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**Appearances**

R.F. Peters K.L. Kalinowsky	Counsel for The Public Utilities Board of Manitoba ("the Board")
J.E. Foran, Q.C.	Counsel for Centra Gas Manitoba Inc. ("Centra")
K. Melnychuk	Representing Coalition of Eastern Natural Gas Aggregators and Sellers ("CENGAS")
B.J. Meronek, Q.C.	Counsel for Consumers' Association of Canada (Manitoba) Inc./Manitoba Society of Seniors ("CAC/MSOS")

**2.0 Witnesses for Centra**

H.M. Kast	Vice-President, Finance and Gas Supply
H. Stephens	Senior Manager, Gas Supply Storage and Transportation
W. Derksen	Controller

**3.0 Intervenors**

City of Brandon and Six Other Cities and Towns and Winnipeg School Division No. 1

Coalition of Eastern Natural Gas Aggregators and Sellers ("CENGAS")

Communication, Energy & Paperworkers' Union, Local 681 ("CEPU")

Consumers' Association of Canada (Manitoba)/Manitoba Society of Seniors ("CAC/MSOS")

Simplot Canada Limited

**4.0 Intervenor Witness**

Professor John H. Herbert, witness for CAC/MSOS.

## 5.0 Background

Centra purchases most of its gas from TransCanada Gas Services ("TCGS") under an arrangement wherein the commodity price of natural gas is indexed to the prices recorded in the Canadian Gas Price Reporter for the AECO and Empress indices.

In Board Order 3/96, dated January 30, 1996, the Board reviewed Centra's proposed price management policy and plan, and stated:

"The Board is of the view that a price management policy is an appropriate and prudent response to the change in gas purchasing arrangements from an annual fixed price to a monthly indexed pricing mechanism. Centra has confirmed that the purpose of the price management activities at all times is to manage the risk of exposure to price volatility, and not to speculate in the gas market. Centra has further confirmed that at all times the onus remains with Centra to demonstrate that the price management transactions have been executed in a reasonable and prudent manner. It is on this basis that the Board will approve in principle the use of price management techniques."

In Board Order 79/98 dated June 19, 1998, the Board dealt with significant price management losses incurred by Centra. The Board found that the price management results were due to Centra embarking on speculative trading, contravening its approved policy, lack of management, and the extreme volatility of the gas market. The Board disallowed significant losses due to the first three reasons, but allowed costs reflecting market volatility to be passed on to the consumers. Notwithstanding the results of Centra's price management program in the last two years, the Board was also of the view that, in a marketplace of indexed pricing for natural gas, where such prices may be extremely volatile, a well executed price management program will serve the interest of ratepayers. To do otherwise would expose the ratepayers to the vagaries of the marketplace. The Board also indicated price management could be conducted internally within Centra or outsourced to a third party.

During the 1998 General Rate Application, Centra stated its interim passive hedging program would exclude dynamic trading and would meet the goals and objectives initially developed for a

passive hedging program. Furthermore, Centra was to ensure that its interim passive hedging program had effective controls, checks and balances. The Board also indicated that such controls were to provide an assessment of whether Centra met the goals and objectives of its program. The checks and balances to be considered for inclusion in Centra's price management program included, but were not limited to,

- timely and adequate reporting of the positions including a description of the instruments, prices, amounts and volumes related to specific underlying volumes of gas;
- performance measurements;
- timely independent assessment of compliance with policies and procedures;
- regular senior management reviews of the market views inherent in the price management policies to adjust the targets to long term changes and market trends; and
- an appropriate limit structure to include, for example, stop losses and counter party limits.

The Board also indicated that Centra's price management program review should soon be completed and filed with the Board, together with Centra's response to the recommendations and the reviews. Thereafter Centra should file the details of its passive price management program which it is seeking to conduct.

## **6.0 Application**

Centra applied for an Order approving the Policy Guidelines which were filed with the Board on October 28, 1998 and the Price Management Plan which was filed with the Board on November 23, 1998. A hearing was held February 15 to 18 and closing argument was heard on February 25, 1999.

## **7.0 Policy Guidelines**

In Centra's view the previous price management policy was not effective in tempering volatility on behalf of the ratepayers, and the undesirable results culminated in a significant disallowance of gas costs. Hence, new Policy Guidelines were drafted by Centra. Witnesses for Centra submitted that the new Policy is simple in concept, easy to understand, track and control, and one which will meet the needs of the ratepayers. The Policy outlines the possible derivative based strategies to be used, defines the controls to be in place and delineates the levels of external approval that must be received prior to the implementation of the program.

In preparing the Policy, Centra received input from Ernst & Young, Risk Advisory Services, and Westcoast Energy Inc. ("Westcoast"), Centra's parent company. Although Westcoast provided final policy approval, the two external consultants were not requested to provide comments on the final Policy.

Centra noted it has been conducting price management under its proposed Policy notwithstanding not having received Board approval. Centra contended that the proposed Policy was being used because it represented a more conservative approach and contained enhanced controls and monitoring.

### **7.1 Philosophy**

Centra's philosophy of price management is to provide a means of balancing market responsive pricing with rate stability. It is not Centra's objective to obtain the lowest possible cost by trying to "beat the market". Rather, extremes in price volatility are to be managed. Centra defined extremes in volatility as being the impact that price volatility, excluding weather effects, has on monthly gas bills to customers over and above customer indicated tolerances.

