. Marketers are allowed to select the path or paths upon which they choose to acquire capacity. Each of the six paths has a specific surcharge or credit that is designed to result in the same average weighted price being charged for all upstream transportation. When the surcharge/credit is combined with the charges that the marketer pays directly to the pipeline, the resulting transportation cost is the same cost regardless of the path selected. The upstream weighted average cost in this filing is a slight increase from $1.074 to $1.076 per MMBtu.

Firm transportation customers take service as either FT-1 or FT-2 customers. FT-1 service requires the customer to have telemetering, while FT-2 customers do not have telemetering. FT-2 customers are subject to the assignment of a proportion of the company's underground storage capacity and peaking inventory supply. These FT-2 rates are changed with this filing as follows:

1. The firm transportation Marketer Gas Charge for storage is decreased from $0.0528 to$0/0491 per Ccf.
2. The peaking inventory cost is priced at the company's cost for LNG which is $6.15 per MMBtu, an increase from the $5.25 per MMBtu currently charged.

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[53] Id., Ex. TSL-1 & 2.

Gas Marketers pay for a portion of storage capacity and have the option of purchasing inventory for underground storage at a rate set by the filing. The rate is based on the company's actual cost for storage gas. In the filing the company estimated (based on five months actual data and two months projected) the rate to be $4.957 per MMBtu, or $1.786 per MMBtu higher than last year.

A Pool Balancing Service Charge is available to accommodate minor delivery imbalances. In the filing, the company has slightly decreased this charge from $0.002 to $0.0018 per Ccf.

In his pre-filed testimony, Mr. James DeMetro explained the basis for the GCC factors and their relationship to the Price Stabilization Plan of Docket No. 2581. Mr. DeMetro explained that a GCC filing included a forecast of all gas supply costs and any variation between the actual cost incurred and the forecast is charged or credited in the following year's GCC.[54] It was noted by Mr. DeMetro that ProvGas had "hedged a portion of its gas supply" through a lock-in of a portion of its gas supply, storage over the summer injection period, and a capping of the price of a portion of its gas supply.[55] Mr. DeMetro explained that the significant increase in the GCC factor was due to higher wholesale natural gas prices and the fact that over the previous three years ProvGas had been charging a below market natural gas rate due to its long-term gas supply contract

[54] ProvGas Ex. 00-2 (DeMetro's pre-filed testimony), pp. 1-2.
[55] Id., p. 5.

with Duke Energy.[56] Mr. DeMetro stated that ProvGas was in active discussion with the Division about creating a gas supply hedging plan.[57]

On September 22, 2000, ProvGas filed an interim commodity purchase strategy plan to mitigate price volatility. The plan noted that from October 1, 1997 to September 30, 2000, ProvGas had a fixed-price hedge on all its gas supply, but that due to future prices for wholesale natural gas being at historic highs, the situation called for a different approach than that taken three years ago.[58] The objective of this interim commodity purchase strategy was to provide customers with a significant level of protection from significant increases in natural gas commodity prices, while continuing to offer the opportunity to take advantage of price declines.[59] ProvGas explained that "any hedging strategy is...a form of insurance for customers".[60] ProvGas would utilize different methods of hedging such as fixed price agreements, purchasing options and re-trading options.[61] In making hedging decisions, ProvGas would consider future market prices, the current GCC price, total cost of hedges and industry news and events.[62]

ProvGas explained that the upcoming 24-month period would be divided into four periods: two Peak and two Off-Peak periods. The Peak period would include November through March of each year and Off-Peak

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[56] Id., p. 6.
[57] Id., p. 8.
[58] ProvGas Ex. 00-3, p. 1.
[59] Id.
[60] Id.
[61] Id., p. 2.

period would include April through October of each year.[63] At the beginning of each Peak and Off-Peak period the hedging target would be to move into each period with approximately 65% of expected purchase either fixed, capped or collared with a range between 50% and 80% depending on prices relative to the current GCC.[64] The target hedging percentage would be achieved through dollar-cost averaging purchases and discretionary purchases.[65] Within each season, ProvGas' goal would be to move into each month with approximately 80% of expected purchases for that month to be either fixed, capped or collared.[66] By November 1, 2000, ProvGas' targets were: 65% for the Peak season of 2000-2001, 40% for the Off-Peak season; and 20% for the Peak season of 2001-02.[67]

VII. Division's September Rebuttal to ProvGas' September 1, 2000 Filing

The Division submitted the pre-filed testimony of Bruce Oliver. A portion of his pre-filed testimony reiterated comments he made in his pre-filed testimony regarding Valley. Mr. Oliver noted that ProvGas had not solicited bids on a long-term (multi-year) gas supply agreement to replace the agreement it had in Duke Energy.[68] Mr. Oliver reviewed ProvGas' use of hedges such as a physical hedge, storage and a financial

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[62] Id., p. 3.
[63] Id.
[64] Id., p. 4.
[65] Id.
[66] Id., p. 5.
[67] Id., p. 6.
[68] Div. Ex. 00-1, (Oliver's pre-filed testimony), p., 14.

hedge, and found that in total their actions fell well short of what was necessary to mitigate the impact of gas cost increases to the ratepayers.[69] Mr. Oliver noted that ProvGas had locked in gas prices for only 4% of its annual supply assuming normal weather conditions, capped pricing of only 0.7% of its normal winter gas supply, and had in storage only 28.7% of its normal winter gas supply.[70] As a result, ProvGas had only 35% of its normal winter gas supply subject to hedging and price security, and that Duke, under its agreement with ProvGas, had taken the action to store 28.7% of ProvGas' normal winter gas supply.[71] Mr. Oliver expressed concern that since ProvGas' September 1, 2000 GCC filing, wholesale gas had risen noticeably, and therefore necessitated a further increase in the GCC factor. This would result in a 27.7% increase in the typical residential heating customer's bill for the year.[72] Mr. Oliver argued that ProvGas should have hedged larger volumes of its gas supply. Instead, ProvGas locked and capped prices for limited volumes of gas supply. Had ProvGas locked and capped prices, it would have resulted in lower gas prices for customers in light of current wholesale natural gas prices.[73] Mr. Oliver argued that ProvGas was not more aggressive in mitigating gas cost increases because there was a lack of alignment in shareholder interests and the interests of ratepayers.[74]

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[69] Id., p. 15.
[70] Id., pp. 16-17.
[71] Id., p. 17.
[72] Id., p. 19-20; Ex. BRO-4.
[73] Id., p. 20.
[74] Id., pp. 20-21.

As for ProvGas' interim gas purchase strategy, Mr. Oliver disagreed with representations made in the plan.[75] For instance, Mr. Oliver explained that the Division's push for "greater gas price stability" was the "motivating rationale" for the three year fixed price contract with Duke Energy.[76] Mr. Oliver stated that "continued reliance on short-term gas purchases strategies that are dependent on volatile spot market (or future market) pricing indices are not in the best interest of the residential" customers.[77]

The Division stated that the Commission should withhold its approval of ProvGas' interim gas purchase strategy plan for the following reasons: (1) it did not address the lack of alignment between ratepayers and shareholder interests; (2) the procurement guidelines were vague; (3) the seasonable approach for gas procurement distracted from long-term rate stability objectives; (4) the hedging within the guidelines was completely within ProvGas' discretion; and (5) there was not enough time before the 2000-2001 winter to justify approval of ProvGas' interim strategy for the 2000-2001 winter.[78]

Due to increases in gas prices in recent weeks, Mr. Oliver recommended that the Commission take no action regarding ProvGas' interim gas purchase strategy for the 2000-2001 winter and instead focus on devising a long-term strategy, which could possibly include an

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[75] Id., pp. 21-22.
[76] Id., p. 22.
[77] Id., p. 23.

incentive structure to ensure that ratepayers and shareholders interests are more clearly aligned in gas procurement.[79] Also, Mr. Oliver noted that ProvGas' filed GCC factor could understate its actual gas costs and therefore the Commission should require ProvGas to file an updated analysis of its actual and projected wholesale gas costs as well as the status of its deferred cost balance no later than December 15, 2000.[80] If necessary, Mr. Oliver noted, the Commission could approve adjustment to the GCC rate to permit recovery of some or all the gas cost increase before the majority of the winter season sales have been billed so as to reduce the magnitude of any further deferred gas cost balance.[81]

VIII. ProvGas' Hearing of September 27, 2000

After public notice, a public hearing was held at the offices of the Commission at 100 Orange Street, Providence, Rhode Island. The following appearances were entered.

FOR PROVGAS:	John Partridge, Esq. Dennis Duffy, Esq.
FOR DIVISION:	Leo Wold, Esq. Special Assistant Attorney General
For COMMISSION:	Adrienne Southgate, Esq. General Counsel

At the hearing, Mr. DeMetro and Mr. Lyons were sponsored as witnesses for ProvGas. Mr. DeMetro noted that the wholesale natural

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[78] Id., pp. 24-25.
[79] Id., p. 26.
[80] Id., pp. 30-31.
[81] Id.

gas commodity charge constituted approximately 35% of a ProvGas' customer bill and that the remainder of the bill would essentially remain unchanged under an extension of the Price Stabilization Plan in Docket 2581.[82]

Under cross-examination, Mr. DeMetro acknowledged that discussions had occurred in October 1999 amongst the Division, Duke Energy and ProvGas for an extension of the three-year fixed price contract.[83] Mr. DeMetro admitted that the three-year, fixed-price contract with Duke Energy reflected the Commission's "ongoing concern" with price stability" but added that "affordability is at issue as much as is the volatility" and "it's a balancing" of these two objectives.[84]

Although Mr. DeMetro argued that approximately 50% of ProvGas' winter gas supply was locked in, he admitted that only 28.7 percent of the gas supply needed for a normal winter had been locked in.[85] Mr. DeMetro concurred that prior to the implementation of the three-year fixed contract with Duke Energy in 1997, ProvGas had a pilot hedging program and the Commission had allowed ProvGas to recover the costs for hedging as recoverable under the GCC.[86] Mr. DeMetro testified it became apparent in May 2000, that it would be difficult to maintain stable gas prices, and that no LDC except for one or two in the country

[82] Tr. 9/27/00, p. 23.
[83] Id., p. 32.
[84] Id., p. 34.
[85] Id., pp. 46-47.
[86] Id., p. 47.

were prepared for the rapid escalation in natural gas prices.[87] Mr. DeMetro acknowledged the importance of diversification in gas procurement methods to mitigate price volatility.[88]

Under cross examination, Mr. DeMetro admitted that ProvGas took no action in response to a letter from the Division dated June 3, 1999, informing ProvGas that natural gas prices had dropped to "levels below those of other years in recent memory" and therefore ProvGas should "take action to secure a gas supply" for the period after the conclusion of the Price Stabilization Plan.[89] Mr. DeMetro admitted that anytime during the previous three years, ProvGas could have presented the Commission with a plan for wholesale gas costs and gas procurement for the period commencing at the conclusion of the Price Stabilization Plan.[90] Lastly, Mr. DeMetro argued that an increase in the GCC factor affects ProvGas' stockholders because uncollectibles grow and sales growth slows.[91]

At the end of the hearing, ProvGas introduced revised TSL exhibits to Mr. Lyon's pre-filed testimony as ProvGas Exhibit 00-5. This exhibit sought an increase in the GCC factor, effective October 1, 2000, of an increase from $1.283 per Mcf to $4.060 per Mcf for residential customers or an increase for residential heating customers from $1,060 to $1,365 or 28.8%.[92]

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[87] Id., pp. 66-67.
[88] Id., pp. 83-84.
[89] Id., p. 82; Div. Ex. 00-3.
[90] Id., p. 121.
[91] Id., p. 210.
[92] Id., p. 218; Prov. Ex. 00-5 (TSL-2 & 3).

