MANITOBA	**Order No. 55/00**
THE PUBLIC UTILITIES BOARD ACT	**April 17, 2000**

Before: G. D. Forrest, Chairman
D. L. Barrett-Hrominchuk, Member
J. A. MacDonald, Member

AN APPLICATION BY CENTRA GAS MANITOBA INC. FOR AN ORDER TO APPROVE A RATE SETTING METHODOLOGY AND A RATE SETTING PROCESS FOR PRIMARY GAS

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Executive Summary

In late 1998, Centra Gas Manitoba Inc. ("Centra") filed with the Public Utilities Board ("the Board") Centra's Price Management Policy and Plan. Subsequently, the Board issued Order 100/99 directing Centra to refile the Policy and the 1999/2000 Price Management Plan based on the Board's findings and directives in that Order. In concert with its new owner, Manitoba Hydro, Centra significantly changed its approach to address rate volatility and market responsive pricing. On December 22, 1999, Centra filed a Rate Management Policy, including a Derivative Hedging Policy, and sought approval for a Rate Setting Methodology and a Rate Setting Process. A public hearing regarding this application was held in Winnipeg at the Board offices on March 6 to 9, 2000, and final argument was heard on March 10, 2000.

In this Order, the Board approved a Rate Setting Methodology that will adjust Primary Gas sales rates at the beginning of each gas year quarter, commencing May 1, 2000, to reflect 50% of the difference between the updated 12-month forward price curve (weighted for the cost of gas in storage) and the sales rates set for the previous quarter. The Rate Setting Methodology will also dispose of the Primary Gas purchase gas variance account ("PGVA") balance at the end of each quarter over the next 12 months. The Rate Setting Methodology will enable the PGVA to be cleared on a more frequent basis, and improve the market responsiveness of sales rates.

The Board also approved, on a trial basis, the alternative Rate Setting Process put forth by Centra during the hearing where Centra will file an application with the Board on the first of the month prior to the beginning of each gas year quarter, and provide public notice during the first and second weeks of that month. Board approval will be requested before the commencement of the next gas year quarter. Given the current volatility in the natural gas market, the Board stated that it is important for customers to be informed of proposed changes in rates and have the opportunity to express their views on the requested rate changes. The Board, after considering all comments on each application, may order a public process if the Board deems it to be necessary. Whether or not a quarterly hearing is held, all parties will have an opportunity to test the evidence through a full hearing process at the annual cost of gas proceeding.

Centra's Derivative Hedging Policy differed significantly from the Price Management Policy that was filed with the Board in connection with Board Order 100/99. The Board approved the Derivative Hedging Policy, but directed Centra to update the document to include the objectives, strategies and circumstances under which derivatives are to be placed. The Board noted concerns expressed by intervenors that infrequent use of derivatives may lead to imprudent decision making. The Board views the responsibilities for prudent derivatives hedging transactions to be within the purview of management and directed Centra to deal with them appropriately.

There are no rate changes resulting from this Order.

1.0 Appearances

R. Peters K. Kalinowsky	Counsel for The Manitoba Public Utilities Board ("the Board")
J. Foran, Q.C. M. Murphy	Counsel for Centra Gas Manitoba Inc. ("Centra")
B. Meronek, Q.C. K. Saxburg	Counsel for Consumers' Association of Canada (Manitoba) Inc./Manitoba Society of Seniors Inc. ("CAC/MSOS")
D. Foreman	HVAC Coalition of Manitoba ("HVAC")
J. Turner	Manitoba Conservation, Petroleum, and Energy

2.0 Witnesses for Centra

M. Kast	General Manager, Finance & Administration Department, Centra
G. Meyer	Manager, Rates Department, Centra
H. Stephens	Senior Manager, Gas Supply Storage & Transportation Department, Centra
P. Thompson	Manager, Enterprise Risk Department, Manitoba Hydro
V. Warden	Chief Financial Officer, Vice President, Finance & Administration Department, Manitoba Hydro

3.0 Intervenors of Record

Coalition of Eastern Natural Gas Aggregators and Sellers

Communications, Energy and Paperworkers' Union, Local 681

Consumers' Association of Canada (Manitoba) Inc./Manitoba Society of Seniors Inc.

ECNG Inc.

Gateway Industries Ltd.

Griffin Canada Inc.

HVAC Coalition of Manitoba

Manitoba Conservation - Petroleum and Energy Branch

Municipal Gas

SaskEnergy Incorporated

TransCanada Gas Services ("TCGS")

4.0 Witness for CAC/MSOS

A. Pringle	President, GSC Energy

5.0 Background

Since November 1993, Centra has purchased gas under an indexed price formula where prices are set on a month-to-month basis. The use of an indexed pricing formula can result in significant volatility in gas costs because of market volatility. A Purchased Gas Variance Account ("PGVA") was approved by the Board to track the differences between forecast gas costs included in sales rates and actual gas costs paid by Centra that result from the pricing formula.

Under indexed pricing, sales rates have typically been changed twice in a year, once at a General Rate Application ("GRA") at the beginning of the year and again at a Cost of Gas hearing, usually held near the end of the year. In many circumstances, there have been significant rate changes due to volatility in market prices and the required disposition of the balance in the PGVA. As well, sales rates do not necessarily reflect current market prices.

After the introduction of indexed pricing, Centra developed a Risk Management or Price Management Program with the objectives of achieving market responsive pricing and tempering market volatility. The Price Management Program was introduced by Centra in 1995, and was substantially reviewed by Centra in 1998. In late 1998, Centra filed, with the Board, its Policy Guidelines for Price Management, and a 1998/1999 Price Management Plan. After reviewing the Policy and Plan, the Board issued Order 100/99, directing Centra to re-file the Policy and a 1999/2000 Price Management Plan based on the Board's findings and directives in that Order.

In the same timeframe that the Price Management Program was being reviewed by Centra, a number of other applications and Board directives highlighted the need for a revised Rate Setting Methodology and process. These directives included the unbundling of Centra's sales rates for Primary Gas, Storage & Peaking Gas and Transportation & Delivery Service, the implementation of a Western Transportation Service which allows Brokers to provide Primary Gas to customers at their own prices, and a directive by the Board that Centra consider options to eliminate the confusion and inaccurate price signals caused by the PGVA.