Though rate stability is one objective of price management, Centra witnesses agreed that rate stability and market responsive pricing were mutually exclusive and posed a fundamental dilemma to the policy. If one objective is eliminated then it will diminish the reflection of the other objective. Centra's price management could temper or mitigate the variability impacts over a period of time so that the rate changes were within customer levels of reasonableness.

The Philosophy also states that "it is unreasonable for the Company to take on additional risk as there is no profit earned." Witnesses for Centra testified that it was inappropriate, given the amount of money at risk, to expect Centra to take positions and then have an ex post facto review and disallowances, when the risk is not reflected in the rate of return.

Centra's witnesses explained that controls, oversight and monitoring in the Policy Guidelines were greater than those contained in the previous Policy. Similar to the previous Policy, there is a prohibition against speculation. Centra noted that trading could not be engaged in under this Policy, and therefore Centra was of the view that it could not find itself in a similar situation to that recorded in Board Order 79/98.

## 7.2 Eligible Volumes

Gas volumes eligible for price management are determined by two limits: first, that hedging can only be applied to a maximum of 100% of all assured base load supply, (defined as the volumes purchased in a defined warmest year) Second, only those volumes purchased under the long term contract with TransCanada Gas Services could be eligible to be price managed, which would thereby exclude American supply, incremental peaking supply, and spot purchases. With these limitations Centra cannot engage in price management for volumes not actually required, thereby ensuring no speculation occurs. Centra contended that to conduct price management by matching derivative instruments to actual volumes and using peak volumes, as suggested by Professor Herbert, could result in Centra speculating on volumes not required if the weather is warmer than the defined warmest year.

The percentage of 1998 gas volumes eligible for price management based on a warmest year is 74%; a normal year is 67%; and a coldest year is 59%.

### **7.3 Strategies and Tactics**

Centra has proposed a multi-step process by which the price management strategy would be reassessed annually, as follows:

- attempt to assess customer expectations of gas supply pricing through the use of surveys and focus groups;
- determine an understanding of customer expectations through a collaborative process with the Board and other stakeholders;
- design a price management program to meet those expectations;
- receive Board approval before undertaking any price management transactions;
- calculate a gas cost forecast and determine eligible volumes four weeks prior to the commencement of the gas year;
- develop an annual plan with three alternatives and one recommendation;
- obtain regulatory approval prior to the commencement of a new gas year.

Following regulatory approval, the derivative contracts are not to be sold or otherwise dealt with except in certain circumstances as listed in the Policy. Any changes will require regulatory approval as will changes to the annual Plan.

### **7.4 Derivative Instruments**

Centra will limit itself to the use of over the counter instruments consisting of price swaps, caps, and collars.

## 7.5 Controls

Centra has implemented a system to control the operation of the price management program. The control requirements include clear definitions and segregation of duties, knowledgeable staff to fulfill duties, complete and accurately record transactions, improved reporting to responsible parties, and a high level of oversight.

A substantial part of the Price Management Policy details the roles and responsibilities of the committees and individuals involved. A newly constituted Gas Supply Committee is to meet monthly respecting price management and gas supply issues. That Committee is the highest level of authority in Centra for price management and is responsible for the development, implementation, oversight, control and effectiveness of the price management program. The roles and responsibilities of the middle office manager, and front and back office personnel are also set out in detail, as are the reporting requirements. Centra testified that it had competent individuals in place who could adequately discharge their responsibilities. Furthermore, the reporting requirements now meet the more stringent and newly developed needs of the Gas Supply Committee.

The Middle Office Manager is the key individual responsible for oversight of the price management program on a daily basis and for compliance with the Policy and Plan. Various other positions were charged with ensuring that reporting was adequate and systems are appropriate.

## 7.6 Performance Measurements

Risk Advisory Services of Calgary recommended, and Board Order 79/98 directed Centra to create performance measurements. To satisfy the need for quantitative and qualitative assessments, Centra indicated that the customer level of risk tolerance as derived from the

survey would be an adequate performance measurement, and that level was a +/- \$5 per month change in monthly bills for gas consumed (excluding the impact of weather).

### 7.7 Risk

Centra witnesses testified that as a result of the Policy Guidelines the risks of price management would diminish on an overall basis compared to the previous policy. Market risk would not substantially be altered, but the operational risk would be reduced because the proposed Policy contemplates significantly fewer transactions. With fewer transactions, the control and reporting risk will be reduced. Additionally, the organizational structure has been realigned and controls greatly expanded. Credit risk would largely remain the same even with fewer transactions as each transaction involves a larger monetary amount. Finally, the regulatory risk is reduced since the intent is to shift the Board's involvement from ex-post to ex-ante approval of the program, but still recognizing the Board's authority to review the execution of specific transactions after the fact. The applied for approach is aligned with a future test year regulatory regime by which Centra is regulated for other cost components. A less complex program generally should enhance the comfort level and mitigate risk, according to Centra.

Furthermore, Centra would not hedge the basis differential between the NYMEX and Alberta prices since under the new TCGS contract the index was to be 70 percent AECO-NIT and 30 percent Empress and no hedging was to occur between the two Alberta indices. This would further curtail the price management program from its previous scope.

Centra witnesses testified that, in their opinion, Centra had addressed the many concerns regarding price management identified by the Board in Order 79/98.

