Office of the People's Counsel
District of Columbia
1133 15th Street, NW • Suite 500 • Washington, DC 20005-2710
202.727.3071 • FAX 202.727.1014 • TTY/TDD 202.727.2876

Elizabeth A. Noël
People's Counsel

July 17, 2009

Ms. Dorothy Wideman
Commission Secretary
Public Service Commission of the
District of Columbia
1333 H Street, NW, 2d Floor, West Tower
Washington, D.C. 20005

Re: Gas Tariff 01-1–(Washington Gas' 2008-2008 Hedging Report)

Dear Ms. Wideman:

Enclosed please find for filing an original and fifteen (15) copies of the "Comments of the Office of the People's Counsel Regarding Washington Gas Light Company's 2008-2009 Hedging Report" **(Public Version)** in the above-referenced proceeding.

Please contact the undersigned if you have questions regarding this matter.

Sincerely yours,

Barbara L. Burton
Assistant People's Counsel

Enclosures
cc: All parties of record

BEFORE THE
PUBLIC SERVICE COMMISSION
OF THE DISTRICT OF COLUMBIA

In the Matter of the Application of	)	
Washington Gas Light Company, District	)	
of Columbia Division, For Authority	)	Gas Tariff 01-1
to Amend its General Service Provisions	)	**(PUBLIC)**

COMMENTS OF
THE OFFICE OF THE PEOPLE'S COUNSEL
REGARDING WASHINGTON GAS LIGHT COMPANY'S
2008-2009 HEDGING REPORT

Pursuant to Order Nos. 15293 and 15319 issued by the Public Service Commission of the District of Columbia ("Commission" or "PSC") on June 4 and July 1, 2009, respectively, in the above-captioned proceeding,[1] the Office of the People's Counsel ("OPC" or "Office") hereby submits its Comments regarding the annual report filed by Washington Gas Light Company ("WG") on June 1, 2009, *entitled Gas Hedging Pilot Program 2008-2009 Confidential Report* ("Hedging Report") addressing its District of Columbia pilot natural gas hedging program.

SUMMARY OF OPC'S POSITION

Washington Gas has consistently asserted that "the fundamental goal of the [hedging] Program is to reduce the volatility of natural gas costs for firm sales service customers of Washington Gas." It goes on to state however, "As this Program was implemented to reduce the effect of wholesale natural gas price volatility, the hedging acquisition strategy may not always result in the lowest cost of gas."[2] WG asserted that its hedging activities for 2008-2009 met the objectives for the hedging program by reducing the price volatility of natural gas purchases made

[1] GT01-1, *In the Matter of the Application of Washington Gas Light Company, District of Columbia Division, for Authority to Amend its General Service Provisions*, Order No. 15293 (June 4, 2009) and Order No. 15319 (July 1, 2009).
[2] Hedging Report, p. 1.

for the District's firm sales service customers.[3] Unfortunately, WG's Hedging Program did not deliver on its promise to consumers. OPC's analysis concludes that the prices WG hedged in 2008-2009 showed higher volatility than the price of unhedged gas prices. As a result, ratepayers did not get full protection from price volatility despite paying higher natural gas prices.

The Commission has agreed with OPC that WG's sole focus on minimizing price spikes, which directly impacts the Company's cash flow, limits WG's customers' ability to benefit from decreases in gas prices. Specifically, the Commission, in discussing OPC's comments on WG's 2007-2008 Hedging Program "agree[d] with OPC that WGL should consider hedging alternatives and not focus solely on minimizing price variability, because minimizing price variability limits WGL's ability to take advantage of any downward price movements. We believe that customers should be able to benefit from any decrease in gas prices as well as be protected from price spikes. Consequently, volatility associated with declining gas costs is not detrimental to ratepayers."[4]

OPC reviewed the Hedging Report for 2008-2009 to determine whether or not WG's pilot natural gas hedging program (i) was developed and implemented as a component of a balanced portfolio approach as OPC has consistently advocated since 2001[5], (ii) protected D.C. ratepayers from natural gas price volatility and exposure to extreme price hikes, and (iii) utilized all available information in determining when and at what price to hedge.

