

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA
1333 H ST., NW, Suite 200, West Tower
WASHINGTON, DC 20005

ORDER

June 15, 2004

FORMAL CASE NO. 874, IN THE MATTER OF THE GAS ACQUISITION STRATEGIES OF THE DISTRICT OF COLUMBIA NATURAL GAS, A DIVISION OF THE WASHINGTON GAS LIGHT COMPANY, Order No. 13221

I. INTRODUCTION

1. By this Order, the Public Service Commission of the District of Columbia ("Commission") removes the existing 10-percent cap on the Washington Gas Light Company's ("WGL" or the "Company") hedging for its projected annual sales and leaves the company free to make whatever hedging decisions it believes are prudent based upon its current statistical approach. Additionally, with regard to purely financial or derivative hedging, the Commission directs WGL to undertake a simulation for the next hedging season and track the effects of a hypothetical derivative hedging program for the same volume of gas that is currently hedged by the company in its pilot program. The Commission further directs the company to report the results of the simulation in its annual report of hedging activities for 2004.

II. BACKGROUND

2. This formal case is the vehicle through which the Commission monitors WGL's gas acquisition and procurement practices in an on-going effort to ensure that rates are just and reasonable. Inasmuch as the prices that consumers pay are driven, in large part, by the wholesale market prices of gas, and because these prices have been extremely volatile, the Commission adopted a pilot program in 2001 for the purpose of determining whether hedging would provide consumers some protection against price volatility. Under the pilot program, the Commission has allowed WGL to hedge up to 10 percent of its projected annual sales volumes.¹

¹ *Gas Tariff 01-1, In the matter of the Application of Washington Gas Light Company, District of Columbia Division, for Authority to Amend its General Service provision, Order No. 12201, rel. October 5, 2001 ("Order No. 12201").*

3. The Commission scheduled and held a status hearing in this matter on November 12, 2003. At that hearing, the Commission asked WGL to respond to the following questions:

- a. What new decision-making approach are you using this year that you did not use last year in making hedging purchase decisions? Is this a statistical-based approach? Please explain.
- b. Is it worthwhile to try to contract for the gas supply of Interruptible Customers that are interrupted for price reasons? In other words, can the gas supply of Interruptible Customers be obtained if there was a price advantage relative to the PGC gas price, even under economic interruption scenario situations? If yes, how? Is it a worthwhile endeavor? If no, why not?
- c. Is it worthwhile to engage in longer term hedging, such as earlier in the year? Or now for next year? Why or Why not?
- d. What is the status of the MD. and VA. hedging programs?
- e. How much of the total natural gas supply for MD. and VA. is being hedged?
- f. Should we raise the hedging volume limit in D.C. if we decide to renew the pilot program? If yes, to what level and why? If no, why not?
- g. How should the Commission evaluate the results of the current pilot program? What benchmarks should be used?²

WGL answered the questions orally at the hearing and in written comments after the hearing.³ OPC filed written comments as well.⁴

² *Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company, Order No. 12984, rel. November 7, 2003*

³ *Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company, Washington Gas Light Company's Comments ("WGL Comments") on Order No.12984 Questions, filed on December 3, 2003. Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company, Washington Gas Light Company's Reply Comments ("WGL Reply Comments"), filed on January 9, 2004.*

⁴ *Formal Case No. 874 In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company, Office of the People's Counsel's Revised Comments ("OPC Comments"), filed December 8, 2003 Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light*

III. RESPONSES OF THE PARTIES

4. WGL's witness explained that the Company initially used a historical average approach, which looked at a five-year average of gas prices to determine whether hedging was appropriate. The Company would enter into fewer hedging transactions when prices were toward the higher end of the historic five-year band. However, as market prices became increasingly volatile, the Company realized that an examination of gas prices over the last three years was a better indicator of projected market prices for the next two to three years. Therefore, the Company abandoned the historical average approach and adopted a statistical method of examining market dynamics.⁵ OPC does not object to WGL's statistical approach.⁶

5. WGL states that it would not be worthwhile to contract for gas supply for interruptible customers that are interrupted for price reasons. According to WGL, it has less than a dozen customers with interruptible sales service.⁷ OPC agrees that the number of interruptible customers served by WGL is too small to be a factor in the scope of the Company's hedging program.⁸

