national fuel

March 6, 2006

Hon. Jaclyn A. Brilling
Secretary
Public Service Commission
Three Empire State Plaza
Albany, NY 12223-1350

Re: Case 04-G-1047, National Fuel Gas Distribution Corporation
Proposed Tariff Amendment

Dear Secretary Brilling:

National Fuel Gas Distribution Corporation ("Distribution" or the "Company") submits the following revisions to its tariff, P.S.C. No. 8 – GAS:

Leaf No.76	Revision 3
Leaf No.86	Revision 6
Leaf No.87	Revision 3

The proposed revisions are issued as of today for an effective date of May 19, 2006. In support of this request, Distribution states as follows:

A. Description of Proposed Revisions

In this filing, Distribution is proposing a pilot Marketer Hedge Program ("MHP") designed to accommodate the sale of fixed price products by marketers. The proposed revisions authorize a procedure for Distribution's purchase or settlement of unsubscribed hedges offered by marketers to retail customers. In connection with Distribution's gas cost volatility mitigation plan ("Plan"),[1] the Company will conduct a Fixed Price Option ("FPO") open season ("Determination Period") prior to April 1 (preferably no later than March 15 of each year). Conceptually, the Program would be integrated with Distribution's Plan by, in effect, "carving out" a small component of the Plan to enable marketers the opportunity displace a portion of hedged supplies that would otherwise be acquired by Distribution. Assuming the Program is fully utilized, Distribution's sales customers would be generally no worse off under the Plan than they would be without the MHP. If participating marketers are unable to achieve full enrollment of their hedged offerings, Distribution will financially "settle," or purchase the marketers' unsubscribed hedges. The purchase cost would be charged to Distribution's monthly gas sales customers.

[1] See Case 97-G-0600, Order Requiring the Filing of Proposals to Ameliorate Gas Price Volatility and Requesting Comments (issued June 5, 1997) ("Volatility Order").

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If approved, the MHP would continue through the term of Company's current rate plan approved by the Commission in an order ("Rate Order") issued on July 22, 2005. [2]

B. Background and Explanation

The Rate Order provided that Distribution would develop a pilot program "pursuant to which the Company will purchase or financially settle any part of a marketer's hedged supply offering that is unsubscribed." Rate Order at 17-18. The MHP was conceived by the parties as a means to encourage marketers to offer fixed price contracts to retail customers. Marketers report that they cannot offer fixed price contracts because although hedge products can mitigate price risk, they do not protect against the risk of unsubscribed *volumes*. For example, if a marketer hedges supply to offer a fixed price contract at some future date for 1,000 customers, and less than 1,000 customers enroll, the marketer's price risk relating to volumes sold is mitigated, but not the risk of loss arising from the "unsubscribed" hedge, or hedged supply for the difference between the enrollment target and enrollment actually achieved.

The Company's proposed MHP is designed to reduce marketer risk by authorizing Distribution to settle up to 25% of a marketer's unsubscribed hedged supply. As stated in the Joint Proposal, "[u]nder the pilot, marketers will hedge supplies for their offers to customers and the Company will purchase or financially settle a part of the marketer's unsubscribed enrollment volume." Joint Proposal at 51. To achieve this result while protecting Distribution's monthly gas sales customers, the Program will, in effect, utilize an allocation of Distribution's gas cost volatility mitigation purchases. More particularly, the Program will operate as follows (further explanation below):

Program Scope:

1) MHP pilot will be limited to the winter season (November through March);
2) Program Total Daily volume limited to 10,000 Dkth/day
    a. Enough to meet requirements for 17,800 residential customers.
    b. Minimum marketer allocation will be 1,000 Dth/day.
    c. Marketers will hedge supplies for retail fixed price offers.
        i. May be offered to marketer's new or existing customers.

Forward Priced Gas Reduction:

3) Distribution will adjust its volume of forward-priced gas based on customer participation levels (and ordinary customer migration).
    a. Distribution will establish an Average Price Cap ("APC") equal to the average of the NYMEX daily settle for the winter strip during a Determination Period.
    b. The Determination Period will be a ten-day period of trading days in May or June, as announced by the Company.
    c. During the Determination Period, Distribution will reduce its forward-priced gas purchases by 2,500 Dth/day (i.e., 25% of Program total daily volume limit).
        i. Reductions will be based on Program participation level.
        ii. The reduction in purchasing will be achieved by withholding triggering of forward-purchase contracts by Distribution during the Determination Period (see explanation below).