Based on its review, OPC has concluded that WG's hedging program is <u>not</u> based on a balanced portfolio approach. Moreover, as currently implemented, the hedging program does

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[3] Id., p. 7.
[4] Order No. 15212, ¶11 (March 5, 2009).
[5] GT01-1, *In the Matter of the Application of Washington Gas Light Company, District of Columbia Division, for Authority to Amend its General Service Provisions*, Reply Comments of the Office of the People's Counsel, (August 17, 2001).

not shelter ratepayers from price volatility and exposure to extreme price increases during 2008-2009. Additionally, it appears that WG did not utilize all available information in implementing its hedging program. Accordingly, OPC cannot support continuation of the pilot program beyond the 2009-2010 winter heating season as being in the public interest. If, however, the Commission decides to approve continuation of the pilot program beyond the 2009-2010 winter heating season, OPC strongly requests that WG change the manner in which it implements its hedging program as discussed below.

I. Summary of WG's 2008-2009 Hedging Report

WG's Hedging Report describes its pilot hedging activity for the 2008-2009 winter heating season. This period covers November 1, 2008 through March 31, 2009. The Company executed the bidding process to secure hedged commodity prices for 31%, 22%, 25% and 22% of the volumes being purchased in May, June, July and August, respectively.[6] WG asserts that this schedule produced a blend of market prices for the winter period and significantly reduced the risk of securing total volumes during a period of extreme market volatility.[7]

In addition, WG states that it secured about 54% of the total volume of hedged commodity from production areas other than the Gulf of Mexico in order to minimize disruption of gas supply from force majeure events in natural gas production and processing areas.[8] Finally, according to WG, senior representatives from the Risk Management and Energy Acquisition departments approved the final hedging price bid.[9]

[6] Id., pp. 1-2.
[7] Id., p. 1.
[8] Id., p. 2.
[9] Id.

WG further asserts that to avoid speculative trading, it limits the volumes to be hedged so that it meets the lowest firm demand anticipated by ratepayers during the winter period.[10] Accordingly, WG hedged ***CONFIDENTIAL INFORMATION OMITTED***of daily base load requirements for November 2008 to March 2009, respectively.[11] The total hedged volume was ***CONFIDENTIAL INFORMATION OMITTED*** dekatherms. This represents approximately ***CONFIDENTIAL INFORMATION OMITTED*** of the maximum hedged commodity volume. This hedged volume and storage will price protect about ***CONFIDENTIAL INFORMATION OMITTED*** of forecasted normal weather winter firm sales.

WG indicates that its 2008-2009 hedging activities incurred approximately $6,000,000 in additional costs for the District. The impact of the $6,000,000 on District customers' bills is an annual natural gas bill increase of about $33 for an average residential customer.[12]

Finally, WG asserts that it has met the objectives for the hedging program by reducing the price volatility of the natural gas purchases made for District of Columbia firm sales service customers for the 2008 - 2009 winter heating season. The Company also stated that the hedging program has stabilized natural gas costs by minimizing sudden price increases.[13]

II. Discussion

A. WG's hedging program was not based on a Balanced Portfolio Approach.

OPC has consistently urged the Commission to implement a balanced supply portfolio. A Balanced Portfolio Plan is the result of a portfolio optimization model that allows a regulated utility to determine the most efficient and cost effective way of acquiring natural gas. The

[10] Id., p. 3.
[11] Id., p. 4, Table 2.
[12] Id., p. 6.
[13] Id., p. 7.

optimization model treats hedging as a component of the various strategies implemented to acquire natural gas, rather than an isolated supply acquisition option.[14] OPC submits that an appropriate hedging program incorporated into a balanced portfolio approach will allow WG to determine the optimal (i) percentage and/or volume of natural gas to hedge, (ii) timing of hedging and delivery points, and (iii) cost of implementing the hedging program. WG's hedging program fails to meet these standards.

