Centra Gas Manitoba Inc.

Cost of Gas Application

Before the
Manitoba Public Utilities Board

Evidence of Drazen Consulting Group, Inc.

on Behalf of Centra Gas Manitoba Inc.

DRAZEN CONSULTING GROUP
Energy & Regulatory Economics

Project No. 151562
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Q1 PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A1 Mark Drazen, 225 S. Meramec Avenue, Suite 1033T, St. Louis, Missouri, USA, and 31 Aspen Stone Grove, S.W., Calgary, Alberta, Canada.

Q2 WHAT IS YOUR OCCUPATION?

A2 I am a consultant in the field of public utility economics and regulation and a member of Drazen Consulting Group, Inc.

Q3 PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A3 I have worked in this field since 1972 in rate cases, regulatory analysis, project planning and negotiations throughout Canada (eight provinces and federal jurisdictions) and the United States (40 states and federal jurisdictions). Our firm has been in this field since 1937. I have degrees in mathematics and engineering from the Massachusetts Institute of Technology. Details are given in Appendix A.

Q4 ON WHOSE BEHALF ARE YOU SUBMITTING THIS EVIDENCE?

A4 I am appearing on behalf of Centra Gas Manitoba Inc.

Section I–Introduction and Overview

Q5 WHAT IS THE SUBJECT OF THIS EVIDENCE?

A5 In its Interim Order No. 12/15 on Centra's Interim Application for Non-Primary Gas Rate Riders (July 31, 2014), the Board noted that in 2013-2014 Centra's net income was much higher ($20 million) than that approved in the most recent General Rate Application ($2.5 million). The Board went on to say:

> *In the upcoming Cost of Gas Application, the Board expects Centra to consider whether a portion of its retained earnings, which resulted from the cold weather, should be used to reduce the negative impact on customers from the further recovery of the Supplemental Gas PGVA.* (page 22)

This evidence discusses why using part of retained earnings (or income) to offset purchased gas cost is not advisable.

Q6 PLEASE SUMMARIZE THE MAIN POINTS IN THIS EVIDENCE.

A6 They are:

- Centra's PGVA was proposed and approved by the Board on the basis that it would recover exactly the cost incurred;
- Gas cost recovery mechanisms such as Centra's Purchased Gas Variance Account are used throughout Canada and the U.S. The magnitude and variability of purchased gas cost relative to earnings makes it desirable to insulate earnings from the risk of variations in gas supply cost;
- All other Canadian gas distributors have exact gas cost recovery mechanisms–that is, the distributor recovers exactly the cost that it pays;

- Likewise, virtually all U.S. distributors have exact gas cost recovery mechanisms;
- Although the extremely cold weather in 2013-14 resulted in a high level of income to Centra, in other years Centra has experienced losses, so 2013-14 should not be viewed in isolation; and
- On a long-term basis, Centra's actual earnings have been only modestly higher than the expected level. In fact, excluding 2013-14, Centra has, on average, earned less than the expected net income.

Q7 WHAT IS THE ORGANIZATION OF THIS EVIDENCE?

A7 **Section II** discusses the use of gas cost recovery mechanisms by Canadian utilities.

Section III discusses the use of gas cost recovery mechanisms by U.S. utilities.

Section IV reviews Centra's operating results over the last 10 years.

Section V is a summary.

Section II–Canadian Utility Practice

Q8 IS CENTRA'S PURCHASED GAS VARIANCE ACCOUNT CONSISTENT WITH GENERAL PRACTICE?

A8 Yes. Terminology, structure and the regulatory framework all differ somewhat among provinces, but the intent is the same. The cost of gas purchased by the utility is flowed through to customers on a dollar-for-dollar basis. The utility does not make money or lose money on the cost of purchased gas.

Q9 WHAT IS THE RATIONALE FOR GAS COST RECOVERY MECHANISMS?

A9 Under regulation, a utility is supposed to have a reasonable opportunity to recover its cost of service. One reason for this is that it reduces the risk to the utility and, as a result, reduces the overall cost to the customers. Purchased gas cost is both the largest single element in a utility's cost of service and also the one that is most variable. Without the ability to recover that cost, utilities would face an extremely high level of risk. This, in turn, would require compensation for additional risk borne by the utility.

Q10 PLEASE DESCRIBE CENTRA'S PURCHASED GAS VARIANCE ACCOUNT.

