BEFORE THE STATE OF NEW JERSEY
BOARD OF PUBLIC UTLITIES

GAS UTILITIES' PROVISIONAL RATES AND FLEXIBLE PRICING MECHANISMS	)))	
I/ M/O PUBLIC SERVICE ELECTRIC & GAS COMPANY'S LGAC FILING	)))	**BPU DOCKET NO. GR00070491**
I/M/O NUI/ELIZABETHTOWN GAS CO.'S LGAC FILING	)))	**BPU DOCKET NO. GR00070470**
I/M/O NEW JERSEY NATURAL GAS COMPANY'S LGAC FILING	)))	**BPU DOCKET NO. GR99100778**
I/M/O SOUTH JERSEY GAS CO.'S LGAC FILING	))	**BPU DOCKET NO. GR00050293**

INITIAL BRIEF ON BEHALF OF THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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I. INTRODUCTION

Beginning last spring and continuing through the current winter, wholesale natural gas prices have reached unprecedented levels. When the State's four natural gas utilities filed their emergent rate petitions with the Board of Public Utilities ("BPU" or "Board") in October, wholesale natural gas costs for the January through March 2001 period were averaging $5.00 per dekatherm, twice the levels prevailing last year. *RPA-20,* p. 13. Since that time, gas prices have surpassed even these very high levels. As of the filing of the Ratepayer Advocate's testimony in this matter on December 15, 2000, the average January through March wholesale price had reached $8.90 per dekatherm. *RPA-20,* p. 14. While prices have fluctuated since that time, they still remain at record high levels.

In their filings, the utilities have focused on the impact of the increase in natural gas prices on their own recovery positions. The Ratepayer Advocate urges the Board or to give equal weight to the plight of ratepayers. As noted by the Ratepayer Advocate in her opening remarks to the Board in this proceeding, the high cost of natural gas "has emerged as the most important consumer issue in the State of New Jersey at the present time." 1T7:25 to 1T8:4.[1] On the day the Board's provisional rate orders were announced, this office "received more press calls and interview requests that day than in any other day in the history since I've been there .... IT8:5 to 11." There have been numerous consumer inquiries about the natural gas price increases; consumers--especially those on low incomes-- are rightly concerned about the specter of paying hundreds of dollars more this year for an essential lifeline service. 1T8:18 to 25.

[1] Transcripts will be cited by volume page and line number. "1T7:25" refers to volume 1, page 7, line 25.

Utilities are entitled to the opportunity to earn a reasonable return--but they are not guaranteed immunity from all business risks. In a year in which natural gas prices have reached extraordinary and unprecedented levels, the utilities are not entitled to have ratepayers shoulder 100 percent of the burden. Furthermore, as set forth in detail below and in the Ratepayer Advocate's testimony in these proceedings, the utilities' performance in protecting ratepayers from unreasonably high gas prices has been less than optimal. Only one utility took any appreciable steps to hedge the price of its gas supplies for this winter, and even this company could have done more to protect its ratepayers. *See* Point III.C. below.

The Ratepayer Advocate is recommending two measures to allocate an appropriate share of the burden to the utilities. First, the Board should deny the utilities' request to modify the Board's longstanding policy prohibiting interest on under-recovered fuel balances. Second, the three utilities that failed to take any significant measures to hedge their gas supplier should be charged with disallowances of a portion of their gas costs.

This proceeding also highlights the need to assure that the utilities' firm gas supply customers are protected from unreasonably high gas costs in the future. The Board should therefore take prompt decisive steps to assure that all four utilities have in place suitable hedging programs as well as long-range strategic plans to insure affordable natural gas supplies for all New Jersey consumers.

The Board also needs to play a pro-active role in ensuring consumer education about escalating natural gas prices, and what consumers can do to deal with them. While some of the consumer education and mitigation measures required in the Board's provisional rate orders, such as bill inserts, have been implemented, there is room for improvement by all of the utilities.

Also, there remains a major gap--the mass media campaign to be conducted as part of the ongoing customer choice education programs is woefully inadequate. As of the time of the evidentiary hearings, only a single radio public service announcement was under development, with no specific date determined for it to air. This is in sharp contrast to New York, where the Public Service Commission announced a statewide consumer education campaign in September 2000 and began rolling out ads soon thereafter. As of the filing of this brief, the Utility Education Committee ("UEC") was continuing a massive state-wide television, radio and newspaper campaign on customer choice and "slamming," despite the fact that there are virtually no marketers making offers to residential consumers. Surely, a larger share of the generous budget available to the UEC could be devoted to helping consumers weather the large rate increases they are facing this winter, and will continue to face through the next winter heating season. Further, as noted in the January 22, 2001 letter to from the New Jersey Utilities Association ("NJUA") to the Board's Chief of Staff, the Energy Education Council ("EEC"), which provides formal oversight of the UEC with input from members including the NJUA, the Ratepayer Advocate, a representative of third-party suppliers, and many State agencies, has not held a meeting for many months (see Appendix A). It is important that meetings of the EEC resume, so that New Jersey consumers can be assured that the education measures funded through charges to ratepayers will be relevant, timely, and responsive to their needs.

Finally, the Ratepayer Advocate urges the Board to act promptly on other initiatives that will help consumers deal with high energy costs. On January 2, 2001, New Jersey Statewide Heating Assistance and Referral for Energy Services ("NJ SHARES") filed its request to be recognized as the designee of the Energy Assistance Fund created under P.L. 2000, Chapter 132 (see Appendix B). NJ SHARES is awaiting only the Board's action to receive $1.6 million immediately, and approximately $800,000 in March 2001. This funding is urgently needed to alleviate the burden of high energy costs for needy consumers who have exhausted all other available resources. Also, the proceeding to consider a Universal Service program is fully briefed and is awaiting the Board's decision. While it may be too late to implement a program for this high-cost winter heating season, it is of the utmost importance to have a program in place when the Board's winter moratorium expires in March, and for next fall and winter when the utilities gas rates are projected to remain at current levels, or higher. The Energy Efficiency and Renewables programs under consideration in the Board's Comprehensive Resource Analysis docket likewise are awaiting action by the Board. The Board should implement these important programs without further delay. Failure to act will only exacerbate the pain and frustration experienced by New Jersey ratepayers.

II. PROCEDURAL HISTORY

This matter has its genesis in Levelized Gas Adjustment Clause ("LGAC") petitions filed at the BPU in 1999 and 2000 by each of the four natural gas utilities: New Jersey Natural Gas Company ("New Jersey Natural"), NUI Elizabethtown Gas Company ("Elizabethtown"), Public Service Electric & Gas Company ("Public Service"), and South Jersey Gas Company ("South Jersey Gas").

A. The Companies' Filings.

1. New Jersey Natural Gas Company ("New Jersey Natural").

On September 30, 1999 New Jersey Natural filed a petition, Docket Nos. GR99100778, GR99100779, GR99100780, and GR99100782, seeking revision of several tariff adjustment clauses, including a decrease in its LGAC gas cost factor. The filing was transmitted to the Office of Administrative Law ("OAL") as a contested case on January 31, 2000.

In the late spring and early summer of 2000, while settlement discussions were ongoing, natural gas prices increased significantly. Consequently, on July 17, 2000 New Jersey Natural filed an Amendment to the Initial Petition, amending the filing to more accurately reflect its projected gas costs and proposed rates for the 2000-01 LGAC year and to provide more flexibility in responding to gas cost changes. In that petition New Jersey Natural proposed to increase its overall LGAC billing factor from $0.1564 per therm to $0.2894 per therm, an increase for the typical residential customer using 100 therms per month of 16%.

New Jersey Natural also requested permission to increase its Flexible Pricing Mechanism ("FPM"), wherein the company could change its Gas Cost Recovery Factor ("GCR") each month without additional Board approval. The Board had previously authorized the FPM within certain limits--a monthly cap of $0.007 per therm, an annual limit of $0.035 per therm, immediate decreases without a cap, and utilization of the mechanism only during the months of November through March. In the Amended Petition New Jersey Natural requested permission to increase the monthly FPM cap to $0.014 per therm, the annual cap to $0.070 per therm and to utilize the FPM throughout the calendar year.

A public hearing on the amended petition was held on August 22, 2000.

On October 3, 2000, New Jersey Natural filed an Emergent Motion with the Board, seeking immediate provisional rate relief of approximately 16%.

2. Elizabethtown Gas Company ("Elizabethtown").

On July 21, 2000 Elizabethtown filed its annual LGAC petition with the Board, BPU Docket Nos. GR00070470, GR00070471. In the petition Elizabethtown sought to increase its LGAC rate from $0.1236 per therm to $0.2665 per therm. This request would have increased the rate for the typical residential customer using 100 therms per month by 17.63%.

Elizabethtown also requested authority to establish a Flexible Pricing Mechanism ("FPM") so that it might modify its gas cost rates on a monthly basis, without further Board approval, in response to changes in the commodity price of gas.

On August 1, 2000 the filing was transmitted as a contested case to the OAL; public hearings were held on September 10 and 21, 2000.

On October 4, 2000 Elizabethtown filed an Emergent Motion with the Board, seeking immediate provisional rate relief of approximately 29.9%.

3. Public Service Electric and Gas Company ("Public Service").

Normally, Public Service files its annual LGAC petition in July for adjustment of gas costs before the coming winter. However, during the 1999 calendar year the company filed no petition for the 1999-2000 LGAC year.

On July 27, 2000 Public Service filed a petition in Docket No. GR00070491 in which the company sought to change its existing Monthly Pricing Mechanism ("MPM"). On July 31, 2000 Public Service amended the petition at Staff's request to designate it as an LGAC petition.

Public Service had been authorized to change its monthly gas cost rate by up to $0.07 per dekatherm per month for November through April, up to an annual limit of $0.35 per dekatherm. *I/M/O Public Service Electric and Gas Company*, BPU Docket No. GR98070445, Order Adopting Final Stipulation and Initial Decision, p. 6-7 (Dec. 22, 1998). In the July 27 filing Public Service sought authority to increase the monthly MPM cap to $0.35 per dekatherm per month, exercisable in any month with no annual limit. Moreover, the filing did not include a reconciliation of prior gas costs, projections for future gas costs or documentation regarding the company's gas procurement activities.

On August 9, 2000 the matter was transmitted to the OAL; public hearings were held on September 6 and 7.

On October 3, 2000 Public Service filed an Emergent Motion with the Board, seeking immediate provisional rate relief of approximately 26.8%.

A third public hearing was held the evening of October 3, 2000.

4. South Jersey Gas Company ("South Jersey").

South Jersey did not file an LGAC petition in calendar year 1999. On April 28, 2000 the company filed its LGAC petition for the 1999-2000 year. However, it failed to provide supporting documentation and workpapers with the filing.

On May 25, 2000 the filing was transmitted to the OAL as a contested case.

On June 6, 2000 South Jersey amended its petition, seeking certain kinds of relief, but did not seek to change its LGAC rate despite the increasing cost of gas. On August 11, 2000 South Jersey filed a Second Amended Petition, requesting an LGAC increase. The company sought, among other requests, to increase its LGAC factor from $0.1068 per therm to $0.2333 per them, which would have increased a typical residential customer's winter bill by 23%. South Jersey Gas also requested Board approval to implement a quarterly LGAC mechanism which would allow it to alter rates on a quarterly basis, up to $1.25 per dekatherm annually, without further Board permission.

Additionally, South Jersey sought to recover a projected $26.5 million underrecovery incurred during the November 1, 1999-October 31, 2000 LGAC Year, the year in which it failed to file a timely LGAC petition.

On October 4, 2000 South Jersey Gas filed an Emergent Motion with the Board, seeking immediate provisional rate relief of approximately 31.5%.

A public hearing was held on October 10, 2000.

B. Provisional Rate Requests.

As noted above, the four gas utilities filed emergent motions for provisional rate relief with the Board on October 3 and 4, 2000.

By letter dated October 4, 2000, Frances L. Smith, Secretary of the Board, advised the Ratepayer Advocate of the Board's receipt of the emergent motions and requested that the Ratepayer Advocate file a response to the motions by October 6. On October 5, the Ratepayer Advocate filed its letter response, followed by a certification from its consultant, Mr. Richard LeLash, which was filed on October 6.

