

February 27, 2009

BOARD STAFF SUBMISSION

NATURAL RESOURCE GAS LIMITED ("NRG")

APPLICATION FOR FRANCHISE AGREEMENT RENEWAL WITH THE TOWN OF AYLMER (EB-2008-0413)

1.0 APPLICATION AND BACKGROUND

Natural Resource Gas Limited filed an application dated December 23, 2008, with the Ontario Energy Board (the "Board") under section 10(2) of the Municipal Franchises Act, R.S.O. 1990, c. M.55, as amended (the "Act"). NRG is seeking to renew its franchise rights with the Town of Aylmer (the "Town") by way of a new 20-year franchise agreement. NRG has an existing franchise agreement with the Town of Aylmer which expires on February 27, 2009. The NRG application is based on the Model Franchise Agreement established by the Board in 2000, which would grant NRG the right to construct and operate works for the distribution of gas in the Town's municipal boundaries and to supply gas to the Town's residents.

A letter filed with the Board on January 9, 2009, by the Town of Aylmer, states that to the best of the Town's knowledge, it is one of six municipalities that are served by the natural gas distribution system operated by the Applicant, NRG. According to that letter, NRG has one or more Franchise Agreements with each of these municipalities, each of which have different renewal dates. The years in which the existing terms of the franchise agreements end with the other municipalities which are served by NRG are as follows:

- a. The Township of Malahide: 2012 and 2014
- b. Corporation of the Municipality of Thames Centre: 2012
- c. The Municipality of Bayham: 2012 and 2015
- d. Corporation of the Township of South-West Oxford: 2013
- e. Corporation of the Municipality of Central Elgin: 2016

NRG informed the Board as part of its December 23, 2008 application that it has been unable to reach agreement with Town of Aylmer on the terms and conditions of the franchise renewal.

NRG also requested that the Board grant interim relief under section 10(4) of Act to continue the right to operate works for the distribution of gas in accordance with the

existing franchise agreement until an Order is made under section 10(2) of the Act in respect of this application. In addition NRG is requesting consideration for further and other relief as the Board may deem necessary or appropriate.

A Notice of Application and Notice of Hearing was served on the Clerk of the Corporation of the Town of Aylmer on January 9, 2009 and was also published on January 14, 2009 in the Aylmer Express.

An oral hearing was held in the Town of Aylmer on February 12, 2009. The Town of Aylmer and the Integrated Grain Processors Co-operative Inc. participated in the hearing.

At the conclusion of the oral hearing, the Board issued an oral decision granting, on an interim basis, NRG's rights as set out in the existing franchise agreement, to continue for 90 days or until the renewal of that franchise agreement is granted under section 10(2) of the Municipal Franchises Act, whichever comes first.

On February 13, 2009, the Board issued an Interim Order to allow the right of NRG to construct and operate works and to extend and add to the works for the distribution of gas in the Town of Aylmer, to continue on the terms and conditions set out in the existing franchise agreement until May 14, 2009 or until a renewal of the franchise agreement is granted under the Municipal Franchises Act, whichever comes first.

2.0 THE MUNICIPAL FRANCHISES ACT

Subsection 10 (2) of the Municipal Franchises Act states:

The Ontario Energy Board has and may exercise jurisdiction and power necessary for the purposes of this section and, if public convenience and necessity appear to require it, may make an order renewing or extending the term of the right for such period of time and upon such terms and conditions as may be prescribed by the Board, or if public convenience and necessity do not appear to require a renewal or extension of the term of the right, may make an order refusing a renewal or extension of the right.

3.0 POSITION OF THE TOWN OF AYLMER

The Town of Aylmer is in favour of renewal of a Franchise Agreement with NRG for an initial term of three years¹. The purpose of the three year term is to:

- (a) allow NRG an opportunity during this time frame to regain the confidence of its customers within the Town as their incumbent gas supplier; and

¹ The Town of Aylmer Pre-filed Evidence of Margaret Heather Adams, dated February 10, 2009, Paragraph 13, page 4

- (b) permit the next renewal to come up in 2012, which would coincide with the pending renewals of NRG's Franchise Agreements with the Township of Malahide, the Municipality of Thames Centre, and the Municipality of Bayham.

