

MANITOBA) **Order No. 50/05**
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THE PUBLIC UTILITIES BOARD ACT) **April 8, 2005**

Before: Graham F.J. Lane, C.A., Chairman
Susan Proven, P.H. Ec. Member

**APPLICATION BY STITTCO UTILITIES MAN LTD. FOR A
REVISED RATE SCHEDULE INCORPORATING THE
RATE RIDER APPROVED IN ORDER 20/03 IN
CURRENTLY APPROVED BASE RATES, AND
CONFIRMATION OF ORDER 20/03 AS FINAL**

Application

On March 22, 2005 Stittco Utilities Man Ltd. ("Stittco") applied to The Public Utilities Board ("the Board") for permission to simplify its customer bills by removing the rate rider from its rate schedule and consolidating the rate rider within approved base rates. The change would neither increase nor decrease overall existing rates. Stittco also sought to have the rates established by Board Order 20/03 confirmed as final.

The \$0.3662 rider approved by Interim Ex Parte Order No. 20/03 of February 18, 2003 affected rates and billings commencing with meter readings taken on and after February 1, 2003. The rider was disclosed separately in billings to Stittco's domestic (residential) and commercial customers, and integrated within negotiated rates in the case of Stittco's industrial and large volume customers. The rider had no expiry date.

(In Board Order 111/95, the Board approved the use of the Propane Purchase Variance Account ("PPVA") to record differences between propane supply costs and propane costs recovered from Stittco's customers through rates. Subsequently, and as the result of the development of balances in the PPVA, the Board approved a series of rate riders, to adjust for variations in the cost of propane. At one point, two riders were in place at one time. With the Board's approval of Stittco's application to remove the \$0.3362 per cubic meter rider, no riders would be in place.)

Introduction

Stittco distributes propane supplied by railcar in northern Manitoba (Thompson, Flin Flon and Snow Lake). As at December 31, 2004, Stittco's total customer base approximated 1,100, with the majority being residential Thompson customers.

Because of the relatively small customer base, the Board regulates Stittco on a least cost regulation basis relying on the exchange of information, audited financial statements, safety audits and historical experience.

Leaving aside the necessary recovery of appropriate propane supply, regulatory and other operating costs, the Board employs a rate base, rate of return methodology to establish a fair return to Stittco's parent company.

The Board also oversees the safety of Stittco's pipeline-based operation. No safety related problems were outstanding as of the date of the public hearing. Stittco has reported that it has service personnel available on a 24-hour 7-day basis, to deal with customer problems as they may arise.

The Board employs Energy Consultants International ("ECI"), an engineering consulting firm, to perform safety checks on Stittco's operations, and ECI has found Stittco's operations and practices to be appropriate.

The Board-established schedule of rates is intended to recover Stittco's costs of propane supply and operating expenditures, as well as provide its shareholder with an opportunity to earn a reasonable rate of return on invested capital. The rate schedule is based in part on the forecast cost of the propane supply, which approximates 70% of overall cost of service.

The Propane Purchase Variance Account ("PPVA"), established with the approval of the Board, records differences between actual propane supply costs and the

propane costs recovered from customers through rates. The balance in the PPVA can range from amounts owing to Stittco to amounts due to its customers.

To ensure fair treatment to both customers and Stittco, the Company credits the PPVA with interest when the PPVA balance is negative (amounts owing to customers), and charges the PPVA with interest when the balance is due to Stittco. The annual interest rate credited or charged has been bank prime plus 1%.

The rate rider (as established by Order 20/03) was struck to allow Stittco to recover from its customers a forecasted large PPVA balance. At its peak the PPVA account balance was \$260,455. The PPVA balance was eliminated by a period of relative price stability (commodity costs were \$2.341 million in Stittco's 2003/04 fiscal year, which ended July 31, compared to \$2.531 million in fiscal 2002/03), achieved through supply contracts which expired March 31, 2005.

By the end of February 2005, the outstanding PPVA balance had been fully recovered, and a balance of \$49,931 was due to customers. Unfortunately, propane supply prices have risen substantially, requiring the continuation of the revenue generated by the rate rider to avoid the development of a return to a significant PPVA balance due to Stittco.