At its agenda meeting on October 10, 2000, the Board considered three of the four motions filed--those of New Jersey Natural, Elizabethtown, and Public Service. South Jersey Gas's motion could not be considered since that company had not yet held a public hearing (which, coincidentally, was held the evening of October 10) regarding its request for a rate increase. South Jersey Gas's motion was considered at the November 9 agenda meeting. These rulings were memorialized in written Orders Authorizing Provisional Rates issued on November 1, 2000 (New Jersey Natural, Elizabethtown, Public Service), and on November 16, 2000 (South Jersey Gas). *I/M/O Petition of New Jersey Natural Gas Co.*, BPU Dkt. Nos. GR99100778, GR99100779, GR99100780 and GR99100781, Order Authorizing Provisional Rates (Nov. 1, 2000) ("New Jersey Natural Provisional Rate Order"); *I/M/O Petition of NUI Elizabethtown Gas Co.*, BPU Dkt. Nos. GR00070470 and GR00070471, Order Authorizing Provisional Rates (Nov. 1, 2000) ("Elizabethtown Provisional Rate Order"); *I/M/O Public Service Electric and Gas Co's Proposal for a Change in its Monthly Pricing Mechanism*, BPU Dkt. No. GR00070491, Order Authorizing Provisional Rates (Nov 1, 2000) ("Public Service Provisional Rate Order") *I/M/O Petition of South Jersey Gas Co.*, BPU Dkt. Nos. GR00050293 and GR00050294, Order Authorizing Provisional Rates (Nov. 16, 2000) ("South Jersey Provisional Rate Order").

In its Provisional Rate Orders the Board recalled the following issues previously transmitted to the OAL: 1) the level of rates necessary for each company to recover its prudently incurred gas costs, and 2) each company's flexible pricing proposal. *See*, *e.g.*, New Jersey Natural Provisional Rate Order, p. 5. After consideration of the issues, the Board provisionally approved increases, subject to refund and interest, in the gas utilities' rates, modifying the amount of the increase in three of the four cases. New Jersey Natural's rate was provisionally increased by 16%, the amount requested. New Jersey Natural Provisional Rate Order, p. 5. Public Service's rate was also increased by 16%, a reduction from the requested 26.8%. Public Service Provisional Rate Order, p.2, 5. Elizabethtown's rate was increased by 17.3%, a reduction from the requested 29.9%. NUI Elizabethtown Provisional Rate Order, p. 2, 5. South Jersey Gas's rate was increased by 19 %, a reduction from the requested 31.5%. South Jersey Provisional Rate Order, p. 2, 8.

The Board also provisionally approved for all four utilities additional five 2% increases to take effect on December 1, 2000, January 1, 2001, February 1, 2001, March 1, 2001 and April 1, 2001. See New Jersey Natural Provisional Rate Order, p. 6. These increases were subject to documentation requirements set forth in the Provisional Rate Order, and the February 1, March 1, and April 1 increases were further subject to a showing of need, to be demonstrated in filings made by the companies on December 1, 2000 and evidentiary hearings held in January 2001. *Id.* Finally, the Board provided that rate should be decreased, if warranted, based on changes in the wholesale natural gas markets. *Id.*

C. Utility and Ratepayer Advocate Filings and Evidentiary Hearings.

On December 1, 2000, the utilities submitted testimony and data in support of their requests for further rate increases beyond January, 2001. *NJ-1; NJ-2 PS-1; ETG-1; ETG-2; SJG-1; SJG-2.* In addition to the rate increases through April, 2001 contemplated in the Board's provisional rate orders, each of the utilities sought authorization to implement three additional 2% increases in May, June and July, and to resume monthly 2% increases next fall if needed. The utilities also sought to recover interest on their gas cost underrecoveries.

On December 15, 2000 the Ratepayer Advocate submitted the prefiled testimony of its witness Richard W. LeLash. *RPA-20* (see summary attached as Appendix C).

On December 21, 2000, a prehearing conference was held and a schedule established. On January 3, 2001, pursuant to the schedule, New Jersey Natural and Public Service filed supplemental testimony regarding their compliance with the consumer education and mitigation measures required in the Board's Provisional Rate Orders. *NJ-3*; *PS-6.*

Discovery was completed by January 10, 2001.

Commissioner Frederick F. Butler presided over hearings held on January 11, 12, and 16, 2001.

Initial briefs were originally due by noon on January 23, 2001 with reply briefs due by noon on January 26, 2001. On January 18, 2001, the Ratepayer Advocate filed an emergent motion to extend the briefing schedule and allow additional surrebuttal. On January 19, 2001 Commissioner Butler granted that part of the motion requesting an extension but denied the Ratepayer Advocate's request for additional surrebuttal. Initial briefs are now due on January 30, with reply briefs due on February 6, 2001.

III. ARGUMENT

A. THE BOARD SHOULD REJECT THE UTILITIES' PROPOSALS TO EXTEND THEIR AUTHORITY TO IMPLEMENT AUTOMATIC RATE INCREASES, AND SHOULD INSTEAD IMPLEMENT A MECHANISM WHICH ALLOWS APPROPRIATE REVIEW AND OVERSIGHT OF THE UTILITIES' GAS COSTS AND GAS PROCUREMENT ACTIVITIES.

The current extraordinary conditions in the natural gas market have brought into focus two related issues. The first is how to balance two current policies which are in conflict: avoiding large deferred fuel balances, and avoiding rate shock for consumers. The second issue is prospective: whether, and to what extent, to maintain the utilities' existing levelized annual gas cost recovery mechanism, as opposed to some form of market-based pricing. Both issues have implications for the development of a competitive natural gas market in New Jersey as contemplated by the Electric Discount and Energy Competition Act of 1999 ("EDECA"), *N.J.S.A.* 48:3-49 *et seq.* More frequent rate adjustments tied to changes in the wholesale natural gas marketplace may encourage customers to shop or consider another supplier. However, basic gas supply service ("BGSS") customers should have stable and predictable prices, as well as the benefit of the utilities' storage and hedging activities.

Three time frames are relevant to the Board's consideration of the appropriate pricing mechanisms for the utilities' gas costs: (1) this winter season; (2) a transition period while a competitive retail market develops; and (3) the long term. The Ratepayer Advocate's recommendations for all three time periods are discussed below.

1. For the Current Winter Season, It Was Reasonable for the Board to Limit the Utilities' Rate Increases.

The pricing mechanism in effect for the current winter was effectively established in the Board's Provisional Rate Orders for the four utilities. Under these Orders, the utilities were allowed initial rate increases ranging from 16 to 19 percent, followed by five two percent rate increases on December 1, 2000 and January 1, February 1, March 1, and April 1, 2001, subject to documentation requirements set forth in the Board's Order. The February 1, March 1 and April 1 increase were further made subject to the evidentiary hearings conducted by the Board in this matter. In view of the current extraordinary circumstances in wholesale natural gas markets, the Ratepayer Advocate believes that it would have been unduly burdensome to consumers to immediately absorb the full amount of the recent increases in wholesale natural gas prices. Thus, the Ratepayer Advocate believes that the Board's adoption of a "phased" approach was appropriate. *RPA-20,* p. 19.

2. The Board Should Reject the Utilities' Proposal to Allow Further Automatic Rate Increases After This Winter Season, and Beginning in the Fall of 2000, Should Implement a Mechanism to Allow Limited Rate Changes During the Winter Season, Subject to Proper Notice, Review, and Board Approval.

In their filings, the utilities have proposed to extend their authority to implement continuing two percent rate increases through May, June and July 2001. They also propose that monthly adjustments be resumed in the fall of 2001 and, presumably, be continued thereafter on an indefinite basis. This approach should be rejected. The current mechanism is appropriate only as a <u>temporary measure to address an extraordinary and atypical market transition that is occurring at the present time</u>. There should be no further rate increases beyond those already authorized in the Board's Provisional Rate Orders without new filings and new evidentiary hearings. *RPA-20*, p. 19.

With regard to the utilities' requests to implement two percent increases in May, June and July, the testimony of Ratepayer Advocate witness Richard LeLash explains why summer rate increases should be viewed with caution. Most natural gas usage occurs during the winter months, and only a fraction of the utilities' revenues are derived from sales from May through the end of the summer. *RPA-20,* p. 20, Sch. 1, p. 2 of 2. Thus, implementing additional two percent increases through July would have a relatively minimal impact on the utilities' fall 2001 gas cost recovery balances. *RPA-20,* Sch. 1, p. 1 of 2. In addition, rates established before and during the peak winter period will more accurately reflect market conditions and therefore reflect actual costs that will be incurred for supplying gas during this period. *RPA-20,* p. 22. Further, rate increases implemented in the summer may not be apparent due to lower gas usage; consumers may be unpleasantly surprised in the fall when the full impact of such increases is reflected in their energy bills. It is fairer to consumers to provide notice and implement increases when consumers will be more aware of their impact.

For the above reasons, rate increases should be allowed during the May through July time period only upon a convincing showing of need. At a minimum, the utilities should be required to demonstrate, after hearings, that (1) further increases are needed to prevent large deferred fuel balances as of the fall of 2002, and (2) they have taken appropriate measures to assure reasonable and stable prices for next winter. *RPA-20,* p. 19.

One utility, Elizabethtown, argues in the prefiled testimony of company witness Robert Clancy that extending automatic rate adjustments through July and next fall will allow Elizabethtown's rates to more accurately reflect the market, and will further allow the company to promptly reflect in its rates any reduction in wholesale gas prices. *ETG-2*, p. 12. However, Mr. Clancy acknowledged on cross-examination that this will not necessarily be the case:

> The situation we are in now, where we have prices in effect that are significantly underrecovering our costs, and prices go down, we wouldn't seek to reduce prices if we are still projecting that we are going to be in a significant underrecovered position.
>
> 2T381:18 to 23.

Given the large underrecovery positions projected by all of the utilities, it seems likely that an extension of the existing mechanism into the summer would result in higher rates, even if there is a seasonal decrease in gas prices in the wholesale markets.

The Board also should deny the utilities' request to resume automatic adjustments next winter. Instead, the Board should implement a gas cost recovery mechanism, as proposed by the Ratepayer Advocate, which recognizes the fact that most gas usage occurs during the winter, and which requires diligent regulatory review of the utilities' natural gas procurement activities. Beginning with the 2001-02 winter season, the utilities should be required to make annual filings, on or before August 1, for an initial rate to be effective on October 1, subject to review and evidentiary hearings. In order to permit appropriate review, these filings should include reconciliations, as well as detailed descriptions of the utilities' gas procurement policies and activities including hedging. *RPA-20,* p. 5-6, 19. The initial rate should be subject to no more than two adjustments during the November through February time period. Increases should be permitted only upon a showing that the utility would incur a deferred balance in excess of two percent of its forecasted gas costs for the next twelve-month period. *RPA-20*, p. 21. Adjustment filings should be made at least six weeks prior to the proposed implementation date, and should be subject to notice and hearings. Finally, if the utilities are granted an adjustment mechanism for rate increases, they should be under an obligation to initiate rate decreases when indicated. Rate decreases should not be subject to the two percent or other limitation. *RPA-20,* p. 22.

The above mechanism allows for an initial rate to be effective during the entire winter season, and two more potential adjustments during this same period. This should provide the utilities with sufficient opportunity to adjust rates to conform to market levels during the period when gas usage is the highest. *RPA-20,* p. 21. This mechanism also can provide for sufficient regulatory review, especially if the required filings are standardized as they were in the Board's November, 2000 Provisional Rate Orders. *Id.* The utilities' proposals to continue automatic rate increases through next winter would subject ratepayers to frequent and confusing rate changes, without the opportunity for adequate review. The Ratepayer Advocate therefore urges the Board to adopt the mechanism set forth by its witness Mr. LeLash.

In addition to their proposals to extend the current rate adjustment mechanism, three of the utilities also have proposed a variety of flexible pricing mechanisms as part of their LGAC filings. These proposals should be rejected.

a. Public Service Proposed Monthly Pricing Mechanism.

In Public Service's petition for a change in its Monthly Pricing Mechanism ("MPM") filed on July 27, 2000, it sought to modify its existing MPM from strictly limited monthly adjustments capped at \$.07/Dth a month and subject to an annual adjustment of \$.35/Dth, to increases as great as \$.35/Dth a month, allowing annual changes of up to \$4.20 per Dth. Moreover, Public Service proposed to institute these increases through compliance filings, which meant that they would not be subject to review other than during the annual reconciliation. (As noted in the Procedural History section above, it is not clear that Public Service contemplates even annual reconciliations, as the company did not file one in 1999, and submitted one only in response to specific discovery requests in 2000.) Furthermore, Public Service's proposal would extend its rate flexibility from the winter to a year-round process, even though most of its residential sales are in the winter. *RPA-20*, p. 25. Thus Public Service's proposed MPM does not provide for adequate regulatory review, and it does not recognize that most gas usage occurs in the winter.

b. New Jersey Natural Proposed Flexible Pricing Mechanism.

