ONTARIO ENERGY BOARD

STAFF FINAL ARGUMENTS

NATURAL RESOURCE GAS LIMITED 2011 DISTRIBUTION RATES APPLICATION

EB-2010-0018

October 1, 2010

Natural Resource Gas Limited ("NRG" or the "Applicant"), filed an application dated February 10, 2010 with the Ontario Energy Board under section 36 of the *Ontario Energy Board Act*, *1998,* S.O. c.15, for an Order or Orders approving or fixing just and reasonable rates and other charges for the sale, distribution, transmission and storage of gas for the 2011 fiscal year, commencing October 1, 2010.

NRG is a privately owned utility that sells and distributes natural gas within Southern Ontario. The utility supplies natural gas to Aylmer and surrounding areas to approximately 7,000 customers with its service territory stretching from south of Highway 401 to the shores of Lake Erie, from Port Bruce to Clear Creek.

The Board issued a Notice of Application dated March 1, 2010. The Town of Aylmer, Union Gas Limited ("Union"), Integrated Grain Processors Co-Operative Inc. ("IGPC") and Vulnerable Energy Consumers Coalition ("VECC") applied for and were granted intervenor status.

A technical conference was held on June 14, 2010 to address further questions arising from the response to interrogatories and to seek clarification on the evidence filed by the Applicant. The technical conference was immediately followed by a settlement conference. At the end of the settlement conference, the parties agreed to continue discussions on June 28th with the objective of reaching a settlement among the parties.

On August 3, 2010, IGPC filed a Notice of Motion to resolve certain issues related to the disagreement over the reasonable cost of construction of the 28.5 km pipeline built by NRG to serve natural gas to the IGPC ethanol plant (the "Motion"). In the Motion, IGPC indicated that although the facility is in service, IGPC and NRG have not been able to resolve differences over costs of constructing the pipeline and IGPC requested the Board's assistance to achieve a resolution on these matters.

The Board issued Procedural Order No. 5 on August 9, 2010 to deal with the Motion. The Board called for written submissions on how to deal with the issues identified in the Motion. The Board scheduled an oral hearing on September 7, 2010 to hear the Motion which was immediately followed by the rates case hearing.

At the oral hearing, the Board panel decided to hear the issues identified in the Motion as part of the rates case proceeding. At the end of the hearing, the Board decided that it would address issues that impact rates. The other issues that IGPC identified would be dealt with in one fashion or another, at a later point in time.

The submissions below reflect observations and concerns of Board staff on issues that remain unsettled and which require a decision by the Board. Board staff have addressed the following issues in the submission:

- Rate Base
- Cost of Service (Deferral and Variance Accounts, Cost of Gas)
- Cost of Capital
- Cost Allocation

The submission is intended to assist the Board in evaluating NRG's application and in setting just and reasonable rates.

Although NRG's pre-filed evidence includes a proposal on an Incentive Regulation Mechanism ("IRM") and is identified in the Settlement Agreement as an unsettled issue, the Applicant decided at the oral hearing that it would prefer to file its IRM plan as a Phase 2 of the proceeding at a later date. The parties and the Board agreed to defer IRM to a later date and determine the 2011 base rates as part of the current phase of the proceeding.

RATE BASE (Issue 2.6)

In the Application NRG has proposed to close an amount of $5,073,000 to rate base for the IGPC pipeline (Exhibit B6, Tab 2, Schedule 1). However, in response to Undertaking J2.4, a revised calculation indicates an amount of $4,905,251 that should be closed to rate base. In its reply argument, NRG is requested to clarify the amount that it is seeking to close to rate base.

COST OF SERVICE

Deferral and Variance Accounts (Issue 4.11)

Pursuant to the Technical Conference, NRG filed an update to the Regulatory Expense Deferral Account ("REDA") as Exhibit D1, Tab 7, Schedule 2. At the oral hearing Board staff questioned the amount of $111,123 requested for disposition with respect to the Union Cessation of Service proceeding (EB-2008-0273).

NRG's position is that the Board ordered that NRG's shareholders should bear the intervenor costs while NRG costs for the proceeding could be recovered from ratepayers[1]. Board staff do not agree with this view and submit that the Board clearly indicated that NRG could not recover any costs from ratepayers.