WG reports that the percentages of hedged volume were 31%, 22%, 25% and 22% in May, June, July and August, respectively. Furthermore, WG hedged ***CONFIDENTIAL INFORMATION OMITTED*** dekatherms in the 2008-2009 winter season.[15] WG limited the maximum volume to hedge (including storage) to ***CONFIDENTIAL INFORMATION OMITTED***of forecasted normal weather firm sales.[16]

1. <u>Determination of hedging percentages and volumes</u>

The Hedging Report does not include a natural gas acquisition plan document (e.g., balanced portfolio plan) that explicitly shows how these percentages and volume were determined, and whether or not these percentages or volume offered the maximum protection from price volatility for District ratepayers. OPC submits that a hedging volume that is not based on the balanced portfolio approach will not offer the maximum protection from price volatility and exposure to extreme price increases to ratepayers.

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[14] *See*, NARUC, Energy Portfolio Management: Tools & Resources for State Public Utility Commissions, 2006; NARUC, NARUC/IOGCC Joint Task Force, Policy Recommendations on Long-Term Contracting for Natural Gas Transportation, Storage Services and Liquefied Natural Gas Delivery, October 2005; Awerbuch, S., Jansen, J.C., Beurskens, L., and Drennen, T., 2005. The Cost of Geothermal Energy in the Western US Region: A Portfolio-based Approach-A Mean-Variance Portfolio Optimization of the Region's Generating Mix to 2013, by Sandia National Laboratories; Padberg, U., and Haubrich, H.-J. 2008. Stochastic Optimization of Natural Gas Portfolios. RWTH Aachen University, Institute for Power Systems and Power Economics, Germany.
[15] Hedging Report, p.4.
[16] Id., p.5.

2. Timing of hedging activities

WG states that execution of hedging activities during the months of May, June, July and August will allow lowering or reducing price volatility. Historical trends of natural gas prices may indicate that gas prices tend to decline following the winter season. However, the Hedging Report does not show the result of a portfolio optimization model that supports WG's conclusion that hedging activities limited over a period of only four months will protect ratepayers from exposure to price volatility and price spikes.

Regarding diversifying natural gas receipt points, OPC agrees with WG that diversifying natural gas receipt points is an approach that will offer a different form of protection, especially for extreme weather events. However, without knowing the probability with which extreme weather events occur, OPC submits it seems unreasonable to implement a receipt point diversification program based only on the occurrence of recent weather events (e.g., Hurricane Katrina). OPC avers that WG has not utilized a portfolio optimization model to show that diversification of natural gas receipt points is beneficial to ratepayers.

3. Hedged natural gas costs

Finally, a hedging program that is based on a balanced portfolio approach should minimize the overall cost of hedging. The cost of hedged natural gas purchased by WG for 2008-2009, when priced at the first-of-the-month price ("FOM"), is approximately $6,000,000. This represents an increase in the average District residential customer's bill of about $33 per year or $3/month.[17] OPC does not consider the magnitude of the increase *de minimis*, particularly given the economic recession in which the District unemployment rate is over 10%. OPC notes that once again WG's hedging activities have not resulted in decreased natural gas

[17] Id., p. 6.

costs for District consumers. OPC believes that WG could have reduced the cost of natural gas in 2008-2008 if its hedging program were an integral part of a balanced portfolio approach.