New Jersey Natural's Amendment to the Initial Petition filed on July 17, 2000 proposed a modification to its existing Flexible Pricing Mechanism ("FPM"), which, like Public Service's existing mechanism, allowed limited monthly adjustments capped at $.07/Dth, with an annual cap of $.35/Dth. Citing the "unprecedented and unavoidable increase in the commodity cost of gas," New Jersey Natural proposed to double these limits, to permit monthly adjustments of up to $.14/Dth and with an annual cap of $.70/Dth, subject to review once an increase of $.35/Dth was reached. Amendment to Initial Petition, p. 1. With regard to the current winter, the company's proposal has been pre-empted by the mechanism established in the Board's Provisional Rate Orders. For the reasons explained above, New Jersey Natural's proposal should be rejected; the Ratepayer Advocate's proposed mechanism is preferable to the company's proposal for automatic increases for implementation beginning next fall.

c. **South Jersey Proposals**.

In its December 1, 2000 filing, South Jersey proposed to replace its traditional LGAC filing, normally made on or about August 31, with a filing to be made "shortly before December 1, 2001" to establish gas recovery rates for the 2001-02 winter with an effective date of December 1, 2001. *SJG-5*, p. 6. In addition, South Jersey makes the extraordinary request for authorization to raise rates an additional two percent each month through July 2002. *SJG-5*, p. 6; 2T457:2 to 2T458:6. This proposal would not permit adequate regulatory review of the company's proposed rate increases. While South Jersey does not specify when it would make its filing for rates to be effective December 1, 2001, its proposed time frame of "shortly before December 1, 2001" does not appear intended to allow for an adequate review of the company's reconciliations and gas procurement activities before the rate becomes effective. Moreover, it is unclear whether South Jersey intends to allow adequate time to hold public hearing upon the statutorily required twenty days' notice. The proposed monthly adjustments apparently would be implemented automatically, without updated current data filings, without public hearings, and without evidentiary hearings to test the accuracy of the utility's alleged need for a rate increase. As explained above, both initial rates and adjustments should be subject to filings, review and public and evidentiary hearings. In addition, South Jersey's proposal would allow rate adjustments during the low-usage summer months, rather than limiting them to the high-usage winter months.

In the alternative, South Jersey proposes to implement the quarterly LGAC adjustment mechanism that was proposed in the company's Second Amended LGAC petition. SJG-5, p. 6. This mechanism would allow quarterly LGAC adjustments subject to an annual "cap" of $1.25 per dekatherm for any given LGAC period. Second Amended Petition, p. 6, par. 15. For the reasons explained above, the Ratepayer Advocate believes that it is preferable to adjust rates only during the winter period.

3. The Utilities Should Propose Alternatives to the Present LGAC Mechanism for Review as Part of an Evaluation of the Long-Term Structure of New Jersey's Gas Industry.

As is explained in Mr. LeLash's testimony, the utilities' present LGAC mechanisms should evolve with the development of a competitive retail natural gas market in New Jersey. With the advent of a competitive environment, the concept of cost pass-throughs should be re-evaluated, and consideration should be given to implementing performance-based incentives for the utilities' gas procurement activities. Also, the nature of the utilities' role as BGSS providers is under evaluation by the Board. Thus, the existing LGAC framework may be an impediment to the implementation of retail natural gas competition. As noted by Mr. LeLash, "gas procurement, like other aspects of utility operations, in now ripe for some performance-based incentives." *RPA-20,* p. 49-50.

Regulatory commissions in many other states have already begun to evaluate alternatives to the traditional LGAC recovery mechanisms. Recently adopted rules in New York allow utilities to propose alternative pricing and adjustment mechanisms as part of their Gas Adjustment Clauses. *I/M/O the Rules and Regulations of the Public Service Commission*, Case 97-G-1178, Memorandum and Resolution Revising 16 NYCRR Section 270.55 (Apr. 13, 1999) (available on NY PSC website). The Maine Public Utility Commission recently issued notice in an inquiry on issues related to natural gas competition. *Notice of Inquiry Into Natural Gas Competition and Unbundling,* Docket No. 99-342 (Me. PUC June 4, 1999) (available on Maine PUC website). The issues to be investigated included those related to the structure and pricing of gas service to be provided by the utilities in a competitive market, including the continued viability of the adjustment clause mechanism, and whether appropriate incentives could be developed for gas procurement. *Notice of Inquiry*, p. 11-12.

States that have already implemented performance-based mechanisms include California, Pennsylvania, and Wisconsin. *Southern California Gas Co.,* 150 PUR 4th 271 (Cal. PUC 1994); *Southern California Gas Co.,* Decision No. 00-06-039, Application No. 99-060027, 2000 Cal. PUC Lexis 258 (June 8, 2000); *Pennsylvania PUC v. The Peoples Natural Gas Co.,* Dkt. Nos. R-000984281 *et al.,* 1998 Pa. PUC Lexis 203 (July 31, 1998); *Madison Gas and Electric, 190 PUR 4th 445 (Wis. PUC* 1999). Rules permitting incentive mechanisms have been issued Massachusetts. *Incentive Rate Regulation,* DPU 94-98 (Mass. DPU 1995).

The mechanism by which utilities charge their customers for natural gas is intimately related to the way in which they procure natural gas. Therefore, the Board should define the scope of a generic proceeding to consider how the utilities' gas cost recovery mechanisms should be phased out as a true competitive environment develops. This proceeding should include issues such as procurement, pricing, and service standards. All stakeholders should be included in this inquiry.

B. BASED ON LONGSTANDING BOARD POLICY, AND THE UTILITIES' FAILURE TO TAKE ALL POSSIBLE STEPS TO MITIGATE NATURAL GAS COSTS, AND CONSIDERATIONS OF EQUITY, THE UTILITIES SHOULD NOT BE PERMITTED TO RECOVER INTEREST ON GAS COST UNDERRECOVERIES.

The utilities' filings all request that they be permitted to recover interest on their gas costs underrecoveries. The utilities argue that they should be allowed to collect interest to compensate them for their inability to recover 100 percent of their deferred fuel balances during their current LGAC periods. The Ratepayer Advocate respectfully disagrees. This winter, when natural gas prices are at unprecedented high levels, is not the time to change the Board's policy prohibiting interest on gas cost underrecoveries. The Board, by requiring that the utilities' requested rate increase be implemented in phases, recognized that the utilities' interest in full recovery of their gas costs had to be balanced against the needs of ratepayers. As noted by Ratepayer Advocate witness Richard LeLash at the evidentiary hearings in this matter, "[i]t is illogical for the gas utilities to assume that the Board, in limiting gas cost recoveries to mitigate the impact of wholesale price increases, would then authorize the gas utilities to add interest to the already excessive amounts to be recovered." 3T531:22 to 3T532:3.

Contrary to the utilities' arguments, they have no entitlement to require their customers to bear the full impact of this winter's extraordinarily high gas prices. As observed in the concurring opinion in *Jersey Central Power and Light Co.,* 810 F. 2d 1168, 1191 (D.C. Cir. 1986) (Starr, J., concurring):

> the Fifth Amendment does not provide utility investors with a haven from the operation of market forces. *See, e.g. Federal Power Comm'n v. Natural Gas Pipeline Co.,* 315 U.S. 575, 590 (1942).

As noted by Mr. LeLash, given the market conditions that prevail this winter, "... I do not believe that having utility shareholders finance an interest free deferred recovery plan is unreasonable at this time." 3T532:18 to 23.

A continuation of the Board's policy of not allowing interest on underrecoveries is not likely to be as costly as the utilities are suggesting. The Board's decision to limit the utilities' rate increases this winter may actually save them money, by avoiding an increase in uncollectible expenses that would have occurred had they attempted to fully recover all of this winter's gas costs on a current basis. 3T688:18 to 3T689:12. This testimony was based on Mr. LeLash's specific experience with other east coast utilities that have passed through the high gas costs to customers more quickly than in New Jersey. These utilities' accounts receivable are "beginning to escalate dramatically." 3T688:18 to 3T689:12.

Furthermore the utilities are, in varying degrees, responsible for a significant portion of the large gas cost under-recoveries they are currently projecting. The utilities' failure to take all reasonable measures to hedge against excessive gas cost increase is fully discussed in Point III.C. below. Since the utilities have not taken all reasonable steps to protect their customers from high gas prices, they are not entitled to full recovery.

In addition, South Jersey's underrecovery position is, in part, the result of its unjustified delays in filing an LGAC petition. As of August 31, 1999, when South Jersey should have filed its 1999-2000 LGAC petition, the company's deferred fuel balance reflected an underrecovery of $11.9 million. *SJG Response to TR-002*. Nevertheless, the company delayed filing for eight months until April 28, 2000, when it filed a petition to maintain its LGAC rates without change "due to the 'press of regulation' . . . despite the fact that had South Jersey filed such an LGAC petition, it would have resulted in a rate increase. *I/M/O Petition of South Jersey Gas Co.*, BPU Docket No. GR00050293, Petition, par. 11 (April 28, 2000). The petition contained a request to implement a quarterly LGAC pricing mechanism, but this was not proposed to become effective until "the winter season commencing November 1, 2000." *Id.*, par. 13. This filing contained no schedules relating to South Jersey's underrecovery balance.

Further compounding this delay was South Jersey's decision to file an Amended Petition on or about June 6, 2000 that again requested no change in LGAC rates and contained no schedules or data supporting this conclusion. The utility stated that "due to recent increases in the cost of gas to South Jersey," the utility was evaluating whether to seek a rate increase. Amended Petition, par. 11

(June 6, 2000). However, South Jersey did not request an increase until two months later, when it filed its Second Amended Petition in August, 2000.

Had South Jersey filed its 1999 LGAC petition on a timely basis and with adequate supporting schedules, at least a portion of its underrecovery balance could have been addressed at that time. South Jersey, however, apparently believed that there was no reason to change rates during the 1999-2000 LGAC period, and that the underrecovery balance did not require extraordinary measures such as charging ratepayers interest. There is no justification for placing this burden on ratepayers now, when they are also burdened with paying for unprecedented high gas costs.

In summary, based on established Board policy, fairness in allocating business risks, and the utilities' own actions contributing to their gas cost underrecoveries, ratepayers should not be charged interest on the utilities' underrecovery balances. The utilities' requests for such interest should be denied.

C. THE UTILITIES FAILED TO TAKE ADEQUATE MEASURES TO HEDGE AGAINST GAS COST INCREASES ON BEHALF OF THEIR CUSTOMERS, AND THEREFORE SHOULD BE HELD ACCOUNTABLE FOR THIS FAILURE.

1. A Prudent Gas Purchasing Strategy Should Include Hedging to Mitigate the Risk of Sharp Gas Price Increases.

It is a long-established regulatory principle in New Jersey that utility service must be provided at "just and reasonable" rates. *N.J.S.A.* 48:2-21. This standard presupposes diligent management. A utility is entitled only to those rates which will allow it to conduct its operations "under efficient and economical operation ...." *Public Service Coordinated Transport v. State*, 5 N.J. 197, 225 (1950). As the New Jersey Supreme Court has stated, "Good company management is required; honest stewardship is demanded; diligence is expected; careful, even hard, bargaining in the marketplace and at the negotiation table is prerequisite." *In re Board's Investigation of Telephone Companies*, 66 N.J. 476, 495 (1975).

As explained in the prefiled testimony of Ratepayer Advocate witness Richard LeLash, when the utilities' LGAC mechanisms were originally established, gas utilities generally purchased natural gas from interstate pipelines under long-term contracts which included both the natural gas commodity and the interstate pipeline transportation and storage capacity required to bring the gas to New Jersey. The prices for such supplies were established by federal regulators and were not subject to state review. Thus, state regulatory commissions had only limited role in evaluating the reasonableness of the gas costs reflected in the utilities' rates. *RPA-20,* p. 32.

With the unbundling of gas supply and capacity at the federal level, however, commodity gas became available directly from gas suppliers, under varying terms and conditions. *RPA-20,* p. 22.

