2007 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 2007 to promote effective and efficient regulation of natural gas.

Since 2000 consumers throughout the nation have 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.

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[1]Gas prices on the spot market since 2000 more than doubled from the historic level of approximately $2.00 per million British thermal units (MMBtu) to about $5.25 per MMBtu in 2002. By 2004, prices had quadrupled to nearly $8.00 per MMBtu, punctuated with spikes to $10.00 per MMBtu in 2001 and to $19.00 per MMBtu in 2003. In 2005, after Hurricanes Katrina and Rita damaged the Gulf coast supply area, gas prices stayed at $14.00 per MMBtu during the fall and early winter. During 2006 prices moderated to between $6.00 and $8.00 per MMBtu and have settled to $5.00 - $7.00 for much of 2007 with record high levels of winter storage nationally. While natural gas prices have been less volatile in 2007, oil prices have risen dramatically since the middle of 2006, so that natural gas spot market prices are now less than one-half the cost of No. 2 fuel oil per Btu.

In 2005, 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 and to help moderate gas revenue imbalances that accrue between rate adjustment intervals. In 2006, we monitored the performance of previously-implemented alternative rate mechanisms and guided the implementation of new policies, such as capacity assignment, and new services, such as non-daily metered transportation service. In 2007, with the sale of Bangor Gas Company, we approved a 3-year extension of its rate plan ensuring some measure of rate stability to those customers. We discuss these actions in more detail below.

II. GAS UTILITY 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 modify its innovative gas pricing mechanisms 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 second 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 has had a number of customers elect the fixed price option each year, suggesting that some customers (including a school district) find this rate option to be valuable.

On November 1, 2007, Maine Natural Gas implemented the final phase of its first-ever base rate increase pursuant to an approved settlement between Maine Natural Gas and the Office of the Public Advocate (OPA), achieved with the active involvement of Commission staff, which put in place a 3-phase rate increase, projected to raise an average residential customer's bills by about 3% per year in each of its three years.

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 winter gas commodity rates for its customers, avoiding frequent mid-term adjustment of Northern's cost-of-gas factor rates as had occurred in 2000-2002. We will conduct an in-depth review of Northern's hedging plan in 2008 to determine whether the plan's costs are reasonable compared to its benefits.

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. We have hired a consultant to conduct a management safety audit of Northern's operations due to several recent serious gas incidents. The audit will be completed by June 30, 2008 and will include the consultant's evaluation of Northern's safety programs and practices and the effectiveness and accountability of Northern's management in seeing that it meets safe practice standards. The Commission would be happy to provide the Utilities and Energy Committee with a summary of the results of the management audit if the Committee would find such a summary useful.

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 annual review of Northern's 2004 and 2005 service quality plan performance resulted in the provision by Northern on customers' bills of credit amounts derived from penalties of $26,550 and$12,600 respectively. Our staff is currently working with the OPA to develop a plan for disbursing substantial penalties for its extensive issuances of estimated bills to some customers from 2004 through 2006.

After the initial two years of a 3-year cast iron facility replacement program for Northern in the Lewiston/Auburn service area, Northern is on target to complete the project next year. In 2008, we will review whether a similar program should be adopted for Northern's Portland/Westbrook service area in 2008. In 2005, Northern agreed to provide an alternative rate plan for possible adoption when it next files a base rate increase proposal. Northern did not seek a base rate increase in 2006 or 2007 to include cast iron replacement costs in rates despite its initial expectation that rate increases in each year of the program would be necessary.

In late December 2005, we approved a stipulation in Docket No. 2005-87 that implements a capacity assignment policy governing the terms for Northern's provision of delivery service in Maine. The policy assigns capacity costs to delivery service customers equal to 50% of their total design day load on Northern's system. In so doing, delivery service customers bear a portion of the costs of capacity retained by Northern to support Northern's provision of sales service to delivery service customers that return to sales service in the future.

During 2006, we implemented rate schedules and terms and conditions of service for new services and charges that were approved with stipulation and resolved related issues (such as the creation of a capacity-exempt class and non-daily metered delivery service) that arose as a result of the new capacity assignment policy.

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 increases,[2] pricing flexibility, and authority to enter into special contracts without prior Commission approval.

The rate plan initially included a seasonal cost-of-gas adjustment. Bangor Gas purchases gas at market prices. In 2003, to mitigate price volatility, the Commission approved its change 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. We also approved a Fixed Price Option (FPO) for the winter period to provide customers with a further bill-stabilizing option. However, we have directed Bangor Gas to prepare an in-depth analysis of its hedging and fixed price option programs for our review in January 2008 to review the cost-effectiveness and fairness of these gas purchasing mechanisms for all customers.

In 2007, we approved a 3-year extension of Bangor Gas' rate plan at the request of Energy West which purchased Bangor Gas from Sempra Energy. The extension, in which we also reset the earnings sharing account to reflect the write-off of Sempra's losses, will ensure rate equity and stability for customers during the transition of ownership.

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

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

("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. The non-daily metered service has proven to be very popular; over 20% of Northern's transportation load is now comprised of non-daily metered service customers.

At this time, approximately five natural gas suppliers provide service to customers on Northern's system, although, many more are registered allowing them to offer gas supply service for Maine. In 2003, numerous medium and large commercial and industrial customers, representing approximately 89% of all gas volumes delivered in Maine, took delivery service from their local distribution company, while purchasing gas from competitive suppliers. However, it appears that implementation of capacity assignment by Northern has resulted in a decrease in delivery service customer load, as some expected.

The current high world oil prices has resulted in a better value per British thermal unit (Btu) of gas for customers, spurring renewed interest in conversions to gas this year. 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.