STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 97-G-0600 - In the Matter of the Commission's Request for Gas Distribution Companies to Reduce Gas Cost Volatility and Provide for Alternate Gas Purchasing Mechanisms

STATEMENT OF POLICY REGARDING GAS PURCHASING PRACTICES

Issued and Effective: April 28, 1998

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

COMMISSIONERS PRESENT:

John F. O'Mara, Chairman[1/]
Maureen O. Helmer
Thomas J. Dunleavy
James D. Bennett

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In June 1997, we addressed the issue of volatility in gas commodity prices and determined that:

> The current utility practice of purchasing all supplies based upon a single reference price with a history of volatile movement (or of indices which have a high correlation with it), merits reconsideration. In order to provide diversity in acquisitions and defuse price spikes and valleys for gas supplies, LDCs shall review their gas procurement practices and develop an acquisition strategy to include a mix of purchase options composed of, but not limited to indices, cash market and financial transactions with a view toward fostering price stability. The companies should provide guidelines and limits in support of these strategies, as well as an assessment of risk for each action proposed.[2/]

[1/] John F. O'Mara served as Chairman of the Commission until April 14, 1998.

[2/] Case 97-G-0600, Gas Cost Volatility and Alternative Gas Purchasing Mechanisms, Order Requiring the Filing of Proposals to Ameliorate Gas Price Volatility and Requiring Comments (issued June 5, 1997), p.3.

We directed ten of the eleven[1] largest gas distribution companies (LDCs) to file proposals for increased supply diversity.

Utility Responses

Each of the affected utilities filed a response to that order. While several did indicate that they had recently addressed the issue or were in the process of addressing the issue the general tone to the responses was that the strategy currently in place provided the necessary diversity.

It appears that most LDCs buy natural gas primarily through contracts that reset the price monthly based on a specified price index. For the domestic supply, the indices used tie gas prices either directly to the New York Mercantile Exchange (NYMEX) natural gas futures price for the next month("Bid Week" price), or to published production area price indices for the next month. The production area price indices are highly correlated with the NYMEX prices. For the Canadian supply a weighted market basket of oil and gas prices is used, but some of those indices are being reset to NYMEX-based monthly or spot pricing.

A number of utilities highlighted the fact that they make significant use of storage and acquire supplies from a number of sources located in both the United States and Canada. However, a review of the pricing mechanisms associated with these purchases indicate that, as with flowing gas supplies, most are tied to indices which are either based on the NYMEX Bid Week price or indices that have high correlation to that price. Therefore, while sources of supply are diversified, pricing is not.

LDCs also purchase a small amount of gas in the cash (spot) market. Cash market prices can vary significantly from NYMEX prices month-to-month but are also highly volatile.

[1] New York State Electric & Gas Corporation is currently operating under a hard price cap, and was therefore exempted from the order.

Some utilities believe that a gas supply portfolio using a number of relatively independent pricing mechanisms may leave them at a price disadvantage against competitors should gas prices subsequently drop. They imply that they want to buy gas at the near-term market price because their competitors are. In fact, however, it appears that marketers use a more diversified strategy.

While some of the LDC's have taken steps to diversify their supply portfolios, including financial hedging,[1/] LDCs are doing only a small amount of hedging, primarily for their fixed price option programs. Individual LDCs tend to rely on one type of index and one price trigger. For example, some LDCs rely almost exclusively on a NYMEX bid-week related price for their gas purchases. Other LDCs rely almost exclusively on first-of-the-month production area price indices for delivery at specific pipeline locations. Some of the LDCs have responded to the volatility of the price of gas and our prior order by taking action to bring reasonable diversity to their portfolio; others proposed no or only minimal changes.

Discussion

The current, almost exclusive reliance on spot or monthly pricing does not attempt to recognize or manage price volatility. Under the current approach the price of gas can vary dramatically each month, depending on the level of NYMEX prices for near-month deliveries. Last winter, the price of the November '96 contract was $2.57/MMBtu[2/] while two months later the January '97 contract had risen to $4.25/MMBtu. This winter the price of gas went the other way, with the November '97 contract at $3.51/MMBtu and the January '98 contract being priced at $2.27/MMBtu.

[1/] Hedging is the use of financial instruments, such as NYMEX natural gas or over the counter futures and options contracts, to wither purchase gas at a fixed price, or to retain the option to do so.

[2/] An MMBtu of gas is roughly equivalent to an Mcf of gas.

Two themes appear to dominate gas purchasing practices in the LDCs responses to our June 1997 order. The first is the concern that the pricing portfolio be prudent at all times, coupled with the belief that paying the current market price ensures such prudence. The second theme is that using a number of relatively independent pricing mechanisms may leave an LDC at a price disadvantage against competition should prices drop.

With respect to the former approach, we note that being tied to the near term market price at all times does not necessarily demonstrate prudence, as it ignores price volatility as a factor to be considered in the purchasing strategy. As to positions relative to competitors, it appears that marketers, unlike most LDCs, are making substantial use of strategies to mitigate price volatility.

Conclusion

Local distribution companies have many ways to meet their loads; they should consider all the available options for purchasing gas and assess the benefits of each approach. Options may include short and longer term[1/] fixed price purchases, spot acquisitions, the use of financial hedges, and contracts which provide for flexibility in the amount of gas taken over the term of the agreement.

We expect companies to manage their gas portfolios to meet the needs of their systems[2/]. We note that since we issued our previous order, several of the LDCs have diversified pricing, while others have remained largely with predominantly non-diversified pricing strategies. While we are not directing any particular mix of portfolio options, volatility of customer bills is one of the criteria, along with other factors such as cost and reliability, that LDCs should consider in their gas supply

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[1/] Longer term, for these purposes, is defined as several months to a year.

[2/] Parties should be aware that we may reexamine this issue if we consider whether and, if so, how local distribution companies should continue to be gas merchants.

purchasing strategies. Excessive reliance on any one gas pricing mechanism or strategy does not appear to reflect the best management of the gas portfolio. Any utility without a diversified gas pricing strategy will have to meet a heavy burden to demonstrate that its approach is reasonable.

By the Commission,

(SIGNED) JOHN C. CRARY
Secretary