On September 28, 2000, the Division filed a recommendation regarding ProvGas' GCC rate increase. The Division recommended that the Commission approve an interim increase in the GCC rates of $1.419 per Mcf effective October 1, 2000. This amount would allow ProvGas to recover a level of gas costs equal to that reflected in Valley's GCC rates approved by the Commission on September 1, 2000. The Division noted that more time was needed to complete the hearings on the GCC charge. Also, the Division strongly suggested that ProvGas had opportunities to reduce the magnitude of the GCC increase and ProvGas' gas procurement activities raised questions regarding whether ProvGas' had taken sufficient action to ensure reasonable rate stability. At an open meeting on September 29, 2000, the Commission voted to increase ProvGas' GCC rates on an interim basis subject to refund and further investigation as follows: 1. $2.702 per Mcf for residential and small C & I customers; 2. $7.043 per Mcf for C & I Medium/Large; 3. $6.78 pre Mcf for C & I Extra Large. The Commission also approved the Transportation Gas Charge factors filed by ProvGas on September 1, 2000.

IX. ProvGas and Valley's November 29, 2000 Filing

On November 29, 2000, ProvGas and Valley ("Companies") filed proposed increases in the GCC and PGPA factors for ProvGas and Valley respectively. The filing also included a proposed Mitigation Strategy Plan, which consisted of a Gas Purchase Program and a Gas Price Mitigation Program. The Companies also proposed to contribute an

additional $333,000 ($250,000 for ProvGas and $83,000 for Valley) to their Low-Income Heating Assistance Program ("LIHEAP") program subject to the Commission's approval of the Mitigation Strategy Plan.[93] In support of its filing the Companies also submitted pre-filed testimony of Mr. DeMetro.

The objective of the Mitigation Strategy Plan is to mitigate the price impacts that customers would experience this heating season and future heating seasons due to price volatility in the natural gas commodity market.[94] The Mitigation Strategy Plan covers a 19-month period from December 1, 2000 through June 30, 2002. This would coincide with the completion of a rate consolidation plan resulting from the merger with Southern Union and the end of the extension period for the Price Stabilization Plan.[95]

With regard to the Gas Purchasing Program, its purpose is to establish gas-purchasing guidelines that will serve as a basis for evaluating the Companies' gas procurement performance. It is designed to indicate to the Companies the portion of their supplies that should be purchased at market-index prices and the portion that should be purchased using certain hedging instruments.[96] The gas purchasing guidelines are structured to allow Companies to hedge a larger portion of supplies when future wholesale gas prices are below the established

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[93] ProvGas Ex. 01-1, p. 1.
[94] Id.
[95] Id., p. 2.

benchmark and to purchase a larger portion of supplies on the spot market when future wholesale gas prices are above the established benchmark.[97] The primary hedging tools to be used by the Companies are fixed price agreements and cap-price agreements.[98] A fixed price agreement serves to lock in gas at a specific price for a specific quantity; the Companies noted that injection into storage should be considered a fixed price hedge.[99] A cap-price agreement establishes a maximum price for a specific quantity of gas that the Companies can purchase while retaining the right to purchase gas supplies below the set maximum price.[100] The Companies have also referred to this as a call option, and have noted that the Companies would seek to recover the premium paid for these cap-price agreements through the GCC and PGPA.[101]

The Gas Purchasing Program also established pricing, volume and timing parameters for the use of hedging tools. The pricing parameters establish the percentage of projected total monthly volumes that would be eligible for purchase using hedging tools based on NYMEX future prices.[102] The pricing parameters would be established at the time of the Companies' GCC or PGPA filings by setting a band of $1.00 (+/-) around the NYMEX monthly prices that underlie the GCC/PGPA factor.[103] The

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[96] Id.
[97] Id., p. 3.
[98] Id., pp. 3-4.
[99] Id.
[100] Id., p. 4.
[101] Id.
[102] Id., p. 5.
[103] Id.

volume parameters establish target percentages for the use of hedging tools for gas purchases based on the proportion of normal, firm gas supply.[104] If market prices are below the lower level of the band, the Companies would be allowed to utilize hedging tools to purchase gas at a higher percentage of volume, but if market prices are above the higher level of the band, the Companies would be allowed to utilize hedging tools to purchase gas at a lower percentage of volume.[105] The target hedging percentage would be achieved through dollar-cost averaging and discretionary purchases, and the Companies would make 40 percent of their gas purchases using a dollar-cost averaging approach so that the Companies would systematically purchase specified quantities of gas at pre-determined intervals at prevailing market prices.[106] Discretionary purchases would be made at a relatively uniform pace if commodity prices remain within the band of the price established at the time of the GCC/PGPA filing.[107]

In addition, the Companies proposed filing quarterly reports with the Division and Commission on their gas purchasing programs.[108] Furthermore, the Companies stated that cap-price agreements will not exceed 30 percent of hedged purchases, and the expenditures related to these cap-price agreements will be included in the GCC and PGPA.[109]

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[104] Id.
[105] Id., p. 6.
[106] Id.
[107] Id.
[108] Id., p. 7.
[109] Id.

In regards to the Gas-Price Mitigation Program, the Companies proposed to mitigate the price impacts that customers would experience during the winter of 2000-2001 because of the high prices of wholesale natural gas.[110] The Companies proposed to recalculate the GCC and PGPA factors to incorporate gas purchases over a 19-month period that would run December 1, 2000 through June 30, 2002, so that the GCC/PGPA factors for the coming winter would be lower. This would be done by averaging the relatively high gas costs expected for the winter of 2000-2001 with the lower gas cost purchases projected for the 2001-2002 heating season.[111]

Lastly, ProvGas proposed increasing the GCC factors as follows: $4.098 per Mcf for residential and small C&I customers; $8.439 per Mcf for medium/large C&I customers; and $8.176 for extra large C&I customers. The typical residential heating customer bill would increase from $1,216 to $1,369, an increase of $154 or 12.6%. Valley Gas proposed increasing the PGPA factor to $2.967 per Mcf which would increase the typical residential annual heating customer bill by $115 or 12.4%.

In support of the filing, the Companies submitted pre-filed testimony by Mr. James DeMetro. In his pre-filed testimony, Mr. DeMetro discussed a strategy for the Companies to mitigate increases in gas commodity costs to firm sales customers during the 2000-2001

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[110] Id.

heating season.[112] Mr. DeMetro explained that purchasing wholesale gas on the spot market ensures that customers will not pay more than the market price at the point the gas was purchased and therefore it eliminates the need to determine whether the price paid for the wholesale gas is reasonable but added it subjects customers to price volatility.[113] On the other hand, Mr. DeMetro noted that the cost of purchasing wholesale gas for future use may vary from the wholesale price at the time the gas is required. Therefore hedging mitigates price volatility by fixing prices at certain levels, but the fixed prices of the wholesale gas when it was purchased may be more or less than the prevailing market price for gas at that time it is required.[114] As a result, Mr. DeMetro argued that a hedging strategy requires the establishment of a structure that provides guidances in determining the reasonableness of the purchase prices for gas customers.[115]

Mr. DeMetro outlined the types of hedging tools available to the Companies such as fixed price and cap-price agreements.[116] Mr. DeMetro explained that if the Commission's objective was for customers to pay no more than market prices at any time then the spot market gas procurement approach would be appropriate, but if the Commission's objective was to mitigate price volatility and have stable rates then a

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[111] Id., pp. 7-8.
[112] ProvGas Ex. 01-2 (DeMetro's pre-filed testimony), p. 1.
[113] Id., pp. 3-4.
[114] Id., p. 4.
[115] Id.
[116] Id., p. 5.

hedging gas procurement approach would be appropriate.[117] Furthermore, Mr. DeMetro argued that because a hedging procurement approach establishes gas prices that may not coincide with market prices at the time of consumption, the Commission needed to approve a hedging program that included assurance that costs for hedging could be recovered in the GCC and PGPA factors.[118]

In addition, Mr. DeMetro described the structure of the Mitigation Strategy, which consists of a Gas-Purchasing Program and a Gas-Price Mitigation Strategy Plan that covers a 19-month period ending June 30, 2002.[119] Mr. DeMetro explained that the Gas Purchasing Program is designed to manage gas supply costs in a volatile market through hedging tools and spot market purchases. The purpose is to average price fluctuations and take advantage of market price declines.[120] Mr. DeMetro reiterated the pricing, volume and timing parameters for the Gas Purchasing Program discussed in the Mitigation Strategy Program filed with the Commission.[121] Mr. DeMetro also reiterated the details of the Gas-Price Mitigation Program relating to the calculation of the GCC and PGPA factors through June 30, 2002.[122]

In regard to the impact on gas procurement by the merger of ProvGas and Valley Gas with Southern Union, Mr. DeMetro suggested

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[117] Id., p. 6.
[118] Id., pp. 6-7.
[119] Id., pp. 8-9.
[120] Id., p. 10.
[121] Id., pp. 11-14.
[122] Id., pp. 14-16,

that the coordination of the gas-supply portfolios of the LDCs, purchased by Southern Union in Rhode Island and Massachusetts, would enable Southern Union to utilize peak-shaving facilities and peak-supply contracts more efficiently as well as economies of scale for gas purchasing.[123] Furthermore, Mr. DeMetro indicated that gas-cost savings could be achieved from the bundling of the gas-supply resources of the Companies and the solicitations of competitive bids for the opportunity to manage those resources after the expiration of the Mitigation Strategy Plan in June 2002.[124] In conclusion, Mr. DeMetro stated that if the Mitigation Strategy Plan was approved by the Commission, the Companies would make an additional contribution of $333,000 to LIHEAP. If the Commission disapproved the Mitigation Strategy Plan, then the Companies requested guidance as to the purchasing objectives that should be followed by the Companies.[125]

X. Division's December 2000 Rebuttal to the Companies' November 29, 2000 Filing

In response to the Companies' filing of November 29, 2000, the Division submitted additional pre-filed testimony by Bruce R. Oliver. Mr. Oliver stated that the months following September 2000 had shown NYMEX future prices for gas for the winter of 2000-2001 to be volatile,

[123] Id., pp. 16-17.
[124] Id., pp. 17-18.
[125] Id., pp. 18-19.

with a dramatic upward trend.[126] For instance, Mr. Oliver noted that NYMEX future prices for gas to be purchased in December 2000 and January 2001 were approximately $5.30 per MMBtu on September 26, 2000, about $4.50 per MMBtu near the end of October 2000, and then surged to $9.50 per MMBtu by December 11, 2000.[127] The Division supported the adoption of the Companies' proposed GCC and PGPA factors filed on November 29, 2000, but encouraged the Commission to take four additional actions.[128]

First, Mr. Oliver recommended that the Commission limit interest computed by the Companies on their deferred gas cost balances to a level more closely reflective of the Companies' cost of short-term debt.[129] For instance, the Companies were currently computing monthly carrying charges on deferred gas cost balances at the prime rate of 9.5%, which was above the cost of short-term borrowing and thus could unnecessarily inflate the costs to consumers especially if there were large under recovery balances.[130] The Division recommended that the carrying charge applied to the deferred gas cost balances be reduced to a level comparable to what ProvGas was paying on customer deposits, which was the rate paid on 10 year U.S. Treasury Bonds.[131] Mr. Oliver

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[126] Div. Ex. 01-02 (Oliver's additional pre-filed testimony), p. 2.
[127] Id., pp. 2-3.
[128] Id., p. 8.
[129] Id.
[130] Id., pp. 9-10.
[131] Id., p. 10.

estimated the reduction in the carrying charge rate would reduce costs to consumers over the 19-month period by approximately $450,000.[132]

Second, Mr. Oliver recommended the Commission deny the Companies the recovery of carrying costs on any under-recovery in gas costs that exceed the amount of deferred gas cost included in the Companies' proposed November 29, 2000 GCC and PGPA factors.[133] The Division stated that the Companies knew the Commission desired stable and affordable gas costs for consumers and that the Companies had a "fiduciary responsibility to actively pursue those goals in the gas procurement activities that they undertook on behalf of their customers".[134] Also, despite the Commission's desire for gas price stability expressed in this proceeding and prior proceedings, customers were, at the time, faced with wholesale gas costs that were 250% above the price in the Price Stabilization Plan and were 35% above the price in effect during the September hearings in these dockets.[135] Mr. Oliver argued that the Companies "have had clear opportunities to produce more stable and affordable" rates but they have failed to do so.[136] Also, Mr. Oliver estimated that this recommendation could result in ProvGas foregoing $1,675,000 of revenue for carrying charges.[137]

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[132] Id., p. 11.
[133] Id., p. 8.
[134] Id., p. 12.
[135] Id.
[136] Id.
[137] Id., pp. 13-14.

