



LETTER NO. L-5-01

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VIA FACSIMILE

February 5, 2001

Mr. David M. Masuhara
Vice President
Legal, Regulatory & Logistics
BC Gas Utility Ltd.
24th Floor, 1111 West Georgia Street
Vancouver, B.C. V6E 4M4

Dear Mr. Masuhara:

Re: BC Gas Utility Ltd.
Guidelines for Setting Gas Recovery Rates
and Managing the Gas Cost Reconciliation Balance

Until recently, gas cost recovery rates for BC Gas were set once per year effective January 1st. In 1999 and 2000, however, gas prices increased dramatically and mid-year rate changes were required. The difference between revenue from the gas cost recovery rates and gas costs incurred accumulates in the Gas Cost Reconciliation Account ("GCRA") and is paid back to BC Gas or refunded to customers in subsequent years. The rising gas prices in the last few years resulted in gas costs that were higher than rate revenue and led to a GCRA balance estimated at around \$180 million at the end of 2000.

Due to concerns about the mid-year rate increases and the large GCRA balance, the Commission asked its staff to prepare a report on the method of establishing gas cost recovery rates for BC Gas and amortizing the GCRA balance. The staff report was circulated to BC Gas and other parties on November 7, 2000. BC Gas and four other parties responded with comments.

Based on its review of the staff report and the submissions made by BC Gas and the other parties, the Commission has decided to request quarterly reports from BC Gas and establish the attached Guidelines for Setting Gas Recovery Rates and Managing the GCRA Balance ("the Guidelines"). Although the Guidelines were developed with specific reference to BC Gas, the Commission believes that the Guidelines will also be appropriate for other provincial gas utilities.

Yours truly,

Original signed by:

Robert J. Pellatt

MAG/mmc
Attachment

cc: Mr. C.P. Donohue, Director
Regulatory Affairs & Gas Supply
Pacific Northern Gas Ltd.
Mr. I.D. Anderson
Vice President, Finance
Centra Gas British Columbia Inc.
Mr. R.T. O'Callaghan
R.T. O'Callaghan & Associates Inc.

Mr. R.J. Gathercole
Executive Director
B.C. Public Interest Advisory Centre
Mr. S. Yallouz
Vice President
PremStar Pacific

BRITISH COLUMBIA UTILITIES COMMISSION
Guidelines for Setting Gas Recovery Rates
and Managing the Gas Cost Reconciliation Account Balance

1.0 Background

BC Gas Utility Ltd. (“BC Gas”) purchases gas on behalf of its sales customers and passes these costs through to sales customers without markup. Costs related to the gas commodity are recovered from customers through gas cost recovery rates. Since rates are based on forecast costs and actual costs invariably differ from forecast costs, the Gas Cost Reconciliation Account (“GCRA”) was established to accumulate the difference between the cost incurred by BC Gas to purchase the gas commodity and the revenue collected by BC Gas through the gas cost recovery rates.

Until recently, gas cost recovery rates were established once per year effective January 1 based on forecast costs for the upcoming year. In 1999 and 2000, however, gas costs were much higher than forecast and mid-year increases were sought by BC Gas and approved by the Commission effective September 1, 1999 and July 1, 2000 to reduce the under-recovery of gas costs. Even with the mid-year rate increases, the GCRA balance moved from a net credit balance (gas cost recovery revenue exceeded gas costs incurred) to a net debit balance (related costs exceeded gas cost recovery revenue) of around \$180 million by the end of 2000.

The general rule for dealing with the GCRA balance has been to amortize it over three years through Rate Rider 6. A net debit balance results in a positive rate rider and higher effective gas cost recovery rates, while a net credit balance results in a negative rate rider and lower effective gas cost recovery rates. BC Gas has, in the past, been directed by the Commission to deviate from the rule and use the net credit GCRA balances to offset future rate increases to the greatest extent possible.

