

Service Date: December 30, 2004

DEPARTMENT OF PUBLIC SERVICE REGULATION  
BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MONTANA

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IN THE MATTER OF ENERGY WEST	)	UTILITY DIVISION
MONTANA, Application for Annual Review	)	
of Monthly Gas Cost Tracking Adjustment	)	DOCKET NO. D2003.6.75
Procedure and Final Approval of Interim Rates	)	
Resulting from that Procedure (Great Falls	)	ORDER NO. 6552a
And West Yellowstone)	)	

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**FINAL ORDER**

Findings of Fact and Discussion

Introduction

1. On June 11, 2003, Energy West Montana (EWM or Company) filed before the Montana Public Service Commission (PSC or Commission) an application for approval of the annual (2002/2003) true-up of EWM's monthly gas cost tracking procedure and final approval of interim monthly rates approved therein. In the application EWM consolidates the monthly tracker period covered by EWM's next previous (2001/2002) annual tracker filing, Docket No. D2002.6.77. The total true-up period covered in EWM's is about 26 months.

2. During the period available for discovery intervenor Montana Consumer Counsel (MCC) submitted substantial data requests to the Company. On June 8, 2004 the MCC filed the testimony of George L. Donkin before the Commission. On August 25, 2004, at 10:00 a.m. a public hearing was held by the Commission in the Courthouse Annex in Great Falls with Commission Vice-Chairman Tom Schneider presiding and Commissioner Greg Jergeson in attendance. EWM presented two witnesses on its behalf, Earl Terwilliger, Division Manager for EWM, and Shawn Shaw, Senior Accountant. A third representative of the company present at the hearing, Lynn Hardin, Manager of Regulatory Affairs, was called to discuss aspects of the Company's purchasing policies and practices. The MCC presented its expert witness, George L.

Donkin, of the firm J. W. Wilson & Associates, and his review and analysis of the Company's application. Each witness's testimony is discussed in more detail below.

3. In its filing EWM requested final approval of a 2.54 percent increase in rates for Great Falls residential customers and a 4.43 percent decrease in rates for West Yellowstone residential customers. Rate changes for other customer classes vary. In its application EWM also proposes separating its Great Falls and West Yellowstone operations for gas tracker purposes and removing limitations (open season) on timing of customer choice. EWM is requesting a rate increase of \$652,273 in Great Falls and a rate decrease of \$52,452 in West Yellowstone.

4. The PSC has allowed EWM to combine actual gas cost for Great Falls and West Yellowstone for tracking purposes. EWM suggests that this has worked well in the past, but with recent trends in market pricing EWM now suggests that customers in each location will be better served if gas costs are tracked separately. EWM states that this change will send proper pricing signals and reduce customer confusion.

5. Currently, EWM customers can move to open access only during an "open season." EWM believes that eliminating this requirement will lead to greater customer choice and will relieve considerable administrative burden and eliminate customer confusion. EWM proposes to allow customers to move to a supplier or return to the utility at the beginning of any billing cycle. In order to do this EWM argues that it would propose an elimination of all carryover credits and liabilities being charged customers who elect choice or who return from a choice supplier.

6. EWM uses three main elements in procuring gas supply. EWM does not assign a certain percentage of supply, rather it strives for three, roughly equal, parts. EWM's gas supply strategies is:

1. Storage is not only a cost control measure, but it is also a necessity for firm peak day supply through the winter. EWM monitors Alberta Energy Company (AECO) trading hub prices and to a lesser degree, Colorado Interstate Gas (CIG) pricing. Using direct information from publications and supplier and trader forecasts, it tries to match purchases for storage injection with the lowest possible prices. Until this year, EWM has had a long term purchase agreement with Coral for 5,000 MMBtu/d that necessarily filled most of the storage capacity at a price based on the monthly AECO index. Currently and

in the future, EWM will have more flexibility in choosing how and when storage gets filled.

2. Around half of the remaining supply requirement is contracted for on a floating monthly AECO Index. This usually also involves a standby provision for peaking supply which requires an adder to the index, or a monthly demand charge. The actual additional peaking gas that may be required is priced on a daily index basis.

