



ONTARIO ENERGY BOARD

STAFF FINAL ARGUMENTS

NATURAL RESOURCE GAS LIMITED 2011 DISTRIBUTION RATES AND IRM APPLICATION – PHASE 2 EB-2010-0018

January 9, 2012

Natural Resource Gas Limited ("NRG" or the "Applicant", not to be confused with the related company NRG Inc.), 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.

The Board issued a decision and order on December 6, 2010 that determined rates for the 2011 rate year (effective October 1, 2010). The Board also accepted NRG's request to address the IRM component of the Application for 2012 and beyond (and certain other discrete issues) in a second phase to the proceeding ("Phase 2").

NRG filed a revised IRM plan on May 6, 2011. On July 18, 2011, NRG completed its Phase 2 filing requirements by filing an independent system integrity study that identified alternatives to maintaining system pressure in NRG's southern service area as opposed to purchasing gas from the related company.

A settlement conference was held on September 26, 2011. A settlement agreement was reached on two of the three issues before the Board in Phase 2; the price for gas purchased from NRG Corp., a related company remained unsettled. NRG filed a settlement agreement on November 11, 2011. The Board accepted the settlement agreement at the oral hearing held on November 30, 2011.

The submissions below reflect observations and concerns of Board staff on the cost of gas purchases from the related company, NRG Corp.

The reason NRG's proposed gas purchases from NRG Corp is an issue in this proceeding arises from the unusual set-up of NRG's distribution system. NRG's current distribution system grew out of what had been a small gathering system for local production. It is NRG's submission that because of this, its current system requires local injection of gas to maintain system pressure in certain areas under certain conditions. On a very cold day with very heavy demand, NRG may not be able to get enough gas from its existing connections to Union Gas's system to maintain adequate pressure in certain parts of its own distribution system. In order to ensure adequate pressure at all times, NRG maintains that it must also take local gas into its system.

NRG further argues that the only acceptable local supplier of gas is NRG Corp. NRG Corp. is a related, non arm's length company. Although not technically "affiliates" within the definition provided by the Board's *Affiliate Relationships Code for Gas Utilities*, the two companies have had a very close relationship for many years (sharing at various times both corporate officers and employees)¹. The fact that the two companies are related results in a possible conflict of interest: NRG Corp., like any company in the business of developing gas wells and selling gas, will want to obtain the highest price possible for the gas it produces. NRG's interests (and the interests of its consumers, which the Board is mandated to consider), however, are best served where it can obtain the lowest price possible for gas. Board staff submits that in circumstances such as these the Board must be very cautious in allowing for payment of anything more than a market price for gas, and that the onus rests firmly with NRG to establish that any such arrangement is appropriate. Indeed, NRG appears to agree that this is an appropriate subject for careful Board scrutiny.²

The issue before the Board is the appropriate price that NRG Ltd. should pay for gas purchased from NRG Corp. According to a letter dated September 30, 2009, NRG Corp. is not willing to sell gas below a floor price of \$8.486 per mcf. At the hearing, NRG Corp. clarified that the price of \$8.486 did not only apply to system

¹ NRG AIC, para. 4.

² NRG AIC, paras. 48, 50.

integrity gas as indicated earlier but to all of the gas supplied to NRG Ltd³. In other words, there would be no “cap” on the volume of gas NRG could purchase from NRG Corp. at a floor price of \$8.486. The issue here is that the price sought by NRG Corp. is significantly higher than the current price of \$5.11 per GJ including tolls and represents a 74% premium⁴. The argument presented by NRG Corp and NRG Ltd. is that this represents a “good deal” for customers⁵. However, Board staff believes that NRG has offered limited evidence to support this view.

NRG Ltd. undertook a system integrity study that identified alternatives to maintaining system pressure within the southern distribution area in place of purchasing gas from NRG Corp. The issue looked at only building a pipeline. The study presented three alternatives with pipeline costs ranging from \$8 million to \$23 million. NRG has estimated the new pipeline costs to be in the range of \$200 per customer and it is in this context that it believes that purchasing gas from the related company at a premium represents a good deal for customers.

Board staff does not agree with this opinion and believes that the study did not look at all possible solutions. In addition, the simulation was based on a worst case scenario with a temperature of -28 degrees and all the grain dryers operating. Even with the worst case scenario the whole system does not seem to be severely impacted; rather the impact shows unacceptable pressure levels immediately south of the Town of Aylmer.

NRG also argued at the oral hearing that there may be other cost impacts as a result of getting more gas into the system from Union than contracted for such as higher demand charges and higher transportation costs⁶. Board staff agrees with this issue but this issue could be resolved by modifying contracts or other means as opposed to incurring additional charges on a consistent basis. In any event, the savings that could be realized in this regard are quite limited.⁷

³ Transcript Phase 2, Volume 1, pages 130-131

⁴ AECO December 2011 1 month spot = \$3.22 per GJ + TCPL tolls of \$1.89 per GJ = \$5.11 per GJ as compared to NRG Corp’s price of \$8.91 per GJ

⁵ Transcript Phase 2, Volume 1, page 33, lines 26-27

⁶ Transcript Phase 2, Volume 1, pages 38 and 141

⁷ NRG AIC, para. 67.