6. According to WGL, longer term hedging would not be advisable. WGL states that it purchases gas for the winter months during the immediately preceding summer months.⁹ Because the company uses a bid solicitation method to hedge, WGL asserts that the most opportune time to engage in such transactions is during the bid week periods of the summer.¹⁰ Additionally, WGL notes that the volume gas that it purchases is ultimately based on a number of factors, such as the level of firm delivery service participation, that are difficult to predict well in advance of the winter season in which the gas will be used and could leave the Company with unneeded gas purchases.¹¹

Company, Office of the People's Counsel's Reply Comments ("OPC Reply Comments"), filed December 17, 2003.

⁵ *Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company*, Transcript at 34-37 ("Tr.") filed on November 17, 2003.

⁶ OPC's Comments at 8

⁷ WGL Comments at 3.

⁸ OPC Comments at 9.

⁹ Tr. at 12,29

¹⁰ Tr. at 105.

¹¹ Tr. 39; WGL Reply Comments at 8.

7. OPC, on the other hand, believes that WGL should expand its hedging activities to consider alternatives outside the framework of solicitations during bid week.¹² In fact, OPC believes that WGL should consider hedging transactions on a year-round basis, or even a multi-year basis, if circumstances warrant.¹³ OPC also believes that WGL's hedging program should include financial derivative transactions as well as summer purchases for storage injections as the former are intended to permit the company greater flexibility in guarding against price spikes and price volatility.¹⁴

8. In WGL's view, hedging storage injection gas, hedging year-round, and using the OPC-type of financial hedges would not necessarily be in the best interests of ratepayers. The Company points out that more hedging does not necessarily result in more savings. According to the Company, the gas withdrawn for use in the winter season is usually purchased in the prior summer season when the price of gas is lower. Therefore, the company states that the objectives of protecting customers from price spikes, which occur during the heating season, and stabilizing the price paid for gas are already achieved through the normal operation of storage. Similarly, because prices are usually lower and less volatile during the summer months than during the winter months, WGL does not believe that hedging year-round will necessarily be beneficial to consumers. WGL also rejects OPC's suggestion that the Company explore active examples of financial hedging because it would significantly increase management oversight and the additional cost would be borne by ratepayers.¹⁵

9. WGL asserts that the best way to measure the results of its hedging efforts is to determine whether the Company's hedging guidelines are adequate to meet its stated objective of protecting customers from price spikes.¹⁶ OPC, however, believes that we should evaluate the results by comparing what customers paid under existing practices against what they would have paid if: 1) there had been no hedging transactions; and 2) other hedging alternatives had been chosen.¹⁷

10. OPC also notes that, Formal Case No. 1020 provides an opportunity to evaluate WGL's practices in the context of an actual case.¹⁸ There, OPC filed a complaint alleging that WGL failed to hedge prices for any of its winter 2002-2003 District of Columbia sales and, thereby, failed to afford District customers any protection from the price spikes and price volatility that ensued when prices climbed to historic

¹² OPC Comments at 12-13.

¹³ *Id.* at 9-10.

¹⁴ OPC Comments at 14-15

¹⁵ WGL Reply at 6-8.

¹⁶ Tr. at 47

¹⁷ OPC Comments at 21.

¹⁸ *Id.* at 23

highs in February and March 2003. WGL counters that the record supports a Commission finding that the company has acted in a prudent manner with respect to its past and present decisions to hedge in the District of Columbia.¹⁹

11. With regard to similar hedging programs in Virginia and Maryland, WGL states that Virginia's pilot program will end at the close of the 2005-2006 heating season. WGL states that Maryland initially approved a two-year pilot program. Although the company requested an extension of the Maryland program to make it correspond to the program in Virginia, the Maryland Commission approved the extension only until the close of the 2004-2005 heating season.²⁰ According to the Company, it hedged 12.8 percent of gas in both jurisdictions compared to 10 percent in the District.²¹ OPC does not take issue with these figures.

