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New England Gas Company

COMMISSION

Ms. Luly Massaro, Commission Clerk
Rhode Island Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 20888

Re: Docket No. 3436, Gas Purchase Incentive Plan

Dear Ms. Massaro:

On December 9, 2004, the Rhode Island Public Utility Commission ("Commission") conducted a technical conference regarding the Gas Purchase Incentive Plan (the "Plan" or "GPIP") that was approved for the New England Gas Company (the "Company") in Docket No. 3436. At the technical conference, the Commission instructed the Company and the Rhode Island Division of Public Utilities and Carriers (the "Division") to evaluate whether the methodology for imposing penalties under the Plan should be modified.

The Commission's interest in potential modifications to the penalty structure stems from the current market environment, which is characterized by a steady trend of rising natural gas prices. When market prices are steadily trending upward, the Company does not have the opportunity to lock in prices at or below the benchmark level established under the Plan. As a result, the Company is subject to penalties for making discretionary gas purchases at prices above the benchmark level, even if the purchases are necessary to achieve a desirable level of locked purchases for the winter season. In light of this dynamic, the Commission expressed concern that the current penalty structure may need to be modified to eliminate any disincentive for the Company to lock in the level of gas purchases under the Plan.

As requested by the Commission, the Company met with the Division and its consultant, Mr. Bruce Oliver of Revilo Hill Associates. The Company and the Division discussed a number of potential modifications to the penalty mechanism encompassed in the GPIP, each of which is discussed below. Although the Company and the Division were unable to reach consensus on a joint recommendation, the discussion enabled the Company to identify a proposed course of action to address the Commission's stated concerns.

Alternative Approaches

In evaluating modifications to the Plan, it is important to recognize that there is no "perfect" approach to ensure that the GPIP will meet the multiple (and sometimes conflicting) policy objectives of the Commission, which are to: (1) achieve stable prices for customers; (2) purchase supply at the lowest cost possible, and (3) maintain supply

100 Weybosset Street
Providence, RI 02903

reliability. Under the Plan, discretionary purchasing is designed to work as a complement to the dollar-cost averaging approach applied to mandatory purchases. In that regard, discretionary purchasing is specifically designed to encourage price-oriented, opportunistic buying to supplement the more structured and programmatic purchasing protocol applied to mandatory purchases under the GPIP. This combination of structured and opportunistic purchasing has produced successful results for the program to date.

Within the context of the GPIP, the establishment of a benchmarks for discretionary purchases based on the price achieved for mandatory purchases has generally proven to be a reasonable strategy to encourage lower-cost purchases for the benefit of customers. For example, during the first year of the Plan, discretionary purchases averaged almost $0.50 per dekatherm less than the benchmark. More recently, however, steadily rising prices have denied or substantially limited the Company's opportunity to make any discretionary purchases below the benchmark. In fact, in an environment of volatile (and rising) prices, it is only clear through hindsight that more discretionary purchasing at a particular point in the cycle would be beneficial. Since the potential for prices to fall in the future is greatest at the outset of the 20-month buying cycle, discretionary purchases in the early phase of the buying cycle are particularly risky for the Company. Even if the Company were to make discretionary purchases early in the 18-month buying cycle at a price that is under the benchmark, a penalty could later result if prices were to fall in the latter stages of the buying cycle and lower-priced (mandatory) purchases are factored into the benchmark. This generally has the effect of discouraging the Company from locking-in discretionary supplies early in the buying cycle.

a. Original Proposal

The original GPIP, which was jointly filed by the Company and the Division, recognized this phenomenon and included a second benchmark set at the closing NYMEX price for the month (18 months prior) to address the problem. Discretionary purchases below this second benchmark were eligible for incentives that would have remained in place and that would not be eliminated by a subsequent decline in the mandatory purchase benchmark. In some months of the buying cycle for the 2004-05 winter season, the existence of the second benchmark would have encouraged beneficial purchases for customers and resulted in incentives for the Company. However, this method is problematic because (like the current method) it creates a benchmark early in the cycle that may become stale and ineffective if prices move higher during the buying cycle, thereby substantially limiting or eliminating any opportunity to implement purchases without incurring penalties.