3. The other part of the remaining supply requirement is usually contracted for on a fixed price basis for the delivery through the winter block, which is November through March. EWM usually has an option to convert a portion of the indexed supply to a fixed price during the term of the contract.

In the future, EWM is considering contracting for gas supply at various times during the year rather than issuing an RFP at the same time every year. Also, EWM will be investigating the advantages and disadvantages of production property investment.

### Testimony

#### Earl Terwilliger (EWM)

7. Mr. Terwilliger's prefiled testimony presented the Company's rate changes, including the proposed increase for Great Falls and the reduction proposed for West Yellowstone and the changes proposed in the annual tracker filing, specifically the separate trackers for West Yellowstone and Great Falls service area customers. Mr. Terwilliger's testimony also described the Company's proposed change to terms and conditions governing customer moves to the Company or to an alternative supplier and the rationale for the change.

#### Shawn Shaw (EWM)

8. Mr. Shaw's prefiled testimony addressed mechanics of the monthly gas trackers including projected purchased gas cost and proposed rate changes for EWM and West Yellowstone. At the hearing Mr. Shaw was queried concerning EWM's winter season supply mix. Mr. Shaw testified that approximately one-half of the winter season supply is purchased via fixed price contracts. Mr. Shaw testified that EWM wanted to have a mixed portfolio of resources during the heating season.<sup>1</sup>

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<sup>1</sup> Transcript, pages 31-32.

Lynn Hardin (EWM)

9. Mr. Hardin, Manager of Regulatory Affairs for EWM, stated during the hearing that his expectation, on a long term basis, is that gas will be scarce and demand strong and he feels that gas prices will remain strong.<sup>2</sup> Mr. Hardin said EWM has between 500,000 to 600,000 MMBtu stored in the ground on NorthWestern Energy's (NWE) system for use this winter, which it will continue to fill. EWM said at this point in time it is right on schedule. Mr. Hardin stated that EWM has recently increased its storage capacity from 700,000 MMbtu to 1.1 million MMBtu at no addition cost through NWE's filings and tariffs.<sup>3</sup>

10. Mr. Hardin stated the EWM has looked into call options and price collars, he felt there may be some advantages to them. With a call option it would allow EWM to make a decision, prior to the upcoming month, whether to exercise that option to buy gas at a certain stated or strike price, fixed price, or to buy gas on a monthly AECO index. He felt that would be a very powerful option to have and a reasonable way to mitigate gas costs.<sup>4</sup> Mr. Hardin did express concern over the cost of using a call option and said that EWM has not made up its mind on this issue. Regarding price collars EWM has looked at that in the past but has not analyzed the current market for those collars.

George L. Donkin (MCC)

11. The only formal intervener testimony in the case was filed by the MCC. George L. Donkin testified as an expert witness on behalf of the MCC. Mr. Donkin stated in his prefiled testimony that he was especially asked to focus on evaluating the reasonableness of the natural gas supply acquisition policies and practices pursued by EWM. Mr. Donkin noted besides his prior work for the MCC on gas cases that he had also participated in a September 2003 seminar on natural gas issues in Montana and served as a consultant for the MCC in Docket D2003.10.151, a public docket inquiring into natural gas utility and default supplier supply acquisition strategies. In Mr. Donkin's view the major supply challenge to Montana gas utilities, including EWM, is to obtain sufficient supplies at the lowest reasonable cost. According to Mr. Donkin, the definition of lowest reasonable cost has evolved over the last several years to include some measure of price stability, a reaction to the increasing market volatility of natural gas

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<sup>2</sup> Transcript, page 17, lines 19-21

<sup>3</sup> Transcript page 22, lines 19-20

<sup>4</sup> Transcript page 26, lines 6-12

prices. In the decades of the nineteen eighties and nineties, “lowest reasonable cost” was interpreted as a gas portfolio average cost that did not differ significantly from the market price in the appropriate geographic region. Changing market conditions make it reasonable to accept a gas portfolio with an average cost that is more stable over time, but that might deviate somewhat from the market price.