A10 The PGVA was established in 1993, as authorized in Board Order No. 10/93. Among the reasons cited by the Board was:

> *The Company testified that* ***the function of the PGVA is to ensure that the rates charged to customers will recover all of the gas costs incurred by the Company, no more and no less. The Company can neither gain nor lose on its purchased gas unit cost,*** *which is fair to both the Company and its customers.* (Section 12.0, page 102)

Further, in PUB Order 79-98 the Board said:

> *The Board agrees with the company and CAC/MSOS that the implementation of a PGVA account is an appropriate methodology to deal with the increasing complexities of gas procurement in a reasonably simple manner.* (pdf page 105)

In Order No. 118/03 (July 29, 2003), the Board said (emphasis added):

> *The Board notes the significant increase in the working capital allowance component of rate base, as a result of the* ***large increases in gas commodity costs, which is passed on to customers without mark-up****.* (Section 7.3.2, page 30)
>
> *The Board notes the significant run up in the cost of gas and PGVA balances during 2000/01 and 2001/02 and that* ***Centra purchases gas on a flow through basis at cost****. The build up in the PGVA at that time was unprecedented given the very high natural gas prices, resulting in Centra incurring higher than normal debt to finance gas purchases.* (Section 8.2.2, page 35)

Q11 IS CENTRA LIKE OTHER CANADIAN UTILITIES IN THIS RESPECT?

A11 Yes. All Canadian gas utilities have some form of a gas cost recovery mechanism. They are all intended to flow through the actual costs of gas supply to customers, with no profit or loss to the utility. Typical statements of this are (with emphasis added in all cases):

> ***Alberta Utilities Commission***
> *Use of the DGA* [Deferred Gas Account] *takes into account that, under a regulated gas sales rate, customers pay only the actual costs of the gas consumed by them and* ***the utility is neither to incur a profit nor suffer a loss in the course of procuring and selling the gas.***[1]
>
> ***FortisBC (British Columbia)***
> *FortisBC buys natural gas from producers, and then charges you exactly what we paid for it.* ***We don't mark up the cost of gas. That means you pay what we pay.***[2]

[1] http://www.auc.ab.ca/applications/decisions/Decisions/2006/2006-042.pdf
[2] http://www.fortisbc.com/About/AboutNaturalGas/Pages/Cost-of-gas.aspx

Enbridge Gas New Brunswick
Competitive Pricing: Enbridge Gas New Brunswick purchases natural gas on the customer's behalf and sells it at the same price we pay for it. ***We do not profit from the sale of natural gas.*** *Anytime we are able to get better prices, you benefit!*[3]

Heritage Gas (Nova Scotia)
The Gas Cost Recovery Rate (GCRR) is a variable charge that appears on your bill as a "$ per GJ" charge. This rate is applied to the total energy consumed during the billing period. ***This is a "pass through" charge, meaning there is no additional mark-up applied by Heritage Gas.***[4]

Ontario Energy Board
Utilities in Ontario are not allowed to earn a profit on the supply – ***the price paid on the open market must be passed through to customers with no markup.***[5]

Gaz Métro (Québec)
The variable price supply service and compressor fuel are provided directly by Gaz Métro and billed according to a rate that varies on a monthly basis, to reflect fluctuations in market price. ***Gaz Métro does not make a profit on these two services.*** *You are thus sure of paying the real market price.*[6]

SaskEnergy (Saskatchewan)
In setting the commodity rate, SaskEnergy follows the standard Canadian natural gas utility regulatory practice which is to pass through the cost of natural gas sold to customers without applying any margin or additional costs. ***No profit or loss should be incurred by the utility on the sale of natural gas.***[7]

Q12 ARE THERE ANY CASES IN WHICH THE UTILITY DOES NOT RECOVER THE FULL COST OF SUPPLY THAT IT PAID?

A12 Yes. Regulation is intended to give the utility the opportunity to recover its *prudently* incurred costs. However, if the regulator determines that a cost was imprudently

[3] http://naturalgasnb.com/CMS/en/home/rates/enbridgeutilitygas/default.aspx
[4] http://www.heritagegas.com/residential/rates/
[5] http://www.ontarioenergyboard.ca/OEB/Consumers/Natural+Gas/Natural+Gas+Rates
[6] http://www.gazmetro.com/en/faq/ "What is the variable price supply service?"
[7] http://www.saskenergy.com/business/WebsiteCommentary.pdf

incurred, it should not be recovered from ratepayers. This applies to both non-gas and gas costs.

On rare occasions, a utility has not been allowed to recover 100% of the purchased gas cost. This occurs when the regulator has found imprudence in the utility's acquisition practice.