Due to concerns about the large rate increases, the discretionary nature of the two mid-year corrections and the lack of opportunity for customers to comment on or plan for the mid-year rate changes, the Commission asked its staff to provide a report on the method of establishing gas cost recovery rates for BC Gas, the method of amortizing the GCRA and alternate GCRA and gas cost commodity rate setting methods used in other jurisdictions. The staff report also discussed the various attributes of deferral account and rate setting methodologies including rate stability, price transparency, implications for the expected size of the deferral account and efficiency of process.

On November 7, 2000, the Commission circulated the report and invited feedback from utilities, customers and other stakeholders with the intent of preparing guidelines for gas cost recovery rate setting procedures for BC Gas. Parties were encouraged to comment on the suitability of BC Gas’ gas cost recovery rate setting process and GCRA methodology given the current volatile and high price environment, as well as the merits of alternative processes. The issue was also raised at BC Gas’ Annual Review on November 21, 2000.

Based on this process, the Commission has decided to request quarterly reports from BC Gas and establish Guidelines for Setting Gas Recovery Rates and Managing the GCRA Balance (“the Guidelines”). The Guidelines set out the conditions under which the Commission will generally expect BC Gas to file applications for changes to commodity cost recovery rates and the method of amortizing the GCRA balance.

The Guidelines are intended as a general guide only. Nothing in the Guidelines precludes BC Gas from filing applications for rate changes at times other than those implied by the Guidelines or proposing alternate treatment of the GCRA balance in unusual circumstances. Similarly, nothing in the Guidelines precludes the Commission from requesting rate applications at times other than those implied by the Guidelines.

Although the Guidelines were developed with specific reference to BC Gas, the Commission believes that the Guidelines will also be appropriate for other gas utilities.

2.0 Analytical Framework and Stakeholder Comments

The staff report discussed the various attributes of deferral account and rate setting methodologies including rate stability, price transparency, implications for the expected size of the deferral account and administrative requirements. These attributes provide a framework for analyzing proposed deferral account and gas cost rate setting methodologies and are described in Appendix II.

The Commission received comments on the staff report from BC Gas and four other parties. A summary of the comments is provided in Appendix III.

3.0 Determination

The Commission's preferences with respect to discretion in rate changes, the frequency of rate adjustments and the amortization period for the GCRA balance are outlined below.

Discretion in Rate Changes

BC Gas has proposed adjustments to gas cost recovery rates based on a pre-defined formula. The Commission is of the view that a mechanistic, formula-driven process of establishing gas cost recovery rates could lead to volatility in rates if 12 month gas cost forecasts vary significantly from month to month or quarter to quarter. The Commission is also concerned that setting rates based on a formula could result in undesirable rate changes and make it difficult to adapt to changing circumstances. This is of particular importance for the near future since the cost of energy from natural gas is now similar to the cost of energy from electricity and oil. For these reasons, the Commission finds that setting rates based on a pre-defined formula would be inappropriate at this time, and that BC Gas and the Commission should retain discretion in terms of the gas cost recovery rates applied for and approved.

Frequency of Rate Changes

The Commission is of the view that the current procedure of setting gas cost rates once per year with mid-year adjustments on an as required basis is no longer appropriate. However, a monthly process could lead to overly frequent rate changes and rate oscillations that impede, rather than improve, the price signal to customers, and would involve a great deal of administrative effort by both BC Gas and the Commission. The Commission also believes that while more frequent processes should generally reduce the size of required rate changes, even monthly adjustments would not prevent very large rate increases if gas costs change rapidly as they have over the last two years.

The Commission finds that a quarterly process for adjusting gas cost rates would provide a good price signal to customers, would help to reduce the size of the required rate changes, would help to keep the GCRA to manageable levels, and would be less onerous administratively. Accordingly, the Commission prefers a quarterly adjustment process rather than a monthly process as proposed by BC Gas.

Mechanism for Changes to Gas Rates

BC Gas and the Consumers' Association of Canada (B.C. Branch) et al. ("CAC (BC) et al.") proposed that the intra-year rate changes would be triggered by certain conditions. BC Gas suggested that changes be required if the difference between projected gas costs over the next 12 months and projected rate revenue over the next 12 months plus the GCRA balance (excluding the 2000 year-end balance) exceeds \$50 million. The CAC (BC) et al. suggested that rates should be adjusted if the forecast under-recovery or over-recovery exceeds 5-10 percent of the forward gas bill.