B. WG's hedging program did not protect ratepayers from volatility of natural gas prices.

WG asserts that the goal of its hedging program is to protect ratepayers from price volatility.[18] WG assessed the hedging program results in part by comparing the standard deviations of the FOM index prices with hedged commodity prices by receipt location. WG states that standard deviation, a measure of volatility of natural gas prices, shows about the same value for FOM index prices at two receipt points.[19] However, WG did not compare the volatility of FOM prices with the volatility of hedged prices. OPC performed a simple calculation of WG's hedged price presented in the report (*see,* OPC Appendix A, Tables 1, 2, and 3). The results in Tables 1 and 2 indicate that the standard deviation of hedged price at different rounds of bids and average hedged prices range from *****CONFIDENTIAL INFORMATION OMITTED***.** The results in Table 3 indicate that the winter (November 2008-March 2009) purchased gas cost ("PGC") that ratepayers pay every month has a standard deviation of*****CONFIDENTIAL INFORMATION OMITTED***.** However, the average standard deviation of FOM prices from WG's two receipt points was about *****CONFIDENTIAL INFORMATION OMITTED***** (*see* also OPC Appendix A, Table 2).[20] These findings indicate that hedged prices show higher volatility than un-hedged market (FOM) prices. The fact that FOM prices are less volatile than WG's hedge prices means that ratepayers are not getting full protection from price volatility despite paying higher natural gas prices ever since WG started its pilot hedging program. For these reasons, OPC disputes WGs assertion that the

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[18] Id., p. 1.
[19] Id.
[20] Id., ***(***CONFIDENTIAL INFORMATION OMITTED***).***

hedging program has met its objective of protecting ratepayers from price volatility during 2008-2009.

C. WG's hedging program is not based on an in-depth review of all available information.

WG's hedging strategy should be executed based on an in-depth analysis of all available market (supply and demand for natural gas, storage, supply of Liquefied Nitrogen Gas (LNG), analysis of price manipulation by hedge funds and brokers) and non-market information (e.g., trends in weather). OPC asserts that even after developing a hedging strategy based on portfolio optimization model results, several factors can affect the implementation of a balanced portfolio approach. These factors may include, but not are not limited, to (i) changes in forecast of weather patterns, (ii) changes in storage or production that were not captured during the optimization model run, (iii) changes in imports of LNG or other international factors that may affect the supply and demand for natural gas, (iv) changes in patterns of economic growth both regionally and nationally, and (v) activities of hedge funds, banks, brokers, etc. These factors, independently or collectively, may have altered movement of prices despite no significant change in the fundamentals of supply and demand for natural gas. However, nowhere in the Hedging Report is there any indication that WG considered these factors.

The Hedging Report does not contain nor show the information that was available or considered by WG at the time it implemented its hedging activities for the 2008-2009 season. For example, it was common knowledge that the United States' economy and the world economy were experiencing a severe economic slowdown since the first quarter of 2008. The economic slowdown meant that the demand for natural gas by the industrial sector could be expected to decline resulting in excess supply. By August 2008, information was available which indicated that forward Henry hub prices for the upcoming winter were in the range of $7-

$8 per dekatherm. Although prices at WG's delivery points may be different from Henry hub, it is not reasonable to expect that prices would reach as high as ***CONFIDENTIAL INFORMATION OMITTED*** per dekatherm, which is the price WG paid. [21] For these reasons, OPC submits that if WG had studied and considered all available information, it could have executed hedging transactions at a lower price than the Company actually paid and protected ratepayers from extreme price increases as a result.

D. Recommendations for WG's Hedging Program

In the Hedging Report, WG claims that "the fundamental goal of the program is to reduce the volatility of natural gas costs for firm sales service customers of Washington Gas." Further, WG contends that "the hedging acquisition strategy may not always result in the lowest cost of gas."[22] Additionally, WG concludes that it "has met the objectives for the hedging program by reducing the price volatility of the natural gas purchases made for District of Columbia firm sales service Customers for the 2008 - 2009 winter heating Season."[23] OPC disagrees.

WG has failed to show that its program protected ratepayers from price volatility and limited ratepayers' exposure to extreme price increases. A primary objective of a hedging program is to reduce price variability. However, this must be within the defined parameters of just and reasonable prices. An inflated but stable gas price is not in the public interest. The hedged price must be reasonable and the program itself must be a component of a balanced portfolio. In this instance, WG's price is inflated, is more volatile than the FOM price, and is not a component of a balanced portfolio approach. Hence, its claim is unsubstantiated even by its own standards.

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[21] Id., Appendix A, p. 1.
[22] Id., p.1
[23] Id., p. 6.