12. Finally, in response to the question of whether the 10 percent cap should be raised, both WGL and OPC responded that the cap should be lifted entirely.²² WGL states that the 10 percent cap is unnecessary in light of its formula that establishes a maximum volume that can be hedged on a non-speculative basis.²³ OPC believes that WGL should modify the formula because it unnecessarily limits the potential benefits to consumers.²⁴

IV. COMMISSION DECISION

13. Both parties have, to some degree, attempted to use this case as vehicle for either challenging or defending the prudence of WGL's hedging activities. However, we are not conducting a prudence review of WGL's actions at this juncture nor are we attempting to pre-approve WGL's hedging policy. A pre-approval would presume the prudence of costs before they are specified or incurred and effectively guarantee that WGL can recover those costs from customers. We are disinclined to guarantee recovery unless WGL provides, at a minimum, evidence that the plan is beneficial to consumers and that the company has a strong incentive to efficiently carry out the plan. WGL has not sought pre-approval of its plan nor has it provided any evidence that would justify pre-approving it. Therefore, WGL's hedging decisions are subject to a possible prudence

¹⁹ WGL Comments at 5

²⁰ Tr. at 42-43

²¹ WGL Comments at 4.

²² Tr. at 46; WGL Comments at 4 ; OPC Comment at 15

²³ WGL Reply at 4.

²⁴ OPC Comments at 16

review, which is an after-the-fact determination of whether WGL's hedging decisions were reasonable under the circumstances.²⁵

14. With regard to the 10 percent cap, WGL initially suggested it as a pilot limitation to permit the Company, the Commission, and the general public to become more familiar with the opportunities and attendant risks associated with gas hedging.²⁶ The cap served to insure that WGL did not over-commit to a hedge volume that the customers do not need, a circumstance that could force the company to go back out in the marketplace and sell the gas, perhaps at a loss.²⁷ Now, after several years of experience with hedging, WGL states that its current hedging plan establishes the maximum volume to be hedged on a non-speculative basis and thereby renders the 10 percent cap unnecessary. We agree that the cap no longer serves a purpose in light of WGL's current practice of limiting its system-wide hedging volume based on the amount of gas that the company believes that it can consume. Therefore, we remove this constraint on hedging gas volumes and encourage the company to make whatever hedging decisions it believes are prudent, subject of course to its current limits for operational flexibility and the possibility of a future prudence review.²⁸

15. Under WGL's current plan, it does not hedge storage injection gas, hedge year-round, or directly engage in purely financial or derivative hedging. For the reasons articulated by WGL, as set forth in ¶ 8 of the Order, we see no basis for compelling WGL to hedge storage injection gas or hedge year-round. However, purely financial/derivative hedging may offer some additional advantages to WGL's current hedging practices, e.g., the costs of disposing of an option for above market priced gas may be substantially less than the cost of disposing of the physical gas itself.²⁹

16. In order to explore this area further, we direct the company to conduct a "simulation" for the next hedging season and track the effects of a hypothetical derivative hedging program for the same volume of gas that is currently hedged by the company in

²⁵ Of course, if we were to conduct a prudence review of WGL's hedging practices, that review would hinge on an examination of the information that the company had at the time the hedging decisions were made, not upon the actual outcome of its hedging practices.

²⁶ *Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company*, Order No. 12327 at ¶ 19.

²⁷ Tr. at 28.

²⁸ We note that our colleague would prefer to raise the cap to 15 percent rather than eliminate it. In his view, this creates a "safe harbor" that somehow limits the scope of future complaints regarding the hedging program. First of all, we have never previously stated or implied that a cap, whether set at 10 or 15 percent, creates a zone of reasonability such that all hedging within the cap is subject to less scrutiny. Additionally, we never asked either party to address the propriety of raising the cap to 15 percent nor have they done so. In our view, it would be inappropriate to turn the decision on questions that were neither asked nor answered.

²⁹ See Costello, Ken, *Use of Hedging by Local Gas Distribution Companies: Basic Considerations and Regulatory Issues*, NRRRI, May 2001, F.C. 874 WG Cross Exhibit No. 1.