After receipt of Order 100/99, and in concert with its new owner, Manitoba Hydro, Centra undertook a further review of its Price Management Policy and Plan. This review involved assessing the required Rate Setting Methodology and process to develop a comprehensive plan that would accomplish the objectives of reducing rate volatility and achieving rates reasonably responsive to the market. The comprehensive plan is referred to in the current application as "Rate Management." In addition, as a result of the work done by Centra since Order 100/99 was issued, the Price Management Policy was significantly revised and condensed to be consistent with other Centra and Hydro policy documents.

Centra's review process resulted in a Rate Management Policy, a Rate Management Plan for the 1999/2000 gas year and a Derivatives Hedging Policy that all relate to Centra's Primary Gas service. In addition to a Rate Setting Methodology, Centra also proposed a Rate Setting Process that relates only to the Primary Gas component of sales rates. An Application for approval of a Rate Setting Methodology for Primary Gas and a Rate Setting Process for Primary Gas was filed with the Board on December 22, 1999.

6.0 Application

The application filed with the Board on December 22, 1999 requested approval of the following:

1. A Rate Setting Methodology for Primary Gas that involves adjusting the Primary Gas rates at the beginning of each of the gas year quarters (commencing on May 1, 2000) to reflect:

   (i) 50% of the difference between the updated 12-month forward price curve (weighted for the cost of gas in storage) and the rate set in the previous quarter; and

   (ii) disposal of the estimated Primary Gas PGVA balance over the next 12 months.

2. A rate setting process for Primary Gas in which Centra will file updated Primary Gas rates on or before the 15^{th} of the month before the start of the next gas year quarter, to be reviewed and approved by the Board on an interim ex-parte basis, to take effect at the start of the next gas year quarter.

Centra's application also included its revised Derivatives Hedging Policy and responses to the concerns expressed by the Board in Order 100/99. Centra's application did not request Board approval of this policy.

A public hearing regarding this application was held in Winnipeg at the Board offices on March 6 to 9, 2000, and final argument was heard on March 10, 2000.

7.0 Customer Research

Centra retained Viewpoints Research Ltd. ("Viewpoints") to assist in determining customers' expectations regarding rate volatility due to changes in Primary Gas prices. The market research was conducted in August 1999. Viewpoints conducted 10 focus groups comprising a total of 79 Centra customers. The 10 focus group sessions included roundtable discussions and written exercises. Eight groups were conducted at Viewpoints' facility in Winnipeg, while two were held in Morden. Five of the groups consisted of 41 customers on the budget plan while the other five included 38 customers not on the budget plan. Focus groups were segregated according to income level (low and average to upper income), two sessions were conducted with seniors (16 participants) and two with rural customers (18 participants). The seniors groups were comprised of retired people over 55 from a mix of income levels. The Morden groups were comprised of participants from a range of income and age levels.

Based on Viewpoints' interpretation of the research, Centra put forward the following three key findings:

- Customers are prepared to pay a premium to obtain cost stability.
- The vast majority of budget plan participants indicated they would accept monthly fluctuations in their bills, unrelated to weather, of plus or minus $5 resulting from gas price changes.
- The vast majority of all participants indicated that an annual non-weather related variance of between $50 and $60 in their Primary Gas cost was tolerable.

Centra noted that the results of this study were consistent with the study performed in 1998, and the three key findings were important factors in developing the proposed Rate Setting Methodology.

8.0 Primary Gas - Rate Management Policy

In the past, Centra's focus on rate volatility under an indexed pricing regime was related to the use of derivatives under Centra's Price Management Program. It is now Centra's contention that "Price Management" be viewed in the more general context of "Rate Management", which may provide an opportunity to reduce volatility without using derivatives. To accomplish the objectives of reduced price volatility and market responsive rates, it is necessary, in Centra's view, to consider both how rates are set and the use of derivatives in an overall comprehensive manner.

The Rate Management Policy for Primary Gas was approved by Centra's Board of Directors on November 25, 1999. The Rate Management Policy developed by Centra is based on several fundamental principles including:

- The magnitude of price and rate volatility as determined by customer expectations;
- Lowest cost refers to indexed or market based prices and does not imply speculative trading or an attempt to "beat the market";
- Indexed pricing will inherently be volatile;
- Supply price volatility does not necessarily imply rate or bill volatility;
- The use of derivatives has a cost;
- Supply price management should be viewed in the larger context of Rate Management; and
- Rate Management activities will be focused on the expectations of the majority of Centra's customers.

Centra noted that there are certain stabilizing effects that already reduce bill volatility. These stabilizing effects include the use of storage gas during the winter months, the small volumes of consumption during the summer months, and the fact that Primary Gas represents only 30-35% of the total bill. Centra contends that it must take advantage of these stabilizing effects as they do not cause additional costs and risks inherent in the use of derivatives.

The principles and practices that will be applied in the application of the Rate Management Policy are:

(a) A PGVA will be used to track timing differences between the actual cost of gas and the forecasted cost of gas included in sales rates.

(b) Rate volatility attributable to changes in the cost of Primary Gas will be managed through the following process:

  (i) Primary Gas costs will be transferred to customers through rates which have, to the extent possible, regard for the customers' tolerance regarding volatility while being reasonably responsive to market changes.

  (ii) Primary Gas rates will be adjusted periodically through an automated rate setting mechanism. Rates will take into account the 12-month forward price curve and residual PGVA balances.

  (iii) Derivatives will be utilized when appropriate to mitigate gas cost volatility. A stringent control environment will be in place to address risks, as outlined in the Derivatives Hedging Policy.

(c) A plan to manage rate volatility will be prepared on an ongoing basis and updated as necessary.

(d) The program will operate under the guidance of a Gas Supply Management Committee with membership and Terms of Reference approved by the Executive Committee.

The objective of the Rate Management Policy is to reduce bill volatility, as this is what is important to customers. Under the Rate Management Policy, Centra will acquire natural gas for customers at the lowest possible cost having regard for security of supply and rate volatility. Centra was of the view that the lowest cost achievable would be the market price given that Centra is not attempting to speculate and "beat the market." Centra stated that customers must bear the price risks of the natural gas market. Centra has assumed that the market price, in the long term, will be the lowest price. The use of derivatives will only increase that price. Therefore, in Centra's view, it must, where possible, look to other solutions to manage bill volatility.

