MANITOBA	Order No. 208/02
THE PUBLIC UTILITIES BOARD ACT	
	December 6, 2002

Before: G. D. Forrest, Chair
R. Mayer, Q.C., Vice Chair
Dr. K. Avery Kinew, Member

A FILING BY MANITOBA HYDRO REGARDING INTEGRATION ACTIVITIES AS A RESULT OF THE ACQUISITION OF CENTRA GAS MANITOBA INC. AND RESPONSES TO THE DIRECTIVES IN ORDER 146/99

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Executive Summary

In May 1999, Westcoast Energy Inc. ("WEI") and Manitoba Hydro ("Hydro") executed an agreement for the purchase and sale of all of the issued and outstanding shares of Centra Gas Manitoba Inc. ("Centra") for a price of approximately $245 million ("the Transaction"), subject to certain conditions and adjustments. After a public hearing, the Board issued Order 146/99 dated July 30, 1999, wherein the Board approved the Transaction and commented on several matters examined at the public hearing. The Board expressed concerns but concluded that, on balance, the Transaction would not unduly impact the continued provision of safe and reliable service, and would not negatively impact competition in either the gas or electric industry. The Board also concluded that while there would be risks, the Transaction, if well managed, should have no significant negative impact on the rates charged to ratepayers of the gas or electric utilities.

The Board stated, that "Approval of the Transaction does not confer any approval for Hydro to functionally integrate or corporately merge Centra's operations into Hydro's operations." Order 146/99 also included a number of specific directives which would require subsequent follow-up by the Board.

On November 30, 2001, Hydro provided the Board with an update on the Integration of Centra, including information on how costs and synergies are allocated between the electric and gas utilities. The filing also responded to the Board's recommendations and directives from Order 146/99.

In this Order, the Board has directed Hydro to account for the Acquisition Transaction and Integration Costs in the books and records of Hydro as opposed to Centra for regulatory purposes. The Board has also directed Hydro to file a revised listing of Acquisition Costs, Integration Costs and Integration Savings, as well as a revised Impact Analysis of the Transaction and Integration on consolidated Net Income and Rates based on specific directions contained in this Order. These matters will be reviewed as part of the Centra General Rate

Application, based on a 2003/04 future test year, which the Board has directed be filed by no later than December 9, 2002.

The Board has directed Centra to apply the full amount currently included in sales rates for income taxes of approximately $11 million each year to fully extinguish the one-time tax related debt and carrying costs as quickly as possible. The amortization period of 30 years for the acquisition and integration related costs was accepted.

In response to a number of concerns expressed by Intervenors, the Board requested Hydro and Centra to establish a more regular schedule for periodic rate reviews for each utility to improve the efficiency, effectiveness and timeliness of the regulatory process. The Board also directed that the time period between GRA's for each utility should not exceed three years, even if no rate changes are requested.

1.0 Appearances

R. Peters	Counsel for The Manitoba Public Utilities Board (“the Board”)
M. Murphy O. Fernandes	Counsel for Manitoba Hydro Electric Board (“Hydro”)
B. Meronek, Q.C. K. Saxburg	Counsel for Consumers’ Association of Canada (Manitoba) Inc./Manitoba Society of Seniors Inc. (“CAC/MSOS”)
T. McCaffrey	Counsel for Manitoba Industrial Power Users Group (“MIPUG”)
J. Feldschmid	Counsel for Canadian Centre for Energy Policy Incorporated (“CCEP”)
J. Hayden	Communications, Energy and Paperworkers Union, Local 681 (“CEPU”)
E. Fleming	Provincial Council of Women of Manitoba, Inc. (“PCWM”)
K. Melnychuk	Municipal Gas, A Division of Direct Energy Marketing Limited (“Municipal Gas”)

2.0 Witnesses for Hydro

V. Warden	Chief Financial Officer, Vice President, Finance & Administration
G. Rose	Vice President, Customer Service & Marketing
C. Wray	Division Manager, Business Analysis & Regulatory Affairs
W. Derksen	Manager, Management Accounting and Budgeting
R. Owen	Partner, Assurance Practice, KPMG LLP
E. Cassells	Principal, Policy Economic and Financial Analysis, KPMG LLP
J. Ehrling	Principal, Policy Economic and Financial Analysis, KPMG LLP

3.0 Intervenors of Record

The Board granted Intervenor status to the following:

1. Consumers’ Association of Canada (Manitoba) Inc./Manitoba Society of Seniors Inc. (“CAC/MSOS”)
2. City of Winnipeg
3. Municipal Gas
4. Manitoba Industrial Power Users Group (“MIPUG”)
5. Communications, Energy and Paperworkers Union, Local 681 (“CEPU”)
6. Provincial Council of Women of Manitoba (“PCWM”)
7. Canadian Centre for Energy Policy Inc. (“CCEP”)
8. Manitoba Keewatinowi Okimakanak Inc. (“MKO”)
9. Time to Respect Earth’s Ecosystems/Resource Conservation Manitoba (“TREE”)

Subsequent to the City of Winnipeg registering as an Intervenor, Hydro entered into negotiations with the City of Winnipeg to purchase all of the assets of Winnipeg Hydro. As a result of this transaction, the City of Winnipeg withdrew from active participation as an Intervenor in this hearing.

4.0 Witnesses for CAC/MSOS

J. Todd	President, Econalysis Consulting Services, Inc.
B. Harper	Manager, Econalysis Consulting Services, Inc.
M. Matwichuk	Partner, Stephen Johnson, Chartered Accountants

5.0 Background

In May 1999, Westcoast Energy Inc. ("WEI") and Hydro executed an agreement for the purchase and sale of all of the issued and outstanding shares of Centra Gas Manitoba Inc. ("Centra") for a price of approximately $245 million ("the Transaction"), subject to certain conditions and adjustments. Pursuant to The Public Utilities Board Act ("the Act"), the agreement required Board approval, and after canvassing all interested parties of record, the Board determined that the public hearing should examine the impact of the Transaction on:

- the provision of safe and reliable service
- rates charged to ratepayers of both utilities
- competition in both the electric and natural gas industries in Manitoba
- future regulation of each of the utilities

In Order 146/99 dated July 31, 1999, the Board approved the Transaction and commented on several matters examined at the public hearing. The Board expressed concerns but concluded that, on balance, the Transaction would not unduly impact the continued provision of safe and reliable service, and would not negatively impact competition in either the gas or electric industry. The Board also concluded that while there would be risks, the Transaction, if well managed, should have no significant negative impact on the rates charged to ratepayers of the gas or electric utilities. The Board did express concern that there was little margin for error in controlling costs and realizing cost savings, and that there existed a real and significant risk for both utilities' customers should the forecasted savings and synergies not materialize.

During the Acquisition Hearing in 1999, there was a strong message from Intervenors that their support of the Transaction was predicated on the Board maintaining a very strong regulatory oversight of the two utilities. In Order 146/99, the Board emphasized that there should not be a change in the method of regulating either utility in the near future as a result of the Transaction.

The Board also stated, that “Approval of the Transaction does not confer any approval for Hydro to functionally integrate or corporately merge Centra’s operations into Hydro’s operations.”

The Board issued the following directives in Order 146/99:

1. Hydro submit, for Board approval, at the earliest possible time, a functional Integration Plan including an annual monitoring process.

2. Hydro record all costs and revenues separate from electric costs and revenues for regulatory purposes.

3. Hydro record separately all direct Acquisition Costs for review by the Board on an annual basis.

4. Hydro record separately all direct Integration Costs for subsequent review by the Board.

5. Hydro record separately all cost savings directly related to the Transaction for subsequent review by the Board.

6. Within twelve months of the date of closing, Hydro report to the Board on the revised estimate of Acquisition Costs, Integration Costs, expected cost savings, and a proposed plan as to how the net benefits arising from the Transaction are to be shared between the customers of the gas and electric utilities.

7. Hydro make applications to the Board at the earliest possible date for confirmation of the rates for the year 2000 for both the gas and electric utilities.

8. Hydro consider a shorter amortization period for all costs of the Transaction, including Integration Costs and Goodwill.

9. Hydro not cross-subsidize the operations of one utility using the operations of the other utility.

10. Hydro consider the need for a new code of conduct, which addresses how customer information and business Transactions should be shared between the two utilities.

