EB-2007-0606
EB-2007-0615

IN THE MATTER OF the *Ontario Energy Board Act 1998,* S.O. 1998, c.15, (Schedule B);

AND THE IN THE MATTER OF an Application by Union Gas Limited for an Order or Orders approving or fixing a multi-year incentive rate mechanism to determine rates for the regulated distribution, transmission and storage of natural gas, effective January 1, 2008;

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. for a Order or Orders approving or fixing rates for the distribution, transmission and storage of natural gas, effective January 1, 2008;

AND IN THE MATTER OF a combined proceeding Board pursuant to section 21(1) of the *Ontario* Energy *Board Act, 1998.*

WRITTEN ARGUMENT OF
UNION GAS LIMITED
COMMODITY RISK MANAGEMENT

Overview

1. In EB-2005-0520, the Board reviewed and approved Union Gas Limited's ("Union") commodity risk management program. In granting its approval, the Board considered and rejected the arguments advanced by some intervenors that risk management had a negative impact on competition, conservation, or was unnecessary having regard to the QRAM and Union's equal billing program.

2. It is the position of Union that the Board should, again, approve Union's risk management program. As previously found by the Board, Union's risk management program is consistent with industry best practices and provides value to consumers by reducing, at a modest cost, gas price volatility.

3. Union's pre-filed evidence can be found at Exhibit B, Tab 3. The evidence is supported by a report prepared by Risk Management Incorporated ("RMI"), industry experts in utility risk

management practices. The RMI report is at Exhibit B, Tab 4. Union is the only party that has filed any evidence in respect of risk management.

Union's Risk Management Program

4. Union's risk management program is unchanged from the program approved by the Board in EB-2005-0520. As stated in Union's Risk Management Policy, the primary objectives of Union's program are (1) to provide value to consumers through a diversified portfolio and (2) to reduce price volatility.

5. Union's risk management objectives are met through a diversified portfolio of fixed price contracts, indexed price contracts, financial hedging and supply basin diversification. This diversification allows Union to provide its customers with a reasonable, market sensitive cost of gas; a price that reflects the current market prices and trends but which protects against the risk, which is more prevalent than ever before, of "spikes" in the cost of gas.

6. Union has been successful in achieving its risk management objectives. In every year during the five year period from 2002 to 2006, Union reduced the volatility in its monthly actual cost of gas relative to the market price (NYMEX Monthly Settles). In four of the five years, the reduction in volatility was greater than 25%. Overall, the reduction for the period was 31% (see Exhibit B, Tab 3, page 8).

7. Similarly, risk management had a positive effect on the volatility experienced in the Purchased Gas Variance Account ("PGVA"). In five of the six years from 2002 through August 2007, Union reduced the dollar amounts cleared through the PGVA. On a percentage basis, the impact varied from a reduction of 35% to a modest increase of 2%. In four of the years, the reduction was over 20% (see Exhibit JTA.26).

8. In EB-2005-0520, the Board commented on the value to consumers of the reduction in PGVA volatility, stating:

> 2.2.17 To be sure, the effect is modest. Over the period from January 2003 to January 2006, Union was able to demonstrate a 16% reduction in volatility as it related to the PGVA, which resulted in a reduction in the consumer's experience in terms of overall bill impact of less than 1%. **While this result is modest, the Board**

> **notes that over that same period, risk management activity resulted in a reduction in the range of PGVA rate riders by about 30%.** This is to say that the range of adjustments required for disposition of the PGVA was reduced from 6.0 to 4.2 cents per cubic meter. It is noteworthy that the reduction in volatility is best measured on a quarter by quarter basis, rather than over an extended period. **In the period described, there were quarters where gas price increases were substantially mitigated through risk management. The mitigating effects were not necessarily a trivial outcome for consumers of gas in that quarter.** (Emphasis added.)

9. In Exhibit B, Tab 3, Appendix B corrected, Union has updated the evidence referred to by the Board above in EB-2005-0520. The update provides that Union's risk management activity, measured quarterly, from January 2003 to July 2007, reduced the size of PGVA rate riders by 14% and the volatility of those rate riders by 17%. In several of the quarters the effect of risk management was substantial, reducing the amount cleared through the PGVA by a third or more.

10. Significantly, because of the market sensitivity of Union's diversified portfolio, the cost of risk management has been modest. Over the five year period (2002 - 2006), the impact on Union's actual annual cost of gas was just $0.02/GJ, or approximately 0.3% (see Exhibit B, Tab 3, page 8). The cost of risk management in any one year has never exceeded 6% of the cost of gas; in fact, in two of the years (2003 and 2005), risk management decreased the cost of gas while there was no effect in a third. As described below, however, Union does not view risk management as a means to beat the market.

11. On a mark to market basis, the cost of Union's risk management activity was also small. Over the same five year period, the mark to market cost was never greater than 6% of an equivalent unhedged portfolio in any one year, and averaged 0.1%. In dollar terms, the total cost of risk management over those five years was just $3.4 million.

Risk Management in Relation to QRAM and Equal Billing

12. The QRAM and the Equal Billing Program ("EBP") are not substitutes for risk management. These two items perform a complementary, but not overlapping function. Each is discussed below.

13. ***QRAM***. Union uses the QRAM to set reference prices for commodity and upstream transportation, and also to incorporate the prospective recovery of gas cost related deferral account balances. The use of the current QRAM was approved in RP-2003-0063, and became effective January 1, 2004.