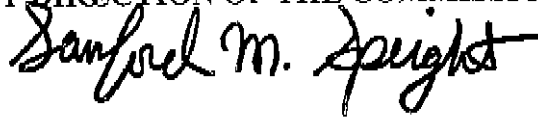
its pilot program. The results of the simulation should be reported as part of WGL's annual report on its hedging activities. In addition, we direct WGL to explore the feasibility and desirability of undertaking hedging derivatives, for periods longer than the upcoming winter heating season. The results of that exploration should be reported in WGL's annual hedging report along with an evaluation of WGL's hedging equation on hedging volumes.

THEREFORE, IT IS ORDERED THAT:

17. The 10 percent cap on hedging gas volumes is eliminated; and
18. WGL shall consider purely financial hedging in accordance with ¶ 15 of this Order and include the results in its next annual report of its 2004 hedging activities.

A TRUE COPY:

BY DIRECTION OF THE COMMISSION:



CHIEF CLERK

**SANFORD M. SPEIGHT
ACTING COMMISSION SECRETARY**

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA
1333 H ST., NW, Suite 200, West Tower
WASHINGTON, DC 20005

DISSENT OF COMMISSIONER ANTHONY M. RACHAL III

ORDER

June 15, 2004

FORMAL CASE NO. 874, IN THE MATTER OF THE GAS ACQUISITION STRATEGIES OF THE DISTRICT OF COLUMBIA NATURAL GAS, A DIVISION OF THE WASHINGTON GAS LIGHT COMPANY, Order No. 13221

I. INTRODUCTION

1. By this Order, the Public Service Commission of the District of Columbia ("Commission") removes the existing 10-percent cap on the Washington Gas Light Company's ("WGL" or the "Company") hedging for its projected annual sales and leaves the company free to make whatever hedging decisions it believes are prudent based upon its current statistical approach. Additionally, with regard to purely financial or derivative hedging, the Commission directs WGL to undertake a simulation for the next hedging season and track the effects of a hypothetical derivative hedging program for same volume of gas that is currently hedged by the company in its pilot program. The Commission further directs the company to report the results of the simulation in its annual report of hedging activities for 2004. For the reasons expressed below, I must respectfully dissent from the majority opinion with respect to this decision.

II. BACKGROUND

2. This formal case is the vehicle through which the Commission monitors WGL's energy acquisition and procurement practices in an on-going effort to ensure that rates are just and reasonable. Inasmuch as the price that consumers pay is driven, in large part, by the price of gas on the market, and because the price of gas on the market has been extremely volatile, the Commission adopted a pilot program in 2001 for the purpose of determining whether hedging would provide consumers some protection against price volatility. Under the pilot program, the Commission allowed WGL to hedge up to 10 percent of its projected annual sales volumes.¹

¹ *Gas Tariff 01-1 In the matter of the Application of Washington Gas Light Company, District of Columbia Division, for Authority to Amend its General Service provision, Order No. 12201, rel. October 5, 2001 ("Order No. 12201").*

3. The Commission scheduled and held a status hearing in this matter on November 12, 2003. At that hearing, the Commission asked WGL to respond to several questions² WGL answered the questions orally at the hearing and in written comments after the hearing.³ OPC filed written comments as well.⁴

III. DISCUSSION

4. In general, the majority takes an ultra conservative approach regarding the WGL hedging program. The Commission should send a clear signal to WGL indicating that more should be done with respect to hedging. If the Commission is truly supportive of an increase in the hedging activities in the District, we should respond by changing our hedging goal. The Company should be encouraged to explore and fully take advantage of all hedging opportunities, including traditional hedging, financial hedging, and supply inventory hedging, in order to provide both rate certainty and rate stability. I encourage the Company to increase its efforts in developing a diverse, and robust hedging program, and I urge the Commission to demonstrate our commitment by specific support for such a program up to 15 percent.

5. Thus, I support raising the hedging cap up to 15 percent as compared to the existing 10 percent cap. Taken alone, completely eliminating the hedging cap does not provide any guidance to WGL regarding whether or not the Commission firmly supports the Company's efforts to hedge. Increasing the hedging cap definitively and affirmatively indicates to the Company that more hedging should be done if the Company finds hedging to be prudent under the relevant circumstances. Although the majority believes that removing the cap entirely provides the Company with an even greater degree of flexibility than I am proposing, in reality, this move will have a chilling affect on the Company's hedging activities. The uncertainty of what may be deemed appropriate after a prudence review looms larger without any guidance.