Stittco attempted to renew its annual propane supply contract as of April 1, 2005. It sought to secure 50% of the required annual volume at a fixed price, with the remainder at market prices to be set at time of delivery. Stittco normally contracts its annual propane supply in this way.

Unfortunately, Stittco was unable to secure a fixed price reflecting its view of a reasonable price because of a recent spike in oil-based and natural gas commodity prices. As at the date of release of this Order, oil prices were in excess of \$55 US

U.S. and natural gas approached \$8. Propane is a derivative of natural gas and its pricing generally follows pricing developments in the oil and natural gas markets.

Stittco was unwilling to firm up an annual supply at much higher prices than it incurred for its average 2004 supply contract, and chose to wait for lower prices. Stittco forecasts that propane supply market prices will decline in the summer of 2005. In the interim, Stittco will purchase propane on a 100% variable price basis, albeit at forecast prices requiring the revenue equivalent of the rider.

In the summer, Stittco plans to re-tender its supply requirements in accordance with its historical practice of a 50-50 fixed-variable basis. While there is no guarantee that prices will fall by then, prices are usually lower in the summer. As well, it is possible the speculation-driven recent price spike will fade.

Stittco will maintain the PPVA internally, and continue to record differences between its actual propane supply costs and the cost approved by the Board as reflected in current overall rates. By maintaining the revenue associated with the rate rider through this commodity price spike, Stittco hopes to avoid the development of another large PPVA balance. Large PPVA balances risk inter-generation inequity as costs incurred in prior periods are passed on in subsequent periods to the customers of the future.

To confirm, Stittco's application seeks the consolidation of the rate rider within base rates, and the confirmation of Order 20/03. Stittco did not request any change to overall rates.

Background

On January 27, 2005 Stittco filed financial information with the Board based on its audited financial results for its fiscal year ending July 31, 2004.

According to Stittco's audited financial statements, as of July 31, 2004 the Company had total assets of \$2.121 million (July 31, 2003: \$1.838 million), and shareholder's equity of \$1.401 million (2003, \$1.254 million). Shareholder equity was comprised of \$1.201 million of issued common shares and retained earnings of \$199,512.

Company revenues for fiscal 2003/04 aggregated \$4.3 million, of which 94% arose from propane sales and rates. Excluding the provision for income taxes, Stittco incurred expenses of \$3.744 million in fiscal 2003/04, with 63% of those costs attributable to the cost of propane supplies. After taking into account the provision for income taxes, the Company recorded net income of \$346,519 (2002/03, \$84,066). Stittco paid dividends of \$200,000 to its parent company (2002/03, \$125,000).

On February 15, 2005, the Board advised Stittco of its intention to review the rates charged by Stittco at a public hearing to be held in Thompson, Manitoba on March 30, 2005. The Board requested additional information related to the following operational matters:

- Propane Supply Contract;
- Purchase Propane Variance Account ("PPVA");
- Rate rider;
- Rate of return;
- Shared Services arrangements;
- Parent Company charges; and
- Sustainability of operations.

Stittco's response was filed with the Board on March 3 and 22, 2005.

With respect to the Company's propane supply contract, which expired on March 31, 2005, and as indicated previously, Stittco advised that its tender for propane supplies had not been successful, and that it had decided to purchase propane on a variable price basis until prices fell.

Stittco's operating and administrative expenses for its 2003/04 fiscal year were \$1.221 million, an increase of 7.3% over two years from the expense aggregate approved by the Board in Order 172/02, which related to Stittco's 2001/02 fiscal year.

The detailed summary of operating and administrative expenses for the fiscal year ended July 31, 2004 was provided to the Board, and reviewed.

Operating expenses included an administrative fee of \$130,862 paid to Stittco Energy Limited, the parent company. Stittco received \$51,600 from Stittco Energy for shared service fees, and paid \$38,134 in turn. Stittco Energy carries on an unregulated propane business in northern Manitoba, so some costs are shared between the parent and Stittco.

In response to Board inquiries, Stittco had a review of inter-company charges performed by Emerald Regulatory Services in 1998. The review found the transactions reasonable, and the level of charges and fees remain consistent with that review.