b. Embedded Cost Waiver of Penalties

A second possible approach is to waive penalties for any purchases that were higher than the benchmark, but below the embedded cost underlying current GCR rates. This approach would also allow the Company to make purchases that are beneficial to customers early in the buying cycle without the risk of incurring penalties. However, like

the original proposal, this approach creates a benchmark early in the cycle that is likely to become stale over time and will be ineffective if prices persistently remain above the level of the embedded prices.

c. **Dead-Band Approach**

Another possibility is the use of a dead-band to create a range of pricing in which the Company would not be exposed to penalties, nor eligible to receive incentives. Although this approach appears reasonable because it provides the Company with some flexibility before penalties are assessed, this approach would be symmetrical and would therefore eliminate incentives as well as penalties. Thus, in addition to reducing the disincentive to purchase when prices are rising, it could reduce the impetus for the Company to make purchases as prices are declining, unless the price declines to a level that is all that much lower than the benchmark. As a result, the approach does not serve the Commission's objective of creating a mechanism that maximizes the incentives to make discretionary purchases.

Secondly, there will be difficulty in setting the width of the band under this approach because the wider the band, the less effective the incentives under the program will be. Also, a bandwidth set today will tend to become stale over time as market dynamics and prices change. As a result, in practice it will be difficult to set a deadband that will solve the problems experienced with the GPIP program.

d. **"Circuit Breaker" Approach**

A common problem with the three prior approaches is that the exceedingly dynamic nature of the market tends to make any established benchmark, or limitation, outdated fairly quickly. A different approach would be to allow the Company, the Commission, or the Division to request that additional purchases be made at any time, subject to approval by the Commission and the Division. Penalties on these purchases would be excused. This has the benefit of providing a "circuit breaker" to allow for purchases when circumstances warrant, without the incurrence of penalties.

However, the circuit breaker approach requires almost instantaneous action by the Commission, because delays caused by the need to seek approval may result in missed opportunities. Moreover, it requires a determination as to the amount of gas to buy or the appropriate trigger price at which to buy. In the Company's experience, there is significant uncertainty in deciding how much to buy and when to buy based on differing perceptions of market conditions.

Because price changes are caused by factors such as weather, storage results, weakness in oil prices and other factors that are wholly outside the control of the Company, the Commission and the Division, there is no way to predict when prevailing circumstances in the market will change or reverse or what the impact on prices will be as a result of changed circumstances. Consequently, the most successful aspect of the GPIP has been the staged and programmatic purchases of a large portion of the required supply

with a smaller portion available for purchasing as market trends and prices become apparent.

e. Time Limit Approach

Another approach that may address the staleness of preset benchmarks or limits is the use of a time limit. Under this approach, if the benchmark was consistently below the market for a period of time (i.e., 6 months), the Company could be allowed to make a discretionary purchase that would not be subject to penalties. This approach attempts to address directly the Commission's concern regarding the role that the penalty mechanism has played in discouraging discretionary purchases. However, the major drawback to this approach is that the determination as to the timing of the period would be arbitrary, which may in and of itself cause a missed opportunity if the timing is off. Moreover, the structure would create an incentive for the Company to make purchases based on the arbitrary time limit, and therefore the modification to the GPIP would be of little value in practice. It would make more sense to take one further step and simply eliminate penalties altogether.

f. Elimination of Penalties

Elimination of the penalties relieves the Company of the risk associated with discretionary purchases but creates an asymmetrical incentive system. Although this result would be acceptable to the Company, the Company recognizes that it may not satisfy the Commission's policy objectives. Therefore, the Company is not recommending removal of the penalty structure in the Plan.

g. Raise the level of Mandatory Purchases

The incentives established in the Plan as currently structured are intended to encourage opportunistic buying and to reward the Company for carefully evaluating the market and executing purchases under favorable prices. It is clear from the experience of the GPIP to date that the incentives accomplish their objective under most market conditions. The GPIP has greatly improved the stability of gas costs for customers and the discretionary purchases made during the first year of the program provided additional savings in the amount of just under $1 million. However, it has also become apparent that, under certain market conditions, the incentive structure discourages the Company from entering into discretionary purchases, and therefore, does not produce the level of locked-in purchases that the Commission desires particularly for the winter season.