12. When Mr. Donkin was asked if EWM’s use of approximately 50 percent of gas procurement through fixed price contracts was not enough, too much, or within an acceptable range, he felt that within the overall context of the regulatory system and the gas tracker provisions that exist today, it was certainly reasonable.<sup>5</sup> Mr. Donkin added that EWM has some additional hedge or protection against price volatility by using storage in the winter. Even though storage is at a blended price it tends to fluctuate a lot less than the AECO index price during the winter season. Mr. Donkin said a lot more than 50 percent of the winter usage is at relatively stable prices and the rest is at index.

13. During November 2001 through April 2002, EWM purchased 1,085,746 MMBtu at a fixed price of \$3.44 per MMBtu. During the same six months, EWM purchased 1,177,000 MMBtu at an average cost of \$2.49 per MMBtu under its floating monthly AECO Hub index price contracts. EWM’s fixed winter period contract price was much higher than average market index price during the winter of 2001/2002.<sup>6</sup>

14. During October 2002 through March 2003, EWM purchased 908,885 MMBtu under a fixed price contract at a price of \$3.49 per MMBtu. During that same six months EWM also purchased 1,078,000 MMBtu at floating monthly market prices at an average cost of \$5.25 per MMBtu. During the winter period of 2002/2003, EWM’s strategy of buying a significant portion of its total winter gas supply requirement on a forward, fixed price basis resulted in cost savings, relative to the AECO Hub market prices that prevailed during that same period of time.<sup>7</sup>

15. Mr. Donkin felt that this differing result between two winters was not unusual. He stated that the significant increase in natural gas price volatility that has occurred in recent years has made it difficult to predict with accuracy either the level or the direction of future gas prices.

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<sup>5</sup> Transcript page 47, lines 9-11

<sup>6</sup> George L. Donkin Direct Testimony, page 6, lines 14-19

<sup>7</sup> George L. Donkin Direct Testimony, page 7, lines 1-7

Due to this fact, in recent years, forward fixed price contract prices in contracts entered into in prior periods have often been significantly different from actual current monthly index prices.<sup>8</sup>

16. Mr. Donkin supports EWM utilizing financial derivatives as a hedge against future supply price volatility. He stated that EWM could buy a significant portion of its total gas supplies at monthly index prices and at the same time purchase a call option to be used as a ceiling price in the event future market prices rise unexpectedly to levels above the option's strike price.<sup>9</sup> Using the financial derivatives approach could reduce the effects of gas supply price volatility and insulate EWM and its customers from the adverse effects of huge, unexpected price increases, and at the same time do less damage to economic efficiency in the pricing of gas supplies in the Company's gas tracker.<sup>10</sup> Mr. Donkin points out that the use of financial derivatives as a component of its overall gas supply procurement strategy and the prudently incurred costs of those transactions should be recoverable in the Company's gas tracker rates.

17. In conclusion Mr. Donkin feels that EWM's gas supply transactions and the related gas supply costs in its dealings with Energy West Resources during March 2001 through June 2003 appear to have been reasonable.

#### Other Comments

18. Two members of the public present at the hearing offered comments into the record. Mr. Dignin of Great Falls expressed his concern about the consistent and large increases in rates over the last several years and the impact of those increases on consumers, especially on people with low incomes or who have families. Mr. Sturgeon, also of Great Falls, asked for an explanation as to why West Yellowstone was getting a decrease in rates and Great Falls was getting an increase in rates. Mr. Shaw was recalled to the stand to explain that in the West Yellowstone service territory EWM had over-accrued on its gas tracker and was reimbursing the over-accrual back through the tracker. In Great Falls the opposite had occurred – there was an under-accrual in the tracker. The two systems are physically separate and the gas supply sources are different.