## **8.0 1998/99 Price Management Plan**

### **8.1 Customer Risk Appetite**

Centra engaged Viewpoints Research Ltd. to research customer perceptions on natural gas pricing and expectations regarding potential price management scenarios. The research incorporated discussions with two focus groups and a telephone survey of 600 customers.

Floating, fixed, and insurance or capped pricing options were reviewed with customers as follows:

- fixed option - Centra locks into a fixed gas rate for a year or more. Customers would pay the fixed rate for gas every month whether gas prices go up or down;
- premium option – the consumer would pay a premium above the current price to guarantee that their monthly bill would not exceed a specified maximum increase (approximately \$62 annually for the average homeowner). If gas prices go down, then consumers would benefit from the decrease by paying a lower monthly bill;
- floating option – consumers would pay a floating rate reflecting the current and variable price of gas. If the price of natural gas goes up then their monthly bill increases; if the gas prices fall, their bill would decrease. On an average monthly bill of \$60 the price might go up or down by \$5.

There was no consensus among customers and preferences were fairly evenly distributed between the three options. The Viewpoints Report noted that some participants expressed interest in being provided with pricing options, although most indicated they did not want to be bothered with such a decision, particularly since the monetary impact was insignificant, and they did not have the time nor the expertise to make a knowledgeable decision.

Centra acknowledged that the interpretation of the survey could be subjective, particularly in light of the conflicting opinions customers provided. As an example, 78 percent of customers agreed with the statement "Paying the market rate for natural gas might save me a little money in the long run, but I'm not comfortable with paying a rate which might go up or down by as much as 10 percent every month." In the same instance however, most customers believed a \$5 monthly increase or decrease would be acceptable since that was viewed as an insignificant change.

Of the customers surveyed by telephone, 75 percent indicated they did not want a floating option. Centra witnesses justified their choice of a floating option by stating they placed greater weight on the customer focus groups since more time and discussion on the options was permitted compared to the telephone survey. What Centra concluded from the focus group and incorporated into the Plan was that a plus or minus \$5 per month variance in the monthly bill was inconsequential to most customers.

## **8.2 1998/99 Price Management Plan**

Centra's proposed price management Policy requires an annual Plan providing three alternatives and a recommendation to be developed for the upcoming gas year. According to Centra, these alternatives would take into consideration customer preference regarding rate stability, balanced with the desire to obtain the lowest possible price. Rather than focussing on gas price volatility, the 1998/99 Plan focuses on the stability of rates as reflected in the customer's gas bill. For the purpose of comparison of the effectiveness of alternate price management strategies, Centra submitted the impact such transactions have on monthly gas bills is the most relevant indicator of its acceptability to customers.

Centra prepared fourteen different price management scenarios to demonstrate the effects of gas price increases and decreases on sales rates for 1998/99, taking into consideration various combinations of transactions and volumes hedged. These scenarios contain variations of

volumes to be hedged, and various assumptions of price increases and decreases. The prices associated with the purchase of some options, although indicative, will vary with the timing and volatility of the market at the time of the transaction.

In one set of scenarios, Centra used as a worst case scenario the variation of 50 cents per GJ as Centra believed that to be a fairly drastic move in the market over the course of the twelve month strip. If the price is left fully floating and the market moves up or down 50 cents, there would be a movement in the customer's monthly bill of approximately \$5.00. Based on the information derived in the survey and the judgment of Centra, \$5.00 was within customer tolerance levels.

Based on the various price scenarios analysed, Centra concluded that price management will have a relatively limited effect on sales rates, and customers' perceptions of rate stability. Centra therefore recommends that no price management transaction be executed for the 1998/99 gas year volumes. Centra indicated that its recommendation focuses on gas price volatility and the corresponding effect on rate stability. The focus is based on the amounts ratepayers see on their bills.

As noted, Centra has filed a Plan for the 1998/99 gas year commencing November 1, 1998, so much of the year has already passed. The heating season which has the heavy customer consumption has already occurred, but the gas purchases are relatively constant throughout the year since Centra purchases volumes in the summer for filling storage.

### **8.3 PGVA Account**

Centra recommended the PGVA balance be disposed of on a more frequent basis. The current method of allowing balances to build to significant amounts prior to disposal does more to create the impression of rate instability than do changes to the commodity price of gas.

## **9.0 Regulatory Test and Process**

### **9.1 Test**

The proposed Policy contains a provision that: "A possibility always exists that price management activities may result in a negative outcome. However, if the underlying derivative usage is managed on a reasonable and prudent basis, the cost of any negative consequences should be included as a component of the Company's cost of service." Witnesses for Centra agreed this was a similar test as articulated in Board Order 3/96. The proposed Policy also contains a provision that, "It is through maintenance of an appropriate control environment that the reasonableness and prudence of management is demonstrated and operations and credit risk are managed." Witnesses for Centra agreed this had the effect of narrowing the reasonableness and prudence test to being within the framework of the control environment, which included the operational risks inherent in a derivative program.

Under the proposed Policy and Plan Centra urged the Board to determine prudence and reasonableness based on a test of Centra's ability to execute forward transactions based on forward market conditions at that time. With pre-approval of the Plan, Centra should be judged on its adherence to that Plan and the Policy in placing financial derivative instruments. In argument, Centra's counsel indicated that Centra does not take issue with the criteria or the regulatory test and is not seeking it be changed from Order 79/98.