The utilities had the ability to purchase gas under contracts of varying duration and under varying pricing mechanisms (*e.g.* fixed versus index-based pricing), or on the "spot" market. *RPA-20,* p. 32-33. In this environment, it has become increasingly important for utilities to take steps to provide stability in the rates charged to their consumers. *RPA-20,* p. 33. While some price stability is provided by storage (which permits utilities to purchase gas in the summer, when prices are generally lower, for use in the winter), gas utilities, like other firms that rely on commodities, have begun to include hedging as part of their procurement strategies. *Id.*

The concept of hedging was explained in the prefiled testimony of Ratepayer Advocate witness Richard LeLash. As shown very clearly by the current wholesale gas markets, spot or index-based prices can be subject to sharp run-ups. Utilities can manage this risk by using a combination of physical contracts and financial instruments to lock in prices for portions of their gas supply over time. *RPA-20,* p. 47 . As an example of a very simple hedging strategy, a utility could establish a policy of hedging at least 50 percent of its gas purchases over an 18-month time horizon. Under this strategy, at least 50 percent of the gas used in any given month would reflect average gas prices over the past 18 months. *RPA-20,* p. 48-49. While hedging programs should be tailored to each individual utility, each utility should include a specified minimum of gas purchases that will be hedged, regardless of current gas prices or projected future prices at the time targeted for hedging transactions. *RPA-20,* p. 47; 3T675:15 to 22. Specified minimums are needed in order to achieve the objective of hedging, which is price <u>stability</u> rater than attempting to obtain the lowest possible price. As Mr. LeLash explained, "[t]he assumption of hedging is that you do not know where the price is going." 3T675:13 to 15. Thus, "[i]f the hedges are predicated solely on price consideration, that is speculation and not hedging." 3T675:23 to 3T676:3.

Hedging is not a novel concept. Other industries that rely heavily on commodities typically rely on hedging to reduce the risk of price run-ups. Only the utility industry, with its guaranteed cost pass-throughs, has lagged behind. *RPA-20,* p. 35-35. Even home heating oil suppliers and customers use hedging when they enter into contracts to lock in the price of heating oil prior to the start of the heating season. *RPA-20,* p. 35.

The importance of hedging for gas utilities has been recognized in New Jersey, as well as other states. As shown in the record of these proceeding, Board-approved hedging programs have been in effect for New Jersey Natural since 1994, and Public Service since 1997. *RPA-19*; 1T70:9 to 13. Examples of other state regulatory commissions that have expressed approval of hedging include Iowa and New Mexico. *Re Gas Price Hedging*, 163 PUR 4th 377 (Iowa. Utilities Bd.1995); *Re PNM Gas Services*, 188 PUR 4th 448 (NM PUC 1998). A recent New York decision commented that "[u]tilities should develop formal risk management programs that have reasonable restrictions and guidelines ...." *I/M/O the Rules and Regulations of the Public Service Commission*, Case 97-G-1178, Memorandum and Resolution Revising 16 NYCRR Section 270.55, p. 4 (Apr. 13, 1999) (available on NY PSC website).

At least two other states have imposed gas cost disallowances against utilities that failed to hedge gas against high gas prices. In a 1997 decision the Nevada Public Service Commission held that the gas purchasing strategy of a natural gas local distribution company was imprudent because it failed to include measures to mitigate price risk stemming from its reliance on index-priced contracts. *Re Southwest Gas Corporation*, 183 PUR 4th 323 (Nev. PSC 1997) (see Appendix D).

The Commission reduced ratepayers rates' in the company's Northern Nevada division by $3.8 million and the Southern Nevada division by $1.8 million. *Id.*, p. 338-39. The Indiana Utility Regulatory Commission very recently disallowed nearly $3.8 million in gas costs claimed by Indiana Gas Company ("IGC") because that company did not take action until August, 2000 to lock in prices for part of is gas supply for the 2000-01 winter season. *Application of Indiana Gas IGC,* Cause No. GCA68, Interim Order, p. 11 (Jan, 4, 2001) (see Appendix E). In its analysis of IGS's natural gas procurement strategy, the Commission sharply criticized the company for "plac[ing] the magnitude of the risk of winter gas price volatility on the customers of IGC." *Id.*, p. 10.

The importance of hedging to a prudent gas procurement strategy has been recognized in New Jersey as well as other states. Thus, the Board's evaluation of the New Jersey utilities claimed gas costs for the 2000-01 winter must include an evaluation of whether the utilities took sufficient measures to mitigate the risk of volatile gas prices for their customers.

The Electric Discount and Energy Competition Act of 1999 ("EDECA") does not remove the Board's historical obligation to determine the reasonableness of the gas costs the utilities are seeking to pass through to their ratepayers--including the issue of whether the utilities' gas procurement strategies included adequate measures to mitigate the risk of unreasonably high gas prices. Section 10 of EDECA states that charges for BGSS are to be based on the utility's cost of providing such service, "including the cost of gas commodity and capacity purchased at prices consistent with market conditions ...." *N.J.S.A.* 48:3-58 (t). While this provision could be interpreted as a procurement standard, it cannot be interpreted as a complete standard. "Market" price does not necessarily mean only unhedged index or spot prices. Hedged supplies are also purchased at "market" prices; the physical or financial transactions used to hedge the utility's gas supply will reflect the natural gas market at the time of the hedging transactions. A hedged supply is no less "consistent with market conditions" than prices based solely on market indices or the spot market. *RPA-20,* p. 33-34.

Further, given EDECA's goal of establishing a competitive natural gas marketplace, the "market" standard should be viewed with reference to the procurement practices of third party suppliers, which typically include price hedging. Thus, a hedged supply is more relevant to the conditions that will actually prevail in a competitive market, and thus provides an appropriate benchmark for evaluating whether gas has been prudently purchased consistent with conditions in the marketplace.

2. The New Jersey Gas Utilities Did Not Take All Reasonable Measures to Hedge Their Gas Suppliers for the 2000-01 Winter Season.

In the current proceeding, it has become apparent that none of the four New Jersey utilities took all appropriate and prudent measures to assure reasonable gas costs for their ratepayers. As noted, only one of the four New Jersey utilities, New Jersey Natural, engaged in significant hedging, and even this utility could have done more to protect its ratepayers. Accordingly, a portion of the gas costs of Public Service, South Jersey and Elizabethtown should be disallowed, and New Jersey Natural's less than optimal hedging performance should be considered in evaluating this company's request for interest on gas cost underrecoveries. The practices of each of the four utilities is discussed below.

a. New Jersey Natural Gas Company Has an Appropriate Hedging Program in Place, But Did Not Perform Optimally Given its Experience in Hedging.

Of the four New Jersey gas utilities only New Jersey Natural carried out a hedging program for the 2000-01 winter season which accords with generally accepted market hedge methodologies. In his prefiled direct testimony, New Jersey Natural witness Joseph Shields set out the company's natural gas purchasing plans, explaining that it followed "established guidelines previously discussed with the BPU Staff and the Ratepayer Advocate." *NJ-1,* p. 12-9. The guidelines provide that:

> ...between 50% and 70% of the Company's winter gas purchase volumes should be hedged prior to November 1 of each year. After November 1, up to 90% of the purchase requirements can be hedged. Hedging positions are subsequently modified as the market changes and these guidelines are not automatic triggers. Management's expertise and market judgement allow for any necessary divergences based upon market information, timing, and physical flow requirements.
>
> NJNG has a Risk Management Committee which includes four members of senior management and provides the oversight and executive authorization for executing hedging strategies performed by Energy Services staff.
>
> *Id.* p. 12.

Mr. Shields further explained at the evidentiary hearing that this program is based on a policy of "layering in", that is, purchasing certain volumes of gas at different periods regardless of price in order to create price stability. 1T246:11 to 12, 1T247:23 to 24. If the hedging plan called for the purchase of a particular volume of gas at a particular time, the gas is purchased, regardless of the price. As Mr. Shields states, "it's not a matter of [*sic*] we think it's a good or bad price, it's a matter of [*sic*] we think we need to hedge in layers for stability." 1T246:24 to 25; 1T247:24.

This approach resulted in substantial savings for ratepayers. As shown Schedule 4 to the prefiled testimony of Richard LeLash, based on December 8, 2000 NYMEX Strip prices, New Jersey Natural's hedging activities saved its ratepayers $49.9 million. As discussed below, on a proportional basis, these savings are much higher than those achieved by any of the other three New Jersey utilities. *RPA-20,* Sch. 4.

Nevertheless, while the Ratepayer Advocate has used New Jersey Natural as the benchmark for evaluating the hedging activities of other three New Jersey gas utilities, it should not be inferred that New Jersey Natural's price hedging was as extensive as it should have been. New Jersey Natural's hedging strategy for the 2000-01 winter remained essentially the same as that for the 1999-2000 winter, as did the volumes purchased. 1T249:19 to 1T250:2; *NJNG Response to TR-1*. Although New Jersey Natural's hedging guidelines provide that up to 90% of flowing gas requirements could be hedged by the end of November 2000, the company only hedged 75% of its projected supply requirements, buying the balance of its gas at the ever-increasing index price. *NJ-1, p.* 12. 1T247:5 to 9. As Mr. LeLash noted in his direct testimony:

> [New Jersey Natural's] total hedging activities still only are projected to lower its LGAC costs by 9% to 10%. New Jersey Natural has been authorized to use financial hedging subject to specified dollar limits. As of July and August of this year, the company had committed only between 25% and 50% of these dollar limits. Likewise, the company's forecasts for calendar year 2000 projected hedged prices on only 28% of the company's total firm sales ....
>
> *RPA-20,* p. 43.

New Jersey Natural did not challenge Mr. LeLash's calculations, nor did it challenge his analysis of those calculations. Indeed, for the period November 2000 through March 2001, the company's total hedged volumes are 9.9 Bcf out of total gas purchases of more than 50.0 Bcf *RPA-15*.

New Jersey Natural, which is experienced in gas price hedging, could have done more hedging than it historically had done, once the level and trend in wholesale gas prices became evident. A review of the company's Financial Risk Management report, filed with the Board on January 3, 2001, shows very few hedging transactions during the September through November 2000 period. Even Public Service and South Jersey, which, as discussed below, unreasonably failed to hedge over the spring and summer months, took substantial hedged positions during this period. *PS-2*, p. 7, Sch. 7; *SJG-13*. Thus, while New Jersey Natural fulfilled a minimum requirement for price hedging, it could have done more to mitigate firm customers' gas prices by hedging additional suppliers during the fall months. Indeed, Mr. Shields has admitted that the company could have saved the ratepayers more money if it had hedged a larger percentage of gas supply. 1T257:8 to 9.

Because New Jersey Natural utilized its hedging program adequately, if not optimally, the Ratepayer Advocate is not recommending a gas cost disallowance for this company. However, the company's failure to maximize hedging opportunities should be considered by the Board among other factors discussed in Point III.B. above, when it evaluates New Jersey Natural's request for interest on its deferred fuel balances.

b. Public Service Electric and Gas Company Failed to Hedge Pursuant to its Board-Approved Hedging Program.

Public Service has had Board-approved hedging programs in place since 1997. Under a Board-approved Stipulation in the company's 1996-97 LGAC proceeding, Public Service was authorized to hedge up to 50 percent of residential customers' gas supplies through a combination of fixed price transactions and financial instruments. *I/M/O Motion of Public Service Electric and*

Gas Co., BPU Dkt. No. GR96070544, Decision and Order Adopting Phase III Stipulation and Initial Decision, p. 3 (July 30, 1997). This program was re-affirmed in the Stipulation resolving the company's 1997-98 LGAC proceeding, and then modified to permit the company to hedge additional volumes (up to 80 percent of residential customers' gas supplies), in the stipulation resolving the 1998-99 LGAC proceeding. *I/M/O Motion of Public Service Electric and Gas Co.,* BPU Dkt. Nos. 97110839 *et al.,* Order Adopting Final Stipulation and Initial Decision, p. 7-8 (June 26, 1998); *I/M/O Motion of Public Service Electric and Gas Co.,* Dkt. Nos. Order Adopting Final Stipulation and Initial Decision, p. 7-8 (Dec. 22, 1998). In its testimony in the 1998-99 proceeding, Public Service witness John Scarlata stated that the purpose of the modifications to the hedging program was to "continue to acquire future supplies of gas up to the allowed limits in order to stabilize the cost of the residential customers' gas portfolio." *RPA-2,* p. 8.