In addition, the Town of Aylmer submitted that in order to addresses various concerns related both to the financial viability of NRG, and to the quality and reliability of its service to customers, it requires the Model Franchise Agreement² to include seven additional conditions:.

A summary of the seven conditions are:

- 1) Following execution of the Agreement, NRG will apply to the OEB for a comprehensive rate hearing.
- 2) NRG will implement the proposed amendments to the Gas Distribution Access Rule (EB-2008- 0313) regarding customer service measures.
- 3) NRG will, by May 15, 2009: a) adopt and adhere to a written and publicly available consumer security deposit policy per the OEB proposed amendments to the GDAR (EB-2008-0313); b) adopt and adhere to a written and publicly available complaint process for its customers; and c) adopt and adhere to a written policy to new and relocating retail, commercial and industrial customers on a timely basis and at a competitive rate.
- 4) NRG will keep all monies from consumer security deposits in a trust fund and it will not use such monies as working capital.
- 5) NRG will make its annual audited financial statements available, each year for the next three years, to the public no later than 4 months following the close of NRG's fiscal year.
- 6) NRG will give notice to the Corporation of any proceeding before the OEB that the NRG is a party to, particularly, but not limited to, any application to the OEB made by NRG.
- 7) By no later than December 15 of each year, NRG will provide the Corporation with annual detailed and up-to-date maps of its system assets within and outside the Town of Aylmer as well as their age and condition.

² The Town of Aylmer Pre-filed Evidence of Margaret Heather Adams, dated February 10, 2009, Tab L including a new Appendix A containing seven conditions

3.1 Effect of the 3 year Term on NRG's Financial Position

The Town position³ is that a 3-year term will not affect NRG's ability to refinance its long term debts in the interim. The Town notes that NRG itself has been arranging financing on a relatively short term (5-year on-demand) basis and not on a 20-year term.

The Town believes that as NRG's debt would be fully secured against assets regulated by the Board, this would remain the strongest assurance of repayment to any existing or new lender to NRG.

3.2 Requiring NRG to Apply to the Board for a Comprehensive Rate Hearing

The second aspect of the Town's proposal in paragraph 1 of Schedule "A" to its revised Draft 2000 Model Franchise Agreement is that NRG immediately apply to the Board for a comprehensive rate hearing.

According to the Town⁴ this would address the issue of the \$13,461,418 of "retractable" Class C shares currently classified as equity. The Town believes that these shares should be shown as a liability (debt). This is due to the fact that they are redeemable and retractable at the option of the shareholders at any time.

3.3 Unsecured and Rising Customer Security Deposits

The Town submitted⁵ that customer security deposits held by NRG have risen dramatically recently, from approximately \$105,000 in 2005, to \$280,000 in 2006, and again to \$603,000 in 2007. The Town stated that NRG's audited 2008 Financial Statement, attached at Tab "E" to NRG's pre-filed evidence dated February 10, 2009, it appears these deposits have risen yet again to \$757,065 in 2008. This according to the Town⁶ represents, as pointed out by the Town, a 650% increase over 3 years. It cannot, according to the Town, represent "business as usual", or be defended as such.

The Town is concerned that, after repayment of the Bank and Union, there may simply be no assets within NRG with which to repay these customer deposits.

