EB-2007-0606
EB-2007-0615

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

AND 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 an 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.*

ENERGY PROBE RESEARCH FOUNDATION
("ENERGY PROBE")

ARGUMENT – COMMODITY RISK MANAGEMENT

February 19, 2008

UNION GAS LIMITED
2008 INCENTIVE REGULATION MECHANISM

EB-2007-0606

Energy Probe Research Foundation Argument
– Commodity Risk Management

How these Matters came before the Board

1. Union Gas Limited (Union) filed an Application on May 11, 2007, for an order from the Ontario Energy Board 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.

2. Union filed a Settlement Agreement on January 3, 2008, following extensive interrogatories being filed and answered, Technical Conferences and many days of negotiations between the parties in a Board sanctioned ADR. The comprehensive Settlement Agreement was accepted by the Board in its Decision issued January 17, 2008.

3. There are three issues outstanding following the acceptance of the Settlement Agreement: the commodity risk management program (risk management program), to be dealt with through written argument; the treatment of customer additions under incentive regulation; and, the treatment of certain tax changes under incentive regulation.

Argument Overview

4. The last time that the Applicant came before the Board for a full cost of service review, in EB-2005-0520, Energy Probe Research Foundation (Energy Probe) observed, in its Argument on May 30, 2006, Transcript 5, starting at Page 130, Line 22:

> **… it is possible to believe that Union has created a PBR asset by failing to provide the Board with the fully-loaded costs of all its bits and pieces in different cost centres which together comprise the true cost of risk management.**
>
> **And how would they cash in on this asset? In a PBR period Union could just cease risk-management activities and bank the costs and no one would notice, because there would be no impact on customers.**

5. Now Union is entering a PBR period and once again the Board is examining the risk management program of the Applicant. In view of the Decision With Reasons issued by the Board in the previous cost of service review of Enbridge Gas Distribution Inc. (Enbridge) establishing its 2007 rates, EB-2006-0034, that terminated the Enbridge risk management program and which was issued some six months subsequent to the Decision in Union's 2007 rates proceeding, Energy Probe submits that it would be of value for the current Panel to examine the similarities between the risk management programs of the two utilities.

No Significant Benefits: Union's Risk Management Program

6. The stated objectives of Union's risk management programs are:

1) To provide value to customers through a diversified portfolio, and

2) To reduce price volatility while charging a market sensitive price.

7. The first of these objectives duplicates various other more effective diversification efforts of the utility, such as supply basin, transmission path, and contract diversification. The second of these objectives is plainly contradictory.

8. In considering why Union has so actively defended for many years its involvement in risk management, an activity the utility claims is purely a pass-through, it may be that the actual objective of Union's risk management program is to provide the utility with a talking point with which to respond to customers objecting to commodity price increases. If the utility were being totally honest in explaining risk management to customers calling in to complain about a gas cost increase, the utility would indicate that the risk management program does nothing to lower costs for consumers, in fact it increases cost.

9. Union acknowledges that its risk management program is raising the cost of gas for consumers above and beyond the administrative costs that consumers bear. In the Applicant's Argument in Chief at Paragraph 11, it states that over the period 2002-2006 "the total cost of risk management over those five years was just $3.4 million."

10. What Union neglects to mention is that by including in its calculation the most recently available results in this proceeding, up to August 2007, the net loss over the period starting in 2002, excluding administrative costs, amounts to $22.7 million. (JTA.26b, filed Oct. 11, 2007)

11. By reviewing the program results portrayed in JTA.26b we are reminded that the risk of risk management is always the risk of having the program incur a very large loss, as did Enbridge during 2006, extending into 2007. To date Union has fortunately avoided a very large loss in any one year. However, the swing between a positive result in 2003 of $30.4 million and a negative result of $22.0 million in 2006, is over $50 million.