The EB-2008-0273 Decision states on page 7 –

> "In the case of Union's request for security, NRG did not act in a timely manner. The record suggests that NRG essentially stone-walled Union. This resulted in significant costs for Union, the Board, the Town of Aylmer and the Integrated Grain Processors Co-Operative. This type of brinkmanship is not helpful where 6,500 customers and a recently activated ethanol plant supported by substantial Federal and Provincial funding are involved. **The Board also directs that costs being paid by NRG shall be paid by NRG's shareholder and not passed on to the NRG rate payers.**" (emphasis added)

It is clear that the Board was critical of NRG's role in this matter and the Board's use of the words, "The Board also directs that costs being paid by NRG shall be paid by NRG's shareholder" is relatively clear on whether costs can be recovered from ratepayers. The specific words "costs being paid by NRG" includes all costs in Board staff's submission, intervenor costs or its own legal costs. The Board did not state that the shareholders should pay intervenor costs and all other costs can be recovered from ratepayers.

Board staff submit that NRG should not be able to recover the amount of $111,123 that it has requested for disposition in the REDA.

[1] Oral Hearing Transcript Volume 1, Page 112

In an amended filing to the Deferral and Variance Accounts section, NRG has requested an order to establish a deferral account to record the costs incurred to convert to the International Financial Reporting Standard (“IFRS”). Board staff have no concerns with NRG’s request to establish the IFRS Deferral Account.

Cost of Gas (Issue 4.12 and 4.13)

In the 2006 rates Decision (EB-2005-0544), the Board approved a specific methodology for NRG to calculate the contract price for gas purchased from the related company NRG Corp. This price was based on a publically available index and the Board accepted NRG’s methodology to recalculate the contract price on an annual basis. The Board also directed NRG to seek prior permission should it decide to change either the source from which prices are calculated or the methodology to determine the price.

Board staff have identified several issues within cost of gas and will deal with each issue separately.

1. Failure to recalculate the price of gas purchased from NRG Corp.

In response to Board staff IR #23, the Applicant indicated that the previous management of NRG neglected to follow the Board directive and did not recalculate the purchase price. In other words, the price has essentially remained the same from 2007 onwards. At the oral hearing, NRG confirmed that as of September 30, 2010, the failure to follow the methodology will result in an overpayment of approximately 97,000 to NRG Corp[2]. However, it is not clear if NRG will be recalculating the rate for the 2011 fiscal year. Since the Board will not be able to issue its decision on this matter prior to September 30, 2010, the overpayment is likely to continue past September 30th should the contract rate remain unchanged.

Board staff submit that NRG should start recording the credit/debit balances to the Purchased Gas Commodity Variance Account (“PGCVA”) as of October 1, 2010 and update the amount until the purchase price is reset after the Board issues its Decision. The estimated overpayment of $97,000 as of September 30,

[2] Oral Hearing Transcript Volume 1, Page 114

2010 should be refunded to ratepayers in the same manner as other deferral and variance accounts over a time period determined by the Board. The overpayment was the result of NRG failing to comply with a Board order, which is a serious matter. There can be little question that it should be returned to ratepayers.

2. Requirement to purchase gas from NRG Corp. in order to maintain system stability

At the oral hearing, NRG indicated that the distribution system in the southern district requires dual supply from both, Union Gas and NRG Corp. gas wells. The dual sources of supply are required to provide adequate supply and to maintain system pressure. NRG estimates that 2.4 million cubic meters is required from NRG Corp. in order to maintain system pressure[3].

NRG also indicated that it may have to pay higher than market price to purchase the minimum required quantities of gas from NRG Corp. In response to Board staff IR #23, NRG provided a letter dated September 30, 2009 which indicates that NRG was willing to pay a price of $8.486 mcf in order to purchase gas from NRG Corp. NRG has termed this gas as Integrity Gas and provided a proposal for its pricing in its Argument-In-Chief. The proposal is as follows:

- To pay NRG Corp. $8.486 per mcf whenever the market price for natural gas is $9.999 per mcf or less; and,
- To pay “market price” for natural gas when gas is $10.00 per mcf or more.