Third, Mr. Oliver recommended the Commission investigate other means of mitigating or phasing in any further GCC and PGPA increases that may be necessary before June 30, 2002 to avoid accumulation of a large under recovery at that time.[138] Mr. Oliver noted wholesale gas prices were volatile and had declined in late October 2000 at which time the Companies took advantage of a price dip to lock-in a portion of its winter 2000-2001 gas supply.[139] However, Mr. Oliver noted that the Companies had left about 50% of their normal winter gas supply unlocked and exposed to market volatility and that these "Companies would never pursue such risky strategies in activities" which would "impact their shareholders".[140]

Fourth, Mr. Oliver recommended that the Commission require ProvGas to explain and justify the derivation of forecasted sales volumes that were presented in their November 29, 2000 filing for the months of October 2001 through June 2002. In addition, if there is a need for adjustment of those sales volume figures, any resulting increase in the deferred gas cost balances should be carried by the Companies without carrying charges.[141] ProvGas presented large unexplained reductions in forecasted sales to small, medium and large C&I classifications in the updated Exhibit TSL-2, which could be based on the presumption that

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[138] Id., p. 9.
[139] Id., pp. 14-15.
[140] Id., pp. 15-16.
[141] Id., p. 9.

customers will shift from sales service to transportation service.[142] If ProvGas' forecast turned out to be incorrect, ProvGas would be forced to make additional spot market purchases of gas, even under normal weather conditions, which could have an adverse impact on ProvGas' overall cost of gas.[143] Accordingly, Mr. Oliver recommended that the Commission require any resulting increase in the ProvGas' deferred gas cost, due to ProvGas' underestimation of gas sales, to be carried without carrying charges.[144]

Lastly, Mr. Oliver noted that a typical ProvGas' residential heating customer bill would be increased on an annual basis from $1,060 to $1,369 or 29.2% since the conclusion of the Price Stabilization Plan.[145]

XI. December 13, 2000 Hearing

After public notice, a public hearing was held at the offices of the Commission, on December 13, 2000 at 100 Orange Street, Providence, Rhode Island. The following appearances were entered:

FOR COMPANIES:	John Partridge, Esq.
FOR DIVISION:	Paul Roberti, Esq. Assistant Attorney General
FOR OSRAM SYLVANIA:	Gregory L. Benik, Esq.
FOR COMMISSION:	Adrienne Southgate, Esq. General Counsel

[142] Id., pp. 17-18.
[143] Id., p. 18.
[144] Id.
[145] Id.

At the hearings, Mr. Timothy Lyons and Ms. Sharon Partridge testified on behalf of the Companies. Mr. Lyons stated that if the proposed GCC and PGPA factors were not implemented the under-collection for ProvGas would be $27.4 million and for Valley Gas would be $12.2 million.[146] Mr. Lyons emphasized that a delay in implementation of these GCC and PGPA factors would result in: 1) fewer volumes from which to recover the under-recovered wholesale gas costs; 2) the migration, in the long-term, of commercial and industrial customers to transportation service from sales; and 3) larger carrying costs for the under-recovered gas costs.[147] Mr. Lyons further noted that under the terms of ProvGas' tariff, C & I customers could migrate to transportation service from firm sales service without having to pay for their portion of the under-collection of gas costs.[148] The Commission requested that ProvGas alter the terms of its tariff to require C & I customers that migrate to transportation service to pay for their portion of the under collected wholesale gas costs.[149] Lastly, Mr. Lyons explained that the reduction in sales volume estimated by ProvGas in Exhibit TSL-2 filed on November 29, 2000, was due to unbundling, and if no further unbundling occurred, there would be "no material impact" in terms of the calculation of the GCC factor.[150]

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[146] Tr. 12/13/00, p. 40.
[147] Id., pp. 41-43.
[148] Id., p. 49.
[149] Id., pp. 51, 77.
[150] Id., pp. 71-72.

The Division agreed that the proposed GCC and PGPA factors should go into effect on an interim basis on December 15, 2000.[151] The Division counsel also argued that the Companies, by law did not need Commission approval to procure gas. Counsel for the Companies agreed to provide a memorandum of law on the issue of whether the Companies are required to obtain prior Commission approval before implementing a hedging or mitigation strategy.[152]

At an open meeting on December 15, 2000, the Commission approved to go into effect December 15, 2000, on an interim basis subject to refund and further investigation, the ProvGas GCC factors of $4.098 per Mcf for residential and small C&I customers, $8.439 per Mcf for medium C&I customers, and $8.176 per Mcf for extra large C&I customers, as well as the Valley PGPA factor of $2.967 per Mcf.[153]

XII. Division's Review of the Mitigation Strategy Plan

In response to the Companies' Mitigation Strategy Plan, the Division submitted pre-filed testimony by Richard W. LeLash, an outside consultant. Mr. LeLash recommended approval of the Companies' Gas Purchasing Program subject to certain modifications such as: (1) the adoption of a phase-in for non-discretionary purchase of gas; (2) the adoption of quarterly reporting of gas procurement activities and

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[151] Id., pp. 31, 131.
[152] Id.
[153] The Commission approved these factors less than 30 days after they were filed as required by R.I.G.L. § 39-3-11 because they are wholesale "pass through" costs subject to an existing tariff. These GCC & PGPA factors were publicly noticed and hearings

quarterly review of gas pricing benchmarks and a procedure for updating these benchmarks; and (3) the recognition that the Companies remain responsible for demonstrating the reasonableness of their gas procurement activities and that compliance with the general outline of the Gas Purchasing Program "does not imply automatic pass-through to consumers of all gas procurement costs that the Companies may incur."[154]

Mr. LeLash noted that a gas-purchasing program should seek to reduce the impact of wholesale gas price volatility through the setting of minimum and maximum constraints on the levels of hedged purchases of gas.[155] Over the long-term, Mr. LeLash explained that the Companies would be responsible to purchase gas supply "through storage, fixed price supplies, and market priced supplies in approximately equal proportions" but these proportions should be subject to adjustment based on market conditions as to price levels and volatility.[156] As to the extent and nature of gas price hedging to be done by the Companies, Mr. LeLash stated that the greater the expertise of the Companies, the greater the proportion of discretionary hedges by the Companies.[157] Accordingly, Mr. LeLash concluded that the Companies' Gas Purchasing Program appeared reasonable because the program significantly relied

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were conducted. Furthermore, delay in implementation would have resulted in the loss of the opportunity to bill for these gas costs during the peak of the heating season.

[154] Div. Ex. 01-1 (LeLash's pre-filed testimony), pp. 6-7.

[155] Id., pp. 7-8.

[156] Id., p. 8.

[157] Id., p. 9.

upon non-discretionary hedging, and where there is discretionary hedging, the parameters are based on monthly pricing levels.[158]

Mr. LeLash expressed concern over the near term transition into the program in particular because "hedging is most appropriate in periods of rising prices and least appropriate when prices are falling."[159] As a result, Mr. LeLash suggested that the initial hedging target be moderated and that until September 2001, the Companies' hedging targets be adjusted to 50% of the levels set forth in the proposed Gas Purchasing Program. Regarding the hedging activities for next winter, October 2001 through March 2002, it should be proportioned to 75% of the levels proposed in the Gas Purchasing Program.[160] In the event of further material declines from recent price trends such as occurred at the end of October 2000, he recommended that these proportionate hedging targets be augmented.[161]

Mr. LeLash emphasized that many LDCs were considering extensive hedging programs and that the purchase of wholesale gas at "indexed rates" should not be presumed to be prudent.[162] Also, Mr. LeLash explained that Commission approval of the Gas Purchasing Program would not constitute pre-approval of the Companies' gas procurement activities but instead would give the Companies guidance

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[158] Id., pp. 9-10.
[159] Id., p. 10.
[160] Id., pp. 10-11.
[161] Id., p. 11.
[162] Id., pp. 14-15.

for future procurement evaluation and would reduce the Companies' concerns of regulatory "second guessing."[163]

XIII. The Companies' Additional Testimony and Memorandum of Law for the January 22 and 23, 2001 Hearings

To further support their Mitigation Strategy Plan, the Companies submitted the pre-filed testimony of John J. Reed, an outside consultant from Navigant Consulting. Mr. Reed stated that the rapid increase in wholesale natural gas prices "was a surprise to all" and that most state regulators have approved immediate pass through of these high prices.[164] Mr. Reed indicated that the Mitigation Strategy Plan would require hedging, which is a risk management activity, whereas speculation is the purchase of gas "at a fixed price simply because of a perception or conviction that the market is going up."[165] Mr. Reed explained that hedging will not always result in the lowest prices but "is intended to bring certainty to gas costs."[166] If the Gas Purchasing Program was to be approved, Mr. Reed predicted that the cost of gas purchased by the Companies "will be much more stable than it is currently", but it will not necessarily be the lowest cost of gas available for consumers.[167] Mr. Reed argued that the Gas Purchasing Program required Commission approval prior to implementation because it "represents a significant

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[163] Id., p. 18.
[164] Companies Ex. 01-3 (Reed's pre-filed testimony), pp. 6-7.
[165] Id., pp. 18-19.
[166] Id., p. 22.
[167] Id., p. 25.

deviation from past gas purchasing practices."[168] Mr. Reed concurred that the Commission could evaluate and pass judgment on the Companies' actions but the standards should be known in advance and that the Gas Purchasing Program establishes the necessary standards.[169]

As for incentive mechanisms regarding the Companies' gas purchasing decision, Mr. Reed argued that incentives should be linked to those gas cost elements over which the Companies have some control, as opposed to the element of wholesale gas costs.[170] In general, Mr. Reed concurred with the suggestions of Mr. LeLash in his pre-filed testimony but he recommended that the parties draft an Appendix which clearly set forth the procurement standard, the procedure for determining and revising the benchmarks, the frequency and content of the reports to be filed by the Companies, and assurance that prudently incurred gas costs and risk management costs will be collected through the GCC.[171]

The Companies also submitted pre-filed testimony by Kenneth Hogan, a Senior Vice President for the New England Division of Southern Union, wherein he addressed the issue of the appropriate interest rate to be applied to the deferred gas cost account in the Companies' GCC and PGPA tariffs. Mr. Hogan stated that the Prime Rate, currently used in the GCC and PGPA tariffs had been in effect for at least 18 years and represented a publicly-available means of calculating carrying costs on

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[168] Id., pp. 27-28.
[169] Id., p. 29.
[170] Id., p. 30.

deferred gas cost balances.[172] Mr. Hogan argued that the Prime Rate was more consistent with the rate necessary to finance the extended deferred gas cost balance for over 12 months.[173] Mr. Hogan explained that the use of a short-term borrowing rate for deferred gas costs would not be consistent with the Price Stabilization Plan approved in Docket 2581 and would "reduce ProvGas' return on equity ("ROE") since the short-term debt that is used to fund the deferred gas cost requirements is also used to fund rate base requirements."[174] If the Commission approved the Division's proposal to lower the interest rate on the deferred gas cost account, Mr. Hogan requested that it would be appropriate to re-evaluate the Companies' capital structure in a rate hearing.[175] If the Commission were to lower the interest rate on deferred gas costs, Mr. Hogan recommended that the Commission adjust the Prime Rate downwards by 75 basis points. Because the deferred gas cost balance under the Gas Price Mitigation Plan would extend through June 2002, Mr. Hogan stated that an intermediate term rate would be more appropriate than a short-term interest rate, which is used to finance assets for less than one year.[176]

In addition, counsel for the Companies filed a memorandum of law as to whether it is necessary to obtain Commission approval to

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[171] Id., pp. 31-33.
[172] Companies Ex. 01-4 (Hogan's pre-filed testimony), p. 2.
[173] Id., p. 4.
[174] Id., pp. 4-5.
[175] Id., p. 6.
[176] Id., pp. 6-7.

undertake gas procurement activities. Counsel for the Companies noted that the Commission has the regulatory authority pursuant to R.I.G.L. § 39-1-1 and 39-3-11 to set just and reasonable rates.[177] The Companies asserted that gas procurement is within the management prerogative but that the Commission has a general oversight role in gas procurement because gas procurement could "unreasonably and unjustly" affect ratepayers.[178] Accordingly, the Companies should seek Commission approval for its gas procurement approach if the "Company proposed a fundamental deviation from approved practices" and if there could be "serious impacts on the public".[179] Counsel for the Companies referred to the Pilot Hedging Program approved in 1996, and the three-year fixed-price agreement approved in 1997 as "deviation" as well as "novel and precedent-setting" approaches to gas procurement.[180] Citing these examples, counsel for the Companies argued that "it would be unwise for the Company to unilaterally and fundamentally change its gas purchasing strategies without first seeking ...the Commission's approval".[181] Furthermore, counsel for the Companies articulated that the Companies' historic strategy for wholesale gas procurement was purchases based on a "frequent and current market price basis", and therefore a "fundamental change in gas purchase strategy" such as the

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[177] Companies' Memorandum of Law 1/22/01, pp. 3-4.
[178] Id., pp. 2, 12; quoting Providence Water Supply Board v. Public Utilities Commission, 708 A.2d 537, 543 (R.I. 1998).
[179] Id., p. 12.
[180] Id., p. 13.
[181] Id., p. 15.