² *Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company*, Order No. 12984, rel. November 7, 2003.

³ *Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company*, Washington Gas Light Company's Comments ("WGL Comments") on Order No. 12984 Questions, filed on December 3, 2003. *Formal Case No. 874 In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company*, Washington Gas Light Company's Reply Comments ("WGL Reply Comments"), filed on January 9, 2004

⁴ *Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company*, Office of the People's Counsel's Revised Comments ("OPC Comments"), filed December 8, 2003. *Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of the District of Columbia Natural Gas, a Division of the Washington Gas Light Company*, Office of the People's Counsel's Reply Comments ("OPC Reply Comments"), filed December 17, 2003

6. Additionally, 15 percent is more in line with historical levels of hedging that were maintained in Maryland and Virginia during the last winter heating season. This is based on the fact that the system average for all three jurisdictions was 12.3 percent. With the District at 10 percent, the hedging percentage in Maryland and Virginia had to be higher than 12.3 percent in order to drive the system average up to 12.3 percent. Testimony from WGL's witness confirms the hedging levels in Maryland and Virginia were between 13 percent and 14 percent.⁵ Moreover, I believe that 15 percent is a very reasonable number under current circumstances, representing a 50 percent increase in the hedging cap for the District, and only a 2.7 percent increase over the system wide hedging average.

7. A specified hedging cap should also help to limit the scope of future complaints regarding the hedging program, because it establishes parameters that should provide a "safe harbor" for the company's hedging activities. Arguably, if the company's hedging activities remain within the boundaries of the parameters, then those activities should be considered to be appropriate as opposed to any hedging activities done outside of the accepted parameters. In my opinion, no hedging cap makes all of the Company's hedging activities subject to over intense scrutiny. As is the case with hindsight, any after the fact assessment makes it is easy to determine whether or not a particular hedging decision worked to the best interest of consumers. Established parameters will help to eliminate many concerns that may arise based upon such hindsight evaluations of the Company's hedging decisions. The Commission should create a "safe harbor" for the Company, so that hedging will be incorporated into the Company's total strategy to maintain reasonable, stable, and reasonable rates.

8. Accordingly, the Company should be encouraged to increase their existing hedging efforts. Although I am pleased with the work that is being done to date, I note that WGL has devoted limited resources to its hedging program. The assignment of only one person to such management activities renders the company ill equipped to be aggressive in its hedging activities. The Company should be asked to explore other hedging options, particularly financial hedging and physical/inventory hedging, and report back to the Commission concerning the feasibility of those options. I believe that storage hedging exists today, but has not been fully accounted for as one component of a comprehensive strategy. This must be done and addressed separately from all other hedging measures in the context of this hedging debate. The Company should be required to quantify its ability to hedge using storage, and account for this hedging option separately from the present hedging programs as well as a projection of financial hedging to be done in the future. I also support OPC's comments as noted in paragraph seven of the majority opinion of this Order. The Company should be encouraged to develop a diverse, well-balanced hedging program.

9. Furthermore, I would urge the Company to continue to explore a 12-month hedging program, and report their findings to the Commission. Such a program,

⁵ See Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of Washington Gas Light Company, the District of Columbia Division, November 12, 2003, Status Hearing-Hearing Transcript, Pages 43, 44, 45, 64, and 65.

when appropriate, should provide the Company with another option, and thus additional flexibility to maximize the potential benefits of hedging. A 12-month hedging program in my mind encompasses both the ability to enter into hedging agreements in any month of the year, and also the ability to enter into hedging agreements 12-months in advance of the time that the agreement is executed. In the interim, the proposed increase in the hedging cap to 15 percent seems appropriate in order to immediately provide the company with some additional flexibility. I am not suggesting that the Company be required to hedge on a twelve-month basis, only that the Company be given the ability to do so when deemed prudent.