9.0 Rate Management Plan

Centra's proposed Rate Management Plan consists of a Rate Setting Methodology and a proposed Rate Setting Process. Centra listed three objectives for the Rate Management Plan being:

- To provide Primary Gas to customers at the lowest possible cost, subject to security of gas supply and control over gas rate volatility within reasonably acceptable parameters.
- To manage the impact on customer bills resulting from month-to-month volatility inherent in Primary Gas supply arrangements that are priced based upon a monthly index and to manage year-to-year impacts on customer bills to a level acceptable to customers.
- To the extent possible, develop a mechanism to temper rate volatility as an alternative to the use of financial derivatives, due to the inherent costs associated with derivative instruments.

Centra intends to monitor its Rate Management Plan on an ongoing basis and make refinements as necessary to achieve its rate management objectives.

9.1 Risk Advisory

Risk Advisory provided an opinion on Centra's proposed 1999/2000 Rate Management Plan judging it to be responsive to:

(i) the stated position of the Board;

(ii) the risk tolerance of the ratepayers derived from the 1999 Viewpoints' market research study; and

(iii) prudent risk management practices.

It was Risk Advisory's opinion that the proposed Rate Setting Methodology and the price management strategy will achieve the objective of reducing rate volatility while still allowing a component of market sensitive pricing. The third objective and, in Risk Advisory's view, the groundbreaking aspect of the Rate Setting Methodology is that it addresses the year-over-year volatility that can otherwise occur with significant moves in the market. The decision to use price caps and costless collars to provide the necessary upward price protection is also considered appropriate.

Risk Advisory noted that the limitation on hedgeable volumes being tied to the warmest year scenario might cause rate moves in excess of ratepayers' tolerances if load is greater than the minimum year and gas prices move up above the strike price of the call. Performance measurement of the program should take this into consideration. Risk Advisory also stated that the use of minimum volumes might expose the customers to risk.

10.0 Rate Setting Methodology

Under the current Rate Setting Methodology, rates for Primary Gas are set approximately twice per year based upon the forecast cost of gas. The difference between the forecast cost of gas included in rates and the actual cost of gas paid by Centra is accumulated in the PGVA. The rate adjustments required to dispose of PGVA balances are often of significant magnitude. These adjustments must not only reflect the inevitable differences between forecast and actual gas costs, but also the accumulated effect of not including such amounts in sales rates as they are incurred. This results in a "doubling" effect on rate changes which is not in the interest of Centra's customers.

Centra is of the view that rate changes should be more frequent to reflect the market price of gas, and to avoid any significant build-up of the PGVA balance. The frequency and magnitude of rate changes should reflect a compromise between the customers' desire for rate stability and the need for price transparency in a competitive market.

Longer-term price trends are captured through a 12-month rolling average of the forward price curve. Centra believes that this forward price curve reflects market perceptions and is the most objective predictor of factors which affect price.

In considering an appropriate Rate Setting Methodology, Centra identified a range of six rate adjustment alternatives:

1. Monthly rate adjustments based on the 12-month forward price curve;
2. Monthly rate adjustments based on the near-month forecast price;
3. Annual rate adjustments based on the 12-month forward price curve as of the start of each year (the current methodology);

4. Quarterly adjustments based on the 12-month price curve;
5. Quarterly adjustments based on the 12-month forward price curve. Adjustments would only be made if the PGVA balance, whether positive or negative is greater than $5 million; and
6. 50% of the quarterly adjustments based on the 12-month price curve.

Each scenario contemplates recovery of the Primary Gas PGVA balance at the end of the quarter over a 12-month period.

Each alternative was applied to historic data that incorporated forecast and actual monthly pricing data for the months of November 1997 to August 1999. As a result of this financial modeling, alternatives 1 and 2 were discounted because of the frequency of the rate changes and the rate changes tended to oscillate frequently. Neither alternative met the customer thresholds of variances of plus or minus $5 relative to the base case. Alternative 3 was discounted on the basis of unacceptable change in customer bills in the month of November and the large PGVA balances. Alternative 4, while better, was discounted because it exceeded the monthly customer threshold of $5 and resulted in large PGVA accumulations. Alternative 5 was discounted due to the large bill adjustment occurring in November of each year.

Alternative 6 was selected as the most appropriate of the six considered rate setting methodologies. Centra stated that this methodology reflected the best compromise between frequency and magnitude of rate changes, the absence of oscillation due to the long-pricing horizon, and most importantly, it met the customer-defined thresholds without the use of derivatives, when applied to a data series with significant market volatility.

10.1 Evaluation Criteria

Centra established four criteria to evaluate the six alternatives considered. These alternatives were:

- The magnitude of rate changes.
- The frequency and oscillation (ups and downs) of rate changes.
- Market responsiveness and ability to reflect market conditions.

  Centra stated that although referred to as price transparency in the application, the term market responsiveness is more appropriate. Centra defined price transparency as the ability for customers to see on the bill the unit rate being charged and the terms and conditions attached to the charge relative to their neighbours.
- Simplicity of implementation and ease of automation.

The magnitude of rate changes was weighted 40%, given that the primary focus of the plan is to ensure that rate changes and resultant monthly bills meet customer expectations. Centra's rationale for this weighting is consistent with the common perception that large rate changes are less palatable to customers.

The frequency and oscillation of rate changes was weighted 25%. Centra indicated that fewer rate changes were considered more palatable to customers as long as they did not inevitably result in large changes. Further, Centra was concerned that rate changes which result in an increase one month only to be followed by a decrease the next month will result in customer confusion and dissatisfaction. Centra's weighting of this criterion reflected its view that while it is important to customers, it is not as significant a criterion as the magnitude of rate changes.

The market responsiveness of rates was weighted 25%. The Rate Setting Methodology should facilitate a comparison of customers' service options and the pricing associated with those options. Billed rates should generally be reflective of current market conditions. This criterion was viewed as being equally important to customers as the frequency and oscillation of rate changes.