On January 4, 2001, Centra filed a General Rate Application ("GRA") with the Board based on a 2001/02 test year. The GRA included an estimate of annual Integration Savings of $12.5 million and discussed the key assumptions for the baseline financial projections used to determine these savings. The Board issued Order 14/01 on January 24, 2001 that established a timetable for the public hearing. At that time, Integration Matters were to be considered in conjunction with the GRA hearing initially scheduled to commence on May 29, 2001. The Board also expanded the minimum filing requirements that Centra would be required to file in support of the GRA.

In Order 106/01 dated July 27, 2001, the Board agreed with Hydro's proposal that the examination of Integration Matters be detached from the proposed Centra GRA, and be held in conjunction with a proposed Hydro GRA. Subsequently on November 30, 2001, Hydro filed a Status Update Filing which included Integration Matters. The Board determined the Hydro Status Update Filing, including the reasonableness of Hydro rates, was a matter separate from Integration Matters, including the Board's decisions and directives in Order 146/99. Accordingly, the Board conducted separate hearings into these matters. A separate Board Order will be issued in respect of Hydro's Status Update Filing.

A pre-hearing conference was held on January 16, 2002 to define the scope of the hearing to deal with Integration Matters and to establish a timetable for the orderly exchange of information. A public hearing was held on various dates between April 16 and 26 and the Board heard final arguments on May 21, 2002.

6.0 The Filing

Order 146/99 directed Hydro to submit, for Board approval, at the earliest possible time, a functional Integration Plan including an annual monitoring process. In addition, the Board directed that within 12 months of the date of closing of the Transaction (July 31, 1999), Hydro report to the Board on the revised estimate of Acquisition Costs, Integration Costs, expected cost savings, and a proposed plan as to how the net benefits arising from the Transaction would be shared between the customers of the gas and electric utilities.

On November 30, 2001, Hydro provided the Board with an update on the Integration of Centra, including information on how costs and synergies are allocated between the electric and gas utilities. The filing also responded to the Board's recommendations and directives from Order 146/99.

Hydro identified the following objectives for a successful integration:

1. To be a one-stop energy company to meet customers' total energy needs.
2. To attain cost savings of as least $12 million per year.
3. To build a strategically stronger energy company better equipped to meet the energy needs of Manitobans and the competitive challenges of the future.
4. To minimize rate increases to customers.
5. To provide challenging learning and growth opportunities for employees.

Hydro stated that the highest standards of safety, reliability and commitment to customer service have been maintained throughout the Integration Process, and that the impact of integration would not in any way compromise the high level of satisfaction previously enjoyed by customers of both utilities.

7.0 Accounting for the Transaction

The framework that Hydro proposed for accounting for the acquisition of Centra provides that all costs identified with the acquisition and integration of Centra be allocated to Centra. These costs include:

- The amortization of Acquisition Costs and Integration Costs;
- The Acquisition Premium, being Goodwill and the depreciation and amortization related to the difference between the fair market value of the assets and liabilities acquired and the carrying value of those assets and liabilities on Centra's books; and
- The financing costs associated with the purchase and integration of Centra with Hydro.

Hydro stated that accounting for the acquisition in Centra's books ensures that the results of the electric operation would not be negatively impacted by the acquisition. As well, to ensure that Centra's financial results are not negatively impacted, Hydro committed that the first $12 million in synergy savings be allocated to Centra, thus providing an offset to the acquisition-related costs.

Hydro noted that although some other jurisdictions had not allowed the Acquisition Premium including Goodwill to be recovered in rates of the utility acquired, these cases related to acquisitions as investments and did not contemplate a complete integration.

7.1 The Purchase Price

Hydro stated the Purchase Price was as follows:

	Millions
Net book value of Centra's assets at July 31, 1999	$398
Net book value of Centra's liabilities at July 31, 1999	(277)
Net book value of Centra's net assets at July 31, 1999	121
Write-up of assets to fair market value	73
Write-up of liabilities to fair market value	(17)
Goodwill	65
Total Purchase Price	$242

The write-up of assets and liabilities is being amortized over 30 years, which Centra contends is consistent with the average remaining useful lives of the assets acquired. The Goodwill was being amortized over that same 30-year period until the Canadian Institute of Chartered Accountants ("CICA") issued a new accounting recommendation effective for fiscal 2002. This new recommendation requires that Goodwill no longer be amortized but be reviewed periodically for impairment in fair value as compared to carrying value, and if impaired, written down at that time. As at the hearing date, Hydro had not conducted an impairment review with respect to the Acquisition Goodwill, but maintained that the Goodwill determined at the Acquisition Date was not impaired.

7.2 One-Time Tax Liability

Immediately following the Transaction, Centra became a tax-exempt entity when it became a wholly-owned subsidiary of Hydro. As a result, a one-time tax liability, originally estimated at $78 million, but ultimately determined to be $58 million, was payable by Centra. Hydro stated that the reduction in one-time tax from that originally estimated was a result of a reduction in the tax value of the assets used in calculating the one-time tax liability. Hydro further stated that reduction in tax value of assets was unrelated to the value of Centra for purposes of the Transaction.

At the Acquisition Hearing, Hydro indicated that it planned to use the income tax component of approximately $11 million currently embedded in Centra's sales rates to pay down the one-time tax liability over time. Hydro intended to record the one-time tax payment as a deferred amount on Centra's balance sheet which would also attract carrying costs. The approximate $11 million currently embedded in Centra's sales rates would be applied against the deferred tax amount until such time as the principal amount of the transfer tax was recovered. At the 1999 hearing, it was estimated that the principal amount of the tax liability would be repaid in approximately eight years. Following the repayment of the principal amount of the transfer tax, approximately $4 million per year would be paid to the Province of Manitoba, and $7 million per year would pay down the carrying costs. It was expected that once the carrying costs were fully paid, the entire $11 million tax component included in Centra's rates would be paid to the Province. At this hearing, Hydro indicated that the Province of Manitoba had recently agreed to forego all payments related to the one-time tax matter that were to commence approximately eight years after the Acquisition.

As a result, Hydro altered its accounting treatment and proposed to amortize the tax balance and related carrying charges over 30 years or approximately $2 million each year.

7.3 Undisclosed Liabilities

Hydro stated that it is satisfied that there has been no breach of the Representations and Warranties contained in the purchase agreement and, therefore, no basis for recovery of costs from WEI at this time for the environmental issues related to the Sutherland facility and the Portage la Prairie site. Costs are currently estimated to be approximately $510,000 which is less than the $1 million threshold stipulated in the Agreement. Hydro stated that it would continue to monitor environmental issues and costs at these sites to ensure that no claims are warranted within the five-year timeframe provided in the Agreement.

7.4 Intervenor Positions

CAC/MSOS

CAC/MSOS submitted that the Transaction could, at this point, not be reversed. It was their position that the acquisition should be accounted for in the records of Hydro not Centra and that both the gas and electric ratepayers should be held harmless. Any integration expenses not offset by synergies would be absorbed by the retained earnings of Hydro. However, as Hydro was confident of achieving synergies in excess of costs, there would be minimal risk to ratepayers.

CAC/MSOS stated that the 30-year amortization period used for the write-up of assets and liabilities, as well as the Acquisition and Integration Costs, should be shorter as the longer amortization period results in inter-generational inequities and greater carrying costs. CAC/MSOS added that the Board would have to weigh the risks associated with choosing not to amortize Goodwill with the impact on consumers of passing through amortization of Goodwill in rates.

CAC/MSOS noted Mr. Matwichuk's observation that other jurisdictions have disallowed the inclusion in rates of the Acquisition Premium including Goodwill and the write-up of assets and liabilities to fair market value. CAC/MSOS stated that there is a real risk that there will eventually be a loss in the value of Goodwill if synergies are not sustained. As a result, rates would have to increase to recover such costs.

With respect to the income tax issue, CAC/MSOS stated that Centra's proposal for the payment of income tax is not consistent with the no harm principle, and since there is no income tax expense, a component for taxes should not be included in rates. CAC/MSOS also expressed concern that there is no guarantee that the Provincial government will not reinstate the "grant-in-lieu" arrangement, once the one-time tax is fully paid.

MIPUG

MIPUG was of the view that the accounting for the Transaction by Hydro and Centra has become scrambled. The pushdown approach results in a synergy short fall being charged to electric customers. MIPUG suggested that the acquisition, integration and the related costs be accounted for in the parent of both the electric and gas utility. Such treatment would ensure that the ratepayers are held harmless and that the risks and benefits accrue to the same entity. Under this approach, Centra would account for items as it had prior to the Transaction. Dividends would be paid to finance the acquisition, the same way WEI financed the costs when it purchased Centra's shares.