[2] Case 04-G-1047, Order Establishing Rates and Terms of Two-Year Rate Plan (issued July 22, 2005) (approving the "Joint Proposal," which contains the terms and conditions of the rate plan).

        iii. It is anticipated (and intended) that participating marketers will purchase hedged supplies during the Determination Period.

4) Distribution and marketers will review results of MHP customer offers in late September.
    a. Marketers will be required to demonstrate Program results including the offering of hedged products to retail customers.

Settlement Process:

5) Forward Winter Settlement Price ("FWSP") will be established.
    a. FWSP is end of September winter strip settle price (November – March).
    b. Specific date shall be the October NYMEX settle date.
6) If the APC (marketer hedges) are below the FWSP:
    a. Marketer will maintain position to support retail sales or cash out the contract for its benefit.
        i. Customers receive benefit of marketer hedge through the lower-than-market fixed price.
    b. There is no settlement with Distribution.
7) If the APC (marketer hedges) are above the FWSP:
    a. Unsubscribed hedges may be financially settled by Distribution in October.
    b. Settlement price ("SP") = APC minus FWSP.
    c. Distribution confirms marketer's unsubscribed volume.
        i. Volume eligible ("VE") for settlement allowance is the lesser of the unsubscribed volume or 25% of marketer's total allocated volume.
        ii. Amount paid to marketer is SP x VE.
        iii. One-time October payment with no further adjustments.
    d. The settlement amount is reflected as a cost of gas in the monthly gas supply charge to sales customers from November through March and is recovered by Distribution as a gas cost in its annual gas cost reconciliation.

<u>Re-balancing of Plan</u>

8) Forward-priced gas allocation under Plan is restored:
    a. Distribution acquires additional forward-priced gas to meet Plan target allocation (currently 33% of total winter supplies).
    b. Existing forward-priced contracts triggered in October.
    c. This process brings Distribution's winter supply portfolio into compliance with the Plan, correcting for migration and 'making up' for hedged gas purchases foregone to accommodate the MHP.

C. <u>Effect of MHP on Participant and Distribution Sales Customers</u>

The MHP is designed to enable marketers to provide up to 17,800 more fixed price contracts than are currently made available by the market. For customers who enroll in a marketer's fixed price program made possibly by the MHP, the chief benefit is price stability; i.e., the customer's commodity price will be either fixed or capped, protecting the customer from the price swings that are common to natural gas commodity markets.

In approving the concept of the MHP, the Commission stated "we caution the Company against making any commitment that would make it responsible to cover the costs of excessive or over-priced hedges."[3] Toward that end, MHP has been designed to leave Distribution's sales customers generally no worse off than they would be under ordinary circumstances of customer migration. To achieve that result, however, the MHP was designed with certain reasonable assumptions in mind. The first assumption is that if a marketer fixed product is "in the market," it is successful and will result in customer migration. The second assumption is that if the marketer fixed price product is "out of the market," the marketer will not offer the product (or will offer it unsuccessfully), will seek settlement from Distribution, and migration from the Program, if any, will be less than 25% of the level provided for by the MHP allocation (i.e., less than 17,800 customers). To illustrate the effect of the MHP on customers, the attachment hereto sets forth two hypothetical scenarios. Each is explained below.

1. <u>Marketer Fixed Price Product is In the Market</u>

Distribution undertakes winter supply purchasing in advance of the winter period in order to "lock in" winter prices for a portion of the Company's supply portfolio. The Company utilizes standing forward-priced gas contracts with purchase clauses, reflected in the above outline, which can be "triggered" at a current price for delivery of gas in a future period. The current Plan targets 33% of winter supplies be composed of forward-priced gas. To meet this target, the Company's forward-priced contracts are triggered in the Spring. As shown on the above outline, during the Determination Period, Distribution foregoes triggering its forward-purchase contracts to allow marketers to acquire their own hedges. It is during the Determination Period that the APC is established.