Simplicity of implementation was weighted 10%. Although simplicity and the ability to gain approval with a streamlined and cost effective regulatory process are important considerations, this criterion was given less weight than the others to ensure that the desire for simplicity did not inhibit the goal of meeting customers' expectations.

Centra stated that the process of evaluating the rate options involved a degree of judgment based on the market research filed with the Application, other market research performed in previous years, and the experience of the staff involved. However, Centra performed a mathematical analysis by multiplying the relative rankings of each alternative by the weightings noted above. The option achieving the lowest value was considered as the best alternative. The table below details the ranking of each alternative and its related score based on the four criteria.

Rate Change	**Basis**	**Magnitude 40%**	**Frequency 25%**	**Transparency 25%**	**Simplicity 10%**	**Score 100%**
Monthly	12-month forward price curve	3	4	2	3	3.00
Monthly	Near-month forecast price	4	5	1	4	3.50
Annual	12-month forward price curve	4	1	6	5	3.85
Quarterly	12-month forward price curve	2	3	4	1	2.65
Quarterly	12-month forward price curve if existing PGVA> $5 million	4	3	5	2	3.80
50% Quarterly	12-month forward price curve	1	2	3	1	1.75

11.0 Rate Setting Process

11.1 Proposed Rate Setting Process

The process that Centra proposed to set Primary Gas rates is as follows:

1. Centra will adjust its Primary Gas sales rates at the beginning of each of the gas year quarters (February 1st, May 1st, August 1st, November 1st) to reflect 50% of the difference between the updated 12-month forward price curve (weighted for the cost of gas in storage) and the sales rate set in the previous quarter. The use of the gas year quarters will coincide with the changes in the broker Primary Gas rates under WTS and as such will facilitate price transparency and price comparison.
2. Centra will dispose of the Primary Gas PGVA balance at the end of each gas year quarter over the next 12 months. The Primary Gas PGVA balance will be calculated based on actual information up to the end of the second month of the previous quarter and estimated for the third month. The ending balance will be recovered over the next 12 months so that the impact is spread over an entire year.
3. Centra will file the updated Primary Gas sales rates and supporting schedules and calculations on or before the 15th of the month before the start of each gas quarter. Centra proposed that the application be filed on an interim ex-parte basis. Under Centra's proposal, the Board would review Centra's rate calculations and supporting material and issue an interim Order approving Primary Gas rates for implementation on the 1st day of the next gas quarter.
4. Centra proposed that the changes to the Primary Gas rates be first implemented on May 1, 2000. This should be acceptable because Centra's current Primary Gas rates sales were implemented on December 1, 1999 and as such reflect relatively current pricing forecasts. If

the Board's decision was delayed, the implementation should be August 1st, the start of the next gas quarter.

Centra's position is that a paper hearing process is not required for quarterly Primary Gas rate changes under the Rate Management Plan. Centra's concerns over the paper hearing process relate to matters of cost, timing, restrictions on resources, the methodology is formula based, and, in any event, there will be an annual public hearing process. A public process in each quarter would, in Centra's view, represent a significant regulatory burden given the simplicity of the Rate Setting Methodology Centra is proposing and the rate change would be based on an objective forward price curve. Under Centra's proposal, the Board would review the information on a quarterly basis and would conduct a full review on an annual basis. In Centra's view, a hearing, paper or oral, would only be required in unusual circumstances. As such Centra is proposing an interim ex-parte process for the adjustment of Primary Gas rates under its Rate Management Plan. Counsel for Centra argued an interim ex-parte hearing was appropriate since the special circumstances requirement of Section 45 of The Public Utilities Board Act ("the Act") was satisfied by the volatility of the natural gas market and its effect on rate making. In addition, Centra stated the proposed process:

1. reduced costs, both internal and external;
2. was more timely;
3. was formula driven and therefore required public involvement up front instead of during the process; and
4. would still have an annual public review process.

Centra stated the Board should be able to appropriately review the rates within a two-week period.

Centra's view was that using three months of actual figures (e.g., April, May and June for November 1st rates) as opposed to two months of actual and one month of estimated data (e.g., May and June actual data and July estimated data for November 1st rates) would not change the PGVA balance significantly and it may be easier to administer.

Centra stated that the PGVA accounts relating to other components of the customers' natural gas bills will be determined and dealt with on an annual basis, and the process will not change as a result of this application.

11.2 Alternative Rate Setting Process

In response to concerns raised at the hearing regarding the lack of public involvement in the proposed Rate Setting Process, Centra put forth an alternative process which would include public notice. Under this alternative, Centra would file an application with the Board on the first of the month prior to the beginning of the gas year quarter. During the first and second week, notice of the application would be published in the newspaper and information would be inserted with the customer's bill. During the third week, the public could respond to the Board with any concerns. The Board would be asked to approve the rates before the beginning of the gas year quarter. There would be no opportunity to ask written or oral questions, and no opportunity for final argument under this process.

As this proposal would involve more lead time, Centra proposed that the PGVA balance be determined using two months of actual data and one month of estimated data prior to the month immediately before the start of the gas year quarter. For example, actual data for April and May and estimated data for June would be used to determine rates effective August 1st.

If this alternative is approved, Centra suggested that it continue for a one-year evaluation period, recognizing that customers will be relatively educated about the process after that period of time.

Centra noted the Board always has the ability to call a hearing if it was deemed necessary. However, Centra envisioned that a required hearing would be the exception rather than the rule.

11.3 Interim Ex-Parte Issues

Centra argued that the Board has jurisdiction to approve the proposed process under Section 45 of the Act which allows for an interim ex-parte hearing in special circumstances. It noted the Act does not include the words "emergency", "extraordinary" or "unusual." Centra stated the "special circumstance" required in Section 45 of the Act is the volatility in the natural gas market at the present time and Centra's requirement to manage that volatility in the interest of consumers. Centra added the proposed process was cost effective, timely, and included public involvement both to develop the process initially and review it on an annual basis. Centra noted the Board has complete discretion under Section 45 to determine the appropriate time for a hearing to be held. Centra stated that the Board must do a balancing act between situations where notice should be given, and situations that can most efficiently be dealt with at one point in time through an ex-parte process, recognizing there will ultimately be a full public process on an annual basis.