This is key because, if it is the Commission's objective to ensure that a relatively high level of supply requirements are locked in at the start of the winter season, then the modification to the Plan should be aimed at achieving the Commission's objective directly rather than at attempting to achieve the goal indirectly through the Company's purchasing strategies, which may be thwarted by adverse market conditions and events, however well intentioned. An approach that would more directly accomplish the Commission's goal of ensuring that a higher level of supply for the winter be locked sooner in the purchase cycle would be to increase the mandatory purchase level for the winter months. This approach would spread the risk of adverse winter prices over the full

buying cycle, eliminating the potential for a hurricane or low storage injections to put the Company in the position where it must buy exceptionally expensive gas to meet its minimum winter obligation under the Plan.

Specifically, under the Plan as currently structured, mandatory monthly purchases are defined as purchases of gas volumes made in uniform monthly increments. Specifically, the Plan states that mandatory monthly purchases will equal 50% of forecasted normal weather gas purchase requirements for each gas supply month. Similarly, the Plan states that discretionary monthly purchases may be up to 45% of forecasted normal weather gas purchase requirements with a total minimum level of locked purchases and storage at 75 % or 80% of normal weather gas requirements depending on the month. If the mandatory amount were raised to 70% of purchases (excluding storage), the Commission's goal of achieving a relatively high level of locked-in supplies would be achieved, while maintaining the existing incentive/penalty structure to motivate opportunistic buying by the Company over the 20-month buying cycle for volumes over the minimum of 70% of purchases. Had there been a higher required level of mandatory purchases in place over the 18-month cycle completed for the 2004-05 winter season, the Company would have been making purchases for mid-winter months over the entire purchasing cycle rather than taking the risk that an unexpected event such as a hurricane would cause it to make purchases at higher prices than market conditions would have indicated was possible.

By raising the mandatory monthly purchase requirements for each gas supply month from November to March to 70%, the modification to the Plan would alleviate the pressures of a market that no longer reflects the benchmark price in the event of staleness, would allow the Company to lock-in purchases at the level desired by the Commission without being subject to a penalty, and would allow the Division and the Commission to know that a penalty structure remains intact to insure that the Company continues to make opportunistic purchases that maintain the spirit of the Plan.

More specifically, this modification would create a higher level of locked-in purchases during the critical winter period, while still maintaining the opportunity for significant discretionary purchases in the key months of December, January, and February. It would also guarantee that a higher level of locked-in purchases are made prior to the winter season regardless of whether an opportunity to make discretionary purchases at levels considered "reasonable" arose. By increasing the mandatory purchase level, the Company will be in a better position to make discretionary purchases at prevailing prices consistent with the goal of the GPIP. Lastly, customers will benefit through greater advanced purchasing with less risk from supply disruptions or severe weather. Therefore, this approach directly addresses the Commission's concern without upsetting the delicate balance of incentives encompassed in the current Plan.

For these reasons, the Company believes that this approach is the most reasonable and well-targeted approach among the group of alternative modifications in light of the circumstances that occurred in the market over the past 12-18 months.

h. Additional Metrics

The Company and the Division were also asked to discuss and suggest additional metrics to measure the performance of gas purchasing. Metrics are generally established to compare actual results to some other benchmark in order to evaluate performance and to focus attention on an area where performance may be improved. In that regard, the GPIP already includes useful metrics in the form of the mandatory purchase benchmark and the discretionary purchase average unit cost. These metrics can be compared to NYMEX pricing. In fact, Company routinely monitors the costs actually incurred under the GPIP against the NYMEX price at contract close and, as recently as December, has shared those results with the Commission.