8.0 Acquisition Costs

At the Transaction hearing, Hydro had estimated that Acquisition Costs would be approximately $4 million. Hydro stated that it has recorded all direct Acquisition Costs separately. Acquisition Costs incurred to September 30, 2001 were $3.9 million, comprised of $3.7 million of direct costs and $0.2 million of internal labour and overhead charges.

A break down of the Acquisition Costs is as follows:

Acquisition Costs by Element ($ thousands)

Cost Element	Actual to September 30, 2001
Acquisition advisors	$2,151
Legal advisors	837
Valuation/Fairness opinion	363
Due diligence	228
Internal hearing costs	207
Actuarial	39
Other	71
	$3,896

8.1 Internal Due Diligence Costs and Hearing Costs

Hydro is of the view that internal due diligence costs are non-incremental costs, and should not be included in Acquisition Costs. In addition, since WEI paid for the Transaction hearing costs in 1999, these costs have not been included as Acquisition Costs.

8.2 Intervenor Positions

CAC/MSOS

CAC/MSOS supported the view of Mr. Todd and Mr. Harper that not all incremental costs resulting from the acquisition were captured by the reporting process. By failing to capture internal Acquisition Costs and undisclosed liabilities in the analysis, Centra did not hold to its definition of direct costs, being all costs associated with the acquisition. CAC/MSOS noted that third party costs that were incurred during the due diligence phase of the acquisition were included as Acquisition Costs even though the completion of the Transaction was uncertain. To be consistent, internal due diligence cost should also be included as Acquisition Costs.

9.0 Integration Costs

Hydro stated that it has separately recorded all direct Integration Costs. Direct Integration Costs incurred to September 30, 2001 were $9.4 million, compared to the $13.6 million estimated by Hydro at the Centra Acquisition Hearing, detailed as follows:

Integration Costs ($ thousands)

Costs		**Actual to September 30, 2001**	**Projected at 1999 Acquisition Hearing**
Early Retirement Program		4,080	5,100
Training & Personnel Related Costs		284	0
Network Integration		145	500
Accounting System Integration		562	500
Billing System Integration		0	3,000
Other Integration Planning and Administration Costs:			
Human Resources	1,574		
Transmission and Distribution	347		
Customer Service	346		
Customer Billing and Information Technology	468		
Finance	275		
Regulatory and Legal	721		
Other	583		
Total Other		4,314	4,500
Total		**9,385**	**13,600**

Hydro intends to capitalize costs related to this hearing as Integration Costs once they are known and incurred.

Of the $9.4 million of Integration Costs, $5.7 million relates to direct costs and $3.7 million relates to internal labour and overhead charges. Of the $3.7 million of internal labour and overhead, $2.9 million relates to Hydro staff and $0.8 million relates to Centra staff.

Hydro stated that integration was a discrete activity, while implementation was embedded into other ongoing business activities, and would have been very time-consuming and expensive to record. Hydro also submitted that no incremental funding was provided to implement team recommendations, and therefore concluded that implementation costs were not direct Integration Costs and should not be included.

9.1 Early Retirement Program (“ERP”) Costs

Expenditures related to ERP were approximately $4.1 million or $30,000 per position. Hydro stated that if Centra had not been acquired, there would not have been a reason to offer a voluntary early retirement plan to all Hydro employees in 1999. Therefore, all expenses relating to positions included in synergy savings have been included as Integration Costs.

9.2 Customer Information System (“CIS”) Costs

Prior to the Transaction, Centra used the Banner CIS through a licensing agreement with Enlogix, a company related to WEI. Hydro developed a short list of potential vendors for its own CIS, based on a 10-year net present value analysis and concluded that using the Enlogix system provided the highest benefit. Therefore, considering the economic and qualitative analysis, the project team recommended that Hydro purchase a license for the Banner CIS from Enlogix to be used by Centra. As a result, Centra acquired its own software license and installed and operated it on Hydro owned hardware. The cost of purchasing the Banner system was approximately $4.6 million, including computer hardware, the Banner software license, internal labour, Enlogix delivery and installation, scheduling software, computer room renovations, and other miscellaneous expenditures.

Although it is anticipated that the Banner CIS will be used to service both gas and electric customers in the future, the decision to proceed with that specific course of action for the electricity customers has not yet been made. The cost to add the electric customers to the Banner CIS is estimated to be $10.5 million.

Hydro stated that the benefits of migrating electric customers to a new CIS are related to the electric side of the business. It is not considered to be a part of the Integration because Hydro would have required an updated CIS even if Centra had not been acquired. The costs of purchasing the Banner system, should Hydro decide to do so, are directly related to Hydro operations. However, in Hydro's view, the operating saving related to having a common CIS with Centra is integration related, and as such, would be categorized as a synergy savings.

9.3 Financing Costs

In addition to financing required for the Acquisition and Integration Costs, there are two specific advances from the Province of Manitoba to Hydro that are related to the acquisition of Centra. The terms of these advances are as follows:

Purpose	Principle	Yield Rate	Maturity Date
Purchase price	$242 million	6.212%	September 1, 2029
Transfer tax	$58 million	6.237%	February 22, 2010

The yield rate above does not include the provincial guarantee fee. At the time of the Transaction the Provincial guarantee fee was 0.65%. The rate increased to 0.70% in May 2000 and to 0.95% in April 2001. Hydro added that the acquisition of Centra increased Hydro's debt ratio by approximately 0.6%.

9.4 Other Integration Costs

Hydro stated that integration has not resulted in any stranded assets. However, a number of assets have become surplus or redundant, including office buildings, vehicles and work equipment, office furniture and computer equipment. All surplus office buildings are either sold or are in the process of being sold. The redundant assets related to staff reductions have been redeployed thereby creating a reduced requirement for new or replacement assets in the future. The book value of surplus office buildings was $659,000 with an estimated market value of $814,000. Hydro noted that overall, redundant assets are expected to be sold for more than their net book value. Therefore, there is no cost related to redundant assets resulting from the Integration.

The harmonization of wages and benefits and the pension resolution resulted in a $5.8 million increase in the actuarial liability of the Union Employees Pension Plan, of which $2.8 million would be financed through actuarial surplus. Hydro noted that the pension cost change, although represented as a lump sum, is a recurring, annual cost and as such, it is inappropriate to capitalize these costs. Hydro was of the view that it was not possible to reasonably allocate any portion of the pension cost to direct Integration Costs as there was a pre-existing dispute between the Centra employees union and former management.

Overtime costs in Hydro and Centra did not fluctuate materially over the period 1999 to 2001. Therefore, Hydro is of the view that all incremental wage costs had been captured in the Integration Costs listed above.

9.5 Intervenor Positions

CAC/MSOS

CAC/MSOS supported the view of Mr. Todd and Mr. Harper that not all incremental costs resulting from Integration Activities were captured by the reporting process. Implementation costs should have been included in Integration Costs by Hydro, but were not. CAC/MSOS stated that implementation is not part of normal company activity and would likely represent a significant cost to the company. Similarly, human resource harmonization costs should be considered including the additional pension costs, salary increases, and holiday changes but these costs have not been included as Integration Costs. It was also CAC/MSOS' view that costs of the Integration Hearing should be included as Integration Costs.

CAC/MSOS was of the view that the repatriation of the Banner CIS system was done with a view to combining the electric and gas customers onto one system. It is unlikely that this event would have occurred under WEI ownership. Therefore, the cost of repatriation as well as the cost to transfer electric customers should be considered as an Integration Cost to the extent that cost savings have been considered as a benefit.

10.0 Integration Savings

In Order 146/99 the Board directed Hydro to record separately all cost savings directly related to the Transaction for subsequent review by the Board. Hydro stated that each business unit adopted a common process to identify, prioritise and monitor the planning of integration at the functional or line level in the organization. The following processes and controls were put in place to ensure the projected cost savings were appropriately determined and results were accurate, as requested by the Board:

- Synergy projections were developed based on previously approved budgets;
- An appropriate measurement and reporting framework was established and communicated to staff;
- Staff familiar with gas and electric operations developed the synergy targets and implemented the processes designed to achieve those targets;
- Synergy savings reporting accrued on an ongoing basis;
- Executive oversight occurred at all stages of the process;
- Independent reviews and cross checks were put in place;
- Synergy targets were embedded into budgets and business unit Vice-Presidents are responsible to achieve those targets; and
- A Top-Down review was performed to ensure that synergies were achieved.

