2005 Annual Report by the Public Utilities Commission

To the Utilities and Energy Committee On Natural Gas Ratemaking Mechanisms and Actions Taken by the Commission Pursuant to 35-A M.R.S.A. § 4706

I. BACKGROUND

35-A M.R.S.A. § 4706(1) authorizes the Public Utilities Commission (Commission) to adopt alternative ratemaking mechanisms for gas utilities "to promote efficiency in operations, create appropriate financial incentives, promote rate stability and promote equitable cost recovery." In particular, the Commission may: adopt multi-year ratemaking plans with mechanisms for future rate changes; reconcile costs and revenues; index revenues or rate changes; establish financial incentives; streamline regulation or deregulate services where not required to protect the public interest; approve rate flexibility programs; and modify cost-of-gas adjustment requirements.

This report describes Commission actions taken during 2005 to promote effective and efficient regulation of natural gas.

Throughout 2003 and 2004, consumers throughout the nation faced increased natural gas prices and market volatility resulting in significantly higher consumer bills, particularly during the winter months.[1] In May 2003, the Commission invited Maine's local distribution companies (LDCs) to propose pricing options similar to those offered by the heating oil industry, such as fixed price or capped price products, that could be offered to customers to assist them in managing their gas bills. The utilities were also invited to propose hedging strategies. In 2004 we approved a fixed price option for Bangor Gas Company and revised fixed and indexed price options for Maine Natural Gas for customers who prefer greater stability and predictability in their monthly bills.

In 2005, an upward spiral for gas market prices continued, climbing from approximately $6.00 per MMBtu to sustained periods in which prices exceeded $14.00 per MMBtu during the fall and early winter.

In response to this backdrop of price volatility, pursuant to the flexibility afforded by § 4706, we approved monthly cost of gas adjustment mechanisms for Maine's two start-up LDCs to ensure more realistic price signals to consumers

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[1] Gas prices on the spot market during 2002 ranged from approximately $2.00 to $5.25. Gas prices spiked to $19.00 per million British thermal units (MMBtu) in February 2003 then ranged from about $4.50 to $6.00 per MMBtu for much of the remainder of the year. In 2004, prices averaged around $5.00 - $6.00 per MMBtu and hit a high of almost $8.00 per MMBtu.

and to help moderate gas revenue imbalances that accrue between rate adjustment intervals. We also approved a 3-phased base rate increase for one LDC, avoiding a more precipitous increase in consumers' rates had we implemented it all at once. We discuss these actions in more detail below.

II. GAS UTILITIY COMPANY ACTIVITY

A. Maine Natural Gas, L.L.C. (formerly CMP Natural Gas, L.L.C.)

Since 1999, using its authority to enter into contracts that rely on entrepreneurial resources rather than regulatory oversight, Maine Natural Gas has contracted with increasing numbers of large customers that serve to “anchor” expansion into new areas. These customers include the Westbrook Energy Center (WEC) gas-fired electric generation facility, Brunswick Naval Air Station (BNAS), and the University of Southern Maine at its Gorham campus. Maine Natural Gas first built facilities to WEC, then to the Gorham campus. In the fall of 2001, the company completed installation of its pipeline system to BNAS for service on November 1, 2001. Expansion during 2003 included Windham's Enterprise Business Park on Route 302, the Topsham Fair Mall and Highland Green development, and BNAS Brunswick Gardens housing project. The Company continues to work toward expanding service in Windham, Gorham, Brunswick, Topsham, and other municipalities to increase its customer base for all classes of customers.

When initially certified, under its rate plan, Maine Natural agreed not to seek a base rate increase for five years to counterbalance the degree of entrepreneurial freedom that it was granted by the Commission. This rate freeze expired March 31, 2004. Unlike Maine's two other LDCs, Maine Natural Gas did not have a cost of gas adjustment to flow its gas commodity costs on to ratepayers. Instead it employed an innovative commodity pricing strategy using market price inputs and offering customers either fixed or flexible pricing options. In late 2003, the Company reported that market volatility and high gas prices had strained the financial viability of these mechanisms as currently designed and proposed changes to its Indexed Price and Fixed Price Options, as well as a plan to implement a monthly gas cost reconciliation mechanism. Maine Natural Gas proposed to abandon its innovative gas pricing mechanism because of the much greater risk of losses in a volatile gas market. It sought authorization to reconcile its gas costs on a monthly basis. In 2004, we approved Maine Natural Gas's request. This summer, we completed our review of Maine Natural Gas's first year of monthly cost of gas changes and found that the performance of that mechanism satisfactorily maintained rates that provided a closer price signal to market rates and that reduced the rate-distorting effects of accruals of large gas revenue imbalances throughout the year. In addition, Maine Natural Gas reported that several of its fixed price option customers re-enrolled for the 2005-2006 fixed price year, suggesting that some customers (including a school district) find this rate option to be valuable.