³ The Town of Aylmer Pre-filed Evidence of Margaret Heather Adams, dated February 10, 2009, Paragraph 15, page 5

⁴ The Town of Aylmer Pre-filed Evidence of Margaret Heather Adams, dated February 10, 2009, Paragraphs 27-22, pages 5-6

⁵ The Town of Aylmer Pre-filed Evidence of Margaret Heather Adams, dated February 10, 2009, Paragraphs 31-36, pages 10-11

⁶ The Town of Aylmer Pre-filed Evidence of Margaret Heather Adams, dated February 10, 2009, Paragraphs 32, page 10

4.0 POSITION OF NRG

NRG acknowledges⁷ that the Board has sole jurisdiction when it comes to determining: (a) whether or not to grant a franchise renewal; and (b) if a renewal is granted, the terms and conditions that it may establish in a franchise agreement.

NRG indicated⁸ that the main issues are the **term** of the franchise agreement, and the imposition of certain **conditions** requested by Aylmer in the renewed franchise agreement.

NRG further indicated that both the Town of Aylmer and NRG are satisfied with the form of the Board's 2000 Model Franchise Agreement); and that certain of the conditions sought by the Town have been agreed to by NRG.

NRG indicated⁹ that, there are only four issues that are outstanding, and require determination by this Board. The four issues are:

- (1) Term: 20 years (as requested by NRG) or 3 years (as requested by Aylmer), or another term as determined by the Board.
- (2) Rate Application Filing: NRG to file a comprehensive rate application by December 31, 2009 (as requested by NRG) or "immediately upon the execution of [a renewed franchise agreement]" (as requested by Aylmer), or by some other date determined by the Board.
- (3) Security Deposit Trust Fund: NRG to keep all monies from consumer security deposits in a trust fund and not use such monies as working capital (as requested by Aylmer) or reject this condition (as requested by NRG).
- (4) Provide Notice to Aylmer: NRG to give notice to Aylmer of "any proceeding before the OEB that [NRG] is a party to" (as requested by Aylmer) or reject this condition (as requested by NRG).

NRG submitted¹⁰ that in coming to a determination on the above four issues, the legal test set out in the Act is whether "the public convenience and necessity appear to require it." In other words:

- Does the public convenience and necessity require a shorter than normal term for the renewed franchise agreement?
- Does the public convenience and necessity require that it be a condition of the renewed franchise agreement that NRG file a rate application before the end of 2009?

⁷ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraph 2, page 1

⁸ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraph 3, page 1

⁹ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraph 5, page 2

¹⁰ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraph 6, page 2

- Does the public convenience and necessity require that it be a condition of the renewed franchise agreement that NRG's security deposit monies be held in a separate trust fund, and not be used as working capital?
- Does the public convenience and necessity require that it be a condition of the renewed franchise agreement that NRG provide notice to Aylmer of any OEB proceeding that NRG is a party to?

4.1 Issue 1: Length of Term of Franchise Renewal¹¹

NRG submitted¹² that it has requested 20 years (longer than the minimum the Board considered adequate in E.B.O. 125) because the risk to NRG has not decreased over the initial term of the franchise agreement with Aylmer. NRG has vastly expanded the asset base of the utility in the initial franchise period. As a result, the risk to NRG has not decreased, because its undepreciated capital assets have increased.

NRG noted that the evidence in this proceeding demonstrates, almost all of NRG's pipelines are new, and since 1979 NRG has grown its customer base from 2,000 customers to nearly 7,000 customers¹³.

NRG indicated that it is unique among gas distributors in Ontario. The fact is that during the term of its franchise agreement with Aylmer, NRG¹⁴ did not start with an extensive system that merely depreciated over the term of the franchise agreement. Rather, NRG has spent the past twenty or so years improving and developing what was essentially a gathering system for local production into a true gas distribution utility.

In addition, NRG pointed out that there are several other important reasons¹⁵ for establishing a franchise renewal period that is within the normal range of renewal terms, including:

- a) the Town is not arguing for a three-year term on any public interest grounds;
- b) an abnormally short renewal term puts NRG at risk of losing its financing or to amortize its remaining asset base over the shortened period, which would cause rates to increase significantly;
- c) nearly all of Aylmer's issues with NRG (i.e., Aylmer's proposed conditions to the renewed franchise agreement) have been agreed to by NRG, and could be enforced under a long-term franchise renewal agreement; and
- d) a three-year term would not provide any incentive to NRG to spend any money on capital assets, which the Town seeks to have happen.