Although it may be desirable to find different ways to measure the "success" of the GPIP, it would be very difficult (if not impossible) to develop additional metrics that would provide a meaningful evaluation of the performance of the GPIP. This is because the three fundamental goals of the Plan are not susceptible to comparison in relation to "independent benchmarks." These three goals are: (1) to ensure that gas supplies are as low cost as possible; (2) to ensure that gas costs have a high level of stability for customers; and (3) to ensure that gas supplies are reliable. Performance on each of these goals would be very difficult or even impossible to measure in a way that is different from the mechanisms inherent in the current Plan.

For example, reliability of supply is the Company's highest priority. The failure to have the requisite level of gas supply available in cold weather is far more deleterious to the customers' interest than the magnitude of the price increase required to maintain a high level of reliability. In the past two years, the Company's supply has been eminently reliable, sustaining service through peak cold days not experienced in over 45 years. In addition, the Company's supply arrangements are supported by a long-range planning study that was provided to the Commission.

As a result, there is no indication that the Company's "performance" on this goal could be improved, nor is there a way to compare the "reliability" of the Company's portfolio to an independent benchmark. The Company's supply portfolio is a configuration of resources that is unique to New England Gas Company and there is no feasible way to compare the reliability of the portfolio to another portfolio, except to test the portfolio in operation. In effect, this has occurred over the past two years and no vulnerabilities have developed.

The Company's second highest priority is to minimize gas costs on behalf of customers balanced with reliability considerations. The GPIP includes a metric for commodity gas costs through the discretionary purchase incentive, which measures and rewards the Company for opportunistically purchasing supply. Along with the Asset Management Incentive, this metric also furthers the goal of reducing gas costs by motivating the reductions in gas supply and fixed pipeline costs. There is no other feasible way to evaluate whether gas costs are "as low as possible," because there is no independent benchmark that can be applied for comparison purposes.

For example, it would be inappropriate to compare current prices with historical prices because the Company can only make purchases based on the current pricing available in the market. Similarly, it would be inappropriate to compare the Company's GCR price to that of other gas companies because each and every LDC operates using a unique resource portfolio, and therefore, has a unique cost structure. In addition, most companies in the Northeast do not operate with a price-stabilization plan that is as comprehensive as the GPIP, which means that the Company's results would not be comparable to the results of other companies, even if the portfolio of resources were the same.

The only other way to perform a comparative analysis would be to compare the prices of purchases made under the GPIP to market indices, which is already accomplished by the current Plan through a comparison to NYMEX prices. Although other indices exist, the complexity of the portfolio and the disparate pricing of the various supply sources makes it difficult to develop a simple, consistent metric to measure performance beyond the NYMEX index, especially where NYMEX pricing is publicly available.

The third goal of the gas purchasing strategy is to achieve a high level of price stability for customers. Under the Plan, this goal is achieved through the mandatory purchase requirement, which now spreads a minimum of 50% of the purchasing of all supply for any month over a 20-month period. Price stability is also enhanced significantly by storage operations.

However, in terms of measuring "performance" on this metric, it is important to note that the relative level of stability achieved for customers is ultimately a function of changes in market prices, which are not under the control of the Company. Thus, prices cannot be validly compared across historical periods or across LDCs. Moreover, the Plan is founded on a purchasing strategy that is designed to produce as stable a price as possible for customers without exposing customers to substantial price risk. If the Company were to lock in bigger and bigger portions of gas supply at a single price, the Plan would produce a very high level of price stability, but would also have a significant potential to conflict with the goal of minimizing prices. Because the level of price stability achieved is a direct function of the design of the program, it is impossible to create a comparison of "price stability" based on an independent benchmark because the Company's program is unique.

In light of the difficulties that prevent the development of independent benchmarks, the existence of critical metrics in the GPIP as it currently stands and the requirements placed upon the Company to report to the Commission on the results of the GPIP, the Company believes that further consideration of new performance metrics would not produce meaningful results for the Commission. However, the Company appreciates the opportunity to comment on the issue and will continue to evaluate whether there are metrics that would have the potential to provide beneficial information regarding the Plan's performance.

