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May 20, 2013

Debra A. Howland
Executive Director
New Hampshire Public Utilities Commission
21 South Fruit Street, Suite 10
Concord, NH 03301-2429

Re: DG 13-119 Northern Utilities, Inc.
Petition to Modify Hedging Program
Staff Recommendation

Dear Ms. Howland:

On April 23, 2013, Northern Utilities, Inc. (Northern) filed a petition for approval to change its hedging program. Northern began hedging in 2001 and the original hedging plan has been revised throughout the years as deemed appropriate. The current plan was approved by the Commission in Order No. 25,087 (March 30, 2010), in Docket No. DG 09-141. The approved program uses a portfolio approach that hedges 70% of winter supply requirements using both physical and financial hedges. Under the current program, of total winter supply requirements, approximately 50% is physically hedged, and approximately 20% is financially hedged. The current program also financially hedges 40% of May and October shoulder-season supply requirements. Financial hedges are made by purchasing futures contracts up to 18 months in advance that lock in prices for the hedged period, with a price ceiling on futures prices above which contract purchases are suspended. The current program also requires the sale of futures contracts that appreciate by 40% or more. If, on the contract expiration date, the natural gas price is less than the contract price the resulting loss is charged to the cost of gas. If natural gas prices exceed the contract price on the contract expiration date, the gain is credited to the cost of gas.

In its filing, Northern proposes to cease purchasing futures contracts and begin purchasing call options to hedge against price spikes. While both futures contracts and call options protect against price spikes, unlike futures contracts that lock in the price and do not allow Northern to take advantage of lower prices, call options will allow Northern to take advantage of price-drop opportunities. Northern also requests Commission approval to discontinue hedging April, May and October supplies and proposes a transition plan to implement the revised hedging program. The hedging transition plan calls for Northern to complete the final purchases of future contracts to satisfy the 2013-14 hedging requirement and to hold those contracts until they expire or appreciate in value by 40% or more. Northern will purchase futures contracts to hedge 2014-15 as required under the current plan but if the revised hedging plan is approved those futures contracts would be liquidated and option contracts purchased as necessary to hedge 70% of the 2014-15 winter supplies required under the proposed hedging plan. The liquidation of future contracts and purchase of call options will take place within one month of Commission approval of the proposed hedging plan. Gains or losses on the sale of 2014-15 future contracts will be credited or charged to the 2014-15 winter cost of gas consistent with the how gains and losses are treated under the current program.

The proposed hedging plan requires Northern to determine the volumes to be financially hedged, calculate the projected cost of those supplies based on futures prices, and use 2.5% of the projected cost to purchase call options. The filing includes a Sample Hedging Plan for 2014-15 which presents a $3.3 million supply cost estimate based on futures prices (based on a weighted average strike price of $4.45 per MMBtu), resulting in an $83,490 budget for the purchase of call options. The call options purchased to hedge the required supplies have a weighted average strike price of $6.51 per MMBtu. If natural gas prices do not exceed the call option strike price on the expiration date of the contract, there would be no gain or loss reflected in the cost of gas. The cost of the call options would be charged to the cost of the gas. If, on the contract expiration date, natural gas prices exceed the contract rate (*i.e.*, ranging from a 40% to 56% increase, depending on the month, with a weighted average increase of 46%), the difference would recorded as a gain and credited to the cost of gas.

Northern, under the new program, would file its hedging plan for the next year's winter period, that is, 18 months in advance, with its summer cost of gas filings. The filed plan would include the hedging budget, the number of contracts to be purchased and expected strike prices. The hedging plan would provide an analysis showing how each component of the proposed budget was determined and include the customer bill impact of the hedging activity. Northern may propose revisions to the plan based upon plan results and changes in the natural gas market.

Northern estimated that a ten percent change in NYMEX natural gas prices translates to only a one percent change in the total delivered rate for residential heating customers, and that given the relationship between commodity prices and the ultimate customer rate impact, the proposed program is designed to protect only against significant increases in price, while accepting the impact of moderate increases in price and preserving the benefit of price decreases.

The proposed hedging plan is consistent with the hedging plan Northern's Maine Division filed with the Maine Public Utilities Commission (MPUC Docket No. 2012-00448), and approved by the Maine Commission on April 25, 2013.

Based on its review of the filing, Staff recommends that the Commission grant Northern's request to implement the proposed hedging plan. The proposed plan will allow Northern to take advantage of declining natural gas prices while protecting ratepayers from price spikes and the cost of the program is relatively small (with a hedging budget of approximately $100,000 compared to winter gas costs of approximately $25 million).[1]

The proposed hedging plan eliminates April, May and October shoulder-season financial hedges, which reduces hedging costs without significantly increasing the financial harm to ratepayers related to significant increases in natural gas commodity prices. Under the proposed plan, the five hedged months cover 70% of the annual natural gas consumption of an average residential heating customer, with rate increases during that period having the most significant impact on customer costs. The combined usage for the shoulder-season months of April, May and June is 20% of annual usage, and therefore increases in gas rates during those months will have less of an impact on monthly bills and annual gas costs.

Northern will continue to report the results of its hedging transactions for Commission review and will be filing its hedging plan 18 months in advance of the period to be hedged (i.e., with the previous calendar year's summer cost of gas filings), and before executing the contract purchases for the period to be hedged. If the hedging results or market changes suggest revisions to the hedging plan are appropriate, proposed revisions will be filed and subject to Commission approval.

For the reasons cited above Staff believes the proposed hedging plan, including the hedging transition plan, as filed by Northern is in the public interest and should be approved.

Sincerely,

Stephen P. Frink

Stephen P. Frink
Assistant Director, Gas & Water Division

cc: Service List

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[1] Hedging cost based on 2014-15 Sample Hedge Plan and gas costs based on Docket. No. DG 12-273 - Northern 2012-13 winter cost of gas filing.