¹¹ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 29 -101, pages 9-23

¹² Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 31, page 9

¹³ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 32, page 9 and NRG Pre-filed Evidence Exhibit C/Tab 1/p.1/lines 26 to 28.

¹⁴ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 34-35, page 10

¹⁵ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 38, pages 10-11

4.2 Issue 2: Timing of Rate Application¹⁶

NRG stated that the second issue to be determined by the Board is: Does the public convenience and necessity require that it be a condition of the renewed franchise agreement that NRG file a rate application before the end of 2009?

NRG has stated¹⁷ that it would be prepared to file an application by December 31, 2009. The rationale for this date is to allow NRG to: (a) understand any rate implications arising from the Board's decision in this case; and (b) allow sufficient time for NRG to properly prepare a comprehensive application.

NRG pointed out¹⁸ that the preparation of a cost-of-service rate application (and pre-filed evidence) by a smaller utility such as NRG involves a significant financial and personnel commitment on the part of the utility. NRG submitted that it would obviously comply with whatever the Board orders in terms of a rate filing deadline, but asked that the Board be mindful of the significant work and time involved in the preparation of a rate application.

4.3 Issue 3: Trust Account for Security Deposits¹⁹

The third issue to be determined by the Board, as identified by NRG is: Does the public convenience and necessity require that it be a condition of the renewed franchise agreement that NRG's security deposit monies be held in a separate trust fund, and not be used as working capital?

As mentioned at the hearing, NRG²⁰ argued that it does not support holding security deposits in a separate trust fund, for three reasons:

- a) NRG does not believe that its financial well-being warrants holding security deposit monies in a segregated account;
- b) at present, the security deposits held by NRG (and by the other two gas utilities) reduce the utility's rate base, but placing these funds in a trust account would increase NRG's rate base; and,
- c) there are other costs associated with managing and auditing a trust account that currently do not have to be incurred by NRG.

NRG notes that, the concern with items b) and c) is that they result in higher rates for NRG's customers, since the security deposits held by NRG reduce NRG's rate base

¹⁶ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 102-105, pages 23-24

¹⁷ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraph 103, page 24

¹⁸ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 104, page 24

¹⁹ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 106-114, pages 24-25

²⁰ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 107, page 24

through working capital. In addition NRG submitted that there will be operating expenses associated with the maintenance of a trust account (e.g., auditing costs) that currently do not form part of NRG's budget.

4.4 Issue 4: Mandatory Notification of Aylmer²¹

NRG stated that the fourth and final issue to be determined by the Board is: Does the public convenience and necessity require that it be a condition of the renewed franchise agreement that NRG provide notice to Aylmer of any OEB proceeding that NRG is a party to?

NRG argued that it believes this condition is unnecessary²², and should not be inserted as a special condition to a renewed franchise agreement.

NRG submitted that part of its concern²³ is that it is the type of condition that could easily be overlooked or "fall between the cracks", ultimately have little consequence to Aylmer, but nevertheless be a breach of the franchise agreement. For example, it would not be in anyone's interest for NRG to be in breach of its franchise agreement merely because NRG inadvertently failed to notify Aylmer about a generic proceeding that NRG was only tangentially involved in.

For these reasons, NRG submits that the inclusion of this condition in a renewed franchise agreement is not in the public interest.

5.0 POSITION OF BOARD STAFF

Board staff recognizes that the Town of Aylmer continues to have concerns in regard to the financial viability of NRG, and to NRG's lack of transparent procedures in dealing with its customers e.g., lack of a written and publicly available complaint process for its customers. The Town is seeking that the Board address these concerns by imposing conditions on NRG as part of the franchise renewal process.