Gas Purchasing Program should be approved by the Commission prior to implementation.[182]

XIV. The Hearings of January 22, & 23, 2001

After public notice, a public hearing was held at the offices of the Commission at 89 Jefferson Boulevard, Warwick, Rhode Island on January 22 and 23, 2001. The following appearances were entered:

FOR COMPANIES:	John J. Partridge, Esq.
FOR DIVISION:	Paul Roberti, Esq. Assistant Attorney General
FOR COMMISSION:	Steven Frias, Esq. Senior Legal Counsel

On January 22, 2001, the Companies had Mr. DeMetro and Mr. Reed testify regarding the Companies' Mitigation Strategy Plan. Mr. DeMetro stated for many years the Companies' had been purchasing gas at prices that reflected the market at the time the gas was needed and therefore the Gas Purchasing Program "departs radically from past practices" and requires pre-approval by the Commission.[183] Mr. DeMetro agreed that the Gas Purchasing Program does not sanction the action of locking in, on a single day, 100 percent of the Companies' gas needs at a fixed price.[184] Mr. DeMetro stated that the benchmark price was the GCC and PGPA factors set on December 15, 2000, and indicated that the Companies would raise the benchmark if "prices could go up or start to

[182] Id., pp. 18, 20.
[183] Tr. 1/22/01, p. 38.
[184] Id., p. 44.

climb", or if there was information that suggests "that for some period of time, six months, eight months, twelve months, prices are going to stay up."[185]

Mr. DeMetro concurred that the objective of the Gas Purchasing Program is to create stable rates in response to the price volatility of the wholesale gas market while in the past the Companies had argued that their policy was to obtain the lowest price gas available on the spot market.[186] If there was price volatility in the wholesale gas market and it "was anticipated to continue for some extended period of time" then Mr. DeMetro agreed that the Companies would pursue the objective of achieving stable rates.[187] Also, it was Mr. DeMetro's opinion that "an example of bad judgment" by the Companies "would be speculating" which is "to take an action based on an assumption" that "prices will go up or down".[188] Also, Mr. DeMetro concurred that approval of the Gas Purchasing Program does not insulate the Companies from a prudence review of the gas costs incurred.[189] Mr. DeMetro emphasized that higher wholesale gas costs harms the Companies because its under-collection increases.[190] Lastly, Mr. DeMetro stated that an incentive plan for the Companies to keep costs down should not be limited to just gas

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[185] Id., pp. 62, 67-68.
[186] Id., pp. 84-85.
[187] Id., p. 87.
[188] Id., p. 93.
[189] Id., pp. 126-127.
[190] Id., p. 131.

commodity costs but should encompass the overall cost of gas to the customer.[191]

In addition, Mr. Reed testified that the Gas Purchasing Program essentially has three components of approximately 40 percent for non-discretionary lock-in gas purchases, approximately 30 percent for additional discretionary lock-in gas purchases, and approximately 30 percent of gas purchases from the spot market.[192] Mr. Reed indicated that the adoption of the Gas Purchasing Program would provide stable and predictable gas prices but not necessarily the lowest gas price available on the spot market.[193] Mr. Reed concurred that a least gas cost strategy would be pursued for the 30 percent of gas purchases made on the spot market.[194] Also, Mr. Reed pointed out that a large under-collection is harmful because of the addition of carrying charges, failure to encourage conservation, and the creation of "intergenerational disequities" between customers coming onto and leaving the system.[195] Mr. Reed elaborated that speculation would occur if the Companies were to decide one day to purchase wholesale gas for "six months at the index" but then decided "to wait two months" before acting on this decision due to the belief that "the market will improve in those two months."[196] Mr. Reed testified that an incentive plan should involve virtually all elements

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[191] Id., pp. 144-145.
[192] Id., p. 257.
[193] Id., p. 265.
[194] Id., pp. 277-278.
[195] Id., pp. 279-280.
[196] Id., pp. 286-287.

of gas costs including wholesale commodity charges. Such a plan could be adopted for the Companies in the merger rate case.[197]

At the hearing, Mr. LeLash and Mr. Oliver testified on behalf of the Division. Mr. Oliver stated that the "timing of the purchases both within a month and over a period of months" is an area of discretion for the Companies subject to a prudence review by the Commission.[198] In addition, Mr. Oliver noted that how the Company "managed its storage resources" was an area of great discretion for the Companies and subject to a prudence review as well.[199] Mr. LeLash noted that many LDCs failed to hedge in 2000 because they anticipated wholesale gas prices would become lower and that this failure to act was inappropriate.[200] Mr. LeLash and Mr. Oliver felt that the proposed Gas Purchasing Program struck a proper balance between a price stability strategy and a least cost strategy.[201] Mr. Oliver noted that since the spring of 2000, the Companies had the opportunity to introduce dollar cost averaging to gas procurement on their own initiative and failed to do so. He further noted that although hedging is less useful when prices are declining, it becomes an "important tool" when prices are rising.[202]

The hearing resumed on January 23, 2001 and addressed the issue of the appropriate interest rate to be applied to the deferred gas

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[197] Id., pp. 292-293.
[198] Id., p. 157.
[199] Id., p. 170.
[200] Id., pp. 171-172.
[201] Id., pp. 112-183,
[202] Id., pp. 193, 248.

cost account. Mr. Hogan testified on behalf of the Companies. Mr. Hogan stated that a short-term rate for the deferred gas account would be inappropriate and an intermediate-term rate was more reasonable. Furthermore, he stated that a change in the interest rate should be done in the context of a rate hearing when the capitalization structure of the Companies is determined.[203] Mr. Hogan admitted that ProvGas has maintained a short-term debt balance in excess of 11 million for all months since September 1999, and that Valley has likewise maintained a short-term debt balance in excess of 3 million for all months since January 1999.[204] Mr. Hogan also acknowledged that in the early 1980s, when the Prime Rate was established in the GCC and PGPA tariffs, the short-term borrowing rate was equal to the Prime Rate.[205] Mr. Hogan explained that in economic conditions at the time of this hearing, the short-term borrowing rate was approximately 200 basis points (2 percent) below the Prime Rate.[206] Mr. Hogan admitted that for fiscal year 2000, the short-term debt rates of ProvGas were between 5.50 percent and 6.91 percent and the rates for Valley were between 5.38 percent and 7.40 percent.[207]

Mr. Oliver testified on behalf of the Division. Mr. Oliver indicated that the capital structure of ProvGas is not fixed.[208] Also, Mr. Oliver

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[203] Tr. 1/23/01, pp. 16-18.
[204] Id., pp. 51-52.
[205] Id., pp. 56-57.
[206] Id., p. 58.
[207] Id., p. 118.
[208] Id., pp. 129-130.

indicated that the purpose of the interest rate charged in the GCC and PGPA tariff is only to cover carrying charges.[209] Mr. Oliver disagreed with the use of an intermediate-term rate because the duration and the magnitude is not known for the deferred gas cost balance.[210] Also, Mr. Oliver stated the Companies could have a short-term debt rate for the deferred gas cost account by maintaining lines of credit with various banks.[211] Mr. Oliver testified that most states use a short-term borrowing rate for deferred gas cost accounts and some jurisdictions such as New Jersey do not allow any carrying charges on any deferred gas costs as an incentive to buy gas cheaper.[212] After a recess, the parties indicated they had reached an agreement on the interest rate for the GCC and PGPA tariffs.[213]

XV. Modifications to the Mitigation Strategy Plan and the Settlement of the GCC and PGPA Interest Charge

On January 30, 2001, the Division submitted a letter to the Commission specifically indicating its modifications to the Companies' Mitigation Strategy Plan. The first modification was: the adoption of a phase-in for non-discriminatory purchases of gas under which the minimum hedging volume should be adjusted to 20% for each month beginning April 2001 through September 2001, then to 30% for the months of October 2001 through March 2002, and then the full 40% be

[209] Id., p. 131.
[210] Id., pp. 161-162.
[211] Id., pp. 163, 174-175.
[212] Id., p. 182.

achieved by April 2002.[214] The second modification was: the adoption of requirements for quarterly reporting of gas procurement activities and quarterly reviews of gas pricing benchmarks, as well as the establishment of a procedure for updating those benchmarks when requested by the Companies and determined by the Commission to be appropriate.[215] The third modification was: the recognition that the Companies remain responsible for demonstrating that they have implemented their gas purchasing in a reasonable manner and that the results are consistent with the objectives of the plan. Further, the Companies' adherence to the general outlines of the adopted Gas Purchasing Program would not imply automatic pass-through to consumers of all gas procurement costs that the Companies may incur.[216]

Also, the Division supported Mr. Reed's suggestion that a short period of time be permitted after Commission approval of the Gas Purchasing Program for the parties to refine technical implementation parameters for the Plan.[217] Lastly, the Division indicated that the issue of the understatement of C&I sales volumes, which could cause the Companies' purchasing targets to be inappropriately low, be addressed by the parties in the efforts to refine the parameters of the Plan.[218]

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[213] Id., pp. 189-190.
[214] Division's letter dated 1/30/01, p. 1.
[215] Id., p. 2.
[216] Id.
[217] Id.
[218] Id.

On February 9, 2001, the Division and the Companies filed a settlement agreement on the issue of the appropriate interest rate to be applied to the deferred gas cost account in the GCC and PGPA tariffs. The parties agreed that the GCC and PGPA tariffs be modified to change the use of the Fleet prime interest rate in the deferred gas cost calculation to be Fleet Prime less 200 basis points (2 percent) effective March 1, 2001.[219] The parties also agreed that the calculation of the return on equity in the earnings report filed with the Commission by ProvGas pursuant to the Price Stabilization Plan be modified to reflect the use of short-term debt to fund deferred gas costs and that specifically, the short-term portion of the capital structure be adjusted to exclude that portion of average short-term debt balance associated with the average deferred gas cost balance.[220] Lastly, the adjusted capital structure would be used for calculation of common equity applicable to rate base and return on common equity.[221]

At an open meeting on February 21, 2001, the Commission approved the Mitigation Strategy Plan, including the Gas Purchasing Program and Gas Price Mitigation Plan, as modified by the Division's January 30, 2001 filing and in addition, reserved the right to extend the Gas Price Mitigation Plan beyond June 30, 2002, in order to avoid

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[219] GCC and PGPA Interest Rate Settlement, p. 2.
[220] Id., pp. 2-3.
[221] Id., p. 3.

additional GCC or PGPA factor increases.[222] In addition, the Commission approved the settlement on the change in the interest rate for the GCC and PGPA tariffs.[223]

XVI. Notice for the Prudence Review Hearings

On February 9, 2001, counsel for the Companies filed a memorandum of law regarding the appropriate notice needed for a Commission inquiry into the prudence of the Companies' actions to procure gas for the winter heating season of 2000 to 2001. Counsel for the Companies stated that R.I.G.L. § 39-3-11 is "comprised of two separable parts" the first of which deals with "a rate change application by a utility", and the second is to "monitor tariff provisions" by holding public hearings and conducting an investigation.[224] The Counsel for the Companies argued that an investigation into tariff provisions under R.I.G.L. § 39-3-11 is a contested case set forth in the Administrative Procedures Act pursuant to R.I.G.L. § 42-35-9, and therefore a party shall receive notice which "in plain terms draws attention to...the subject matter being considered at the hearing."[225]

Accordingly, the Companies indicated that a new notice should be issued stating that the Commission will conduct an inquiry into the propriety of gas purchases made by the Companies during the period of

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[222] The Companies' Mitigation Strategy Plan filed November 29, 2000 and the Division's letter of January 30, 2001 are attached as Appendix A hereto and incorporated by reference herein.
[223] The settlement filed February 9, 2001 is attached as Appendix B hereto and incorporated by reference herein.
[224] Companies' Memorandum of Law, 2/9/01, pp. 3-4.