14. The major features of the QRAM include :

- A quarterly change to the commodity reference prices using a 21-day average of the forward 12 months' gas prices as indicated on the NYMEX.
- Applicable deferral account balances recovered prospectively.
- True-ups for historical variances up to the effective point in time, between previously projected and actual amounts within the relevant deferral accounts.
- TCPL transportation toll changes as approved by the NEB.
- An efficient, mechanical filing and approval process.

15. Under the QRAM process, the actual year-end deferral account balances are subject to the Board's review for final approval and disposition. Customers ultimately pay Union's full cost of gas, as the QRAM sets rates based on a forecast of costs and then trues-up over the next twelve months once the actual costs are known. In that way, the QRAM is a method to smooth customers' bill payments, but *does not* in any way affect the actual cost of gas that customers pay in the end.

16. ***Equal Billing***. Union's Equal Billing Program ("EBP") is a program available to residential natural gas delivery service customers, regardless of their gas supply arrangement. However, only 39% of residential customers currently participate in the EBP.

17. The purpose of this program is to equalize bill payments throughout the year so participants are not exposed to large winter bills when consumption is high. The monthly EBP payment is determined by taking the customer's total natural gas usage for the previous year and using it to calculate their estimated annual cost for the upcoming year using current rates. That amount is then spread out equally over eleven monthly installments. In the twelfth month the

customer's account is credited or debited for any difference between the total equal billing plan installments paid and the total charges for gas used during the period. The customer's account is reviewed throughout the year and the monthly EBP amount may be adjusted to avoid a large debit or credit at the end of the EBP period. By year-end, however, as with the QRAM process, EBP customers pay the same amount for the gas consumed as they would have done had they not been on the EBP.

18. While risk management, and QRAM/EBP are in some sense complementary tools, they perform a different function and are not substitutes for one another. Risk management affects Union's ultimate cost of gas which is passed on to customers. The QRAM and EBP merely smooth customers' bill payments. Generally, the QRAM smoothes the *rate* customers pay while the EBP smoothes the *consumption*. In the event of price volatility induced by either supply or demand fundamentals, customers are subject to the price impacts and price volatility irrespective of the QRAM or whether they are on the EBP.

19. Further, risk management has a longer term impact as compared to the QRAM and EBP. QRAM and EBP affect only payments on one-year cycles. Union's risk management program allows for hedging for up to a five-year time horizon and utilizes a variety of hedging tools including financial instruments (caps and collars) and fixed-price swaps. Within Union's approved risk management program, rolling twenty-four month fixed-price contracts have also been incorporated to reduce volatility and will eventually account for 20% of the total sales service supply portfolio.

20. Despite the longer term impact of risk management, the risk of any adverse inter-generational impact is minimal. Given Union's QRAM mechanism, every quarter PGVA deferral balances are incorporated into a new rate rider and recovered over a rolling twelve month period. In the last four years, the average rate rider has been less than 10% of the cost of gas. Risk management activity works to minimize the variance between the QRAM price and the actual gas costs, thereby decreasing the size of the PGVA. To the extent that risk management reduces the size of the PGVA, it reduces the size of inter-generational impacts.

The RMI Report

21. Union retained RMI to review Union's risk management program and provide an opinion on the role of that program relative to the QRAM and the EBP.

22. RMI is an industry recognized expert in risk management. RMI is familiar with Union's risk management program, having conducted thorough reviews of that program as part of Union's 2004 and 2007 rate proceedings.

23. In RMI's opinion, commodity risk management is designed to provide a level of price stability and price certainty against unforeseen risk or catastrophic events and should never be viewed as a means to beat the market. The use of hedging plans to manage commodity risk by utilities is a prevailing trend which has brought utilities in line with what has been a long standing practice among the majority of private corporations. Nearly 90% of North American natural gas utilities use risk management as a hedge against market price volatility.

24. With respect to Union's risk management program, it is RMI's opinion that the program's objectives of providing ratepayers reasonable value through a diversified portfolio and reducing price volatility are well focused and exemplify the rationale of commodity risk management. More significantly, RMI specifically agrees with Union that risk management, the QRAM and EBP are not substitutes for one another in enhancing price stability; they are complementary tools that utilities can, and should, use.

Summary

25. In EB-2006-0034, the Board ordered Enbridge to discontinue risk management. The Board did so because of the company's substantial risk management losses and its evidentiary failure to differentiate risk management from the QRAM and EBP. It is respectfully submitted that the Board's determination in the Enbridge case should have no application to this proceeding. Here, the evidence strongly supports one conclusion; risk management is beneficial for consumers.

26. Union is the only party that has filed evidence. This evidence, supported by RMI, confirms that the QRAM and EBP are not substitutes for risk management. The evidence further shows that Union's risk management program, with its diversified portfolio focused on

delivering a market sensitive price, has successfully reduced, for a modest cost, natural gas price volatility whether compared to the monthly cost of gas (by over 30%) or the size of PGVA rate riders (by 17%).

27. Risk management is analogous to insurance. For a relatively small amount, consumers receive protection against potentially significant adverse price movements. While Ontario has been fortunate over the past few years, as described in Union's evidence, the natural gas market is changing - supply and demand are tightening - and, therefore, the risk of significant price movements should not be discounted. Risk management is intended to, and does, protect against these adverse movements by shaving off their peaks and valleys.

28. For these reasons, Union submits that the Board should, as it did in EB-2005-0529, approve Union's commodity risk management program.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

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Of counsel for Union Gas Limited