Centra argued if the Board was of the opinion that Section 45 of the Act did not apply, then Section 47 contemplates the proposed process by allowing for an order coming into force at a future date.

Centra expressed its hope that the Board would consider every reasonable measure to ensure this innovative and effective methodology is not struck down because of a process issue.

12.0 Derivatives Hedging

Centra stated the guiding principle for its Rate Management Policy for Primary Gas and for derivative hedging is to "acquire natural gas for customers at the lowest possible cost having regard for rate volatility." Centra does not subscribe to the premise that the use of derivatives is the sole method to manage volatility. Due to the inherent costs and risks associated with a derivatives based program, Centra is of the view that other viable alternatives should first be explored. Derivatives should be used to complement the managing of price volatility through the proposed Rate Setting Methodology. Accordingly, the Rate Management Plan focuses first on different rate setting mechanisms to manage volatility within parameters that customers can accept and on derivatives, as a secondary measure to be used as necessary.

Centra agreed with the Board's conclusion in Order 100/99 that price management strategies and controls are the responsibility of Centra's Board of Directors and management. In addition, Centra's focus shifted from Price Management to Rate Management. Given the directives contained in Order 100/99, and Centra's risk adverse corporate culture, Centra believes it has made the necessary revisions to its policy and plan.

Centra is not requesting approval of its Derivative Hedging Policy which it filed with the Board in this application, and is attached as Appendix A. Centra testified it has strong controls in place that address processes, procedures and personnel. Centra stated every transaction must be approved by the Gas Management Supply Committee and the Executive Committee. Centra indicated that it has the appropriate people in place through the Gas Supply Committee and the Executive Committee to ensure derivatives are prudently placed. The Executive Committee's knowledge was said to be sufficient to carry out its due diligence requirements.

Although not included in the Application or the Derivative Hedging Policy, Centra stated that it will strike the new rates based upon the current forward curve and the proposed methodology.

Then, it will perform a calculation, based upon normal volumes for small general service customers, to determine the average annual bill. It will determine the increase in Primary Gas in terms of the AECO/Empress price necessary to meet the upper threshold of $60 annually that customers have identified. Then, Centra will calculate the probability of the price approaching or exceeding that threshold. If the probability of prices exceeding that threshold is greater than 5%, then Centra will place a derivative transaction given approval by the Gas Supply Committee and the Executive Committee.

Centra indicated that the circumstances under which Centra is to place derivatives was not stated in the policy or the application because Centra wanted to maintain flexibility. It noted that the individuals involved possessed the skills to identify these circumstances.

In cross examination, witnesses for Centra agreed the ratepayer would be exposed to the vagaries of the marketplace, it was just a question of when. It was agreed that Centra can achieve most of its rate smoothing through rate management without resorting to derivative hedging and that Centra did not have an aggressive derivative hedging strategy. However, Centra would not agree it had downplayed its responsibility regarding derivative hedging, since they had merely introduced a new methodology to use derivatives on a very selective basis, thus lowering the costs to customers.

Centra stated it had no plans to outsource its Price Management activities, but will retain outside consultants as necessary. In addition, Centra does not envision fixing prices in the context of its 1999/2000 Rate Management Plan. Fixing prices would remove any degree of market responsiveness and, depending on the timing, could result in significant losses.

Performance measurement is fundamental to assessing the effectiveness of any plan in meeting its stated objectives. According to Centra, the Rate Management Plan is entirely customer focused, and it is therefore appropriate that the performance measure applied be based on customer expectations previously identified. Centra will monitor and evaluate its Rate Management Policy activities against this performance measure.

Centra remains of the view that derivative instruments should be placed as required on the basis of the warmest year scenario as affirmed by previous Board Orders. Centra disagrees with Mr. Pringle that caps should cover volumes up to cold winter scenarios and that collars should cover volumes up to the average volumes. Centra added that if it were to use an expected volume scenario, Centra would be hedging volumes which might not be needed.

Centra also maintains that once a derivative transaction is in place, it should remain in place unless some extraordinary occurrence takes place. According to Centra, the buying and selling of derivative instruments as depicted by Mr. Pringle appears to be contrary to the directive given by the Board in Order 100/99 that Centra not pursue an aggressive price management plan, and is unsuitable for a public utility.

13.0 Intervenors' Positions

13.1 CAC/MSOS Witness

Mr. Pringle, an expert in the use of derivatives produced as a witness for CAC/MSOS, noted the objectives of restraining the volatility of gas costs, achieving the lowest possible gas costs, and providing market responsive prices are inherently contradictory. Centra's dominant objective is to mute to acceptable levels the volatility of customers' bills. According to Mr. Pringle, Centra's plan will certainly reduce bill volatility. The quarterly adjustment of gas price and rolling collection of the PGVA on a 12-month basis will smooth both gas rates and customers' bills. This mechanism does not aim to insulate the consumer from market prices, for the consumer will sooner or later pay the actual market price for gas consumed. Instead, the mechanism buffers the consumer from price shocks with the PGVA.

The proposed smoothing mechanism by itself should come close to satisfying the objective of containing annual bill volatility to $60. Mr. Pringle also recommended monthly billing variations be further smoothed by implementing the equal monthly billing budget plan such that it be obligatory for customers unless they opt out of the plan.

Further rate smoothing was available by varying the amount of the adjustment of the difference between previous rates and the forward price curve from 50% to some other percentage.

Rate smoothing could also be achieved through the derivatives hedging program. If the rate smoothing mechanism is insufficient to limit the ratepayers' exposure to volatility within the tolerance level, then derivatives should be used as additional protection to the customer. Since a hedge reduces financial risk and uncertainty, then Centra should be hedging its gas to ensure it falls within that level of tolerance. The shedding of risk costs money, particularly in the volatile gas market, and therefore any derivative hedging program will have a cost.

According to Mr. Pringle, the derivatives hedging program should be applied to average year volumes rather than minimum year volumes, such that call options or collars are placed on these additional volumes. In doing so, the risk is minimized, and the hedge is merely insurance providing for a price within a level. Since the average winter is the best guess of expected volumes, that should be the volume hedged.