In Hypothetical 1, the FWSP would exceed the APC, presumably resulting in customer migration because the marketer's fixed price offering would be less than the FWSP. If indeed there is customer migration, there is no effect on Distribution's sales customers.

If, for whatever the reason, customer migration were less than 25% of the MHP allocation, then Distribution would be required to trigger its forward-purchase contracts at the higher FWSP. In doing this, the Company would be purchasing higher-priced supplies than it would have in the absence of the MHP. However, although the price fixed for the MHP volumes in this instance would be higher than the price the Company would have paid had it not foregone its triggering right during the Determination Period, the Company's Plan (in this example) for 33% hedged supplies would remain intact.

2. <u>Marketer Fixed Price Product is Out of the Market</u>

If the FWSP falls below the APC, the marketer's fixed price contracts would be out of the market. In this instance, migration may not occur as it otherwise might, and the marketer would seek payment from Distribution. As illustrated in Hypothetical 2, Distribution's payment to the marketer plus the cost of FWSP-triggered contracts would equal the price Distribution would have incurred had the Company triggered purchases during the Determination Period in the absence of the MHP. That is, Distribution's customers would be no worse off than they would have been had Distribution purchased its forward supplies during the Determination Period.

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[3] Rate Order at 34, n. 24.

Even in circumstances where customer migration is less than the MHP allocation level when the marketer's fixed price offering is in the market – a result that is possible but cannot be predicted - the MHP will not cause Distribution to deviate from its Plan's target for forward-priced gas. It should be noted that in those circumstances, Distribution would be paying more for winter gas than the Company would have in the absence of the MHP. Nonetheless, the MHP, as mentioned above, is integrated into and made a part of Distribution's plan, which implements and is consistent with the Commission's Volatility Order. Furthermore, Distribution's proposal to limit its contribution to 25% of the total daily volume allocated to the MHP acts as a hard cap on the absolute level of price risk allocated to its sales customers. The 25% cap also assures marketers an incentive to develop a responsible hedge product. Therefore, the Company believes that the MHP meets the Commission's requirement regarding no "net cost impact" on sales customers as set forth in the Rate Order inasmuch as the Company's Plan is not materially affected by the designed operation of the MHP. The Company respectfully requests that the Commission confirm that the MHP meets the prescriptions of the Rate Order and is in the public interest. If the Commission believes that the MHP does not meet the requirements of the Rate Order, then the Company requests that the Commission either (a) waive that part of the Rate Order that would subject the Company to any risk of disallowance of gas cost expense arising solely from the MHP or make a statement to the same effect;[4] or (b) permit the Company to withdraw this filing from further consideration.

D. Newspaper Publication

Notice will be published in newspapers of general circulation in Distribution's service territory as required by the Public Service Law §66(12) on the following dates: March 24 and 31, 2006 and April 7 and 14, 2006, or on such other dates as may be appropriate.

E. Conclusion

For all of the foregoing reasons, Distribution respectfully requests that the MHP and above-listed tariff amendments be approved as described above.

Respectfully submitted,

/s/ Michael W. Reville

cc: Service List, Case 04-G-1047 (*via e-mail*)

Attachment

[4] This request is limited to gas costs incurred under the MHP, and is not intended to limit or in any way restrict or diminish the Commission's authority and remedies with respect to Distribution's gas purchasing practices and activities generally.

Marketer Hedge Program (MHP) Scenarios

Average Price Cap

(APC) = $8.00

Hypothetical #1

Forward Winter Settlement Price (FWSP) = $9.00

APC "in market" $1.00

ESCo's retain hedged supplies

Migration should have occurred

NFG reviews migration and adjusts forward priced gas by increasing or decreasing triggers pulled in October

NFG forward priced gas valued at market (approx .FWSP)

FWSP = $9.00

Hypothetical #2

Forward Winter Settlement Price (FWSP) = $7.00

APC "out of market" $1.00

ESCo's receive $1.00 from NFG

Migration may not have occurred

NFG reviews migration and adjusts forward priced gas by increasing or decreasing triggers pulled in October

NFG forward priced gas valued at market (approx. FWSP) plus the $1.00 paid to ESCo's

$7.00 + $1.00 = $8.00 (APC)