Conclusion and Recommendation

For all of the reasons listed above, the Company recommends a single modification to the GPIP, which is an increase in the level of mandatory monthly gas purchases from 50% to 70% for each gas supply month in the period November to March. To that end, the Company has provided a redlined strikeout version of the GPIP for the Commission's review and approval.

The Company appreciates the Commission's attention and interest in this matter. The Company is available to discuss this proposal at the Commission's request.

Sincerely,

Kevin F. Penders, Esq.
Manager, Regulatory Relations

Enclosures

cc: Paul J. Roberti
Stephen Scialabba
Bruce Oliver

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Gas Procurement and Asset Management Incentive Plan for NEG

Revised - November 2004

I. Objectives

A. To encourage the New England Gas Company ("NEG" or "Company") to achieve lower overall gas commodity costs for its customers; and

B. To encourage the Company to minimize fixed costs and obtain the maximum value from its pipeline, storage and supply resources.

II. Structure of the Incentive Plan

A. The Incentive Plan ("Plan") has two components

1. A Gas Procurement Incentive Program ("GPIP"); and

2. An Asset Management Incentive Program (AMIP").

B. This Plan became effective June 1, 2003. It will be reviewed with each gas cost recovery (GCR) filing. The Company will file Plan results semi-annually at the end of January and July. These reports shall include reporting all Plan activity and results through the end of the month prior to the filing.

1. Gas Procurement Incentives apply only to discretionary purchases made on or after June 1, 2003. The first month for which the incentive will be calculated under the Plan will be November 2003.

2. Beginning in 2005, the AMIP applies to fixed gas supply expenditures for the 12-months ended June 30th of each year except for the 2004/2005 year, which will include the period from November 1, 2004 to June 30, 2005.

C. Limits on Incentives – Both the GPIP and the AMIP, will be subject to limits on the magnitude of incentives applicable to the Company in each fiscal year.

1. For the Gas Procurement Incentive Program limitations are placed on the maximum amount of incentives that can be earned or penalties paid by NEG for each fiscal year. For at least the first two years of the program (i.e., through June 30, 2005):

a. NEG may not earn more than $1,000,000 in Gas Procurement Incentives in any fiscal year; and

b. NEG may not be exposed to penalties of more than $500,000 in any fiscal year.

2. For the AMIP the maximum amount of incentive for the Company for a one-year period will be $400,000. Since the Rhode Island Public Utilities Commission ("Commission") annually reviews and can exercise control over the amount of fixed gas supply costs projected for the coming GCR period, no specific penalty structure is proposed to address unanticipated increases in Asset Management costs.

D. The Company will file its forecasted normal weather natural gas purchase requirements with its annual GCR filing. In addition, whenever the Company updates its annual forecast of projected purchases at the time of the annual update or in the event that an adjustment based on migration is warranted, it will file support for the revised purchase forecast with the Commission and Division.

III. The Gas Procurement Incentive Program

A. The Company will make purchases of natural gas incorporating the lock of the NYMEX Henry Hub portion of the variable cost. For any future gas supply month the Company will make three types of gas purchases:

1. Mandatory Purchases

a. Are defined as mandatory monthly purchases of gas volumes made in uniform monthly increments. (Mandatory purchases will vary as the forecast of purchases is updated periodically.)

b. Will equal 50% of forecasted normal weather gas purchase requirements for each gas supply month from April to October and 70% of forecasted normal weather gas purchase requirements for each gas supply month from November to March. Purchases will be based on the forecast of requirements in place when the purchases are made.

c. Will be purchased in uniform monthly increments on a mandatory basis starting 24 months prior to the month of delivery and ending 4 months prior to the start of deliveries.

d. The first purchases made each month will be deemed the Company's mandatory purchases up to the amount of the Company's uniform monthly purchase requirement unless such purchases are made under the recommended purchase guidelines (RPG) as defined below.

2. Discretionary Purchases

a. Are defined as the physical volume purchased at least 6 business days prior to the start of the delivery month for delivery to the system or storage in excess of the Mandatory Purchase requirements in a month and which, in aggregate, do not exceed 45% of forecasted normal weather gas purchase requirements for a given gas supply month.

b. The cost and benefit of any financial hedges will be included in the calculation of the average unit price.