In May 2005, Maine Natural Gas requested its first-ever base rate increase. It proposed a 3-phased increase, spread over a 3-year period through 2008. We approved a settlement between Maine Natural Gas and the Office of the Public Advocate (OPA), achieved with the active involvement of our staff, which put in place a modified phased rate increase that is projected to raise an average residential customer's bills by about 3% per year in each of its three years.

Finally, we approved the delayed purchase by Maine Natural Gas of fixed price option gas for the 2005-2006 winter period, due to natural gas market price spikes following hurricanes Katrina and Rita. Ultimately, in mid-November, Maine Natural Gas was able to lock in needed quantities of gas at a reasonable price, achieving for its customers the price stability they sought when enrolling in this program.

B. Northern Utilities, Inc.

Unlike the alternative ratemaking procedures approved for Bangor Gas Company and Maine Natural Gas, traditional regulatory processes govern Northern Utilities' (Northern's) rates and operations. During 2003, the Commission approved Northern's proposed revised hedging program for gas supply procurement designed to dampen the effect of market price spikes on consumers. Northern's limited use of financial hedging instruments under a detailed hedging plan has helped stabilize its gas commodity rates for its customers for the current winter period, avoiding frequent mid-term adjustment of Northern's cost-of-gas factor rates as had occurred in 2000-2002.

In November 2000, Northern's ultimate parent corporation, NiSource, Inc., merged with Columbia Energy Group. The integration of these two large corporate families has resulted in management and policy changes and staff cuts at the Northern/Bay State Gas level. The Commission continues to monitor Northern's post-merger operations and revenues to ensure that service to Maine's customers remains safe, adequate and reasonably priced.

Because of ongoing customer complaints regarding call center and billing operations, in 2002 and 2003 the Commission ordered a management audit of Northern's customer services to determine their adequacy. The audit revealed that substantial post-merger internal restructuring, including loss of or migration of a substantial number of service operations and management to the mid-western home of the parent corporation, had negatively impacted certain aspects of Northern's operations. The Commission used the information gained by the management audit to implement a service quality performance incentive plan that became effective January 1, 2004. The plan established benchmarks for eleven measures of Company performance that must be met to avoid a monetary penalty, to help ensure that Northern meets adequate service standards.

The first annual review of Northern's 2004 service plan performance concluded in December 2005 with the provision by Northern on customers' bills of a credit amount derived from a penalty of $26,550 incurred during 2004 for failures to meet its service standards under the plan. We also approved a stipulation between Northern and the OPA, achieved with our staff's active involvement, amending two measurement formulas and other details of the service quality plan.

In 2005, we approved an accelerated cast iron facility replacement program for Northern in which it will remove all cast iron segments of its distribution system in the Lewiston/Auburn service area during the next three years. We will review whether a similar program should be adopted for Northern's Portland/Westbrook service area in 2008.

Northern has indicated that it expects to seek a base rate increase in 2006 and will provide an alternative rate plan for possible adoption at that time.

Finally, in late December 2005, we approved a stipulation in Docket No. 2005-87 that was entered into by Northern, the OPA, and several competitive gas suppliers to implement a capacity assignment policy governing the terms for Northern's provision of transportation-only service in Maine. The policy assigns capacity costs to transportation customers equal to 50% of their total design day load on Northern's system. In so doing, transportation customers bear a portion of the costs of capacity retained by Northern to ensure system reliability -- backstopping the transportation customers' needs in the event of supplier default -- and to support Northern's provision of sales service to transportation customers that return to sales service in the future. The implementation of this policy clarifies the utility's role in the developing competitive service environment in Maine.

The stipulation also resolved issues under investigation in Docket No. 2005-273, which included the revision of the allocation formula that assigns gas portfolio costs between Northern's New Hampshire and Maine Divisions and the resolution of disputed costs that have accrued since May 2004 under the then-effective (and approved) allocation formula. This proceeding employed joint conferences and settlement discussions among the staffs and public advocate representatives of each jurisdiction, and competitive gas supply marketers.[2]

C. Bangor Gas Company, L.L.C.

Bangor Gas Company operates under the alternative rate plan approved by the Commission in 1998, which includes a 10-year distribution rate freeze, a rate cap set initially on a 3-year average of oil prices, indexed rate cap

[2] The Chairman dissented from the Order Approving the Stipulation.

increases, pricing flexibility, and authority to enter into special contracts without prior Commission approval.