Centra's derivative hedging program was said to be limited and irregular, passive in nature, and perhaps, too conservative. When questioned whether Centra has downplayed its responsibility in pursuing derivative hedging on behalf of its customers, Mr. Pringle responded that Centra is not attempting to manage price risk, but rather was setting up a mechanism to smooth the price impact to its customers. Derivatives will merely be used to mute the volatility, not to manage price. Mr. Pringle also noted that the proposed infrequent use of derivatives concerned him, since Centra would not gain the requisite experience. Nonetheless, with its conservative risk adverse culture, Mr. Pringle considered Centra qualified to conduct its very limited hedging program of placing collars. With such an infrequent derivatives program, the possibility of outsourcing should be considered.

The proposed policy of Centra placing a derivative transaction and then leaving it in place was said to limit opportunities for the consumer to improve the position, unless Centra was hedging fixed price gas purchases rather than options.

Mr. Pringle concluded that Centra's strategy was reasonable and prudent, albeit the implementation of the strategy raises serious questions. For Mr. Pringle, the past use of derivatives by Centra had not been particularly encouraging, so he raised concerns about operating an in-house derivatives program. Based upon his knowledge of the reporting requirements, skills and experience of those who intended to hedge, Mr. Pringle urged the Board to be cautious in permitting such a program. Without adequate reporting and measurement of physical and derivative risk, these risks cannot be managed effectively. Accordingly, improved reporting was recommended.

In reviewing the Derivatives Hedging Policy and material filed, Mr. Pringle stated Centra should more clearly state its hedging objectives, particularly the circumstances under which it intended to place derivatives, how to decide the strike price, and when it might decide a call was too expensive. However, Centra had adequately addressed its operating policies.

In summary, Mr. Pringle made the following recommendations:

1. The smoothing mechanism should be approved and implemented.
2. The Budget Plan should be made the default for SGS customers as it is a classic, simple, and effective solution to the problem of the volatility of customers' bills due to seasonal fluctuations in demand.
3. Centra should better define its hedge strategies and consider relying on gas supplies to embed them in physical deals.

13.2 CAC/MSOS

CAC/MSOS argued the Board should not approve the application as filed. It stated it is a good practice to set the ground rules and added only parts of the total Rate Management Policy have been filed for approval. CAC/MSOS added Centra has ignored its objective of achieving lowest cost. However, if the Board were to approve the application, CAC/MSOS requested the Board not implement the process in perpetuity, as the effects of such a system are not known.

Rate Setting Methodology

If managing volatility is the goal, the Rate Setting Methodology accomplishes this goal. CAC/MSOS stated that it would have preferred if customers were consulted regarding which alternative best suited their needs. The methodology should take into account customer tolerances by changing the percentage of difference between previous rates and the new forward price curve for the amount of PGVA cleared, thus keeping it within customers' tolerances.

The budget plan is a good way to manage volatility on an individual customer basis. Education programs should highlight the budget plan's ability to protect the customer from frequent rate changes.

CAC/MSOS questioned the validity of the research on a statistical basis and does not have confidence that the true level of tolerance has been determined.

Rate Setting Process

CAC/MSOS is opposed to the rate setting process and the alternative proposed by Centra. It argues the Board does not have the statutory power to implement such a process given that this process would not constitute a special circumstance, and it is for an enduring period of time which is not contemplated under Section 45 of the Act. In addition, there will be no opportunity for interested parties to contribute to the process and consumers would not be notified in advance of a rate change. Special circumstances are to be considered as "emergency" circumstances. If it were the intention of the legislature to allow the Board to do away with the requirement for public hearing on a permanent basis, it would have stated so in clear language. CAC/MSOS further argued the alternative does not include sufficient public process as there is no opportunity for interested parties to ask questions and test the evidence.

CAC/MSOS suggested a paper hearing with information requests citing the “least cost regulation” of the Gladstone Austin Natural Gas Co-op as an example. Under this scenario the Board would retain the option to call a full hearing. Counsel for CAC/MSOS argued this scenario should be accepted as it was cost effective, addressed timing issues for quick implementation of rates, and included public input.

Derivative Hedging Policy

CAC/MSOS noted Orders 79/98 and 100/99 required Centra to file its Price Management Plan. It is therefore incongruous for Centra to say approval is not required. In addition, CAC/MSOS questioned whether imprudence could be found if Centra followed an unapproved policy or plan. CAC/MSOS argued that the obligation of Centra to file its derivatives hedging program still exists regardless whether Centra’s focus has expanded and the name has been changed.

CAC/MSOS agreed with the evidence of Mr. Pringle that Centra should be permitted to hedge greater than minimum year volumes as long as the derivatives used decreases risk and not increases risk, and added that Centra will need to further develop its expertise in the area if the Board was to permit this.

CAC/MSOS stated that Centra should seriously consider outsourcing. Without the ground rules for hedging established by inclusion of the objectives and circumstances in the Policy, CAC/MSOS argued each and every derivative hedge will be the subject of challenge as to whether Centra has fulfilled its obligations. As Centra has failed to submit appropriate policies, this application should be rejected. If Centra is not planning to outsource, these hedging policies must be better defined and committed to paper and be submitted to the Board for approval.

13.3 TCGS

In a letter dated March 8, 2000, TCGS stated that it supported Centra's application for Rate Management Proposals Relating to Primary Gas and urged the Board to adopt the proposal. It stated that the proposal represented the best possible compromise between frequency and magnitude of rate changes for the Manitoba customer. TCGS also supported the passive Derivative Hedging Policy for Primary Gas. Its believes the gas cost treatment outlined by Centra in its Application to be a fair and reasonable means of recovering its cost upon disposition of the 1999 PGVA.

14.0 Board Findings

14.1 Rate Setting Methodology

Centra's proposed Rate Management Policy seeks to balance the objective of managing gas price volatility to keep rates within a tolerance acceptable to customers with the objective of ensuring those rates are reasonably responsive to changes in market pricing. With these objectives in mind, Centra identified six alternatives for a Rate Setting Methodology, which were evaluated against four criteria: magnitude of rate changes (40%); frequency and oscillation of rate changes (25%); market responsiveness (25%); and simplicity of implementation (10%).