At the hearing, Board staff questioned whether NRG has explored alternatives to purchasing gas from NRG Corp. NRG was asked to provide a response on the hypothetical assumption that all natural gas wells of NRG Corp. were dry and NRG was no longer able to obtain the required quantities to maintain system pressure. In response to Undertaking J1.11, the Applicant noted that based on informal discussions with engineering firms, NRG would have to build a new six inch pipeline approximately 16.7 kms. in length to source additional gas and maintain system pressure. NRG has estimated the preliminary cost to be $1.89 million excluding regulatory, financing and land acquisition costs.

[3] Oral Hearing Transcript Volume 1, Pages 118-119

Board staff is of the opinion that there could be other proposals that have not been considered. In addition, the above alternative presented by NRG is based on informal discussions and there is no expert opinion on record. Accordingly, Board staff submit that NRG should be ordered to obtain an independent third party engineering study which identifies options (including high level cost estimates) to maintain system pressure in the absence of supply from NRG Corp, the results of which should be submitted to the Board within twelve months of the date of the current rates decision.

In addition, the Applicant has indicated that if the Board accepts NRG's proposal for the pricing of Integrity Gas then NRG is of the opinion that there would be no accumulated differential payable either way (either to or from ratepayers)[4]. In other words, the estimated overpayment of $97,000 would not exist anymore. Board staff fail to understand the logic of this position. Any proposal approved by the Board would be effective at a future date and would not be applied retroactively. Board staff submit that the question of repaying the $97,000 overpayment to NRG Corp. should not arise as the methodology for determining these gas costs have been set out in a Board decision; this amount must be refunded to ratepayers.

3. Methodology to calculate purchase price going forward

In its Argument-In-Chief, NRG has proposed a methodology to set the price of gas going forward. The methodology essentially divides the required gas quantities into two different groups:

<u>System Integrity Gas</u>
As noted above, the first 2.4 million cubic meters termed "Integrity Gas" will be purchased at a price of $8.486 per mcf when market price is $9.999 or less and at market price when gas is higher than $10.00 per mcf.

Although this proposal appears reasonable at first glance, the price forecast for natural gas within North America for the medium term (five year outlook) indicates that prices are likely to remain low. The unprecedented growth in

[4] NRG Argument-In-Chief para 91

unconventional natural gas production (shale gas) has altered gas price relationships and long-term outlook in North America.

Board staff submit that the Board reject NRG's proposal of pricing Integrity Gas as it is more likely to benefit NRG Corp. rather than ratepayers. If approved, the proposal would imply that NRG ratepayers would be paying a premium to buy gas from a related company. The Board should not allow the shareholder to benefit at the expense of ratepayers.

In case NRG wishes to purchase gas from NRG Corp. at a price above market, Board staff submit that NRG be allowed to recover only the market price from ratepayers.

Non-Integrity Gas

In its Argument-in-Chief, NRG has submitted that the "market price" should be used as the basis for the price to be paid by NRG to NRG Corp. However, it has proposed a different approach as compared to the directive set out in EB-2005-0544.

NRG has proposed that the methodology allow NRG to base the price on a few selected indices including the Shell Trading Report. The other change that it is seeking is to set the price on a quarterly basis coinciding with NRG's QRAM[5]. Board staff agree with the proposed changes as this would reduce the risk for ratepayers.

Board staff submit that the methodology to determine the price should be based on the following criteria:

a. Transparency (based on published data or publicly available information)
b. Use a methodology that can be replicated
c. Price determined should reflect market prices for the specific period

Board staff submit that if the price needs to be reset on a quarterly basis then NRG could also use Union's Quarterly Rate Adjustment Mechanism. It fulfils all the criteria noted above and can be easily determined by NRG and is available to

[5] NRG Argument-In-Chief para 89

all parties. Board staff submit that Union's *Ontario Landed Reference Price* which represents the South Purchase Gas Variance Account reference price and the Spot Gas Variance Account reference price for incremental gas purchased in the Southern Operations Area be used for calculating the purchase price of gas.

Alternatively, NRG could use its proposed methodology. However, the Board should stipulate the source from which the price is determined. For instance, if NRG uses the Shell Trading Report, it should be consistent and not change the data source in subsequent price adjustments. In case the data is not available anymore, NRG should seek prior approval for using an alternative source in its QRAM application.