Unfortunately, Public Service unilaterally decided not to follow this Board-approved program for the 2000-01 winter season. In a discovery response in the company's current LGAC proceeding, Public Service disclosed for the first time that "due to the availability of residential unbundling and its request for monthly pricing for residential customers, the company made a decision not to hedge volumes for the 2000-01 winter season." *RPA-20,* p. 37; *RPA-5*. Public Service maintained this position until mid-October, when it finally began to hedge portions of its winter gas supply. *PS-2*, p. 15 & Sch. 7. In Mr. Scarlata's December 1, 2000 testimony, Public Service states that it had locked in the price of approximately 40% of its residential winter gas use. *PS-2,* p. 7. However, the company's hedging transactions were done principally in October, well after gas prices had risen to historically high levels. *PS-2,* p. 15 & Sch. 7; *RPA-20,* p. 8.

Public Service's own estimated hedging savings are evidence that this company did "too little, too late." The Public Service estimates, as shown in Mr. LeLash's prefiled testimony, reflect hedging savings of about $66 million based on December 8, 2000 NYMEX Strip prices. *PS-20,* Sch. 4. By way of comparison, New Jersey Natural, a company with total LGAC costs of about one-third those of Public Service, achieved hedging savings of nearly $50 million. *RPA-20,* Sch. 4. If New Jersey Natural is used as a benchmark, Public Service could have achieved an additional $80 million in savings. *Id.*

Public Service's failure to hedge appears to have been in furtherance of a proposal to obtain the ability to control and manage, for the benefit of shareholders, the company's considerable gas supply and capacity portfolio. This proposal, filed with the Board on August 11, 2000 in the Board's Docket No. GM00080564, seeks to transfer Public Service's gas supply and capacity contracts and operating agreements to an unregulated affiliate. As part of this proposal, the unregulated affiliate would be given a no-bid full requirements contract to supply gas to Public Service's BGSS customers, after which time the affiliate would have the right to full control of the company's gas portfolio. Under the proposed requirements contract, the gas would be supplied to the utility, at prices based on a monthly market-based index. Public Service's decision not to hedge, and thus purchase more of its firm customers' gas supply at indexed or "spot" prices, thus appears calculated to move its residential customers toward pricing based wholly on a monthly index. This would facilitate the company's ability to implement its proposed contract transfer and full requirements supply contract.

Public Service's discovery responses in this matter specifically state that the decision not to hedge was motivated by a desire to implement monthly index-based pricing, although for a different reason. As noted, the company's response to a Ratepayer Advocate discovery request stated that Public Service did not hedge "due to the availability of residential unbundling and its request for monthly pricing for residential customers ...." *RPA-5*. In a response to a Staff discovery request, Public Service stated that it did not hedge because "with choice afforded to all customers [the company] cannot be in a situation whereby its costs are not in line with the market." *RPA-7*.

In any event, neither the pending proposal to implement monthly pricing as part of the pending contract transfer petition, nor the implementation of residential unbundling, was a valid reason for Public Service's unilateral decision not to hedge. The decision as to whether ratepayers should be charged for BGSS based on unhedged monthly indexed prices is within the jurisdiction of the Board. Public Service had no right to unilaterally redefine the nature of its BGSS service without Board approval. The company's asserted concern about residential unbundling was also insufficient reason to abandon its hedging program. As of November of this year, only 4,398 of Public Service's residential customers out of 1.6 million (less than one percent) had switched to a third party supplier. Given this low rate of migration, there was little risk that Public Service would be faced with a take-or-pay liability had it hedged 50 percent of its gas supply as contemplated in its approved hedging program. *RPA-20*, p. 38. Thus, "residential unbundling is not yet a procurement concern." *RPA-20*, p. 8. This was certainly not a valid reason to deny the protection of hedging to the remaining 99 percent of the company's residential customers.

In its December 1 prefiled testimony Public Service advanced a different reason for its decision not to hedge over the summer and early fall. The prefiled testimony of company witness John Scarlata states that Public Service did not hedge during the first half of 2000 because the price increases that began to occur in early 2000 were felt to "indicate some type of pricing anomaly, which many experts felt would ultimately return to more stable levels." *PS-2*, p. 14. Thus, the company made a "conscious decision" to await lower prices before locking in prices for the 2000-01 winter. *Id*. According to Mr. Scarlata's testimony at the evidentiary hearing, this was the company's "primary" reason for not hedging. 1T78:7 to 19.

This justification was not even mentioned in Public Service's discovery responses, and should be viewed with skepticism for this reason alone. It is, moreover, contrary to Mr. Scarlata's own description of the purpose of the company's hedging program as stated in the same December 1 prefiled testimony:

> The Company has reiterated its position in prior proceedings that hedging does not necessarily guarantee <u>lower</u> prices, but is a mechanism that assists in providing <u>stable</u> prices.
>
> *PS-2*, p. 11 (emphasis in original).

Further, the justification stated in the December 1 testimony is at odds with Public Service's Board-approved hedging program, as described in Mr. Scarlata's testimony in the 1997-98 LGAC proceeding. As Mr. LeLash explained in his surrebuttal testimony, the testimony in that proceeding stated that the company's policy was to take hedge positions "on a rateable basis," that is, over time. 3T837:20 to 3T838:3; *RPA-2*, p. 10. Thus:

> one would anticipate that Mr. Scarlata would have been taking his hedge positions during, even potentially the fall of 1999, the winter of 1999 and 2000, and certainly through let us say April and May of 2000 when the prices were moderate and the prices would have been favorable compared against prior periods.
>
> 3T838:4 to 10.

Thus, based on the company's own description of its hedging plan in the 1997-98 LGAC proceeding, Public Service should have begun to hedge for the 2000-01 winter <u>well before the occurrence of the anomalous market conditions which the company now asserts as the reason for not hedging</u>. Thus, some hedging should have occurred before October 2000 even if Public Service had decided to cease hedging based on the market conditions described by Mr. Scarlata.

It is also significant that Public Service's decision was made without consulting either the Ratepayer Advocate or the Board's Staff. As Mr. Scarlata stated on cross-examination, "[t]o my knowledge we have never solicited the Ratepayer Advocate nor the Staff in our purchasing decisions." 1T111:12 to 15. The Ratepayer Advocate and other parties were not advised of this decision through the company's LGAC filings, which normally have included detailed gas procurement data and descriptions of the company's gas procurement activities. Public Service made no LGAC filing in 1999, and its July 2000 filing, while characterized as an LGAC filing, was limited to a request for authority to expand the company's existing monthly pricing mechanism and contained no information about the company's hedging practices.

At the evidentiary hearing, Public Service suggested that the Ratepayer Advocate should have been aware of the company's lack of hedging activity through monthly reports provided by the company. 3T570:12 to 3T571:12. These reports, however, did not effectively disclose the company's decision not to hedge. Examples of these reports, which consist of a single page entitled "Recent Activity - Natural Gas Hedging" in a broader monthly report, were received in evidence as Ratepayer Advocate Exhibit RPA-22. 3T563:3 to 7; 3T710:4 to 3T711:7. These provide a month-by-month presentation of transactions that have occurred since the previous month, and do not disclose the company's existing hedging positions. 3T711:8 to T712:2. Further, the reports included in Exhibit RPA-22, list a substantial number of transactions for May and June of 2000, which, as noted, are reported as natural gas hedging activities. Thus, it was not readily apparent from these reports that the company had ceased hedging. 3T712:8 to 3T713:9. The reports also contained no narrative explaining this change in the operation of the company's hedging program, despite a requirement in the Board's 1998-99 LGAC order that the monthly reports include details of the operation of the LGAC and "a narrative explanation of any variances ...." *I/M/O Motion of Public Service Electric and Gas Co.*, Dkt. Nos. Order Adopting Final Stipulation and Initial Decision, p. 11 (Dec. 22, 1998).

Based on the evidence discussed above, Public Service's decision not to take any hedged position on behalf of its residential customers until October of 2000 was clearly imprudent. Based on its Board approved hedging program it should have hedged much earlier. Moreover, it appears that the company's decision to leave it customers unprotected was made to further its own corporate interests in facilitating a proposed transfer of gas contracts to an unregulated affiliate, and without adequate disclosure to the Ratepayer Advocate or the Board.

Public Service's failure to hedge warrants a significant disallowance. The Ratepayer Advocate recommends a disallowance of $9.7 million, the approximate amount of the incentives paid to shareholders for margins obtained on capacity transactions subject to margin sharing. *RPA-20*, p. 38.

Based on a comparison to the performance of New Jersey Natural, a much higher disallowance could be justified.[2] However, a significant disallowance is appropriate to establish that the Board will disallow gas costs for utilities that do not take adequate steps to protect their customers from the risk of rapidly escalating gas costs. *RPA-20*, p. 38. The amount of Public Service's margin sharing incentives is an appropriate amount, as the company should not be allowed to retain a reward for mitigating gas costs through capacity transactions, when it has failed in another key component of gas supply activities. 3T655:12 to 21. The Board should therefore adopt the Ratepayer Advocate's recommended disallowance of $9.7 million for Public Service.

c. South Jersey Gas Company Has No Hedging Program, and Took Only Minimal Measures to Hedge its Gas Supply for the 2000-01 Winter Season.

South Jersey's performance was also deficient. South Jersey conducts its gas procurement activities under "Commodity Purchase Guidelines" that were established in 1996 following extensive litigation on prudency issues on the company's 1994-95 and 1995-96 LGAC proceedings, and the completion of a Board-Ordered audit of the company's gas procurement activities. *I/M/O Petition of South Jersey Gas Co.*, BPU Dkt. Nos. GR94080383 and GR95080401, Decision and Order Approving Stipulation and Initial Decision, (Apr. 10, 1996); *I/M/O the Board's Determination That a Focused Audit Be Performed on the Gas Capacity and Gas Supply South Jersey Gas Co.*, Dkt. No. GA94110526, Order Accepting Audit with Modifications, (Aug. 21, 1995). Although the company

[2] A much higher disallowance could also be justified based on a comparison with Public Service's hedging activities for the 1999-2000 winter. Such an approach was taken in the *Indiana Gas* decision cited above. In that decision, the utility had hedged approximately 27 percent of its 1999-2000 gas supply prior to August, 1999. The disallowance for the company's 2000-01 gas costs was based on the savings that would have been achieved if the company had hedged a similar amount prior to August, 2000. *Application of Indiana Gas IGC,* Cause No. GCA68, Interim Order, p. 11-12.

has referred to these guidelines as a "hedging" program, these guidelines provided no more than a broad outline of a gas portfolio purchase program. As described by South Jersey witness Jeffrey DuBois, the main feature of this guidelines specified that the company's winter supplies were to be purchased within three time frames: one-third during the summer for injection into storage, one-third during the August through October time period at the then current winter season prices, and the final third during the winter at index-based prices. 2T433:20 to 2T434:17. South Jersey hedges solely through physical transactions, (*i.e.* contracts for the actual delivery of gas at specified price terms). This is due, at least in part, to the company's reluctance to use financial transactions in the absence of the Board's pre-approval to recover the costs of these transactions. 2T429:2 to 7.

What is absent from these guidelines is specified hedging objectives such as the "layering in" approach followed by New Jersey Natural. This can be seen from South Jersey's hedging activities for the 2000-01 winter season, which are shown on Exhibit SJG-13. Other than volumes injected into storage,[3] this exhibit shows that South Jersey hedged 5,442,040 Dth, or 19.7 percent of its total LGAC throughput of 27,622,000 Dth . Moreover, most of this hedging was done too late to effectively mitigate gas costs. Of the 5,442,040 Dth of hedged supplies, none were hedged before July 25, 2000, and only 1,510,000 Dth, or 5.5 percent of total throughput, were hedged before mid-October.

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[3] During cross examination South Jersey's counsel represented that 1,424,934 Dth (from Exhibit SJG-13) of gas injected into storage were hedged volumes. 3T641:10 to 22. However, the exhibit shows that these volumes were purchased during the month they were injected, and thus could not have been supplies for which prices were "locked in" in advance. Based on a review of materials from the company's current LGAC filing, it appears that these volumes were supplies provided under the company's Transco FS supply contract. Accordingly, only 5,442,000 Dth of the volumes listed on this exhibit or about 19.7% of the company's total LGAC throughput of 27,622,000 Dth volumes, represents hedged volumes.