Stittco has no debt financing. Its capital assets and net working capital requirements are financed 100% by equity. Over the years, the rate of return on shareholder's equity allowed by the Board has varied and been amended.

In the Company's 1998 General Rate Application, Stittco proposed it be allowed an overall rate of return on equity of 12.75%, down from the 13.75% in place for many years. The 12.75% rate of return requested at that time was based on a 6.5% Government of Canada long bond yield plus an equity risk premium of 6.25%. The Board did not accept Stittco's proposal, but for 1998 indicated that a return of 10.89% would not be unreasonable.

The risk premium on shareholder's equity over long term Canada bond rates recommended by Robert E. Evans on behalf of Stittco in August 1991 was 4.25%, and some analysts are of the view that the risk premium should rise as long bond yields fall. The interest rate on long Government of Canada bonds has fallen sharply since 1991, and the requested risk premium over long bonds rose to in excess of 6% by 2002.

A relatively high-risk premium and the acceptance by the Board of Stittco's financing of capital asset and working capital requirements by equity, are, according to Stittco, justified by the particular circumstances of Stittco's operations.

Stittco operates in very competitive circumstances, possessing less than 25% market share. Stittco provides regulated propane service to areas with small potential customer bases, in basically one-industry dominated northern Manitoba locations. Competition from electricity is intense, electricity being a viable alternate energy source that is priced on a cost of service basis rather than tied to the commodity markets.

Stittco has reported that competition for commercial and industrial customers has increased with the arrival of an alternate propane supplier. The competitor operates an unregulated business where rates can potentially be designed for a single customer.

For competitive, small market and northern one-industry location reasons, Stittco has confirmed its longstanding inability to secure long term debt, supporting its contention that financing by equity is an appropriate capital structure at this time.

The Company's inability to attract debt is a significant issue with respect to customer rates, as lower cost debt is not available to mitigate and balance higher-yield shareholder equity.

Privately owned utilities in large and diversified markets are financed by a mix of long-term debt and shareholders' equity. And, the rate of return on rate base (capital assets plus net working capital) for these utilities is set by a practice that involves establishing an allowable rate on the debt and a different rate on shareholders' equity.

The Energy and Utility Board of Alberta ("EUB") recently established rates of return on shareholders' equity and utility rate bases for 2005, and set a generic return on equity of 9.50%. The generic allowable rate of return on equity was determined by considering factors including the yields of 10-year and 30-year Government of Canada bonds and the establishment of a risk premium.

The overall allowable rate of return on the rate base of many Alberta utilities is arrived at by first assigning a mix between debt and equity funding, and then applying allowable rates of return for debt and equity against those funding components. For the EUB, a generic debt:equity ratio would be in the range of 65:35, as compared to the 0:100 of Stittco.

In Stittco's case, where the entire rate base is funded by shareholders' equity, the rate reductions enjoyed by the customers of larger utilities in larger more diversified markets are not available, with the absence of lower rate debt funding. And, Stittco's less advantageous competitive reality is such that a higher risk premium may be justified for its shareholder's equity.

The Board did not approve a specific rate of return in response to Stittco's 1998 application, but indicated that a rate of return on shareholder's equity of 10.89% for 1999 would not be unreasonable. In 2003, after again reviewing Stittco's financial and operating situation, the Board once again indicated that a rate of return on shareholder's equity of 10.83% would not be excessive at that time.

The Company has historically earned a rate of return on both an actual and normalized for weather basis that was less than the allowed return. Normalization for weather is the process by which the effect on propane supply volumes arising from the actual weather of a year is adjusted to historical norms.