October 1, 2000 through March 1, 2001.[226] In addition, the Companies requested that the investigation into the prudence of the Companies' gas procurement activities be made a separate docket because: (1) the nature of the proceeding would be extremely fact-specific involving issues of management prerogatives; (2) the discovery process would need to become focused; (3) it would be a highly contested case; and (4) it would not seem inappropriate to have this investigation in the context of a purchase gas adjustment tariff.[227]

In response, on March 9, 2001, counsel for the Division filed a memorandum of law stating that the public notices already issued by the Commission were adequate and that a new docket to investigate the propriety of the Companies' procurement practices would not be appropriate. At the outset, counsel for the Division noted that at no time during the hearings of September 26-27, 2000 did the Companies contest or object to the adequacy of the notice or the questioning of the Companies' witnesses regarding their procurement activities.[228] Counsel for the Division argued that adjustment clauses such as the GCC and PGPA, in which wholesale costs are incurred, do not require an automatic change in retail rates because these adjustment clauses are subject to investigation by the Commission pursuant to R.I.G.L. § 39-3-

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[225] Id., pp. 4-6, citing Providence Gas Co. v. Burke 119 R.I. 487 (1977).
[226] Id., p. 10.
[227] Id., pp. 11-13. The Companies conceded that the opening of a separate docket is subject to the judgment of the Commission. Id., p. 11, citing Providence Gas Co. v. Malachowski 656 A.2d 949 (R.I. 1995).
[228] Division's Memorandum of Law, 3/9/01, p. 1, fn. 2.

11.[229] The Division argued that since 1995, the Commission has evaluated the prudence of the Companies' gas procurement decisions. At no time during the course of those proceedings did the Companies ever state any objection that the notices were inadequate or that a prudence review was outside the scope of the GCC and PGPA proceedings.[230] In regard to the notices in these dockets, counsel for the Division noted that the notices mentioned a "review" of the GCC and PGPA factors and he further cautioned the Commission on the precedent of identifying the specific scope of inquiry by placing "arbitrary dates" in notices as well as the difficulty of issuing a new notice on every instance a new issue is identified during the proceeding.[231] Lastly, counsel for the Division warned that the transfer of the investigation into the Companies' gas procurement activities into a separate docket would cause the Commission to run "the risk of exceeding its jurisdiction" because the Commission's authority to investigate the propriety of rates and monitor tariffs pursuant to R.I.G.L. § 39-3-11 is in reference to a rate proceeding.[232]

Upon review of the memoranda of law, Chairman Germani, the presiding commissioner in these dockets, denied the requests of the Companies. Chairman Germani noted that in the past proceedings and

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[229] Id., pp. 2-3, citing Narragansett Electric Company v. Burke, 381 A.2d 1358 (R.I. 1977).
[230] Id., pp. 4-6, citing Order No. 14567 dated 2/24/95 in Docket 1673, pp. 2-3 as well as Order No. 16031 dated 1/18/00 in Docket 1736, pp. 3-5.
[231] Id., pp. 7-9.
[232] Id., pp. 9-10.

during the hearings of September 26-27, 2000, the Companies never objected to the notice or inquiries into the propriety or prudence of the Companies' gas procurement activities. Also, Chairman Germani determined that notice was adequate because a prudence review of the Companies' gas procurement activities is implicit in these dockets. Furthermore, Chairman Germani decided that it would be unnecessary to open a separate docket. Lastly, Chairman Germani concluded that any further hearings in these dockets could involve inquiries into the prudence of the Companies' actions to procure gas for the winter period of 2000-2001.

XVII. Companies' Rebuttal to Prudence Review

On March 2, 2001, the Companies submitted pre-filed testimony by John Reed; pre-filed testimony was amended on March 15, 2001. In his pre-filed testimony, Mr. Reed articulated a prudence standard in which there exists a "presumption of prudence" with regards to a utility's expenditure and furthermore, a determination of imprudence requires "clear evidence of misconduct by the utility" such as dishonest or obviously wasteful expenditures.[233] In determining if a utility's actions were prudent, Mr. Reed recommended the following four principles.[234] The first principle is a "presumption of prudence" in which a utility's

[233] J. Reed's pre-filed testimony of 3/2/01, p. 2, citing the concurring opinion of Justice Brandeis in Missouri ex. Rel. Southwestern Bell Telephone v. Public Service Commission 262 U.S. 276 (1923).
[234] Id., Mr. Reed identified these four principles based upon the National Regulatory Research Institute's publication entitled The Prudent Investment Test in the 1980s, NRRI 84-16.

investment is "assumed" to be reasonable.[235] The second principle is "reasonableness of circumstances" in which the utility's action is "evaluated in light what was known at the time the decisions were made."[236] The third principle is a "prescription against hindsight."[237] The fourth principle is a "retrospective, factual inquiry" in which a "record of facts" as they "existed at the time of the utility's decision was made" is used to measure and evaluate the utility's decisions.[238] In general these four principles demonstrate two related concepts: the prudence standard applies to decisions not results; and that cost cannot be imprudent, only actions.[239]

Next Mr. Reed discussed the gas purchasing standards in Rhode Island. Mr. Reed noted that in Rhode Island that there is no "formal gas purchasing standard" because although the Commission is statutorily responsible for ensuring just and reasonable rates, the Commission has expressed different objectives on gas costs.[240] Also, the Commission has approved major initiatives in gas purchasing prior to implementation, but the Companies have purchased gas on a short-term basis on the spot market without prior Commission approval.[241] Accordingly, Mr. Reed found the purchase of gas on the spot market to be reasonable and the purchase of gas at a price that subsequently proves to be higher than

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[235] Id., p. 3.
[236] Id.
[237] Id., p. 4.
[238] Id.
[239] Id.
[240] Id., p. 6.

the market price to be risky because the gas costs could be subsequently disallowed.[242] In general, Mr. Reed noted that prior Commission approval was sought when there was a "shift in utility purchasing practices" from a lowest priced gas available on the spot market to a long-term fixed price agreement.[243]

Based on Mr. Reed's review of the wholesale gas market since the end of September 2000, he concluded that the Companies actions were prudent because the high prices could have declined and he estimated that the Companies' hedging activities mitigated the impact of gas price volatility by approximately $5.5 million.[244] Also, Mr. Reed stated the Companies could not divine the Commission's intent and characterized Mr. Oliver's approach as the use of hindsight to judge the Companies' actions.[245] Furthermore, Mr. Reed stated that "the use of extensive risk management techniques by LDCs is the exception rather than the norm."[246] In conclusion, Mr. Reed found that Mr. Oliver's recommendation to deny some of the carrying costs in the deferred gas account to be arbitrary and that the Companies' decisions were prudent given the information available at the time the decisions were made.[247]

XVIII. Implementation Plan of the Gas Purchasing Program

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[241] Id.
[242] Id., pp. 7-8.
[243] Id., p. 9.
[244] Id., p. 12.
[245] Id., pp. 15-16.
[246] Id., pp. 18-19.
[247] Id., pp. 21-22.

On May 30, 2001, the Companies filed the Implementation Plan of the Gas Purchasing Program approved by the Commission.[248] The Companies stated that the Implementation Plan was developed in consultation with and had the support of the Division. The Implementation Plan indicated that the benchmark was the NYMEX prices as of November 17, 2000 that were used in the development of the currently effective GCC/PGPA rates.[249] Also, the Companies will provide quarterly reports which will include discretionary and non-discretionary purchases, monthly estimated purchase volumes, locked volumes and prices, dollar cost averaging price, and assessment of gas cost deferral balances including the estimated deferral balance as of June 30, 2002.[250] In addition, all hedging quantities are considered minimums and the Companies, with notification to Division, can add to the prescribed minimums.[251] Furthermore, the percentage of non-discretionary purchase hedges will increase gradually from 20% to 40% by April 2002, but as to discretionary purchase hedges, of 10% to 30%, the Companies have broad latitude as to the timing of the purchases.[252] In the area of cash market purchases, which range from 50% to 30%, the Companies may use call options or collars and thereby exceed the hedged percentages of the Gas Purchasing Program if a certain month appears to

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[248] Implementation Plan filed on May 30, 2001 is attached as Appendix C hereto and incorporated by reference herein. Under this Plan, the Gas Purchasing Program commenced on April 1, 2001.
[249] Implementation Plan, p. 1.
[250] Id.
[251] Id.

be particularly vulnerable to a price spike.[253] Lastly, the forecast of gas purchase requirements for firm customers was revised to reflect the latest estimates of migration to transportation.[254]

XIX. Settlement of the Prudence Review

On June 15, 2001, the Division and the Companies reached a settlement regarding the inquiry into the propriety of gas procurement by the Companies for the winter heating season of 2000-2001.[255] Under the settlement, ProvGas will immediately reduce the Deferred Gas Cost Account of the GCC by $795,600 from the weather mitigation revenues credited to the Deferred Revenue Account during the winter season of 2000-2001.[256] ProvGas also agreed to absorb the increased risk for warmer than normal weather by reducing the threshold for weather mitigation under warmer than normal conditions from 4,857 degree days, or 2% warmer than normal, to 4,807 degree days, or 3% warmer than normal.[257] The Companies will also contribute $500,000 to reduce their Deferred Gas Cost Account balances.[258]

XX. Division's Support for the Settlement

On June 15, 2001, the Division submitted the pre-filed testimony of Stephen Scialabba, the Division's Chief Accountant. Mr. Scialabba

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[252] Id., pp. 1-3.
[253] Id.
[254] Id.
[255] A copy of the settlement is attached as Appendix D hereto and incorporated by reference herein.
[256] Joint Ex. 01-1, p. 6.
[257] Joint Ex. 01-1, p. 6.
[258] Id., pp. 6-7.

outlined the four recommendations made by the Division through Mr. Oliver in December 2000.[259] The first recommendation, a reduction in the interest rate on deferred gas cost balances, was addressed in a settlement to reduce the interest rate by 200 basis points (2 percent) which was approved by the Commission.[260] The third recommendation, the mitigation or phase in of any further GCC/PGPA increases to avoid the accumulation of a large under-recovery in the gas cost account, was addressed through the Gas Purchasing Program because future prices for gas are now below the current GCC/PGPA factor.[261] Mr. Scialabba also mentioned that the Companies would soon file a tariff provision that would ensure that eligible C&I customers pay their fair share for the gas they consumed so as to reduce the under-recovery if the customer leaves for transportation service.[262] The fourth recommendation, the justification of forecasted sales volume in the November 29, 2000 filing, was addressed in the Implementation Plan for the Gas Purchasing Program.[263]

The second recommendation, the denial of recovery for carrying costs for a deferred balance that exceeded the projected balances in the Companies' CGG/PGPA factor, is the focus of the settlement with the Companies.[264] The recommendation was made because the Companies'

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[259] Div. Ex. 01-4 (Scialabba's pre-filed testimony), p. 2.
[260] Id., pp. 2-3.
[261] Id., p. 3.
[262] Id., pp. 3-4.
[263] Id., p. 4.
[264] Id.

gas procurement activities had left customers excessively exposed to volatile prices and the denial of carrying charges would discontinue the pass-through of costs to consumers with no financial harm to the Companies for their gas procurement.[265]

Mr. Scialabba stated that the main element of the settlement was the contribution of $500,000 from shareholders to the deferred gas cost balances of ProvGas and Valley.[266] In addition, the credit balance of $795,600 in the ProvGas Deferred Revenue Account, as a result of the settlement in Docket No. 2581, will be applied to the deferred gas cost account immediately instead of being returned to customers at the conclusion of the Price Stabilization Plan.[267] Also, ProvGas' shareholders would assume additional weather risk of up to $390,000 by increasing the warm weather band with from 2% to 3%.[268] Furthermore, Mr. Scialabba noted that in Order No. 16584 in Docket 2581, the Commission lowered ProvGas' allowed return on equity from 10.9% to 10.7%, approximately $200,000, due to ProvGas' gas procurement activities.[269] In addition, the shareholders contributed $333,000 to LIHEAP when the Commission approved the Mitigation Strategy Plan.[270]

XXI. June 21, 2001 Hearing

[265] Id., pp. 4-5.
[266] Id., p. 6.
[267] Id.
[268] Id., pp. 7-8.
[269] Id., pp. 9-10.
[270] Id., p. 10.