The PGC allows WG to be made whole with respect to its revenue from the sale of natural gas, while ratepayers have no such mechanism and are being subjected to higher volatility and increases in hedged gas costs. OPC recommends that the Commission require WG to develop a hedging program as a component of a balanced portfolio approach, rather than being implemented as a standalone program (e.g., as a simple insurance tool). Further, WG's hedging report should compare the volatility of FOM and hedged prices, and explain the difference in volatility between hedged and un-hedged (FOM) prices. Finally, WG should be required to show all market and non-market information that was used at the time WG executed each hedging transaction. If WG does not change the manner in which it designs and implements the hedging program, ratepayers will continue to be exposed to volatility of natural gas prices and higher gas costs.

III. CONCLUSION

Wherefore, for the foregoing reasons, the Office urges the Commission to consider requiring modifications consistent with the comments presented above.

Respectfully submitted,

Elizabeth A. Noel
People's Counsel
D.C. Bar No. 288965

Sandra Mattavous-Frye
Deputy People's Counsel
D.C. Bar No. 375833

Barbara L. Burton
Assistant People's Counsel
D.C. Bar No. 430524

OFFICE OF THE PEOPLE'S COUNSEL
OF THE DISTRICT OF COLUMBIA

Suite 500
1133 Fifteenth Street, N.W.
Washington, D.C. 20005-2710
(202) 727-3071

Dated: July 17, 2009

Appendix A. Results of Standard Deviation of Hedged and FOM prices

[This portion contains information which Washington Gas alleges to be proprietary. Please Contact Washington Gas for an appropriate proprietary agreement or file with the Commission for a Proprietary Information Determination. Parties may seek a Commission ruling on contention at any time in this proceeding.]

Table 1. Summary of Hedged Prices by Round of Bids

Table 2. Summary of Average Hedged and FOM Prices

Table 3. Summary of Purchased Gas Costs (PGC)

CERTIFICATE OF SERVICE

Gas Tariff 01-1

I hereby certify that on this 17th day of July, 2009, a copy of the foregoing "Comments of the Office of the People's Counsel Regarding Washington Gas Light Company's 2008-2009 Hedging Report" **(Public Version)** were served on the following parties of record by hand delivery, electronic mail, or first class mail, postage prepaid:

Richard Beverly, Esq.
General Counsel
Public Service Commission of the
District of Columbia
1333 H Street, NW
7th Floor, East Tower
Washington, D.C. 20005

Kimberly Lincoln-Stewart, Esq.
Senior Attorney Advisor
Public Service Commission
of the District of Columbia
1333 H Street, NW, 7th Floor, East Tower
Washington, D.C. 20005

Dr. Phylicia Fauntleroy-Bowman
Public Service Commission
of the District of Columbia
1333 H Street, NW, 7th Floor, East Tower
Washington, D.C. 20005

Hon. Betty Ann Kane
Chairperson
Public Service Commission
Of the District of Columbia
1333 H Street, NW, 7th Floor, East Tower
Washington, DC 20005

Mary Dubyosky
United Energy
201 Najoles Road
Millersville, MD 21108

Cathy Thurston-Seignious, Esq.
Washington Gas Light Company
101 Constitution Avenue, NW
Washington, D.C. 20080

Richard E. Morgan
Commissioner
Public Service Commission of the
District of Columbia
1333 H Street, NW
7th Floor, East Tower
Washington, D.C. 20005

Lori M. Lee
Commissioner
Public Service Commission of
the District of Columbia
1333 H Street, NW, 7th Floor, East Tower
Washington, D.C. 20005

Frann G. Francis, Esq.
Apartment & Office Building Association
1050 17th Street, NW, Suite 300
Washington, D.C. 20036

Hon. Muriel Bowser, Chairperson
Committee on Public Services and
  Consumer Affairs
Council of the District of Columbia
1350 Pennsylvania Ave., NW, Suite 406
Washington, DC 20004

Barbara L. Burton
Assistant People's Counsel