12. Following the arguments previously presented by Enbridge, Union makes all the same torturously stretched arguments that the smoothing effects of QRAM and equal billing cannot be compared to the smoothing effect of risk management. The key relevant facts are that QRAM, equal billing, and risk management smooth gas costs over long periods (a period of up to one year for QRAM and equal billing, while for risk management the time period can extend further) and that QRAM, equal billing, and risk management are not intended to reduce the actual costs that consumers pay.

13. Exhibit JTA.25 shows how the smoothing impact of risk management pales beside the smoothing impact of equal billing. With risk management, under non-equal billing, monthly changes in bills since 2003 are routinely $40-$60 per month and sometimes greater than $120. Meanwhile, if risk manage was eliminated but a customer remained on equal billing, the maximum monthly bill change over the period from 2003-2007 would only have been $6 when compared against the case of equal billing with risk management.

Risk Management is Not Insurance

14. Union asserts that risk management is analogous to insurance (Argument in Chief para 27), an assertion that Energy Probe can agree with in one respect. Both risk management and insurance increase expected lifecycle costs.

15. Beyond the similarity of raising expected costs, there are a number of very significant differences between risk management and insurance. Purchasing insurance is only financially justifiable if the harm being insured against occurs rarely and in the event of its occurrence, the impact is beyond the means of the customer to bear. Union has failed to demonstrate that the brief instances of historically high natural gas prices experienced since 2000 constitute for ordinary

customers what Union claims is a “catastrophic event” (Argument in Chief para 23) much less that risk management is a cost-effective response when compared with the smoothing effects of QRAM and equal billing, which are costless for the customer (unlike risk management).

16. Another key difference is that insurance may only be purchased to protect your own financial risks, not those of others. Union has been using money collected from customers to pay for risk management. Indeed, the risk of higher costs of commodity rests with the utility’s customers, since commodity cost is a pass through for Union.

17. It should be noted that one of the principal benefits of insurance is that the cost of the insurance is set and guaranteed prior to the policy becoming in force. It does not create further risk. The cost of risk management programs can only be assessed at the expiry of the risk management instruments.

18. Yet another difference between insurance and risk management is that neither the insurer nor its affiliates are dealing in the commodity that is being insured.

What is “Reasonable Value”?

19. Union has repeated for years its claim that risk management provides “reasonable value”. In fact, risk management has raised the cost of gas and provided slight smoothing effects that are significantly overshadowed by the smoothing effects of QRAM and equal billing. Viewed objectively, there is no value gain for consumers from risk management whatsoever, simply a costly fig leaf for Union to use when responding to customer complaints.

20. Energy Probe submits that it would be of value for the current Panel to consider the manner in which the Board Panels in EB-2005-0001 and EB-2006-0034, both Enbridge proceedings, raised the bar by enshrining the impact on consumers as the standard when determining "reasonable value". For ease of reference, Energy Probe quotes a passage from the EB-2006-0034 Decision With Reasons in which the Panel was referring back to the Decision in EB-2005-0001 and where the bar was originally set:

> **The question that remains is the extent to which Enbridge's risk management program is redundant or represents a useful and cost effective tool to reduce customer price volatility in a fair and reasonable way.**
>
> **…**
>
> **No evidence has been provided that demonstrates whether the hedging activity had a *material effect on the volatility experienced by customers*, given the effects of QRAM, the PGVA, and equal billing programs over the same period. (Emphasis added)**
> **(EB-2006-0034 Decision With Reasons, Page 38)**

21. In its Argument in Chief refers, at Paragraph 6., Union refers to successfully achieving its risk management objectives by reducing the volatility in its monthly actual cost of gas relative to the market price (NYMEX Monthly Settles). The reduction over the five year period was what Union would have us believe is an astounding 31%. But how does this relate to customers?