10. I also support the "Fully Hedged" methodology to hedging, as opposed to the "Purchase or Wait" methodology, which appears to be the more common approach to hedging. Under the Purchase or Wait approach, a buyer analyzes and evaluates gas prices in the futures market, and makes gas purchase decisions based upon whether they conclude that future prices are estimated to be too high or too low. The buyer will purchase gas if they believe the prices are too low, or wait to purchase gas if they believe that the prices are too high. However, the hedging cap or maximum is only reached once during the relevant year or heating season.

11. The Fully Hedged approach provides a buyer with the option of potentially reaching the hedging maximum several times during the relevant period. For example in the District under the initial ten percent hedging maximum, the company would be Fully Hedged when it reached the ten percent maximum. However, as those contracts are executed, new contracts could be entered into immediately in order to reach the ten percent maximum again. If the prices are better in the spot market, hedging contracts can be extended in order to take advantage of lower spot market prices. In my opinion, the Fully Hedged approach enhances the potential benefits of hedging, and should be considered by the Company as a means to maximize the benefits of hedging for District consumers.

12. I am troubled by the majority position that "WGL's hedging decisions are subject to a prudence review, which is an after-the-fact determination of whether WGL's hedging decisions were reasonable under the circumstances."⁶ If hedging is utilized to obtain stable rates over the long term, then the primary objective of hedging is accomplished once the hedging agreements have been made. Hedging provides certainty, because the expected outcome is known at the time the agreements are executed. In this respect, there is no speculation involved. This statement by the majority implies that whether or not a hedging decision is prudent, is contingent upon a hindsight review of consumer purchase gas costs. If ratepayers pay lower purchase gas costs as a result of hedging, then the hedging strategy was prudent, but if ratepayers pay higher gas costs, then the decisions were imprudent? In my opinion, this is not the correct or appropriate measure of the value of a hedging program. Rather, hedging is a rational device to deter price spiking, like insurance against major catastrophic losses. It is a risk management device applied to assure steady pricing and the availability of supply at reasonable prices.

⁶ See Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of Washington Gas Light Company, the District of Columbia Division, Order No. 13221, rel. June 15, 2004, Pages 5 and 6.

13. The Commission and consumers should remain mindful of the fact that the primary benefits of hedging are rate certainty and rate stability. A properly managed hedging program should help to produce level and predictable rates over time. Stable rates insulate consumers from rate spikes, and allow customers to budget for their energy needs. Additionally, the value of a hedging program in the District of Columbia should be evaluated over a period of time rather than based upon the performance of the program within one year. With each passing year, the hedging experiences in the District, Maryland, and Virginia, should be incorporated into the Company's strategy when making future hedging decisions.

14. I do not support the majority decision to direct the Company to implement a financial hedging simulation program, and report on that imaginary program in its next annual hedging activities report. I believe that it is unfair to ask the Company to dedicate the resources to such an unproductive project, and I believe that the success or failure of such a program would be too difficult to ascertain. Furthermore, if the Commission believes that such a simulation would be of value to the Commission, then the Commission should dedicate the necessary internal resources to support this endeavor. I believe that it is disingenuous for the majority to send signals to the Company that clearly support a decision to curtail hedging activities, and at the same time ask the Company to dedicate more of its resources to a simulated hedging activity, with no real associated benefits to consumers.

15. As noted above, in many respects, a hedging program functions like an insurance policy in that it allows the Company to manage its customer's rate risks and exposure to rate shock. The rates resulting from a hedging program may be higher or lower than market rates at any given point in time. However, the value of a hedging program is not diminished when market rates are lower than rates derived from a hedging program. Rate certainty, rate stability, and risk management are the primary goals of a hedging program. The majority's logic would lead one to conclude that car insurance would be an imprudent expense if the insured never had an accident, despite the fact that the costs associated with one accident could be devastating. This Commission need only look to California to see the impact of a shortsighted energy procurement strategy.