The inadequacy of these efforts can be seen by comparing South Jersey's claimed hedging savings with the savings achieved by New Jersey Natural. Based on December 8, 2000 NYMEX Strip prices, South Jersey could have saved its ratepayers an additional $16 million had it followed a program comparable to New Jersey Natural's. *RPA-20,* Sch. 4. *Id.* By any reasonable measure, South Jersey did too little, too late in the season, to protect its ratepayers against excessive gas costs.

At the evidentiary hearings, South Jersey attempted to suggest that it was "unfair" to criticize the company for its lack of a hedging program because nobody ever told the utility to develop one. This argument is tantamount to an admission that South Jersey is unable to develop effective procurement strategies unless ordered to take specific action. It has been five years since the company implemented its "Commodity Purchase Guidelines" following litigation and a Board-ordered audit. By way of comparison, New Jersey Natural has proposed and obtained agreement and Board approval for two modifications to its hedging program since the original approval of a pilot program in December 1994. *RPA-19.* Further, the Board-approved hedging programs in effect for both New Jersey Natural and Public Service could have provided guidance to South Jersey had it taken the initiative to explore ways to improve upon its existing gas procurement policies.

South Jersey also attempted to suggest that its failure to engage in adequate hedging should be excused because it experienced a higher percentage savings than New Jersey Natural due to storage transaction. 3T630:4 to 3T636:15. However, as Mr. LeLash explained in response to South Jersey's cross-examination, storage is a "passive" hedge. 3632:8 to 13. All of the utilities have storage, and the storage levels which they currently maintain "are to a large degree a result of a number of historical actions taken by the utilities many, many years ago." 3T633:10 to 13. As is clearly shown by the record in this proceeding, passive reliance on storage is not sufficient, when other hedging tools are readily available to the utilities. *RPA-20,* p. 35.

Further, even if storage is "counted," South Jersey's performance is lacking. South Jersey's cross-examination was based on Mr. LeLash's Schedule 2, page 2 of 2, which shows estimated savings based on December 8, 2000 NYMEX Strip prices from four types of mitigation measures: (1) gas price hedging, (2) storage, (3) off-system and capacity credits, and (4) interruptible and other credits. *RPA-20,* p. 41 & Sch. 2, p. 2 of 2. This schedule shows that South Jersey's somewhat higher storage savings is offset by poorer performance not only with regard to "gas price hedging," but also with regard to "off-system and capacity credits" and "interruptible and other credits." *RPA-20,* Sch. 2, p. 2 of 2. The total discrepancy, as stated by South Jersey's counsel in his cross-examination of Mr. LeLash, is about five percent as a proportion of total pre-mitigation gas costs. 3T630:4 to 3T632:6. While South Jersey appeared to suggest that this is a minimal amount, five percent of South Jersey's $278.1 million "total gas costs without mitigation" is approximately $14 million. *RPA-20,* Sch. 2, p. 2 of 2. In South Jersey's rebuttal testimony, conducted later that same day, company witness David Kindlick testified that $1.5 to $2 million in interest would represent a "significant" amount to the company! 3T728:6 to 3T729:12 Thus, even taking into account storage savings, South Jersey's deficient performance in gas price hedging had a significant impact on its ratepayers.

South Jersey's poor hedging performance warrants a disallowance of a portion of its gas costs. Consistent with the disallowances recommended for Public Service, the amount of the disallowance should be equivalent to the estimated amount of South Jersey's share of margin sharing revenues, $548,400. *RPA-20,* p. 43.

d. Elizabethtown Gas Company Has no Hedging Program, and Did Not Engage in Any Substantial Hedging.

Of the four New Jersey utilities, Elizabethtown did the least to protect its ratepayers from high gas costs. According to the company's December 1, 2000 filing, its only savings in commodity costs were achieved through storage injections and through a long-term supply contract which provided a discount from current market rates for approximately 18 percent of its gas supply. *ETG-1*, p. 17. Elizabethtown did not lock in the prices for any of its non-storage gas supplies for the 2000-01 winter season. 2T341:10 to 16; 2T361:15 to 2T362:7. This company, alone among the four New Jersey utilities, failed even to take advantage of the retrenchment in gas prices that occurred in October, 2000. *Id.;* 2T325:2 to 328:14.

Elizabethtown's poor performance appears to stem from two factors: (1) an *ad hoc* internal decision making process, rather than a defined hedging program; and (2) an apparent objective of "beating" historic gas prices, rather than achieving stable prices. With regard to Elizabethtown's decision making process, the company acknowledges that a "successful hedging program requires a clear set of goals, objectives, and business rules" that are understood by all parties. *ETG-1*, p. 18. Elizabethtown, however, does not have such a program. According to the prefiled testimony of Thomas Smith, Elizabethtown's Director of Energy Planning, the company's approach to hedging consists in its entirety of "stand[ing] ready to take advantage of opportunities to lock in prices for portions of its baseload gas demand if and when it appears reasonable to do so." *ETG-1*, p. 17-18. At the evidentiary hearing, Elizabethtown witnesses Paul Chymiy testified that these decisions are based on an ongoing analysis of pricing trends, rather than any specified goals for achieving specified levels of hedged positions. 2T341:4 to 25; 3T361:15 to 2T362:7. Thus, the company's hedging strategy appears to consist of little more than waiting for a “feeling” that the appropriate time to hedge has arrived.

The lack of an established hedging program is, moreover, compounded by a fundamental misunderstanding of the purpose of hedging. Elizabethtown appears to acknowledge that the purpose of hedging is achieving price stability. 3T792:25 to 3T793:4. However, as described by Elizabethtown witnesses, its decision-making process consists of waiting for a time when current prices fall below a benchmark based on historic pricing levels. 3T342:2 to 6. Elizabethtown’s failure to take advantage of the moderation in gas prices that occurred in late October 2000 appears to have been the result of this approach. The two gas supply witnesses who testified at the evidentiary hearings did not appear familiar with developments in natural gas market in late October. 2T321:23 to 3T322:5. Nevertheless, company witness Nancy Sobelson testified that a $4.42 January futures price prevailing in late October would not have justified a decision to hedge, because this price was higher than historic levels. 2T327:17 to 2T328:14 . Thus, Elizabethtown appears to be defining hedging as based on a desire to “beat” a specified price, rather than an objective of achieving price stability.

Based on December 8, 2000 NYMEX Strip prices, Elizabethtown is claiming $9.5 million in hedging savings, presumably resulting from the discounts provided through long-term gas supply contracts. *RPA-20,* Sch. 4. A reasonable hedging program would have resulted in considerable additional savings for ratepayers. Ratepayer Advocate witness Richard LeLash estimates that Elizabethtown could have achieved an additional $20 million in savings had this company followed a program comparable to New Jersey Natural’s. *RPA-20*, Sch. 4.

At the evidentiary hearings in this matter, Elizabethtown attempted to suggest that the company's failure to implement a hedging program was due to the opposition of the Ratepayer Advocate to hedging programs proposed by the company in prior LGAC proceedings. 3T770:2 to 3T782:20. However, based on the exhibits introduced by Elizabethtown and the testimony of Elizabethtown and Ratepayer Advocate witnesses at the hearing, it is clear that Elizabethtown's proposals in prior proceedings were not adopted because they had serious flaws.

Elizabethtown first proposed a "hedging" program as part of its 1996-97 LGAC filing. This proposal, described by the company as a "performance based commodity cost recovery mechanism," was received in evidence in this proceeding as Elizabethtown's Exhibit ETG-6. 3T770:5 to 8. Elizabethtown's proposal was to be permitted to purchase gas commodity in accordance with an undefined "framework" to be established by the company, and then "share the risks and rewards" based on whether the actual price achieved by the company was above or below a benchmark based on an average of monthly index and "spot" gas prices. *ETG-6,* p. 22-25; 3T791:6 to 10. This proposal was contrary to the fundamental concept which has been articulated throughout this proceeding--that the purpose of hedging is to achieve stability and not to beat the market. As Mr. LeLash explained:

> The first proposal that was made in 1996-'97 is really not a hedging proposal. It is not comprehensive at all and most importantly, it was not seeking to do what a hedging program should do, it was not targeted at stabilizing gas prices. It was targeted at beating a gas price. And we had ample testimony from company witnesses as well as from myself that that's not the objective of a price hedging program. It is stabilization.
>
> 3T841:18 to 3T842:3.

In addition, the 1996-97 proposal included a provision that the "costs and benefits" of the program would be shared on a 50-50 basis, but only up to $1 million. As noted by Mr. LeLash, this apparently would have limited Elizabethtown's financial exposure to $500,000, thus providing an incentive to take unreasonable risks to earn an "incentive." 3T842:7 to 3T843:5.

Thus, it is clear that Elizabethtown's first proposal for a "hedging" program was rejected, not because of unreasonable opposition from the Ratepayer Advocate, but because it was seriously flawed. Moreover, the Board-approved Stipulation resolving this proceeding specifically provided that it was without prejudice to the company's right to resubmit another proposal, and that the docket would remain open to allow the parties to discuss the possibility of allowing the company to use financial instruments to mitigate price risks. 3T799:8 to 21. Thus, the Stipulation reflects the Ratepayer Advocate's disagreement with the specific program proposed by Elizabethtown, but it does not reflect any opposition by the Ratepayer Advocate to the concept of hedging.

Elizabethtown's proposal in its 1997-98 LGAC proceeding was better defined than its previous proposal, but it still included a questionable incentive mechanism. 3T843:13 to 21. Elizabethtown's proposal was to hedge is gas supplies by using combinations of "put" and "call" options." *ETG-8*, p. 19. The company proposed to be provided with an incentive based on whether the hedged price was better than an index price at the time the options closed. 3T797:12 to 18. Thus, Elizabethtown again was proposing to implement an incentive based on "beating the market." Moreover, this proposal was overly complicated, involving the use of sophisticated financial instruments to attempt to gain protection against high prices, without losing the ability to take advantage of gas price drops. 3T845:18 to 22. In recommending that Elizabethtown start with less sophisticated hedging vehicles like fixed priced contracts over options and collars, Mr. Miller, Ratepayer Advocate's witness during the 1997 LGAC noted that "ETG has not demonstrated the expertise or experience to deal with these additional complexities." *ETG-10,* p. 7-12. The flaws in the company's proposal were explained in greater detail in Ratepayer Advocate's testimony in the 1997-1998 LGAC proceeding. *ETG*-10.

As in the 1996-97 proceeding, the Stipulation resolving the 1997-98 LGAC filing did not reflect any opposition by the Ratepayer Advocate the concept of hedging. This Stipulation included a provision requiring the company to "consider whether to purchase a portion of its customers' annual natural gas requirements under fixed price contracts or by using financial instruments in an attempt to mitigate the impact of volatility in the market for natural gas." 3T798:11 to 16. For unknown reasons, Elizabethtown failed to resubmit another hedging proposal for over two years until this proceeding.

Elizabethtown has had ample opportunity to develop an appropriate hedging program that would be acceptable to the Ratepayer Advocate and other parties. The Board-approved hedging for New Jersey Natural and Public Service, as well as the Ratepayer Advocate's testimony describing the flaws company's 1997 proposal, could have provided the company with the necessary guidance to develop an acceptable hedging program. Elizabethtown alone is responsible for its failure to implement a hedging program. The Board should reject this company's attempt to suggest that this failure is the fault of the Ratepayer Advocate or any other party.

Elizabethtown's unjustified failure to hedge warrants a disallowance of a portion of its gas costs. Consistent with the disallowances recommended for Public Service and South Jersey, the amount of the disallowance should be equivalent to the estimated amount of Elizabethtown's capacity margin sharing of $383,014. *RPA-20,* p. 43.

3. The Utilities Should be Required to Develop Hedging Programs, Subject to Review and Board Approval, to Protect Their Customers Against Future Gas Cost Increases, and to Evaluate Other Mitigation Measures Including Storage Projects.

It has been quite evident during the past few months that the New Jersey gas utilities' hedging programs and policies are inadequate to protect their ratepayers against the risk of excessive natural gas prices. The programs lack specified hedging targets and time frames, and, in the absence of such stated objectives, aside from New Jersey Natural, the utilities continue to try to second-guess wholesale gas price trends. This philosophy was demonstrated by frequent references to the utilities reliance on historical prices and price forecasts as the basis for hedging decisions, and their continuing inaction as they waited for prices to return to "normal" levels before establishing hedged positions. *See* Point III.C.2. above.