The Board is of the view that the ability of the customer to see the rate paid for Primary Gas on the bill is a precondition for a competitive market, as was stated in Order 15/98. Therefore, price transparency must be a significant consideration when developing a Rate Management Policy or a Rate Setting Methodology. Regarding Centra's criteria, the Board considers market responsiveness should be ranked first followed by frequency and oscillation of changes, magnitude of rate changes, and finally, simplicity of implementation.

The Board considers Centra's proposal to be responsive to its direction in Order 15/98 that requested Centra to consider options to eliminate inaccurate price signals caused by the PGVA. With quarterly changes to the Primary Gas sales rates and the disposal of PGVA balances on a more frequent basis, rates should more closely reflect the market price of gas. Additionally, when the WTS option is implemented, price transparency should be further enhanced. The Board will therefore approve the Rate Setting Methodology requested by Centra.

The Board accepts Centra's assessment of its alternatives and its proposed Rate Setting Methodology as most suitable to meet the needs of its customers and the marketplace at this time. On a forward-looking basis, it is expected that customers will be exposed to rate changes both upward and downward as dictated by the marketplace. While it is not known with certainty, the methodology should also reduce the magnitude of rate changes. While such a process may not be totally consistent with bill stability, it is a reasonable compromise recognizing that bill stability is also offered by Centra's budget plan, which the Board continues to believe should be an optional service for customers.

While the Board will accept Centra's 50% adjustment at this time, it agrees with CAC/MSOS that that percentage adjustment will need to be reviewed in each quarter in the context of the marketplace and, perhaps, adjusted to meet the overall rate setting objectives.

The Board will accept the proposal to dispose of the PGVA balance over the next 12 months, recognizing that, for example, under the alternative proposal for November 1st rates, the determination of the PGVA will incorporate actual results for July and August, and estimates for September. Although this will create a slight delay in achieving market responsiveness, it does satisfy the criteria of simplicity of implementation.

With respect to the Budget Plan, the Board notes CAC/MSOS' position that the budget plan is a built-in rate smoother. Slightly less than half the customers have chosen to exercise this option. The Board also heard that Centra did not support making the budget plan mandatory, with an opt-out clause for its customers. The Board agrees that the purpose of the budget plan is to provide an option to customers to smooth their monthly bills, but is not convinced that enrolment in the budget plan should be automatic. Rather, the Board would prefer Centra to continue its customer education with respect to the benefits of the budget plan. Consumers can then make educated choices as to whether the budget plan fits their needs.

With respect to the Viewpoints' study, the Board reiterates what it stated in Order 100/99. The Board appreciates Centra's efforts to include customer input in price management through customer focus groups even though the results can only be considered a general indicator of pricing preferences.

The Board commends Centra's comprehensive review of Primary Gas rate setting alternatives that is both responsive to the marketplace, yet considers customers' desires for bill stability.

14.2 Rate Setting Process

Centra applied for an ex-parte rate setting process. Centra urged the Board to find special circumstances, as required for an interim ex-parte order in Section 45 of the Act, including the volatile nature of the natural gas market. As pointed out by counsel for Centra, the Board has noted this volatility in several Orders. Rather than consider the volatility of the natural gas market as being a special circumstance giving rise to the need for rate changes without any public notice, the Board considers the volatility of the natural gas market to be a factor that increases the need for public notice of rate changes.

During the hearing, an alternative was brought forward by Centra to provide for public notice and limited public participation. The Board will accept the alternative proposal, recognizing that customers should have the right to be informed of proposed changes in their rates, and have an opportunity to express their opinions on those proposals. Furthermore, the Board notes this methodology addresses and satisfies each of Centra's four issues; namely, reduction of costs, timeliness, public involvement to develop the formula driven rate setting mechanism, and the maintenance of an annual review process. This procedure is in accordance with the form of least cost regulation the Board employs for regulating Stittco Utilities Man Ltd. and the Gladstone Austin Natural Gas Co-operative. Accordingly, since there will be public notice, quarterly applications under this rate setting process should be filed for interim orders under Section 47 of the Act.

The Board, at its discretion, will order a hearing be held for any quarterly application if, upon the review of the application and the comments received by the public, the Board considers there to be a need for a hearing process. That quarterly hearing will not incorporate an information request process. All parties, including the Board, will have an opportunity to test the evidence through a full pre-hearing disclosure processes at the annual cost of gas proceeding.

The Board, with Centra, will determine the appropriate minimum filing requirements for quarterly filings and notice requirements to ensure the rate setting process is conducted expediently, efficiently, and in a cost effective manner. The process must ensure the public is aware of both the requested rate change and the subsequent annual review. The Board will require Centra to file an application annually such that an oral public hearing is held every fall prior to the commencement of the gas year. At that hearing, the Board will review the disposition of the PGVA, including the effects of derivative hedging, and other material in support of the rates approved on a quarterly basis. Whether this annual review is part of a GRA or is confined to a Cost of Gas hearing will be left to the discretion of Centra. However, filing the information as part of an annual GRA might improve the expediency, efficiency, and cost effectiveness of the process.

Since this process is new, the Board considers implementation to be on a trial basis. Subsequently, the comments of Centra and other stakeholders on the overall effectiveness of the process will be considered, including any suggestions for modification or improvement.

14.3 Derivative Hedging Policy

The Board spent substantial effort in two recent proceedings establishing guidelines for the future direction of price risk management for Centra. The Board considers that Centra has not fully complied with the Board's requirements. Centra initially sought approval of Policy Guidelines for Price Management. For reasons noted in Order 100/99, the Board did not approve those Policy Guidelines, but provided extensive directions for revisions, and directed Centra to file new Policy Guidelines by August 31, 2000.

Centra did not seek the approval of the Board for its Derivative Hedging Policy or its plan for 1999/2000 in light of the new approach to rate setting proposed and the directives contained in Order 100/99. Paradoxically, Centra testified it would seek Board approval for any changes in that policy. Centra stated it is prepared to demonstrate the prudence of its conduct regarding derivative hedging in conjunction with the annual review of gas costs and the PGVA.

