

SECTION 5. LONG-TERM HEDGING ASSESSMENT

The procurement plans that have been guiding purchasing and hedging activities for the past five years have focused on each upcoming winter heating season as well as one, two, and three years out. The plans have provided guidance, structure, and discipline to the natural gas supply procurement function. With this procurement timeframe stabilized and functioning properly, it is time to assess long-term hedging strategies, meaning locking in a portion of each year's supply for a long period of time at known fixed prices. The goal of short-term hedging is to dampen volatility, but it does not provide protection against overall market price trends and movements. Long-term hedging, meaning transactions covering anywhere from 5 to 30 years, provides protection against overall upward price movements or trends by locking in future prices based on market conditions known at the time the transactions are entered into. Such long-term hedging is in addition to price stability already provided by short-term hedging. NWE has determined that ownership of natural gas reserves and production at appropriate prices is the preferred form of long-term hedging and NWE will continue to pursue reasonable opportunities.

Ownership of Natural Gas Reserves and Production

Over the past two years NWE established a process to identify, analyze, and pursue opportunities to purchase natural gas reserves and production. NWE personnel involved in engineering, natural gas transmission, storage, supply, regulatory affairs, marketing, finance, as well as others were called upon to comprehensively identify and evaluate natural gas equity opportunities. A number of properties were analyzed, and on at least four occasions formal offers were extended to owners and later rejected. In the summer of 2010, NWE successfully acquired a majority interest in the Battle Creek Field located in north central Montana. The Battle Creek acquisition is small in relation to NWE's overall natural gas needs; however it provided an excellent opportunity for NWE to gain experience in asset valuation, legal, land and title matters, and other

contractual and administrative items involved with acquiring natural gas production and reserves. Importantly, as NWE takes responsibility for the operation of the Battle Creek field, additional knowledge involving operations, maintenance, and development of producing properties will be gained. NWE will continue to pursue opportunities to acquire natural gas reserves and production that make sense operationally and economically, as these investments provide long-term price certainty to customers.

A key consideration for NorthWestern in acquiring natural gas reserves and production assets is timely cost recovery. Because the Battle Creek purchase was market-based, the buy/sell process would not accommodate a lengthy regulatory review process, and NWE could not utilize the Commission's pre-approval process for acquiring natural gas production or gathering resources.

Prior to acquiring an interest in Battle Creek, NWE was purchasing the output from that field under a contract that expired on October 31, 2010, and those supply costs were being recovered in the natural gas tracker. In order to "bridge" the time between the acquisitions and when the Commission has an opportunity to formally consider its costs for inclusion in rates, and after discussions with Commission staff and the Montana Consumer Counsel, NWE included the costs of its share of Battle Creek in the natural gas supply tracker for rates effective November 1, 2010. The November 1, 2010 rates were approved (on an interim basis as with all monthly trackers) as filed. NWE anticipates it will continue recovering Battle Creek costs on this basis until this asset is proposed for rate treatment in a future filing.

NWE intends to continue to analyze opportunities to purchase natural gas reserves and production assets. Similar to Battle Creek, it is highly likely that such opportunities will be priced based on then current natural gas market, resulting in short timelines to submit bids and complete closing, which results in the inability to utilize the pre-approval process provided for under statute. Therefore, in order to better match the time when NWE makes investments and

customers commence receiving benefits, with cost recovery, NWE proposes to include the costs of any future acquisitions in the natural gas tracker on an interim basis similar to the approach described above for Battle Creek.

SECTION 6. DEMAND SIDE MANAGEMENT

Natural Gas Demand Side Management (DSM) Program

NorthWestern continued its Natural Gas DSM Program activities during the 2009 and 2010 periods using the services of KEMA, Inc., for ongoing program implementation. Funding for Natural Gas DSM Program activities comes primarily from energy supply rates. The associated DSM Program activities are the main focus of this DSM Plan. Other natural gas DSM activities that are funded from the Universal System Benefits (USB) Charge are noted but not extensively detailed in this Plan.

There are two general components to the energy supply-funded E+ Natural Gas DSM Program portfolio:

1. A group of individual DSM programs that offer mail-in rebates for programmable thermostats, certain heating equipment, increased insulation levels for attics, above-grade walls, basement walls and crawl space walls, and more², are offered to NorthWestern natural gas space heat customers. The program includes a list of preferred installation contractors that program participants may use. A list of qualifying measures for the 2011-12 program periods is presented in Table 6:

² Certain restrictions apply based on existing insulation levels. Details on qualifying beginning and ending insulation levels, along with additional program details, are available at http://www.northwesternenergy.com/display.aspx?Page=Insulation_Rebate&Item=102

Table 6: 2011-12 Natural Gas DSM Program Qualifying Measures

Residential: Existing Buildings
Attic/Ceiling R-0 to R-49 Insulation
Attic/Ceiling R-11 to R-49 Insulation
Attic/Ceiling R-19 to R-49 Insulation
Crawlspace R-0 to R-19 Insulation
Exterior Wall R-0 to Blow-In R-13 Insulation
Slab Insulation R-0 to R-5 (4 ft)
Service Hot Water Pipe/Boiler Pipe Insulation
Water Heater Tank Insulation
Boiler Controls
Boiler Diagnostic Testing, Repair and Maintenance
Furnace Diagnostic Testing, Repair and Maintenance
Heater Diagnostic Testing, Repair and Maintenance
High Efficiency Condensing Boiler
High Efficiency Condensing Furnace
High Efficiency Gas Room Heater
High Efficiency Water Heater
Programmable Thermostat
Faucet Aerators
Low-Flow Showerheads
Self Install Weatherization
Self Install Window Treatment
Residential: New Buildings
Natural Gas Boiler Controls
High Efficiency Condensing Boiler
High Efficiency Condensing Furnace
Northwest Energy Star Manufactured Home (Natural Gas)
Commercial: Existing Buildings
Boiler Tune-Up
DHW Circulation Pump Time clock retrofit system
Heating Duct Sealing & Insulation
Energy Management System (EMS) Optimization (commissioning)
High Efficiency (power burner/premium) furnace/boiler > 90%
High Efficiency Windows (Multiple Glazed, Low Emissivity)
High Efficiency Water Heater EF > 0.62 or > 90% TE
Service Hot Water Pipe/Boiler Pipe Insulation
Infrared Fryer
Ceiling Insulation
Exterior Wall Insulation (above grade)
Stack Heat Exchanger
Domestic water heater tank insulation
Commercial: New Buildings
Energy Management System (EMS) Optimization
Heat Recovery from AC
High Efficiency (Power Burner/ Premium) Furnace/Boiler 90% Eff
High efficiency water heater EF equal to or greater than 0.62 or 90% thermal efficiency
Stack Heat Exchanger
Water Heater Tank Blanket/Insulation