It is important to protect New Jersey's natural gas consumers against the risk of future sharp run-ups in wholesale natural gas prices. All of the utilities should develop hedging programs which incorporate two fundamental objectives: (1) to hedge at least a specified minimum level of their gas supplies, and (2) to establish hedged positions over time, under specified time frames, to avoid short-term fluctuations in prices.

The importance of clear parameters is clearly shown by the testimony of Public Service witness John Scarlata on cross-examination. As noted above, Public Service's Board-approved hedging program authorized it to hedge specified percentages of its gas supply, and it had expressed its intent to continue to hedge up "up to the allowed limits" of its programs. *See* discussion at page 32 above. Nevertheless, the company considered that the program gave it the discretion to forego any hedging during the spring, summer and early fall of 2000. 1T111:22 to 1T112:3. Clearly defined objectives and targets are needed to avoid conflicting expectations as to the utilities hedging programs in the future.

The hedging programs to be implemented by the utilities will reflect important policy decisions which will affect energy costs for consumers throughout New Jersey. These programs therefore should be developed through a process which provides a meaningful opportunity for input by all parties and consideration by the Board. 3T554:2 to 14. The Ratepayer Advocate recommends the following approach:

1. The utilities should be directed to submit an evaluation of a prospective strategy and a proposed hedging program.

2. Once the submission is received, the Ratepayer Advocate, the Board's Staff, and other interested parties should be provided with the opportunity to review and analyze each utility's proposal; and

3. The proposals should be submitted to the Board for approval subject to any hearing that may be required to resolve disputed issues.

RPA-20, p. 45-46.

Based on the utilities' different levels of experience with gas price hedging, the individual hedging proposals will differ in content, but they should all address their portfolio approach as specified by the Board in its Provisional Rate Orders. Specifically, the should specify a "gas purchasing strategy based on a mixed portfolio approach, consisting of fixed gas price contracts (both short-term and long-term), storage inventories, financial instruments, and spot market purchases." *See, e.g.* Public Service Provisional Rate Order, p.9. The Ratepayer Advocate further recommends that the proposals:

1. Incorporate some specified minimum percentage, between 30% and 50% of annual gas purchases which must be price protected

2. Include a“discretionary” component to the hedging which would be responsive to where gas prices are relative to some agreed upon benchmark.

3. Specify what percentages of total hedge positions will be fixed using physical versus financial hedges.

RPA-20, p. 47-48.

As discussed above, both Public Service and New Jersey Natural both have hedging programs in place. During the past year the major shortcoming for their programs was the lack of any established standard for the level of hedged volumes which were to be established over time. Both utilities need to establish minimum, and perhaps maximum, levels of locked in pricing, expressed as a percentage of gas purchases, which will be obtained by specified dates. To the degree necessary, they should also affirm or revise their mix of hedging between physical and financial positions.

Public Service also should modify its program to provide for better high-level corporate review of its hedging activities. According to Public Service witness John Scarlata, the company's decision not to hedge was not reviewed internally beyond the Gas Supply Management group. 1T109:8 to 1T110:8. Public Service should establish a committee to oversee and review gas hedging policies. This committee should include additional senior management and should review the activities of the Gas Supply Management Group at least monthly. As noted above, New Jersey Natural has a Risk Management Committee which include four members of senior management. *NJ-1*, p. 12.

For Elizabethtown and South Jersey, the proposals need to be far more comprehensive since these utilities have not yet established any basic hedging or risk management programs. They should follow the frameworks established by Public Service and New Jersey Natural. However, they will need to establish their own objectives and target hedging levels. They should also address in detail how the hedging will be managed and controlled and describe what resources will be used to implement and run the hedging activities.

It is also important for the Board to evaluate the utilities' prospective procurement strategies to assure that all reasonable options are being considered to eliminate a recurrence of the crisis that has occurred this winter. As part of their submissions, the utilities should be required to identify other ways of lowering and stabilizing gas costs for firm ratepayers. As noted in Mr. LeLash's testimony, if the utilities required additional capacity, they could, as an alternative to pipeline transportation, consider additional underground storage capacity, which provides a natural hedge by allowing utilities to purchase gas during the summer for use in the winter. *RPA-20,* p. 16. As shown in the reports provided as Appendix B to Mr. LeLash's prefiled testimony, there has been increasing recognition of the importance of storage as a tool to meet increased demand for natural gas at reasonable rates, and many new underground storage projects are under development nationwide, including high-deliverability storage projects in Pennsylvania to serve the Northeast market. *RPA-20,* Appendix B. While present storage capacity is limited, the utilities should identify any available economic storage capacity from either existing sources, the projects currently under development, or any other feasible storage sites. *RPA-20,* p. 16. The utilities should also re-examine the economics of expanding their above-ground liquefied natural gas ("LNG") facilities in light of the substantial changes in the natural gas market that have occurred over the past several months. *Id.*

Finally, the Board should review the utilities' interruption practices to ensure that firm ratepayers are not being adversely affected by any limitations placed on economic interruption or pricing methodologies. *RPA-20,* p. 16. The Board has already directed the utilities to submit testimony on their interruption practices as part of the LGAC-related issues which remain for consideration by the OAL. The record of these proceedings should be considered as part of the Board's evaluation of the utilities' procurement strategies.

D. THE BOARD SHOULD TAKE IMMEDIATE STEPS TO ASSURE COMPLIANCE WITH CONSUMER EDUCATION AND MITIGATION MEASURES REQUIRED IN PROVISIONAL RATE ORDERS.

Pursuant to the Provisional Rate Orders, the four gas utilities were required to implement a variety of consumer education and mitigation measures to ameliorate the impact of this winter's high natural gas costs. *E.g.* Public Service Provisional Rate Order, p. 9-11. While some measures, such as bill inserts, have been implemented, there is a major gap--the mass media campaign to be conducted as part of the ongoing customer choice education programs is woefully inadequate. There is also room for improvement by all of the utilities with regard to the Board's other requirements. The deficiencies in the utilities' compliance with the Board's required consumer education and mitigation measures are discussed below.

1. The Mass Media Campaign to be Funded Through the Customer Choice Education Program is Woefully Inadequate.

The Board's Provisional Rate Order require the utilities to "provide additional education through other media, to be funded through the existing customer choice education program to advise customers of the availability of the various assistance programs where people can go for help." *E.g.* Public Service Provisional Rate Order, p. 10. To date, these measures have been woefully inadequate. The Board first directed the utilities to undertake this effort at its October 10, 2000 agenda meeting, when the Public Service, New Jersey Natural and Elizabethtown emergent rate requests were considered. However, as of the time of the evidentiary hearing in this matter, only a single radio public service announcement had been developed by the Utility Education Committee ("UEC"). As explained by New Jersey Natural witness Anne-Marie Peracchio, this public service announcement was "being circulated to the UEC members at this time," but with no specific dates set for it to be broadcast. 1T239:23 to 1T240:25.

The consumer education campaign implemented by the New York Public Service Commission provides an example of the type of program that could be implemented. On September 20, 2000, the New York Commission announced that its staff would implement a statewide consumer education campaign to alert consumers about natural gas price increases, and to inform them about the steps they could take in response. *RPA-20,* p.58 and Appendix D to Testimony. The objectives of the campaign included increasing consumers' understanding of the extent and reasons for the price increases, and providing information about various financial assistance programs, the Commission's protections against shutoffs, and conservation measures. *Id*. As noted by the Ratepayer Advocate in her opening statement to the Board, the New York Commission's education campaign was implemented beginning shortly after it was announced. 1T14:23 to 1T15:5.

This single public service announcement planned so far for New Jersey consumers stands in sharp contrast to the UEC's other media efforts. As of the filing of this brief, the UEC was continuing a massive, state-wide television, radio and newspaper campaign on customer choice and "slamming," despite the fact that there are virtually no marketers making offers to residential consumers.

The UEC clearly has the ability and the resources to conduct an effective campaign to educate consumers about high gas costs, and measures available to them to reduce their energy costs, and, if necessary obtain assistance in paying their bills. The UEC should be directed to immediately undertake an effective education campaign.

Further, as noted in the January 22, 2001 letter from the New Jersey Utilities Association ("NJUA") to the Board's Chief of Staff, the Energy Education Council ("EEC") (which provides formal oversight of the UEC with input from members including the NJUA, the Ratepayer Advocate, a representative of third-party suppliers) and many State agencies, has not held a meeting for many months. It is important that meetings of the EEC resume, so that New Jersey consumers can be assured that the education measures funded through charges to ratepayers will be relevant, timely, and responsive to their needs.

2. The Utilities Should be Directed to Conduct Assessments of the Impacts of Their Rate Increases on Low-Income Customers.

The Board's Provisional Rate Orders directed each of the utilities to submit, as part of their December 1, 2000 filings, an "assessment of how the rate increases have impacted its low-income customers and how programs such as budget billing and extended payments have helped such customers." *E.g.* Public Service Provisional Rate Order, p. 7. As noted in the Ratepayer Advocate's prefiled testimony in this matter, none of the utilities complied with this requirement, or even stated when they would be prepared to do so. *RPA-20*, p. 54. The utilities appear to be awaiting further direction from the Board before proceeding with the study. *NJ-2,* p. 14; 2T389:8 to 20. This study is an important component of the mitigation measures ordered by the Board. High energy prices burden everyone, but especially low-income consumers. It is of the utmost importance that the studies be completed promptly, to assure that the other education and mitigation measures required under the Board's Provisional Rate Orders are meeting the needs of New Jersey's most vulnerable citizens.

3. The Utilities Should Be Directed to Correct the Other Deficiencies in Their Individual Customer Education and Mitigation Measures.

a. The Board Should Require Public Service to Institute Consumer-Friendly Education and Mitigation Measures.

Public Service has taken steps to implement the consumer education and measures required in the Board's Provisional Rate Order, but there is substantial room for improvement in the accessability of these measures to consumers. The Ratepayer Advocate recommends that Public Service be directed to take a more consumer-friendly approach in several areas.

With regard to bill inserts, Public Service has provided a substantial amount of information to its customers, but not always in a manner that is easy for customers to understand. For example, one of Public Service's bill inserts incudes a notification to customers about wholesale natural gas price increases. However, the information is overly technical, and does not explain the reasons for the steep increases that have impacted them, the consumers, since last winter. *PS-6,* Sch. VSV-2, Attachment B, p. 4 of 14. When asked about this, Public Service witness Victor Viscomi responded that there was limited space in the company's bill inserts, and that more detailed information had been provided in press releases. 1T190:11 to 21. Public Service should supply more customer-friendly information, such as that provided by New Jersey Natural. *NJ-3,* Attachment A.

Public Service also made an attempt to comply with the Board's requirement to notify customers of available assistance programs and eligibility standards. However, this was done in a disjointed manner, with information supplied through several different bill inserts, instead of a single, easy-to-understand bill insert describing all available forms of assistance. *PS-6,* Sch. VSV-2, Attachments A. B, C and D. Interestingly, Public Service in fact has prepared and supplied to its own employees a comprehensive summary, in the form of a card. *PS-9.* When asked why Public Service did not make this card generally available, Mr. Viscomi had no good response, except to say it was available when requested, or offered through contracts with Public Service employees. 1T197:15 to 1T. The Board's Provisional Rate Order, however, contemplates that this information be supplied to customers. Public Service should be directed to distribute the card, or some other easily understandable summary of all available assistance programs, to all of its customers.

Similarly, Public Service has made an effort to obtain accurate meter reading, by offering weekend, call-in and mail-in reads, and maintaining keys to some locations. 1T219:9 to 19. However, when asked whether the company had considered electronic meter reading, Mr. Viscomi responded that the customer service department was not involved in discussions on this issue. 1T219:20 to 1T:220:17. The Ratepayer Advocate suggests that both customers and Public Service might benefit if the company's customer service personnel were to become involved in discussions about meter reading policy, as accurate meter readings contribute to customer satisfaction. Public Service might also consider eliminating its $60 fee for installing an outdoor remote device for those customers for which the company is consistently unable to obtain an actual meter read. 1T232:23 to 1T233:16.

During the hearings Public Service was asked about its extended payment plan. According to Mr. Viscomi, Public Service currently offers payment plans ranging from one to eighteen months. 1T185:13 to 17. However, when asked whether the company has offered any payment plans "above and beyond" those previously in place, as required by the Provisional Rate Order, the company provided a response indicating that there has been no increase in participation in these plans from 1999 to 2000. *Public Service Response to TR-187.*

With regard to NJ SHARES, Public Service has contributed funds to initiate the program as well as to administer it. However, of all of the member utilities, Public Service's customers have the lowest rate of contributions to the program. More persuasive and timely bill inserts might influence Public Service's customers to contribute more to this worthy program.

b. South Jersey Should be Required to Improve its Bill Inserts and its Communication With Social Service Agencies, and Place its Tariffs on its Website.

