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Ontario Energy Board

Board Consultation –
2010 Natural Gas Market Review

SUBMISSIONS ON BEHALF OF

ENERGY PROBE RESEARCH FOUNDATION

November 2, 2010

Submissions On Behalf Of

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How these Matters came before the Board

1. In its letter of July 13, 2010 (the "Announcement Letter"), the Ontario Energy Board launched the 2010 Natural Gas Markets Review ("NGMR"). As stated in the Announcement Letter, the overall objective of the NGMR is to assess how natural gas markets in Ontario are responding or adapting to changing market conditions with particular reference to the impact on the Ontario energy sector of increased shale gas production at Marcellus and potential impacts over the next 3-5 years on prices, services and transportation infrastructure utilization.

2. The Announcement Letter also stated that the specific objective of the NGMR is to determine the need for regulatory changes that may be necessary in response to the potential impacts identified.

3. In its subsequent letter of August 20, 2010, the Board presented specific questions to be addressed at a stakeholder conference scheduled for October 7th and 8th, 2010 and confirmed that participants in NGMR would have the opportunity to submit written comments thereafter.

4. Energy Probe Research Foundation ("Energy Probe") received "eligible participant" status in the NGMR, reviewed the ICF Market Report, attended the informal Q &A meeting on the ICF Market Report, reviewed the submissions of other participants, and participated in the stakeholder conference.

Overview of Energy Probe Comments

5. In its comments, Energy Probe will not seek to explore all outstanding issues raised in the NGMR, but will be examining those issues of concern to Energy Probe where we believe we can be of most assistance to the Board.

6. Energy Probe will approach these matters from the general perspective of promoting economic efficiency and environmental quality through competition, recognizing that some regulatory measures, when appropriately designed and implemented, may be necessary to achieve those objectives. This follows from the conviction that competition for its own sake is not a desirable policy objective as it leads to the protection of competitors *from* competition and thereby leads to inefficiency. Rather, competition is generally the most effective means by which efficiency can be achieved.

Board Question #1 – Given the changes identified in the ICF Market Report, what might be the opportunities for Ontario gas market participants (i.e., producers, storage providers, transmitters, distributors, wholesale and retail gas marketers, gas generators, and industrial, commercial and retail users)?

7. Energy Probe finds the ICF Market Report highly useful and is largely in agreement with its findings. However, it is difficult to specify in advance what opportunities will be available in the future. Generally, the market participants can be expected to make those adjustments that are in their long-run economic interests.

8. As discussed in the ICF Report, production of shale gas is now commercially feasible due to recent technological innovation that allows production from tight gas plays. Assuming that production is commercially attractive, it will generate gas volumes that will result in lower commodity gas prices than would otherwise be available in the market. Subject to the considerations discussed below, these lower prices should be passed on to business and household consumers in the normal course of economic activity.

9. It would therefore be expected that new pipelines would be built, existing patterns of gas transport may be changed, and different import and export opportunities will arise. To the extent that market participants identify profitable investments that arise ultimately from the technological innovation, they should be permitted to make those investments subject, of course, to applicable regulations.

Board Question #2 – What might be the challenges for Ontario gas market participants?

10. Energy Probe anticipates that the lower-cost shale gas production will reduce the commodity natural gas price in Canada and that this lower price will create various challenges for Ontario gas market participants.

11. This assumes that other factors do not unexpectedly arise to push the commodity price higher. One such factor is the level of economic activity. However, under current and expected economic conditions over the next three years, the demand for natural gas consumption will be not be driven by high economic growth.

12. Moreover, the increased demand for natural gas from the power sector as indicated in the ICF report will not lead to an increase in the gas price. In this regard, Energy Probe notes that Ontario Power Authority, a participant in NGMR, has submitted a report indicating that any effects of the increased consumption of natural gas by electricity generators on the commodity gas price will be both minor and temporary.[1]

[1] See "Natural Gas-Fired Generation in the Integrated Power System Plan", prepared for the Ontario Power Authority by North Side Energy, LLC, May 2008, at p.19.

13. There may significant issues for TransCanada Pipeline Limited ("TCPL") throughput to the extent that gas production delivered to the U.S. northeast comes increasingly from Marcellus shale. Similarly, making cheaper shale gas available to households and businesses in Ontario may reduce the throughput on TCPL's main line and lead to further increases in TCPL tolls.

14. As indicated in the stakeholder conference, there is also the question of gas supplies to Northern Ontario, as new pipeline capacity will be needed to deliver cheaper imported shale gas from the south. This puts further strain on TCPL volumes.

