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

December 31, 2008

I. BACKGROUND

Title 35-A M.R.S.A. Section 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 2008 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, the Commission 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, in response to this backdrop of price volatility, pursuant to the flexibility afforded by Section 4706, the Commission approved monthly cost of

[1] From 2000 to 2002 gas spot market prices more than doubled from the historic level of approximately $2.00 per million British thermal units (MMBtu) to about $5.25 per MMBtu. 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. Prices moderated to $6.00 - $8.00 per MMBtu during 2006 and $5.00 - $7.00 for much of 2007. In the first half of 2008, natural gas hit a peak price of $13.00 and fell to a low of about $5.75 per MMBtu.

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, the Commission 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, the Commission approved a 3-year extension of its rate plan ensuring some measure of rate stability to those customers and in 2008, the Commission approved a low income customer bill discount program for Northern Utilities. These actions are discussed 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 to its Brunswick Gardens housing project on November 1, 2001. Service has expanded to include Bowdoin College, Bath Iron Works’ Harding Plant in East Brunswick, BNAS’s flight buildings, Windham's Enterprise Business Park on Route 302, the Topsham Fair Mall and Highland Green development. The Company continues to work toward expanding service to increase its customer base for all classes of customers.

When initially certified, under its rate plan, Maine Natural Gas 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. In July 2004, the Commission approved a settlement between Maine Natural Gas and the Office of the Public Advocate (OPA) to implement its first-ever base rate increase. The settlement put in place a 3-phase rate increase, projected to raise an average residential customer's bills by about 3% per year in three successive years, the last of which occurred on November 1, 2007.

Initially, unlike Maine's two other LDCs, Maine Natural Gas did not have a cost of gas adjustment to pass on its gas commodity costs 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 its mechanisms as designed, presenting a much greater risk of losses in a volatile gas market. In 2004, the Commission approved Maine Natural Gas's request for authorization to reconcile its gas costs on a monthly basis and changes to its Indexed Price and Fixed Price Options. The monthly mechanism provides a price signal that is closer to market rates and reduces the rate-distorting effects of accruals of large gas revenue imbalances. 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. Each summer, the Commission completes a review of Maine Natural Gas' monthly cost of gas charges for the year.

B. Northern Utilities, Inc.

Unlike the alternative ratemaking procedures approved for Bangor Gas Company and Maine Natural Gas, more traditional regulatory processes govern Northern Utilities' (Northern's) rates and operations. However, Northern's use of a detailed hedging plan since 2003 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. The Commission is analyzing Northern's hedging plan's benefits and costs in a Commission proceeding.[2]

The effects of the November 2000 merger of Northern's ultimate parent corporation, NiSource, Inc., with Columbia Energy Group, which resulted in management and policy changes and staff cuts at the Northern/Bay State Gas level, became apparent. After several serious gas safety incidents occurred in 2007, the Commission hired a consultant to conduct a management safety audit of Northern's operations. The audit was completed in August 2008 and included the consultant's recommendations for improving Northern's safety practices and the effectiveness and accountability of Northern's management in seeing that it meets safe practice standards.

The Commission approved a comprehensive settlement of numerous safety compliance actions in which Northern agreed to implement a series of compliance actions and system improvements costing approximately $3.5 million and to pay a substantial monetary penalty. Specifically, Northern agreed to pay $2 million in penalties which will not be recovered in rates, a significant portion of which will go to safety improvements. Northern has also been required to spend an additional $1.5 million in safety improvements, most of which will not be recoverable in rates, to reach full compliance with the Commission's Order approving the settlement. Unitil, which acquired Northern in December 2008, has agreed to implement the terms of the settlement and the recommendations of the management audit.

[2] *Investigation of the Hedging Program (Northern Utilities)*, Docket No. 2008-93.

In addition, in conjunction with Unitil's acquisition of Northern, the Commission approved a 30% bill discount program for all Low Income Home Energy Assistance Program (LIHEAP) eligible customers in Maine, pursuant to Section 4706-A. 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 2006 and 2007 service quality plan (SQP) performance resulted in a finding that Northern had issued estimated bills from 2004 through 2007 to some customers more extensively than was allowed by the SQP. As a penalty, Northern issued credits on customers' bills in July 2008 in the total amount of nearly $236,000 and agreed to make a non-recoverable investment of $316,550 in an Automated Meter Reading program to implement monthly meter reading by 2010. The fact that this investment is non-recoverable means it will not impact rates.

In 2008, Northern completed a 3-year cast iron facility replacement program in the Lewiston/Auburn service area, greatly reducing the threat of leaks and burden of costly repairs to its distribution system there going forward. In 2008, the Commission initiated an investigation into whether a similar program should be adopted for Northern's Portland/Westbrook service area. Northern will propose an alternative rate plan when it next seeks a base rate increase, but has not done so as yet despite its initial expectation that rate increases in each year of the Lewiston/Auburn program would be necessary.

In 2005, the Commission approved a stipulation[3] that implemented a capacity assignment policy that 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 Northern's reserve capacity. During 2006, we implemented rate schedules and terms and conditions of service for new services and charges that were approved with the

[3] *Northern Utilities, Inc., Petition for Approval of Delivery Service Terms and Conditions*, Docket No. 2005-87; *Review of Northern Utilities, Inc.'s Proportional Responsibility Allocation Formula*, Docket No. 2005-273, Order – Part 1 (Dec. 23, 2005) and Order – Part 2 (April 26, 2006).

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 included a 10-year distribution rate freeze, a rate cap set initially on a 3-year average of oil prices, indexed rate cap increases,[4] pricing flexibility, and authority to enter into special contracts without prior Commission approval. In 2007, the Commission 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 the Commission 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.

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. The Commission also approved a Fixed Price Option (FPO) for the winter period to provide customers with a further bill-stabilizing option. However, due to gas purchasing complexities and customer fairness concerns, Bangor Gas no longer offers the fixed price option program.

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 the Commission has monitored developments in neighboring New England states while taking actions that suit Maine's market and regulatory environment. The Commission has 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 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

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

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. Initially, for all three utilities, customers taking this service were required to purchase and install telemetering equipment, but Northern now offers non-daily metered service.

In 2005, Northern brought to us the question of whether the Commission would authorize Northern 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 the Commission 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, the Commission 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, the Commission 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 three natural gas suppliers provide service to Maine customers, although many more are registered to offer gas supply service. 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 and, consequently, of the number of competitive gas suppliers, as some expected.

High world oil prices create a better value per British thermal unit (Btu) of natural gas for customers, spurring a robust interest in conversions to gas this year. The Commission 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 that should be adopted to reduce market barriers and encourage additional market activity for gas supply.