3. Other Discretionary Purchases Not Subject To Incentives

a. LNG and propane supplies.

b. Supplies that lock in price but are not part of the program i.e., the Distrigas FCS contract.

c. Purchases made less than 6 business days prior to the beginning of the month, during the month or under a contract which does not allow for the locking of the price.

d. Purchases made due to updated levels of forecasted migration of throughput volumes from transportation service to sales service.

B. Computation of Gas Procurement Incentives

Gas Procurement Incentives will be determined on the basis of comparisons of the volume-weighted average cost per dekatherm of Discretionary Purchases made after June 1, 2003, and the volume weighted average cost per dekatherm of mandatory gas purchases made after June 1, 2003 for the same gas supply month. All comparisons will be based on the NYMEX portion of the variable cost per dekatherm of the purchased gas supply.

C. Any purchases made for a future gas supply month, excluding other Discretionary Purchases not subject to incentives as shown in III.A.3, that are in excess of the mandatory purchase requirement for the month, will be deemed discretionary purchases.

D. The timing of discretionary purchases is left solely to the discretion of the Company. However, beginning in November 2005 the Company will make sufficient Discretionary Purchases by November 1st of each year, such that a minimum of 80% of supply needed for December, January and February and 75% of supply needed for a normal November and March will be at a fixed or capped price. The fixed and capped supplies will include all forward purchases, financially based hedges, DOMAC FCS contract purchases, LNG purchases and storage supplies.

F. After all purchases for forecasted gas requirements for a given gas supply month are completed, the volume-weighted average cost of Discretionary Purchases is computed.

1. If the weighted average cost of Discretionary Purchases is less than that for Mandatory Purchases, NEG earns a positive incentive equal to 10% of the difference between the weighted average cost of Discretionary Purchases and the weighted average cost of Mandatory Purchases in dollars per dekatherm multiplied by the actual volume of Discretionary Purchases.

2. If the weighted average cost of discretionary purchases is greater than that for mandatory purchases the Company will be assessed a penalty (i.e., negative incentive) equal to 10% of the difference in dollars per dekatherm between the weighted average cost of Discretionary Purchases and the weighted average cost of Mandatory Purchases for the same gas supply month multiplied by the actual volume of Discretionary Purchases.

3. If the weighted average cost of Discretionary Purchases is more than $0.50 below the weighted average cost of Mandatory purchases then NEG will receive a Meritorious Performance Bonus equal to 10% of the difference between the weighted average cost of Discretionary Purchases and the weighted average cost of Mandatory Purchases multiplied by the actual volumes of Discretionary Purchases.

IV. The Asset Management Incentive

A. For each gas supply year during the effective period of this incentive program, NEG will earn a dollar incentive based on reductions achieved in fixed gas supply and fixed storage costs from the amounts projected as

accepted by the Commission for each gas supply year. The net effect of fixed costs recovered from marketers under the capacity assignment feature of the Company's transportation program will not be counted in the calculation of the incentive. The calculation will include all fixed costs associated with gas supply, asset management fees or credits, capacity release credits and off-system sales margins.

B. To discourage achievement of fixed costs savings through the manipulation of gas commodity purchases, the amount of the Asset Management Incentive shall be dependent upon the Company's success in its Gas Procurement activities.

1. If the Company's actual gas procurement costs at the time of the Company's last annual GCR filing are **below** its projected gas procurement costs on a dollars per dekatherm basis, then NEG shall be provided an Asset Management incentive equal to 20% of the amount by which the sum of the Company's actual fixed gas supply costs and fixed storage costs are below the projected fixed gas supply and fixed storage costs accepted by the Commission for the gas supply year.

2. If the Company's actual gas procurement costs at the time of the Company's last annual GCR filing are **above** its projected gas procurement costs on a dollars per dekatherm basis, then NEG shall be provided an Asset Management incentive equal 10% of the amount by which the sum of the Company's actual fixed gas supply costs and fixed storage costs are below the projected fixed gas supply and fixed storage costs accepted by the Commission for the gas supply year.