The Commission agrees with BC Gas and the CAC (BC) et al. that intra-year rate adjustments should not occur if expected rate revenue is sufficiently close to expected gas costs. **The Commission believes that a rate adjustment should be triggered if the ratio of expected 12 month gas cost recovery revenue to the sum of the expected 12 month gas cost and the GCRA accumulated starting January 1, 2001 is less than 0.95 or more than 1.05. For the purposes of this calculation, gas cost recovery revenue would include gas cost rate revenue, gas cost mitigation revenue and revenue from the GCRA rider (except amounts related to**

the 2000 year-end GCRA balance). Gas costs would include the impact of hedging and the cost of storage.

For example, if the expected cost of gas for the next 12 months were \$1,200 million and the GCRA debit balance were \$50 million, BC Gas would file for a quarterly adjustment if expected gas cost recovery revenue were less than $0.95 \times (\$1,200 \text{ million} + \$50 \text{ million}) = \$1,188 \text{ million}$ or more than $1.05 \times (\$1,200 \text{ million} + \$50 \text{ million}) = \$1,313 \text{ million}$.

The 5 percent trigger recommended by the Commission is at the lower end of the range suggested by the CAC (BC) et al. and is slightly higher than the trigger suggested by BC Gas based on current gas costs. The 5 percent trigger could be lower than BC Gas' trigger point if forecast gas costs fall significantly.

The Commission expects that the trigger mechanism would be applied to rate changes for the second, third and fourth quarters only. That is, the Commission expects that BC Gas will continue to file a comprehensive commodity rate application for the first quarter of each year (effective January 1).

Amortization of the GCRA Balance

BC Gas proposed to amortize the initial GCRA balance over the period from January 1, 2001 to October 30, 2002, which is the anticipated date for commodity unbundling. It appears that incremental GCRA amounts would be amortized over one year based on BC Gas' proposal. The CAC (BC) et al. indicates that a one year amortization period would generally be desirable, but that a two year amortization period may be required initially due to the current high GCRA balance. R.T. O'Callaghan and PremStar Pacific support amortization periods of no longer than one year.

The Commission finds that amortization of the GCRA balance over a one year period would be reasonable in normal circumstances. The Commission is concerned, however, about the impact of significant increases to the Rate Rider on customers already facing very high rates at this time. The Commission, in Order No. G-124-00, directed BC Gas to amortize one-third of the projected GCRA balance at December 31, 2000 through rates in 2001. In order to avoid potential rate shock associated with faster amortization of the entire balance, the Commission still finds that appropriate. The Commission expects that GCRA amounts accumulated starting January 1, 2001 will be amortized over a one year period in normal circumstances.

4.0 Reporting Requirements

To keep the Commission informed on expected gas costs, expected revenue from gas cost recovery rates and the GCRA balance, the Commission requests that BC Gas provide quarterly reports by the fifth business day of the month preceding each quarter (March, June, September and December). The Commission anticipates that the quarterly reports would include the following:

PREVIOUS QUARTER

- Actual GCRA balance at the start of the quarter
- Actual gas costs incurred in the quarter (including impact of hedging, storage, etc)
- Actual revenue from gas cost recovery rates and cost mitigation revenue in the quarter
- Actual revenue from Rate Rider 6 in the quarter
- Actual GCRA balance at the end of the quarter
- Explanation of significant differences between the above values and the forecasts for this quarter in the prior quarterly report

CURRENT QUARTER

Actual GCRA balance at the start of the quarter
Estimated gas costs incurred in the quarter (including impact of hedging, storage, etc)
Estimated revenue from gas cost recovery rates and cost mitigation revenue in the quarter
Estimated revenue from Rate Rider 6 in the quarter
Estimated GCRA balance at the end of the quarter
Explanation of significant differences between the above values and the forecasts for this quarter in the prior quarterly report