A historical summary of rates of return follows:

	Mid-Year	Actual	Actual	Normalized	Allowed/ Accepted
	Rate Base	Return	Return	Return*	Return
	\$	\$	%	%	%
1984	\$1,496,193	\$ 16,756	1.12%	6.00%	12.25%
1985	1,744,082	134,949	7.74	7.85	13.75
1986	1,635,439	209,853	12.83	13.17	13.75
1987	1,473,205	134,529	9.13	12.90	13.75
1988	1,496,963	115,922	7.74	10.13	13.75
1989	1,501,948	231,257	15.40	16.36	13.75
1990	1,565,802	232,851	14.87	14.57	13.75
1991	1,680,332	107,171	6.38	7.02	13.75
1992	1,922,222	186,471	9.70	9.73	13.75
1993	2,199,789	196,083	8.91	9.99	13.75
1994	2,214,516	202,893	9.16	7.64	13.75
1995	2,136,964	159,392	7.46	9.19	13.75
1996	2,166,767	307,970	14.21	12.49	13.75
1997	2,317,714	223,207	9.63	8.75	13.75
1998	2,159,054	68,968	3.19	5.18	13.75
1999	2,002,605	103,076	5.18	8.96	10.89*
2000	2,004,411	187,564	9.36	11.32	10.89*
2001	2,285,548	155,238	6.79	7.78	10.89*
2002	2,973,547	108,883	5.25	6.04	10.89*
2003	2,039,653	223,741	10.97	11.92	10.89*
2004	1,897,533	169,904	8.95	10.29	10.83*

+ Indicated by Board not to be excessive.

A summary of rates charged to domestic (residential) customers since 1997 follows:

<u>Year</u>	<u>First 50 cubic meters</u> (includes rate riders)	<u>Over 50 cubic meters</u>
1997 (Order 91/97)	\$1.293	\$1.066
1998 (Order 115/98)	1.293	1.066
1998 (Order 158/98)	1.293	1.066
1999 (Order 182/99)	1.416	1.189
1999 (Order 187/99)	1.416	1.416
<u>Year</u>	<u>First 50 cubic meters</u> (includes rate riders)	<u>Over 50 cubic meters</u>
2000 (Order 120/00)	1.602	1.375
2001 (Order 4/01)	2.0361	1.8091
2001 (Order 124/01)	1.9131	1.9131
2002 (Order 28/02)	1.7271	1.5001
2002 (Order 172/02)	1.650	1.250
2003 (Order 20/03)	2.0162	1.6162
2004 (present application)	2.0162	1.6162

Over the six-year period ending in 2003, domestic rates rose by 88.72 cents for the first 50 cubic meters, or 74%. While this increase is substantial it is considerably lower than the rate increases experienced by natural gas, oil and coal customers. The relative positive differential may be associated to the interplay of supply and demand for a by-product of natural gas.

Public Hearing

Following the advertising of a public hearing to be held in Thompson, through customer bill inserts, the Board held a public hearing in Thompson on March 30, 2005.

The hearing was held to consider Stittco's application with respect to its request to consolidate the rate rider within base rates, review overall Stittco operations and its competitive situation and sustainability, and consider the rate of return currently allowed Stittco by the Board.

Despite notice of meeting having been issued and advertised in the local newspaper, no customers appeared at the hearing. Those present at the hearing were:

For Stittco - Messers. Stitt, Mulbuck and McIntyre

For the Board - Mr. Lane, Ms. Proven and, in his staff capacity, Mr. Barron.

Regardless of the absence of Stittco's customers or the general public, the Board is legislatively mandated to be representative of the public interest. In that capacity, the Board questioned Stittco officials, and discussed propane market and other Stittco operational matters with them.

One expense category that has experienced a significant increase is that of corporate property and liability insurance. The increase in cost of over 30% relates to premium requirements of insurers, not coverage changes. The Board reviewed Stittco's insurance limits with respect to the risk of extraordinary damage, and found it acceptable.

Accounts receivable, the provision for doubtful accounts and bad debts have risen, proportionate to the increase in customer rates attributable to the rising cost of the propane supply. Stittco advised the Board that it makes consumer information on heating efficiency available to its customers, and encourages proper insulation and properly functioning furnaces.

The Board notes that Stittco's sales volume increased marginally (.7 of 1%) in fiscal 2003/04 over fiscal 2001/02 volumes, and that the unit cost of a litre of propane increased 37% over the same two-year period.