After due notice, a public hearing was held at the offices of the Commission at 89 Jefferson Boulevard, Warwick, Rhode Island. The following appearances were entered:

FOR COMPANIES:	John J. Partridge, Esq.
FOR DIVISION:	Paul Roberti, Esq. Assistant Attorney General
FOR COMMISSON:	Steven Frias, Esq. Executive Counsel

At the hearing, Mr. Stephen Scialabba and Ms. Sharon Partridge, Vice President for New England Division of Southern Union testified in support of the settlement. Mr. Scialabba explained that the $500,000 contribution from shareholders in the settlement approximates the amount of carrying charges that would have been disallowed if Mr. Oliver's recommendation was adopted because gas prices and interest rates had declined since December 2000.[271] Mr. Scialabba noted that the Companies' combined net income as of September 2000 was $6,472,000 while the amount of $500,000 from shareholders, $390,000 denied to shareholders if there is warmer than normal weather, and $333,000 from shareholders to LIHEAP constitutes 18.8% of combined net income.[272] Mr. Scialabba also noted that the increase from 2% to 3% in the weather bandwidth is a real risk to ProvGas because in the three winters prior to the winter 2000-2001, the percentage exceeded 2%.[273]

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[271] Tr. 6/21/01, pp. 22-23.
[272] Id., pp. 24, 36.
[273] Id., p. 64.

Ms. Partridge indicated that due to the reduction of the interest rate by 200 basis points in the GCC/PGPA tariffs, the ratepayers are estimated to save $768,000 of which, $171,000 had already been saved between March and May 2001.[274]

She admitted that in the fall of 1999 she "understood" that "the Commission was looking for...price stability".[275] Henceforth, Ms. Partridge explained that if the Companies saw an "extremely favorable price" they would "just lock the prices in" and be "very proactive".[276]

At the hearing, Mr. Gary Beland, Assistant Vice President for the New England Division of Southern Union was called to testify. Mr. Beland stated that in the summer of 1999, ProvGas felt it "was important to get at least some portion of prices locked in on some basis".[277] Mr. Beland indicated that what ProvGas was looking at in the summer of 1999 was a long-term fixed price contract as well as a hedging program like the Gas Purchasing Program approved by the Commission.[278] Mr. Beland admitted that purchasing based on current market prices "obviously subjects customers to price risk" and admitted he purchased gas in anticipation that the price was going up.[279] Mr. Beland admitted that in early 2000 ProvGas wanted to lock in gas supply in the range of $2.50 per Mcf, but only started "to hedge against the possibility of severe

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[274] Id., pp. 29, 75.
[275] Id., p. 41.
[276] Id., p. 37.
[277] Id., p. 108.
[278] Id., p. 116.
[279] Id., pp. 117, 119.

price spikes" in the summer of 2000.[280] Mr. Beland recommended in January 2000 that ProvGas not lock-in its gas supply because he felt prices were high and the company would not "do any worse by waiting".[281] Mr. Beland concurred it would be inappropriate for an LDC to speculate and he defined speculation as "betting that the market is going to move in one particular direction or another."[282] He admitted that ProvGas "had a desire to do some hedging" and it "could have done some certainly."[283]

Lastly, during the hearing, Mr. Roger Buck from The Energy Council of Rhode Island ("TEC-RI") stated he was "not questioning the requirement to recover funds when eligible C&I customers decide to migrate" to transportation service.[284]

At an open meeting on June 27, 2001, the Commission approved the settlement regarding the inquiry into the prudence of the Companies' gas procurement actions for the winter of 2000-2001.

XXII. Docket No. 3347

On June 21, 2001, Southern Union filed a revised ProvGas tariff relating to transportation service. The proposed tariff change established that if a customer who has been purchasing gas from the Companies decides to migrate to a transportation rate schedule where gas is

[280] Id., pp. 129-130, 132-133.
[281] Id., pp.126-127.
[282] Id., p. 138-139.
[283] Id., p. 142.
[284] Id., p. 96.

purchased from a third party, the customer is responsible for its portion of the deferred gas cost balance. The calculation of any under-recovered or over-recovered gas cost attributable to the customer is determined in the Customer Deferred Gas Cost Calculation Guideline.

On July 13, 2001, the Division filed a memorandum stating that it agreed with the tariff change to prevent customers from avoiding their share of unrecovered gas costs incurred over the past winter by migrating to transportation service. However, the Division felt the filed Deferred Gas Cost Calculation Guideline was unduly complicated and needed time to develop an alternative method. At an open meeting on July 11, 2001, the Commission voted to suspend the tariff revision in order to give more time for the Division to complete its investigation.

On July 19, 2001, the Division filed an additional memorandum stating that upon testing with actual customer data the Division determined that its alternative calculation did not produce fair or accurate results especially for high load factor customers because these customers ended up with disproportionate high amounts of gas cost responsibility under the alternative calculation. The Division explained that Southern Union's proposed calculation has two factors. One factor is based on the prior period's under/over-recovery reflected in the current GCC rate and another factor tracks any incremental under/over-recovery that occurred since the current GCC has been in place. The Division also noted that during a conversation with Roger Buck of TEC-

RI, Mr. Buck expressed support for the proposed revision to ProvGas' tariff relating to the Transportation Terms and Conditions. In conclusion, the Division recommended Commission approval of the proposed tariff revisions to transportation service. At an open meeting on July 24, 2001, the Commission approved the Southern Union proposed tariff revisions to ProvGas' tariff relating to transportation services.

COMMISSION FINDINGS

I. THE INCREASE IN THE GCC AND PGPA RATES

During the fall and winter of 2000 it became evident to the Commission that wholesale natural gas prices were rapidly rising to historical records and would not return to the price levels of 1998 and 1999. As a result, the Commission was faced with two options, either: (1) deny a significant increase in the GCC/PGPA rates which would result in an ever increasing revenue under-collection of commodity gas costs, or (2) significantly increase the GCC/PGPA rates in order to pay for some of the commodity gas costs incurred by ProvGas and Valley Gas. The Commission found neither alternative appealing, but in the end, resolved to increase the GCC/PGPA rates to limit the under-collection. This approach parallels the course this Commission has taken in regard to Narragansett Electric's Standard Offer Service rates in Dockets No. 3138, 3243 and 3287. In those dockets, the Commission noted that high natural gas prices were increasing the cost of Standard Offer Service and

as a result, increased the average residential customer's bill by 27.4% in nine months.[285] By way of comparison, the Commission increased the typical ProvGas residential heating customer's bill by 29.2% and increased the typical Valley residential heating customer's bill by 25.6% in less than four months.

As this Commission has previously explained in Docket No. 3138, an under collection will only increase the eventual cost to ratepayers due to additional carrying costs and therefore, should be eliminated or kept as low as possible. In addition, artificially low prices do not encourage conservation. An under-collection creates inequities between those customers coming onto the utility's service and those customers leaving the utility's service. Unfortunately, the GCC/PGPA increases approved by the Commission between September and December 2000 were not enough to allow ProvGas and Valley to stay current with the commodity gas costs incurred by said companies. For instance, as of June 30, 2001, the deferred gas cost under collection was $21.7 million for ProvGas and $8.2 million for Valley.[286]

The Commission was not receptive to any further increases in the GCC/PGPA rates because these rates had already significantly increased in a very short period of time during the winter heating season when ratepayers utilize most of their natural gas needs for the year. As a result, the Commission needed to address five other issues: (1) a

[285] Order No. 16551, in Docket No. 3287, pp. 6-7 (issued 7/10/01).

determination as to the appropriate carry-cost charges or interest rate to be applied to the deferred gas costs account; (2) a requirement that commercial and industrial customers leaving firm sales service by the utility for transportation service would not avoid their share of the deferred gas cost under-collection; (3) an extension beyond the normal twelve-month period of time to recoup the funds necessary to eliminate the deferred gas cost under-collection without an additional GCC/PGPA increase; (4) the creation of a gas nixtensiomd4e defdogram to ensure price

the deferred gas cost account. The Division's witness noted that most states only allow short-term borrowing rates for deferred gas cost accounts, and New Jersey does not allow any carrying costs. Although the Companies may argue that the deferred gas cost account could be large and extend beyond a year, the Companies' witness admitted that the Companies have carried large short-term debt balances for beyond a year.

Accordingly, the Commission accepts the interest rate settlement because it reduces the carrying charge to 2 percent below the Prime Rate. The Commission further notes that the approval of the settlement will reduce the companies' deferred gas cost accounts by approximately $768,000. Lastly, the Commission reserves the right in the future to deny Southern Union the authority to charge any carrying costs for deferred gas accounts as an incentive in their gas procurement activities.

III. MIGRATION TO TRANSPORTATION SERVICE

As previously mentioned, an under-collection has the potential of creating inequities when customers leave the service without paying their share of the under-collection while new customers are required to pay for a portion of an under-collection which they had no role in creating. To address this issue, ProvGas filed a tariff revision to its Transportation Terms and Conditions requiring customers migrating from sales service to transportation service to pay their appropriate share of the under-

collection in the deferred gas cost account. Valley already had such a tariff provision in place prior to this past winter.

The Commission found the proposed tariff revision to be reasonable and in the best interest of the ratepayers. This tariff revision prevents commercial and industrial customers, who enjoyed the below market rates of this past winter, from returning to the market this upcoming winter to obtain gas prices below the present GCC/PGPA rates without paying their appropriate share of the under-collection. Otherwise, commercial and industrial customers could enjoy a windfall which would come at the expense of other customers who can not enter the competitive gas supply market. The tariff revision also would require the company to make payment to customers leaving sales service for any over-collection of gas costs from customers.

IV. GAS-PRICE MITIGATION PLAN

As part of its Mitigation Strategy Plan, the Companies proposed a Gas-Price Mitigation Plan. The purpose of this plan was to extend out the usual 12-month GCC/PGPA period through 2 winter periods or to June 30, 2002 so that the GCC/PGPA rates could be set lower than the market gas price for the winter 2000-2001 by averaging the high gas commodity costs of this winter with the expected lower gas commodity costs for next winter. The Gas-Price Mitigation Plan, in theory, gave the Commission the flexibility not to order an additional increase in the GCC/PGPA rate and yet eliminated the deferred gas cost under collection

within a reasonable period of time. Of course, the basic premise of this approach is that next winter's gas costs would be lower than the winter of 2000-2001. Fortunately, a sharp drop in gas prices in late June 2001 suggests that by June 30, 2002 the deferred gas cost balance for ProvGas will be only $1.3 million and for Valley will be only $1.1 million.[287] Out of an abundance of caution and in light of the volatility in the wholesale gas market, the Commission approved the Gas-Price Mitigation Plan but with the reservation that it can extend the plan beyond June 30, 2002 so as to avoid any additional GCC/PGPA rate increases.

