

## **SECTION 5. LONG TERM HEDGING ASSESSMENT**

The procurement plans that have been guiding purchasing and hedging activities for the past three years have focused on the upcoming winter heating season as well as one, two, and three years out. The plans have worked very well, providing greater guidance, structure, and discipline to this 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 years supply for a long period of time at known fixed prices. As stated in Appendix 1, 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 upward price movements or trends by locking in future prices based on market conditions known at the time the transactions are entered into. Long term hedging provides additional price stability beyond the value provided by short term hedging by providing protection against overall upward movements in market prices.

NWE has identified two basic types of long term hedges that need to be analyzed: 1) ownership of natural gas reserves and production, and 2) long term physical or financial transactions that lock in or fix the price of future natural gas purchases for an extended period of time. By the end of next year, NWE will perform an analysis of the issues, concerns, and opportunities involved with long term hedging and, after soliciting and receiving input from various stakeholders, present its findings and conclusions as to what, if any, type of long term hedging should be employed.

### Ownership of Natural Gas Reserves and Production

A number of strategic issues need to be addressed and analyzed to allow the opportunities to match closely with desired outcomes. In order for the strategy of reserves and production ownership to be realistically considered, NorthWestern must reacquire the ability to rate base natural gas production and gathering.

Therefore, NorthWestern in the 2009 Legislative session will pursue legislation, comparable to HB 25, that provides the opportunity to rate base Natural Gas production and gathering facilities. Some of the other issues to be considered include: should the focus be on asset purchases only or should equity purchases of entire operating companies be considered, what is the desired volume of reserve acquisition, is there a geographical region where the reserves must be located, could reserves be purchased in remote locations and merely serve as a long-term hedge, does NWE want to make reserve purchases on a stand-alone basis or does it want to partner with someone, are there certain basins or areas where NWE should concentrate, does NWE want to be the operator of properties that are procured or would it be willing to take a non-operating position, what are the regulatory/cost recovery issues and what additional skills and resources are needed.

Questions such as these as well as many other similar type issues must be thoroughly analyzed, debated, and agreed upon so that a more narrowly focused strategy can be developed and implemented.

#### Long Term Financial Hedging

An alternative to purchasing physical resources for long-term price stability is to enter into long term physical or financial commitments that lock in or fix the price of future supply purchases. One way of doing this is to enter into a financial swap with one or more counterparties. A financial swap is a transaction entered into between two parties whereby one pricing point is traded or “swapped” for another (usually a swap of a future index price for a fixed, known price, i.e. “fixed for float swap”). Financial swaps are considered paper transactions in that no physical delivery occurs; they are completely independent of the physical purchase of supply. Upon settlement, the pricing differential between the two pricing points is netted, with the owing party paying the other party the net amount. Financial swaps can be entered into for long periods (5 -15 years) and in turn they provide the same price stability and reduced volatility as ownership of natural gas

reserves and production. However, one very important factor that must be considered when employing financial swaps is credit. Upon entering a financial swap, each party will mark the transaction to market (calculate the difference between the current market price and what the price of the swap was) and determine what exposure exists.

Normally, each party to a financial swap provides an amount of open credit to each other. The amount of open credit is negotiated, and in large part is based on each party's credit rating. If exposure exceeds the amount of open credit, the party that is exposed will request some form of credit support (collateral) in order to protect itself from non-performance by the other party. Credit support can take a number of different forms; a very common form is a letter of credit issued by the bank of the Party needing to supply the collateral. Depending on market price movements and swap volumes, the amount of credit support can be very large. Credit issues must be factored in when developing a long term hedging strategy.