Hydro submits that it was in regular contact with the Board with regard to its Integration Plans and Processes. In Hydro's view, a hearing to review the plan would have been unnecessary and expensive. According to Hydro, the fact that the Intervenors were not consulted did not change the appropriateness of the plan. Hydro reminded the Board that KPMG estimated at the

Transaction hearing that even though synergy savings were expected to exceed $12 million, achievement of a minimum of $6 million of synergy savings was required for the Transaction to be fair from a financial point of view.

Hydro developed both a Bottom-Up approach and Top-Down approach to identify, track, and to the extent possible verify cost savings associated with integrating the operations: .

10.1 Bottom-Up Approach

Progress of the work of teams established to identify and quantify synergy cost savings, and subsequent work of line departments charged with the responsibility to pursue identified savings, was reported to senior management at regular intervals. Hydro estimated that it has achieved synergy savings of $13 million for the 12-months ended September 30, 2001 as follows:

Bottom-Up Cost Savings ($ millions)

Cost Area	**Total Annual Projected Savings**	**Total Actual Savings Year Ended September 30, 2001**	**Over/Under**
President & CEO	3.4	3.4	
Finance & Administration	5.7	4.1	(2.4)
Transmission & Distribution	0.7	0.8	(0.2)
Customer Service & Marketing	2.7	1.4	(2.0)
Corporate Other:			
Enlogix Replacement	0.2		(0.2)
Space Planning	1.4	0.1	(1.4)
Early Retirement Program	2.1	3.4	2.0
Total Estimate of Synergy Savings	16.2	13.2	(4.2)

Annualized savings refers to the estimated actual savings expected for a twelve-month period if no further Integration activities were to occur as at September 30, 2001. Hydro stated that actual cumulative synergy savings achieved to September 30, 2001 was approximately $22.1 million.

10.2 Top-Down Approach

The Top-Down approach is a calculation of the difference in the total costs of operations of the two utilities between an estimate of what would have occurred under the previous separate ownership and what actually occurred under Hydro ownership. Hydro stated the Top-Down approach serves as a verification of the synergy savings identified through the Bottom-Up approach. Hydro's Top-Down approach calculation of savings is as follows, based on data for the year ended March 31, 2001.

Top-Down Cost Savings

	$ Million	
Estimate of operating costs that would have occurred under separate ownership per approved budgets		
Hydro		247.8
Centra		55.7
		303.5
Add (deduct): 2000/01 events not contemplated in budgets		
- Accounting policy change for past service pension costs (CICA 3461)	(10.3)	
- Unusual level of storm activity	2.5	
		(7.8)
Adjusted estimate of base operating costs		295.7
Less: Actual operating costs		285.5
Estimate of overall cost reductions realized		10.2

10.3 Baseline Measurement

The information available to Hydro at the Transaction date consisted of budgets approved by the Centra executive prior to acquisition. Hydro reviewed these budgets, and with some minor adjustments, accepted them as being reasonable. Hydro considered the baseline information as the best available and the appropriate benchmark from which to calculate synergy savings, as it was based on the 1998 PUB approved budget adjusted for known and expected changes.

Hydro stated that its annualized operating and administration cost per customer was in the range of $167 and $215 over the period of March 2000 to February 2002. These figures were consistent with or lower than the approximate cost per customer of $200 achieved during 1998.

10.4 Vacant Positions

Hydro was of the view that savings related to unfilled vacant positions should be considered to be synergy savings. Hydro considered that the vacant positions were budgeted to be filled and would have been filled if the Integration of related functions had not occurred. A total of 16 vacant positions were included in synergy savings estimates of $960,000 to September 30, 2001.

10.5 ERP Positions not Implemented

As at September 30, 2001, 132 employees had accepted early retirement packages as a result of integration. The average salary level used to calculate synergy savings was $50,000 plus benefits of 20% of salary. In situations where salary savings were, on average, exceptionally high or low, the average for that work group was used. Of these, 57 positions related to team plans where plans had not yet been implemented.

10.6 CIS

As discussed previously, Hydro is evaluating the possibility of transferring its electric customers to the Banner CIS system. The annual operating cost reduction associated with the migration of electric customers to Banner was forecasted to be $4 million. Hydro is of the view that should this transfer occur, it would not be as a result of the Integration. Therefore, Hydro has not included the projected costs or the savings related to the Hydro CIS in the Integration Costs nor Synergy Savings calculations.

10.7 Income Tax Savings

Hydro was of the view that income tax savings of approximately $11 million each year should be included in the evaluation of the Transaction and the Integration.

10.8 Rate of Return

Hydro stated that Centra had not implemented any general rate changes since its acquisition by Hydro, and as a subsidiary of a Crown Corporation, Centra would not, in the future, be seeking a return on its invested capital at the same level as in the past. Hydro was of the view that the resulting future lower rate increases should be considered in the evaluation of the Transaction and the Integration.

10.9 Other Savings

Centra reduced its capital forecast for the period 1999 to 2003 by approximately $10.7 million after the acquisition. Centra stated that the reduction was not related to the acquisition, but rather to a decrease in the level of government funding available for expansion projects which resulted in lower projected customer attachments. Therefore, Centra was of the view that the capital cost reductions should not be considered in the evaluation of the Transaction and the Integration.

Hydro stated that shared services costs from WEI were eliminated and would not be recurring. Therefore, it was appropriate to include these amounts as synergy savings.

10.10 The KPMG Report

Hydro retained KPMG LLP ("KPMG") to provide an independent review and assessment of the appropriateness of Hydro's estimates of, and accounting for, Centra Acquisition Costs, Integration Costs and synergy savings.

Based on their review of the current cost accounting system and its application at Hydro, KPMG concluded that:

- A logical conceptual framework of cost generation with the business underlies the costing system.
- The costing system had been developed with sufficient management perspective with respect to the nature of the business.
- The system was applied consistently and rigorously over time and across the organization.
- Adequate quality assurance provisions were in place to provide a reasonable expectation of accuracy regarding the results of the system.

- The gas utility has been appropriately incorporated into the current cost accounting system of an integrated utility.

Accordingly, within the scope of KPMG's review, they concluded that the cost accounting system had been designed and applied so as to avoid potential cross-subsidy between the gas and the electric ratepayers. KPMG also concluded that the cost accounting framework in place for fiscal year 2001 was appropriate with respect to the treatment of costs in the transitional period.

KPMG stated that they had no concern with the treatment of Acquisition and Integration Costs and synergy savings and the allocation of costs between the gas and electric utilities, and in particular, the issue of potential cross-subsidy.

Based on information obtained and procedures performed during their review, KPMG concluded that the framework employed by Hydro to record and allocate Acquisition and Integration Costs to Centra was appropriate and consistent with the PUB directives outlined in Order 146/99.

Hydro's estimate of achieved synergy savings of approximately $12 million for fiscal year 2001 was reasonable according to KPMG, and the annualized achieved synergy savings of approximately $13 million reported as at September 30, 2001 were reasonable.

KPMG stated the projected future synergy savings of approximately $16 million had been estimated on a consistent basis, and mechanisms are in place to achieve remaining synergy savings. Synergy savings have been quantified and recorded in accordance with the commitments made by Hydro at the 1999 hearing and the associated recommendation and directives from the Board.

After reviewing the KPMG report, hearing the KPMG witnesses testify, and considering the comments of the Intervenors, the Board has given the KPMG evidence little weight in its deliberations.

10.11 Intervenor Positions

CAC/MSOS

Based on the evidence presented by Mr. Todd and Mr. Harper, CAC/MSOS argued that the $13 million estimate of annual synergy savings was overstated and should be more appropriately be in the order of $0 to $6 million. CAC/MSOS believes that although the acquisition may have been the impetus, it was not the cause, and as such, most of the savings could have been achieved in any event. CAC/MSOS stated that gas ratepayers are not being held harmless, and consumers would not see any benefit from the Transaction until well into the future.

CAC/MSOS stated that the Bottom-Up approach used by Hydro and Centra was not complete. However, the costs to re-perform the Bottom-Up approach would outweigh the benefits. Therefore, the Top-Down approach would have to be used to determine the quantum of synergy savings, and the baseline forecast was the lynchpin of this approach. CAC/MSOS reiterated the concerns of Mr. Todd, Mr. Harper and Mr. Matwichuk that the Board had not reviewed the baseline forecast. In the past, such reviews had typically resulted in reductions to Centra's allowed expenses. A reduction in the baseline would reduce the amount of synergies achieved. Based on the analysis performed by Mr. Todd, Mr. Harper and Mr. Matwichuk regarding operating and administration costs per customers, CAC/MSOS concluded that the baseline forecast was overstated. CAC/MSOS added that Centra's baseline forecast did not include the impact of tax reductions, decreases in the cost of financing, or productivity gains that would have been achieved by Centra in any event.