A fundamental question in Board staff's view is whether the municipal franchise approval is the appropriate regulatory instrument to address these concerns. The 2000 Model Franchise Agreement was developed following significant discussion and negotiation between municipalities and the gas utilities. It has been applied uniformly across the Province for each franchise renewal since the year 2000. Any departure from the Model, in Board Staff view, requires careful consideration by the Board.

Board staff submits that the conditions sought by the Town of Aylmer should not simply be added as additional terms and conditions which serve to amend the Model Agreement. Should the Board choose to address the concerns raised by the Town it is

²¹ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 115-123, pages 26-27

²² Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 116-119, page 26

²³ Argument-In-Chief by Natural Resource Gas Limited (NRG), February 20, 2008, paragraphs 122, page 27

Board staff's position that this should be done outside the gambit of the Board approved Model Agreement or alternatively, if the Board sees fit to address these concerns as part of this proceeding that any proposed conditions be attached to the Board's Decision and Order, which would serve to keep them separate and apart from the Model Franchise Agreement.

5.1 Use of 2000 Model Franchise Agreement and the Twenty Year Term

The Board initiated a generic proceeding on November 1, 1999 with the intent of developing a new Model Franchise Agreement for use across the Province. Participants²⁴ in that proceeding included the gas companies, associations representing municipalities and industrial users as well as individual cities, municipalities and towns. The Board saw merit in applying a consistent approach to franchise renewals given the hundreds of municipalities which have agreements with gas utilities. The proceeding culminated in a Report to the Board, dated December 29, 2000 (the "Report") and an approved 2000 Model Franchise Agreement.

One of the issues considered by the Board in developing the 2000 Model Agreement was the term of the Agreement. A summary of the aspects related to the length of the term of the Agreement is summarized in Appendix A to this submission. Board staff submit that a fundamental consideration is the length of time required by a utility to recover the cost of its investments of expanding and replacing its assets within a franchise territory. Board staff is of the view that a 20-year term is a reasonable period to recover the costs of capital investment in the distribution system. Shorter periods could be a disincentive for a gas distributor to make such capital investments. This is true especially where the cost recovery period for a typical expansion project involving a mix of commercial and residential customers can be over many years and the 20 year terms afford a reasonable assurance for that cost recovery.

Board staff is of the view that the 2000 Model Franchise Agreement should be used without changes for renewal of NRG's Franchise Agreement with the Town of Aylmer. This view is consistent with the historical development of Franchise Agreement leading to the 2000 Model Franchise Agreement in use today. The 2000 Model Franchise Agreement sets out the obligations of the Franchisee in regard to all aspects covering technical, construction, safety, and operations of the system. It does not deal with the important aspects of policies and procedures between the Franchisee and its customers, as these aspects are covered by other regulatory tools and procedures.

5.2 Town of Aylmer's Request for Notification

Board staff recognizes the Town of Aylmer's desire to participate in any proceeding involving the supply of natural gas to its constituents.

²⁴ Association of Municipalities of Ontario ("AMO"), The Gas Companies, The City of Toronto, The Regional Municipality of Ottawa-Carleton, The Industrial Gas Users Association ("IGUA"), The Township of Hay, The Township of Sarawak, The Ontario Good Roads Association, The Town of Oakville

Board staff points out that Rule 21 of the Board's Rules of Practice and Procedure covers all aspects of notification. Unless the Board initiates a proceeding under its own motion, notification of a proceeding is carried out by the Applicant, under direction from the Board via a letter of direction. Such a letter of direction requires either publication or service to specific parties, or both, which depends on the type of proceeding e.g., rate applications by natural gas distributors versus licensing applications by generators. The letter of direction also requires that notification, whether by publication, service or both, be followed by corresponding affidavits to proof publication, service, or both as the case may be. Although the procedural aspects of issuing notice are typically handled by the applicant, it is the Board that determines who is entitled to notice based on the particular circumstances of the application. In any case where the Board determines that the Town's interests may be affected, it will require that the Town receive notice.