This happened to Centra once. In 1997 and 1998, Centra's gas cost hedging strategy incurred losses. The Board decided that the strategy had not been managed prudently and disallowed recovery of part of the losses. In Order No. 79/98 (June 19, 1998), the Board said:

> *The Board found that Centra had entered into dynamic trading without the appropriate plan, with inexperienced traders, and with inadequate supervision. The rigorous controls, checks, and balances were lacking, as was the attention paid by the Hedge Committee of senior management which only met quarterly. The Board found that the Hedge Committee did not act reasonably or prudently by allowing employees with very little experience to engage in dynamic trading, with inadequate oversight.*

However, at the same time the Board reaffirmed the principle that prudently-incurred gas costs are recovered through the PGVA:

> ***The Board recognizes that Centra does not make a profit on gas sales. If Centra purchases gas in a reasonable and prudent manner, then all gas costs are passed on to the ratepayers. Similarly, decreases in gas costs are, and have been, passed on to ratepayers.*** *However, if gas is purchased in a manner that is not prudent, or is unreasonable, then the ratepayers should not pay for that increase in gas costs.* (page iv)

Section III–U.S. Utility Practice

Q13 PLEASE DESCRIBE U.S. UTILITY PRACTICE.

A13 The use of gas cost recovery mechanisms–usually called "purchased gas adjustment" (PGA) clauses–in the U.S. predates those in Canada by decades with the earliest PGA clauses going back to the 1950s. This probably reflects the fact that U.S. utilities tended to have more diverse sources of supply.

There are approximately 250 gas distribution utilities in the U.S., including investor-owned companies and municipal systems.[8] To the best of our knowledge, all of them have gas cost recovery mechanisms.

Q14 DO UNITED STATES UTILITIES ALSO FLOW THROUGH ALL GAS COSTS?

A14 Yes. With very few exceptions, all the utilities flow through the actual cost of gas, with no impact on income. In a 1962 case, the Missouri Public Service Commission said:

> *It is clear that the wholesale price of gas is an expense that must be recovered by the company and that the fixing of such wholesale rates is a matter over which the company and this Commission have virtually no control. Changes in wholesale rates represent changes in a very large element of the company's costs and accordingly have a substantial effect on the results of its operations. The adverse effects upon the company and its customers, as the case may be, due to the delay and expense involved in present procedures can be substantially eliminated by the operation of the clause.* ***The operation of the purchased gas adjustment clause does not affect the return of the company one way or the other. Increases or decreases in wholesale gas cost are simply offset by corresponding increases or decreases in retail rates.*** (*Re: Laclede Gas Company*, 46PUR3rd277,285)[9]

[8] The count depends on how one treats utilities that have operations in more than one state.
[9] Cited in *Gas Rate Fundamentals*, 4th Edition, American Gas Association, Arlington, Virginia.

Q15 PLEASE GIVE SOME EXAMPLES.

A15 Here is a representative sample:

Intermountain Gas Company (Idaho)
What is a PGA [purchased gas adjustment]? It's a method of reconciling or "truing-up" the prices that we pay for purchasing and transporting natural gas to our customers with the rates that we charge for the natural gas we deliver. The price we pay for natural gas fluctuates daily, yet the rates we charge our customers are normally adjusted only once each year through the PGA mechanism. ***Intermountain's earnings do not change as a result of a proposed rate change reflected in a PGA.***[10]

Nicor Gas (Ilinois)
Natural gas is a commodity and its price is determined by the market, based on several factors When Nicor Gas buys gas on your behalf and delivers it to your business, ***we charge you exactly what we paid for it – we are not allowed to mark it up, by regulation of the Illinois Commerce Commission.***[11]

DTE Gas Company (Michigan)
We evaluate the GCR [gas cost recovery] factor every month to reflect the cost we expect to pay our suppliers. Once actual gas supply costs are booked, any cost adjustments over or under are made to the GCR factor - an ongoing "true-up" process resulting in no profit to us. ***By law, the GCR factor is passed on to customers without any profit or markup.*** *Customers pay what we pay for natural gas. The Michigan Public Service Commission reviews and approves the price we charge for gas.*[12]

Laclede Gas Company (Missouri)
The Purchased Gas Adjustment (PGA) is the rate that Laclede charges its customers to recover Laclede's cost of gas including gas supply, pipeline transmission and gathering and contract storage costs. Laclede's tariff on file with the Missouri Public Service Commission (MPSC) provides that, subject to approval by the MPSC, Laclede will adjust its PGA, each November and Laclede may adjust its PGA up to three other times during the year, so long as only one PGA adjustment becomes effective in any two consecutive calendar months. Laclede's PGA changes reflect changes in the Company's cost of gas, most of which is market driven. ***Laclede does not incur any profit or loss by the operation of the PGA.***[13]

Equitable Gas Company (Pennsylvania)
Equitable Gas is required to sell our natural gas commodity without profit. *It is difficult to predict the changing cost of gas and the changing usage patterns of our customers. Equitable Gas often sees a difference between the cost of gas purchased and the amount*