The Commission views the Gas-Price Mitigation Plan as an innovative means to eliminate the under-collection in the deferred gas account without a further GCC/PGPA rate increase. Residential heating customers are experiencing a 25% to 29% rate increase in addition to a 27% increase in their electric bills. Any further increases in ratepayers' energy bills is simply unacceptable at this time. A larger under-collection is a lesser evil than an additional large rate increase in energy costs. As noted in Docket No. 3138, 3243 and 3287, this Commission does not regulate the price of wholesale natural gas. This Commission does set the retail rate for natural gas and for the time being the Commission will hold the line here.

V. GAS PURCHASING PROGRAM

[287] Id.

The other component of the Companies' Mitigation Strategy Plan was a Gas Purchasing Program. The Commission finds that an ideal gas procurement approach balances the objective of price stability with the objective of affordability. The objective of price stability is pursued through a hedging approach while the objective of affordability is pursued through a least cost spot market approach. The witnesses for both the Division and the Companies testified that the Gas Purchasing Program struck a proper balance between price stability and affordability. It appears to the Commission, however, that the Gas Purchasing Program was formulated by the Companies in an attempt to create a gas procurement policy that would avoid the need to increase further the GCC/PGPA rates for the period ending June 30, 2002 and eliminate, if possible, any under-collection. Accordingly, under the Gas Purchasing Program, the purpose of hedging seems to be to avoid any further GCC/PGPA increases for the period ending June 30, 2002 while also reducing the under-collection by locking in prices when they dip below the GCC/PGPA rate. The Commission finds this to be an appropriate objective for the period.

The Commission notes that the Gas Purchasing Program allows the Companies to hedge a larger portion of their supplies if future gas prices are falling. In contrast, the Division witnesses indicated that hedging is most appropriate when prices are rising. The reason for the

apparent difference can be explained by viewing the Gas Purchasing Program as primarily aimed at assuring price stability.

The Commission also notes that because the Gas Purchasing Program encourages spot market purchases of gas when the price is above the benchmark, it allows the Companies to raise the defense that a gas procurement strategy based on the spot market is prudent. When prices were rising in the spring of 2000, above the GCC/PGPA rates, the Companies should not have relied on the spot market but instead, should have aggressively hedged, possibly through dollar cost averaging as suggested by the Division's witness. In general, the purpose of hedging is to obtain insurance for ratepayers against significant rate increases. Accordingly, the Gas Purchasing Program in place after June 30, 3002 should be modified, if necessary, to prevent Southern Union from repeating the mistake the Companies made in 2000, which was not to hedge and instead rely on the spot market to purchase gas. It is probable that a new GCC/PGPA rate and benchmark will need to be established for the period following June 30, 2002, and at that time the Commission would welcome any modifications to the Gas Purchasing Program that will better reflect the objective of affordability in gas rates.

For the present, the Commission has approved the Division's modification requesting quarterly reporting of gas procurement and the ability to review the benchmark quarterly. The benchmark is subject to quarterly review when the Companies file their quarterly reports. The

Commission has also adopted the Division's modifications to phase-in the percentage increase of non-discretionary dollar-cost averaging for gas purchases. The Commission notes however that this phase-in approach was recently abandoned by Southern Union, in consultation with the Division, due to a sharp drop in gas prices in June 2001.[288] The Commission feels this was reasonable in order to lock in prices that are below the current GCC/PGPA rates so as to reduce the under-collection in deferred gas costs.

The Commission also would clearly state that its approval of this plan and Southern Union's adherence to the general outlines of the Gas Purchasing Program does not imply either an automatic pass through to ratepayers of all gas procurement costs or a finding that the Southern Union's actions were prudent. The Commission notes that this Program still grants substantial discretion for the Companies such as when gas purchases are made, or how storage is utilized.

After June 30, 2002, the Commission may modify the Gas Purchasing Program to provide more emphasis on the objective of affordability. The Program in its current form does allow 30% to 50% of purchases to be made at the spot market. Also, it serves its purpose of avoiding further GCC/PGPA increases while simultaneously eliminating the under-collection. Furthermore, because the Commission has adopted the Mitigation Strategy Plan, of which the Gas Purchasing

[288] Id.

Program was a component, without significant modifications, the shareholders of the Companies contributed $333,000 to LIHEAP. The Commission expects that it has clearly indicated to the Companies by approval of this Program that it believes hedging is an appropriate activity to ensure price stability in gas procurement.

Lastly, the Commission emphasizes that the Gas Purchasing Program was not submitted to the Commission until November 29, 2000, on the eve of the peak of the winter heating season months, and was not implemented by the Companies during the past winter. The Commission would not immediately approve the Program without giving time for the Division and the Commission to properly review the Program. If the Program had been filed earlier in 2000, it is possible that the Program could have been designed and implemented so as not to have exposed customers to the high spot market prices for the winter or a significant GCC/PGPA rate increase. Instead, the Companies entered the winter of 2000-2001 without significant hedging. The Gas Purchasing Program in effect served as a means to procure gas to eliminate the under-collection accumulated this past winter without additional GCC/PGPA rate increases. Under these circumstances, the Commission felt it was appropriate to review the propriety and prudence of the Companies' gas procurement activities for the 2000-2001 winter heating season.

VI. PRUDENCE OF GAS PROCUREMENT FOR THE WINTER 2000-2001

A. Background

Pursuant to R.I.G.L. §39-1-1 and 39-3-11, this Commission is obligated to set just and reasonable rates. Purchased gas adjustment clauses such as the GCC and PGPA pass through to customers the cost of gas supplies purchased by the Companies in the wholesale gas market. Under the filed rate doctrine, a state Commission must allow utilities to recover the costs of their wholesale purchases from ratepayers making retail purchases.[289] Under the prudence of purchase doctrine, however, state commissions are allowed to review the prudence of the utility's gas procurement activities.[290] As in any other rate filing, the burden of proof as to the reasonableness of the rates and the prudence of the utility's procurement actions is on the utility. R.I.G.L. § 39-3-12, This is consistent with the Commission's order nearly two decades ago to only approve GCC and PGPA gas costs that are reasonable and prudent.[291]

B. Prudence Standard

Prudence is a difficult concept to define. In 1997 when the Nevada Public Utilities Commission disallowed $4.7 million of gas costs incurred by Southwest Gas Corporation, the Nevada Commission defined prudence as "what a reasonable person would have done under the circumstances which prevailed when the action was taken, knowing the

[289] See Leonard Saul Goodman, The Process of Ratemaking, Volume II, pp. 863 (1998);
[290] Id.
[291] Order No. 10711 in Docket no. 1612, p. 87 (issued 6/23/82).

information available at the time the decision was made."[292] The Nevada Commission's finding of imprudence was based on a finding that Southwest Gas failed to use "fixed price contracts" or use a "financial hedging mechanism" and relied on "index-priced contracts".[293] Similarly, in 2000, the Indiana Utility Regulatory Commission disallowed $3.7 million of gas incurred by Indiana Gas Company and found Indiana Gas imprudent for deviating from "diversification practices that incorporate a level of fixed price contracts or other hedged gas purchases".[294] In addition, as a result of a ProvGas GCC filing in 1997, the Division "reserved the right to challenge the prudence of the Company's gas purchases", and Commission expressed "concerns about the Company's gas purchasing practices" because there had been "no real effort to take advantage of the innovative hedging options available".[295] Implicit in these orders is that prudent gas procurement by a LDC requires some use of hedging. In other words, an LDC must diversify its gas procurement portfolio by hedging a significant portion of its gas supply, unless expressly ordered to do otherwise by a commission, or it may be found to have acted imprudently.

An LDC like ProvGas and Valley has a fiduciary duty to prudently procure gas for its ratepayers. Similarly, in the law of trusts, trustees

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[292] Southwest Gas Corporation, 183 PUR 4th 323, 341 (Nevada PUC, 1997).
[293] Id., pp. 340-341.
[294] Indiana Utility Regulatory Commission, Application of Indiana Gas Company for Approval of Changes in its Gas Cost Adjustment, p. 10 (1/4/01).
[295] Order No. 15208 in Docket 1673, pp. 2-3 (issued 2/5/97).

must prudently manage a trustee's assets on behalf of the trust's beneficiaries.[296] There are some "long accepted indices of prudent conduct" by a trustee such as "diversification at all times, unless it is clearly the intention of the settlor that this not be done".[297] Also, R.I.G.L. § 18-15-3 declares that "a trustee shall diversify the investment of the trust". Like a trustee, ProvGas and Valley each has a fiduciary duty to the ratepayers to diversify its gas supply portfolio through hedging unless the Commission expressly orders the company not to diversify, as in Docket 2581 when ProvGas entered a three-year fixed price agreement with Duke Energy for its entire gas supply with the express permission of the Commission.

Hedging is price insurance against high gas prices.[298] Common sense dictates that the failure to purchase insurance for an item of significant value is inherently imprudent. Accordingly, if an LDC relies almost entirely on the spot market, unless the Commission orders it to do so, the LDC runs the risk of being found imprudent in its gas procurement activities. In the case before the Commission the prudence question boils down to whether or not the Companies should have conducted more hedging for the past winter.

C. The Defense of the Companies

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[296] See Augustus Loring (Charles Rounds, Jr., Eric Hayes, editors), A Trustee's Handbook, p. 147 (7th Edition, 1994).
[297] Id., p. 151.
[298] Kenneth Costello & John Cita, Use of Hedging by Local Gas Distribution Companies, NRRI 01-08, p. 40.

In their defense, the Companies raised the following issues: (1) the Companies could not use hedging to obtain their gas supply because it was a radical departure from past practice by the Companies; (2) the Companies could only engage in hedging if it was pre-approved by the Commission; and (3) nearly all other LDCs in the country did not extensively use hedging this past winter. All of these defenses are flawed and can be rebutted.

First, hedging is not a radical departure for either ProvGas or Valley Gas. In 1996, the Commission approved a Pilot Hedging Program, for ProvGas as a means to manage the "impact of gas price volatility" in light of recent "extreme volatility in the gas markets."[299] The settlement agreement providing for the Pilot Hedging Program specifically stated that the goals of the Program were "to manage the risks of price volatility in the gas market" and "to develop a balanced gas supply cost approach by diversifying from market-indexed supply."[300] A few months later in 1997, the Division threatened to challenge the prudence of ProvGas' gas procurement activities and the Commission expressed concern that ProvGas had made "no real effort to take advantage" of any "hedging options".[301] In the fall of 1997, ProvGas entered into a fixed three-year commodity gas price agreement.[302] The Commission noted that "price volatility" was the "main reason" for this approach and cited, in support

[299] Order No. 15112 in Docket 1673, pp. 1, 4 (issued 10/17/96).
[300] Id., Appendix A.
[301] Order No. 15208 in Docket 1673, pp. 2-3 (issued 2/5/97).

of its approval of the three year contract, a decision by the Indiana Regulatory Commission stating "price diversification is one means for responding to market volatility and addressing customer interest in price stability".[303] ProvGas was familiar with hedging, had engaged in a form of it from 1996 to 2000, and was aware the Commission had approved of such hedging initiatives.

As for Valley, in 1997, the Division's witness instructed the company that it must prepare for price spikes through hedging.[304] Later that year, Valley adopted a risk management policy with goals such as to "diversify from cash-market based gas supply costs", "manage price risk" and develop an awareness of "financial energy supply cost diversification".[305] In 1999, as a result of Valley's statement that it had never implemented its risk management policy, the Division encouraged Valley to adopt a gas procurement strategy that has price stability as an "important objective".[306] Valley was also familiar with hedging, had adopted a risk management policy to engage in hedging and was encouraged to conduct hedging.

