

## **SECTION 8. RISK MANAGEMENT AND MITIGATION**

In the protected portion of Appendix 1, NWE has provided a detailed systematic plan to layer in fixed price hedges. In addition to the systematic layering, additional actions may be taken (if prices begin to trend up or down), that either reduces or increase price exposure, or the decisions to put hedges in place may be accelerated.

The goal of NWE's hedging strategy is to dampen natural gas volatility in an effective, systematic, and efficient manner. The strategy uses a combination of fixed price arrangements (both less than one-year and beyond) and storage to provide reliability and remove a portion of the expected price volatility.

NWE will not try to outperform the market, but rather will be disciplined in layering in hedges over time, use storage, and make opportunistic purchases in the nearer-term. NWE will use its knowledge of the local natural gas market and its expertise in portfolio management to consistently maintain a natural gas portfolio that provides reliability and price stability. Also, if price levels reach defined hard trigger levels, additional purchases will be made.

While these strategies seek to mitigate supply price volatility and provide supply cost stability and affordability, they cannot shield customers from natural gas market price trends. NWE will work diligently to dampen price volatility and currently proposes to have, at a minimum, 65 – 75 percent of the upcoming winter heating season hedged.

### Storage

The storage capacity available to NWE Energy Supply is a key asset. When gas is placed in storage, the index priced gas becomes a known price, and, therefore, becomes a fixed price hedge. Storage hedging is a methodical approach that does not attempt to “out-guess” the market. Purchases at fixed prices will be made by Energy Supply on a determined pattern, i.e., monthly during the injection season.

Storage has proven to be an effective and flexible tool to mitigate short-term price impacts. Seasonal price variation, NWE’s substantial working gas storage rights, and its withdrawal flexibility facilitates price mitigation within each annual period. However, while storage can mitigate price volatility, it cannot shield customers from year-over-year price trends.

In addition to the value that storage provides in terms of reliability and price certainty, NWE will also work to obtain value from storage through the monetization of any available NWE Energy Supply storage. NWE’s purpose will be to monetize, on behalf of customers, the inherent value that storage

possesses because of seasonal price differences and the volatility surrounding those price differences.

#### Layering in Fixed Price Purchases

Fixing the forward price of flowing gas for both the injection and heating seasons reduces price volatility. As the MPSC and Montana Consumer Counsel (MCC) are aware, there is the inherent chance that the action of removing price risk will result in purchases being made at prices above the bottom of the market. However, it is NWE's understanding, per the Guidelines and both the MPSC comments to the Abbreviated Plan and the comments to the 2006 plan, that price stability is an important policy goal for customers.

Energy Supply will execute forward contracts in addition to storage activities. Beyond the level of storage needed to ensure reliability, storage and forward contracts serve essentially the same function (price hedges), but do so using fundamentally different strategies. Decisions regarding forward contracts will be periodically reviewed, as market conditions evolve, up until the contractual date for physical delivery. Additional fixed price contracts could be implemented to take advantage of particular market weaknesses, which present opportunities from a buyer's perspective. Unlike storage refill, which is subject to physical constraints, forward contracts are considerably more flexible.

#### Hard Targets

In addition to the storage and fixed price hedging strategies discussed above, an overlying "hard target" mechanism will be utilized that will trigger additional fixed price purchases for forward delivery. These targets will be set at levels deemed to be "favorable" prices to the customer. This reflects the fact that at some "low" price there may be no desire to have exposure to floating prices. In other words, knowledgeable Energy Supply customers and regulators would likely be relatively pleased to have some, or all, of the portfolio procured at this "hard target" price. NWE proposes that hard targets be reviewed and updated to

reflect changes in the market. At some defined “low” price, the benefit of a hard target may be more valuable than having a systematic, layered approach to fixing prices.

### Physical Acquisition

The primary vehicle for longer term hedging will be either physical or financial swaps (agreements that allow for settlement reflecting the difference between an agreed upon fixed price and an agreed upon index). These transactions are merely the vehicle by which index-priced gas is converted to fixed prices, and in almost all instances they have no effect on the physical molecules used to serve load. However, if opportunities should arise to purchase an equity interest in developed natural gas fields that are deliverable to NWE at the defined hard targets, these purchases will be explored and the results of the analysis will be documented.

### Liquidity

Liquidity is a serious issue that must be taken into account by NWE and policy makers. NWE is raising the liquidity issue in this Plan to begin the discussion on how best to address its concerns. However, NWE is not seeking to use this Plan as the forum for resolving the issues surrounding liquidity. Rather, NWE is using this opportunity to outline the issue and to note that liquidity concerns are significant and need to be addressed.

A liquid asset is commonly thought of as “cash or an asset easily converted into cash”. Ensuring the availability of sufficient liquidity is necessary to guarantee that a company can meet its short-term liabilities. NWE, like all businesses, has a finite amount of liquidity available to meet all of its business functions. Thus, there are ongoing competing business demands between all of the various business functions for the available liquidity. For example, the functions of Electricity and natural gas supply both require the use of large amounts of

liquidity as does maintenance and refurbishment and organic growth of the transmission and distribution systems.

NWE is continuously working to assure it has sufficient liquidity to operate all its business functions, including Energy Supply. Currently, Energy Supply has limited ability to generate or gain access to liquid assets (such as short-term lines of credit) and thus it must “borrow” or lean on other areas of the company for its liquidity. In doing so, it is in a sense taking the liquidity of the other areas (regulated transmission and distribution) to operate Energy Supply functions.

Implementation of natural gas hedging actions can impact the liquidity of NWE and the effects (depending on the type and term of hedging actions, and the volume of the hedges) may become significant to NWE’s operations. For example, for every 1.0 Bcf of gas secured at a fixed price, a one-dollar move in the market would cause the mark-to-market to change by \$1 million. In addition to mark-to-market concerns, substantial upfront-cash outlays are required to fill storage. For instance, if gas prices are \$6.50 per Dkt, a \$6.5 million outlay is required for each 1.0 Bcf of gas placed in storage. Each of these scenarios would require substantial amounts of liquidity. Energy Supply related liquidity demands must compete with other business areas of NWE.