South Jersey's bill inserts contain most of the required information, but they should include more information on extended payment plans as well as the Board's winter moratorium program. With regard to extended payment plans, the bill inserts merely state that extended payment plans are available, with no details on the types of arrangements that can be made and who might qualify for them. 2T493:4 to 2T497:18. South Jersey's bill inserts contain no information about the winter moratorium program. 2T497:25 to 2T498:4. South Jersey witness David Kindlick expressed concern about including this information in a bill insert, because it might encourage customers not to pay their bills. 2T498:10 to 2T499:16. He did acknowledge, however, that lack of information might cause some needy customers to pay more than they could actually afford, because of the fear of being shut off in the winter. 2T499:17 to 25. Information on extended payment plans and the winter moratorium program should be provided to customers, in order to avoid unnecessary hardships to customers who need these programs. South Jersey should be directed to place this information in a bill insert.

With regard to the Board's directive to provide education targeted to social service agencies, South Jersey held a single meeting with its Consumer Advisory Council in October 2000. 2T501:1 to 16. Additional meetings with the Consumer Advisory Council and other assistance agencies would be useful to advise them of the ongoing monthly rate increases and information about the various assistance programs available.

Finally, South Jersey is the only gas utility that does not maintain its tariffs on its web site so that customers can view the company's most current rates. South Jersey should be directed to immediately comply with this requirement of the Board's Provisional Rate Orders.

During cross-examination, South Jersey witness David Kindlick stated that this failure to comply was because the company is awaiting approval of the tariff resulting from last year's natural gas unbundling proceedings. The company does not "want to go through putting the old tariff onto the web site when the new one might be coming out within a couple of weeks ...." 2T502:5 to 12. This is not a valid justification. Two other utilities, Elizabethtown and New Jersey Natural are also awaiting unbundling orders, and they nevertheless have their tariffs available on their websites. Further, it is unfair to withhold the benefits of placing current tariffs on South Jersey's website during this time of monthly rate increases. The Board should reaffirm its direction to South Jersey to place its tariffs on its website.

c. Elizabethtown Should be Required to Send a Bill Insert With the Information Required by the Board, Rather Than Sending this Information Only to Customers Who Request It.

Elizabethtown has not complied with the Board's requirements to prepare at least two inserts containing information about gas cost increases, budget billing and extended payment plans, and available assistance programs. Elizabethtown's bill inserts include a list of assistance programs, but not the "detailed information" required by the Board's Provisional Rate Orders. *RPA-18;* 2T388:6 to 22.

Elizabethtown's discovery responses included a brochure "We Can Help" containing the required information, but this brochure was not sent as a bill insert. *RPA-18.* It is provided only to customers who request it, and customers experiencing payment troubles. 2T397:11 to 17. The Board's Provisional Rate Orders specifically contemplated that this information should be distributed to all customers. The Board should require Elizabethtown to distribute the "We Can Help" brochure as a bill insert.

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IV. CONCLUSIONS WITH REGARD TO PROVISIONAL RATE ORDERS

For the above reasons, the Ratepayer Advocate urges the Board to adopt the recommendations discussed above, which are summarized as follows:

1. For the current winter season, it was appropriate for the Board to adopt a "phased" approach to rate increases, in order to avoid undue burdens on ratepayers.

2. Rate increases during the summer months do not recognize that most gas usage occurs during the winter heating season. Therefore, the utilities should not be permitted to extend the two percent rate increases contemplated in the Provisional Rate Orders into May, June, and July of 2001 absent a convincing showing of need. Otherwise, the two percent increases should extend only through April 1, 2001, as contemplated in the Provisional Rate Orders.

3. Automatic rate increase should not be resumed next fall. Beginning with the 2001-2002 period, each utility should be required to make annual filings, for rates to be effective on October 1 of each year, and to apply for no more than two additional rate adjustments during the November through February period. All rate increases should be after appropriate filing and notice, review, and Board decision. The utilities should be required to initiate rate decreases when warranted. This mechanism should remain in effect pending the Board's consideration of options for phasing out the LGAC mechanism for New Jersey utilities.

4. The Board should define the scope of a generic proceeding to consider how the current LGAC mechanism should be phased out as New Jersey's natural gas marketplace moves to a competitive environment. This proceeding should include issues such as procurement, pricing, and service standards, and should include all stakeholders.

5. To the extent the Board defers recovery of some gas costs during the 2000-2001 LGAC period, none of the utilities should be permitted to accrue interest on associated underrecovered balances. Based on established Board policy, fairness in allocating business risks, and the utilities' own actions contributing to their gas cost underrecoveries, ratepayers should not bear the entire burden of increased gas costs.

6. The Board should find that a prudent natural gas procurement strategy must include a well-defined hedging program, with specified minimums, to protect consumers from the risk of sharp increases in wholesale gas prices.

7. The Board should find that New Jersey Natural has an appropriate hedging program in place, but did not maximize its hedging opportunities for the 2000-01 winter.

8. The Board should make gas cost disallowances for Public Service, South Jersey and Elizabethtown based upon their failure to take reasonable hedging positions for the 2000-01 winter. While these utilities concentrated on capacity transactions which benefitted their stockholders handsomely, they failed to meaningfully limit the impact of gas price increases for their firm residential customers. While far larger disallowances could reasonably be assessed, these companies should, at a minimum, be charged with a gas cost disallowance equal to their portion of capacity margin sharing.

9. The Board should find that Public Service failed to follow its stated price hedging objectives to which it had committed in the past under its Board-approved hedging program, and imprudently failed to take steps prior to mid-October, 2000 to hedge its gas supplies for the 2000-01 winter season. The Board should further find that the company's desire to implement monthly index-based pricing for its residential customers, and its asserted concerns that significant numbers of residential customers would switch to competitive natural gas suppliers, were insufficient reasons to deny the company's customers the protection of hedging. The Board should disallow $9.7 million of Public Service's gas costs.

10. The Board should find that South Jersey has failed to develop and implement a hedging program, and imprudently failed to take adequate steps prior to mid-October, 2000 to hedge its gas supplies for the 2000-01 winter season. The Board should further find that South Jersey's savings from storage transactions do not excuse its failure take adequate steps to hedge its non-storage gas supplies. The Board should disallow $548,000 of South Jersey's gas costs.

11. The Board should find that Elizabethtown has failed to develop and implement a hedging program, and imprudently failed to take any meaningful measures steps to hedge its gas supplies for the 2000-01 winter season. The Board should disallow $383,000 of Elizabethtown's gas costs.

12. Each of the utilities should be required to prepare and submit an evaluation of its prospective hedging strategies and proposed hedging programs. The utilities submissions should include clearly defined objectives and hedging targets, as well as details as to how hedging will be managed and controlled and the resources that will be used to implement hedging activities. Once the submissions are made, the Staff, the Ratepayer Advocate and other parties should be provided the opportunity to review the prospective programs, which should then be submitted to the Board for hearings and subsequent approval or modification.

13. The utilities' submissions should further include evaluation of other means of mitigating high gas costs, including additional underground storage, renegotiation of

existing underground storage contracts, above-ground storage, review of the utilities interruptible tariffs and interruption practices to assure that firm ratepayers are not being adversely affected by any limitations on interruptions or pricing methodologies.

14. The UEC should be directed to promptly implement a comprehensive mass media education campaign to inform consumers about high gas costs, and measures available to them to reduce their energy costs, and, if necessary obtain assistance in paying their bills.

15. The utilities should be directed to submit, within 90 days, their assessments of how the rate increases have impacted its low-income customers and how programs, such as budget billing and extended payments, have mitigated the impact of the increases on these customers. The utilities should further be directed to remedy the other deficiencies in their compliance with consumer education and mitigation measures required under the Board's Provisional Rate Orders.

V. COMPREHENSIVE ENERGY POLICY

In these proceedings, the Board must determine how to address the crisis created by the sharp increases in wholesale natural gas prices that have occurred over the past several months. Without diminishing the importance of the Board's resolutions of the many issues presented in these dockets, it is also important to recognize that the current crisis does not exist in a vacuum. Under EDECA, the New Jersey Legislature directed the Board to examine and revise the entire structure of New Jersey's energy marketplace. This task includes not only the pricing and structure of the basic service provided by the State's energy utilities, but also many other elements to assure that energy restructuring creates benefits for New Jersey's energy users. If we are to avoid another crisis, the Board must move forward with all of the elements of EDECA.

Two of these other elements, efficiency energy and renewables programs and universal service, are particularly relevant to mitigating high energy costs for consumers. This year's unprecedented increase in wholesale gas prices highlights the need for prompt action to implement these important components of EDECA.

With regard to energy efficiency and renewables, these programs, which were supposed to go into effect by February 9, 2000, will play an important role in reducing energy costs by reducing overall demand for energy. Hearings on the utilities' and the Ratepayer Advocate's proposals for energy efficiency and renewables programs were held in November, 1999 and briefing was completed in January, 2000. At the Board's direction, additional hearings were held in October and November, 2000 on the rate impacts of two competing settlement proposals. The Board denied the Ratepayer Advocate's motion to re-open the record on December 6, 2000, but to date no final decision has been issued. Prompt action to implement cost-effective energy efficiency program, as well as to implement renewables programs, is needed so that New Jersey consumers can begin receiving the benefits of these programs.

With regard to Universal Service, legislative hearings and public hearings were conducted in August, 2000 and written comments were submitted to the Board in September, 2000. The parties presented additional testimony and submitted supplemental comments in November, but, to date there has been no Board decision on either an interim or permanent Universal Service program. The consequences of inaction, which were explained in detail in the Ratepayer Advocate's testimony in that proceeding, include shutoffs, the use of dangerous heating methods, and "doubling up" for families who cannot afford to heat their homes. The end of this year's winter moratorium period will cause additional hardships, as families who are unable to pay their bills during the winter are faced with the threat of shutoffs in March. Moreover, this same experience is likely to be repeated next winter, when the utilities' natural gas rates are predicted to be as high as or even higher than this year. Prompt action on interim and permanent Universal Service programs is essential to assure affordable energy for New Jersey's low-income citizens this winter and in the future.

One discrete issue relating to universal service requires immediate action by the Board. On January 2, 2001, New Jersey Statewide Heating Assistance and Refer for Energy Services ("NJ SHARES") filed its request to be recognized as the designee of the Energy Assistance Fund created under P.L. 2000, Chapter 132.[4] According to the NJ SHARES letter, $1.6 million will be made available to assist needy New Jersey residents as soon as NJ SHARES receives the Board's designation, and another $800,000 will be made available in March, 2001. These funds will provide

[4] We are pleased to note that New Jersey Natural has decided to join NJ SHARES. This strengthens and unifies a utility initiative on behalf of consumers statewide who are unable to afford their energy bills due to a temporary financial crisis.

much needed assistance to numerous families who would otherwise be unable to afford to heat their homes. NJ SHARES is awaiting only the Board's action to receive $1.6 million immediately, and approximately $800,000 in March 2001. This funding is urgently needed to alleviate the burden of high energy costs for needy consumers who have exhausted all other available resources.

Other EDECA components also are essential to bringing the benefits of a restructured energy marketplace to consumers. For example, the Ratepayer Advocate has long been a proponent of municipal aggregation, as a means to provide smaller energy users a way to increase their buying power in the market. Aggregation will facilitate the ability of smaller customers to choose pricing options that will minimize their risk of gas price escalations.

More generally, the Board and the State should continue their active roles in the continuing development energy policy on a state, regional, and national basis. This should include the continuing review of EDECA, participation in regional organizations such as PJM, and continuing consultation with national representatives on implementing a federal energy policy. To quote a recent *Wall Street Journal* article, "Price spikes in electricity and natural gas will require the Bush administration and state governors to consider tough energy-conservation measures and find new financial aid to help low-income families deal with shocking energy bills."[5]

Respectfully Submitted,

BLOSSOM A. PERETZ, ESQ.
RATEPAYER ADVOCATE

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[5]John J. Fialka, *Abraham Inherits Seat Already Facing Heat*, THE WALL STREET JOURNAL, Jan. 29, 2001, p. A28.