### **9.2 Regulatory Oversight**

The proposed Policy contemplates circumstances when Board input is sought, in particular for:

- initial approval prior to effectiveness of Policy;
- approval of Policy amendments;

- annual collaborative work with the Board on determining customer expectations;
- approval prior to implementing annual Plan;
- approval of Plan changes;
- disposal of PGVA balances; and
- quarterly reporting of price management to the Board.

When questioned as to whether the proposed Policy has the effect of transferring part of the Company's responsibility for Price Management to the Board, witnesses for Centra agreed that inevitably this would happen to a limited degree although Centra was ultimately responsible for the cost of gas to be paid by customers. Centra would still assume the operational risks of management and monitoring.

The proposed Policy requires an annual filing based on the November to October gas year, which may or may not coincide with a General Rate Application filing. Unfortunately, this may result in a variety of regulatory filings, hearings, and rate adjustments throughout the year.

The Policy contemplates a four week run-up period commencing when Centra forecasts its gas cost in the beginning of October to the commencement of the November first gas year, during which time stakeholders are to be consulted and the Board, through appropriate procedures, is to approve a Plan. Witnesses for Centra noted that this could be accomplished in a six or eight week period if required. A consensus meeting involving all stakeholders could occur in August with a filing for a Board Order no later than October 1. This would allow Centra thirty days to execute its price management. This enhanced timetable would allow the Board to discharge its functions through a public hearing process.

Centra suggested that, although this Board Order should be of sufficient specificity, it be balanced between giving directions that would not compromise Centra's ability to engage in price management by disclosing to the market the date and time of transactions to be entered

into, yet not be vague enough that Centra be judged in hindsight on the timing of it entering into financial derivative transactions.

## **10.0 Intervenors' Positions**

### **10.1 CAC/MSOS Witness**

CAC/MSOS put forth Professor Herbert as a witness. In commenting on Centra's application, Professor Herbert agreed with Centra's first step of undertaking a customer survey, which had not previously been conducted, but was not satisfied with the detail in the survey with respect to price and volatility. Professor Herbert testified that Centra should hedge what it anticipates to be actual volumes or expected requirements rather than minimum warmest year scenario volumes – this would provide the customer with greater rate stability by fixing the price at a level customers are willing to accept. Professor Herbert submitted that this would not be a speculative transaction because there was a reasonable expectation that the volumes were to have been used, even if not used.

Professor Herbert noted that the consultative process with stakeholders and the Board was important in establishing a price management program, but after consensus was achieved, the utility should operate its price management as it would any other utility activity. Professor Herbert testified that more weighting should be given to rate stability than to market responsive pricing based on the customer survey in establishing the role and objectives of Price Management. A further role would be to provide customers with enhanced price transparency. In cross examination, Professor Herbert agreed that: Centra's price management policy should attempt to manage extremes in volatility; the use of the various over the counter financial derivative instruments was appropriate; and fixing a forward price contract for a year could be appropriate. Professor Herbert was satisfied with the various control principles set out in the

Policy, in addition to the roles and responsibilities of those involved in Centra's price management. Professor Herbert however, expressed reservations on the qualifications of the Middle Office Manager, indicating that training in economics and statistics was important.

Professor Herbert urged Centra to include more quantifiable numbers and figures in its survey, involving stakeholders at that stage of price management, file more than three alternatives with the Board, and base its alternatives on variable criteria such as normal winter, cold winter, warm winter, trending prices, highly volatile prices, little volatility, etc. An expansion to the exceptions for selling or otherwise dealing with derivatives once placed as listed in the Policy was recommended, along with detailed examples. Professor Herbert also advocated a statistical framework be used in the Plan development. Furthermore, performance measurements were lacking, notwithstanding Board Order 79/98.

## **10.2 Consumers' Association of Canada/Manitoba Society of Seniors ("CAC/MSOS")**

CAC/MSOS argued that the price management policy approved by the Board in Order 49/95 was still in effect, that there really wasn't anything intuitively wrong with that policy, but that Centra has not followed it.

CAC/MSOS noted the Board had ordered Centra to maintain an interim passive hedging program, meeting the initial goals as set out in the policy document. In maintaining an interim passive-hedging program, Centra was required to incorporate better controls. CAC/MSOS stated Centra should be operating under an interim program, as ordered by the Board, and all actions are to be judged in that context and on that basis until the Board otherwise orders. CAC/MSOS further stated that any Board approval of a new Price Management Policy should be on a prospective basis. CAC/MSOS argued Centra can't now change the policy, operate under the new policy, and then seek Board approval of that program retroactively.

CAC/MSOS believed Centra is seeking to change the standard of review related to the price management program, in terms of risk and responsibility, and is seeking to incorporate these

changes retroactively. CAC/MSOS argued that there is no need to change the standard of review, as articulated in Order 79/98, and that it is totally adequate and embraces the principles endorsed by the Board.

CAC/MSOS agreed that there should be a collaborative process in developing a Price Management Plan and that it would be prudent for Centra to seek consensus with the various stakeholders but not the Board, noting that the Board's role is to render decisions, not to set policy, develop plans or manage the Company's business. Once the Board approves a Policy, Centra's responsibility is to carry out that policy in a prudent and reasonable fashion. CAC/MSOS argued that once a policy is approved, there is no need for pre-approval of a plan. By requiring the Board to pre-approve of the plan, risk would be shifted to the Board, which would derogate from the role of the Board.

CAC/MSOS also noted that if Centra refuses to conduct price management without Board pre-approval, Centra's inaction would still be considered price management, and that inaction should be judged according to its appropriateness at the time gas costs are reviewed by the Board.