The Board also noted that:

- appliance and material sales rose by 48%, to \$14,442, while service revenue remained at fiscal 2001/02 levels
- other costs of sales rose by 57%, to \$107,002 (compared to 2003/04 gross sales of \$124,442, providing gross margin)
- wages and benefits of \$463,855 in 2003/04 were only \$2,695 higher (.58 of 1% higher than two years previous)
- administrative and general expenses rose by \$39,013 from two years prior, 25.5% (driven by increased bad debt expenses which increased by \$55,085)
- regulatory costs fell \$7,870 or 41%
- depreciation costs fell from \$142,869 to \$126, 173, representing the aging of the plant and a relatively low level of capital expenditures over the two year period
- during fiscal 2003/04, capital expenditures aggregated \$62,418 (9.3% of opening undepreciated capital cost), and were lower than the capital cost allowance claimed of \$77,434 – confirming the “aging” of plant and equipment
- the provision for income tax represented 44% of before tax net income for 2003/04 as compared to 49% per Board Order 172/02 (on a taxable income basis, income taxes payable were 38.6% of taxable income for 2003/04)

- the mid-year rate base in 2003/04 was 2.6% lower in 2003/04 than was the case two years previous

At the hearing, Stittco provided a brief overview of its propane efficiency/conservation measures, in response to an enquiry of the Board. Successful measures to reduce customer consumption can affect overall demand, and reduce price pressure.

Stittco advised the Board that its plant and equipment were in good condition and that no major capital expenditures were deemed necessary at this time or forecast in the near future. The aggregate cost of plant in service as at July 31, 2004 was \$4.057 million, compared to \$4.070 as of Board Order 172/02. Immediately following the hearing, the Board visited Stittco's Thompson offices and plant, and found a neat plant with clear evidence of plant maintenance.

The working capital of Stittco as at July 31, 2004 was \$638,990, an increase of \$115,181 or 21.6% over that of Order 172/02. The major increases noted were with respect to propane supply (up \$43,705 or 37%, reflective of commodity price increases), and accounts receivable in arrears (up \$39,826 or 25%, again reflective of increased commodity prices).

Stittco advised that notwithstanding the competitive pressures and the current pricing spike, it was confident as to the sustainability of its operations. Stittco advised that there are advantages enjoyed by propane, as an energy supply, and that it expects the pricing situation to improve over time relative to other energy sources.

As previously indicated, this Order deals only with Stittco's application to eliminate the rate rider and finalize the interim rate schedule established by Board Order 20/03.

All other aspects of the matters discussed at the March 30, 2005 hearing, which ranged from safety matters to competitive issues, with the exception of the rate of return on rate base, will be reviewed in a separate Order, to follow.

With respect to rate of return, the Board will comment briefly on the issue in this Order, and further in its subsequent Order.

Board Findings

The Board will approve Stittco's application for a revised rate schedule reflecting the consolidation of the approved rate rider with approved base rates. The Board will confirm as final the rate schedule established by Order 20/03, which is now replaced by the rate schedule established by this Order.

The Board accepts Stittco's costs as established in its audited accounts for the year-ended July 31, 2004, and its working capital, rate base and shareholder's equity as of that date. The Board accepts Stittco's immediate horizon propane supply price forecast, and its plan to await a commodity price decline before returning to market with a re-tendering of its supply requirements.

Current propane supply market prices require the continuation for the present of the overall rates charged to consumers.

The revised rate schedule is attached as Appendix "A", which, although consolidating the rate rider within base rates, provides no overall change to Stittco's rates for customers.

With respect to Stittco's industrial and large volume customers, and as noted in the rate schedule attached to Order No. 20/03, the amount of the rate rider formed part of the base rates; such rates are set by negotiation. Thus, for industrial and large volume customers this Order does not change rates at all.

Overall, the Board accepts Stittco's view that consolidating the rider within base rates will simplify customer bills, removing a reported customer irritant related to consumer understanding of the rate schedule.

The Board will monitor the month-end balance in the PPVA account, which, as previously indicated, accounts for differences between the cost of the propane supply to Stittco and propane costs recovered through rates. The development of a significant PPVA balance will result in either a new rate application by Stittco, or direction from the Board to Stittco to bring forward a new application.

The Board will also monitor Stittco's re-tendering of its supply requirements, now expected to occur in the summer of 2005, and review the adequacy of the revised rate schedule once the new supply arrangements are complete.