CAC/MSOS supported Mr. Todd and Mr. Harper's statement that the number of equivalent full-time ("EFT") employees increased from 1999 to 2002. This increase brought into question the sustainability of savings related to staff reductions. In addition, the fact that positions were deleted in parts of the organization that were not affected by the Integration suggests that there were efficiencies to be gained in Hydro in any event.

Mr. Todd and Mr. Harper stated that savings attributable to the elimination of vacant positions should not have been included in total synergy savings. Moreover, the 57 positions had no link to Integration activities and should not be included in synergy savings. CAC/MSOS added that Hydro and Centra had not discharged their onus of proof, given the inconsistent analysis of EFT's.

CAC/MSOS was of the view that the short-term incentives of the executives could not be determined and long-term incentives of the executives had previously been disallowed by the Board. Therefore, both these amounts should not be included as a synergy savings. Moreover, the salary of a Centra executive that is currently working for Centra and Hydro should not be included as a synergy savings.

Mr. Todd and Mr. Harper were of the view that the costs related to the repatriation of the Banner CIS and the transfer of electricity customer to the Banner system should be included in the Integration Analysis. CAC/MSOS stated that as no benefits had accrued related to the CIS system, no synergy saving should be attributed to this initiative at this time.

CAC/MSOS further added that the costs to engage KPMG were excessive and that the KPMG report was of limited use and should be given no consideration by the Board in its deliberations.

CCEP

CCEP was of the view that the Bottom-Up approach could not be used and that the Top-Down approach was the only approach available.

11.0 Allocation Methodology

Hydro identified the prime considerations of the cost allocation processes to be:

- Providing a fair and equitable allocation to each of gas and electric operations;
- Meeting the business needs, both internal and external, of each utility; and
- Having consistency in methodology for both gas and electric operations.

Hydro's existing cost accounting methodology was used to meet the needs of both utilities. The methodology was based on full absorption costing principles, as follows:

- Work that is clearly in support of either gas or electric functions is identified, and costs are accumulated on the basis of direct disbursements and time spent. Time charged to this work is costed at an activity rate that is intended to recover the costs of carrying out that work.

- Work for integrated functions is identified, accumulated and charged to gas and electric operations, based upon appropriate cost drivers.

- Corporate overhead is added on to activity charges at a standard percentage rate and charged to gas and electric operations along with the activity charges. Where overhead is directly attributable to either gas or electric operations, but not both, it assigned only to the utility to which it pertains.

In accordance with Hydro's commitment made at the Transaction hearing, the first $12 million of annual synergy savings realized across the integrated operations were allocated to Centra for the year ended March 31, 2001. Synergy savings beyond that amount will be shared between the utilities on the basis of where the savings are actually realized.

Hydro stated that it was not cross subsidizing the operations of one utility with those of the other. Of the $12 million in synergy savings, $5.7 million was embedded in the direct allocation of operating expense to Centra from the integrated accounting system. The $6.3 million remainder, which represents synergy savings that have been allocated to the electric operations, was transferred to Centra through an inter-company account.

11.1 Intervenor Positions

MIPUG

MIPUG was concerned that the total amount of synergies reported by Hydro and Centra had not been achieved and that an over allocation of those savings had been transferred from Hydro to Centra.

12.0 Impact on Rates

Hydro did not make an application for confirmation of rates, arguing that there were no rate changes as a result of the Integration process. Since Hydro acquired Centra, gas rate increases have related only to changes in market-based commodity costs, over which the corporation has limited control. Since the acquisition, substantially all related savings and costs have been allocated to Centra.

For the initial period following the acquisition, baseline financial forecasts were prepared which, to the extent possible, replicated what would have occurred if the Transaction had not taken place. The baseline forecast prepared in fall of 2000 included projected general rate increases of 1.1% for 2000/01, 1.3% for 2001/02 and .07% for 2002/03 which were not requested. Thus, gas customer have benefited by not having had a general rate increase since the acquisition.

Hydro provided the following table to illustrate that the total impact of the acquisition of Centra by Hydro on consolidated net income is positive and therefore there has been no adverse impact on gas or electric rates as a result of the acquisition and integration.

Centra Gas Impacts on Consolidated Net Income - Comparison of Acquisition Hearing Baseline Forecast to Current Forecast

	Actual	**Year Ended March 31 ($ Millions)**									
	Aug/Mar 2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Operating revenue	87.0	121.0	126.0	129.0	130.0	133.0	137.0	140.0	142.0	146.0	149.0
Expenses	83.0	109.0	114.0	117.0	118.0	120.0	123.0	126.0	128.0	131.0	134.0
1999 Baseline Net Income After Taxes	4.0	12.0	12.0	12.0	13.0	13.0	13.0	14.0	14.0	14.0	15.0
Acquisition Related Adj's											
Synergies – gas		12.0	12.0	13.0	13.0	13.0	14.0	14.0	14.0	14.0	15.0
Synergies - electric		0.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	3.0
Income taxes saved		11.0	12.0	12.0	12.0	12.0	13.0	13.0	13.0	13.0	14.0
Transfer tax amort		(2.0	(2.0	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)	(2.)
Forecasting changes		3.0	6.0	8.0	10.0	15.0	19.0	24.0	29.0	35.0	42.0
Lower rate increases		(9.0)	(17.0)	(24.0)	(21.0)	(25.0)	(30.0)	(35.0)	(40.0)	(45.0)	(50.0)
Adjs. to Net Income	4.0	15.0	13.0	9.0	14.0	15.0	16.0	16.0	16.0	17.0	22.0
Acquisition Related Interest											
Amort of LTD FMV write-up		(2.9)	(2.9)	(2.1)	(1.4)	(1.3)	(1.3)	(1.1)	(0.7)	(0.7)	(0.6)
Int. acq./int. costs		0.3	0.4	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Interest on acq. debt		15.4	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7
Interest on trfr tax		3.6	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
PGF		3.2	4.3	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Reduction to debt/int. re: increased amort. and net income		(0.6)	(1.1)	(1.3)	(1.2)	(1.4)	(1.6)	(1.9)	(2.3)	(2.7)	(3.3)
Total Acq. Related Int.		18.9	20.1	21.1	21.9	21.8	21.6	21.5	21.5	21.1	20.5
Acq. Depr & Amort.											
Goodwill		2.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FMV write-up		2.5	2.5	2.5	2.5	2.3	2.0	2.0	2.0	2.0	2.2
Integration Costs		0.4	0.4	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Total Acq. Depr. & Amort.		5.1	2.9	3.0	3.1	3.0	2.7	2.7	2.7	2.7	2.8
Impact on Consolidated Net Income	4.0	3.0	2.0	(3.1)	2.0	3.2	4.7	5.8	5.8	7.2	13.7

12.1 Intervenor Positions

CAC/MSOS

CAC/MSOS stated that the objective of the public hearing was to ensure that both the electric or gas ratepayers were held harmless by the Transaction and integration. It is the view of CAC/MSOS that ratepayers have been harmed.

CAC/MSOS was of the view that there is no guarantee that the grant-in-lieu of taxes originally contemplated wouldn't eventually be reinstated. In addition, the tax savings could not be considered in the analysis, as savings did not occur as a result of the Integration.

CAC/MSOS also contended that lower rate increase should not be included in the analysis as there is no evidence that these rate decreases were as a result of the Integration or that they are permanent. CAC/MSOS added that there is no evidence that WEI would have requested rate increases in the future or that if requested, they would have been approved by the Board.

Mr. Matwichuk stated that if one were to accept the assumptions used by Hydro, then it would appear that gas customers might be no worse off. However, based on his analysis, actual benefits could be as much as $10 to $15 million lower than those calculated by Hydro.

MIPUG

MIPUG submitted that imprudent costs should not find their way into rates and that the underperformance of one utility should not impact the other. MIPUG added that future government charges should be fairly apportioned between the utilities. In addition, MIPUG was of the view that forgoing rate increases should not occur until the Acquisition and Integration Costs were paid. MIPUG added that tax savings should be used to pay for the costs of acquiring Centra.

MIPUG did not undertake its own analysis of the specific costs and savings related to the Integration and the acquisition. However, MIPUG did not disagree with the analysis performed by the witnesses of CAC/MSOS.

CCEP

CCEP stated that all measures necessary to ensure no harm comes to ratepayers should be taken. CCEP was of the view that the Acquisition Premium should not be included in rates. Impacts of the Transaction and the Integration should impact retained earnings only. CCEP added that Hydro, because of its size, is in a better position than Centra to absorb any negative fallout from the Transaction.