EACH OF THE NEXT FOUR QUARTERS STARTING ON THE FIRST DAY OF THE NEXT MONTH

Estimated GCRA balance at the start of the quarter
Estimated gas costs incurred in the quarter (including impact of hedging, storage, etc)
Estimated revenue from gas cost rates and cost mitigation revenue in the quarter based on both current and proposed rates
Estimated revenue from Rate Rider 6 in the quarter
Estimated GCRA balance at the end of the quarter based on both current and proposed gas cost recovery rates

OUTLOOK FOR THE FOLLOWING YEAR (COMMENCING 13 MONTHS FROM FILING DATE)

Estimated GCRA balance at the start of the year based on both current rates and the rates proposed for the upcoming quarter
Estimated gas costs incurred in the year (including impact of hedging, storage, etc)
Estimated revenue from gas cost rates and cost mitigation revenue in the year based on both current rates and the rates proposed for the upcoming quarter
Estimated revenue from Rate Rider 6 in the year
Estimated GCRA balance at the end of the year based on both current rates and the rates proposed for the upcoming quarter

The most recent forecast may be substituted if actual data is unavailable.

5.0 Guidelines for Setting Gas Recovery Rates and Managing the GCRA Balance

- A. BC Gas normally files a revenue requirements application in the fourth quarter of every year to establish rates effective January 1 of the following year. BC Gas is expected to file for quarterly gas cost recovery rate changes if the ratio of expected 12 month gas cost recovery revenue to the sum of expected gas costs for the upcoming 12 month period plus the GCRA balance accumulated starting January 1, 2001 is less than 0.95 or greater than 1.05. For the purposes of this calculation, gas cost recovery revenue would include gas cost rate revenue, gas cost mitigation revenue and revenue from the GCRA rider (except amounts related to the 2000 year-end GCRA balance). Gas costs would include the impact of hedging and the cost of storage. Applications for quarterly rate changes should be made with the quarterly reports by the fifth business day of the month preceding the affected quarter. Quarterly rate adjustments would be effective April 1, July 1 and October 1.
- B. BC Gas will retain its discretion in terms of the rate changes requested in any application. The Commission will continue to use its discretion in approving rate changes.

- C. Due to the high initial balance and the already high rates faced by customers, the GCRA balance as at December 31, 2000 will continue to be amortized over three years. GCRA amounts accumulated starting January 1, 2001 will be amortized over a one year period in normal circumstances. Proposed changes to Rate Rider 6 will be included as part of the application to change gas cost recovery rates.

Nothing in the Guidelines precludes BC Gas from filing applications for rate changes at times other than those suggested by the Guidelines or proposing alternate treatment of the GCRA balance in unusual circumstances. Similarly, nothing in the Guidelines precludes the Commission from requesting rate applications at times other than those implied by the Guidelines.

Although the Guidelines were developed with specific reference to BC Gas, the Commission believes that the Guidelines will also be appropriate for other gas utilities in similar situations.

ATTRIBUTES OF DEFERRAL ACCOUNT AND GAS COST RATE SETTING METHODOLOGIES

Rate Stability

Rate stability refers to both the frequency and the size of rate changes. Customers would generally prefer rate changes to be smaller rather than larger and fewer rather than more, but these goals may conflict if there is a persistent upward or downward trend in gas costs.

Price Transparency

Price transparency refers to whether the gas cost recovery rates reflect market conditions and the overall accuracy of the price signal provided to customers. Setting rates annually generally provides a directionally correct price signal, but rate changes may be too infrequent to provide customers with a good idea of current gas price trends. Setting rates monthly or quarterly provides more frequent feedback, but may lead to oscillations that mask the underlying trend. It may be possible to reduce rate oscillation by setting rates based on the expected cost of gas over the next year rather than the expected cost in the next month or quarter.

Size of Deferral Account

In general, a mechanism that results in relatively small deferral account balances would be preferred to a mechanism that results in relatively large deferral account balances because large deferral accounts can mask underlying commodity price changes and alter the competitive position of the utility relative to smaller gas marketers. Large deferral accounts can also create issues related to the applicability of GCRA rate riders to new customers or customers switching to transportation service that might be avoidable or less important with smaller deferral account balances.