4. Implementation of a transportation charge

NRG confirmed at the oral hearing that NRG Corp. sells gas to Union Gas Limited and the gas flows through NRG's distribution system[6]. However, NRG Corp. does not pay NRG a transportation charge for using the NRG system to transport gas to Union. In other words, NRG ratepayers have been deprived of the revenues that would have offset rates for the number of years that NRG Corp. has been using the distribution system for free.

In response to Undertaking J2.8, NRG provided total volumes that were routed through NRG's distribution system by NRG Corp. Since 2006, total volume of gas transported is 29,660 mcf. As part of the same Undertaking, NRG was also asked to propose a suitable transportation rate[7]. NRG did not suggest a rate. But it has provided the transportation rate of Greentree Gas & Oil Ltd. that NRG Corp. uses to transport gas to Union. Greentree charges $0.95 per mcf and an administration charge of $250 per month for every month that the Greentree system is used for transportation.

Using the same transportation rate of $0.95 per mcf and an administrative charge of $250 per month, Board staff has calculated that NRG ratepayers have been deprived of $31,927 ($28,177 + $3,750) since 2006. Board staff submit that absent the suggestion and rationale of a transportation rate, the Board direct

[6] Response to Undertaking J1.10
[7] Oral Hearing Transcript Volume 2, Page 101

NRG to charge a transportation rate of $0.95 per mcf and an administrative charge of $250 per month for every month the NRG distribution system is used by NRG Corp. to transport gas. Since NRG has not forecasted revenues for transportation in the current proceeding, Board staff submit that the Board establish a deferral account to track revenues from transportation which can be cleared through the annual deferral account disposition mechanism.

Furthermore, in lieu of the fact that NRG ratepayers have been subsidizing the shareholder for the past number of years, Board staff submit that the cost of the independent engineering study to explore alternatives to buying Integrity Gas be borne by the shareholder and not the ratepayers.

Another issue is the relationship between NRG and NRG Corp. Although NRG Corp. is not an affiliate of NRG under the definition in the Affiliate Relationship Code, Board staff is concerned that the nature of the relationship presents the possibility of NRG Corp. benefitting at the expense of ratepayers. Board staff submit that although NRG Corp. is not technically an affiliate, the provisions of the Board's Affiliate Relationship Code ("ARC") should be made to apply to the relationship between NRG and NRG Corp. The Board has made similar decisions in the past. In the Dawn-Gateway Pipeline Limited Partnership ("Dawn Gateway") proceeding (EB-2009-0422), the Board found that the provisions of ARC should apply to the relationship between Union and Dawn Gateway even though Dawn Gateway was not technically an affiliate of Union. In its Decision, the Board deemed Dawn Gateway to be an affiliate of Union and accordingly sought written assurance from Union that it will treat Dawn Gateway as an affiliate for purposes of the ARC. This was despite the fact that Dawn Gateway had proposed a Code of Conduct to deal with preferential treatment, related-party transactions and confidential information.

COST OF CAPITAL

Capital Structure and Return on Equity (Issues 5.1 and 5.2)

In its Application NRG has proposed two alternate capital structures. The first proposal includes 58% debt and 42% equity with a return on equity ("ROE") of 50 basis points over the Board determined ROE as per the Board's Cost of Capital

Parameter Updates issued on February 24, 2010. Alternatively, it has proposed a capital structure of 52% debt and 48% equity along with the Board determined ROE.

In NRG's 2006 rates Decision (EB-2005-0544), the Board approved an equity structure of 42%. In her evidence in support of NRG's proposal, Ms. McShane indicated that a deemed capital structure of 42% equity and 58% debt in conjunction with the premium on ROE is consistent with the company's business risk and will allow the utility access to capital on reasonable terms and conditions. Based on the dividend payment forecast and the planned refinancing of the outstanding principal amount of the fixed rate loan in March 2011, the actual equity ratio according to NRG using gross debt and equity is expected to reach 38%. Measured on net debt basis, the equity ratio will exceed 46% according to the Company[8].

In NRG's previous rates hearing (EB-2005-0544), Ms. McShane provided expert evidence and her view was that NRG should have a 35% equity ratio because that was the actual equity[9]. In the current proceeding, Ms. McShane agreed that the actual equity should be used and 42% represents the average equity ratio for NRG over the next five years.