13.0 Safe and Reliable Service

Hydro stated that the highest standards of safety, reliability and commitment to customer service have been, and will continue to be maintained throughout the Integration Process. Hydro is committed to ensuring that the impact of integration will in no way compromise the high level of satisfaction enjoyed by customers of both utilities prior to integration.

Hydro further contended that integration has allowed for an expansion of programs, such as the Home Comfort and Energy Saving Program and the School Safety Program to gas customers who where previously served by Winnipeg Hydro. Programs are now available to both natural gas and electric consumers in the entire Province.

Hydro suggested that customer satisfaction and operational efficiency has increased because of the One Call, One Locate service for locating underground plant of both utilities by a single individual. Additionally, cross training of employees and amalgamation of District Offices has resulted in enhancing customer service in that only one contact is necessary to enable all classes of customers to address their electric and gas concerns. Customer surveys indicate that, generally, consumers remain satisfied with the level of services being provided.

In response to a number of information requests, Hydro stated that the control environment in place for the gas and electric operations remains unchanged from that in place prior to the Transaction, except that it is now under one organization. Safety is the number one priority governing Hydro’s operations. All operations continue to be carried out in accordance with standard electric and gas industry operating procedures and in compliance with Corporate Safety and Occupational Health Safety Rules and applicable legislation. Hydro submitted that necessary cross-training of employees was undertaken and, as a result, the ERP did not have any unmanageable impacts on Hydro’s ability to effectively and efficiently mange its business activities and affairs. Individuals selected for new positions as a result of the Integration Process were provided with appropriate training and on-the-job technical support. In addition, regular performance reviews are conducted to ensure competency is maintained.

Senior executives from Centra had provided the strategic direction prior to the acquisition. This was now the responsibility of Hydro executives. Hydro stated that, with respect to the day-to-day operations, both gas and electric operations had excellent management teams. These managers continue to be responsible for the provision of safe and reliable service.

13.1 Intervenor Positions

CEPU

CEPU was of the view that Centra and Hydro have maintained a safe and reliable system throughout the Integration and are committed to working with Hydro in the future. CEPU added that any major initiatives undertaken by Hydro, such as the implementation of electronic meter reading, should be reviewed by the Board prior to the costs of the projects being included in rates.

14.0 Competition

In Hydro’s view, Hydro and Centra are both regulated utilities with effective monitoring procedures in place such that there is no need for a formal code of conduct. The sharing of customer information between Hydro and Centra is essential to achieve Integration objectives including synergy savings. Restrictions on sharing customer information would significantly reduce the synergies that formed part of the justification for Hydro’s purchase of Centra. Hydro stated it is not currently aware of any issue related to the sharing of customer information, which has the effect of materially impacting competition.

Hydro has integrated its account management staff and business engineering staff so that they provide customers with a single point of contact for electricity and natural gas commodity sales and energy use advisory services. Account representatives and engineering staff use all relevant customer information to provide customers with advice on the best energy use practices and energy alternatives.

Hydro submitted that there has been no significant impact on Manitoba’s competitive nature with respect to the “gas-on-gas” market. The natural gas commodity market was deregulated prior to the acquisition, and any decrease in the number of Broker’s competing in Manitoba was the result of acquisition of some Brokers by other Brokers, and was not a result of the Transaction. Hydro also contended that, with respect to “gas on electricity” the competitive nature was positive because the customer was now able to get unbiased information from a single supplier of both gas and electricity. Hydro continues to provide certain services, primarily on the electric side, in competition with the private sector.

Hydro witnesses suggested that the acquisition had likely improved the competitive position of Hydro International in that it could now provide consulting services to the gas as well as the electric industry.

Hydro was reviewing its role with respect to the supply of natural gas. Two potential options that could affect competition were exiting the supply market entirely by selling or auctioning off Centra's customers, or entering the competitive market by offering a menu of supply options, such as a fixed price, specific term contracts. Hydro indicated that there was no set time frame for completion of this review.

14.1 Intervenor Positions

No Intervenors took a position on the matter of competition and the code of conduct.

15.0 Functional Integration

Hydro stated that it has incorporated the synergy savings into its annual budgeting process and there is no need to examine the baseline forecasts at a future GRA. Line management is charged with the duty of ensuring that the budgets are met, and as such, synergy savings are achieved on an annual basis. Eventually, Hydro intends to combine the Hydro and Centra corporate entities by some form of merger or amalgamation, but timing and process for such a merger or amalgamation has not yet been determined. Until then, it was Hydro's position that Board approval is not required for a functional integration.

15.1 Intervenor Positions

CAC/MSOS

CAC/MSOS stated that if Hydro and Centra had applied to the Board for approval of an Integration Plan, they could have avoided many of the issues discussed at the hearing. Referencing the ATCO case, CAC/MSOS was of the view that Hydro and Centra were performing an illegal activity by functionally integrating Centra with Hydro without Board approval. CAC/MSOS asked the Board to approve this 'merger' with conditions to formalize what has been done in practical terms. CAC/MSOS took the position that this approval should not impact the regulatory oversight of the Board over Centra.

MIPUG

MIPUG agreed with CAC/MSOS that a de facto merger had taken place, but the Board's jurisdiction was not diminished as a result. However, they disagreed with CAC/MSOS in that the Board was not required to approve this merger. MIPUG submitted that the onus should be on Hydro to come forth with a formal request for approval of the functional integration.

CCEP

CCEP, as a result of this hearing, was of the view that the Board was not under any obligation to approve a functional merger. Instead, the crucial task was to determine what impact the Transaction and the Integration will have on ratepayers. It was the view of CCEP that the Board should give some direction to Hydro and Centra in this regard.

16.0 Future Regulation

Hydro stated that it is committed to ensuring that the Board's directives are followed and its recommendations are considered in all actions taken. Hydro stated that Hydro and Centra will continue to strive to achieve additional benefits for ratepayers, but it should not make a difference whether these future benefits are labelled as acquisition or productivity related. Hydro also agreed that continued regulatory involvement and oversight was necessary and appropriate.

16.1 Intervenor Positions

CAC/MSOS

CAC/MSOS stated that the baseline could not be determined at this time due to lack of information. CAC/MSOS was of the view that an appropriate baseline should be established at the next GRA, from which the amount of synergies necessary to offset the costs of the acquisition would be deducted. This amount would be embedded into the revenue requirement for Centra and Hydro. As such, any inability to achieve synergies would not be passed onto ratepayers.

CAC/MSOS requested that the Board establish rules for going forward, keeping in mind that the commitment to achieve synergies and the onus of proof remains with Hydro and Centra.

Mr. Todd and Mr. Harper stated that the regulation of monopoly utilities is as important, if not more so, when the utility is owned by government as opposed to private shareholders. Events to date reinforce the Board's conclusion in Order 146/99 that "a comprehensive regulatory process must remain in place, with significant regulatory oversight to ensure that the interests of ratepayers are protected." As a start, regulatory review of both the electric and gas operations should occur on a regular basis regardless of whether or not rate increases are necessary.

Accountability to the customers who ultimately pay and transparency of decisions requires no less.

MIPUG

MIPUG was of the view that continued regulation of both Centra and Hydro was required to ensure that rates were fair and reasonable. MIPUG was concerned that electric ratepayers would find themselves paying for disallowed costs of the gas utility. Therefore, MIPUG asked the Board to establish clear, consistent workable ground rules for the acquisition and integration.

PCWM

PCWM submitted that the Board's role was to ensure the well being of both the public and the utilities in regulatory matters. PCWM added that it is difficult to determine whether the activities of the utilities are prudent with large time gaps between proceedings and asked that the Board establish a regular schedule for the utilities to come before the Board.

17.0 Board Findings

17.1 The Filings

In Order 146/99, the Board expressed the view that a detailed tracking process should be implemented so that synergy savings from the Transaction could be identified and shared with the appropriate customers groups. Hydro did file periodic reports with the Board which provided only summary information regarding Hydro's Integration Plan. However, many of the issues debated at this public hearing could have been avoided or simplified if the Integration Plan had been reviewed in a public forum at an earlier time. Hydro did not come forward with an application for review immediately after the Plan was developed. As most of the Integration Activities are now complete, there is no opportunity for the Board and the public to review the process prior to implementation. In the Board's view, Hydro did not fully comply with Order 146/99 with respect to the Functional Integration Plan.