The issue before the Board is fairly complex and multi-faceted. Even if there is a long term solution to this problem, NRG customers still need gas on a consistent basis until a long term solution is implemented.

Firstly, Board staff is of the opinion that the study did not examine the issue in detail nor did it look at all possible solutions. There was no discussion with Union Gas on how they could assist in resolving the issue. It is possible that a new interconnect with Union in the area experiencing the problem in the simulation could resolve the issue. Or there could be other solutions that Union could offer. The study also did not examine the volumes required to maintain system integrity. This makes it difficult for the Board to understand the magnitude of the issue and for other potential suppliers to know if they could alleviate the problem.

The second concern is that NRG appears to have made no serious attempt to look for other possible local gas providers in the area. At the oral hearing, Mr. Graat confirmed that NRG has a map of all the wells in Ontario and there are thousands of wells within NRG's franchise area⁸. It is clear that there has been no serious negotiation and effort on the part of NRG Ltd. to contact these suppliers in order to obtain the required quantities of gas. Mr. Graat, who as an officer at NRG Corp. is a competitor with other local suppliers, indicated at the hearing that he considered all other suppliers as unreliable and unable to provide gas on a consistent basis⁹.

However, there is only limited evidence before the Board to suggest that other sources of gas are not available. In addition there seems to be a conflict of interest with respect to contacting other suppliers. NRG Corp. confirmed at the hearing that NRG Ltd. does not possess the expertise to source gas and it is NRG Corp. that performs this activity on behalf of NRG Ltd¹⁰. Board staff believes that it would not be in the best interest of NRG Corp. to source gas from other suppliers for NRG Ltd. when it is the business of selling gas itself. It is concerning that NRG appears to be taking all of its advice on the local gas supply situation from Mr. Graat, who of course is the secretary-treasurer of NRG Corp., which is the company that would benefit from the proposed price floor.

⁸ Transcript Phase 2, Volume 1, page 118, line 10

⁹ Transcript Phase 2, Volume 1, pages 53 and 118

¹⁰ Transcript Phase 2, Volume 1, page 51

In the circumstances, Board staff submits that NRG has not sufficiently demonstrated that a price floor for gas from NRG Corp. is the most cost effective solution to the system integrity issue. Given the close relationship between NRG and NRG Corp., it is incumbent on NRG to demonstrate that they have thoroughly canvassed all available options before paying any premium for gas to NRG Corp.

NRG has also failed to justify its request that there be no cap on the amount of gas it can purchase from NRG Corp at an above market price. Although there may well be a need for a certain amount of locally sourced gas to maintain system integrity, there is no justification for any premium to be paid on gas purchases not required for system integrity. NRG Corp. indicated that it intended to drill still more wells in the area; however any justification for an above market price must rest on system reliability concerns for NRG, not expansion plans for NRG Corp. Board staff recognizes that there is some uncertainty surrounding the exact amount of gas that can properly be designated as “system integrity” gas. Indeed given the rather extreme conditions required to trigger a system integrity problem, it is possible that in many years there would be no actual need for system integrity gas at all. Given the problems in determining the amount of system integrity gas actually required, Board staff recommends that the current cap of 2.4 million cubic meters be maintained.

Board staff further submits that, to the extent the Board approves a floor price for NRG Corp. gas, this price should also serve as a ceiling. NRG’s proposal is that where the market price is \$10.00 per mcf or higher that NRG Corp. will receive the market price for gas (as opposed to the proposed \$8.486 floor price). In Board staff’s view, if a floor price is approved this represents significant downside risk protection for NRG Corp. If such an arrangement is approved it is reasonable that consumers benefit from a complimentary protection against “upside” risk; in other words a complete protection if the market price exceeds the floor price.

Board staff as part of its submission offers the following recommendations:

1. Board staff submits that NRG should be ordered to conduct another independent study with the participation of intervenors (such as an intervenor steering committee) that could assist in developing the scope of the study. The study should conduct a detailed examination of the NRG

- system, the Union interconnects, local producers within the area and the amount of gas required to maintain system integrity on a daily/weekly/monthly basis. Essentially, the study should examine all possible alternatives.
2. NRG should be ordered to request quotes from all suppliers within the area that are willing to commit to providing the required quantities of gas. NRG Corp. indicated that some producers have shut-in their gas because of low prices¹¹. The Board could allow a premium over the market price (for example: a 10% to 15% premium) in the RFQ considering that it is fulfilling peak demand and this could incite other dormant producers within the area to respond to the request. This premium would still be significantly lower than that proposed by NRG Corp.
 3. In the meantime, Board staff recommends that NRG's current arrangements with respect to system integrity gas remain in place: i.e. a price determined by the formula established previously by the Board for a maximum of 2.4 million cubic meters of gas.

All of which is respectfully submitted.

¹¹ Transcript Phase 2, Volume 1, page 136