Order 100/99 requires approval of the Derivative Hedging Policy. In this instance, for the reasons stated below, the Board will approve the Derivative Hedging Policy subject to the inclusion of the strategies, objectives, and circumstances under which derivatives can be placed. Although the Policy is adequate, the implementation of that policy is of concern to the Board. In Order 79/98 the Board was of the view that, in a volatile marketplace of indexed pricing for natural gas, a well executed Price Management Program can serve the interest of the ratepayers. To do otherwise would expose the ratepayers to the vagaries of the marketplace.

With the proposed policies, customers will be exposed to the vagaries of the marketplace, albeit within a certain tolerance level. However, it is Centra's intention to use derivative hedging only when the volatility of gas prices exceeds the perceived tolerance level. As stated by Centra, it is the customers who will carry the actual risk of volatility in the market and Centra will manage that volatility to an acceptable level.

Order 100/99 required specific hedging objectives and strategies to be formulated each year, consistent with the philosophy. The Board views the strategy and objectives, as explained by Centra during the hearing, to be appropriate for a local distribution company within the context of the Rate Management Plan. These objectives, however, are not succinctly stated in the policy, nor are the circumstances under which Centra will place derivatives. The Board will follow the advice of Mr. Pringle and request Centra to clearly define these objectives and circumstances in either the Policy or some other document. Centra and those members of senior management overseeing the derivative hedging should measure all such transactions against these objectives.

The Board considers that the purpose of derivative hedging is to manage risk. Unfortunately, each customer cannot manage their risk and therefore, Centra must act on behalf of its customers. When questioned about their risk culture, witnesses for Centra characterized it as being conservative, or risk adverse. The Board wants to ensure that Centra will not downplay its responsibility to shed risk in placing derivatives on behalf of its customers.

Mr. Pringle stated that he was less than inspired by Centra's skills and knowledge in this matter. It is not for the Board to judge this, rather, the responsibility resides with the senior management and Board of Directors to ensure that the appropriate personnel are in place. As previously stated in two Board Orders, derivative hedging may be conducted internally within Centra or outsourced to a third party. The Board notes Mr. Pringle's concern that the infrequent use of derivatives could lead to imprudent decision making.

In summary, the Board will approve the Derivatives Hedging Policy, but will require Centra to clearly state, in a formal document, the objectives, strategies, and circumstances under which derivatives are to be placed and file this document with the Board. Furthermore, the Board has expressed concerns about the skills, knowledge, and personnel. The Board views these responsibilities as being within the purview of management and will expect Centra to deal with them appropriately.

With respect to eligible hedging volumes, as stated in several previous Board Orders, the Board will accept Centra's position that it only place derivatives for the warmest year volumes, notwithstanding the advice provided by Mr. Pringle.

15.0 It Is Therefore Ordered That:

1. The Rate Setting Methodology for Primary Gas that involves adjusting the Primary Gas sales rates at the beginning of each gas year quarter to reflect:

   (i) 50% of the difference between the updated 12-month forward price curve (weighted for the cost of gas in storage) and the rate set on the previous quarter, and

   (ii) disposal of the Primary Gas PGVA balance over the next 12 months

   BE AND IS HEREBY APPROVED.

2. The Rate Setting Process for Primary Gas in which Centra will file the updated Primary Gas rates on or before the 15th of the month before the start of the next gas quarter on an interim ex-parte basis to be reviewed and approved by the Board to take effect at the start of the next gas quarter BE AND IS HEREBY DENIED.

3. The Alternative Rate Setting Process for Primary Gas in which Centra will file the update Primary Gas rates during the first week of the month prior to the commencement of each gas quarter, send public notice during the first and second weeks of that month and the Board will be requested to approve these rates prior to the commencement of the next gas year quarter BE AND IS HEREBY APPROVED.

4. The Derivative/Hedging Policy for Primary Gas BE AND IS HEREBY APPROVED subject to the document being updated to include the objectives, strategies and circumstances under which derivatives are to be placed and filed with the Board.

The Public Utilities Board

Chairman

Acting Secretary

THE PUBLIC UTILITIES BOARD

"G. D. Forrest"
Chairman

"Hollis Singh"
Acting Secretary

Certified a true copy of
Order No. 55/00 issued by
The Public Utilities Board

Acting Secretary

Appendix A

Derivative Hedging Policy

Principles and practices that will be applied in the application of derivatives are:

(a) Where derivatives are used to constrain gas cost volatility:

(i) Only over-the-counter ("OTC") instruments will be utilized. OTC products, which may be used, are limited to price swaps, call options, and collars. Once a derivative contract is put in place, that contract will not be sold or otherwise dealt except in unusual circumstances authorized by the Gas Supply Committee. Centra stated that the market circumstances at the time the transaction are placed can impact the premium required for Price Caps or the spread on the Costless Collar. Centra will take these variables into consideration prior to entering into a transaction to ensure that the maximum benefit is obtained for the protection provided.

(ii) Derivatives will not be used for purposes of speculation. There must be an underlying physical requirement for the gas that is being hedged.

(iii) Hedgeable price indices will be limited to underlying physical price indices.

(iv) Hedgeable volumes for each month will be limited to "warmest year" long-term contracted supply volumes.

(b) The following operation controls will be in place:

(i) Clearly defined segregation of duties between employees carrying out transactions and those confirming, recording and reporting on hedge positions will be in place;

(ii) Independent oversight of the derivative program will be provided by the Gas Supply Management Committee and independent middle office risk management function;

(iii) Counterparties will have a minimum credit rating of 'A' from a recognized bond rating agency, or a parental guarantee from an 'A' rated parent will be in place;

(iv) Appropriate legal agreements will be in place to match credit requirements;

(v) Credit exposure dollar limits by counterparty will be set and monitored;

(vi) Management reporting of price management activity, results and risk exposure will be provided, in compliance with requirements set out in detailed procedures;

(vii) Incidents of non-compliance with the policy will be reported. Sanctions will be applied as deemed appropriate by the Gas Supply Management Committee; and

(viii) Detailed written operating procedures approved by the Gas Supply Committee will provide specific guidance and requirements in fulfilling policy statements.