In 2001, Bangor Gas completed installation of its main pipeline to the Bangor-Brewer area. When combined with the many miles of pipeline and facilities it had already installed in those municipalities, Bangor Gas was poised to greatly expand service, and it has steadily added to its customer base in all categories of service. Bangor Gas also serves the Bucksport Energy gas-fired electric generation facility, International Paper (formerly Fort James Corporation, then Georgia Pacific), and the University of Maine at its Orono campus.

The rate plan initially included a seasonal cost-of-gas adjustment. Bangor Gas purchases gas at market prices. In 2002, the Commission approved a streamlined mid-period cost of gas adjustment procedure proposed by Bangor Gas to more efficiently match rates with gas costs. Bangor proposed these changes to reduce the potential for large accruals of over-or under-collection of gas revenues, as well as to reduce regulatory expense for making these adjustments. However, the Company determined, following the large price spike in February 2003, that additional mechanisms to mitigate price volatility were necessary. Accordingly, the Commission approved its proposed change from a seasonal to a monthly cost-of-gas rate adjustment to eliminate the accrual of large seasonal gas cost balances. The Commission also approved a budget payment plan under which customers can elect to spread payment for high winter heating usage over a longer period of time. Currently, approximately 9% of Bangor Gas's customers are enrolled in this budget plan option.

We approved a Fixed Price Option for effect in the 2004-2005 winter period to provide customers with a further bill-stabilizing option. However, due to hurricanes Katrina and Rita, Bangor Gas was unable to obtain a reasonably priced fixed price option for the 2005-2006 winter period. We determined that it would be reasonable for Bangor Gas not to provide this pricing option to consumers this winter given the circumstances. We will review the fixed price option mechanism prior to the 2006-2007 winter period to determine whether any adjustments should be made.

In 2005, we also approved the inclusion in Bangor Gas's base rates of legislatively directed increases to the assessments required by this Commission and the OPA, despite the lack of explicit provision in the rate plan to incorporate such mandated costs during its 10-year term. We did so, due to Bangor Gas's particular circumstances, recognizing that it is not at risk for over-earning and that some incorporation of sizeable mandated costs is the generally accepted practice in the design of most alternative rate plans.

Finally, we approved Bangor Gas's proposed annual price cap adjustment, as authorized under the terms of its rate plan.[3]

III. NATURAL GAS RESTRUCTURING

The Commission implemented gas restructuring in Maine in 1999 in a manner consistent with its interest in encouraging the development of a competitive natural gas supply market within its borders. Since then we have monitored developments in neighboring New England states while taking actions that suit Maine's market and regulatory environment. We have conducted periodic informal surveys of selected registered Maine gas marketers to determine whether pressing matters related to gas competition in Maine have warranted regulatory attention. The Commission's actions to restructure gas service in Maine have stimulated commercial and industrial customers to take transportation-only service.

In 1999, the Commission approved a comprehensive rate redesign and customer reclassification for Northern Utilities that were necessary to prepare Northern for gas supply competition developing in the natural gas industry. In addition, all three gas utilities operating in Maine offer transportation-only ("unbundled") service to all commercial and industrial customers. To date, for all three utilities, customers taking this service were required to purchase and install telemetering equipment. In 2005, Northern brought to us the question of whether we would authorize it to assign its supply capacity to competitive marketers who take on gas supply service for commercial or industrial customers formerly served by Northern. Both Massachusetts and New Hampshire implemented mandatory capacity assignment five or more years ago. Evidence we gathered in Docket No. 2005-87 indicates that their regulatory policies have not been as successful in encouraging the growth of a competitive gas market as has Maine's. In an effort to resolve issues regarding the utility's reliability reserve and portfolio mitigation obligations, we adopted a modified (50%) capacity assignment policy for Northern Utilities with the support of competitive gas suppliers currently serving in Maine who opposed adoption of a 100% mandatory capacity assignment policy. In addition, as with our neighboring states, we approved a non-daily metered form of transportation service that will enable smaller commercial and industrial customers to take transportation service without the costs of installing special metering equipment.

At this time, 16 natural gas suppliers are registered to provide service in Maine. Numerous medium and large commercial and industrial customers, representing approximately 89% of all gas volumes delivered in Maine during 2003, are taking transportation-only service from their local distribution company, while purchasing gas from competitive suppliers. However, persistently higher gas prices from 2003 to date have slowed interest in conversions to gas, though

[3]Bangor Gas has made annual rate cap adjustments to its base rates, as allowed under its rate plan.

natural gas continues to compete effectively with oil for many applications. To date, the market for small commercial and industrial customer conversion to natural gas has developed slowly but should increase in Northern's service area (Portland, Lewiston) with our adoption of non-daily metered transportation service. We will continue to monitor gas market activity in Maine and the region, as well as gas utility response, and to consider whether there are measures we should adopt to reduce market barriers and encourage additional market activity for gas supply.