[10] http://www.intgas.com/docs/default-source/bill-inserts---communications/rate-information.pdf?sfvrsn=4
[11] https://www.nicorgas.com/rates-and-costs/gas-cost-frequently-asked-questions
[12] http://mcsts.dteenergy.com/notices/gcr.html
[13] http://www.lacledegas.com/rates/pga.php

recovered from customers through the commodity rate. The gas cost adjustment is a charge that is a true up for this difference. The gas cost adjustment can be a charge or a credit, depending on recent market conditions.[14]

South Carolina Electric & Gas Company
On the natural gas side, it's called purchased gas costs*, which can account for as much as 74% of your rate. SCE&G is in the natural gas delivery business but is not a producer of natural gas. A significant portion of what an SCE&G customer pays for natural gas is a direct pass-through of costs incurred purchasing natural gas on the wholesale market.* ***SCE&G is not allowed to earn any profit on this part of rates.*** *SCE&G's purchased gas costs are reviewed monthly and this part of natural gas rates is adjusted up or down as necessary to reflect those costs. This is called a* purchased gas adjustment*.*[15]

[14] https://www.equitablegas.com/custChoice/gasCost.aspx?
[15] https://www.sceg.com/paying-my-bill/understanding-my-bill/understanding-rates

Section IV–Evaluating the 2013-14 Results

Q16 ASIDE FROM THE "NO GAIN OR NO LOSS" PRINCIPLE FOR GAS COST RECOVERY MECHANISMS, IS THERE ANY OTHER REASON WHY THE 2013-14 NET INCOME SHOULD NOT BE USED TO OFFSET PART OF THE PGVA BALANCE?

A16 Yes. The 2013-14 results should not be looked at in isolation, but in the context of the longer-term performance of Centra. **Table 1** shows the effective heating degree days (EDD) and Centra's actual net income for each of the past 10 years.

Table 1
Centra Degree Days and Actual Net Income

Year	EDD (1)	Income/(Loss) ($000) (2)
2004-05	4,715	($1,626)
2005-06	3,980	(5,375)
2006-07	4,395	1,074
2007-08	4,733	5,898
2008-09	5,011	8,597
2009-10	3,968	(950)
2010-11	4,592	6,610
2011-12	3,740	(5,752)
2012-13	4,935	7,811
2013-14	5,326	$19,793
Average Yrs 1-9	4,452	$1,810
Average Yrs 1-10	4,540	$3,608
25-Yr Average	4,518	

Sources:
EDD yearly: Centra
Average: 2013/14 GRA filing, Appendix 8.1, page 4
Income/(Loss): Centra financial statements

Average actual annual income over this period was $3.6 million. In four of these years, Centra had a net loss. Given that Centra has not sought–nor has any party proposed– that PGVA rider charges be increased in years when earnings are much lower than expected (especially losses), it would be inappropriate to use higher-than-expected earnings to offset PGVA rider charges.

Section V–Summary

Q17 PLEASE SUMMARIZE THE POINTS IN YOUR EVIDENCE.

A17 The basis on which the PGVA was proposed and authorized is that it would recover the actual cost of gas, "no more or less". This is consistent with general practice in both Canada and the U.S.

Earnings above the authorized level should not be used to reduce PGVA charges just as it would be improper to increase PGVA charges to offset shortfalls in earnings.

In four of the last ten years, Centra's earnings have been negative. On average, the net income has been only a bit higher than the $2.5-$3.0 million authorized by the Board.

Q18 DOES THIS COMPLETE YOUR EVIDENCE?

A18 Yes, it does.

Appendix A

Experience of Mark Drazen

Mr. Drazen has worked since 1972 on economic analysis of energy and utility service, pricing in regulated and deregulated utility markets, contract negotiations, and strategic planning throughout the United States and Canada. His experience covers electric, natural gas, oil pipeline, telecommunications, transportation, waste and water utilities in eight Canadian Provinces (Alberta, British Columbia, New Brunswick, Newfoundland and Labrador, Nova Scotia, Ontario, Québec and Saskatchewan) and in 41 states in the U.S. (Alabama, Alaska, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin and Wyoming).

He has appeared as an expert witness before courts, federal, provincial and state regulatory agencies (including the National Energy Board, the Canadian Radio-Television and Telecommunications Commission, the Federal Energy Regulatory Commission and the Federal Communications Commission).

Drazen Consulting Group offers economic, project planning, regulatory consulting and litigation support services to clients that include industrial utility users, municipalities, schools, hospitals, utilities and government agencies. The founding firm (Michael Drazen and Associates) was established in 1937.

The firm's work covers all aspects of utility regulation (and deregulation), including revenue requirements, cost of capital, cost analysis, pricing, valuation, performance-based regulation and industry restructuring.

Mr. Drazen is a graduate of the Massachusetts Institute of Technology, with the degrees of Bachelor of Science in Mathematics, Master of Science in Electrical Engineering, and Electrical Engineer.