CAC/MSOS also disagreed with the level of eligible gas volumes to be hedged as set out in the policy. CAC/MSOS argued that it was inappropriate for Centra to hedge only the warmest year volumes because, invariably, the customer is exposed to a greater or lesser degree. CAC/MSOS argued that Centra should evaluate the probabilities in any given year as to what volumes can be expected to be required, and then make a determination as to what, if any, of those volumes ought to be hedged. In doing so, the objective of Centra is not to beat the market but to be as close to the market as is possible.

CAC/MSOS also disagreed with the proposal set out in the proposed policy that Centra develop a plan with three alternatives and one recommendation. The alternatives put forward by the Company should be developed based on actual data on the basis of whether the scenarios are risky, based on normal weather, cold weather, warm weather, trending prices, highly volatile

prices, or whether there is no volatility,. CAC/MSOS noted that it is up to Centra to determine, in its best judgment, using its resources, the course of action to be followed.

CAC/MSOS also expressed concerns with the customer survey used in establishing the plan. CAC/MSOS considered it inappropriate that the survey did not pose the question related to price volatility of plus or minus \$5 per month to the customers contacted by the phone portion of the survey, which represented the majority of the respondents to the survey. The survey also failed to make it clear to respondents that the price variance of plus or minus \$5 related only to the gas component of the bill and that other elements could affect the bill by more than \$5 per month. CAC/MSOS urged the Board not to deal with the Plan at this point in time, because it is not consistent with the evidence as to what the customer needs are as determined from the survey.

### **10.3 City of Brandon & Six Other Cities and Towns and Winnipeg School Division No. 1**

Counsel for the Winnipeg School Division No. 1 and the Cities of Brandon, Portage la Prairie, Dauphin and Steinbach and the Towns of Morden, Winkler and Selkirk, generally agreed with the arguments put forward by CAC/MSOS but had specific concerns with the proposed price management policy. Counsel for these intervenors stated the Board should consider whether comparing volatility and consumer tolerances to price increases is the preferred approach.

Counsel for these intervenors also stated that the principal concern derived from the results of the survey is consumers' interest in stability of price. Centra should be concerned about the development of a price management strategy to protect the public from that volatility and the current approach doesn't adequately emphasize price stability.

Counsel for these intervenors argued that it is not the Board's responsibility to take on a collaborative role with Centra. He stated that Centra should recognize its role is one of price managing while the Board's role is to review decisions that Centra has taken. He argued that it

was not appropriate to ask the Board to take on a role of planning with Centra on a year-to-year basis.

Counsel for these intervenors also expressed concern with Centra's proposal that the Board would pre-approve a price management plan such as being put forward by Centra. He stated that it is clear that the motivation for the development of both the policy and, in particular, the plan of Centra has been designed to remove from Centra any risk from price management. Support was offered for the position taken by CAC/MSOS that there was an existing Policy in place. The Board was urged to reaffirm, for Centra's benefit, that as long as it operates within the policy, and doesn't become re-involved in any form of speculation, it is appropriate to carry on with an active price management program.

Counsel for these intervenors agreed with CAC/MSOS that Centra should be at risk for their inaction if it refused to follow a Price Management plan for the 1998/99 gas year unless it is pre-approved by the Board. It was noted that Centra assumed the risk when they acquired the franchise, and that they are required to acquire a commodity on a reasonable and prudent basis for its customers. There was agreement with CAC/MSOS that the parameters being contemplated for action plus or minus \$5 changes in monthly bills are too broad and will not result in any Price Management activity.

#### **10.4 Coalition of Eastern Natural Gas Aggregators and Sellers ("CENGAS")**

CENGAS stated that it did not have any submissions to make on the Policy nor did it oppose Centra's recommended Plan for the 1998-1999 gas year. CENGAS stated that any approval of a future active price management plan will necessitate reconsidering the monthly reference price calculation in light of the interpretation placed by the Board on the calculation of the monthly reference price in Order 6/99.

CENGAS stated that Board approval of Centra's 1998/99 Price Management plan should be conditional upon Centra developing and filing with the Board, in a timely fashion, a Western Bundled T-service which will be available for implementation no later than November 1, 1999. If

not implemented by November 1, 1999, then Centra's shareholders should bear the full cost of any disallowed price management transactions until such time as the service is implemented.

### **11.0 Board Findings**

The Board notes that on March 10, 1999, Manitoba Hydro signed a letter of intent with Westcoast Energy Inc. ("Westcoast") to purchase all shares of Centra Gas Manitoba Inc. subject to required regulatory approvals being obtained. Subsequently, on May 14, 1999, a definitive share purchase agreement was signed. March 10, 1999 was, of course, after the close of the evidentiary and argument components of the hearing. Nevertheless, such a change in ownership, if approved, may affect, as applied for, both the Price Management Policy and Plan. This affects the Board's decision in this matter only in respect to references to the owner of Centra being Westcoast.

### **11.1 Policy Guidelines**

The Board recognizes that there are numerous instances in which the Policy requires Westcoast's intervention, oversight, monitoring or approval of Centra's price management. Areas in which Westcoast is to play a role in price management Policy of Centra include:

- Consultation with Centra for conflict issues with Westcoast policy;
- Policy distribution;
- Amendments to Policy Guidelines are to be authorized by Westcoast;
- Approval of type and use of derivative instruments;
- Foreign exchange and;

- Reporting requirements.