Order 20/03 rates were to provide an opportunity for a return on shareholder's equity of 10.83% per annum, a rate reflective of a 100% equity approach to funding the capital assets and net working capital of Stittco, and including by inference a risk premium. The expected return on shareholder equity took into account the Board's understanding of the particular risks and circumstances of operating a regulated propane operation in a competitive market in a northern Manitoba one-industry dominated environment. It also took into account long-term Canada bond rates and past discussions with respect to risk premiums.

Since then, the yield on long Canada bonds has fallen, and the allowable return on shareholder's equity would potentially best reflect that decrease. However, given that there are only four months left in Stittco's 2004/05 fiscal year, and the major part of the fall/winter 2004/05 heating season is over, the Board accepts the potential 10.83% expected return on equity indicated in Order 20/03 for fiscal 2004/05.

The Board will review the weather normalized rate of return on shareholder equity earned by Stittco for its 2004/05 fiscal year, and may direct rate reductions to be effected for fiscal 2005/06 if the actual return, normalized for weather, exceeds 10.83%.

In a subsequent Order, the Board will reassess its approach to determining the allowable rate of return for Stittco, and may set a different maximum allowable return. As part of that exercise, the Board intends to research the availability of long-term debt and debt generally to Stittco under the circumstances that Stittco operates within. It is possible that the Board may amend the allowable rate of return to reflect a deemed debt:equity ratio.

Prior to coming to a deliberated decision with respect to the rate of return to be allowed Stittco for the 2005/06 fiscal year, Stittco will be asked to provide additional information and perspective on the matter.

Once the propane contract situation is resolved, Stittco will be directed to file a general rate application ("GRA") based on a 2005/06 future test year. As part of that GRA, the Board will direct that Stittco provide an update of its programs and plans related to propane efficiency and conservation.

The Board notes with appreciation the cooperation extended to it by Stittco through this process. The Board considers Stittco to be a quality organization properly focused on safety and customer service.

IT IS THEREFORE ORDERED THAT:

1. Interim Ex Parte Order No. 20/03 BE AND IS HEREBY CONFIRMED.
2. The Schedule of Rates attached as Appendix "A" to this Order, to be effective for all billings based on meter readings for propane consumed on and after May 1, 2005, BE AND IS HEREBY APPROVED.
3. Stittco Utilities Man Ltd. shall continue to monitor PPVA developments, and provide a report to Board on a monthly basis on the status of PPVA.
4. Stittco Utilities Man Ltd. will advise the Board of the results of its re-tender of its propane supply requirements.
5. Once the propane contract situation is known, Stittco Utilities Man Ltd. will file a General Rate Application utilizing a 2005/06 future test year. The GRA should include updated information on rate of return expectations and a summary of Stittco's programs and plans related to customer propane efficiency and conservation.
6. The opening of propane supply tenders is to be attended by Stittco's independent auditor, with a report on the propane tender process and results from the auditor to be provided to the Board.

THE PUBLIC UTILITIES BOARD

"GRAHAM F. J. LANE, C.A."

Chairman

"G. O. BARRON"

Secretary

Certified a true copy of Order No. 50/05
issued by The Public Utilities Board

Secretary

STITTCO UTILITIES MAN LTD.

SCHEDULE OF RATES

For Metered Domestic and Commercial Sales Under The
Public Utilities Board Jurisdiction for all Billings based on
Meter Readings for Propane consumed on and after
April 1, 2005

1. Domestic Services

First 50 cubic meters per month	\$2.0162 per cubic meter
All over 50 cubic meters per month	\$1.6162 per cubic meter

2. Commercial Service

First 1,000 cubic meters per month	\$1.8462 per cubic meter
Next 3,000 cubic meters per month	\$1.7162 per cubic meter
All over 4,000 cubic meters per month	\$1.4862 per cubic meter

3. Industrial and large volume rates may be set by negotiation subject to approval of The Public Utilities Board and subject to such rates being available to all persons purchasing on the same conditions.

4. On all accounts outstanding for more than 30 days from the date of billing, and interest charge of 1½ percent per month will be charged from the date of billing until the account is paid.

5. All taxes extra, if applicable.