The Board also notes with disappointment that neither Hydro nor Centra filed an application with the Board to seek confirmation of 2000 rates, as directed by Order 146/99. Many of the difficult issues discussed during this hearing, including those issues surrounding the baseline measurement, could have been dealt with more efficiently if both Hydro and Centra had filed information in support of confirmation of 2000 rates as directed by Order 146/99. The Board recognizes that a public hearing was held in 2002 to review Hydro's rates. However, Centra has not filed a GRA since the Acquisition Date. Hydro has now advised and the Board will so direct that Centra file a GRA by no later than December 9, 2002.

17.2 Accounting for the Transaction

The shareholders of Hydro initiated the purchase of Centra. The ratepayers of Hydro and Centra should be held harmless as a consequence of the Transaction. Therefore, the risks and benefits associated with the Transaction and the Integration should accrue to the shareholders of Hydro. The Board does not accept Hydro's arguments for recording all costs associated with the Integration on the financial statements of Centra. The Board is of the view that such methodology is inappropriate for regulatory purposes and makes it difficult to fairly assess the impact of the Integration on the operations of each of the two utilities. In addition, Centra is considerably smaller than Hydro, and the risk to gas consumers of a rate impact due to a misallocation of Integration Costs or synergy savings is greater. The Board will therefore direct Hydro to account for the Acquisition Transaction and the Integration Costs in the books and records of Hydro as opposed to Centra for regulatory purposes. This directive will have no impact on consolidated financial reporting, and will result in financial reporting for each separate utility for regulatory purposes that is, in the Board's view, more appropriate.

Hydro's analysis of the impact of the Transaction, and subsequent integration of Centra, on income and rates combines three separate and distinct issues. Hydro should segregate the analysis of each of these items when determining the impact of the acquisition and the Integration on Rates.

1. The Acquisition and Integration Costs:

    Hydro has assured the public that synergy savings will offset the Acquisition Costs, the Integration Costs and the related financing charges. To the extent that these costs are more than covered, the surplus of the synergies will be recorded as additional return on Hydro's investment, which will be available to Hydro to help pay the purchase price and related financing charges of the Transaction.

2. The Acquisition Premium including Goodwill:

The Board notes that Centra's current rates include a component for rate of return. This component of Centra's rates, plus realized synergistic savings will, over time, recover the Acquisition Premium and the financing charges related to the purchase price. The Board believes that this treatment is consistent with the economic intent of the Transaction.

3. The one-time transfer tax liability.

The current sales rates include approximately $11 million related to corporate income taxes which are no longer payable by Centra because of a change in tax status. At the Acquisition Hearing, the Board was advised that this amount would be applied in total each year to first pay down the principal amount of the debt incurred to pay this tax, following which $7 million would be applied to extinguish the carrying costs related to the debt and $4 million paid to the Province of Manitoba. After the carrying costs were paid, the full $11 million was to be paid to the Province of Manitoba.

In Order 146/99 the Board stated that the risk to ratepayers would be substantially reduced if the annual grant-in-lieu of taxes of $11 million was not required once that tax liability and related interest costs were paid. The Board welcomes Hydro's advice that the Government of Manitoba has indicated their intent not to collect this grant-in-lieu in the future.

At the current hearing, the Board heard that Hydro's intent is now to amortize the tax liability over a period of 30 years, which is not consistent with the Board's original approval of the transaction. The Board will therefore direct that Centra apply the full amount of income tax currently included in sales rates, of approximately $11 million each year, to extinguish the principal amount of the debt related to paying the one-time tax, plus carrying costs. This approach should extinguish the one-time tax related costs in less than 10 years, as opposed to the 30 years proposed by Hydro. Once the tax related debt and carrying costs have been extinguished, the Board will then reconsider the need to continue the income tax component in Centra rates.

The Board will direct Hydro to file a revised Impact Analysis of the Transaction and integration on consolidated Net Income and Rates, segregating these three components, as part of the Centra GRA by no later than December 31, 2002.

17.3 The Amortization of Goodwill

The Acquisition Premium consists of two components, one being a write-up of net assets to fair market value, and the second being purchased Goodwill. The write-up of assets of approximately $73 million is being amortized over the estimated useful life of the assets, and as such, will be included in depreciation charges, and recovered through sales rates over time.

The purchased Goodwill of $65 million was amortized for one year, but because of a change in accounting rules established by the CICA, is no longer being amortized. With respect to the accounting treatment of Goodwill, the Board recognizes that Hydro is following the new guidelines established by CICA. The Board is of the view that while these guidelines may be appropriate for financial reporting purposes, there are a number of issues that arise with this matter in the context of setting rates for regulatory purposes. Fundamentally, the purchased Goodwill is a cost that must be recovered through rates over time, just as any investment in capital assets must be recovered through rates over time. Since the Goodwill is not being amortized, there is no specific component in revenue requirement related to Goodwill. The cost of the purchased Goodwill, including carrying costs, must be recovered through a sufficient rate of return from Centra over time, and the achievement of this return is, in turn, tied to the issues of synergistic savings exceeding the costs of acquisition. For now, the Board will accept Hydro's treatment of the Acquisition Premium for rate setting purposes with the caution that any future impairment of Goodwill will be closely scrutinized by the Board, particularly with respect to the potential impact, if any, on future rates.

17.4 Acquisition Costs

The Board recognizes that Hydro has reduced the amortization period for Acquisition and Integration Costs from 40 years as indicated in the Acquisition Hearing to 30 years, which Hydro says is consistent with the useful life of the existing assets. The Board does not accept Hydro's view that the amortization period should be linked to the useful life of the utilities' other assets and is of the view that this lengthy amortization period creates inter-generational inequities. However, the Board is aware of the estimated level of synergy savings achieved by Centra and Hydro and acknowledges that a shorter amortization period could negatively impact rates for both utilities. Recognizing that a balance must be achieved, the Board will accept Hydro's amortization period of 30 years for acquisition and integration related costs at this time. The Board encourages Hydro and Centra to maximize the level of synergy savings achieved so that the recovery of the acquisition, integration, and related financing costs can be accelerated without negatively impacting rates.

The Board has reviewed Hydro's listing of Acquisition Costs and is of the view that Hydro's treatment of Acquisition Costs is inconsistent with the company's definition of direct costs. Hydro has chosen to include some Acquisition Costs, such as internal due diligence but not others, such as the internal labour for assembling the Transaction. The Board is of the view that

"Direct Costs" should be defined as additional expenditures incurred as a direct result of the acquisition. Internal labour and overhead expenses allocated to the acquisition would have been incurred in any event. Therefore, the Board will direct Centra to revise the listing of Acquisition Costs to include only Direct Costs as defined above, which will exclude internal labour and overhead charges, and file it with the Board with Centra's GRA by no later than December 31, 2002.

The Board notes that the potential additional costs related to the environmental issues identified at the Acquisition Hearing have not yet been quantified. The Board acknowledges that these costs are difficult to assess and may not be known for years. The Board expects Hydro to keep the Board informed regarding the status of these issues and their related cost estimates.

17.5 Integration Costs

The Board's comments and directives with respect to specific Integration Costs are discussed below, and the Board's comments and directives with respect to synergy savings are included in Section 17.6.

Direct Costs

The Board is of the view that Hydro's treatment of Integration Costs is inconsistent with how Hydro has defined direct costs. Hydro has chosen to include some Integration Costs, such as internal Integration Costs, but not others, such as implementation costs. The Board recognizes the argument that staff resources could have been performing other duties had the Integration not occurred. However, the Board is of the view that "direct costs" should be defined as additional expenditures incurred as a direct result of the Integration. Internal labour and overhead expenses allocated to the Integration would have been incurred in any event.

CIS

The Board concurs with Hydro's decision to repatriate the Banner system, which should result in significant savings to ratepayers. The Board accepts Hydro's treatment of the costs related to the repatriation of the system and is of the view that they are appropriately excluded from integration costs. The Board will review the costs related to combining the Hydro and Centra CIS systems once Hydro's plan regarding the CIS system is finalized.

ERP

The Board found Hydro's analyses of the early retirement program and equivalent full-time personnel to be contradictory and unclear. The Board is of the view that the 16 vacant positions and the 57 early retirement positions that had not yet been implemented should not be considered in the Integration Analysis as Integration Costs or Savings.

Pension Costs

The Board is of the view that the additional pension costs, incurred after the Acquisition, were as a result of the Integration. While these costs should not be recorded in the Integration Costs capitalized in the books of the utilities, they should be considered when determining the impact on rates.