In the event that all requisite approvals of the transaction involving Manitoba Hydro and Westcoast are obtained, then the references to Westcoast are inappropriate. The relevance of the Policy Guidelines is thus diminished and would be changed by the new ownership of Centra.

### **11.2 Price Management Policy – Future Direction**

This Board believes that, as the regulator of the natural gas utility, its involvement in price risk management policies, objectives, strategies and plans should be limited to providing guidance to Centra on its risk philosophy and outlining what it believes should constitute a prudent and appropriate policy.

It is not the intention of the Board to prescribe to Centra the price risk management strategies it should follow or the specific nature of the controls it should have in place to ensure effective implementation of its risk management program. The Board believes that these functions are more appropriately the responsibility of Centra's Board of Directors and executive management. The Board will prescribe the process that Centra should undertake in developing its price management program.

Centra can either conduct its price management program internally or outsource it to a third party. If it is to be conducted internally, then the Board expects a substantial reworking of the proposed Policy Guidelines as recommended in these Board Findings. Similarly, if Centra is to outsource its price management, then it must ensure that its objectives and philosophy are reflected in the contract arrangement. Outsourcing the execution of price management will not mitigate Centra's responsibility to define appropriate hedging objectives, Policy Guidelines and establish risk profiles to ensure the effective implementation of risk management consistent with the defined philosophy. Should outsourcing be pursued, the Policy Guidelines will have to be rewritten significantly to take into account the service offerings of the outsourcing provider and the nature of the arrangement. Furthermore, the assumption of risk for non-compliance by the parties should be specified in the contractual arrangements.

Finally, many of the comments contained within these Findings are based on Centra undertaking a price management plan and program throughout the year. There is, of course, the opportunity to merely fix one price and remove all price risk exposure for the entire year. This may be an appropriate strategy, if the justification was based upon a rigorous analysis.

The Board believes that if this guidance for creating an appropriate pricing policy framework is followed and if the strategy consistent with these policies is executed prudently under appropriate controls and supervision, then the implemented strategy will be found acceptable and the economic costs or benefits from the risk management program will flow through to the consumer.

The directions contained within this Order require Centra to alter substantially its Policy Guidelines. The Board will direct that the new Policy Guidelines be filed by August 31, 1999.

#### **11.2.1 Philosophy**

As the provider of a public utility service, the objectives of Centra's price management program should differ from those of a commercial organization which uses price management to meet the profit maximizing objectives of its shareholders.

The Board recognizes that without price management intervention, the nature of Centra's indexed supply pricing would expose the consumer to full market price volatility. Given the historical extreme volatility associated with natural gas, the Board believes it is in the best interest of the Manitoba gas consumer for Centra to undertake a price management program aimed at reducing this volatility.

Monthly consumer bill volatility will likely be lower than the market price volatility of the commodity itself because of the inclusion of fixed cost components in the rate structures. The timing of consumer exposure to market price fluctuations may be modified by the use of the

PGVA. Ultimately, in the absence of a price management program consumers would be completely exposed to price volatility and to long term changes in the market prices.

Therefore, whereas Centra had applied for approval of the objectives of balancing rate stability with market responsive pricing, the Board is of the view that the objective should more appropriately be one of reducing price volatility. For the purpose of this objective, price volatility should be considered as both abnormal price spikes (i.e. due to extreme weather or supply disruptions) and the high price volatility that may be considered normal for the participants in the gas market but may be unacceptable to consumers. The Board will not adopt the proposed dual objectives of rate stability and market responsive pricing, because the Board is concerned that with these objectives being diametrically opposed, it will be difficult to apply one strategy to address both objectives. It is imperative for Centra to establish a consistent price management objective as the first step in undertaking a successful price management program. Furthermore, the Board does not want Centra to pursue an aggressive price management plan that actively seeks to obtain the lowest price since such a strategy might foster an overly aggressive plan not suitable to a public utility.

This program should be guided by a philosophy of reducing the price volatility as discussed above, associated with Centra's gas supply contracts to within acceptable parameters. Such parameters may be set with reference to the consumers' perceived tolerances. It is also envisioned that a degree of market price responsiveness should be maintained but that exposure by the consumer to rates above the perceived tolerance levels should be reduced on a defined percentage of eligible volumes. Rate tolerance parameters must be translated into target price tolerance parameters.

Consideration must be given to the appropriate time horizon for risk management. A distinction can be made between short and long term price management. For the purpose of this Order the Board defines "long term" to be longer than one year. Management, over a long-term horizon, will involve forecasting both seasonal and structural factors to project price trends.

Under the current circumstances, it is the decision of this Board that price management plans be limited to a one year horizon as defined by the gas year. Within a year there can be significant price volatility and the Board believes it is in the public interest for Centra to have in place a well executed price management program for that gas year.

The Board appreciates Centra's efforts to include customer input in price management through customer surveys and focus discussion sessions. Even though the results can only be a general indicator of pricing preferences, the Board encourages Centra in its efforts, and expects the results to be included in the annual Plan as filed with the Board.

#### **11.2.2 Defining Key Risks**

While the objective of this section is to set guidelines within which Centra will formulate its policy framework for price management, the Board believes that it is important to explicitly define some of the other key risk categories that will be associated with the implementation of such a program. It is the Board's expectation that there will be policies, formalized processes and plans dealing with each of these risk categories in the Policy Guidelines.