Second, ProvGas and Valley could have, at any time prior to the fall of 2000, filed a proposal allowing for hedging with the Commission. Even if the Companies felt it was necessary to obtain prior Commission

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[302] Order No. 15548 in Docket 2581, pp. 21-23 (issued 3/6/98).
[303] Id., pp. 21-23, citing Indiana Gas, 177 PUR 4th 581, 582 (Indiana Utility Regulatory Commission, 5/28/97).
[304] Order No. 15419 in Docket 1736, pp. 3-4 (issued 10/9/97).
[305] Docket 1736, Osram Ex. 99-7, p. 1.
[306] Order No. 16031 in Docket 1736, pp. 2-3 (issued 1/18/00).

approval before engaging in hedging, the Companies could have easily filed a proposal for Commission consideration well before the fall of 2000. According to ProvGas, gas prices began to escalate as of May 2000 and yet, no proposal was filed until September 2000. Furthermore, ProvGas was well aware that its fixed price agreement with Duke was expiring on October 1, 2000 and again, ProvGas filed no proposals to hedge with the Commission until less than a month before the expiration of the agreement with Duke. ProvGas' failure to be pro-active can be blamed on no one but ProvGas. Similarly, Valley could have filed a hedging proposal at any time with the Commission. According to Valley, prices escalated beginning in February 2000 and yet Valley took no initiative to seek Commission approval to adopt hedging. Valley's failure to take the initiative rests only with Valley. The Commission never indicated to ProvGas or Valley that it would not be receptive to a hedging proposal. The Commission can only approve proposals that are submitted to it for their consideration.

Third, the fact that most other LDCs did not engage in hedging for the past winter is not an absolute defense that shields the Companies from a finding of imprudence. The defense of an industry wide practice is rebuttal in this context and in other areas of the law. For instance, in tort law, industry wide custom is not necessarily the standard for negligence because an entire industry "may have unduly lagged in the adoption of new and available" techniques and that the judiciary

determines "what is required" because "there are precautions so imperative that even their universal disregard will not excuse their omission."[307]

In this instance, price stability as achieved through hedging and diversification of gas procurement is an imperative precaution for ratepayers. Since 1996, the Commission and the Division have encouraged or approved hedging by ProvGas and Valley. Although LDCs in other states are allowed to rely on the spot-market, in this state, hedging is a form of price insurance that this Commission has felt is a necessary precaution, and that price stability is an important objective. The argument that "everyone else is doing it" is not valid for little children or LDCs. Furthermore, the Commission notes that LDCs across the country have "little incentive" to hedge because from their shareholders' perspective the LDCs are allowed to use pass-through mechanisms for gas expenses.[308]

D. The Case Against Valley

As stated earlier, Valley acted improperly by not hedging or seeking Commission approval to hedge at any time during the spring or summer of 2000, especially after February 2000, when, according to Mr. Roy, gas prices began to rise. Also, on numerous occasions, Mr. Roy admitted that he and Valley understood that the Commission wanted price stability.

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[307] T.J. Hooper 60 F.2d 737 (2d Cir. 1932).
[308] Kenneth Costello and John Cita, Use of Hedging by Local Gas Distribution Companies, NRRI 01-08, p. 19.

Instead of hedging, Mr. Roy stated that Valley pursued a lowest priced gas objective through heavy reliance on the spot market. In addition, Mr. Roy concurred that the spot market was volatile and that a diversified gas procurement portfolio would result in greater price stability, but instead, Valley relied almost exclusively on the spot market. In fact, Valley failed to utilize its storage resources for the winter of 2000-2001, and instead, opted to risk buying replacement gas at 'projected' lower market prices that were never realized.

Most damaging, was Mr. Roy's admission that Valley Gas never implemented the risk management policy dated November 25, 1997 that included a hedging program. Lastly, Valley may have speculated on gas prices because Mr. Roy indicated that throughout 2000, Valley wanted to lock in prices but did not do so because of the assumption that gas prices would decrease significantly. The Commission concludes that due to its failure to participate in any significant hedging there was substantial evidence that Valley acted imprudently in gas procurement for the winter 2000-2001.

E. The Case Against ProvGas

As noted earlier, ProvGas acted inappropriately by not hedging a greater portion of the gas supply or even seeking Commission approval to hedge more aggressively during the spring or summer of 2000, especially after May 2000 when, according to Mr. DeMetro, gas prices began to rise dramatically. It was only at the end of September 2000 that ProvGas filed

some sort of proposal for a hedging program. In the meantime, ProvGas had only hedged 35% of its gas needs for a normal winter season and Duke Energy was primarily responsible for most of this hedging that had been performed. Mr. DeMetro stated that ProvGas did not seek a fixed price for gas for the post Price Stabilization Plan period because ProvGas "didn't know what the objective would be." At a later hearing, however, he stated the goals for gas procurement were affordability and price stability as shown in the Duke Energy Agreement.[309]

Mr. DeMetro also acknowledged that diversification in gas procurement would have provided more price stability. Most damaging, ProvGas took no action in response to correspondence from the Division in June 1999 that directed ProvGas to take action to secure a gas supply for the period beginning October 1, 2000 while natural gas prices were low. Lastly, ProvGas may have speculated. Mr. Beland indicated that ProvGas wanted to lock in prices for gas in January 2000 but did not do so because he felt that ProvGas would not do any worse by waiting. This view was probably based on the assumption that gas prices would decline or not go any higher. As a result, ProvGas only started to hedge in the summer of 2000 when it became apparent that gas prices would not decline as ProvGas had anticipated. Although ProvGas did some hedging, it did so only after the price escalation of May 2000. Because of its failure to take more proactive steps, the Commission concludes that

[309] Docket No. 2581, Tr. 8/21/00, p. 61.

there was evidence that ProvGas acted imprudently in gas procurement for the winter 2000-2001.

F. Settlement

In light of this evidence, the Commission is not surprised that the Companies sought a settlement of the prudence review into their gas procurement activities for the winter 2000-2001. The Commission finds the terms just and reasonable and in the best interest of the ratepayers. The settlement has eliminated the need for further litigation and has allowed the parties to focus on the upcoming merger rate consolidation case. The two most important aspects of the settlement are that the under-collection in the deferred gas cost accounts was reduced and that the shareholders were required to depart with some of their earnings.

Shareholders contributed $500,000 to reduce the deferred gas accounts. They also accepted the additional weather risk of a warmer than normal winter, which has occurred frequently in recent years, and could result in shareholders foregoing up to an additional $390,000 in earnings. This is in addition to the $333,000 the shareholders contributed to LIHEAP when the Commission adopted the Mitigation Strategy Plan and the shareholders' reduction on their return on equity from 10.9% to 10.7% (or approximately $200,0000) in Docket 2581 in September 2000. In total, shareholders have contributed $833,000 and potentially have lost the opportunity to earn an additional $590,000. Based on the Companies' net income of $6,472,000 as of September

2000, this constitutes 22% of the Companies' net income. It is a sizeable amount of money that has certainly caused the shareholders of the Companies to feel concern just as the rate increases of 25.6% to 29.2% experienced by residential heating customers this past winter caused many ratepayers to feel discomfort.

The under-collection in the deferred gas account was not only reduced by a $500,000 contribution from shareholders but also by a transfer of $795,600 from the Deferred Revenue Account to the deferred gas cost account. Although ratepayers were entitled to any credits in the Deferred Revenue Account at the conclusion of June 30, 2002, transferring this money to the deferred gas account reduces carrying charges. This is in addition to the estimated $768,000 reduction in the deferred gas account as a result of the approval of the reduction in the interest rate from the Prime Rate to 2 percent below the Prime Rate. In total, the ratepayers could receive $2,986,000 in benefits as a result of the Commission's actions in these dockets and Docket No. 2581. Of this amount, only $590,000 is contingent on factors such as weather and ProvGas' return on equity. The under-collection in the deferred gas accounts is reduced by $2,063,600 and the shareholders could potentially lose 22% of the Companies' net income.

G. The Future

At this time, the Commission must look forward. The Commission eagerly awaits the filing by Southern Union of its merger rate

consolidation case with the much vaunted and highly anticipated merger savings. This past winter the Commission allowed for an increase in residential heating bills of 25% to 29%. The Commission hopes that the combination of falling gas commodity prices and merger savings will lower residential heating customer's bills to approximately the level that existed prior to October 1, 2000, when the first Price Stabilization Plan ended. This Commission cannot regulate the wholesale price of gas but it certainly will regulate and scrutinize the distribution rates charged by Southern Union to the ratepayers. In the context of the new rate case, the Commission will have many options in regard to commodity gas charges. The Commission could eliminate the GCC/PGPA altogether in order to motivate Southern Union to aggressively hedge.[310] The Commission could require Southern Union to share in the benefits and costs associated with hedging as was done by the Michigan Public Service Commission.[311] It is clear that LDCs need a greater incentive to hedge.

The Companies in 2000 acted like the grasshopper in the fable the "The Grasshopper and The Ant". Like the grasshopper, the Companies frolicked during the spring and summer, and did not prepare or plan ahead for the winter. When the winter came, the grasshopper perished. Unless Southern Union wants to share the fate of the grasshopper, it

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[310] Kenneth Costello and John Cita, Use of Hedging by Local Distribution Companies, NRRI 01-08, p. 53.
[311] Id., p. 56.

should plan ahead and be proactive in gas procurement. In addition, Southern Union should be informed that the Commission is interested in merger savings and rate reductions for the period after June 30, 2002. The bills of residential heating customers should be reduced. If gas commodity prices do not come down then the reduction may come from Southern Union's distribution rates. Southern Union has been warned.

Accordingly, it is

(16745) ORDERED:

1. The Valley Gas PGPA factor filed on August 1, 2000, of $1.758 per Mcf is approved for effect September 1, 2000.
2. The ProvGas GCC factors filed on September 1, 2000, of $3.436 per Mcf for residential and small commercial, and industrial customers of $7.777 per Mcf for medium and large commercial and industrial customers, and $7.514 per Mcf for extra large commercial and industrial customers, are denied.
3. The GCC factors of $2.702 per Mcf for residential and small commercial and industrial customer, $7.043 per Mcf for medium and large commercial and industrial customer, and $6.780 per Mcf for extra large commercial and industrial customers are approved for effect October 1, 2000.
4. The Transportation Gas Charge factor filed on September 1, 2000, of: $0.0491 per Ccf for FT-2 Firm Transportation Marketer Gas Charge; $0.0018 per Ccf for Pool Balancing

Charges; $1.076 for the Weighted Average Upstream Pipeline Transportation Cost; the LNG peaking rate of $6.15 per MMBtu; and the proposed Storage Inventory Charge are approved for effect October 1, 2000.

5. The Valley Gas PGPA factor filed on November 29, 2000, of $2.967 per Mcf is approved for effect December 15, 2000.
6. The ProvGas GCC factors filed on November 29, 2000, of $4.098 per Mcf for residential and small commercial and industrial customers; $8.439 for medium and large commercial and industrial customers; and $8.176 for extra large commercial and industrial customers are approved for effect December 15, 2000.
7. The Mitigation Strategy Plan, including the Gas-Price Mitigation Plan and Gas Purchasing Program filed on November 29, 2000, is approved as modified by the Division's filing of January 30, 2001, and with express reservation that the Commission can extend the Gas-Price Mitigation Plan beyond June 30, 2002.
8. The settlement filed on February 9, 2001 reducing the interest rate on the deferred gas cost accounts to the Fleet Prime rate less 2 percent is approved.
9. The settlement filed on June 15, 2001 on the propriety of the gas procurement for the 2000-2001 year is approved.

10. The tariff revision to Transportation Terms and Conditions of Providence Gas filed on June 21, 2001 is approved.

11. The Companies shall comply with the reporting requirements and all other terms and conditions imposed by the Settlement Agreements and by this Report and Order.

EFFECTIVE AT PROVIDENCE AND WARWICK, RHODE ISLAND, ON SEPTEMBER 1, SEPTEMBER 29, AND DECEMBER 15, 2000, AND ON FEBRUARY 21, JUNE 27, AND JULY 24, 2001, PURSUANT TO OPEN MEETING DECISIONS. WRITTEN ORDER ISSUED OCTOBER 17, 2001.

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