22. When translated to a reduction in volatility as it related to the PGVA , as presented in Paragraph 8., the achievement was down to 16%, and as noted by the Board Panel in the EB-2005-0520 Decision, it all *resulted in a reduction in the consumer's experience in terms of overall bill impact of less than 1%*. (Emphasis added)

23. To be more precise, as discovered by Mr. Millar, Board Counsel, in his cross-examination of Ms. Piett, the Union witness, concerning the previous 8 year period leading up to the EB-2005-0520 proceeding wherein the Applicant claimed a 39%

reduction in volatility in its monthly actual cost of gas relative to the market price (NYMEX Monthly Settles):

> **"Mr. Millar: So if we look at -- I think we probably agree that the number the customer cares about most is the number at the bottom of the bill, rather than the individual components that make up the bill. If we looked at the bottom, the final number on the customer's bill, is it fair to say we wouldn't be looking at a reduction in volatility of 1 percent, it would be something about .6 percent, because we're only looking at commodity here?"**
>
> **"Ms. Piett: That's correct, I believe."**
> **(EB-2005-0520, Transcript Vol. 2, Page 78, Line 2)**

24. Does this de minimis consumer impact meet the bar set in EB-2005-0001 and EB-2006-0034? The Applicant submits in the Argument in Chief at Paragraph 25 that the Board's decision to do away with Enbridge's non-beneficial risk management "should have no application to this proceeding", when it is clear that like Enbridge, Union's risk management program is only slightly changing rates, although generally in the unfavourable direction. Energy Probe submits that Enbridge and Union have made essentially the same case for risk management to the Board.

In Summary

25. Where does all this leave us? The Applicant, as did Enbridge, confuses the reduction of the volatility for the utility's gas purchases with those of its residential customers.

26. The Applicant states at Paragraph 12. of its Argument in Chief that "QRAM and the Equal Billing Program ("EBP") are not substitutes for risk management." At Paragraph 18 Union submits:

> **Risk management affects Union's ultimate cost of gas which is passed on to customers. The QRAM and EBP merely smooth customers' bill payments.**

27. And yet the Applicant states at Paragraph 23. of its Argument in Chief through the evidence of its expert that risk management "should never be viewed as a means to beat the market." Union would have us believe that its submission quoted above, that risk management affects the ultimate cost of gas to customers in a manner different than smoothing, is not at odds with its submission that it "should never be viewed as a means to beat the market."

28. If risk marketing does not beat the market, then all it can ultimately do is smooth the cost passed on to customers. It may differ by timing with QRAM and the EBP, but the ultimate result is the same – smoothing. And as we all are aware, when utilities indulge in smoothing, it always results in smoothing cost upwards.

29. In this case, Union has added to the pile of discarded risk management myths: risk management can save customers money; customers demand that their gas utilities perform risk management activities; risk management is very different in its smoothing results than those of QRAM, PGVA and equal billing programs; even though you can't beat the market, the market will beat you if you don't do risk management; risk management is a zero sum game; and now – risk management is just like insurance.

30. The Applicant was able to obtain evidence from Risk Management Incorporated, an industry expert in utility risk management practices, that it should continue its program. Perhaps this outcome is not a big surprise, since Risk Management Incorporated would appear to have less business if utilities started abandoning their low impact, negative value commodity risk management programs.

31. While Energy Probe compliments Union for managing its risk management program somewhat better than Enbridge did, the overall effects of Union's risk management exercise are all directionally comparable to those of Enbridge.

32. It is the submission of Energy Probe that when the pluses and minuses of permitting the Applicant to continue with its risk management program are addressed in terms of whether the hedging activity of Union had a *material effect on the volatility experienced by customers,* the risk of further losses weighed against the effects of QRAM, the PGVA, and equal billing programs provides a clear answer for the Board.

33. Given the direct similarity of facts between Enbridge and Union and applying similar reasoning as it did in its Decision With Reasons in EB-2006-0034, it would follow that the Board should find that Union must terminate its risk management program in an orderly fashion and reduce its revenue requirement at the next rebasing to reflect this change.

Costs

34. Energy Probe submits that it participated responsibly in this proceeding. Energy Probe requests the Board award 100% of its reasonably incurred costs.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

February 19, 2008