##### **Price Risk**

Centra has a supply contract with TCGS through which it sources much of its gas. The remaining volumes are sourced on the Canadian and US spot markets. The TCGS floating index contract therefore naturally provides "market responsive" pricing to consumers. It is the management of this month-on-month volatility over a one year time horizon that the Board recognizes as the objective of the risk management program.

##### **Basis Risk**

This is a component of price risk that may occur when supply contracts are based on a different pricing index from the physical supply, but much of this risk has been substantially altered by a

shift from NYMEX to a 70% AECO-NIT and 30% Empress pricing formula for the TCGS contract rather than a NYMEX based formula. No such basis risk remains in the TCGS contract. This should be clarified in the Policy Guidelines.

Although there is no longer a basis risk inherent in the TCGS contract by using NYMEX, there is a further basis risk. This arises from the natural difference between the hedging instrument to the underlying physical volumes. This basis risk management must be identified, measured and then managed – all of which must be stated in the Policy Guidelines. If Centra is not intending to manage this basis risk, then it must be stated in the Policy Guidelines.

#### **Spread Risk**

This results from the mismatch in timing of hedges versus projected gas supply such that the timing of hedge maturation should closely match with the consumption of volumes hedged.

### **Volume Risk**

The Board wishes to reiterate its position stated in previous Board Orders that Centra only conduct price management on those volumes to be used in a warmest year scenario and not to indulge in any speculation. The attempt to match derivative instruments to actual volumes, including peak volumes as suggested by Professor Herbert introduces a further element of uncertainty and risk into price management. The Board is of the view that such uncertainty and risk does not compensate for the additional benefits to be incurred by attempting to manage additional volumes and the effort entailed in such an exercise. Accordingly, no such risk of volumes should arise.

### **Credit Risk**

Centra's credit risk will principally arise from its use of OTC hedge products with other financial counter-parties. This replaces clearinghouse risk (when using exchange traded instruments) with the credit risk of the individual counterparties.

### **Foreign Currency Rate**

This remains a risk of exposure resulting from the purchase and sale of gas or financial derivative products in foreign currency denominated contracts.

### **Operations Risk**

Operations risks are those associated with flawed execution of the approved strategies. Operations risk will be managed through having an appropriate organizational structure, addressing issues of supervision and segregation of duties, detailed procedures and an appropriate control framework, in addition to adherence to the policies including limit structure, procedures and plan. All of these as applied for are laid out in the Policy Guidelines. However, given the significant change in the objectives and other aspects of the Policy Guidelines, Centra might welcome the opportunity to re-evaluate the operations risks. Furthermore,

notwithstanding anything written in the Policy Guidelines, it is up to the individuals and the committees involved to ensure that the spirit of the Policy Guidelines are followed.

### **11.2.3 Objectives, Strategies and Instruments**

Specific hedge objectives should be formulated for each gas year that are consistent with the approved risk philosophy. Specific hedging strategies should then be formulated by Centra based on the following process steps:

- formulate strategy based on results of formal analysis;
- perform ex ante sensitivity and stress tests on proposed strategy;
- undertake demand modelling of eligible volumes;
- present results to Board for approval; and
- obtain regulatory approval for the Plan prior to the commencement of the gas year.

Included in the process of price management is the step requested by Centra that the Board pre-approve the price management plan. The Board is willing to consider pre-approval similar to its pre-approval of other expenditures undertaken by Centra in the future test year regime under which it currently is regulated. Accordingly, the Board expects Centra to apply for approval of its price management plan containing details of its objectives, strategies and instruments to be used well in advance of the commencement of the November 1 gas year.

The Policy Guidelines should list the approved over the counter hedging instruments and how they can be used in the circumstances. Further, there should be a process for the approval of new instruments. Similarly, the actual specific details of the use of the instruments should be contained in the Plan.

#### **11.2.4 Reporting**

##### **Internal Reports**

The Board will not comment on the nature or the content of the internal reports that Centra prepares except to say that the Board requires Centra to undertake, for its own purposes, reports on sensitivity such as value at risk analysis (eventually given the magnitude of the task), a stress test based on subjective and historical analysis of extreme price moves, and a benchmarking performance measurement analysis. Internal reports should clearly communicate all risk taking activity and resulting risk profile.

##### **Reports to the Board**

The Board will not require Centra to file monthly or quarterly reports on price management other than on an exceptional basis where actual results of price management are at a substantial variance from the projected results. The Board will require Centra to file an annual report on the previous year-to-date price management performance and financial consequences, including benchmarks, how the objectives and strategies have been met and pertinent material with the application for approval of the price management plan for the upcoming year.

##### **Reports to Customers**

To encourage price transparency, the Board will require Centra to address whether it is possible to communicate to consumers, through a bill insert on a regular basis, a graphical representation of historical commodity prices. This should have the effect of educating consumers on the uniqueness of commodity pricing and furthering the development of a competitive market. The Board encourages Centra to work with aggregators, marketers, brokers and consumer representatives to develop a consensus on the filing of this information to the consumer.

### **11.2.5 Risk Measurement Methodology**

A robust risk measurement methodology should ensure reliability of input data, tested and credible pricing models, a revaluation methodology that accurately reflects the cost of closing out current positions at current market prices and an integrated profile of all market risks. Risk measurement methodology should serve to:

- ensure integrity of risk management and derivative pricing systems through a regular process of external (to the risk management department) system audits;
- ensure integrity of the revaluation methodology through regular independent checking of the underlying pricing models and the forward curve interpolation methodologies;
- ensure integrity of input data; and
- check consistency of output data and ensure that risk management data produced by the revaluation and risk measurement approach is both accurate and appropriate for management.