However, the current actual equity ratio is 37% as noted in response to a question at the Technical Conference[10]. In addition, Table 4 in Ms. McShane's report, "Opinion on Capital Structure and Equity Risk Premium For Natural Resource Gas" provides a list of Canadian utilities. A majority of them are at 40% (7 of 11) including all the electric utilities in Ontario.

Board staff submit that if Ms. McShane's view is the same as noted in EB-2005-0544, then NRG should receive its actual capital structure, which is 37%. In the previous rates case, the Board did not consider the future ratio of NRG but its current actual capital structure. In this case, it is 37% and therefore NRG should receive 37%.

[8] Opinion on Capital Structure and Equity Risk Premium (E2/T1/Sc1), pages 13-14
[9] EB-2005-0544 Transcript Volume 1, page 17
[10] Technical Conference Transcript, Page 54 (Lines 19-20)

It should also be noted that Ms. McShane's own evidence indicates a majority of utilities sitting at 40% equity. This is consistent with current Board policy and the capital structures of a majority of distribution utilities in Ontario. Based on the above argument, Board staff submit that the maximum equity ratio that NRG should receive is 40%.

In fact, some intervenors have argued that NRG has no equity at all[11]. As compared to 2006, NRG has almost doubled its rate base and increased its debt substantially, from $5 million in 2006 to $10.5 million in 2010[12]. At the same time, it has added no equity. Furthermore, the recent audited financial statements classify NRG's retractable shares as a liability rather than an asset. It is possible that in the future NRG may be able to change the structure of the shares and may reduce the substantial debt incurred to build the pipeline. However, the several ways in which NRG's capital structure can be calculated and the fact that it may change significantly over the next few years indicates instability in the capital structure. This further strengthens the argument that the Board does not have reliable information and an agreed methodology to determine the actual capital structure. The Board should therefore approve a deemed capital structure of 40% equity and 60% debt which is in line with Board policy.

Premium over Board approved ROE

NRG is seeking an ROE of 10.35% which is 50 basis points over the ROE derived from the Board's formula. The 50 basis points represents the risk premium that NRG received over Enbridge's approved ROE in the previous rates Decision (EB-2005-0544). The premium essentially represents a higher business risk than Enbridge. Ms. McShane's evidence indicates that NRG's risk profile has remained unchanged from 2006 and it should therefore receive the same 50 basis points premium.

Board staff notes that the Board's *Report on Cost of Capital for Ontario's Regulated Utilities* issued on December 11, 2009 was released after the Board's Decision on NRG's 2006 Cost of Service Application. The Board's report concludes that an equity risk premium of 550 basis points will be appropriate, at least as a starting point. Since the policy applies to all regulated utilities and the

[11] Oral Hearing Transcript Volume 3, Page 87
[12] Exhibits E3/Tab1/Sched2 and E7/Tab1/Sched2

Board determined ROE has been awarded to all 2010 cost of service applicants, it would be fair to argue that the 550 basis points represents a risk premium that accounts for and considers all utilities across Ontario. In other words, the Board report recognized that the 550 basis points premium did not represent a specific utility but was generally applicable across all utilities.

In the 2010 cost of service applications, some intervenors argued that the Board in its Report noted that it would continue to include an implicit premium of 50 basis points for floatation and transaction costs. They therefore submitted that Haldimand County Hydro Inc. (EB-2009-0265) and Burlington Hydro Inc. (EB-2009-0259) should not receive the 50 basis points premium as they did not expect to incur any floatation or transaction costs in the Test Year.

The Board in its Decision agreed with the intervenors but determined that the policy should be applied unadjusted. The reason was that the Board already knew that a number of utilities in Ontario did not issue equity or debt to the public and this was understood throughout the evolution of the Board's approach to setting the ROE. In the same manner, the Board also knew that the utilities shared different risk profiles and were of different sizes but it did not make any distinction on this basis neither made an exception for any of the utilities. In fact, there are a number of non-municipal owned utilities such as Eastern Ontario Power and Port Colborne that share a similar profile to NRG in terms of number of customers and rate base[13]. However, these utilities have received the Board determined ROE.