Efficiency of Process

Deferral account and gas cost recovery rate setting mechanisms that are relatively simple are preferred to those that are complex and difficult to understand, and adjustment mechanisms that involve less administration may be preferred to those that involve more administration. Annual review processes may tend to consume fewer resources than more frequent review processes unless the more frequent adjustments are accomplished mechanistically without the need for public input.

**SUMMARY OF COMMENTS RECEIVED
FROM BC GAS UTILITY LTD. AND OTHER PARTIES**

BC Gas Utility Ltd.

BC Gas provided initial comments in a letter dated December 13, 2000. BC Gas indicated that it supports the implementation of a formula-based monthly review process. Rates would be changed at the end of a month if the projected cost of gas for the next 12 months less expected rate revenue for the same period plus the GCRA balance (excluding the initial GCRA balance) exceeds (or is lower than) by \$50 million (approximately \$65 per customer, or 4.4 percent). BC Gas proposed that rates would be set by formula commensurate with expected costs over the twelve month period. Based on BC Gas' proposal, rates would not change if gas costs are relatively stable, but could be expected to change most months if gas costs are trending upwards or downwards. BC Gas proposes to amortize the initial GCRA so that the fund is eliminated by October 31, 2002, the date of commodity unbundling. BC Gas also suggests that if gas prices fall prior to 2002, customer rates should not be reduced until the GCRA balance is reduced to negative \$50 million.

BC Gas believes that the proposed monthly process would help to prevent a large accumulation in the GCRA account, would improve the price signal to customers and reduce the intergenerational inequity caused by large GCRA accounts. BC Gas suggests that the automatic adjustment mechanism would require limited public input and consume fewer resources at the Commission and BC Gas. BC Gas believes that sensitivity regarding frequent rate adjustments will likely be tempered by the increased public understanding of the commodity pricing of natural gas. BC Gas also indicates that slow recovery of large deferral account balances may be perceived by financial markets as increasing the risk of the utility. Such a perception could increase the cost of capital to the utility, thereby increasing rates to customers.

BC Gas filed further comments in a letter dated January 12, 2001. BC Gas reiterated its support for a monthly GCRA review based on a pre-defined formula and its view that a three year amortization period for the GCRA is too long. BC Gas also provided information related to the current status of the GCRA including the possibility that the previous estimate of the GCRA balance as at December 31, 2000 (\$159 million) may be too low by as much as \$20 million.

Consumers' Association of Canada (B.C. Branch) et al.

CAC (BC) et al. indicates that the Commission should direct BC Gas to design a new quarterly gas cost recovery mechanism with further adjustments in the second month of each quarter when required. Rate increases could be triggered if the forecast under-recovery or over-recovery exceeds 5-10 percent of the 12-month forward gas bill. Rates for the upcoming quarter should be based on the forecast average cost of gas over the next 12 months. Amounts in the deferral account should generally be amortized over 12 months, but the very large initial deferral account balance could be amortized over 24 months to reduce rate shock. BC Gas should be required to file monthly reports. The Commission should direct BC Gas to establish a task force including Commission staff, customer representatives and experts to design the new process for implementation January 1, 2001.

BC Health Services Ltd. and R.T. O'Callaghan & Associates Inc.

Minimizing the size of the deferral account is the most important objective of the deferral account and gas cost rate-setting methodology. BC Gas should adopt a monthly rate setting process with amortization of the deferral account balance over a period no longer than one year.

PremStar Pacific

The deferral account and corresponding rate rider should be updated as frequently as possible. The deferral account should be amortized over a period no longer than one year.

Centra Gas British Columbia Inc.

The GCRA balances should be disposed of frequently and systematically. Price transparency, market responsiveness, efficiency of process and volatility of rates are more important than the frequency of rate adjustments. Centra Gas advocates quarterly rate adjustments based on forward strip prices without much in the way of public process.