### **11.2.6 Organizational Structure**

The Board is not totally satisfied with the organizational structure as contained currently in the applied for Policy Guidelines. A effective organizational structure should be in place to ensure effective segregation of duties and effective back-up for key functions and controls. Furthermore, since there will be substantial changes made in the Policy Guidelines as required by this Order, then the organizational structure may no longer be appropriate. Notwithstanding what is in the written Policy Guidelines, the Board notes that every function and individual has to operate completely within their mandate and it is up to the due diligence of the individuals to ensure the appropriate level of performance is adhered to and completely satisfied.

### 11.3 Regulatory Test

Much time was spent at the hearing addressing the level of regulatory oversight required under the proposed Policy Guidelines. The Board considers such level of proposed oversight and participation in the development of the Plan to be so extensive and onerous to constitute a transfer of management's responsibilities to the Board. The Board is of the view that the effect of the Policy Guidelines is to alter both the corporate governance of Centra and the regulator's oversight, such that the regulator is indeed performing the function of either management or the Board of Directors by participating in developing the details of a price management plan. Such a role is not appropriate for the regulator. Accordingly, future Policy Guidelines should alter the regulatory oversight provisions so as to not require such extensive Board involvement.

It was argued that the effect of requiring the Board's pre-approval of the price management plan is to transfer the risk of price management from Centra to the Board. Should the Board not provide ex-ante approval of the price management plan, Centra indicated they would be exposed to the possibility of a cost disallowance. The Board notes that previous disallowances were due to speculation, failure to adhere to the Policy and operational mismanagement. Such reasons for disallowance are still possible, even if the Board pre-approves the Policy and Plan as now requested. Under an appropriately managed Policy and Plan, Centra will not face the risk of disallowances for market fluctuations, just as it did not in Order 79/98. The Board agrees that Centra should not bear any risk of a well managed price management program and that it is the consumers who carry the actual risk of any volatility in the market. It is Centra's role to manage that volatility to a level acceptable to those customers and to the regulator.

The following are some criteria this Board could use in determining whether Centra has adopted a prudent and reasonable approach to implementing its risk management program:

- risk management activities as judged against the spirit of its defined risk management philosophy;

- all risks have been identified and appropriate policies have been approved to deal with the management of these risks;
- adherence to its approved risk management policies;
- implemented strategies have been formulated as a product of a rigorous analysis process;
- implemented strategies have been subjected to an ex ante process of sensitivity and stress testing;
- implemented strategies have been periodically revalued using a tested and sound methodology;
- reports have effectively communicated the nature of the adopted risk profiles to the Centra executive and their Board of Directors;
- appropriate personnel are responsible for the implementation of the risk management program with consideration given to required skill sets and experience; and
- an effective control structure is in place.

#### **11.4 1998/99 Plan**

The Board offered direction on the future of price management in Board Order 79/98:

“The Board expects that Centra’s interim passive hedging program excludes dynamic trading and meets the goals and objectives initially developed for a passive hedging program and included in its Policy Document –

1. achieve a market responsive price

2. introduce stability to temper adverse volatility inherent in achieving a market responsive price, and
3. where appropriate, adjust the portfolio of fixed prices.

The Board also believes that, effective immediately, Centra must ensure that its interim passive hedging program has more effective controls, checks and balances.”

Witnesses for Centra testified that upon completion of the new Policy Guidelines, Centra commenced price management under this Policy, notwithstanding it had not received Board approval.

The preparation of the 1998/99 Plan took into account the possibility of market fluctuations within various ranges and the effect on the gas sales rate which Centra determined to be reasonable for customers based upon the results of the survey it conducted. The decision was then made to not place any financial derivative instruments since the impact of +/- \$.50/GJ had a maximum impact on a customer's monthly bill of \$5.03. The Board considers that management's decision was reasonable and prudent at the time the decision was made, in the circumstances.

However, for the future, the practice of not placing any financial derivative instruments is not acceptable on a long-term basis, as Centra should attempt to manage volatility in its indexed variable pricing arrangements as set out in this Order. As previously indicated, the Board directs that future price management Plans should continue to minimize the risk of indexed variable pricing so long as Centra purchases its gas under the current indexed pricing arrangements with TransCanada Gas Services.

The Board will therefore approve the financial consequences of the 1998/99 price management Plan. However, the approval will only be until the date of the hearing since that is the evidence before the Board in deciding the price management decisions of Centra were reasonable and prudent in the circumstances. The Board will require Centra to file, along with the 1999/2000 Plan, a summary of the 1998/99 price management activities, from the date of the hearing in February, 1999.

**12.0 IT IS THEREFORE ORDERED THAT:**

1. Centra file by August 31, 1999 new price management Policy Guidelines addressing the concerns as expressed in this Order.
2. The financial consequences of the 1998/99 price management Plan to February 18, 1999 BE AND ARE HEREBY APPROVED.

THE PUBLIC UTILITIES BOARD

"G. D. FORREST"

Chairman

"H. M. SINGH"

Acting Secretary

Certified a true copy of Order No. 100/99  
issued by The Public Utilities Board

  
Acting Secretary