If the argument to award an additional 50 basis points is accepted, then one could counter argue that since NRG does not issue equity or debt to the public, it should not receive the 50 basis points for transactional costs. The Board in its Decision for Haldimand and Burlington Hydro did not reject the fact that both utilities did not incur any transactional costs but the issue was consistency in Board policy. Similarly, NRG's actual level of business risk may not be identical to Enbridge but the issue here is whether this is sufficient evidence for the Board to depart from its policy on cost of capital. Board staff submit that there is no compelling evidence to indicate that NRG's risk profile is considerably different

[13] The profiles are compared to Technical Conference Transcript, page 53

from most utilities in Ontario, and therefore submits that it should use the current Board determined ROE of 9.85%.

Cost of Debt (Issues 5.3 and 5.4)

NRG has various loans from the Bank of Nova Scotia. The financing consists of three components: a fixed rate loan, which will be renewed in March 2011, a variable rate loan and a revolving line of credit that is not being utilized. The long-term debt cost of 6.69% reflects a 7.52% interest rate on one of the Bank of Nova Scotia loans, the forecast rate of 4.10% on the other Bank of Nova Scotia loans plus amortization costs related to the refinancing of previous debt as directed in the NRG 2007 rates case decision (EB-2005-0544).

In addition, NRG maintains a compensating balance of $2.75 million in the form of a GIC with the Bank of Nova Scotia. The amount of $2.75 million has in fact been borrowed by NRG to then hold it as a GIC. In other words, although NRG has borrowed this amount and is paying interest on it, it cannot use this loan for business purposes.

As noted at the oral hearing, the holding of the GIC is not a specific requirement imposed by the Bank but it is the manner in which NRG has decided to meet the covenants of the loan agreement[14]. In fact, as indicated at the oral hearing, an injection of equity would have the same effect and in that case NRG would not need to hold a compensating balance[15].

Although NRG is paying a total rate of 6.69% on its long-term debt, the rate that it seeks to recover from ratepayers is 8.26% as noted in Exhibit E8, Tab 1, Schedule 2. This is because it is seeking to recover its actual cost of debt ($662,642) rather than the interest rate which is how most utilities recover within the deemed capital structure. The effect of removing the compensating balance from the total debt and dividing the debt cost of $662,642 by a lower denominator results in a much higher rate of 8.26%.

Board staff note that using the compensating balance to come up with a so-called deemed capital structure is an unusual method to calculate the cost of capital. NRG would benefit under this methodology as it obtains a higher interest

[14] Oral Hearing Transcript Volume 3, Page 46
[15] Oral Hearing Transcript Volume 3, Page 78

rate on its debt which actually forms a much larger portion of the capital structure but is lowered by the compensating balance. This results in a residual equity ratio that is much higher and for which NRG will receive 9.85% plus the premium that it is seeking. In other words, NRG would recover its actual dollar cost of debt as opposed to the rate and at the same time receive a higher dollar amount for the ROE since it is based on a much larger equity ratio than actual.

Board staff submit that based on the above arguments NRG be allowed a rate of 6.69% on the debt portion of the deemed capital structure.

COST ALLOCATION (Issue 7.4)

NRG has proposed certain changes to its existing cost allocation model in order to accommodate the introduction of a new rate class. IGPC is the only customer in the proposed new Rate 6 class. The proposed cost allocation model allocates certain costs that are directly assignable to IGPC. In addition, NRG has allocated an appropriate share of common costs to IGPC.

During the oral hearing, NRG was asked to consider refinements to the cost allocation model to appropriately reflect allocation to the Rate 6 customer class, specifically allocation of insurance costs. Accordingly, NRG amended the allocation of insurance costs to IGPC and reduced the allocation from $221,330 to $173,067.

However, there is still some inconsistency between the opinions expressed at the oral hearing and the Argument-In-Chief. The Argument-In-Chief allocates 100% of the business interruption insurance to IGPC since they are related solely to IGPC. The response to Undertaking J2.6 does not clarify whether the business interruption insurance covers interruption just to the IGPC line or the entire NRG distribution system. In case the insurance policy covers business interruption for the entire NRG distribution system, Board staff submit that the costs should be allocated appropriately and not just to IGPC.

- All of which is respectfully submitted -