16. In its July 2003 Summer Meetings, the NARUC⁷ Board of Directors ("the Board") passed a resolution supporting the development of a Tool Kit by NARUC's Natural Gas Task Force for the use of State Commissions in addressing high natural gas prices and high price volatility.⁸ The Board notes that according to most indicators, in the absence of additional access to adequate land areas and gas supplies, demand-side management, conservation and other measures, natural gas price volatility will continue. As natural gas price increases will ultimately be borne by retail gas consumers, it is

⁷ National Association of Regulatory Utility Commissioners ("NARUC")

⁸ National Association of Regulatory Utility Commissioners-Natural Gas Information Tool Kit, ("Tool Kit") issued by the NARUC Natural Gas Task Force, rel November 2003.

imperative that State Commissions have the tools necessary to carefully examine measures that assure reasonably priced gas utility services.

17. According to the Took Kit, “[t]he Energy Information Administration (EIA) in the U.S. Department of Energy, in its October 2003 Short-Term Energy Outlook (released October 7), reported that, assuming a return to normal temperatures during the 2003-2004 winter season and modest growth in new supply...[r]esidential prices are projected, however, to average \$9.17 per Mcf, up 9 percent from the average \$8.39 last winter...Due to the increase in expected residential prices, per-household natural gas expenditures are projected to rise about 5 percent despite an expected drop in actual consumption in the base case.”⁹

18. The Took Kit also states that “[a]s a general observation, in recent years, state commissions have put more emphasis on price stability as a goal of gas procurement by utilities. In Arkansas, for example, commission rules recently promulgated require utilities to develop gas supply plans that attempt to “achieve the optimum balance of reliability, reduced [price] volatility and reasonable price for the benefit of consumers...The options that gas utilities should consider are long-term contracts as well as financial hedges which act like insurance policies on the cost of gas that utilities must buy.” Overall, since the winter of 2000-2001, state commissions have become more receptive to hedging by gas utilities. Although somewhat still leery of financial hedging, state commissions have increasingly recognized its potential benefits.”¹⁰

19. “State PUCs may also want to consider the extent to which hedging activities (physical and financial hedges) by gas utilities fit into state policy objectives—for example, the value of long-term, fixed-price gas contracts, and the value of using natural gas and weather-related financial instruments to help stabilize purchased gas costs. In recent years it has become more widely acceptable for gas utilities to recover the cost of financial derivatives acquired to hedge limited amounts, (e.g. variable supply requirements during the heating season or swing gas supplies) of their gas purchases. In other jurisdictions, more expansive use of hedging tools is authorized as part of a utility’s gas purchasing incentive plan or as part of a hedging pilot program. State PUCs should recognize the risks involved in allowing utilities to use these tools.”¹¹ I echo these sentiments.

20. The April 2004 Public Utilities Fortnightly contains an article entitled: The Case Against Gas Dependence, “Greater reliance on gas-fired power implies serious economic, technological, and national security risks.”¹² In my opinion, this article

⁹ Id. at page 5

¹⁰ Id. at pages 13 and 14

¹¹ Id. at pages 44 and 45.

¹² Roger H. Bezdek and Robert M. Wendling, “The Case Against Gas Dependence—Greater reliance on gas-fired power implies serious economic, technological, and national security risks.” Public Utilities Fortnightly, April 2004, at page 43.

underscores the need for this Commission to develop sound policies concerning gas procurement measures for the District of Columbia. According to this article, “[i]n 2002, EIA projected nearly 90 percent of all new electric generation over the next two decades will be gas-fired, while in its 2003 forecasts it projects that 80 percent of new electric generation will be gas-fired. Its 2003 forecast of total gas consumption in 2020 is 1.7 Tcf lower than the 2002 forecast, and most of this (1.1 Tcf) is from reduced consumption in the electric generation sector.”¹³ However, “U.S. natural gas production will not keep pace with demand—even with EIA’s reduced estimates of future demands—and gas imports will increase significantly...Further, U.S. gas markets may not be able to accommodate the huge anticipated increase in natural gas demand over the next two decades.”¹⁴

21. Moreover, “Wayne Andrews of Raymond James & Associates noted:¹⁵

- *U.S. gas supply is declining at an unprecedented rate, and U.S. producers will find it very difficult to reverse this negative trend;
- *The gas industry is searching for smaller reserves and decline rates are increasing, and;
- *Imports from Canada are declining; and liquefied natural gas (LNG) is the only long-term solution.