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<sup>8</sup> George L. Donkin Direct Testimony, page 7, lines 10-15

<sup>9</sup> George L. Donkin Direct Testimony, page 9, lines 14-17

<sup>10</sup> George L. Donkin Direct Testimony, page 10, lines 14-18

Analysis and Discussion

19. The PSC approves EWM's request for final approval for interim rates for the 26 month period as discussed in this order. The PSC finds EWM's request for a 2.54 percent increase for residential customers in Great Falls and a 4.43 percent decrease for West Yellowstone residential customers and associated rate changes for other classes of customers to be just and reasonable.

20. The PSC does not object to EWM's request to separate Great Falls and West Yellowstone and allow each location to be tracked separately. The PSC is in agreement with the need to send out proper pricing signals and reduce customer confusion.

21. The PSC accepts EWM's request to remove the limitation of only allowing customers to move to open access during the "open season".

22. A major concern of this Commission is how the gas distribution utility engaged in natural gas purchasing for sale to retail customers manages the risk inherent in the contemporary wholesale gas market. The economic forces of increased demand for natural gas, especially for electric generation, lower than expected supplies within the North American market, and increased pipeline capacity/connections in the intermountain region have combined to push up the price level of natural gas in the region and the rest of the country over the last several years. The tighter market has also meant increased price volatility within the market. This Commission co-sponsored a seminar on gas supply portfolio issues in September 2003 and also opened a public docket (D2003.10.151) to explore Montana specific issues. One major objective of these actions was to gain a better understanding of how load serving distribution companies in Montana are, and might in the future, mitigate the price risk to customers. Based upon Mr. Donkin's, Mr. Shaw's, and Mr. Hardin's testimony, the PSC believes that EWM has managed price risk in its procurement policy in a reasonable manner considering the alternatives available to it for the tracker periods covered in EWM's applications. The PSC notes that, according to Mr. Hardin's testimony, EWM did give some consideration to alternative price risk management tool, specifically, EWM considered a call option, with a supplier for winter gas supply but found the price to not be attractive at the time<sup>11</sup>. The EWM explanation was not entirely clear. The PSC recognizes some limitations may face small local distribution companys, but instructs EWM to more fully document EWM's review of such alternatives in the future. See Finding 16, concerning MCC witness Donkin's recommended hedging strategy.

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<sup>11</sup> Transcript, pp. 26-27

23. The PSC is concerned about the apparent unsettled roles for procurement with the transition of Mr. Hardin to his new position within EWM. The PSC instructs EWM to define participant's responsibilities and proper relationships with affiliates. The PSC directs that this issue be addressed immediately and that notification of EWM participant's responsibilities in this regard be submitted to the PSC.

24. EWM has given indications that it is pursuing the idea of obtaining natural gas production. There is limited record evidence before the PSC to date regarding EWM's possible ventures into gas production. The PSC does not intend to foreclose this EWM option, but the PSC has concerns regarding it, as there may be significant risks associated with the proposal. EWM should be circumspect about the venture and present any serious plans to the PSC for notice and any necessary proceedings for consideration of production procurement plans.

#### CONCLUSIONS OF LAW

25. EWM is a public utility within the meaning of that term at § 69-3-101, MCA. The Commission has jurisdiction over public utilities as provided in Title 69, MCA, including at §§ 69-1-102 and 69-3-102, MCA.

26. EWM's application was properly filed, noticed, processed, and considered, all in accordance with procedural and substantive laws governing the subject matter and actions of the Commission.

27. All pending motions, objections, and arguments not specifically addressed above are overruled to the extent that overruling is consistent with this Final Order.

28. EWM's applications are approved, as stated above. EWM shall comply with the directives in this order and shall file tariffs in accordance with the provisions of this order.

Done and dated this 21st day of December, 2004, by a vote of 5-0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

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BOB ROWE, Chairman

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THOMAS J. SCHNEIDER, Vice-Chairman

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MATT BRAINARD, Commissioner

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GREG JERGESON, Commissioner

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JAY STOVALL, Commissioner

ATTEST:

Connie Jones  
Commission Secretary

(SEAL)

NOTE: Any interested party may request the Commission to reconsider this decision. A motion to reconsider must be filed within ten (10) days. See 38.2.4806, ARM.