15. In Energy Probe's understanding, the same issues arise regarding gas storage facilities in southwestern Ontario.

Board Question #3 – **If, as a result of new gas supply from the Marcellus, new or an expansion of Ontario natural gas pipelines under the jurisdiction of the OEB are proposed, should potential impacts on existing pipeline facilities in the market (in terms of Ontario customers) be considered? If so, why, and what are the implications and/or risks of doing so? If not, why, and what are the implications and/or risks of not doing so?**

16. In Energy Probe's view, potential impacts on existing pipeline facilities in the market should be considered from the perspective of avoiding subsidies to pipeline shareholders at the expense of gas consumers.

17. Should the situation lead to the extreme condition of stranded assets, Energy Probe urges that such costs are properly borne by shareholders and not consumers.

Board Question #4 – **What further action, if any, might the Board undertake on its own or in conjunction with others? Are there areas in which there is need for alignment between the work of the Board and other regulatory agencies? If so, how might that alignment be achieved?**

18. In Energy Probe's view, there remain important questions about the costs of shale gas and the extent to which regulatory decisions regarding or arising from investments in such production, transportation and distribution ought to be based on the observed commodity gas price in the market. In particular, the Board and other regulators should assure themselves that the commodity price is not distorted by subsidies to production and that the regulated rates charged to consumers do not reflect subsidies to property owners in the regions producing gas from shale.

19. The stakeholder conference heard a presentation of a report prepared for the Council of Canadians on the technology used in shale gas drilling.[2] In Energy Probe's view, there appear to be significant environmental damages that require remediation. In addition, since that drilling technology involves significant amounts of water, it is of the utmost importance that drillers pay the full (i.e. the social) cost of the water that they are using.

20. Any failure to pay the full costs of shale production, including remediation of environmental damage, will result in a divergence between the private and social profitability of that production. If producers do not "internalize" the full cost of remediation then they will not include such costs in their investment decisions. Effectively, their profits will include an element of subsidy from society as a whole. In consequence, pipelines will be investing in and transporting, and local distribution companies will be distributing, subsidized shale gas in competition with unsubsidized natural gas from conventional sources.

[2] "Environmental Concerns and Regulatory Initiatives Related to Hydraulic Fracturing in Shale Gas Formations: Potential Implications for North American Gas Supply", A Report Prepared for the Council of Canadians, September 21, 2010.

21. The use of significant water volumes in the hydraulic fracturing process is in itself not problematic. However, if the drillers do not pay the full cost for the water they use, then the private profitability of investing in shale gas will exceed the social value of that activity. As was indicated at the stakeholder conference, drillers draw surface water at the same rates charged by local authorities to households and other businesses. If, as is likely, these rates are below market rates, then too much water will be diverted to all uses including shale gas drilling.

22. As a result, regulatory decisions may have the unintended effect of approving the excessive use of water compared to consumption thereof under competitive prices. While regulators may not know the competitive price for water, they may be able to ascertain a rough estimate for the purposes of the various approvals that will be required from them.

23. Finally, it appears that some owners of property near shale gas drilling sites are demanding either that this activity be severely restricted while others are demanding compensation for lower property values that result from the activity. Energy Probe is of the view that loss of property value is not a true cost of shale drilling and production. If some property values decline, the values of other properties will increase. Accordingly, there may be a transfer of wealth, but this transfer does not affect aggregate wealth in society or the profitability of shale gas exploitation, which should be assessed at the socially correct prices and costs.

24. Energy Probe submits that energy regulation is not the appropriate instrument for compensating property owners. If such compensation is to be provided, it should come from the local government and funded from the local tax base, rather than from increased rates charged to all gas consumers in the jurisdiction.

25. Accordingly, Energy Probe suggests that the Board and other regulators should:

- **require that new shale gas production and pipeline investment proposals demonstrate positive net present values using full-cost of environmental remediation**
- **require that proponents of shale production use either market-based costs of water or estimates thereof before approval**
- **evaluate proposals for new transportation and distribution facilities on the basis of such fully-internalized costs**
- **evaluate new transportation facilities proposing to carry gas from Marcellus to northern Ontario without regard to the impact on TCPL.**

Energy Probe Recommendations

26. The presentations and discussions thoughout this consultation do not lead Energy Probe to conclude that major expansion of pipeline infrastructure falling under the jurisdiction of the Board is necessary.

27. Energy Probe submits that in order to protect the interests of Ontario ratepayers in respect of gas transportation charges, the Board should intervene in the National Energy Board hearings on TCPL tolls.

Energy Probe thanks the Board for the opportunity to file Submissions on these very important gas market review matters.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

November 2, 2010

Energy Probe Research Foundation