22. Mathew Simmons of Simmons & Co., International similarly believes that:¹⁶

- *Although the gas well drilling boom of 2000/2001 was unprecedented, it resulted in few new supplies, and U.S. gas production has been essentially flat since 1995;
- *The decline in domestic gas production is not reversible through a new drilling boom;
- *A 10 percent decline in domestic production is likely but could be far worse; and
- *By 2004, a large number of new gas-fired electric generation plants will be on line and, if all are used in the same week, the “sucking impact on gas will be unprecedented.”¹⁷

¹³ Id. at page 44.

¹⁴ Id.

¹⁵ Wayne Andrews, “Are U.S. Gas Markets Headed for a Disaster?” Presented at FERC’s In the Matter of Natural Gas Marketers Conference, Washington, D.C., October 25, 2002.

¹⁶ Mathew R. Simmons, “The Natural Gas Outlook: Crisis Ahead?” Presented to the Texas Alliance of Energy Producers, Fort Worth, Texas, May 2002.

¹⁷ Roger H. Bezdek and Robert M. Wendling, “The Case Against Gas Dependence—Greater reliance on gas-fired power implies serious economic, technological, and national security risks.” Public Utilities Fortnightly, April 2004, at page 44.

23. "In addition to concerns about future supplies, price volatility is a major problem with using gas to generate electricity. Annual average prices of natural gas to electric utilities have been extremely volatile, and price fluctuations of 50 to 100 percent have been common. Monthly gas price variations to electric utilities have been even more extreme. In recent years, the monthly price of natural gas has varied by more than 300 percent. Natural gas prices are likely to remain extremely volatile during the next two decades. This volatility likely will worsen, given the increased demand for natural gas (especially for electricity generation) and tightening supplies. Even more seriously, this volatility will be occurring along a trend line of increasing gas prices. EIA forecasts that natural gas prices will increase as technology fails to offset resource depletion and increased demand, and prices to electricity generators are projected to reach \$4.40/Mcf by 2015 (2001 dollars)—equivalent to more than \$6.00/Mcf in nominal dollars."¹⁸ A diverse complement of hedging strategies, to the extent possible, can help to shield consumers from this potential price volatility projected for the future.

24. On May 12, 2004, Energy Central sponsored an audio conference entitled "Wholesale Power Markets and the Imminent Run-up in Natural Gas" which highlighted the potential for price spikes in the natural gas power market. According to the featured presenter, Andrew D. Weissman, Publisher of Energy Business Watch, all of the elements are in place for a price explosion that could send power companies reeling. The key message focused on how power companies and regulators can work to mitigate these risks. I believe that this Commission should learn from the mistakes made elsewhere in the country, and be proactive in developing and supporting a prudent energy procurement risk management strategy which includes various forms of hedging as discussed earlier in this dissent.

25. As a final point, I do not believe that this Commission had to bestow WGL with broad authorization to implement a hedging program. I believe that the Company possessed the managerial authority to independently determine whether or not hedging made sense in the District. However, since this Commission has already taken the position that its authorization was appropriate, we should make certain that we address all hedging related issues that arise as quickly as possible. Consistent with this objective, I support the option of implementing an automatic approval process for any WGL hedging decision that falls within pre-established parameters by this Commission. This would insure that all hedging related decisions are made in a timely manner, so that the Commission will not serve as a barrier to the future development of the hedging program in the District of Columbia.

IV. CONCLUSION

26. I believe it is the responsibility of this Commission to be clear and precise. If we truly support an increase in hedging activities we should say so. By an affirmative directive to increase present hedging authority up to 15 percent, we send a direct and

¹⁸ Id. at page 45.

decisive message. The Company would be more assured of our true intentions. Simply taking the caps off will not afford the Company that clear and reliable signal.

V. **THEREFORE, IT IS ORDERED THAT:**

27. For the aforementioned reasons, I must respectfully dissent from the majority's opinion concerning the Washington Gas Hedging Program in the District of Columbia.



Commissioner Anthony M. Rachal III