Financing Costs

The Board notes that the debt and interest charges related to the acquisition and the Integration are significant. The Board is of the view that carrying this debt for at least 30 years, as indicated by Hydro, will result in significant costs to the ratepayers. The Board encourages Hydro and Centra to reduce the term of the debt to ultimately reduce the costs incurred by the ratepayers.

The Board will direct Centra to file a revised listing of Integration Costs with Centra's GRA by no later than December 31, 2002 reflecting the comments above.

17.6 Integration Savings

The Board wishes to reiterate the statements contained in Order 146/99 that in general terms, the Transaction was structured such that in the short term, there is no financial costs and no benefits to utility ratepayers. Because most of the costs were known, the largest unknown was whether costs could be controlled and whether the cost savings would be achieved. The risk to consumers was that the forecasted savings would never be identified, monitored or achieved in any conclusive way. The risk also extended to not being able to determine whether savings might have been experienced in any event, had the acquisition and integration not occurred.

The Board is of the view that Hydro's analysis, using the Bottom-Up approach as the primary methodology with the Top-Down approach to reconcile the results, is acceptable. However, there are a number of items for which the Board has concern.

The Baseline

The Board appreciates the analysis completed by CAC/MSOS regarding the baseline measurement from which synergies could be measured, and is of the view that this analysis provides some indication that Hydro and Centra's baseline may be misstated. However, there is a lack of information at the present time to establish an appropriate baseline from which to measure synergies. Therefore, the Board will review the baseline at the next Centra GRA to be filed not later than December 9, 2002.

ERP

With respect to the early retirement program, the Board is of the view that the 16 vacant positions should not be considered synergy savings, as there were likely opportunities to eliminate these positions in any event. Furthermore, the 57 early retirement positions that had not yet been implemented as at September 30, 2001 should not be included as synergy savings until the team plans have been implemented. The related Integration Costs should also be excluded from the analysis.

CIS

The Board notes that Hydro's plan with regard to combining Hydro's and Centra's CIS systems has not been finalized. The Board will review the savings related to combining the Hydro and Centra CIS systems once Hydro's plans are finalized.

Capital Expenditures

The Board accepts Hydro's argument that capital expenditures have decreased due to factors other than the Integration. The Board is aware that the various levels of government have reduced the level of financial assistance available for system expansion projects.

Executive Compensation

With respect to executive salaries, the Board is of the view that all Centra executives that continue to be employed by the two utilities and continue to perform a strategic role within the companies should not be considered as a synergy savings. In addition, the Board is of the view that bonus amounts for Centra executives that were denied by the Board during Centra's 1998 GRA should also not be included as a synergy savings. The bonus plan amount was not allowed into past rates. Therefore, the Board will direct Hydro to remove the costs related to the executives which continue to be employed by the utilities and costs related to the bonus plan previously denied by the Board from its calculation of synergy savings.

The Centra GRA based on a 2001 test year was withdrawn, partly in response, to high commodity costs. The Board notes that commodity costs have now decreased since and based on projections for Centra, rate increases will be put in place in the future. Therefore, it is inappropriate to include the impact of lower rate increases in an analysis of the impact of the Integration on rates.

The Board will direct Hydro to file a revised listing of Integration Synergy Savings based on the directives provided above with Centra's GRA by no later than December 31, 2002.

17.7 Allocation Methodology

The Board has reviewed the allocation methodology submitted by Hydro and is satisfied that the methodology employed results in a fair and equitable allocation of costs. The Board further notes that no Intervenor took a position with regard to this matter. The Board will accept Hydro and Centra's cost allocation methodology.

17.8 Safe and Reliable Service

In Order 146/99, the Board expected that efficient and effective operations across both utilities would be created without adversely impacting the delivery of safe and reliable service. At that time, the Board had concerns with the provision of service during the transition period. The impact of the Integration on safe and reliable service has not been established. The Board remains concerned and is of the view that Hydro must retain a dedicated, knowledgeable and loyal workforce, allocate the appropriate resources to training and development activities, and maintain a rigorous testing schedule. The Board will expect Hydro to continue to maintain its excellent safety record.

In Order 149/99 the Board noted comments by Campbell Ryder Engineering Limited that there was potential for improved management and controls, communication, maintenance of records, depreciation rates and more precise reconciliation of gas receipts and deliveries. The Board stated its expectation that Hydro would review these matters, prepare and file a summary report of the findings and proposed solutions with the Board by no later than July 31, 2000.

The Board has not received a formal report and will require that such a report be filed in conjunction with the Centre 2003/04 GRA by December 31, 2002. The report should indicate if and in what form any of these matters have been previously addressed. For matters still outstanding, the report should provide findings and recommendations.

17.9 Competition

The Board has considered Hydro's view that two regulated utilities do not require a formal code of conduct. The Board notes that no Intervenor took a position with regard to the establishment of a code of conduct. The Board recognizes that restrictions on sharing of customer information between Hydro and Centra may reduce synergy savings. However, one large dominant utility could lessen the opportunity for competition, particularly if there is no level playing field for other market participants. Although no further action regarding this matter need be taken at this time, the Board remains of the view that strong regulatory oversight is critical. The Board will continue to monitor the impact of Integration on the natural gas and electric consumers in the Manitoba marketplace.

17.10 Functional Integration

The Board notes that there is no request or application before the Board to merge, unite or consolidate Centra with Hydro. There are legislative requirements in Sections 82 and 92 of The Public Utilities Board Act that require prior approval be obtained from the Board for this to occur. The comments and directives contained in this Order do not confer any approval for Hydro to functionally integrate or corporately merge Centra's operations in to Hydro's operations. The Board is of the view that Hydro and Centra have functionally integrated. The onus is on Hydro and Centra to apply to the Board for the necessary approvals that are required pursuant to the legislation. The Board expects that an application for approval will be included in the Centra GRA proceedings, which application is expected to be filed by December 9, 2002. However, the Board reiterates that the Transaction and the Integration does not change any of the Board's current jurisdiction over Hydro and Centra.

17.11 Future Regulation

As time passes it will be increasingly difficult to track and measure costs and savings directly related to the Integration. The Board is hopeful that one further public review of certain aspects of the Integration Process and the Directives given in this Order will be covered at the upcoming Centra GRA which will resolve all remaining outstanding issues related to Acquisition and Integration Matters.

The Board agrees with PCWM that it is difficult to determine the prudence of the utilities activities with large time gaps between the public review process. Therefore, the Board will direct Hydro and Centra to consider establishing a more regular schedule not exceeding three years for periodic rate reviews for each utility even if no rate changes are requested. This regular schedule should improve both the efficiency and the effectiveness and the timeliness of the regulatory process. In addition, the time period between GRA's for each utility should not exceed three years, even if no rate changes are required.

18.0 It Is Therefore Ordered That:

1. Centra Gas Manitoba Inc. file a General Rate Application based on a 2003/04 future test year with the Board by no later than December 9, 2002.

2. For regulatory purposes Hydro is to account for the Acquisition Transaction and Integration Costs in the books and records of Hydro as opposed to Centra.

3. Hydro file a revised listing of Acquisition Costs and Integration Costs that reflects the directives in Section 17.5 and 17.6 with Centra's General Rate Application by no later than December 31, 2002.

4. Hydro file a revised listing of Integration Savings with Centra's General Rate Application by no later than December 31, 2002.

5. Centra should apply the full amount currently included in sales rates for income taxes, of approximately $11 million each year, to fully extinguish the one-time tax related debt and carrying costs as quickly as possible.

6. Hydro file a revised Impact Analysis of the Transaction and integration on consolidated Net Income and Rates with the Centra General Rate Application by no later than December 31, 2002 reflecting the following:

   (a) Segregation of-
      (i) the Acquisition and Integration Costs offset by the synergy savings;
      (ii) the Acquisition Premium offset by Centra's expected rate of return; and
      (iii) the one-time transfer tax liability offset by the tax component included in rates of approximately $11 million annually.

   (b) Updated Acquisition Costs, Integration Costs and synergy savings; and

   (c) The exclusion of foregone rate increases.

7. Centra file with the Board a formal report with respect to the findings and proposed solutions with respect to improved management and controls, communication, maintenance of records, depreciation rates and more precise reconciliation of gas receipts and deliveries in the format stipulated in this Order, in conjunction with the

Centra 2003/04 General Rate Application filing to be filed by no later than December 31, 2002.

8. Hydro and Centra establish a more regular schedule, not exceeding three years, for periodic rate reviews for each utility to improve the efficiency, effectiveness and timeliness of the regulatory process even if no rate changes are requested.

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. 208/02 issued by
The Public Utilities Board

Acting Secretary