Board staff further notes that staff of the Town of Aylmer can access the Board's website, <http://www.oeb.gov.on.ca>, where in the first page under "What's New", there is a daily update of summary listings of important new applications, such as rate applications, and milestones events for them until completion.

For these reasons Board staff is of the view the condition requested by the Town of Aylmer is not necessary.

5.3 The Rate Hearing to Address Customer Related Concerns

NRG has agreed²⁵ to comply with whatever the Board orders in terms of a rate filing deadline. It is Board staff view that rate application is the appropriate procedure under which some of the customer related concerns raised by the Town can be adequately addressed. Staff points out that as NRG's rate year commences October 1, any application filed by NRG should take into consideration the necessary time for the application's review without having retrospective adjustments. Should the Board decide to address the Towns proposed conditions as part of this franchise renewal proceeding, Board staff submit that this should done outside the gambit of the terms and conditions of the 2000 Model Franchise Agreement.

²⁵ NRG's Argument in Chief filed with the Board on February 20, 2009, paragraph 105, page 24

APPENDIX A

SUMMARY OF REPORT TO THE BOARD DATED DECEMBER 29, 2000 [THE 2000 MODEL FRANCHISE AGREEMENT]

A generic proceeding was initiated on November 1, 1999 to deal with various issues related to the terms included in a Franchise Agreement, in response to a letter sent on December 1998 by the Association of Municipalities of Ontario (“AMO”) to the Chair of the Board, requesting that the Board consider amendments to the 1987 Municipal Franchise Act. The proceeding included an oral presentation, and culminated with a Report to the Board, dated December 29, 2000 (the “Report”) and a 2000 Model Franchise Agreement (“2000 MFA”) attached as Appendix A to that same Report.

Duration of the Agreement

During the proceeding²⁶ the issue of duration of the agreement was debated. As discussed above, AMO was originally prepared to accept the ten to fifteen-year renewal term provided the Board accepted its proposal for allowing the franchise agreement to be amended if there is a legislative change. If this is not the case, AMO requested a maximum ten-year term for renewal of franchise agreements.

Position of Parties regarding a Model Agreement

The Gas Companies felt that franchise agreements and renewals should not be shorter than they were (20 and 15 years respectively). The Gas Companies pointed out that they evaluate the economic feasibility for system expansion to recover the costs of an investment in the distribution system to provide service to residential customers over a period of 40 years or more. For a typical expansion project involving a mix of commercial and residential customers, the costs of the project will generally be greater than the revenue for at least 15 years. Therefore, the Gas Companies contended that they do not typically realize a return on the original investment until well beyond the 15-year mark.

AMO and the Gas Companies negotiated and came to an agreement referred to in section 3.2.7 of the Report stating in part that:

“A 20-year term would provide stability for both parties with respect to the duration of the franchise agreement. The ability to modify the franchise agreement in years 7 and 14 of any renewal term, in order to incorporate all model franchise agreement changes other than term, would provide some opportunity to update the terms and conditions of the franchise agreement on a regular basis.”

²⁶ Section 3.2, pages 27-30, of the Report to the Board, dated December 29, 2000 (the “Report”)

Board Panel Recommendations for the 2000 Model Franchise Agreement (2000 MFA)

In Section 3.2.10 the Report, the Panel recommends that
The Panel therefore recommends that Paragraph 4 - Duration of Agreement and
Renewal Procedures- of the 2000 MFA should read as follows:

(a) If the Corporation has not previously received gas distribution services, the rights hereby given and granted shall be for a term of 20 years from the date of final passing of the By-law.

or

(b) If the Corporation has previously received gas distribution services, the rights hereby given and granted shall be for a term of 20 years from the date of final passing of the By-Law; provided that if, during the 20-year term of this Agreement the Model Franchise Agreement is changed, then on the 7th anniversary and on the 14th anniversary of the date of the passing of the By-Law, this Agreement shall be deemed to be amended to incorporate any changes in the Model Franchise Agreement in effect on such anniversary dates. Such deemed amendments shall not apply to alter the 20-year term.